

*SOM Macro Strategies*  
State Of the Markets: *The Biden Agenda Unleashed*

January 6, 2021

Alan Brazil

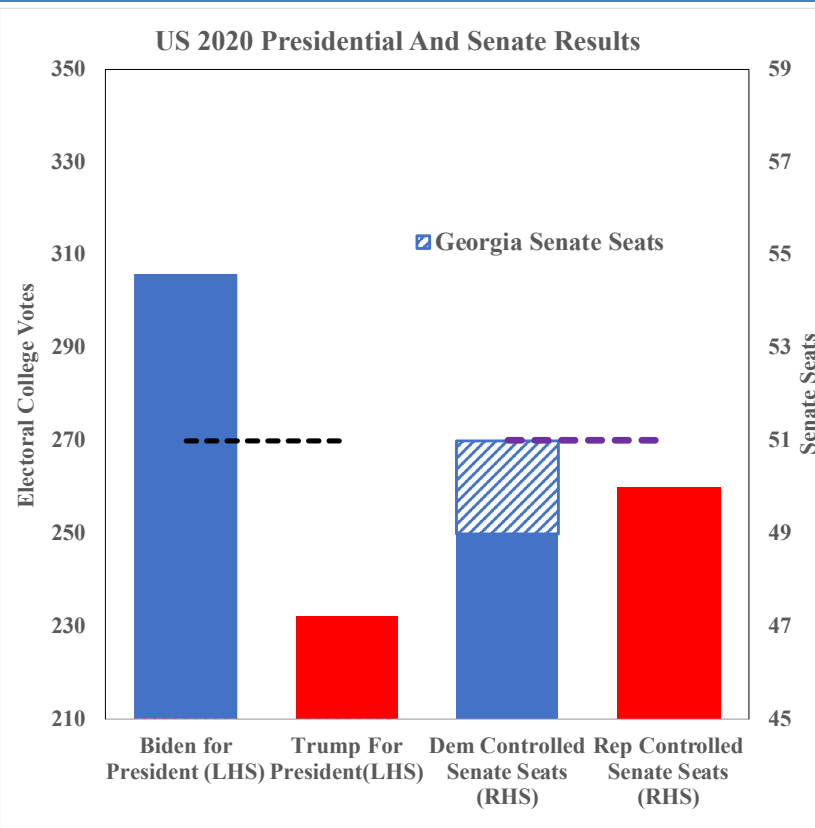
# SOM Macro Strategies

## State Of the Markets: *The Biden Agenda Unleashed*

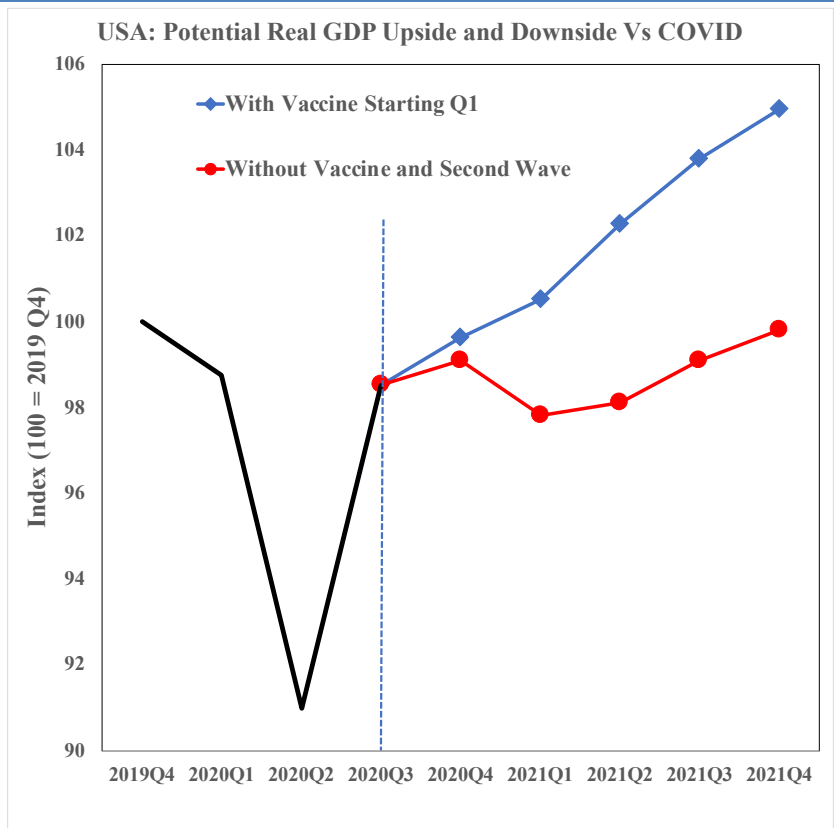
### Step 1: The Macro Theme

### The Impact of The Democrats Control of Congress On Growth And Assets Markets

#### Democrats Win In Georgia Give Them Control of the Senate



#### Will It Impact The Potential Rebound In 2021 Growth?<sup>1</sup>



1. Conference board and author's calculations

# SOM Macro Strategies

## State Of the Markets: *The Biden Agenda Unleashed*

### Step 2: Fundamental Economic Framework

### On The Surface The Biden Agenda Looks Relatively Benign Even If The Dems Control The Senate

#### Biden Policy Agenda<sup>1</sup>

##### Tax Policies

- Increase corporate tax rate to 28% from 21%
- Allow Trump bonus depreciation to phase down
- Increase marginal tax rates to pre-Trump levels (39.6%) for incomes over \$400,000
- Phase out itemized deductions for incomes over \$400,000
- Apply the 12.4% social security tax on income over \$400,000
- Tax capital gains and dividends at the same rate for incomes over \$1 million
- Allow other Trump tax changes to expire in 2026

##### Regulatory and Spending Policies

- 3+ trillion stimulus package focused on helping state and local governments

##### Green New Deal

- Restore limits for oil and gas operations
- No new federal oil and gas leasing
- 100% of new car sales including trucks will be zero emissions
- Carbon pollution from power sector by 2035
- Net zero emission by 2050
- Rejoin Paris agreement
- Reduce carbon footprint of building by 50% by 2035
- 2.5 trillion of climate focused infrastructure spending next two years

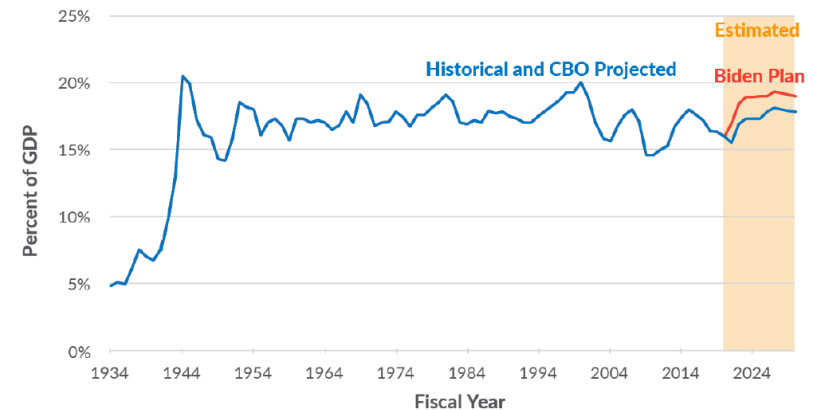
##### Health Care

- Extend and improve Obama Care
- 2+ trillion of spending

#### Tax Changes Pushes Revenue Back To Normal After Trump<sup>2</sup>

##### Biden's Tax Plan Would Return Federal Revenue Collections to 1998 Levels

Federal Revenue as a Percentage of GDP, 1934 to 2030



1. Tax Policy Center, "An Analysis of Former Vice President Biden's Tax Proposals", March 5, 2020

2. Tax Foundation, "Placing Je Biden's Tax Increase in Historical Context" September 3, 2020

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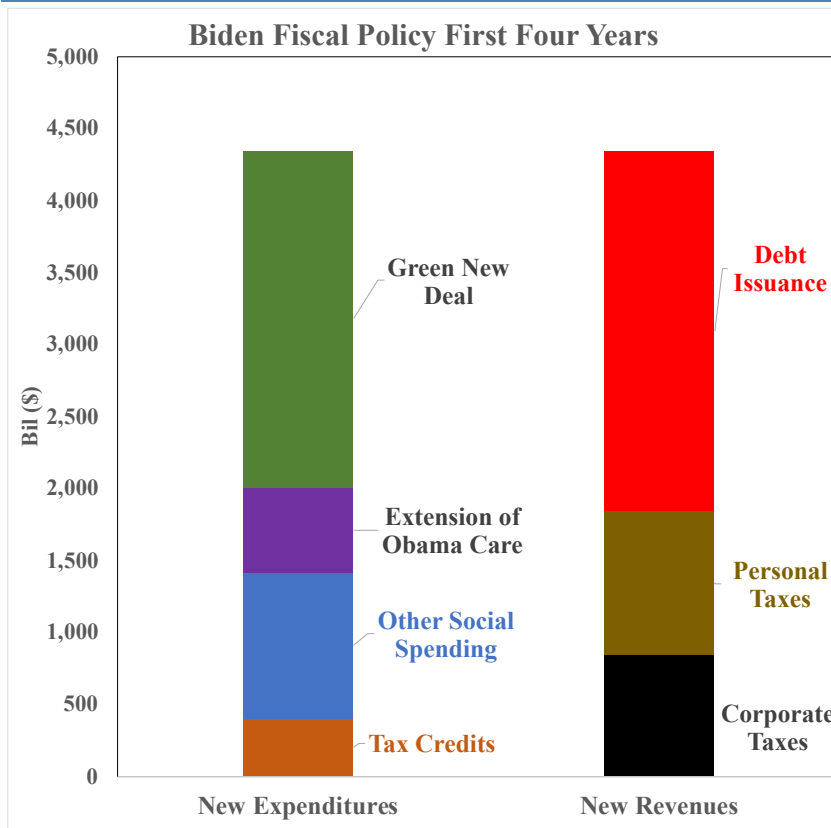
## State Of the Markets: *The Biden Agenda Unleashed*

