

# ***SOM** Macro Strategies*

## State Of the Markets: Portfolio Performance and Recommended Trades

Alan Brazil

July 2018, Month End

# *SOM Macro Strategies*

## State Of the Markets: Portfolio Performance and Recommended Trades

### Update on Performance, and the Portfolio

#### Historical Performance

Positions	Number Trades	Initial Investment (MM)	July 31, 2018	
			Investment (MM)	Total Return
Open	7	35	33	-6.2%
Closed	20	100	276	176.0%
Total	27	135	309	128.7%

#### Commentary

- The model portfolio in aggregate was down 20% from 149% to 129% over the month. This mainly reflects the underperformance of the current open trades vs the open trades as of June month-end.
- I closed two trades over the month and opened 3 new trades
  - Closed trades
    - Long corporate spread trade, which was up 38%
    - Short a basket of EM FX, which was up 210%
  - Opened Trades
    - Long 10% OTM put on Bovespa, October 31, 2018 expiration
    - Long USD/Short CNH 1-year forwards
    - Short AAA CMBX
- By and large this reflects my view that risk-off trades are becoming more compelling giving the slowdown in world growth, particularly EM, as well as the potential escalation of the economic war between the US and China

# *SOM Macro Strategies*

## State Of the Markets: Portfolio Performance and Recommended Trades

### Update of Current Recommended Trades (July 31, 2018)

#### Step 4: Find Asymmetric Trades

SOM Strategy	Trade	Date	Initial Position				Current Valuation (7/31/18)		
			MM/Shares	Price	Face (MM)	Investment (MM)	Price	Investment (MM)	Total Return
Stronger Dollar Part II---Position For A Weaker EM	Buy December 2018 7% OTM Put on EM Equities	28-Jun-18	285	1.75	5.0	5.0	0.8	2.3	-54%
Stronger Dollar Part II---Position For A Weaker EM	Buy Bovepa 10% OTM puts for October	25-Jul-18	13513	370.0	5.0	5.0	400.0	5.4	8%
The Coming Economic War Between The US and China	Sell CNH One Year Forward vs USD	25-Jul-18	100	100.0	100.0	5.0	101.5	6.5	30%
The Return of The King: Long the Dollar	Buy Dec Euro Puts/Dollar Calls, 1.13 strike	29-May-18	454	1.10	5.0	5.0	0.5	2.3	-55%
Electric Metals as The New Oil	Long Electric Metals And Minors	29-Dec-17	100	100.0	100.0	5.0	100.0	5.0	0%
Tail protection	Short AAA CMBX	25-Jul-18	-250	99.3	248.4	5.0	99.3	5.0	0%
Position For Higher Rates	1/5 Payer Swaption 3% Strike	22-Mar-18	556	0.9	5.0	5.0	1.1	6.3	27%

