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State of the Markets: Macro Commentary

Updates to My Strategy Views

Clearly, volatility across markets is increasing as are political risks. However, my fundamental economic framework and views using that framework remains pretty much the same.

- World growth, which seems to be accelerating, will continue even with the increasing degree of political risk and uncertainty
- The Fed will continue to unwind accommodative monetary policy at an accelerating pace by ramping up the sale of treasuries and adding one or two more rate hikes versus expectations, with the ECB and BOJ will follow suit at least in language sometime over the next 12 months
- Labor markets in the US, Japan, Europe will continue to tighten, driving up real wages, but will have limited impact on inflation
- US companies will start adjusting their capital structure in responses to corporate tax (nonfinancial) and Dodd/Frank reform (regional banks—Senate has passed S2155 and the House will make some changes to it but ultimately will pass a similar bill which Trump will sign)
- Mortgage reform is next up
- I think focus on inflation/unemployment (the Phillips curve) misses the point that rates are headed higher with or without inflation increasing. Inflation in advanced economies is being driven by demographics that, if anything, will be getting more powerful as their population ages
- Trump tax reform will do nothing about the slowing growth trajectory of the US economy and could make it even slower as tax reform pushes higher savers to buy debt not invest.

My strategies have changed to some degree:

1. **I am even more convinced that asymmetries to the upside in equities is now more sector specific than in broad indexes**
 - a. I took off by long S&P trade at the end of the year
 - b. The sell-off in February did not change my view given the surge in vol

2. **I am more convinced about interest rates going higher, both because of the Fed but also because of the impact of growing deficits in an expanding economy. Pressure on US rates could be substantial. *I will restructure the trade from the current 3mon/5yr 2.5% payer swaption (a 9 month old 1/5yr) back to 1/5yr with a 3% strike.***
 - a. Fed will likely increase the pace of rate hikes and sell 750 to \$1000 bill in the next 12-16 months as they unwind QE.
 - b. Tax reform could push US federal deficits to 5 to 6% of GDP, the highest level any economic expansion cycle since ww2.
 - c. Financial reform could push US banks to unwind their holding of risk free assets—US Treasuries
 - d. Trade war could push the Chinese to reduce their purchases of US treasuries.
 - e. US could see weaker dollar and higher rates—asset markets react as if the us is a 3rd world country

3. **I am more convinced on being long regional banks**
 - a. Senate has passed on a bipartisan basis DF reform for regional banks (S2155)
 - b. House has taken up the bill and is making changes but will pass a similar version and trump will sign
 - c. And given my views on rates, which benefits all banks

4. **I am less convinced on my HY CDS trade. *Accordingly, I will move from HY to IG CDS***
 - a. Increasing vol in rates likely to be a real headwind in the HY market
 - b. Domestic US corp will delever to optimize their capital structure in response to the cut in corporate tax rates and the cap on net interest expense
 - c. Likely move to IG CDS, given this sector has widened more on a percentage basis vs HY

5. **My view of the normalization in the EMU and buying European banks in unchanged even with the underperformance**
 - a. Italian election is over and as usual nothing has really changed
 - b. Merkel remains in power, so nothing changes in German economic or monetary policy

- c. Continual improvement in NPLs for southern European banks
- d. Likely agreement on Greek debt relief in the next 6 months
- e. ECB has started the path of normalization of monetary policy
- f. Certainly, one negative could be that Macron of France cannot implement “German” like reforms

Trades I am working on:

- **Finding more trades for my EV theme**
 - Find more longs in addition to my long copper, cobalt, lit and miners
 - Find cheap shorts to position for the real story of the transportation industry/commodities gets devastated by EV and Automated Vehicles
- **Developing a view on the dollar given the rising risk of a twin deficits**
 - Will the USD be viewed like a currency of a third world country?
- **Positioning for a normalization of monetary policy by Japan and Europe**
 - Timing is the issue

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