### Step 2: Fundamental Economic Framework

### The Biden Agenda Is A Massive Fiscal Stimulus That Will Create A Massive Monetary Response To Fund It

Funding For Biden Plan Will Come From New Debt <sup>1</sup>

Top 1% Will Pay Almost All of The Increase In Taxes <sup>2</sup>



Income Distribution	Share of Total Federal Tax Change	Average Tax Change	Change In After Tax Income	Share of Federal Income Tax		Marginal Federal Tax Rate	
				Now	New	Now	New
Bottom 80'	2%	2%	0%	33%	30%	11%	11%
80-99%	24%	6%	-1%	43%	40%	22%	23%
<b>Top 1%</b>	<b>74%</b>	<b>40%</b>	<b>-17%</b>	<b>24%</b>	<b>30%</b>	<b>30%</b>	<b>42%</b>

1. Moddy's Analytics, "The Macroeconomic Consequences: Trump vs. Biden", September 23, 2020  
 2. Tax Policy Center, "An Analysis of Former Vice President Biden's Tax Proposals", March 5, 2020

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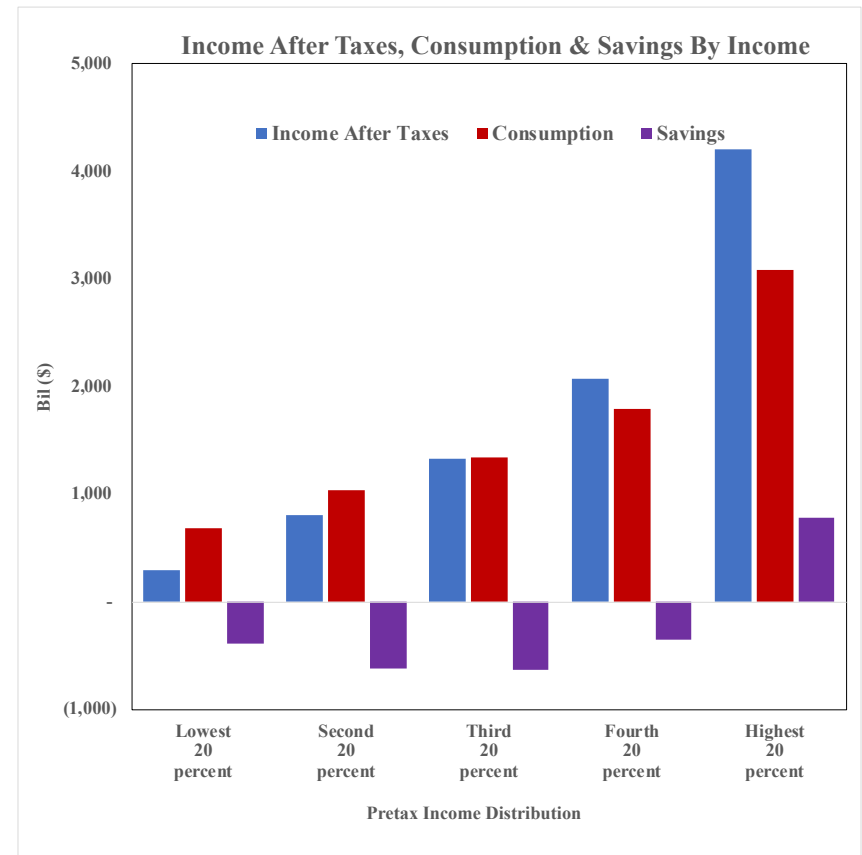
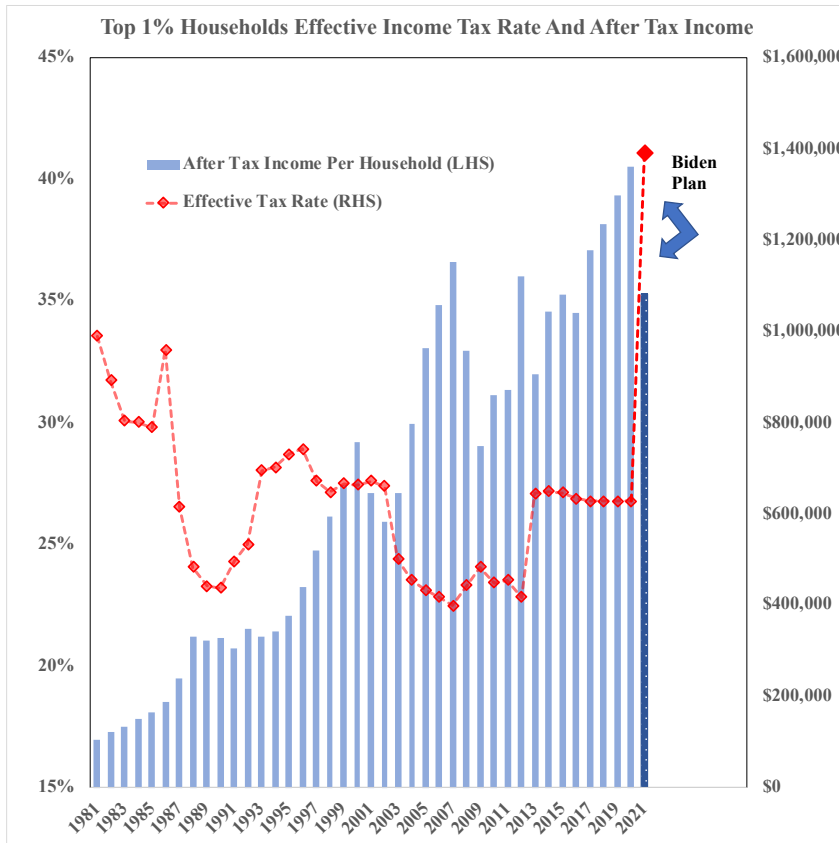
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### Step 2: Fundamental Economic Framework

At Its Heart, However, The Biden Plan Is A Massive Income Redistribution Plan From The 1%

Marginal Tax Rates On Top 1% Will Be At Historical Highs<sup>1,3</sup>

This Will Have Substantial Impact On Their Consumption<sup>2,3</sup>



1. BEA
2. CBO, "The Distribution of Household Income, 2017", October 2020
3. Author's calculations

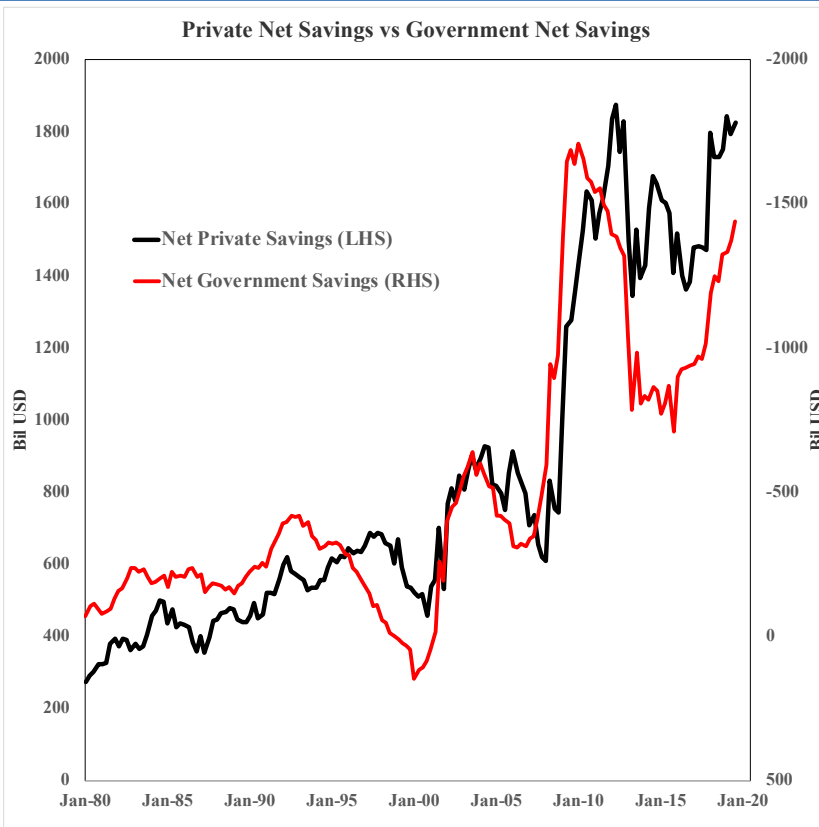
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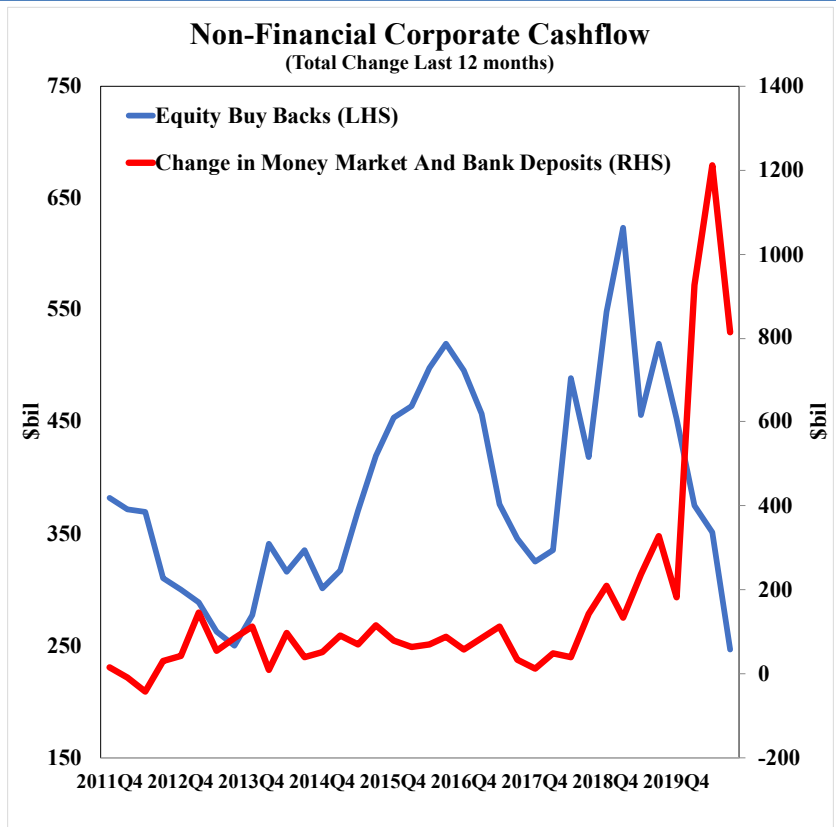
### Step 2: Fundamental Economic Framework