# SOM Macro Strategies

## State Of the Markets: Portfolio Performance and Recommended Trades

### Closed Recommended Trades

#### Step 4: Find Asymmetric Trades

SOM Strategy	Trade	Date	Initial Position				Closed Valuation/Performance			
			MM/ Shares(000)	Price	Investment (MM)		Date	Price	Investment (MM)	Total Return
					Face Value	Actual				
Abenomics	Long a 6-month Call 17000/19000 call spread on Nikkei	9-Sep-16	76.9	6.5	5	5	17-Jan-17	14.0	10.8	115%
Abenomics	Long a 6-month Call 15000/17000 call spread on Nikkei	24-Jun-16	62.5	8.0	5	5	9-Sep-16	18.5	11.6	131%
Brazil	Long Mxn Peso vs Short Brazilian Real at 6.1	8-Nov-16	100.0	100.0	100	5	3-Jan-17	95.0	0.0	-100%
Brazil	Long a 6-month 61000 strike put on Bovespa	31-Oct-16	248.8	2.0	5	5	21-Dec-16	5.7	14.2	184%
Credit is Not a Bubble	Short 5-yr HY CDS	5-Sep-17	400.0	330	400	5	22-Mar-18	345	8.6	72%
<b>Credit is Not a Bubble</b>	<b>Short 5-yr IG CDS at 66 bp</b>	<b>22-Mar-18</b>	<b>-333</b>	<b>66 bp</b>	<b>333</b>	<b>5</b>	<b>25-Jul-18</b>	<b>59 bp</b>	<b>6.90</b>	<b>38%</b>
Greece	Long 30yr GGBs	24-Mar-17	29.3	68.2	20	5	7-Feb-18	114	13.4	269%
Greece	Long basket of Greek banks	25-Mar-17	899.0	1.1	10	5	15-Aug-17	2.1	19.1	182%
Position For Higher Rates	1/10 Payer Swaption 2.5% Strike	9-Nov-16	333.3	1.5	5	5	9-May-17	1.4	4.7	-7%
Position For Higher Rates	1/5 Payer Swaption 2.5 % Strike	9-May-17	625.0	0.8	5	5	22-Mar-18	1.5	9.4	88%
Strategies For BREXIT	Short GBP vs USD at 1.33	1-Jul-16	159.0	100.00	159	5	11-Oct-16	108.27	13.4	263%
Strategies For Trumpanomics	Long Regional banks	9-Nov-16	1.1	46.5	50	5	25-May-18	64.2	24.1	382%
Strategies For Trumpanomics	Long Materials sector	9-Nov-16	1.04	48.3	50	5	14-May-18	59.6	16.7	235%
Strategies For Trumpanomics	Long Mortgage Insurers and Home Builders	9-Nov-16	2.3	21.7	50	5	14-May-18	26.6	16.2	224%
Strategies For Trumpanomics	Long S&P500	9-Nov-16	0.46	216.0	100	5	4-Dec-17	265	27.7	455%
Strategies For Trumpanomics	Best of Puts Euro, Yen vs USD	9-Nov-16	625.0	0.8	5	5	23-Dec-16	3.7	23.1	363%
The Normalization of The EMU	Long EMU Bank Equities	29-Dec-17	0.32	156.7	50	5	24-May-18	141.0	0.0	-100%
The Return of The King: Long the Dollar	Buy 9-month Euro Puts/Dollar Calls, 1.21 strike	11-Apr-18	515	0.97	5	5	29-May-18	5.80	29.9	498%
Stronger Dollar Part II---Position For A Weaker EM	Buy December 2018 7% OTM Put on EM Equites	11-Apr-18	285	1.75	5	5	28-Jun-18	3.75	10.7	114%
<b>Stronger Dollar Part II---Position For A Weaker EM</b>	<b>Buy USD, Sell A Basket of EM Commodity FX (BRL, RUB, ZAR)</b>	<b>11-Apr-18</b>	<b>100</b>	<b>100.0</b>	<b>100.0</b>	<b>5.0</b>	<b>12-Jul-18</b>	<b>110.5</b>	<b>15.50</b>	<b>210%</b>

# *SOM Macro Strategies*

## State Of the Markets: The Return of The King—Positioning For A Stronger Dollar

- ***Step 1: Macro Theme: The Return of The King—Positioning For A Stronger Dollar***
  - The USD has depreciated substantially over the last year, with more depreciation priced in the future
  - The USD could rebound as the forces that drove the weakness fade and potentially reverse
- ***Step 2: Fundamental Economic Framework***
  - The USD is weaker because growing US deficits increased the risk that they could push the current account wider--the “Twin Deficits” theory
  - The USD is weaker despite substantially higher interest rates than Japan/Europe because of the expectation that their central banks will also normalized monetary policy given recent economic trends
  - The USD is weaker because the current budget problems of the US could accelerate the move to the RMB as the new world reserve currency
  - However, the “Twin Deficits” theory is not supported by the data, as the opposite seems to hold true, as historically the private sector has increased savings to offset increased public borrowing
  - Japan/Europe may not normalize their monetary policy as growth and inflation are fading, while US growth is still strong
  - The USD will remain king as the dominate world reserve currency as the RMB is a long way from being a viable substitute
- ***Step 3: Find Potential Catalysts***
  - The USD could strengthen if US private saving could increase offsetting the pressure on the USD from rising deficits
  - The USD could strengthen if current wide interest rate differential weigh on the Euro and Yen as slowing economic growth and inflation reduces the probability of a change in their monetary policy
  - The USD could strengthen as the interest rate spread differential widens versus current market pricing if US growth accelerates and the FED actually follows the “Dots” .
  - The USD could strengthen from an increase in capital inflows from Europe reflecting the impact of US tax reform
  - The USD could strengthen as the impracticality of replacing it with the RMB gets highlighted as world trade continue accelerates
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Buy Euro Puts/USD Calls

# SOM Macro Strategies

## State Of the Markets: The Return of The King—Positioning For A Stronger Dollar

### Step 4: Find Asymmetric Trades

#### Trade 1: Position For A Stronger USD—Buy OTM EUR Puts/Dollar Calls

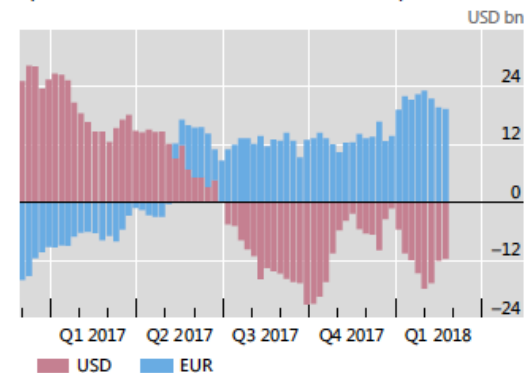
##### Trade Thesis

- USD could rebound from current weakness
  - Impact on USD from rising “Twin Deficits” from increasing federal borrowing could be offset by rising private savings
  - Continued Economic growth in the US/weakening growth in Europe could further widen interest rate differentials
  - World trade growth will increase demand for USD given that RMB is not yet a viable alternative for trade denomination
  - US tax reform could increase demand for USD vs Euro from a substantial increase in capital flows into the US from Europe
- Buy 9-month OTMF of Euro Puts/USD calls

