SOM
Macro
Strategies

May 24, 2021

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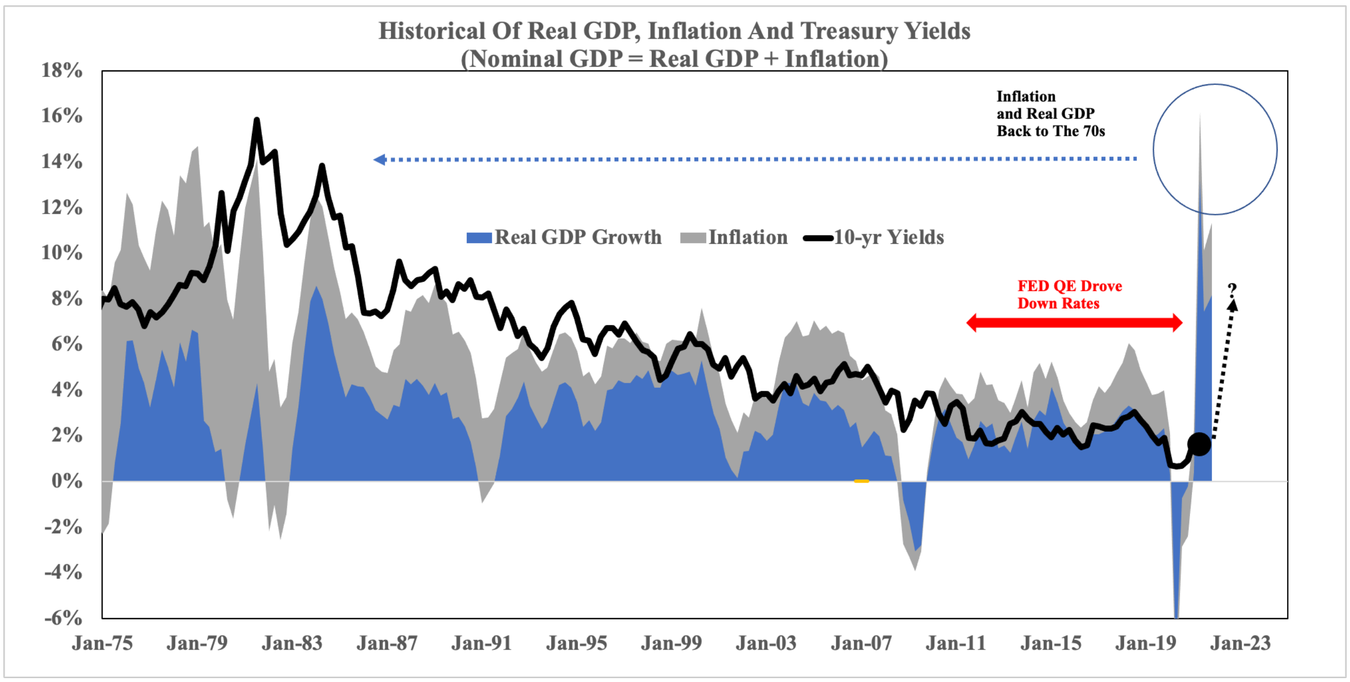
SOM Commentary: Biden Part 2, And New Trades

What I Am Thinking

My central view is that the asymmetric upside for US equities is gone and is now replaced by asymmetry to the downside. This view is based, in part, on data shown in Figure 1 below. Inflation, economic growth, and interest rates could be headed back to levels last seen 60 years aga.

Figure 1



I initiated the long US equities trade back in November of 2020 with the thesis that the economy would surge in the second half of 2021. This surge would reflect the impact from the two tailwinds to equity upside from the likelihood of the passage of $1.9 trillion fiscal stimulus in early January and the falling COVID infections from the rollout of the vaccine. I continued to recommend this trade after the equity rally in the first part of 2021 and restruck my call option. US equities have repriced higher due to the twin tailwinds I highlighted in my original trade thesis. But both those factors have played out to provide the asymmetric upside that I look for with my trade framework. Now, US equities have a decidedly negative asymmetry to the downside. US equities could grind higher at best, buoyed by a solid economic rebound with the Fed on hold. However, my thesis is that there is a high probability that equities could sell off substantially as the twin headwinds of inflation/higher rates and Biden's corporate tax hike take center stage. Markets sometime this summer will begin to look past the peak in economic growth and start to come to grips with these powerful headwinds to equity valuations. And they should because these headwinds could have a much nastier impact on equity prices than those similar factors have had historically.

