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State of the Markets: Strategies for Trumpanomics

Trade 2-4: Buy Regional Banks and Housing Related Equities

Alan Brazil

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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

1. https://assets.donaldjtrump.com/_landings/contract/O-TRU-102316-Contractv02.pdf

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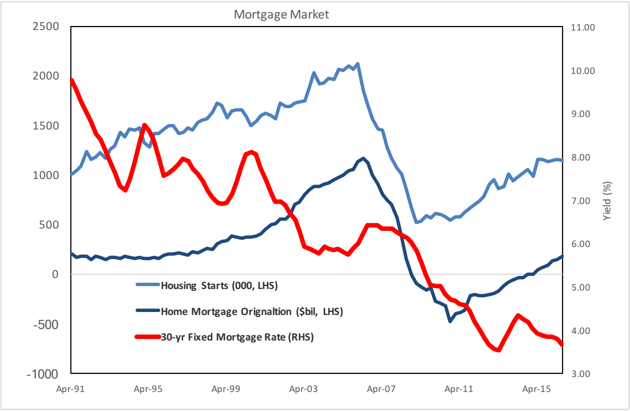
Step 3: Find Potential Catalyst

Trade 2: Buy Regional Banks— Reforms Could Reverse Lending and Investment Slowdown

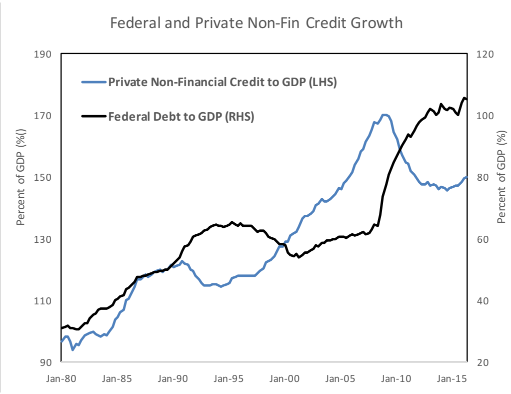
Financial Reform

- Reform Dodd/Frank
  - Reform the Financial Stability Oversight Council (FSOC)
  - Reform Systematically Important Financial Institution (SIFI)
    - Would the failure of a regional bank pose a systemic risk to the the US economy?
  - Reform the Consumer Financial Protection Board (FCPB)
  - Change the penalties for a non-qualified mortgages
- GSE reform, FHA/VA Reform

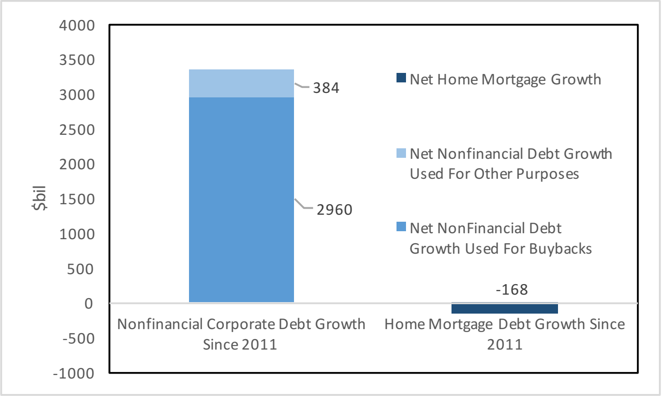
Housing Investment Low Even With Low Rates [1]



Reform Necessary To Spur Lending For Investment [1]



Corporations Are Buying Back Stock Not Investing [2]



1. Data Access Through Fred, Federal Reserve Bank of St. Louis
2. Board of Governors of The Federal Reserve, Flow of Funds Report

