

SOM Macro Strategies

State of the Markets: Strategies for Trumpanomics

Trade 6 & 7: Position For Higher Rates and Stronger Dollar

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State of the Markets: Strategies for Trumpanomics

- ***Step 1: Macro Theme: Trumpanomics***
 - The goal of Trump's economic policy is to push real growth up to 3.5-4% and add 25 MM new jobs in the next 10-years
- ***Step 2: Fundamental Economic Framework***
 - Growth in the US is below historical norms because of slowing investment and productivity
 - Investment growth reflects in part the headwinds of US corporate tax policy and Dodd-Frank
 - Demographics and the impact of retiring baby boomers is a headwind to labor growth
 - Any policy must be massive to offset these hurricane force economic headwinds
- ***Step 3: Find Potential Catalyst***
 - If fully implemented, Trump economic policy would be massive enough to move the needle of economic growth
 - Corporate tax reform could push economic growth above 3% all by itself with relatively small increase in Federal debt
 - Dodd-Reform could push growth even higher by unleashing bank lending in housing and small businesses
 - Energy and infrastructure policy could add to this growth through a build out of US shale energy, particularly nat gas
- ***Step 4: Find Asymmetric Trade***
 - Trade 1; Buy US Equities
 - Trade 2: Buy US Regional Bank
 - Trade 3: Buy Mortgage Insurers
 - Trade 4: Buy Home Builders
 - Trade 5: Buy a Basket of Energy Infrastructure Equities
 - Trade 6: Higher Rates—Buy Payer Swaptions
 - Trade 7: Stronger Dollar—Buy Worst-of-Puts on Euro and Yen vs USD

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Step 3: Find Potential Catalyst

And That Force Could Be Trumpanomics

Massive tax reduction in combination with regulatory relief, trade reform, and lifting restrictions on American energy's

- ***Middle Class Tax relief and Simplification Act***
 - Number of personal income brackets reduce from seven to three, and with simplified tax forms
 - Corporate tax rate reduced from 35% to 15%
- ***Regulatory Reform***
 - Reduce the number of regulations
 - Reform Dodd-Frank
- ***End of Offshoring Act***
 - Seven point trade policy
 - Establishes tariffs to discourage companies from laying off workers in order to relocate in others countries and ship back to the US tax-free
- ***American Energy and Infrastructure Act***
 - Leverages public-private, and private investments through tax incentives, to spur \$1 trillion infrastructure investment over ten years
 - It is revenue neutral

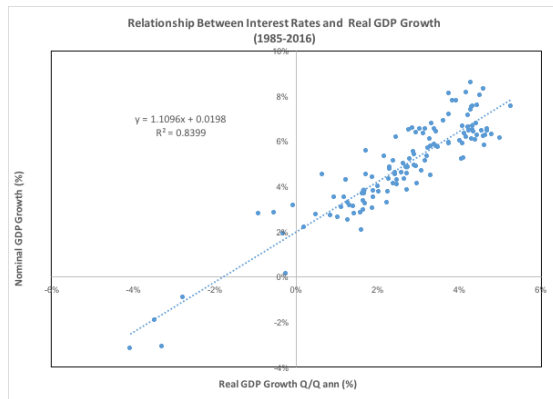
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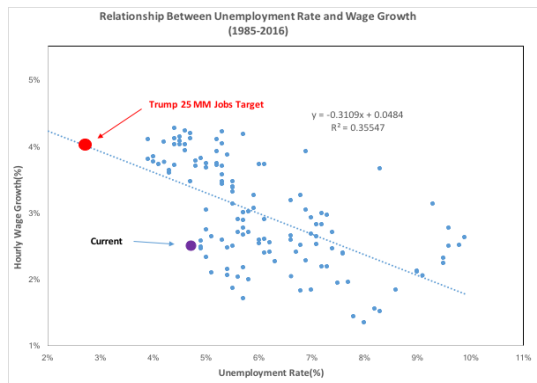
Step 3: Find Potential Catalyst

Trade 6: Higher Rates--Trumpanomics Leads To Higher Rates Through Real Growth and Inflation

