

# ***SOM** Macro Strategies*

## Trade Book: Model Portfolio Performance and Recommended Trades

Alan Brazil

September 2018 Month End

# *SOM Macro Strategies*

## Trade Book: Model Portfolio Performance and Recommended Trades

### Update on Performance, and the Portfolio

#### Historical Performance As of September 28, 2018

| Positions | Number<br>Trades | Investment (MM) |                | Cumulative Total<br>Return (%) |               |
|-----------|------------------|-----------------|----------------|--------------------------------|---------------|
|           |                  | Initial         | End of<br>Sept | End of<br>Sept                 | Last<br>Month |
| Open      | 6                | 30              | 30             | -0.4%                          | 13.0%         |
| Closed    | 21               | 105             | 285            | 171.2%                         | 176.0%        |
| Total     | 27               | 135             | 315            | 133.1%                         | 138.5%        |

#### Commentary

- Model portfolio had a tough month
  - EM, particularly Brazil bounced back
  - The Euro strengthened a bit
  - The performance of the higher rates trade offset some of these, leaving the c TROR to zero on the current 6 recommend trades
- I only did one trade over the month with Restriking the October 7300 put on Brazil equities to 6800 with a December expiry
- I addition, I moved my EV trade into a new section on prospective Macro themes but without near term repricing events
  - This is where the EV should have been all along
  - Going forward, I will use this section to highlight potential macro themes that are interesting but not yet ready for prime time

# *SOM Macro Strategies*

## Trade Book: Model Portfolio Performance and Recommended Trades

### Update of Current Recommended Trades As Of September 28, 2018

#### Step 4: Find Asymmetric Trades

| Trade                                       | Date      | Initial Position |       |           |                 | Current Valuation ( 9/28/18) |                 |              |
|---|-----------|------------------|-------|-----------|-----------------|------------------------------|-----------------|--------------|
|   |           | MM/Shares        | Price | Face (MM) | Investment (MM) | Price                        | Investment (MM) | Total Return |
| Buy December 2018 7% OTM Put on EM Equites  | 28-Jun-18 | 295              | 1.7   | 5.0       | 5.0             | 1.5                          | 4.4             | -12%         |
| Buy Bovepa 10% OTM puts for Dec             | 13-Sep-18 | 13513            | 370.0 | 5.0       | 5.0             | 157.0                        | 2.1             | -58%         |
| Sell CNH One Year Forward vs USD            | 25-Jul-18 | 100              | 100.0 | 100.0     | 5.0             | 103.5                        | 8.5             | 70%          |
| Buy Dec Euro Puts/Dollar Calls, 1.13 strike | 29-May-18 | 454              | 1.10  | 5.0       | 5.0             | 0.7                          | 3.2             | -36%         |
| Short AAA CMBX/Buy Protection on IG         | 25-Jul-18 | -250             | 100.0 | 250.0     | 5.0             | 100.0                        | 5.0             | 0%           |
| 1/5 Payer Swaption 3% Strike                | 22-Mar-18 | 556              | 0.9   | 5.0       | 5.0             | 1.2                          | 6.7             | 33%          |