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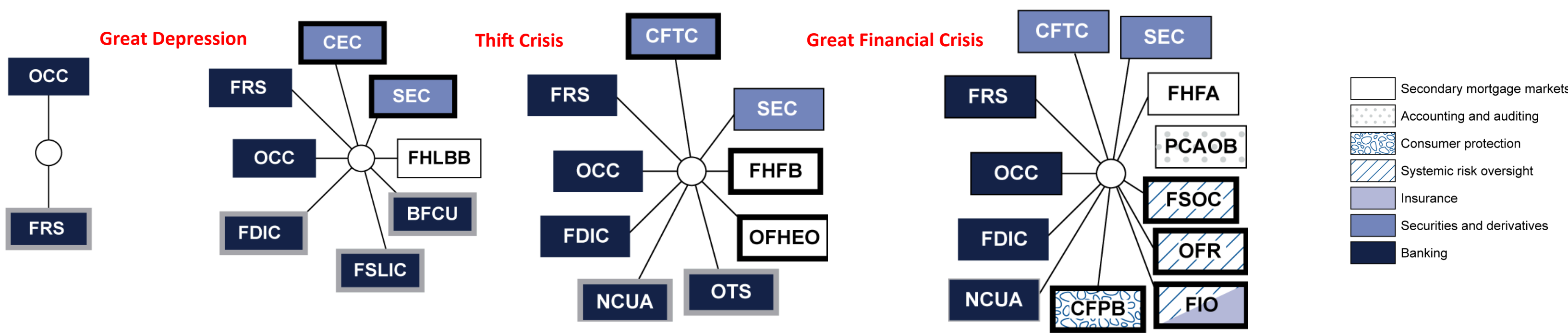
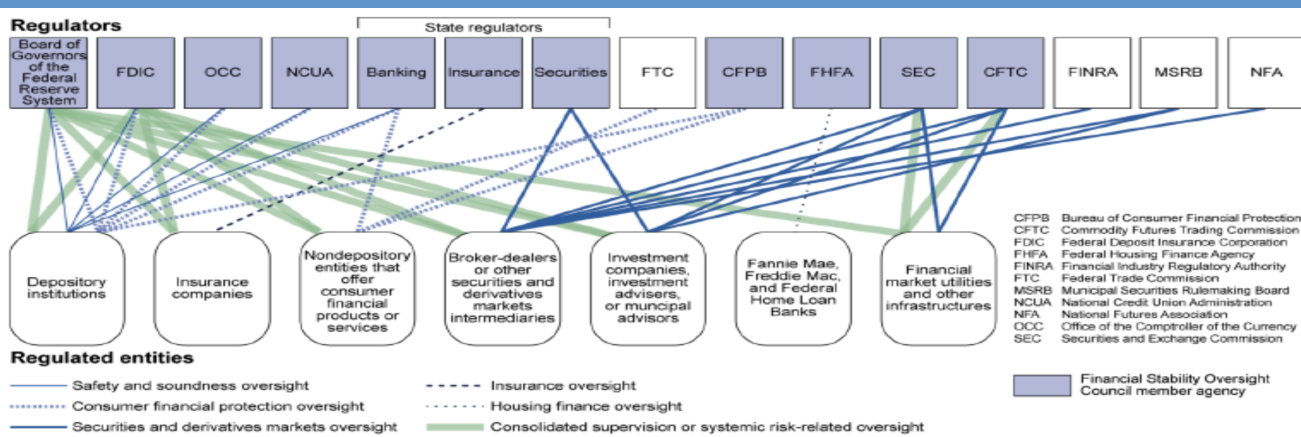
Step 3: Find Potential Catalyst

Trade 2: Buy Regional Banks--Dodd-Frank Has Created Regulatory Headwinds To Credit Growth[1]

Every Crisis Creates More Regulatory Bodies Fighting the Last Crisis Not The Potential New Ones



In the Current Iteration of "Reform" All Regulators Seem to Be Regulating Every Institution



Source: GAO. | GAO-16-175

1. GAO Report, "Complex and Fragmented Structure Could Be Streamlined to Improve Effectiveness" GAO-16-175, Feb 2016

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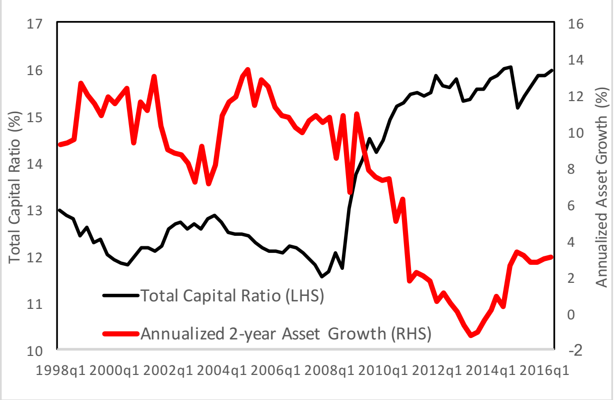
Step 3: Find Potential Catalyst