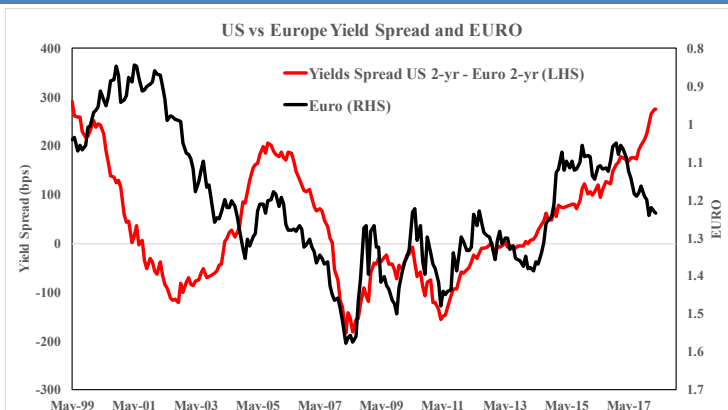
**Risk is continue weakening of USD**

##### Rebound Could Be Swift Given Current Positioning<sup>2</sup>

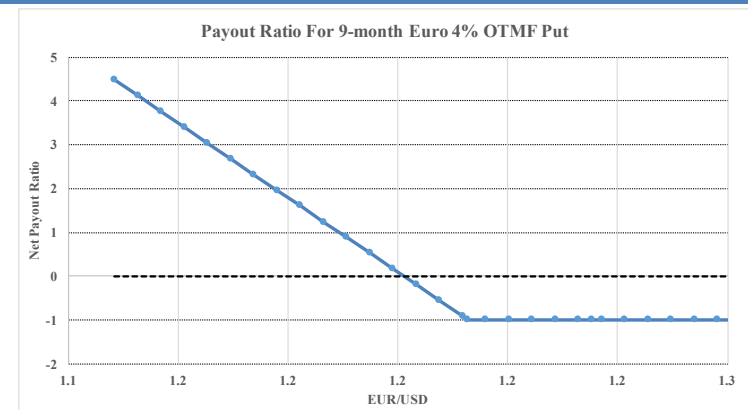
Speculative US dollar and euro net futures positions



##### Euro Looks Vulnerable if ECB Does Not Normalize Rates<sup>1</sup>



##### Potential Net Payouts of Euro Put/USD Calls



1. Bloomberg  
2. BIS Quarterly review, March 2018

# *SOM Macro Strategies*

## State Of the Markets: Stronger Dollar Part II—Position For Weaker EM

- ***Step 1: Macro Theme: Potential Impact of a Stronger Dollar on EM***
  - The USD depreciation since the end of 2015 could reverse as US continues to grow, while the ROW slows
  - EM could weaken as the dollar strengthens along with rising US rates—the real “taper tantrum”
- ***Step 2: Fundamental Economic Framework***
  - The dollar has weakened against a backdrop of synchronized growth across advanced and EM economies
  - The weaker dollar explains much of the synchronized growth particularly for EM
  - A stronger dollar could weaken EM GDP substantially and domestic growth even more
  - Commodity prices, another source of EM growth, could also weaker with a stronger dollar
  - EM relies on a substantial flow of external capital, most of it denominated in USD
- ***Step 3: Find Potential Repricing Events***
  - The USD could strengthen if the BOJ and the ECB do not raise rate if Japanese and European economies slow
  - The USD could strengthen versus pricing if the US economies continues to grow and the Fed raises rates higher and faster versus current pricing
  - The unwind of QE could put reverse the flows of capital into EM, which has supported their growth
  - Pressure on EM FX and EM rates/Central banks could also create a headwind to EM growth by increasing the cost of capital
  - EM banks could tighten credit and slow EM economies as NPL surge with higher funding costs and weakening domestic growth
- ***Step 4: Find Asymmetric Trade***
  - Trade 2: Buy USD, sell a basket of EM commodity currencies
  - Trade 3: Buy OTM puts on EM equities