### Higher Tax Rate Increase Savings And Could Reduce Corporate Buybacks

#### Consumption Of Top Income Households Fall As Savings Rise<sup>1</sup>



#### Corporates May Not Use Their Cash For Buybacks<sup>2</sup>



1. BEA  
2. Board of Governors Federal Reserve, Z1 database

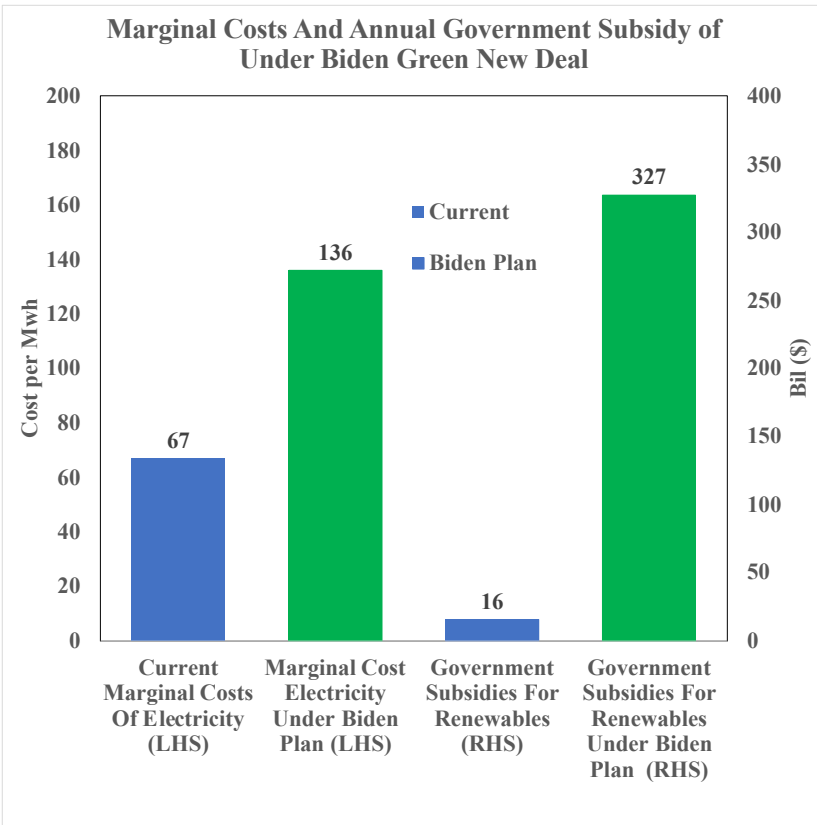
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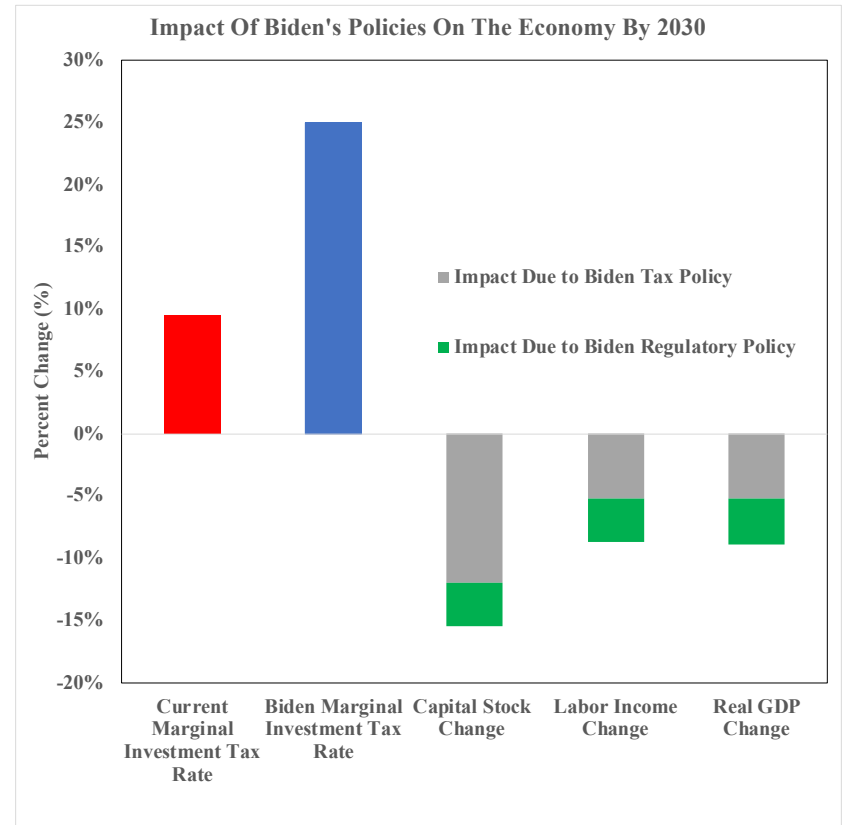
### Step 3: Identify Potential Repricing Catalysts

### Biden Plan Could Reduce Future US GDP From Higher Taxes On Capital And From Climate Policy<sup>1</sup>

#### Capital Tax Rates More Than Double<sup>1</sup>



#### However, Election Not A Mandate And Georgia Will Be Republican



1. Fitzgerald, Hasselt, Kallen and Mulligan, "An Analysis of Vice President Biden's Economic Agenda", Hoover Institution Study, 2020

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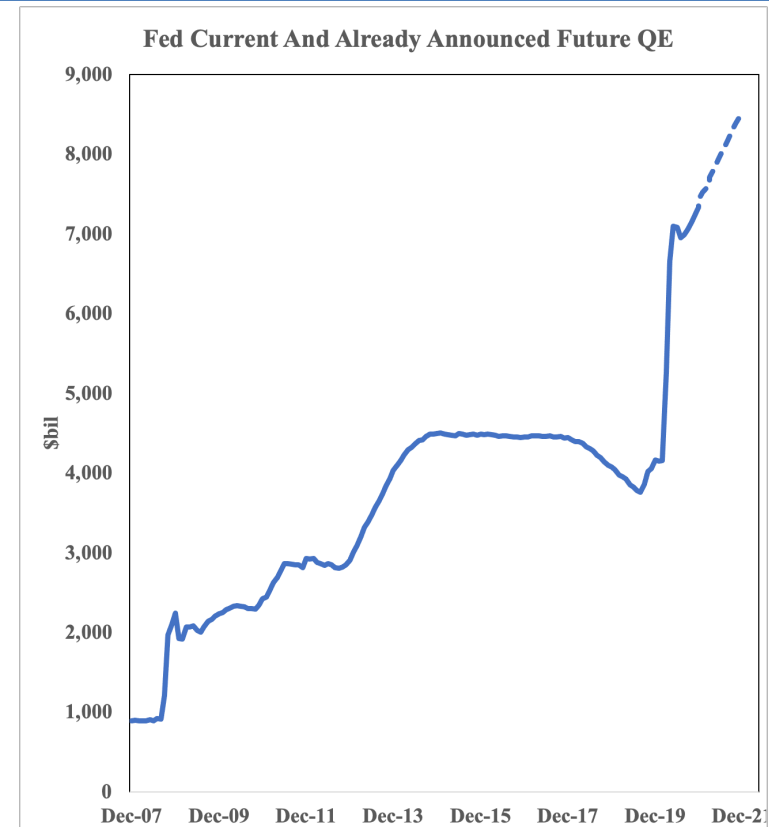
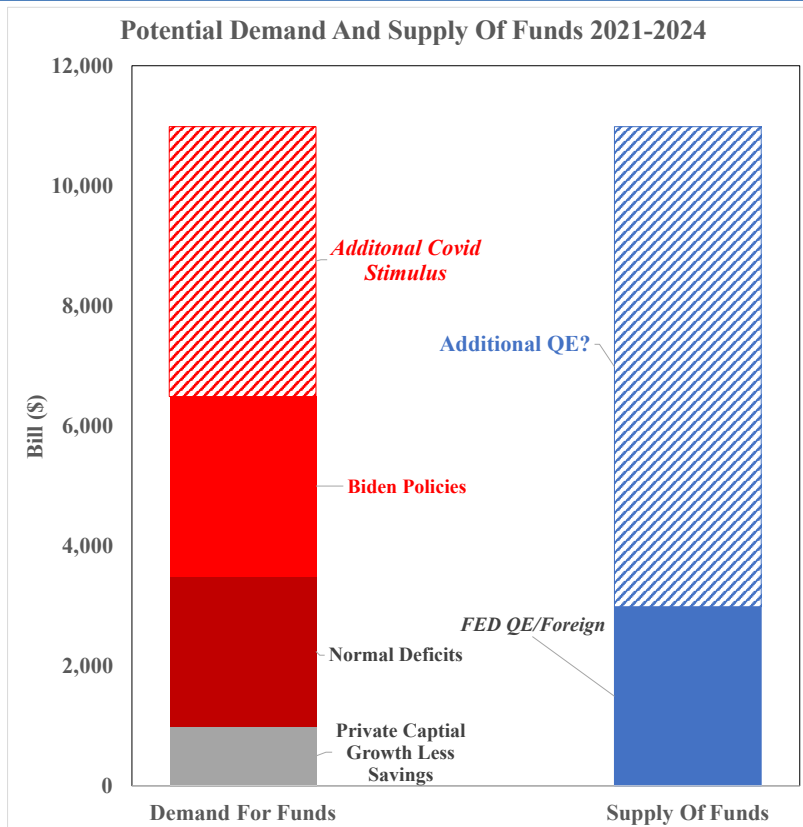
## State Of the Markets: *The Biden Agenda Unleashed*