Trade 2: Buy Regional Banks--Dodd-Frank Has Pushed Banks To Grow Capital Not Assets

Severely Adverse Scenario Is Driving the Derisking of Banks

- Banks with 10+ balance sheet are covered
  - DFAST is the stress testing (75 + Banks)
    - Banks with $10 – 50 billion balance sheet added in 2016
  - CCAR covers the capital plan (33 bank holding companies)
- Main stress comes from the Severely Adverse scenario (SAS)
  - Deep Recession
  - Sharp rise in credit spreads and market volatility
  - Trading positions at largest banks subject to severe global market shock
  - Default of largest counterparty at 8 large BHC after global market shock
- Binding constraint is tier 1 capital in SAS > 4.5%
  - $490 billion in projected losses in 2015

Banks Responded By Raising Capital And Slowing Growth [2]



The Severely Adverse Scenario For CCAR Is Too Severe [1]

Projected Scenario Losses

Loan Type	Model Based	Federal Reserve	Ratio
Prime Residential 1st Liens	3.7	6.6	178.4
HELOCs	7.7	9.1	118.2
Commercial and Industrial	4.0	6.9	172.5
Commerical Real Estate	4.4	8.2	186.4
Credit Cards	15.0	16.8	112.0
Other Consumer	5.8	6.9	119.0

The Result is Safer Banks But Lower Risk Appetite [3]

Loan type	2013	2014	2015	2016
Total loan losses	7.5	6.9	6.1	6.1
First-lein mortgages	6.6	5.7	3.6	3.2
Junior liens and HELOC	9.6	9.6	8.	8.1
C&I	6.8	5.4	5.4	6.3
CRE	8.	8.4	8.6	7.0
Credit cards	16.7	15.2	13.1	13.4
Other comsumer	6.1	6.	5.8	5.7
Other loans	1.8	2.7	2.9	3.4

1. Moody's Analytics: Stress testing and Capital Planning", April 9, 2013
2. FDIC Data
3. EY, 2013-16 CCAR/DFAST results

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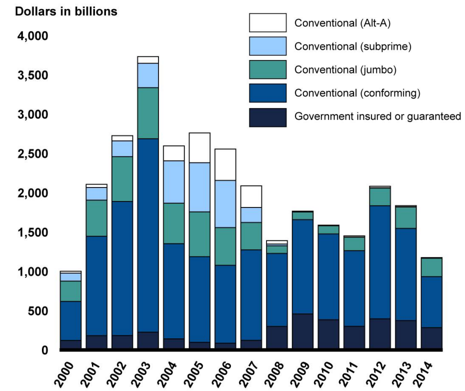
Step 3: Find Potential Catalyst

Trade 2: Buy Regional Banks--DF Has Lead To a Slowdown in Non-Prime Mortgage Lending

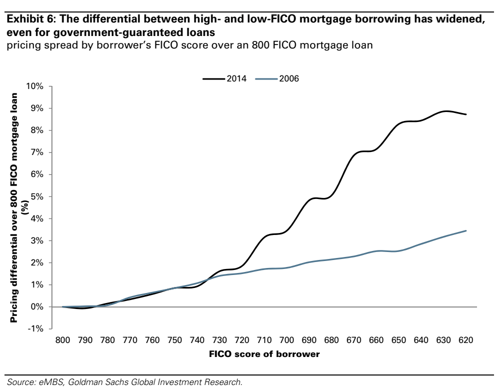
Lenders Are Only Lending To Prime Borrowers Given Legal Risk

- Qualified Mortgage (QM)
  - DTI < 43% or underwritten by FHA or purchased by GSE
  - Safe Harbor against borrower/regulator lawsuits
- Non-Qualified Mortgage
  - DTI > 43%, 5% risk retention for securitization
  - No safe harbor
    - **Defaulting borrower can sue lender for not knowing they could not payback their mortgage, and the lender pays expenses if borrower wins**