# SOM Macro Strategies

## State Of the Markets: Stronger Dollar Part II—Position For Weaker EM

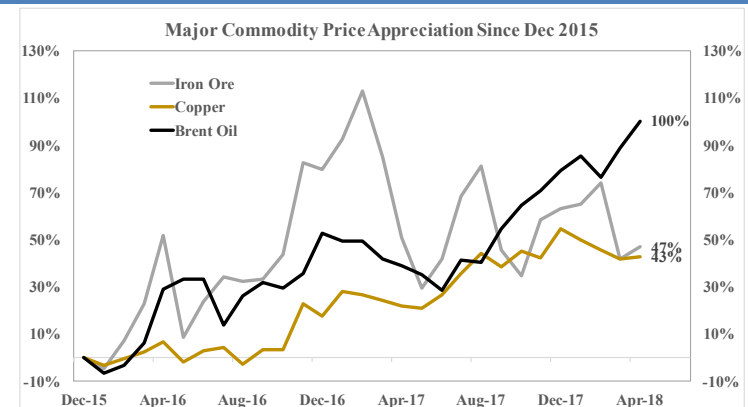
### Step 4: Find Asymmetric Trades

### Trade 2: Position for A Stronger Dollar — Buy USD Against EM Commodity Country FX

#### Trade Thesis

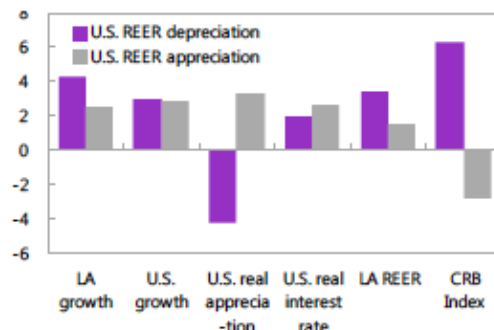
- USD could strengthen
  - The dollar could strengthen as the Fed continues to raise rates and unwind QE as the US economy continues to grow
  - Capital flows into the US spurred by tax reform could also strengthen the dollar result is a strengthening of the USD
- EM commodity country FX could weaken as their economies slow
  - External capital flows could dry up and reverse
  - Dollar funding costs could rise with higher US rates and stronger USD
  - Commodity income could fall as commodity prices fall in the face of a stronger US
  - Domestic credit growth could decline in face of rising problem loans
- Buy USD vs a basket of EM commodity country FX (BRL, RUB, ZAR)

#### Commodity Prices Have Surged As The USD As Depreciated...<sup>2</sup>

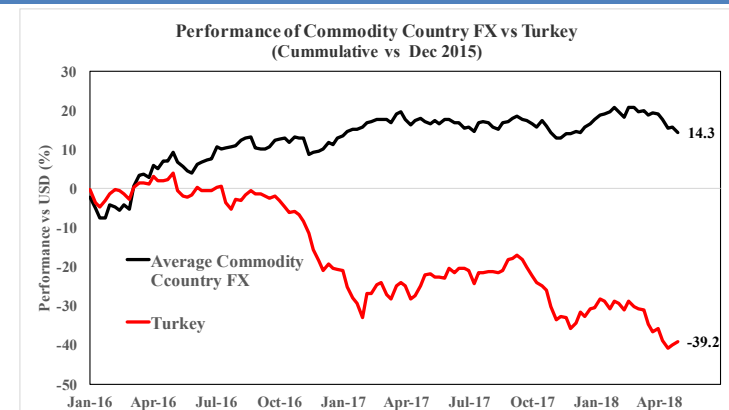


#### Dollar Highly Correlated With Commodities and EM<sup>1</sup>

Figure 6. Appreciation and Depreciation Cycles



#### Which Has Supported Commodity Country FX vs Other EMs<sup>2</sup>



1. Druck, Magud, Mariscal, "Collateral Damage: Dollar Strength and Emerging Markets' Growth", IMF Working Paper, 15/179

2. Bloomberg



# SOM Macro Strategies

## State Of the Markets: Stronger Dollar Part II—Position For Weaker EM

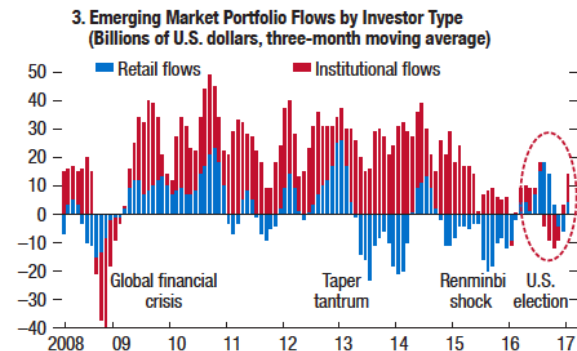
### Step 4: Find Asymmetric Trades

### Trade 3: Position For A Down Turn In EM—Buy Puts on EM Equities

#### Trade Thesis

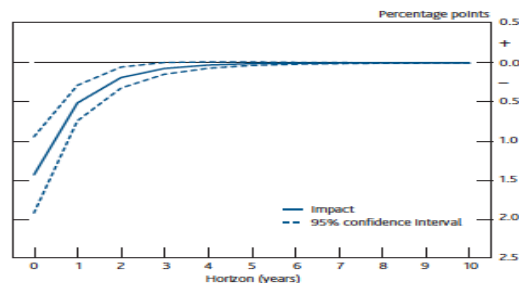
- Dollar strength could slow economic growth and that could reverse the recent rally in EM equities
  - Stronger dollar and higher borrowing cost could push cost of external capital substantially higher
  - Slowing domestic credit growth as banks scale back lending as NPLs rise
  - Domestic income growth slows if commodity prices fall with the stronger dollar
- EM equities prices could also fall if retail investors sell positions driven by another EM crisis
  - Taper tantrum II
- Buy 5% OTM puts with December 2018 expiry for 3.5%

#### An EM Slowdown Or Crisis Could Create Outflow By Retail<sup>2</sup>



#### EM Economies Could Slow If The Dollar Appreciates<sup>1</sup>

Summary chart Average real GDP growth reaction in emerging market economies to a 10% US dollar appreciation<sup>(a)</sup>



Source: Bank calculations.