### Step 2: Fundamental Economic Framework

### The Biden Agenda Is A Massive Fiscal Stimulus That Could Create A Massive Monetary Stimulus To Fund It

Funding For Biden Plan Will Come From New Debt Funded By QE <sup>1,2</sup>

Growth Would Push QE Above It's Already Elevated Growth Levels<sup>3</sup>



1. BEA  
2. Assumes a passage of the original \$3 trillion democratic COVID stimulus program  
3. Federal Reserve Announcements



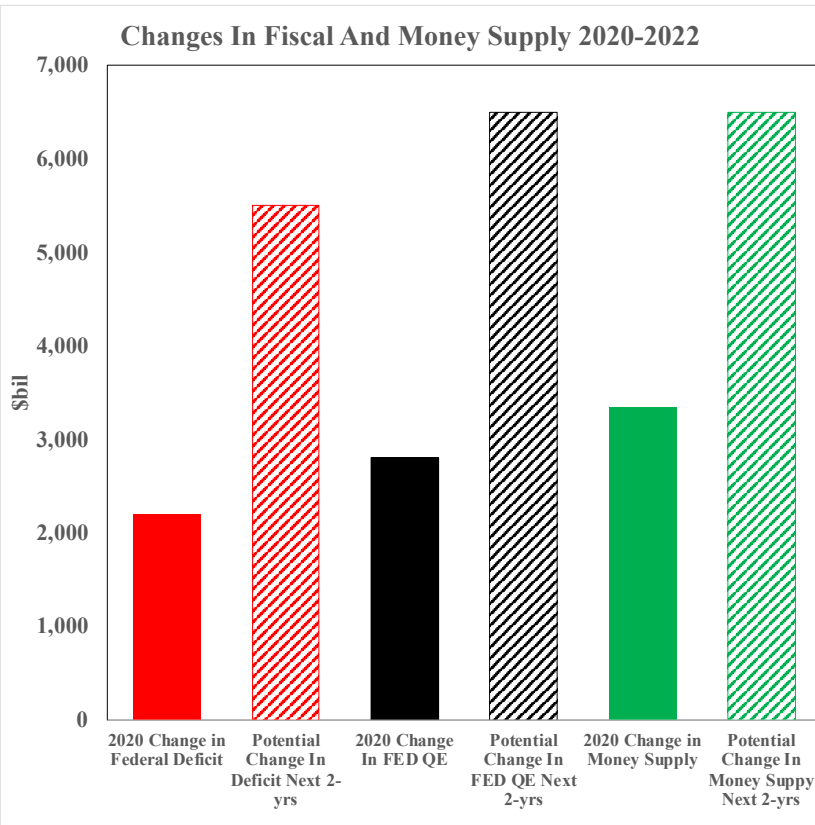
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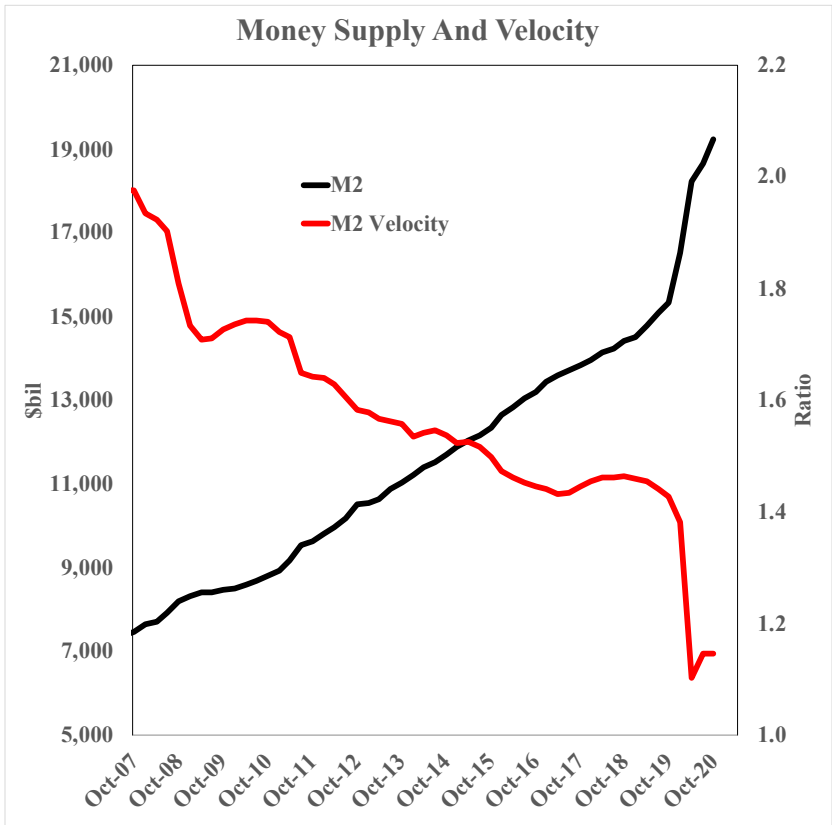
### Step 3: Identify Potential Repricing Catalysts

### Inflation Could Rise Given The Surge In Both Current And Future Money Supply From QE

Fed QE Has Been Substantial To Combat COVID On Economy<sup>1,2</sup>



But Impact On Inflation Has Been Muted Due To Fall In Velocity<sup>3</sup>



1. CBO  
 2. Board of Governors Of The Federal Reserve  
 3. Assumes half of the Biden spending agenda and all of the \$3 trillion stimulus  
 3. Bloomberg

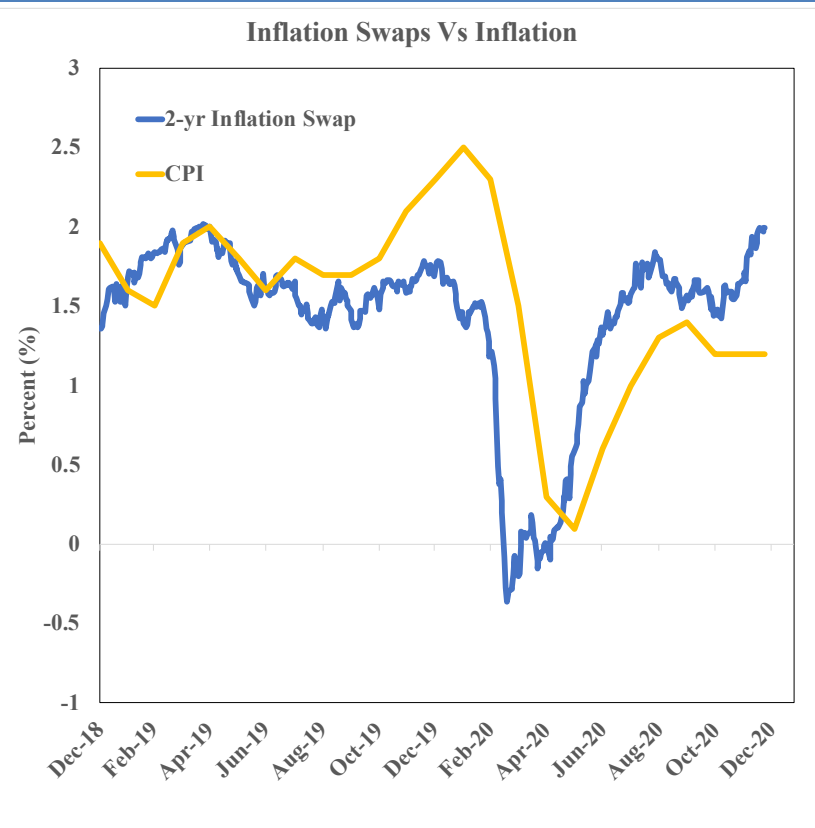
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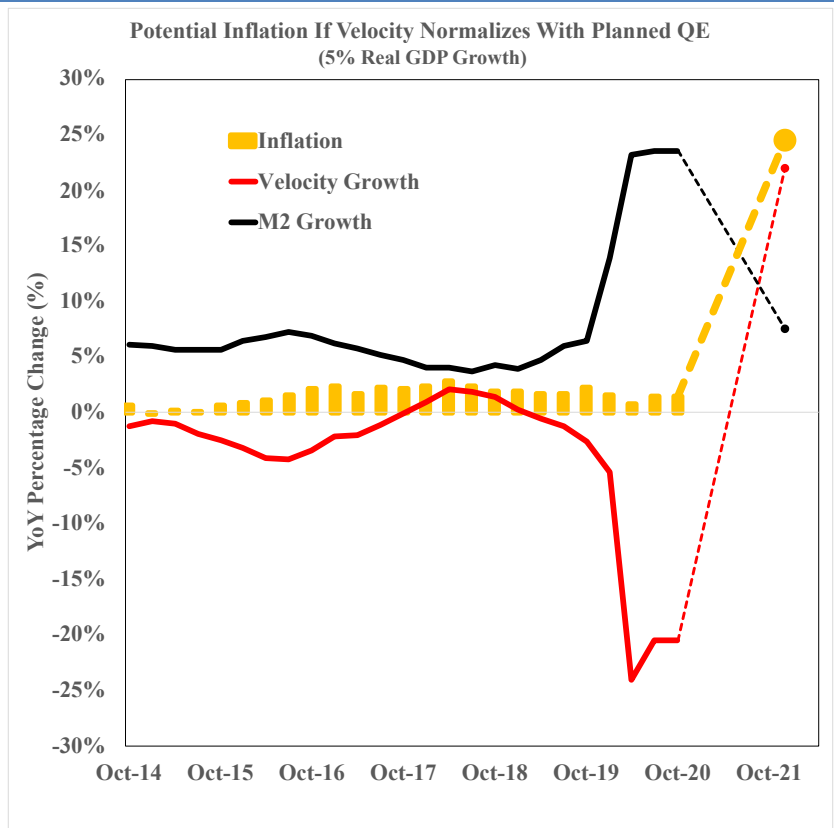
### Step 3: Identify Potential Repricing Catalysts