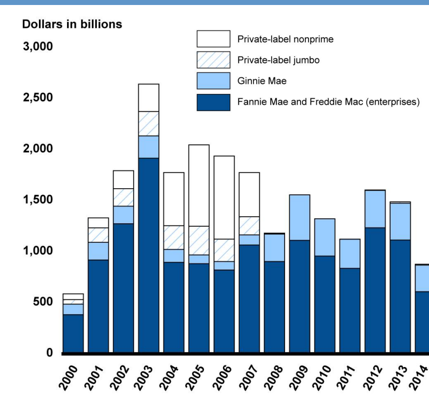
Non-Prime Mortgages Lending Has Stopped [2]



Prohibited Cost of Non-Prime Mortgages Has Slowed Lending [1]



Non-Prime Securitization Has Stopped [2]



1. Goldman Sachs, Global Market Instituted, " Who pays for bank regulation?". June 2014
2. GAO, "Mortgage Reforms: Actions Needed to Help Asses effects of New Regulations", GAO 15-185, June 2015

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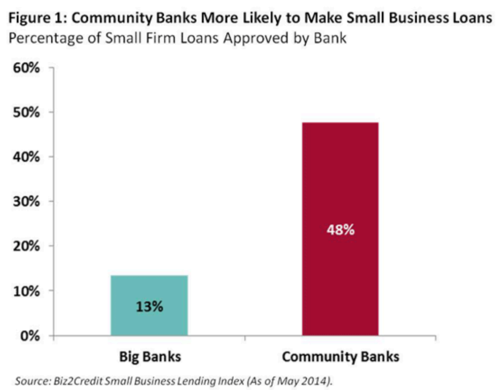
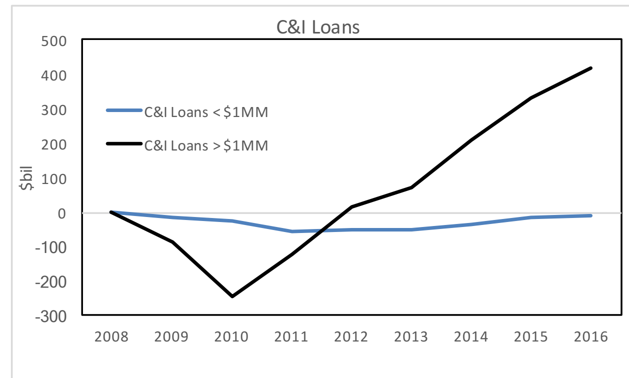
Trade 2: Buy Regional Banks—DF Has Lead to a Slowdown in Small Business Lending By Banks

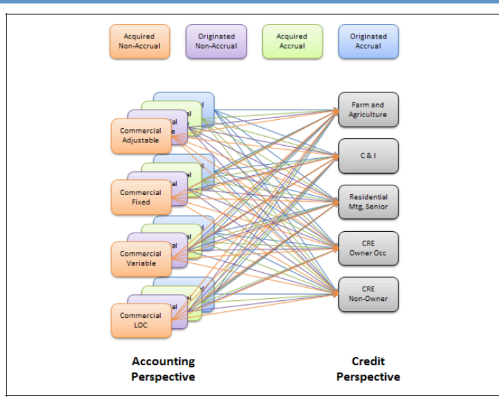
Community Banks Are Crucial For Small Loans [1]



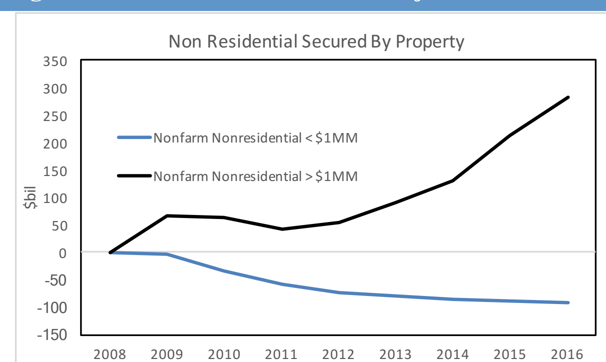
As Result Small Business Lending Has Flatlined [3]