First, both headwinds will be hitting the market simultaneously—think of a hurricane hitting land at high tide. Second, each headwind has a negative factor that investors have not faced in many generations. Markets have faced higher rates in an economic rebound, but now investors are confronted by uncertainty about the future level of inflation, which has not happened since the 70s. The threat of raising corporate tax rates is one thing; pushing tax rates on total corporate income to over 2/3rds is quite another. So, these headwinds could have a very negative impact on US equity valuations.

Let turn to the first headwind of higher rates and inflation uncertainty. US rates will likely head higher as the economy normalizes and the Fed begins to talk about taper and, ultimately, raise short-term rates. That is perfectly normal, and while that would have a negative impact on equity prices, it would not likely be enough to derail the upward trajectory of US equities. The more significant concern is uncertainty about inflation.

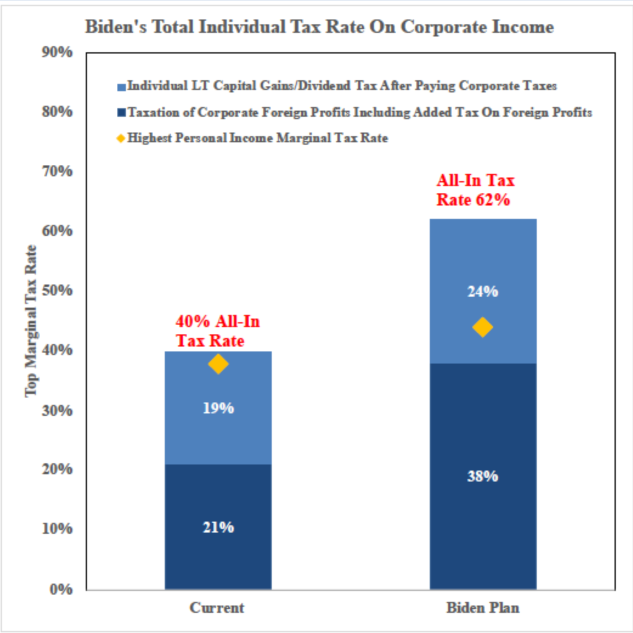
As I laid in my original piece a few months ago, inflation is a real threat to equity valuations. The built-up cash on consumer and business balance sheets could turn into surging demand that supply bottlenecks will compound. The real question for valuations will be dealing with inflation uncertainty: is this higher inflation a temporary phenomenon or a sign of a new cycle of higher inflation? The Fed and the Biden economist argue that the spike in inflation is only temporary and will return to its much lower longer-term trend. They could be right if their econometric models are correct. I believe that the models be wrong, and inflation will be higher than historical averages for quite some time. I reason that the economic models do not capture that the world has changed versus history used to calibrate the models.

First, the amount of cash that could be turned into consumption is massive by many orders of magnitude versus history. The $5 trillion + of COVID transfer payments dwarfs any historical recession-driven stimulus. Second, the supply bottlenecks are going to take a while to ease up. The service sector is unlikely to return to its pre-covid levels any time soon. How easy do you think it will be for a small to medium-size business to round up their 5 to 100 employees that they laid off? It will also take years to build enough housing to satisfy pent-up demand from historically low rates and demographics. Third, the wage pressure is going to be ramping up. Forget about the call for a $15 min wage; wages will need to be substantially higher to get the service sector back to work, as pointed out in point two. In addition, the labor market for these types of employees--less than college-educated—was on fire before COVID. Not as if these employees are banging at their former employer's door looking for work. Four, housing prices could continue to rise, reflecting the supply/demand imbalance. As I discussed in my inflation piece, demand is growing from demographics and low mortgage rates, but supply is limited given the years of underbuilding of housing since 2008. Historically, this imbalance looks almost close to its historical tights in the 70s, which drove inflation higher in that period. And of course, housing inflation is the dominant component of CPI.