(a) Response obtained using a Panel Vector Autoregressive (PVAR) model described in the annex.

#### Rally In EM Equities Could Reverse From An Appreciating USD<sup>3</sup>



1. "The global role of the US dollar and its consequences", Quarterly Bulletin, 2017 Q4 Authors' Calculation  
2. IMF, Global Financial Stability Report, April 2017  
3. Bloomberg

# *SOM Macro Strategies*

## State Of the Markets: The Coming Economic War Between the US and China

- ***Step 1: Macro Theme: Economic War Between the US and China***
  - The Trump administration is determined to engage in an economic war with China
  - They believe that China has been actively engaged already in this war, which goes far beyond trade
  - The question is how far will the US go to win this war
- ***Step 2: Fundamental Economic Framework***
  - The US trade balance with China is growing
  - China is escalating their acquisition of intellectual capital both directly and indirectly
  - China has put barriers to US technology companies entering into China
- ***Step 3: Find Potential Repricing Events***
  - The Trump administration now has the power to impose unlimited tariffs on a range of China imports
    - They followed the protocol of section 232 of the 1962 Trade Expansion Pact
  - Trump's aggressive stance towards China was one of the main components of his contract with America during the 2016 campaign
    - He has delivered on pretty much every other component of this contract
  - China may retaliate through a variety of channels beyond increasing tariffs on US imports
    - Imposing tariffs is a losing strategy for China given the current trade imbalance
    - Constrain access to US markets for US technology companies
    - Use their demand for oil to disrupt US foreign policy
  - China could depreciate their currency to offset US tariffs and reignite trade as a vehicle of growth
    - Depreciation could offset the impact of tariffs on goods shipped to the US
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Buy puts on broad EM equity indexes denominated in USD
  - Trade 2: Receive USD and Sell CNH on a forward basis

# SOM Macro Strategies

## State Of the Markets: The Coming Economic War Between the US and China

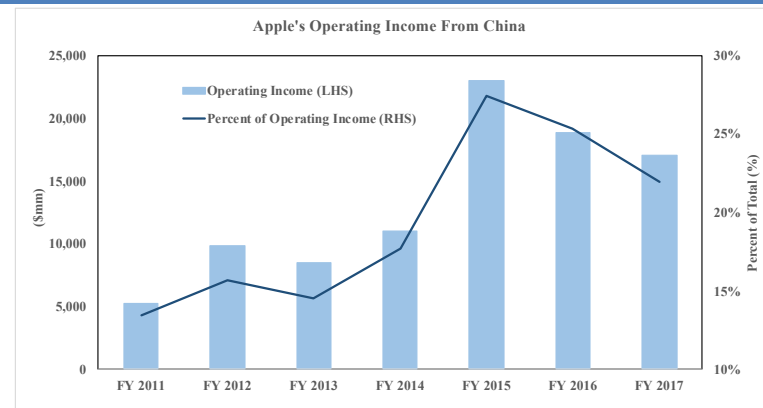
### Step 4: Find Asymmetric Trades

#### Trade 2: Position For Chinese Retaliation <sup>1</sup>

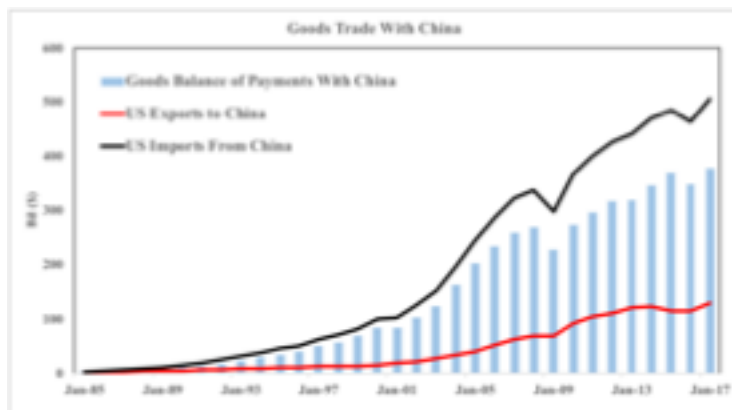
##### Trade Thesis

- The Trump administration is escalating the economic war with China
  - US trade deficit with China is growing, as is the intensity of China's economic war with the US
  - The US could potentially unlimited tariffs on Chinese imports
- China could retaliate against the imposition of US tariffs
  - The could put more barriers to imports from US technology companies
  - They could use oil as a political weapon against the US
- Buy puts on a broad base EM equity index
  - Impact of an economic war on the Chinese equity markets could be substantial
  - China and its circle of influence constitute the majority market weight of broad base EM indexes

