SOM
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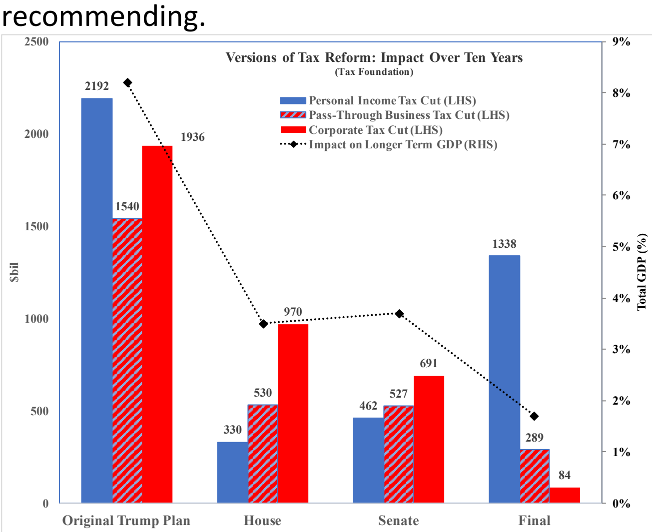
State of the Markets: Macro Commentary

A Few Thoughts On The Equity Market Sell-Off ”

Clearly, there are at least two scenarios at play in the market move of the last few days as equities have fallen are rates have risen. The first scenario is that US equities are overvalued and have already incorporate the positive impact on earnings of the corporate tax cuts, US and world growth, and historically low rates. In this scenario, changes in any one of these three factors will deflate the equity bubble, i.e. higher rates. A second scenario argues that the positive impact of tax reform and world growth is still not fully reflected in earnings. So, equities could still rally with earnings growth offsetting higher rates.

As I have made the point over the last few weeks, I think both scenarios are plausible, though I lean towards the second. Having said that I have been out of the US equity index trade since the end of the year. I believe that corporate tax reform was not as big an earning boost that I originally thought (see the figure below). More importantly—as someone trained at the U of Chicago Economics firmly believes--news such as tax reform gets priced into market fairly quickly. Consequently, the asymmetry to upside in the broad equity markets was gone, which is the cornerstone of my trading strategy recommendations. I fully recognize the index could still rally but risks were growing, particularly from higher rates. So, yes, I did miss the 8% rally YTD in S&P, but I basically broke even given the performance of the other trades I was recommending.



My central views remain the same: world growth is normalizing so too will monetary policy, and further Trumpanomics reform is coming. Based on those views, here are a few of the trades I am recommending particularly given the sell-off:

1. Buy regional bank equities. As a post, the senate is now holding hearings on S.2155, after it passed in the committee on a bipartisan vote. This bill basically removes regionals from the stress tests of Dodd-Frank. So, buy these banks in any sell-offs.
    - Look at my updated SOM piece "Buy Regional Banks…"
2. Buy European equities, particularly banks. Normalization of growth and the NPL cycle in southern Europe is not reflected in valuations. Yes, US equities could be overvalued, but that is not the case for European banks and equities.
    - Look at my SOM piece "Normalization of The EMU"
3. Higher rates. Normalization of growth and Fed policy moves rates back up to their historical norms of 10-year around 4 to 5% over time. This trade was even more attractive in option form given the low levels of implied vol.
    - Look at my SOM piece "Positioning for Higher Rates"