# SOM Macro Strategies

## Trade Book: Model Portfolio Performance and Recommended Trades

### Closed Recommended Trades As of September 28, 2018

#### Step 4: Find Asymmetric Trades

| SOM Strategy  | Trade   | Date             | Initial Position   |              |                 |            | Closed Valuation/Performance |              |                    |                 |
|---|---|------------------|--------------------|--------------|-----------------|------------|------------------------------|--------------|--------------------|-----------------|
|   |   |                  | MM/<br>Shares(000) | Price        | Investment (MM) |            | Date                         | Price        | Investment<br>(MM) | Total<br>Return |
|   |   |                  |                    |              | Face<br>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%             |
| Credit is Not a Bubble                                    | Short 5-yr IG CDS at 66 bp                                | 22-Mar-18        | -333               | 66 bp        | 333             | 5          | 25-Jul-18                    | 59 bp        | 6.90               | 38%             |
| 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 Equities               | 11-Apr-18        | 285                | 1.75         | 5               | 5          | 28-Jun-18                    | 3.75         | 10.7               | 114%            |
| Stronger Dollar Part II---Position For A Weaker EM        | Buy USD, Sell A Basket of EM Commodity FX (BRL, RUB, ZAR) | 11-Apr-18        | 100                | 100.0        | 100.0           | 5.0        | 12-Jul-18                    | 110.5        | 15.50              | 210%            |
| <b>Stronger Dollar Part II---Position For A Weaker EM</b> | <b>Buy Bovepa 10% OTM puts for October</b>                | <b>25-Jul-18</b> | <b>13513</b>       | <b>370.0</b> | <b>5.0</b>      | <b>5.0</b> | <b>13-Sep-18</b>             | <b>800.0</b> | <b>10.8</b>        | <b>116%</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 normalize 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 Repricing Events***
  - 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

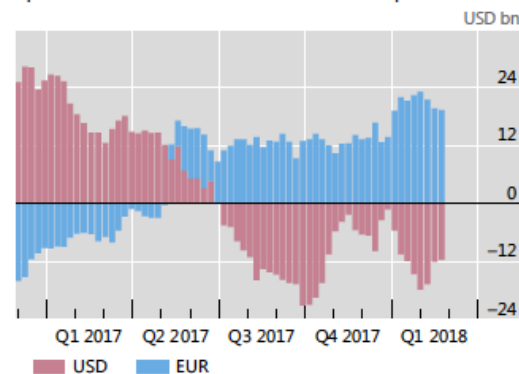
##### Trade Thesis

- 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

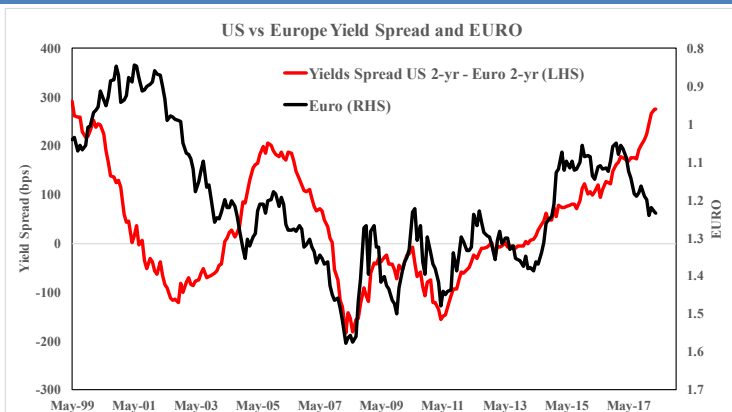
**Risk is continue weakening of USD**

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

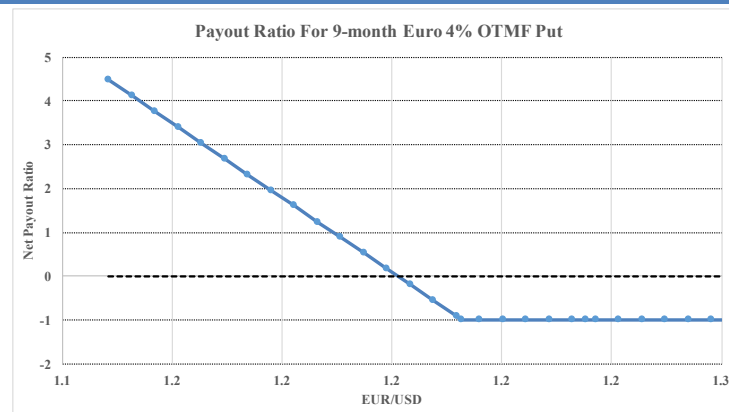
Speculative US dollar and euro net futures positions