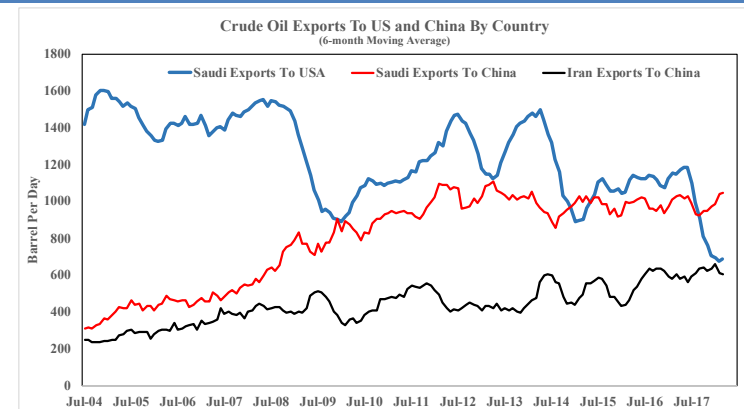
##### US Technology Companies Are Vulnerable to China Retaliation



##### US Deficit With China is Growing



##### China Could Use Its Growing Demand For Oil As A Political Weapon



# SOM Macro Strategies

## State Of the Markets: The Coming Economic War Between the US and China

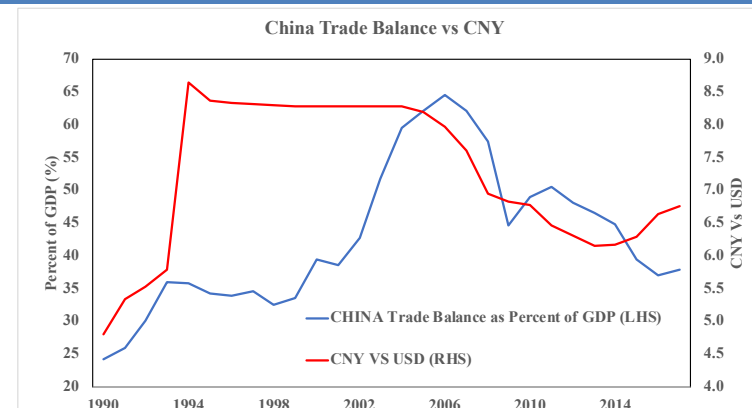
### Step 4: Find Asymmetric Trades

#### Trade 2: Position For A Weaker RMB<sup>1</sup>

##### Trade Thesis

- Fed policy could strengthen the USD against all currencies
  - Reversing QE
  - Raising rates
- China could weaken the RMB for a variety of reasons both directly and indirectly
  - They could weaken their currency to offset the impact of tariffs
  - They could weaken their currency by lowering policy rates to spur their economy
  - They could weaken their currency to reignite trade as an engine of growth
  - They could weaken their currency to retaliate against US tariffs
- Buy USD and sell CNH using a 1-year forward contract

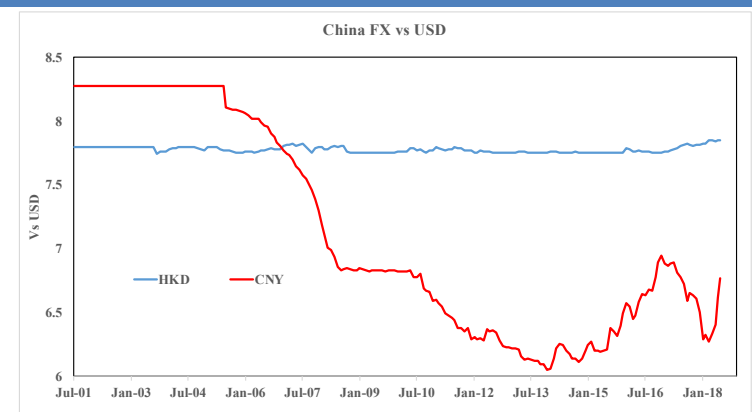
##### China Trade Engine Has Slowed As Their Currency Appreciated