### Inflation Risk Is Rising But That Might Understate The Risk With Normalizes And The Biden Agenda

#### Market Pricing In A Rise In Inflation From Current Levels<sup>1</sup>



#### Inflation Could Soar If The Economy Normalize<sup>2</sup>



1. Bloomberg  
 2. Using Quantity Theory of Money Identity:  $MV = PY$  or  $\text{Money Supply} * \text{Velocity} = \text{Price} * \text{Real GDP}$ . Then,  $\text{Inflation} = \% \text{change of Money} + \% \text{change in Velocity} - \text{Real GDP Growth}$

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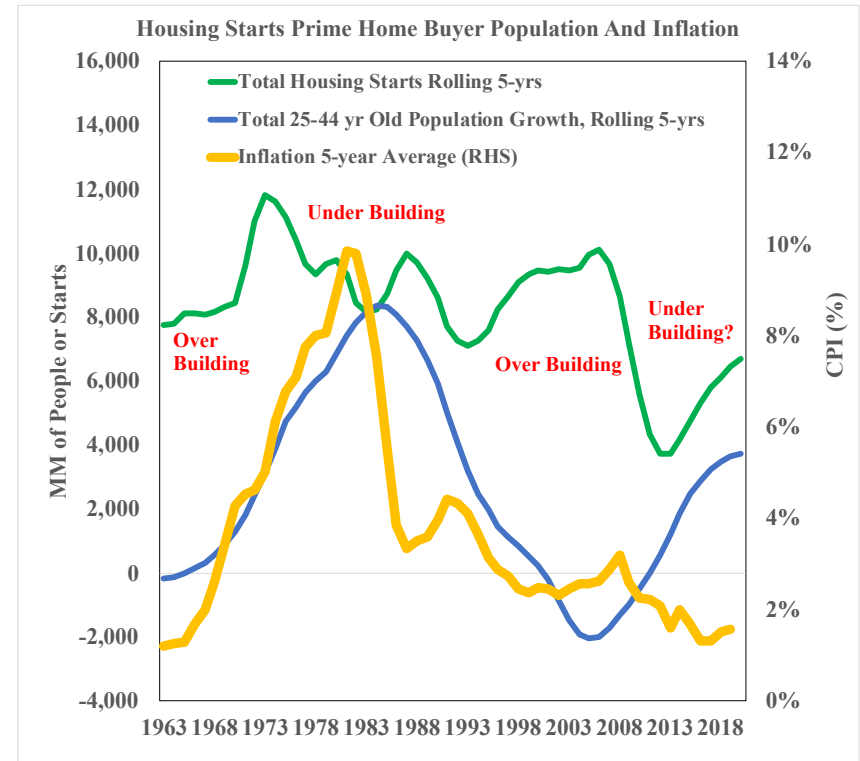
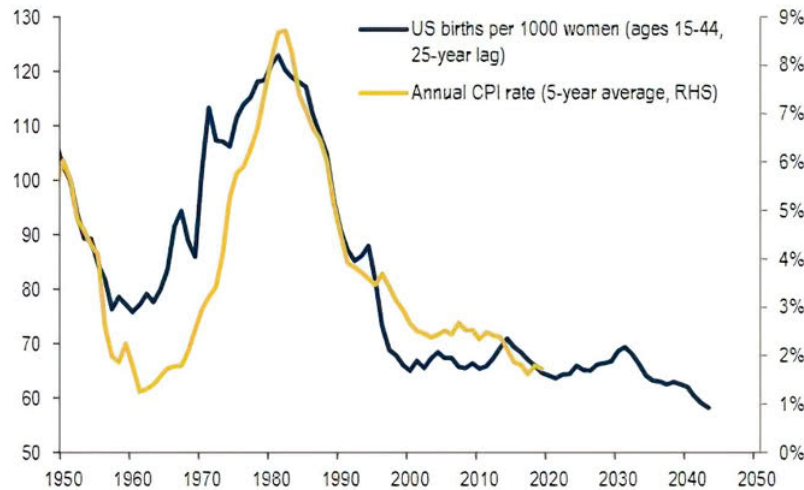
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### Step 3: Identify Potential Repricing Catalysts

### Historically, Demographics Drove Inflation By Pushing Up Housing Demand Versus Inventories

Demographics Highly Correlated With Inflation<sup>1</sup>

Key Factor Is The Demand For Housing<sup>2</sup>



1. Bank of American Research Investment Committee  
 2. Census

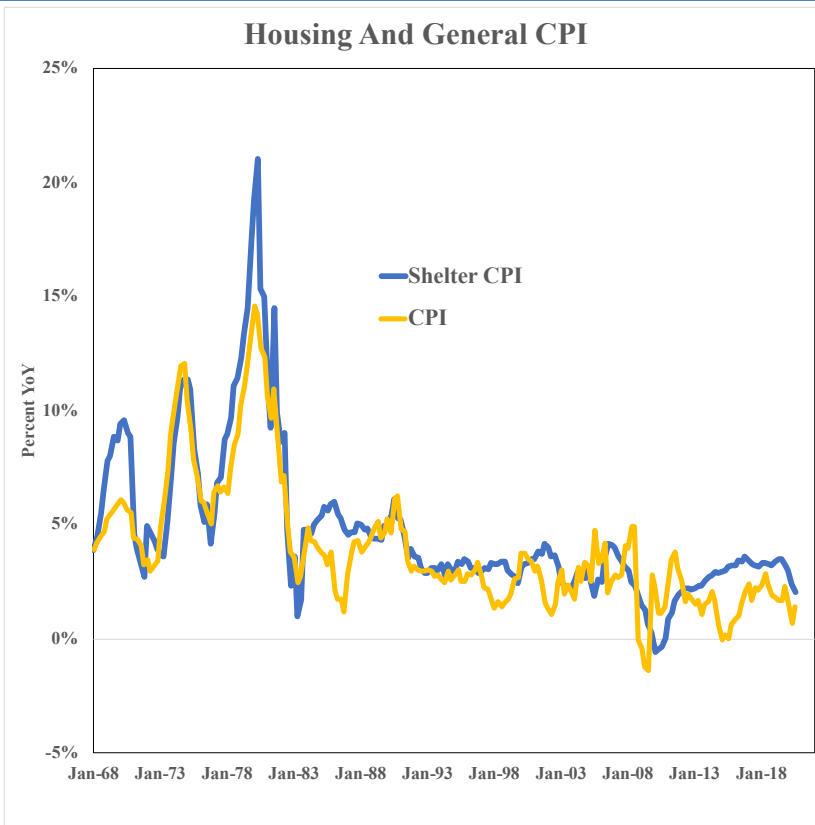
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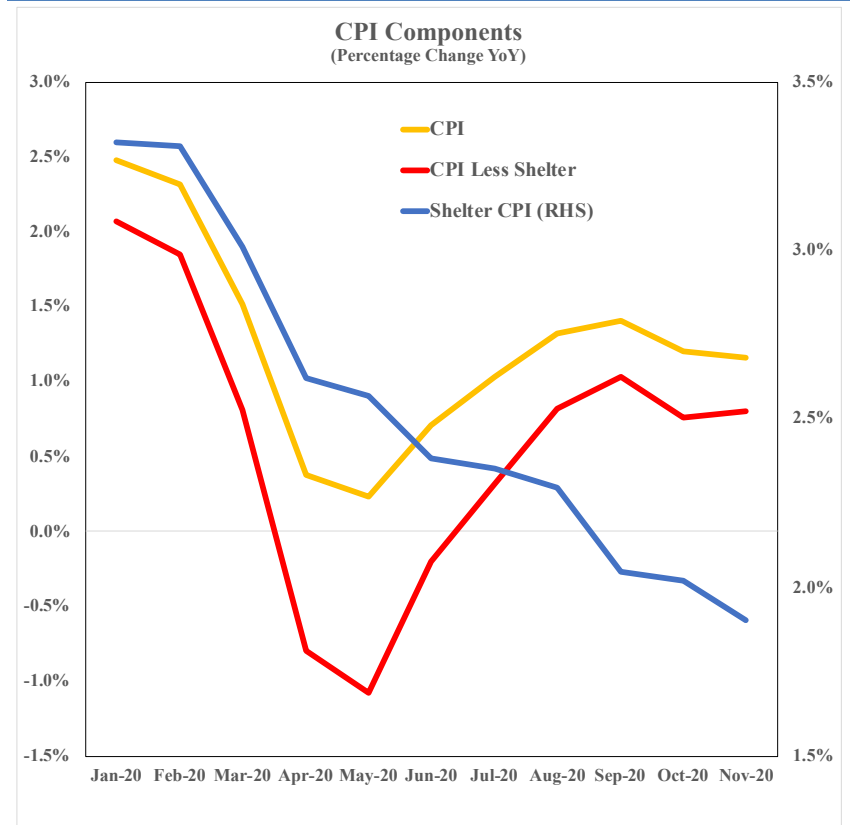
### Step 3: Identify Potential Repricing Catalysts