##### 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

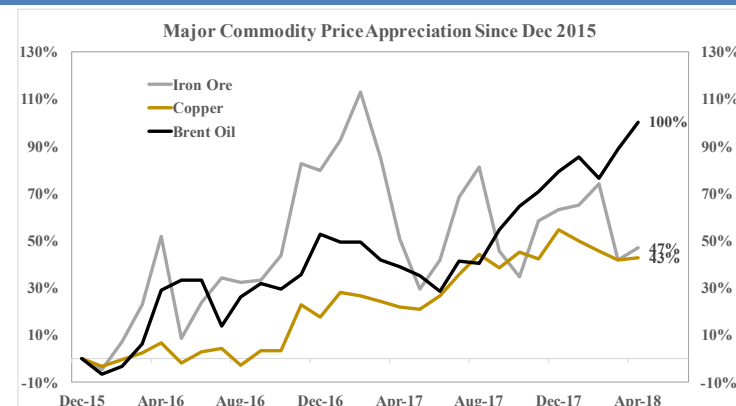
### Step 4: Find Asymmetric Trades

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

#### Trade Thesis

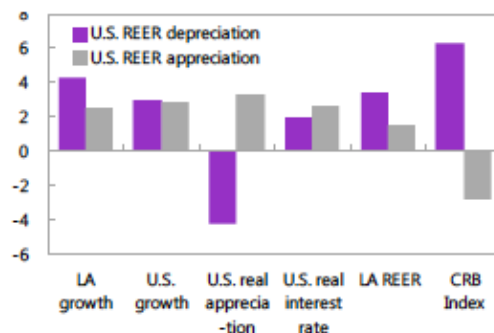
- USD could strengthen
  - The dollar could strengthen as the Fed could continue to raise rates and unwind QE as the US economy continues to grow
  - Capital flows into the US spurred by tax reform could also strengthen the dollar result is a strengthening of the USD
- EM commodity country FX could weaken 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>