Now, look at the second headwind, the Biden corporate tax increase. Look at Figure 2 below, taken from my recent piece. How do you think investors in US equities will respond to having corporate taxes taking 2/3 of corporate income? This tax hike, BTW, does not include state or estate taxes.

Figure 2.

All In Corporate Tax Rate Will Represent About 2/3rds Of Profits[1]



Little Justification For Higher Corporate Taxes Other Than For Cash

- In contrast to perception, the income and wealth share of the top 1% is largely unchanged since the 1980s
- Higher corporate tax rates will not return tax revenues to the levels of the 60s
  - Corporate tax revenues have fallen since the 1960s because profits of corporations subject to the corporate tax (C-corps) has fallen
- Biden's corporate tax plan may not generate as much revenue as projected
  - Corporate tax revenue could be lower as the plan could push C-corps business to a pass-through business structures to avoid double taxation
  - Wealthy individuals can put off the realization of capital gains to avoid the higher capital gains tax
  - Higher taxes on foreign profits could push Multinationals (MNE) to sell their Controlled Foreign Corporations (CFC) to foreign owners that face lower domestic corporate tax rates
- And if it does work, Biden's corporate tax plan could push down after-tax equity earnings by as much as 20% and push down future economic growth

Taxes on corporate income will go up substantially from several different channels. The top line moves from 21 to 28%, the imposition of a minimum tax, the additional tax on US companies' foreign income, and taxing long-term capital gains and qualified dividends taxed at the higher personal tax rate. If it happens, equities reprice lower by 30+%. Clearly, not a foregone conclusion that a corporate tax rate hike happens. But you need to assign some probability that some parts of it will pass. Multinational would appear to be the most at risk. As some models estimates, Biden's corporate tax broadening would increase tax cost to MNE by over 75% over the next ten years from $400 billion to $1.1 trillion, an increase of over $700 billion. That is before the higher capital gains rate hike to personal investors.

Bottom line, look beyond the debate around the move to a higher corporate statutory rate. That is just part of the much more significant tax rate increase. That means an apparent victory on keeping the hike to 24/25%, not 28%, is pretty hallow.

What I Am Recommending

Historical Performance of Recommended Trades

Positions	Number Trades	May 19, 2021 Initial Investment (MM)	Current Investment (MM)	Net Total Return
Open	4	20	49	144%
Closed	68	340	1001	194%
Total	72	360	1050	192%