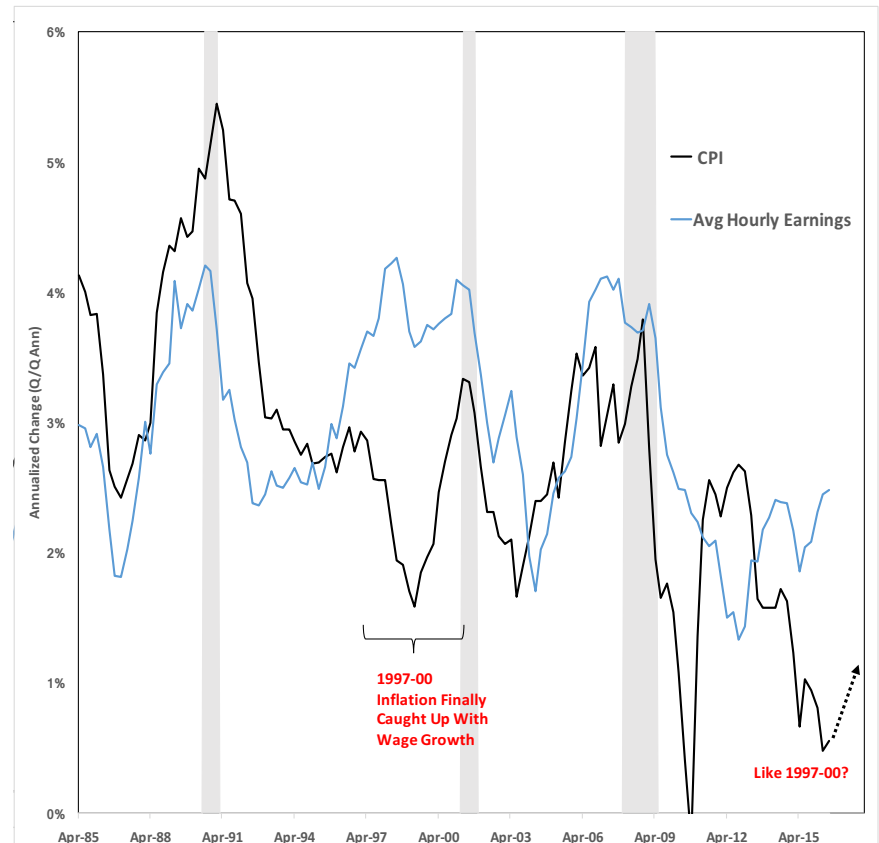
Historically Real GDP Leads To Higher Nominal GDP Growth ^{1,2}



Increasing Employment Will Lead To Wage Growth ^{1,2}



Inflation Could Rebound As Wage Growth Accelerates ¹



1. Federal reserve Bank of St. Louis, Access Through FRED
 2. Authors Calculation

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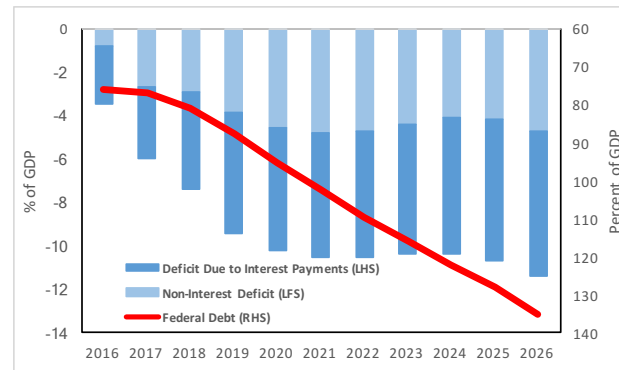
Step 4: Find Potential Catalyst

Trade 6: Higher Rates--Trumpanomics May Fail And Drive Rates Even Higher Due to Inflation