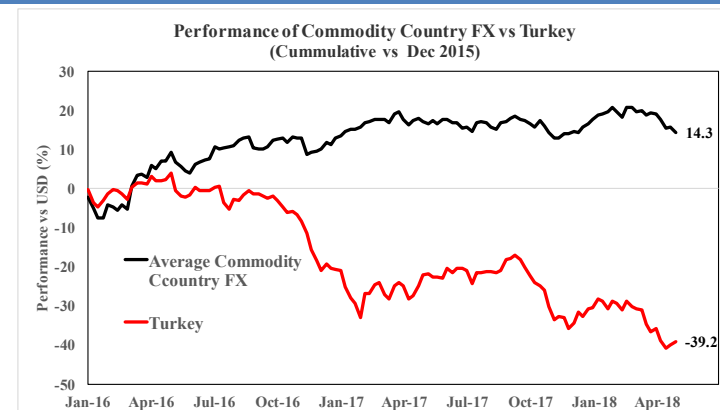


#### Dollar Highly Correlated With Commodities and EM<sup>1</sup>

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

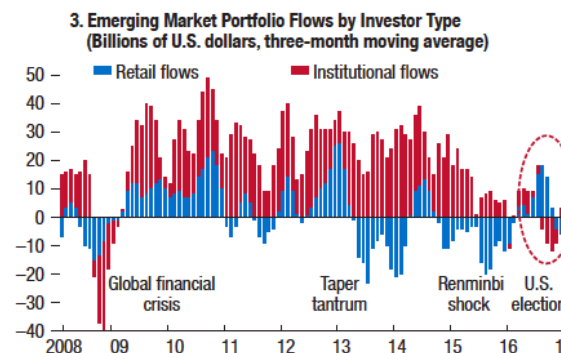
### Step 4: Find Asymmetric Trades

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

#### Trade Thesis

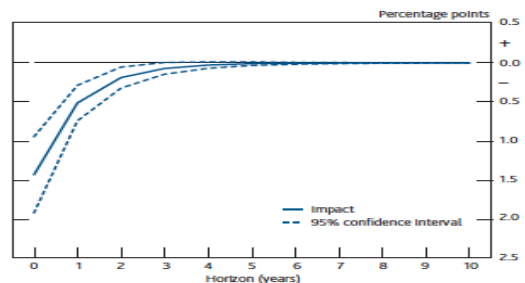
- Dollar strength could slow economic growth and that could reverse the recent rally in EM equities
  - Stronger dollar and higher borrowing cost could push cost of external capital substantially higher
  - Slowing domestic credit growth as banks scale back lending as NPLs rise
  - Domestic income growth 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 Created Outflow By Retail<sup>2</sup>



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

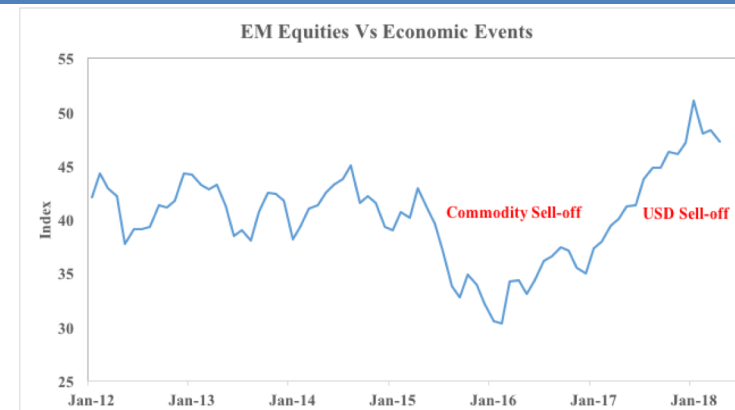
Summary chart Average real GDP growth reaction in emerging market economies to a 10% US dollar appreciation<sup>(a)</sup>



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: Position For A Weaker EM—Shorting Brazil

- ***Step 1: Macro Theme: Position For A Weaker EM--Shorting Brazil***
  - The Brazil economy looks to be softening, with the election looming
  - Brazil asset are starting to price in a return of stress and recession but is there more repricing to come?
- ***Step 2: Fundamental Economic Framework***
  - The USD strength and rising US rates have started to be reflected in the Brazil real economy
  - That headwind to growth has revealed a Brazil economy with substantial vulnerabilities
    - Low savings and investment rates
    - Dependency on external capital
    - Falling capital investment and inadequate investment in infrastructure
    - Poor labor quality but with rising demand for jobs
    - Rising government debt loads
    - Rising pressure from pension spending
- ***Step 3: Find Potential Repricing Events***
  - The USD could strengthen further, while the Fed raises rates higher which would put pressure on the Brazil economy
  - Election could result in no pension reform
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Puts on Brazil equity

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  - Trade 1: Puts on Brazil equity

# SOM Macro Strategies

## State Of the Markets: Position For A Weaker EM—Shorting Brazil

### Step 4: Find Asymmetric Trades

### Trade: Buy 3-month Puts On Brazil Equities

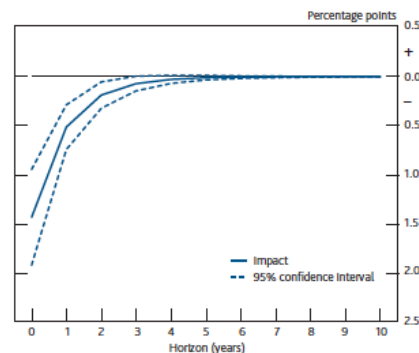
#### Trade Thesis

- Dollar strength could slow economic growth and that could reverse the recent rally in Brazil equities
  - Stronger dollar and higher borrowing cost could slow the Brazilian economy
  - Slowdown reveals substantial vulnerabilities and no real engine of growth
  - Election could result in more pressure if no consensus emerges on pension reform
- Brazil equities look overvalued without a pickup in growth
- Buy 5% OTM puts with December 2018 expiration