Current And Recent Recommended Trades

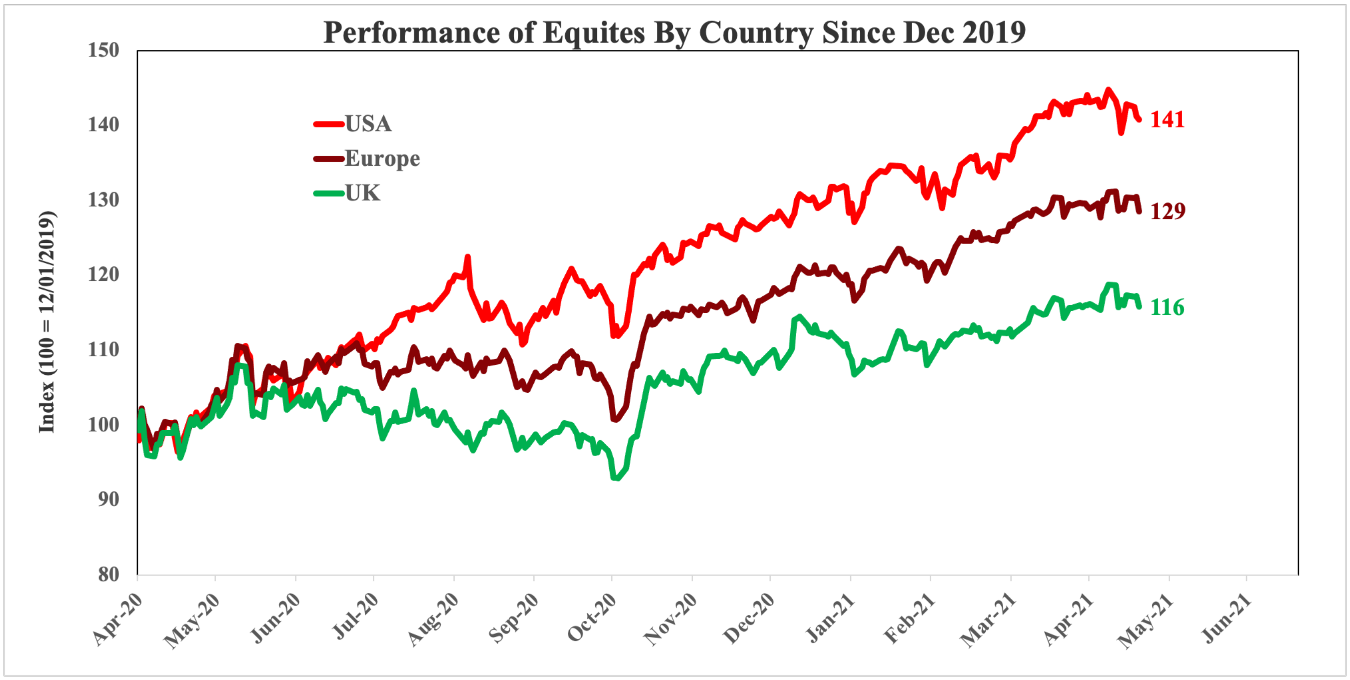
Status	SOM Strategy (Click On Link)	Trade	Initial Position Date	MM/ Shares	Price	Current Valuation Status	Price	May 19, 2021 Invest (MM)	Total Return
New Trade 1	***The Rise of Inflation Risk/And US Economic Growth***	**Buy 1yr/7yr Payer Swaption 50 Bp OTM**	**5/6/21**	**500**	**0.9**	**5/19/21**	**1.0**	**5.4**	**8%**
New Trade 2	***Implication Of Biden's Corporate Tax Plan***	**Buy European Equities And Sell S&P**	**5/6/21**	**150**	**100.0**	**5/19/21**	**101.0**	**6.5**	**30%**
New Trade 3	***IG Credit Is Rich, And Exposed To Corporate Tax Hikes***	**Buy A 6-month ATM Payer Swaption on IG Protection**	**5/6/21**	**1400**	**0.36**	**5/19/21**	**0.36**	**5.0**	**0%**
OPEN	*Key Opportunties Along The Path To Net-Zero*	Buy A Basket of Equites Exposed To Building The New Electrical Transmission Grid & Short S&P	2/18/21	150	100.0	5/19/21	118.0	32.0	540%
Clsoed	*Buy CDX Protection--Credit Is Rich*	Buy CDX Protection (bps)	9/17/20	500	46	5/6/21	52	5.0	0%
Closed	*The US After Trump And COVID*	Buy June 8% OTM Calls On A Equally Weighted Equity Index (Restriking)	2/24/21	416	1.2	5/6/21	4.0	16.6	231%
Closed	*Opportunites in the US Housing Market*	Buy Housing Related Equities Including "For Rent" Companies And Short S&P	8/25/20	150	100.0	5/6/21	119.0	33.5	570%
Closed	*The Rise of Inflation Risk*	Buy 5-year Inflation Swap (2.05%)	12/22/20	500	1.0	5/6/21	4.3	21.5	330%

Trade 1: I am closing my long call on US equities and then going long European equities vs. short US equities

I am closing my US equity upside recommendation and going the other way and using a short in US equity to hedge my long in European equities. I believe there are asymmetric to both sides of this trade, negative for US equities and positive for Europe equities. Let me explain.