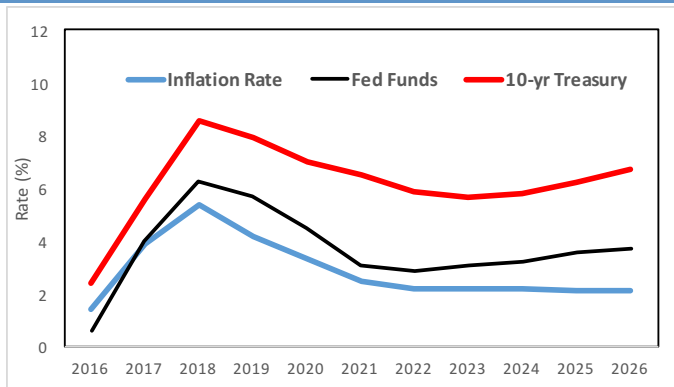
Some Argue that His Polices Will Fail And Push US Into Recession ^{1,2}

- Tax policies fail to deliver enough economic growth to offset loss of tax revenue
 - Potentially these policies could push down real GDP growth over time
- US deficits grow leading to higher funding rates for the Federal Government leading to even higher deficits and rates
- Policies unleash inflation, which also grow the deficit
- Fed raises rates to combat inflation pushing the economy into a recession

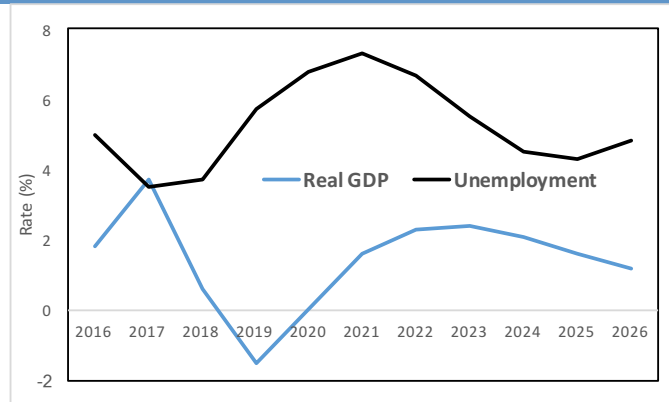
While Deficit and Debt Grow and The Fed Acts...¹



Trumpanomic Lead To Much Higher Inflation and Rates...¹



Pushing The Economy Into A Recession with Rising Unemployment ¹



1. Zandi, et al, "The Macroeconomic Consequences of Mr. Trump's Economic Polices", Moody' Analytics, June 2016
 2. Nunns, et al, "An Analysis of Donald Trump's Revised Tax Plan", Tax Policy Center, October 2016

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Step 4: Find Asymmetric Trade

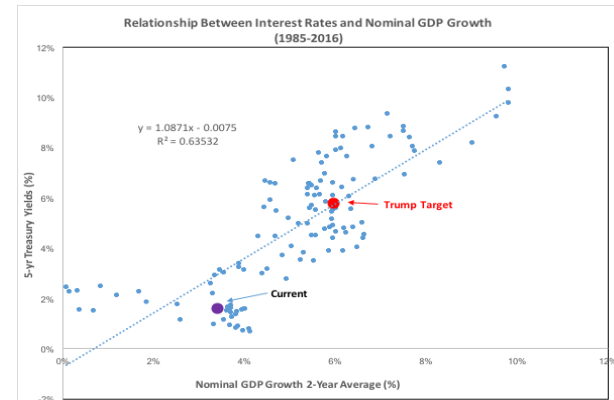
Trade 6: Higher Rates--Buy Out-of-The Money 1/10yr Payer Swaptions

Trade Thesis: All Paths Lead To Higher Rates

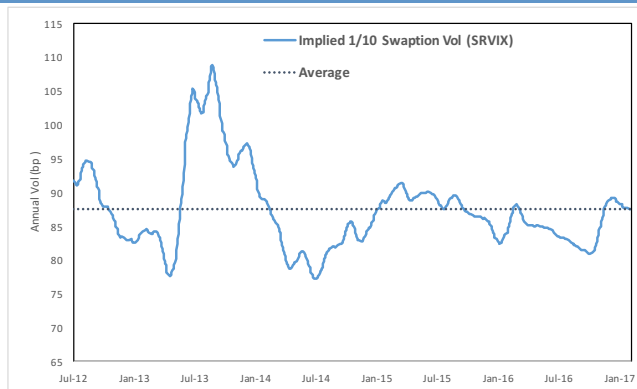
- Trump polices could work or fail and both paths lead to higher rates
- Payer Swaptions are compelling
 - Vol is reasonable vs history so it misprices the tail of significantly higher rates from Trumpanomics
 - Payouts could be north of 3 to 1
 - Trump policy will likely be implemented within the next year