Regulatory Burden of DFAST/CCAR For Mid-sized Banks [2]



Also Lending For Small Fixed Investment Projects [3]



1. Mills, McCarthy, " The State of Small Business Lending" Harvard Business Scholl Working Paper, July 2014
2. Faenza, "DFAST and CCAR: One size does not fit all" FNB Corporation Report , 2014
3. FDIC

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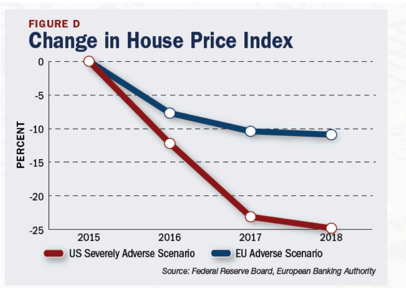
Step 3: Find Potential Catalyst

Trade 2: Buy Regional Banks--Dodd-Frank Has Put US Banks At a Disadvantage to European Banks [1]

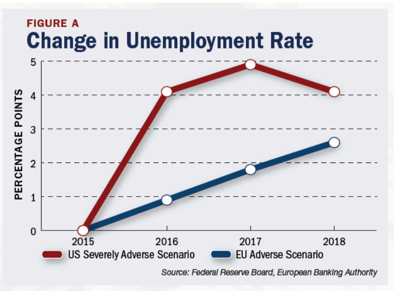
US CCAR Severely Adverse Scenarios More Severe European Stress

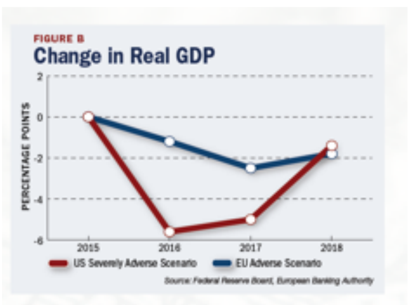
- The European bank stress tests are less onerous than the Feds CCAR/DFAST
- Using CCAR/DFAST on European banks shows a substantial need for capital
  - European banks would need $134 billion of addition capital vs US banks
  - Or US banks have too much capital
- More difficult for US banks To Compete

Comparison of Market Prices in SAS vs Europe [1]

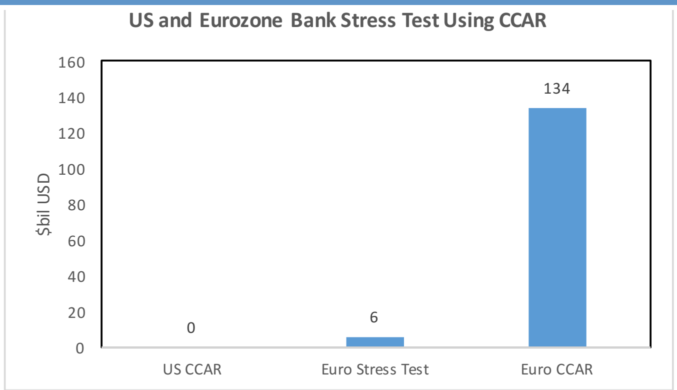


Comparison of Real Economic Shocks in SAS vs Europe





European Banks Need To Hold Less Capital [1]



1. . The Clearing House, Comparison Between US and European Union Stress Tests, May 2016

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Step 4: Find Asymmetric Trades