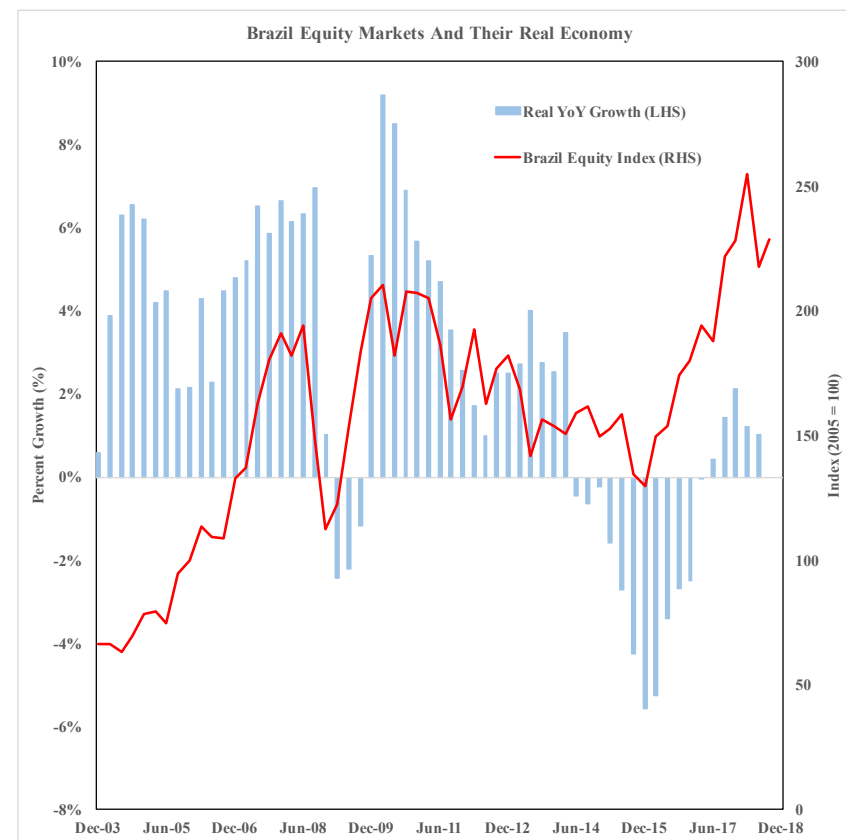
***Risk is Brazil economy rebounds***

#### Dollar Strength Could Slow The Brazil Economy

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



#### Recent Prices Look Rich Versus The Real Economy



# *SOM Macro Strategies*

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

- ***Step 1: Macro Theme: The Coming 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, and how will China respond?
- ***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 301 of the 1974 Trade Expansion Act
  - 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
    - Mandate from 2016 partly driven by impact of Chinese imports on voting patterns in the rust belt
  - 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
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Receive USD and Sell CNH on a forward basis
  - Trade 2: Buy puts on USD based EM equities
  - Trade 3: Buy tail protection on highly rated corporate credit