Risk is that policies are too little and too late to offset cyclically slower GDP and lower Rates

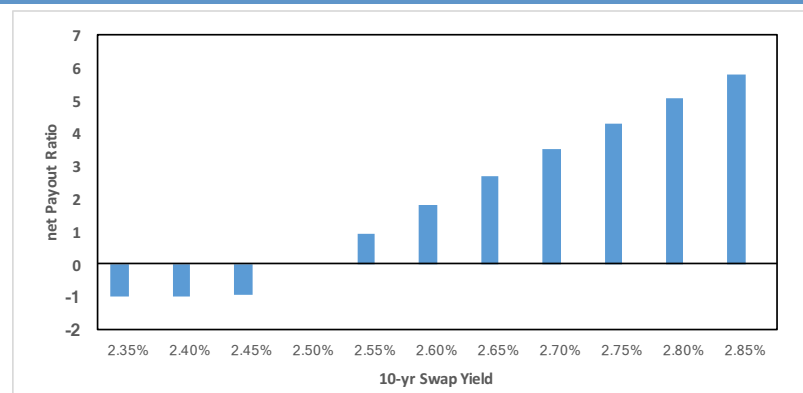
Nominal Growth Will Push Rates Higher ^{1,2}



Implied Volatility Not Rich By Historical Standards¹



Performance of 1/10 Swaption³



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

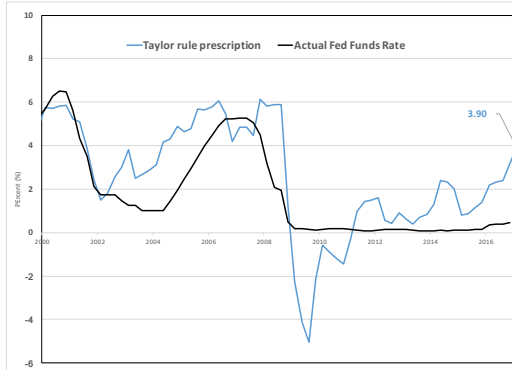
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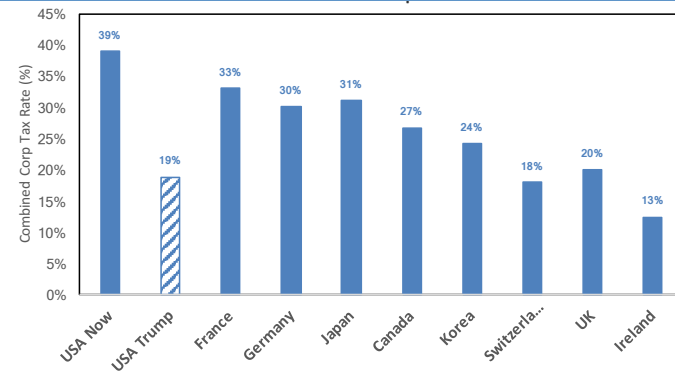
Step 4: Find Potential Catalyst

Trade 7: Stronger USD--Trumpanomics Could Strengthen The Dollar

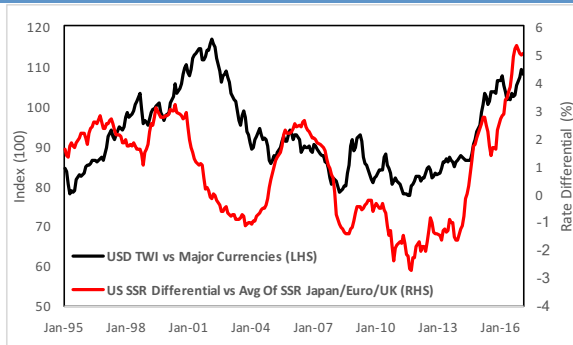
Fed Should Have Already Pushed Rates Higher Even Before Trump ¹