##### US Is Raising Rates While China Is Lowering Rates



##### China Has Plenty of Room to Depreciate



# *SOM Macro Strategies*

## State Of the Markets: Electric Vehicle Metals As The Next Oil

- ***Step 1: Macro Theme: Electric Vehicle Metals As The New Oil***
  - Affordability and government support of electric vehicle (EV) has potentially put them at the cusp of explosive growth
  - Electric vehicles and ultimately driverless cars could transform the transportation industry worldwide
- ***Step 2: Fundamental Economic Framework***
  - EV now has the same affordability level as the Ford's model-T in 1917 prior to the explosive growth of cars with internal combustion engines (ICE)
    - Already on the same exponential growth path of other recent technological innovations
  - Factors driving demand
    - Affordability
    - Policy
  - Metal supply for EV engines and batteries could be substantial
- ***Step 3: Find Potential Catalysts***
  - Demand for EV metals could swamp near term supply
  - Near term EV sales growth could put earnings pressure on existing car companies
    - Development costs for EV and batteries could will be substantial
  - Over the next 20 years technology could fundamentally change the transportation industry
    - EV growth will crush oil demand
    - Driverless cars based on EV could hallow out the auto industry
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Buy EV metals and miners
  - Trade 2: Sell transportation industry

# SOM Macro Strategies

## State Of the Markets: Electric Vehicle Metals As The Next Oil

### Step 4: Find Asymmetric Trade

### Trade: Buy Battery Metals and Miners—Electric Vehicles (EV) Battery Demand Overwhelm Supply

#### Trade Thesis

- Affordability puts EV demand at the cusp of exponential growth
  - EV as with absorption of other technical advancements has reached a take off point where demand explodes
  - As the internal combustion engine (ICE) rapidly replaced the horse, so to could the EV replace the ICE
  - EV needs metals for the engine and for the battery
- As demand takes off, prices for key EV metals such as cobalt, lithium and copper could surge given limited near term supply
  - Earnings of miners of copper and lithium could rise as well
- Buy a portfolio of miners and metals exposed to EV

*Risk is that it is too early in the cycle for EV*

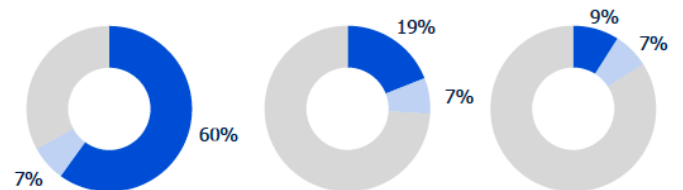
#### Batteries For EV Need Metals Particularly Lithium and Cobalt<sup>2</sup>

##### Common Uses & Features

- Uses: smartphones, laptops, tablets, cameras, wearables
- Higher energy density, shorter life span
- Uses: EVs, grid storage, power tools, medical devices
- Higher life span, higher power
- Uses: EVs, e-bikes, portable computers, grid storage
- Higher energy density, higher cost

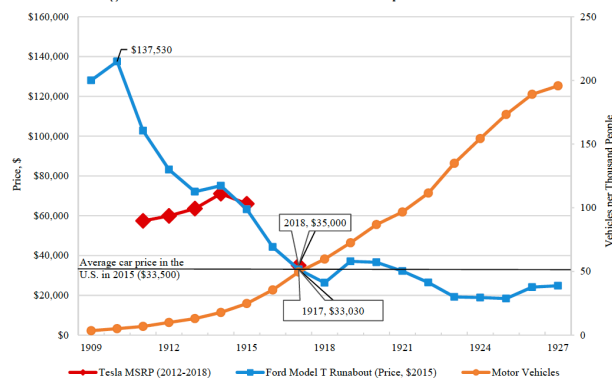
##### Cobalt %

■ Co ■ Li  
■ Other



#### EV Affordability Has Reached the Same Stage as the Model-T Before Demand Surged<sup>1</sup>

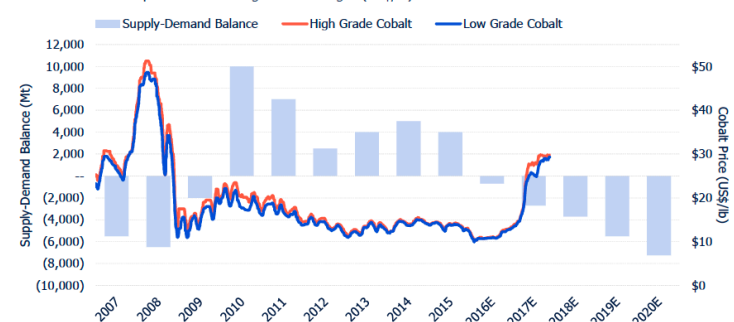
Figure 8: Electric and Motor Vehicles Adoption and Prices



#### Demand Surge Could Swamp Near Terms Supply Pushing Up Prices<sup>2</sup>

##### Supply-Demand Balance and Historical Cobalt Prices (Nominal)<sup>1</sup>

Tonnes | Metal Bulletin High-Low Averages (US\$/lb)



1. Cherif, Hasanov, Pande, "Riding the Energy Transition: Oil Beyond 2040", IMF Working Paper, WP/17/120, May 2017  
 2. Cobalt27, Presentation to Investors, September 2017