### A Rebound In Housing Inflation Would Push Up Inflation In General<sup>1</sup>

Historically, Housing Inflation Driving Force of Inflation



The Decline IN Housing Inflation Has Pulled Down Inflation



# SOM Macro Strategies

## State Of the Markets: *The Biden Agenda Unleashed*

### Step 4: Identify Asymmetric Trades

#### Trade 1: Buy Inflation Swaps

##### Trade Thesis

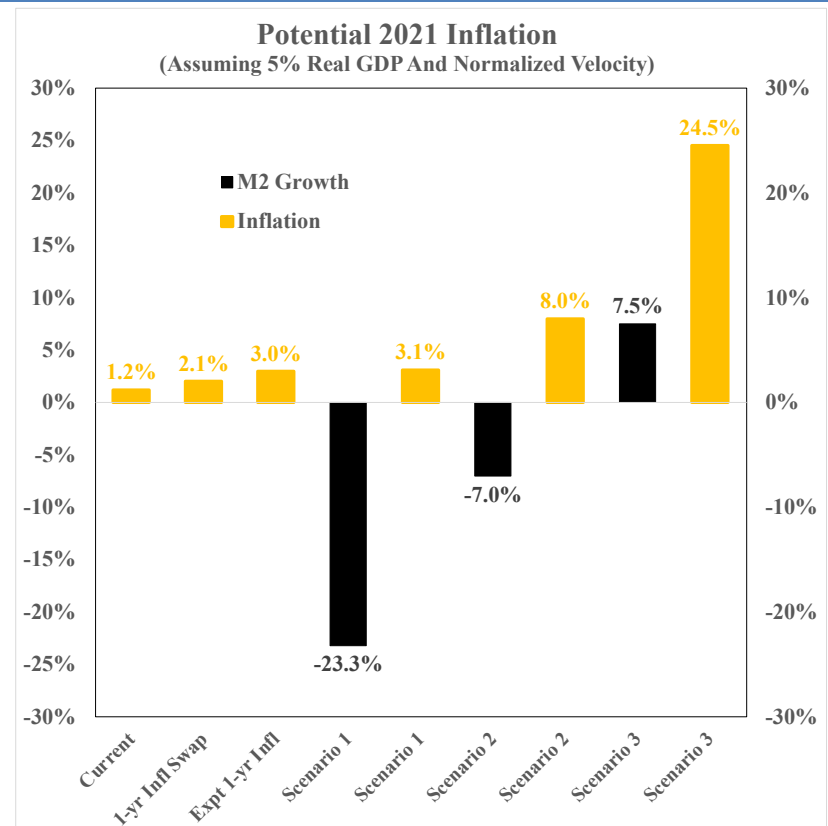
###### Even without the Biden agenda inflation could surge

- Normalization of the economy could push up inflation above current pricing (Scenario 1)
- Even if money supply and velocity normalizes, inflation could still rise back to levels last seen in the 80s if the Fed continues QE while the economy grows (Scenario 2)
- Inflation could surge past historical highs if velocity normalizes, the Fed continues QE, and the private sector continues to hold cash (Scenario 3)

##### Three Inflation Scenarios If The Economy Recovers

- **Scenario 1:** No future QE, normalized velocity and demand deposit normalized to pre- COVID levels
- **Scenario 2:** Same as Scenario 1 but Fed continues with QE plans
- **Scenario 3:** Normalized velocity, Fed continues QE, and deposits do not return to normal

##### Potential Inflation In Three Scenarios<sup>1</sup>



1. Using Quantity Theory of Money Identity:  $MV = PY$  or  $\text{Money Supply} * \text{Velocity} = \text{Price} * \text{Real GDP}$ . Then,  $\text{Inflation} = \% \text{change of Money} + \% \text{change in Velocity} - \text{Real GDP Growth}$

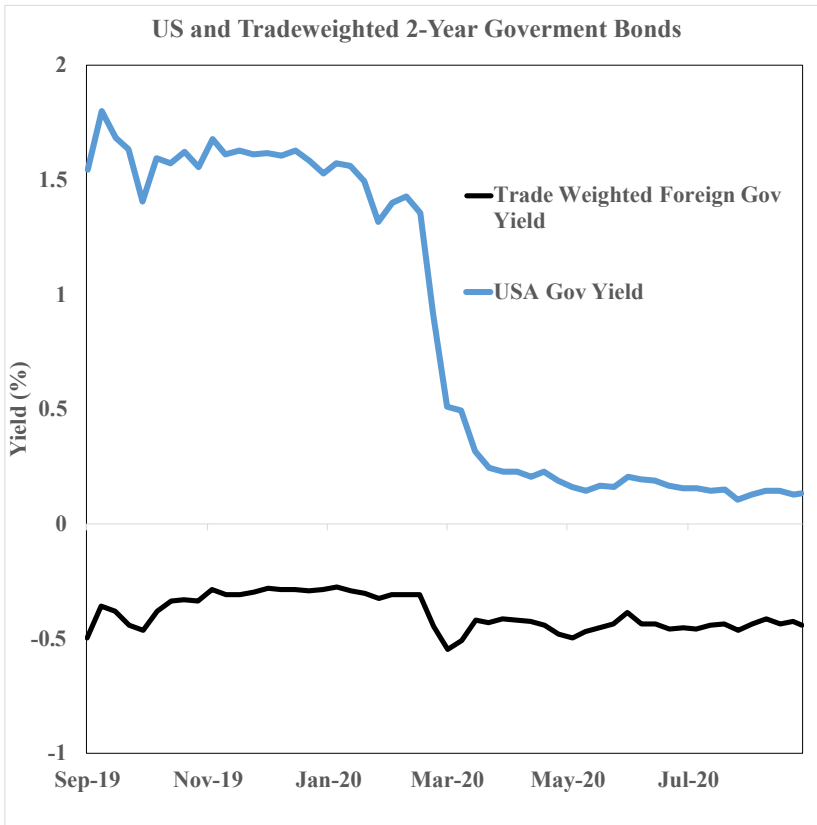
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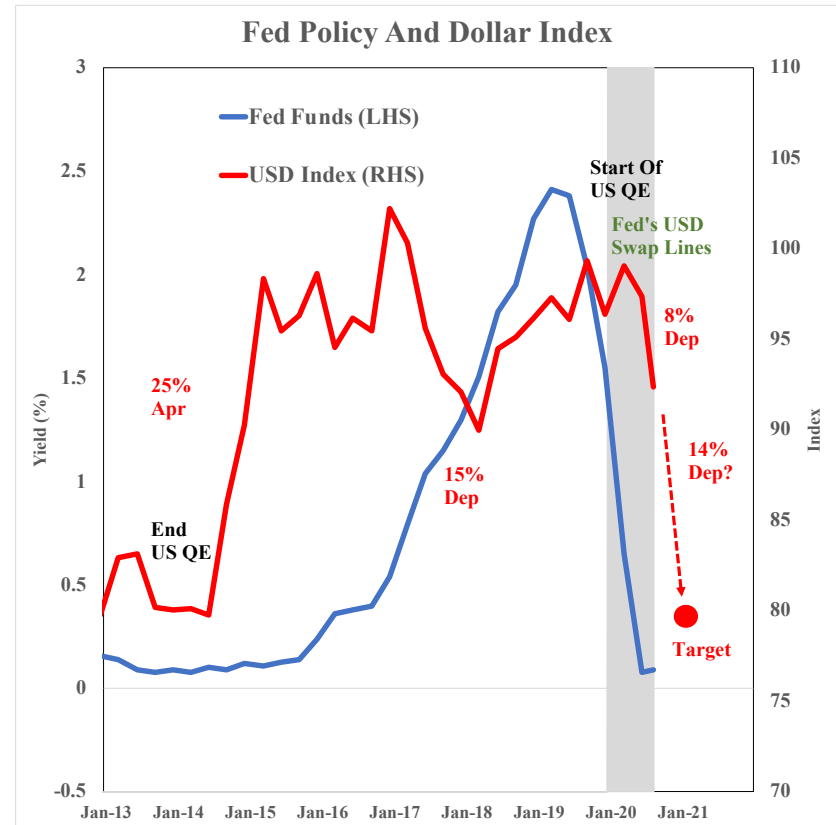
### Step 3: Identify Potential Repricing Catalysts