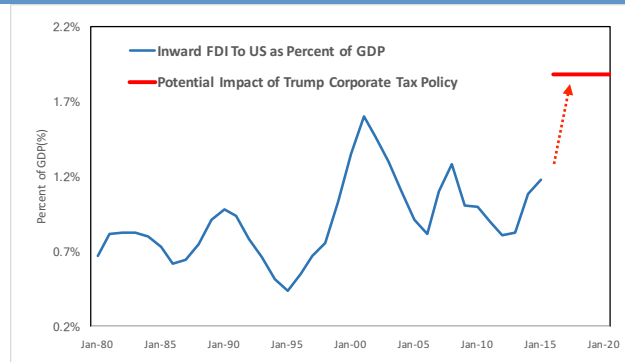
US Corporate Tax Rates Would Be Amongst the Lowest In the World ⁴



USD Could Strengthen From Rising US Interest Rates ^{2,3}



Trump Cut in Corporate Tax Could Create a Surge In FDI ^{3,5}



1. Atlanta Federal Reserve, Taylor Rule Utility Using FOMC Targets and CBO Unemployment Variable
2. Central Bank of New Zealand, SSR stands for shadow short rates, which adjust policy rates for the impact of QE and ZRP.
3. St. Louis Federal Reserve (FRED)
4. OECD Data Portal
5. Hufbauer and Lu, "Lessons for US Business Tax Reform from International Tax Rates", Policy Brief, Peterson Institute for International Economics, PB17.2, January 2017

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Step 4: Find Potential Catalyst

Trade 7: Stronger Dollar--Border Adjustment Taxation Could Lead to A Substantially Stronger Dollar

Push For Border Tax Driven By The Search For Tax Rev Not Trade ¹

- Border tax has the potential of raising as much as \$1 trillion of corporate tax revenue over the next 10-years without affecting consumers or trade
- Simple to implement
 - Expense of buying foreign inputs cannot be deducted against revenue
 - Revenue from exports is not taxed
- The USD would strengthened to offset completely the impact on exporters and importers
 - 20% tax rate would imply a 25% appreciation of the USD

USD Would Need To Appreciate to Offset Impact on Trade

- Historically, implementation of a border type taxes has resulted in a FX appreciation
- Forces that created stronger USD
 - Domestic demand for imports falls as tax cost passed to us consumers. USD appreciates as supply of dollars available externally falls.
 - Foreign demand for US exports increases reflecting the lower tax. USD appreciates as demand for dollars
 - USD appreciates until after tax profits for both importers and exporters return to pretax period turning off the cost driven repricing of exports/ imports

This Tax Could Have Added Almost \$1 Trillion to Corp Tax Revenue ²

	2006	2012	2004-13
Income Tax Base	1,079	1,031	9,320
Remove Exports	(234)	(321)	(2,600)
Add Imports	640	869	7,212
Border Adjusted Tax Base	1,485	1,579	13,932
Larger Tax Base From Border Adjustment	406	548	4,612
Additional Corporate Tax Revenue @ 20%	81	110	922

Example Of the Impact of The Border Tax on the USD ³

Category	Without Border Tax Adjustment		With Border Tax Adjustment		With Border Tax Adjustment After 25% Dollar Appreciation	
	Importer	Exporter	Importer	Exporter	Importer	Exporter
Revenue	100	100	100	100	100	80
Expenses	60	60	60	60	48	60
Net Income	40	40	40	40	52	20
Revenue for Tax Calculation	100	100	100	0	100	0
Expense for Tax Calculation	60	60	0	60	0	60
Net income for Tax Calculation	40	40	100	-60	100	-60
Corporate Taxes at 20%	8	8	20	-12	20	-12
After Tax Income	32	32	20	52	32	32