Trade 2: Buy Regional Banks—Trumpanomics Increases Regional Bank ROEs

Regulatory Reform Could Push Up Regional Bank Prices

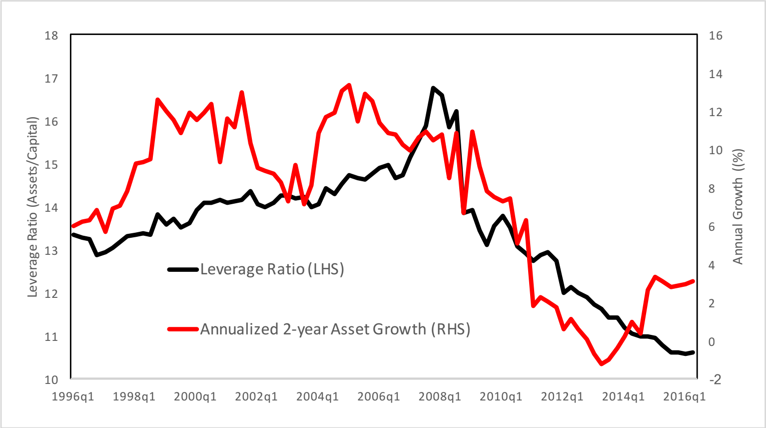
- DF reform could would help all banks but may focus on non-big 7
  - The criteria of "TBTF" does not seem to apply to regional banks
  - Reform could be either reduce the severity of the extreme scenarios or remove them from DFAST
- Trumpanomics increases earnings of banks
  - Lower tax rates would benefit domestic banks since they pay the full statutory rate
  - Banks could increase lending to riskier but higher margin borrowers
- Upside thesis is that banks price to tangible book would go up as banks used the reduction in regulation and lower taxes to increase their ROE
  - Extra capital that could be used to grow assets, particularly higher spread but riskier loans

Risk is that reform does not happen

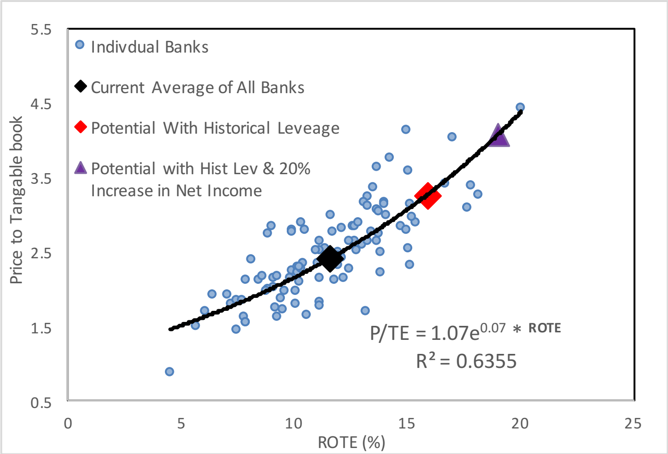
Reduction of Capital Needs From Loser Regulatory

- Return on Tangible Capital a prime driver of bank pricing
- Last year is an example of this pricing
  - Data covers 113 banks that are not G-SIB
  - Exponential regressions illustrates the relationship between ROTE, and Price to tangible book (PTB)
  - Historical leverage is based on data from 2000-2005
- As shown below, banks could rally substantially from current levels
  - Another 35% from current levels if leverage went back to historical norms
  - Another 60% if leverage went back to historical norms and net income grew by 20%

Asset Growth Has Slowed As Bank Leverage Has Fallen [1]



Banks Could Rally If Reforms Allows More Leverage And Risk [2]



1. FDIC
2. Yahoo Finance

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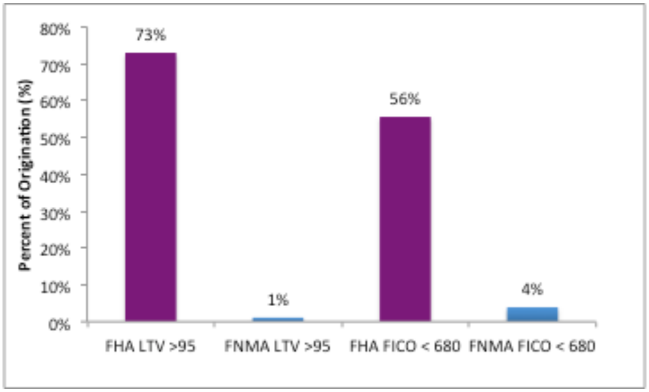
Step 3: Find Potential Catalyst

Trade 3: Buy Mortgage Insures—GSEs/FHA/VA Represent A Bigger Risk to The Public Than US Banks