### More QE And Lower Rates For Longer Could Mean Another USD Weaker Cycle<sup>1</sup>

#### US And Foreign Yields Differentials Have Collapsed



#### Dollar Weaker Cycle Could Be Just Starting



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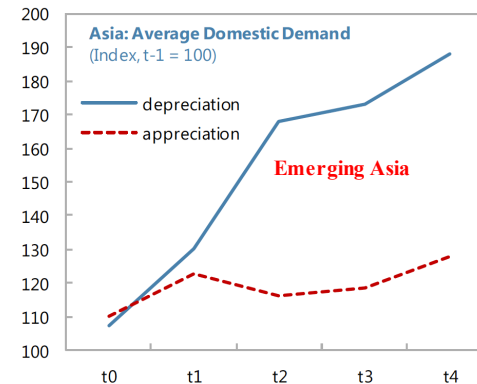
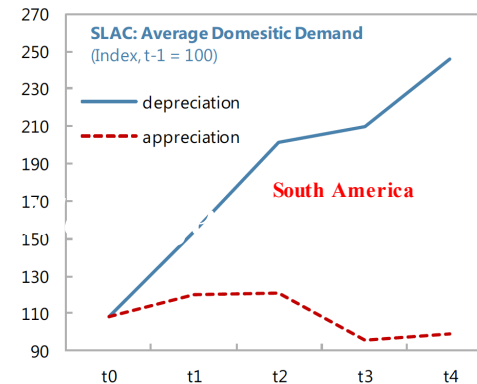
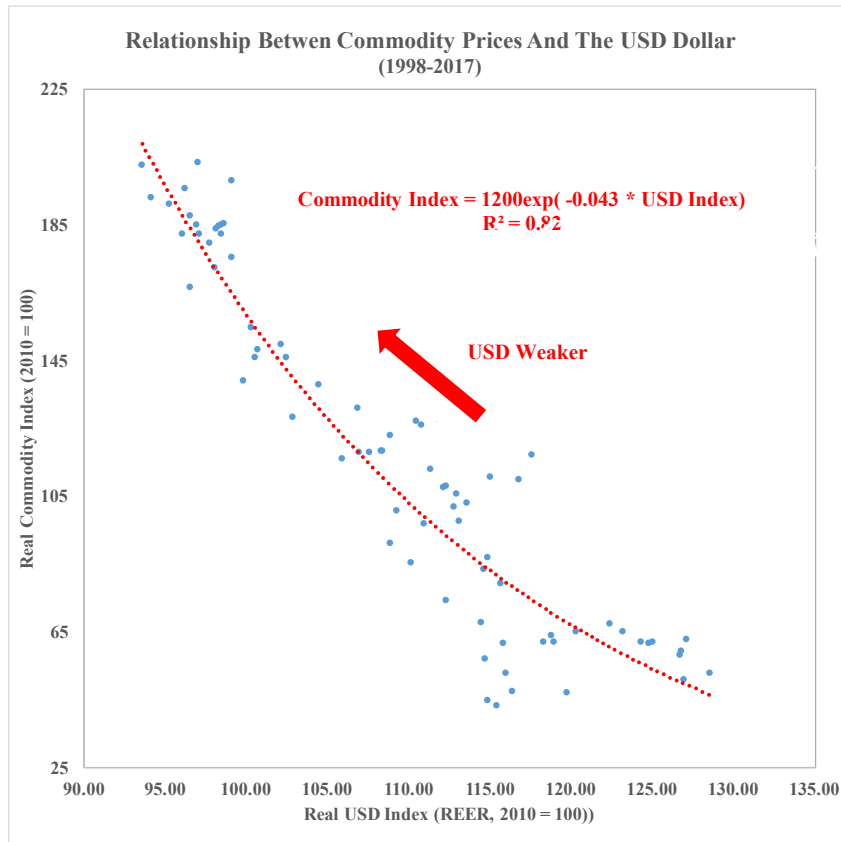
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#### Return Of US QE Weakens USD---Drives Up Commodity Prices And Commodity EM GDP<sup>1,2,3</sup>

Stronger USD Could Affect EM Through A Fall In Commodity Prices

Up Until Recently Oil Seemed Immune To the USD But...



1. Bloomberg
2. Author's calculation
3. IMF

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### Step 4: Identify Asymmetric Trades

### Trade 2: Go Long A Basket of Commodity EM FX Vs USD

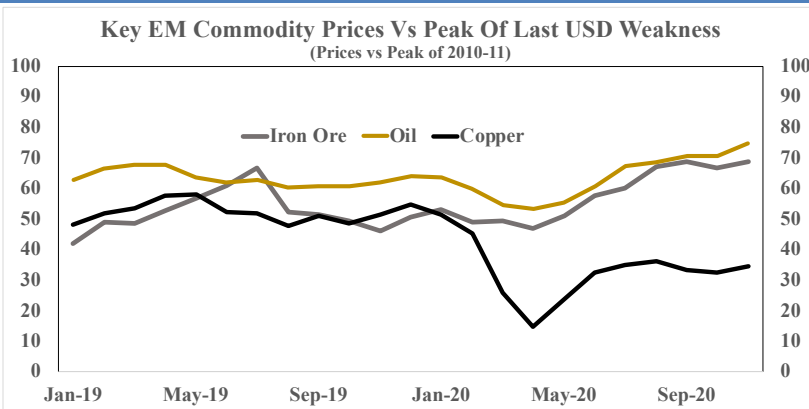
#### Trade Thesis

#### Short the USD vs an basket of commodity EM FX

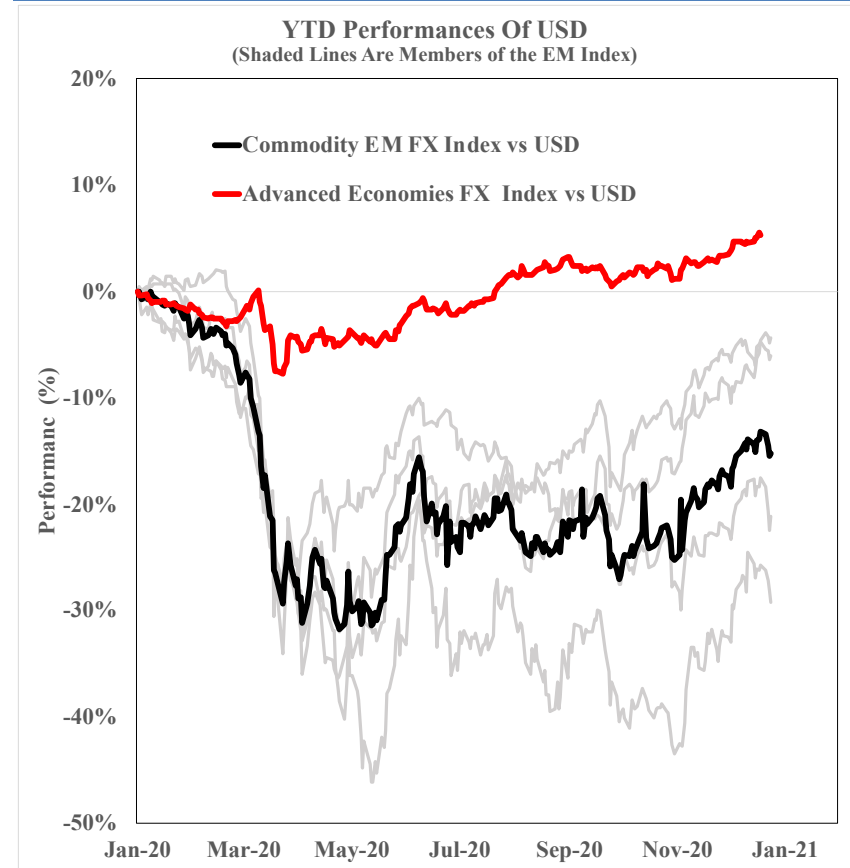
- EM commodity country FX should appreciate vs the USD
- US QE will weaken the USD vs commodity EM FX
  - QE will drive capital flows to EM
  - Weaker USD will drive up commodity prices helping commodity EM Countries
- Commodity country EMs have the capacity for fiscal stimulus that should support their economies and reduce risk
- EM countries have used even stricter containment strategies vs the US to bend the COVID curve

*Risk is a general risk-off environment and a flight to the USD*

#### Negative Real Policy Rates In The US<sup>1</sup>



#### Commodity EM FX Still Have Room To Rally vs USD<sup>1,2</sup>



1. Bloomberg  
2. Equally weighted index of MXN, BRL, ZAR, RUB vs USD



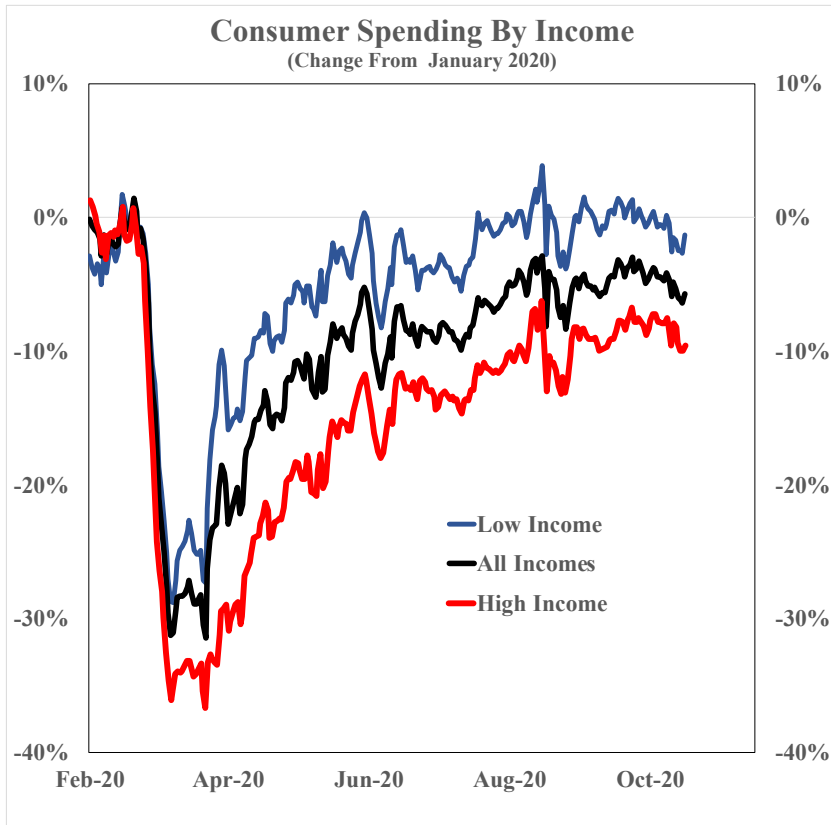
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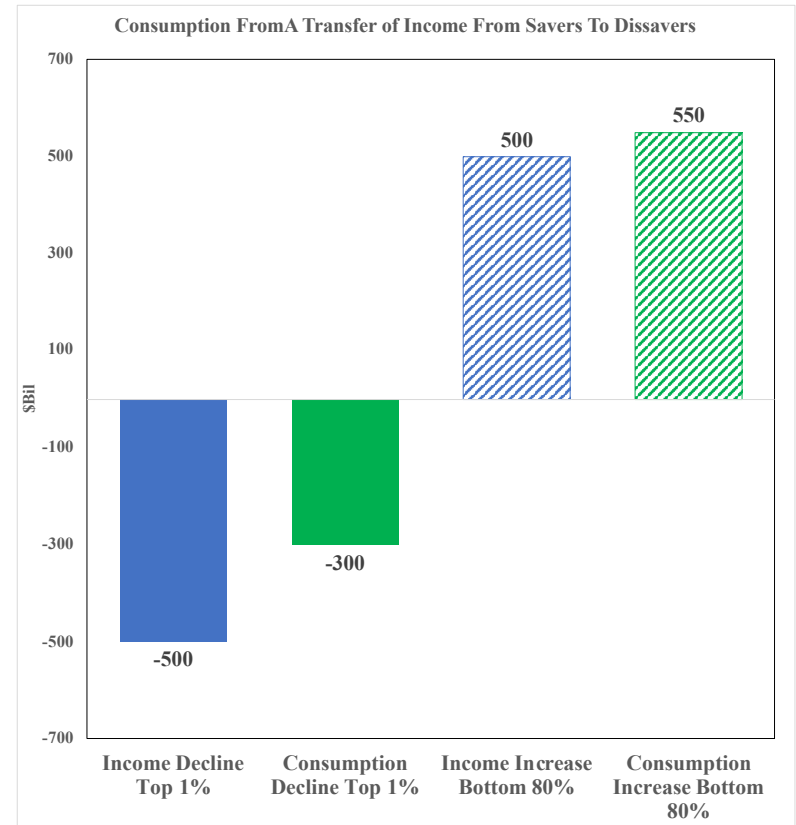
### Step 3: Identify Potential Repricing Catalysts