# SOM Macro Strategies

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

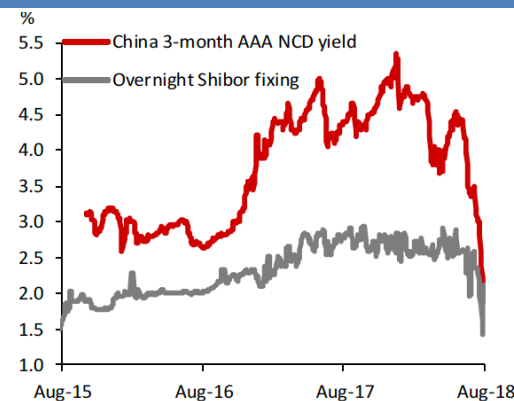
### Step 4: Find Asymmetric Trades

#### Trade 1: Position For A Weaker RMB

##### Trade Thesis

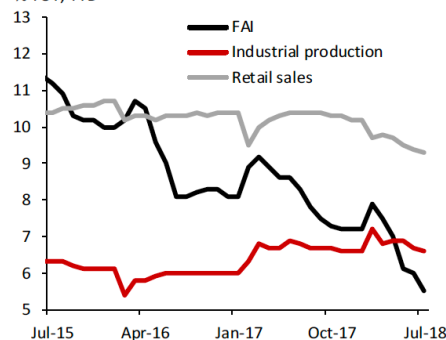
- Fed policy could strengthen the USD against all currencies
  - Reversing QE
  - Raising rates
- China could weaken the RMB for a variety of reasons both directly and indirectly
  - They could weaken their currency to offset the impact of tariffs
  - They could weaken their currency by lowering policy 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<sup>1</sup>