Given my views above, I believe the market has not priced in the powerful headwinds of higher rates/inflation uncertainty and Biden's corporate tax hikes. Either one alone is enough to reverse the upward trend of equity valuations. Together they could create a significant downward trend. In contrast, European equities still have substantial upside both absolutely and versus US equities, Figure 3.

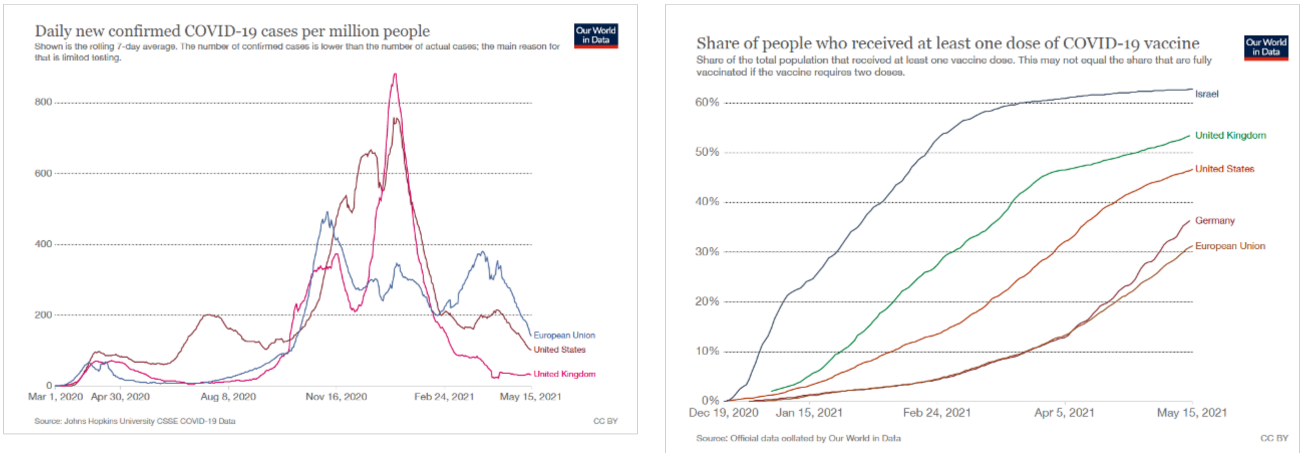
Figure 3.



The case for a rebound for European equities is compelling in my view. First, the COVID infection curve slowdown lagged that of the US but is now catching up with the US. That difference has narrowed as vaccinations in Europe are now approaching that of the US. Further, the UK infections and vaccinations are approaching that of the benchmark of Israel, Figure 4.