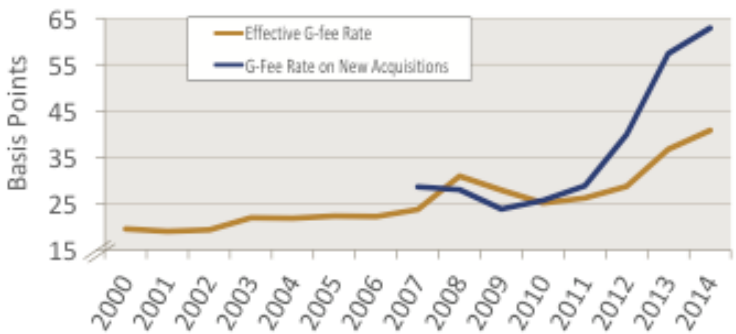
GSEs In An Severely Adverse Scenario Would Need A Fed Bailout [1]

Category	Results
Revenue 2016-18	30.2
Credit loss/provisions	-66.2
Mark-to-market	-11.0
Global market shock/counterparty	-24.6
Reestablishing Value adjustment	-55.9
Scenario loss	-127.5
Current capital	1.7
Treasury funding draw	125.8

FHA/VA Has Even Greater Exposure to The Same Scenario [2,3]



This Scenario Risk Has Already Driven Up Guarantee Fees [2]



Actual Credit Losses Would Be 4 Times The Loss of The GSEs [4,5]

Current FHA Balance ($bil)	1500
2007 vintage default	25%
Loss serverity	50%
Hypothetical Loss	-188
FHA CCAR Actual Credit Losses	-115
GSE CCAR Actual Credit Losses	-27

1. OIG of the FHFA, " GSE Dodd-Frank Act Stress Tests Severely Adverse Scenario", Aug 2016
2. OIG of the FHFA, " The Continued Profitability of Fannie Mae and Freddie Mac is Not Accrued", Report, March 2015
3. FHA Annual Report to Congress, 2016
4. Committee on Oversight and Government Reform May 2013
5. FHA Single Family Loan Performance Trends, 2016

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Step 4: Find Asymmetric Trades

Trade 3: Buy Mortgage Insurers— Public Sector Mortgage Risk is Transferred to The Private Sector

Financial Reform And Mortgage Insurers

- Financial reform could involve pushing the substantial amount of public sector mortgage risk into the private sector
  - GSEs and FHA/VA have more risk to the severely adverse scenario than large banks
- Reform could restart the private mortgage securitization market, both prime and non-prime
- Mortgage insurers would benefit substantially from both

Risk is no GSE reform

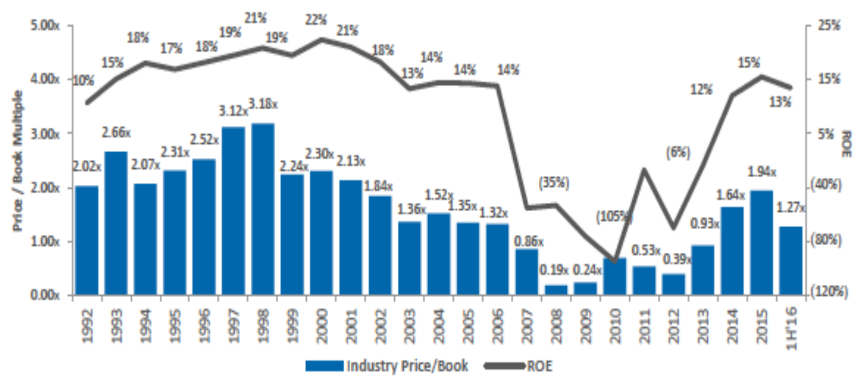
Privatizing Some of The Risk of FHA/VA

- 400 to 500 billion year of high LTV lending with low FICOs
- FHA/VA do not incorporate MI
- Expansion to MI could mitigate the $115 billion adverse scenario risk

Privatizing GSE Risk [1]