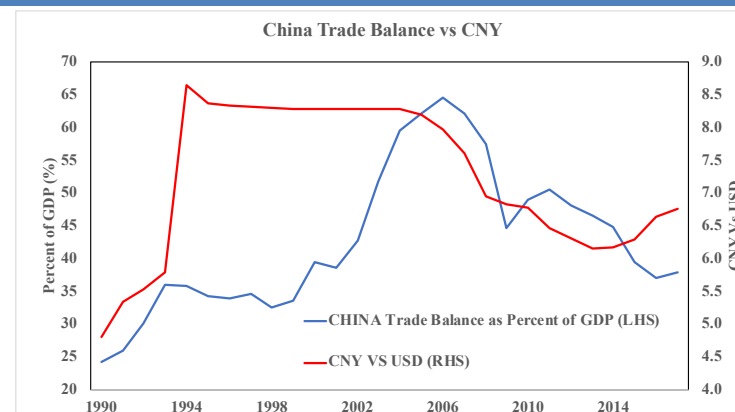


##### US Is Raising Rates While China Is Lowering Rates<sup>1</sup>

Chart 1: FAI, Industrial production, retail sales  
% YOY, YTD



##### China Has Plenty of Room to Depreciate<sup>2</sup>



1. Chow, 'Trade war taking a toll on China; expect more policy support', DBS Economics, August, 14, 2018  
2. Bloomberg

# SOM Macro Strategies

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

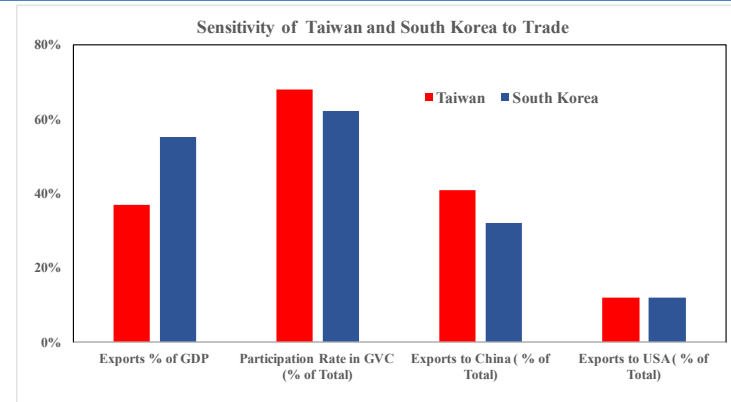
### Step 4: Find Asymmetric Trades

### Trade 2: Buy Puts On USD Based EM Equity Indexes

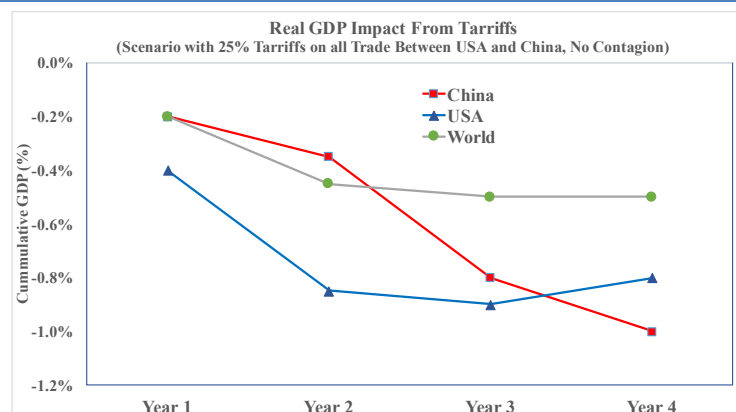
#### Trade Thesis

- EM equity associated with China and their currencies could sell off in an economic war between the US and China
  - US trade deficit with China is growing, as is the intensity of China's economic war with the US
  - The US could potentially put unlimited tariffs on Chinese imports
- China could retaliate against the imposition of US tariffs
  - They 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 USD 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<sup>2</sup>



#### US Deficit With China is Growing<sup>1</sup>



#### China Could Use Its Growing Demand For Oil As A Political Weapon<sup>1</sup>

| Country/Area  | EM Equity Index Exposure (%) | Currency Exposure |
|---------------|------------------------------|-------------------|
| China         | 31.0                         | RMB               |
| Korea (South) | 14.8                         | KRW               |
| Taiwan        | 12.1                         | TWD               |
| India         | 8.9                          | IDR               |
| South Africa  | 6.2                          | ZAR               |
| Brazil        | 6.0                          | BRL               |

1. Bloomberg  
2. "Trade Wars : There are no winners", KPMG, August 2018, Just US And China involved

# SOM Macro Strategies

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

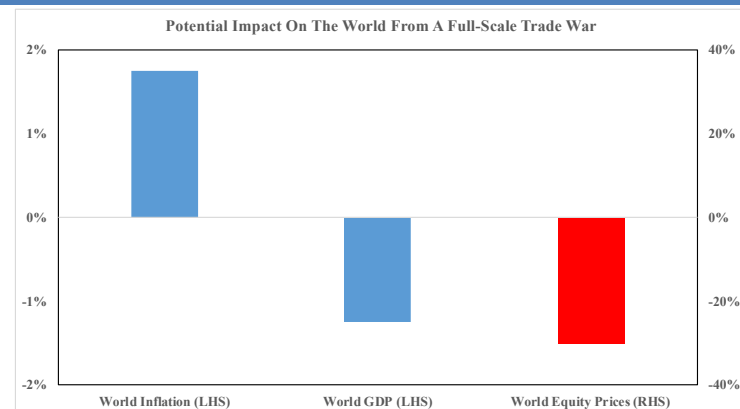
### Step 4: Find Asymmetric Trades

### Trade 3: Position For A Risk-Off Event From A Full Blown Global Trade War <sup>1</sup>

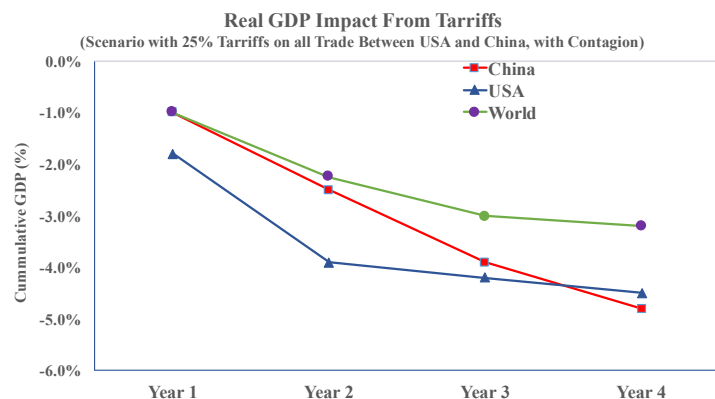
#### Trade Thesis

- This Economic war could escalate creating a tail event
  - The US could potentially put unlimited tariffs on all Chinese imports
  - China could escalate conflict bringing in the rest of the world using non-tariff strategies
- Escalation would affect not only the US and China but also the rest of the world
  - GDP could fall substantially, bringing down equity markets around the world
- Buy CDS protection on highly rated US corporates
  - Cheaper protection than buying protection on US High Yield or OTM equity puts
  - 60 bp will buy a 35% OTM 1-year put on S&P500