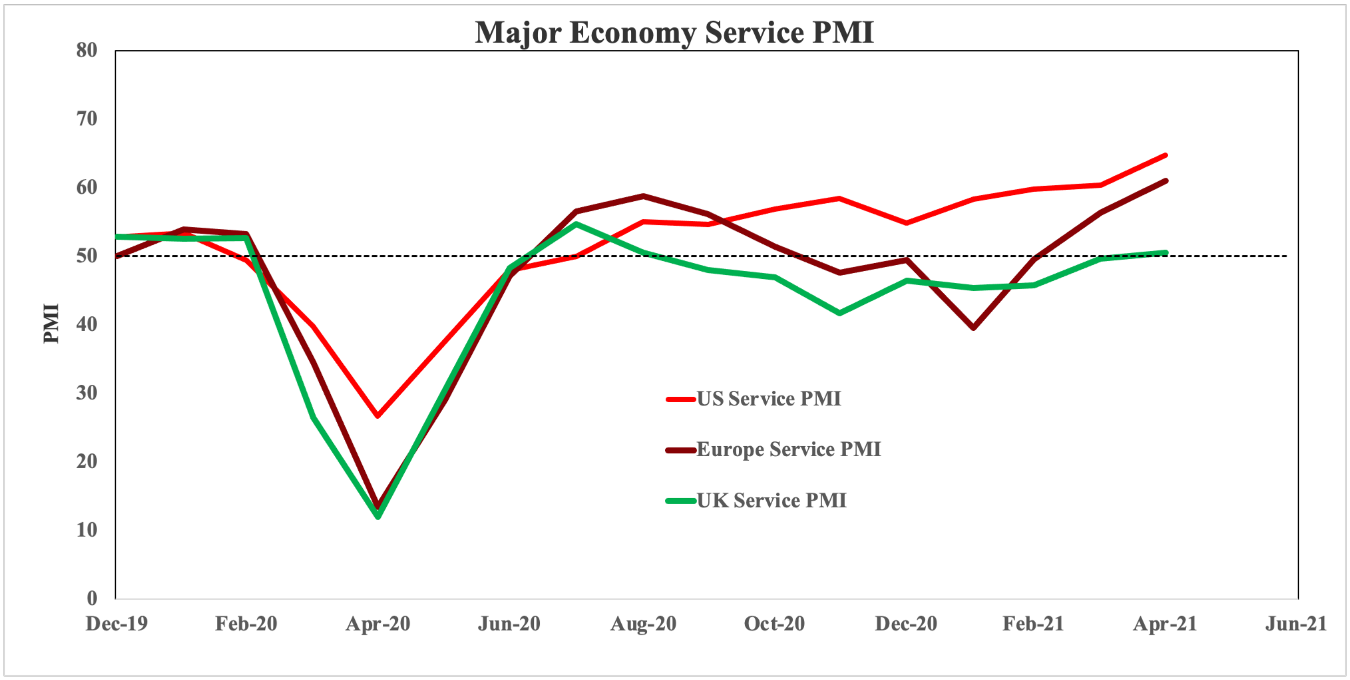
Figure 4.

Confirmed COVID Cases By Country | **Cumulative Vaccinations By Country**



Accordingly, European economic growth is rebounding, approaching the rebound in the US, Figure 5. The UK equities should rebound as well, with the tailwinds driven by mainland Europe.

Figure 5.



Second, European equities will not be faced with the risk of higher inflation or higher rates. The acceleration in European growth, at least not in the same time frame as that of the US. So, the ECB is not near to trigging tighter monetary policy.

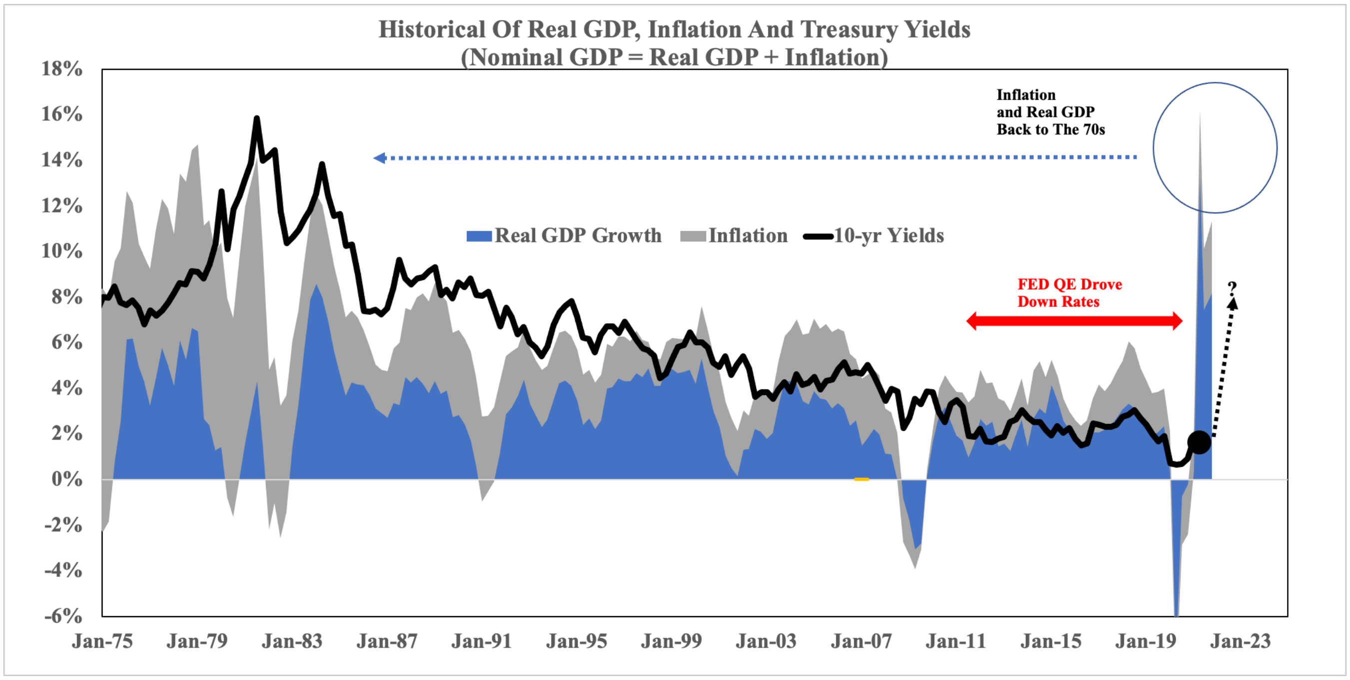
Third, European equities could see some tailwind from a rebound in UK equity prices as their economy rebounds in the post-BREXIT world.