- Pushing more of the GSE guarantee business to private sector
  - Deep Coverage: GSE would need to cover all high LTV loans to 50%
  - Deep coverage would increase private MI fees by 27%, but reduce borrower total fees by 18%
  - Deep coverage would transfer 75% of losses in the DFAST adverse severity scenarios
- Closing down of the GSE's opens up the pool insurance market for prime mortgages
  - 80% or lower LTV is x% of GSE market
  - Fees are … a year
  - Securitization would replace GSE guarantee with subornation or MI pool insurance

MI Are Cheap Vs History And If Financial Reform Happens [2]



1. Bjurstrom, et all ' Analysis of Deep Coverage Mortgage Insurance", Milliman Client Report, October 2015
2. Shuster, "Intro to National MI", NMI Holdings Investor Day, 2016

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Step 4: Find Asymmetric Trades

Trade 4: Buy Home Builders---Reforms Could Spur a Surge In For-Sale Home Construction

Dodd-Frank and Mortgage Reform Could Spur A Housing Boom

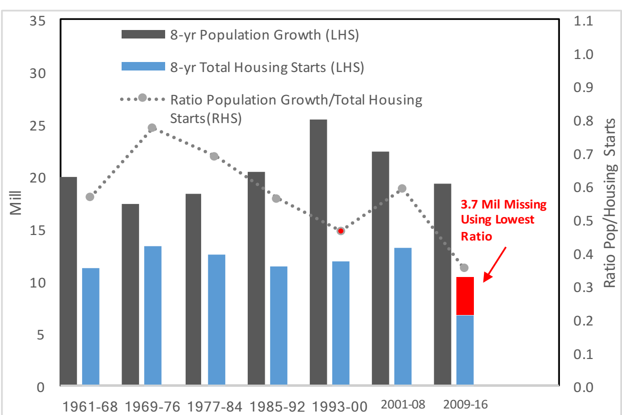
- Financial Regulatory Reform could open up non-prime lending
  - Non-prime lending has dried up given Dodd-Frank
  - Non-prime borrows one reason housing starts are so low vs historical norms
  - These borrowers have been going to for rent vs for sale
- For sale housing could surge if these non-prime borrowers get access to credit
  - There is already a deficit of 3.7 million new homes that need to be built
- Home builders have substantial convexity to the upside in this scenario

Risk is that structural issues are driving lower housing starts

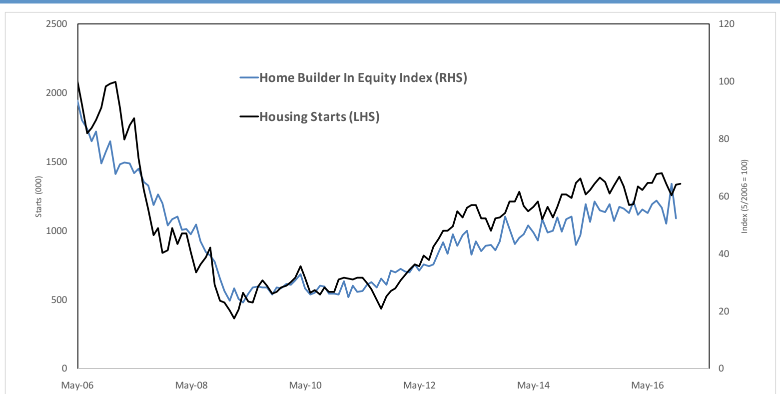
Starts Are Low As Non-Prime Borrowers Cannot Get Loans [2]

FICO	Missing Purchase Loans Given Underwriting Standards of 2001 2012	2013	2014	Total Missing 2012-2014	Market Value of Missing Home Purch ($bil)
660 and below	592,691	876,223	1,007,062	2,475,976	$681
660-720	607,851	369,007	191,791	1,168,649	$321
720 and above	-	-	-	-	$0
Total	**1,200,542**	**1,245,230**	**1,198,853**	**3,644,625**	**$1,002**

Home Building Is Low Given Population Growth [1,2]



Builders Upside If Reforms Start Up The Non-Prime Market [1,4]



1. Data Access Through Fred, Federal Reserve Bank of St. Louis
2. Authors calculation
3. Bai, Goodman, Zhu, "Tight credit standards prevent 5.2 million mortgages between 2009 and 2014", Urban Institute, Urban Wire, Jan 2016
4. Yahoo Finance

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