# *SOM Macro Strategies*

## State Of the Markets: Position For Higher Rates

- ***Step 1: Macro Theme: Position For Higher Rates***
  - Interest rates are very low by historical norms given current economic growth and strong labor market
- ***Step 2: Fundamental Economic Framework***
  - Nominal GDP growth is determined by real GDP growth and inflation
  - Historically interest rates have been highly correlated with nominal GDP Growth
    - The Fisher equation
- ***Step 3: Find Potential Catalysts***
  - Real economic growth could accelerate, particularly given Trumpanomics
  - Tight labor market and both the success and failure of Trumpanomics could push up inflation
  - QE unwind and financial reform could remove barrier on yields moving closer to historical norms
- ***Step 4: Find Asymmetric Trade***
  - Trade : Buy 1/5 25bp OTM payer swaptions

# SOM Macro Strategies

## State Of the Markets: Position For Higher Rates

### Step 4: Find Asymmetric Trade

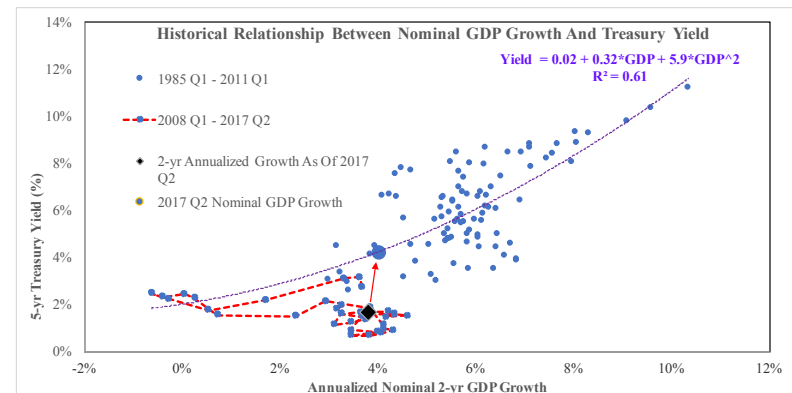
### Trade : Position For Higher Rates--Buy Out-of-The Money 1y/5y Payer Swaptions

#### Trade Thesis

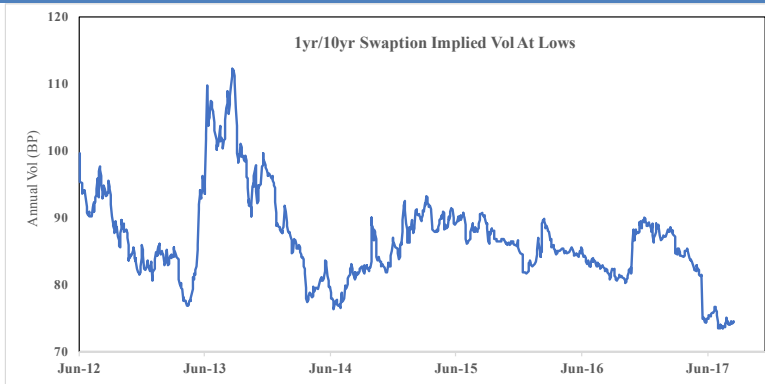
- Interest rates are below normal given current economic conditions
- Rates could move higher closer to norms
  - Real growth pickup, e.g. Trumpanomics
  - Tight job market or deficit spending pushes up inflation
  - QE unwind or financial reform reduces demand for duration
- Payer Swaptions are compelling
  - Vol is low by historical standards so it misprices the tail of significantly higher rates
  - Payouts could be north of 3 to 1

**Risk is the the US is following the path of Japan**

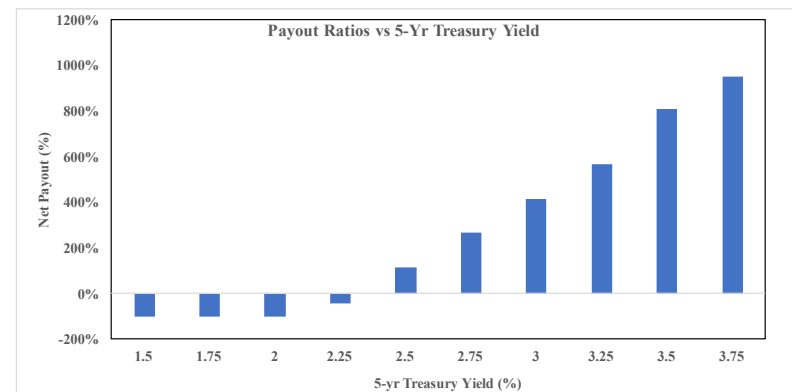
#### Nominal Growth Will Push Rates Higher <sup>1,2</sup>



#### Implied Volatility Not Rich By Historical Standards <sup>1</sup>



#### Performance of 1/5 Swaption <sup>3</sup>



1. CBOE, SRVIX Index of Implied Volatility of 1/10 Swaptions
2. St. Louis Federal Reserve (FRED)
3. Authors analysis

Past performance is not indicative of future results



# *SOM Macro Strategies*

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