Trade 2: I am positioning for higher nominal rates and buying a 50bp OTM 1-yr payer swaption on the 7-yr while closing my long 5-year inflation swap

Positioning for higher nominal rates gives me exposure to both higher inflation and higher real rates. I still believe that inflation could head higher. In December, my 5-yr inflation swap was struck at 2% when the ATM strike was 1.7%. Currently, the ATM strike is now 2.7s. Though inflation could head higher, I found the nominal rates trade provides more upside than just inflation alone. There are just more factors that could drive nominal rates higher in addition to inflation. A surge in real economic growth (real rates), widening deficits from the passage of Biden's broad social agenda funded through reconciliation, and likely move by the FED to tighten monetary policy.

Consider Figure 6 below. The level of nominal GDP growth--Real GDP + inflation--is stunning, reaching levels not seen since the 1970s. Yes, there are many reasons for this growth spike after the impact of COVID combined with stimulus. But, put yourself in place of FED policy makers. What do they think when they look at this exact figure? Yes, based on their models, they believe that inflation is not sustainable at these levels and will fall. But they cannot dismiss the possibility that inflation stays high for much longer than predicted by the models. In addition, what will happen to inflation if the Bidens $3.5 trillion spending package gets passed: maybe inflation could go even higher given the strength of the economy and the labor market? So, against this uncertainly, doing nothing would not seem a viable option. Consequently, it is only a matter of time that they taper, and the "DOTs" start heading higher. Thus, higher rates.

Figure 6.