Impact On Consumption Could Be A Net Positive Reflecting The Massive Stimulus And Taxing The 1%

Spending By Top 1% Will Fall But Savings For The Rest Will Rise<sup>1</sup>



Tax The 1% Could Spur Total Consumption<sup>2</sup>



1. Affinity Solutions, based on credit and debit card transactions by zip code  
 2. CBO, "The Distribution of Household Income, 2017", October 2020

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### Step 4: Identify Asymmetric Trades

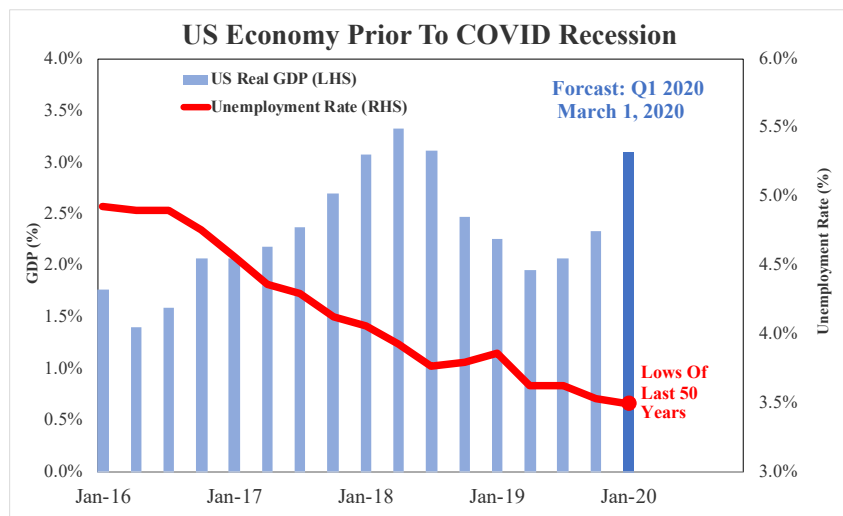
### Trade 3: Buy US Consumer Cyclical Equities

#### Trade Thesis

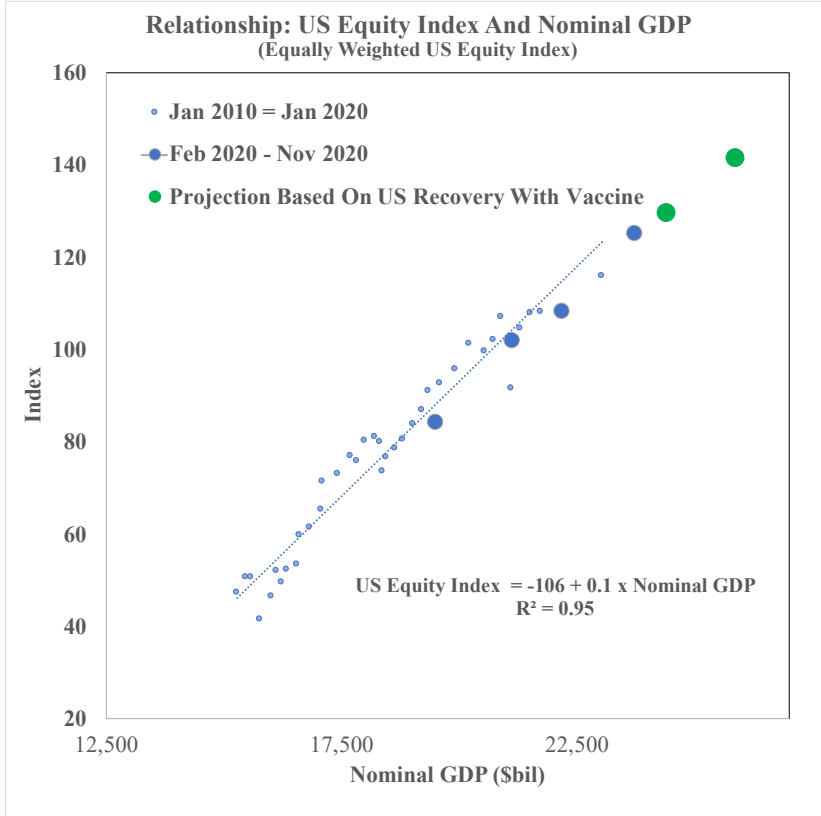
- An effective vaccine combined with the massive stimulus could return the US economy above its pre-COVID growth trajectory
- Accelerating economic growth would drive up US equities particular in those sectors exposed to cyclical growth
  - Person-to-person contact related equities have the most beta to this scenario, e.g. airlines

**Risk is economy does not recover**

#### The US Economy Was Accelerating Prior To COVID<sup>1,2</sup>



#### Substantial Equity Upside If GDP Accelerates to Pre-COVID Levels<sup>3</sup>



1. Bloomberg  
 2. Q1 2020 GDP projections from the Atlanta Fed's GDP now  
 3. Green dots represent equity prices given US nominal GDP in 2021 based on its current trajectory prior to COVID

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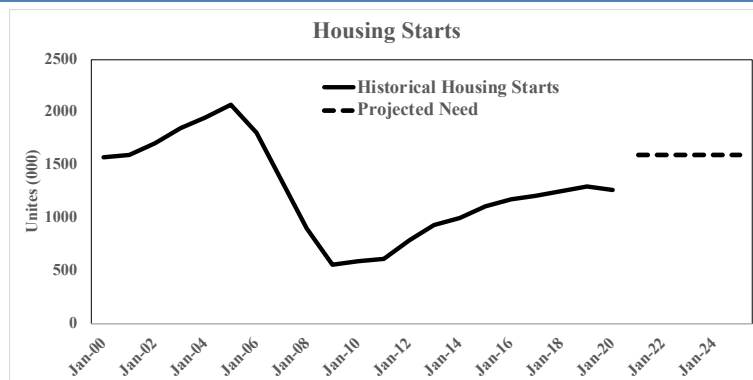
#### Trade 4: Buy Housing Related Equities

##### Trade Thesis

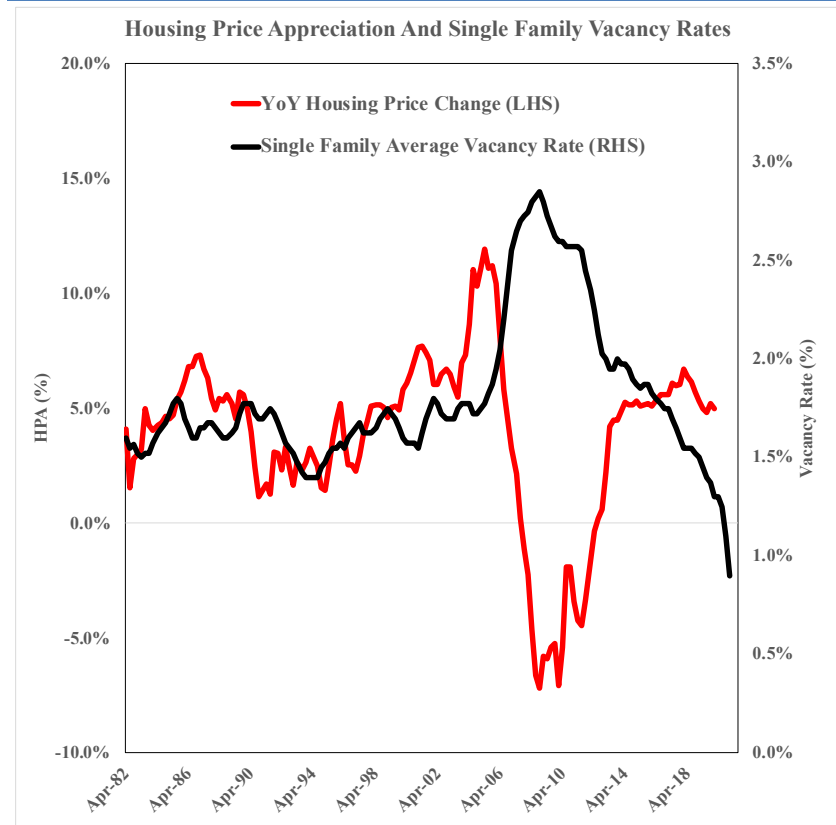
- Housing prices will continue to rise driving higher home asset values and rent rates from building and existing portfolios
- Prices and rental rates will continue to rise even in a stress economy reflecting the rising demographic driven demand and ten years of underbuilding
- Value of land banks of home builders will rise with higher housing prices, while “For Rent” companies underlying home assets will rise along with rental income

**Risk is economy does not recover**

##### Even With The Recent Spike, Starts Sill Below Needed Levels<sup>1</sup>



##### Declining Vacancies Supports Rising Housing Prices And Rent Rates<sup>2</sup>



1. Freddie Mac Projections  
2. Federal Reserve Bank of St. Louis, Fred Data Base

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