SOM
Macro
Strategies

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State Of the Markets: Macro Commentary

Update Of My Views And Trades

Well, clearly a lot has happened since my last piece on March 9th, "Moving From Risk-off, To Risk-On" Ouch! Some of these events I am not surprised about and some I am. But first some housekeeping with an update on my trades

- I closed my long S&P position on 3/11 after it hit my down 5% stop that I recommend on 3/9. (ROI -100%)
    - My bet was stimulus would create the asymmetric upside, unfortunately it seems to have created the opposite. Fortunately, I had performance in my two other trades, which took the sting out of losing on this one.
- I closed my long September DXA (DXY) 97 strike call at the close of business 3/18 at 5.3 pts that I bought on 3/9 at 0.5%. (ROI of +960%) I then replaced it with the same tenor but with a new strike is 103 at a price of 1.2.
    - I thought that the flight from the USD to Euro/Yen was a short-term response that would morph into just the opposite given the likely shortage of USDs as USD liquidity dried up. I still believe there is upside in the dollar even with the FED offering USD swaps to other countries as it did in 2008/9. My view is that like 2008/9 these swaps will not be enough, and the USD will continue its surge.
- I closed my long 5-yr CDS protection on South Africa at the close of business 3/18 at 400 bp that I bought on 2/20 at 165 bp. (ROI of + 880%)
    - I still think SA still has significant downside. However, buying protection at 400 bp is a real tough trade to put on in my framework. But I will be looking for other ways to short it that fit this framework.
- I am still long my 10/2 curve cap with a strike of 45 bps,
    - I still like the thesis that curve steepens as the FED cut rates. The Fed has cut rates and the curve has steepened but there is still more left. The trade has finally started to perform ---which means I am losing less money on it!

What I Am Not Surprised About

So, let me turn first to what I am not surprised about and that is the pace of the epidemic, and policy makers response to that path. Governments are finally moving rapidly to follow the Chinese going full containment. It is the only sensible policy given the lack of any proven antiviral or vaccine. The virus and the pandemic are pretty much all I've talked about for the last month (BTW I am also sending out a piece today to update you on that view). The dynamics of the virus both a month ago and over the next few months are pretty clear if you understand the underlying math of empidemics. It's not rocket science with the math for modeling epidemics being pretty simple and yet very powerful in capturing the

historical course of most epidemic. Clearly, policy makers around the world have better experts than someone like me armed with the R statistical package and google to research the academic literature. Having said that, they have been slow to act but are acting now, both in terms of policy and stimulus. And that brings me too what I am most surprised about. The level of stimulus and focus by policy markets is pretty amazing. Merkel said that as much as 70% of the German population could become infected. So, she gets the magnitude of the virus. In addition, she said that Germany will deploy all of their considerable resources to insure the that no German worker will lose their job. That means deficit spending. Further, the EU has basically unleashed other countries to do the same. The ECB is going to be buying 750 billion of both government and corporate debt. Lagarde then said "Extraordinary time require extraordinary action. There are no limits to our commitment to the euro. We are determined to use the full potential of our tools." Basically, her "whatever it takes" moment. The US is bailing out the airlines and hotels, resorting to "helicopter" stimulus, giving people $1000 checks to the tune of 4 to 5% of GDP. The Fed dropped rates to zero, backed stopped the commercial paper market, and buying $700 billion of debt. And that is just the first round of stimulus. Yet, the equity markets in both areas of the world keeps falling. Wow. So….

What I Am Surprised About

In my last piece, I turned positive on equity risk. I thought there was an asymmetric profile is equites with upside from massive stimulus. Well, I got my massive stimulus in Europe and the US, both monetary and fiscal but the market reacted with another 15% sell-off. That surprised me. This sell-off blasted through my 5% downside stop after only a few days. So, I am asking the same question that you are probably asking is what is really happening?

Clearly there is something going on that I am not capturing that goes beyond the impact of the virus. That reminds me of the events of the Great Financial Crisis. At Goldman, we understood the credit default cycle of a mortgage, and more importantly what drove that cycle. So, once housing prices started to soften and then fall, it was pretty straightforward to model what was going to happened to defaults, and valuations of securities backed by those assets. So, during the course of 2007 through 2008 we were pretty confident in positioning. Then Lehman happened. That Lehman went under was the not real shock, we had just seen WAMU, then Merrill go through near-death experiences. However, what was a shock was that the event uncovered another factor that we had not really captured or fully understood and that was counterparty credit risk. And in my view, this is the factor that drove the GFC not subprime. Every financial firm was exposed to this risk, yet not every firm fully captured it in their risk system. The meltdown in the mortgage market would have created a recession but uncertainty about counterparty credit risk and viability of just about any financial institution turned it into a depression.

Using that as a backdrop, I am looking for factor that the virus is uncovering but I am not fully capturing in my strategies but is repricing markets just as it was in 2008. My guess is that it is similar to 2008 in that we are seeing a credit event but with enormous uncertainty about it. Here is how I think of it. The containment effort will substantially reduce revenue and income of households and companies over the

next few months. While revenue will fall, debt obligation payment will not. That is the credit event. Do households have enough cash to make the next two months of mortgage or auto payments? Do companies have enough cash to payoff short term loans or maturing debt? So, the key is how much money to households and companies have over the next few months to cover these payments. Some will and some wont, but you don't really know for sure, i.e. uncertainty. How much work has been done on identifying cashflows of a company or household over the span of a few months? The answer is not much. Analysist typically don't focus on a time frame of few month unless a company is already under stress. Consumer credit underwriting models also do not capture this risk either. So, the key question and uncertainty around that answer is how companies and households will default in the next few months?

Companies are taking action by drawing down credit lines from financial institutions. Policy makers are looking to give households cash right now to cover these short falls. However, the likely path is rising delinquencies on consumer credit, and episodic defaults by companies that run out of money. Banks will curtail lending to both sectors. This will create stress across sectors over the short- and long-run. For example, the cruise, airline, and hotel industry are basically closed down over the next few months. That is a short-term event. Stimulus measures are focused on providing the cash to offset their cashflow issues. However, what is the policy response other than a bailout if this becomes a long-term event if people are reluctant to go on a cruise, get on a flight, or check into a hotel room when the quarantine is lifted. What happens to cruise ship, airplane, or commercial builders? Short-term vs Long-Term

What To Do?

I am basically doing nothing right now, having only the two remaining trades. Volatility is one reason. But more importantly, I need to spend some time figuring out the next leg of the Corona virus trade. I still think the trades should be more risk on, just not sure how to put this on. I am also going to be putting out my update coronavirus deck latter today. BTW I, like many of you, am quarantining at home. So, I have plenty of free time to have conference calls.