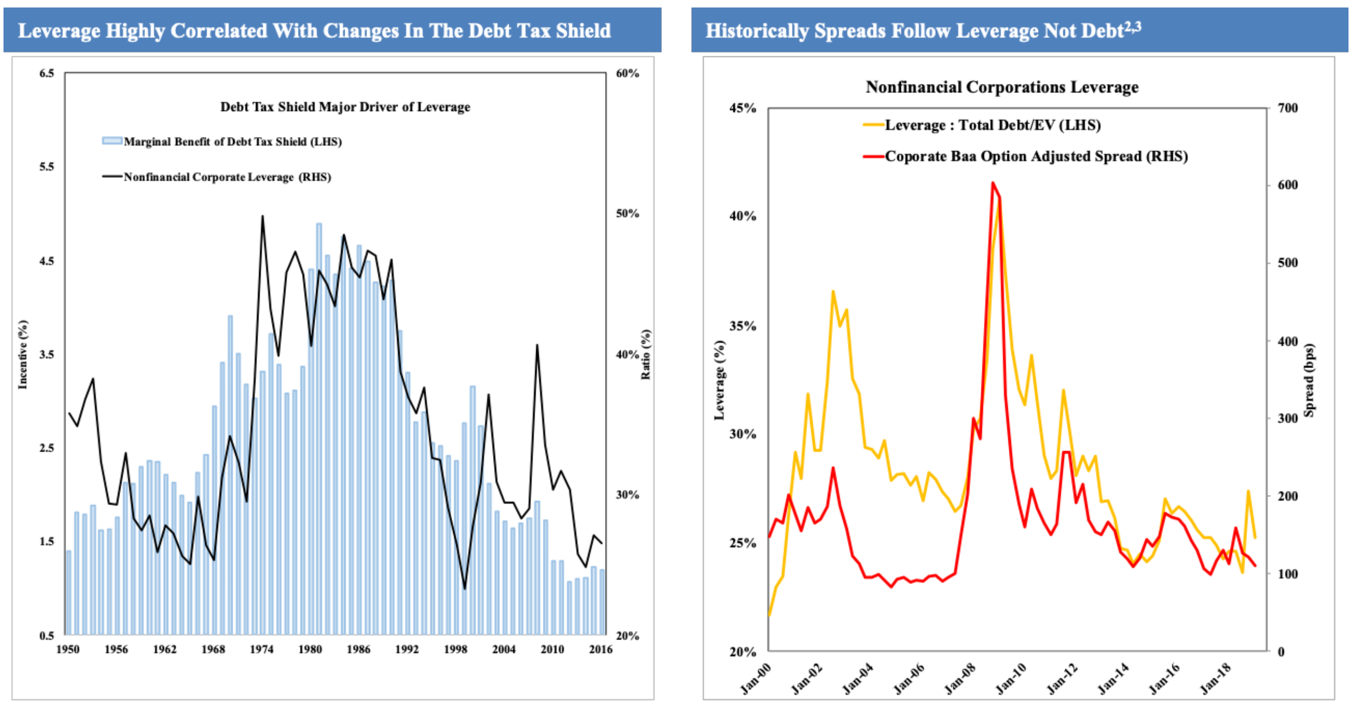


I looked at curve caps, which is a cheaper trade, with the correlation discount. But my concern is that the FED might move faster than I am anticipating and flatten the curve. Having said that, I guess that the FED will be behind the data and be slow to move short-term rates higher. So, if you do the curve cap, I would do one-look and short maturity. That concern about flattening pushed me to the 7-yr over the 10-yr part of the curve. You might even consider the 5-year. I will also be looking at the front end of the curve, which might offer some compelling trades. Overall, while Japan rates could be the future of US rates, that is a long way off.

Trade 3: I am converting my long 5-year IG protection into a 6-month ATM payer swaption on IG

I had a long IG protection position as a cheap portfolio hedge for risk-off shocks against my largely risk-on positions. I am converting this position to a payer swaption because IG spreads are more likely to widen even without a risk-off event. The swaption gives me more leverage to this thesis. IG spreads are more likely to widen over the year because of higher rates and the Biden corporate tax hike passage. Both factors could drive corporate leverage and hence spreads wider. Corporate leverage is driven in large part by the value of the interest rate expense deductibility. As I have written about before, the value of the deductibility and leverage goes up as corporate tax rates rise and/or interest rates rise. In some sense, this trade is also part of my positing for higher rates. Spreads will widen with leverage both from increasing risk (remember a large percentage of IG is BBB) and a surge in debt issuance. Leverage could also go up as equities fall with lower post-tax earnings.

Figure 7.



Trade 4: I am closing my long housing-related equities vs. S&P

I am closing my housing-related trade because the asymmetry is likely finished. The historically low level of mortgage rates is headed up. Homebuilding will soon catch up with demand, while the incremental COVID-driven demand from the urban to suburban housing will slow. I do think there is further upside from the for-rent firms if they start selling their housing inventory into this increasing demand.