1. Pomerleau, "Details and Analysis of the 2016 House Republican Tax Reform Plan", Tax Foundation, July 2016
 2. Patel, McClelland, "What Would a Cash Flow Tax Look Like for US Companies. Lessons from a Historical Panel", Working Paper 116, Office of Tax Analysis, Dept of Treasury, January 2017
 3. Pomerleau, "Exchange Rates and The Border Adjustment", Tax Foundation, January 2017

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Step 4: Find Asymmetric Trade

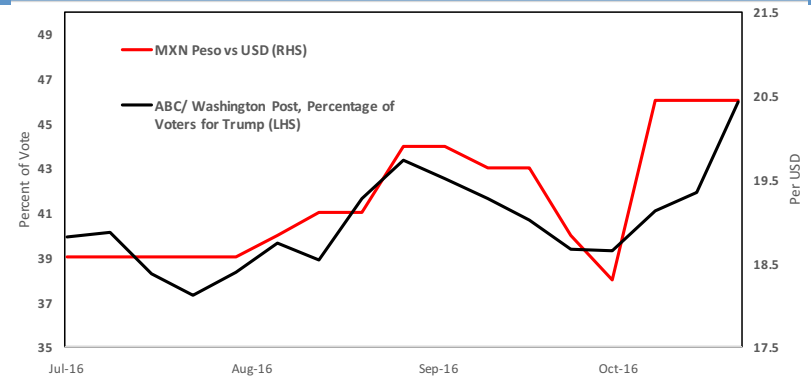
Trade 7: Stronger Dollar--Buy Worst-of-Puts With Yen and Euro vs USD

Trade Thesis: Trumpanomics Drives USD Stronger

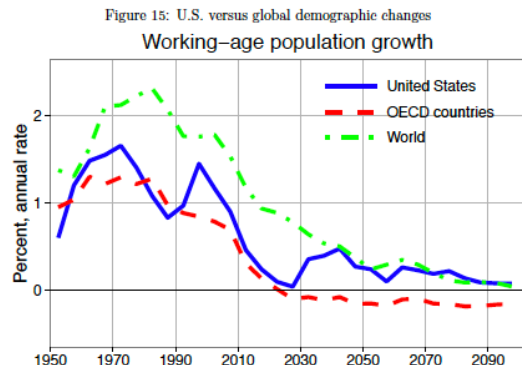
- Foreign Capital flows into the US
 - Investment opportunities grow
 - Relative interest rate differentials widen
- Border tax pushes the USD higher to offset impact of the tax
- Worst of Euro and Yen puts vs the USD is attractive because correlation is less than one
 - Euro and Yen should both be highly correlated under Trumpanomics

Risk is that Trump could want a weaker USD to boost US exports

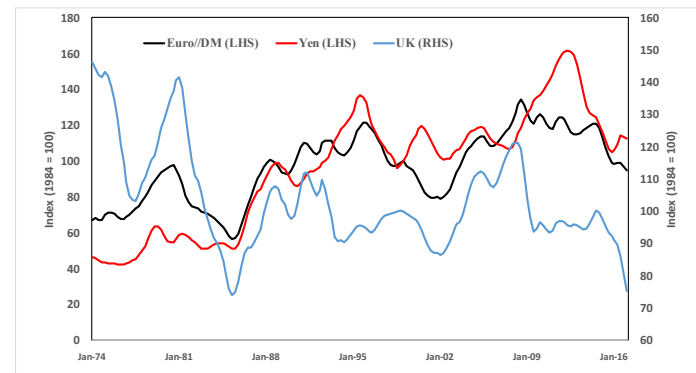
USD Could Strengthen Rapidly In The Event of A Border Tax ^{2,3}



Demographics Are Worse In Japan/Euro With No Trump ¹



The Euro/Yen Could Follow The GBP Back to Their Lows Vs USD ²



1. Gagnon, Johannsen, Lopez-Salido, "Understanding the New Normal", Federal Reserve Working Paper, 2016-080
 2. St. Louis Federal Reserve (FRED)
 3. Washington Post

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