#### US Technology Companies Are Vulnerable to China Retaliation<sup>2</sup>



#### US Deficit With China is Growing<sup>1</sup>



#### China Could Use It Growing Demand For Oil As A Political Weapon<sup>3</sup>

| Dates          | Tail Event            | Corporate Spread Widening |      |         |
|----------------|-----------------------|---------------------------|------|---------|
|                |                       | AAA                       | BBB  | S&P 500 |
| 5/1998-8/1998  | EM Crisis             | 94%                       | 70%  | -16%    |
| 9/2011-10/2001 | September 2011        | 16%                       | 14%  | -8%     |
| 5/2002-9/2002  | Telecom/Inasdaq Crash | 30%                       | 20%  | -24%    |
| 5/2008-3/2009  | GFC                   | 211%                      | 145% | -48%    |
| 5/2011-9/2011  | Euro Crisis           | 82%                       | 63%  | -17%    |

1. "Trade Wars : There are no winners", KPMG, August 2018, World Contagion
2. Luca Paolini, "A zero sum game", PICTET Asset Management, June 2018
3. Bloomberg



# *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 Repricing Events***
  - 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

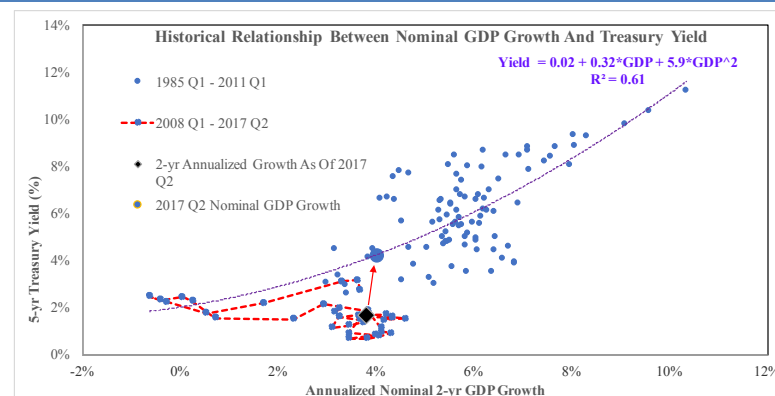
### Trade : Position For Higher Rates--Buy Out-of-The Money 1y/5y Payer Swaptions

#### Trade Thesis

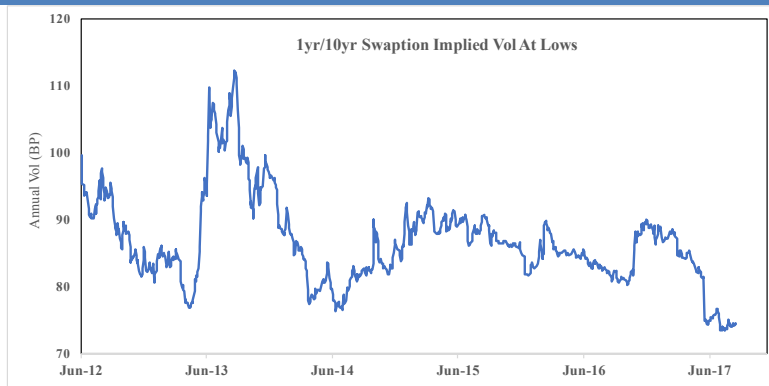
- Interest rates are below normal given current economic conditions
- Rates could move higher closer to norms
  - Real growth pickup, e.g. Trumpanomics
  - Tight job market or deficit spending pushes up inflation
  - QE unwind or financial reform reduces demand for duration
- Payer Swaptions are compelling
  - 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>

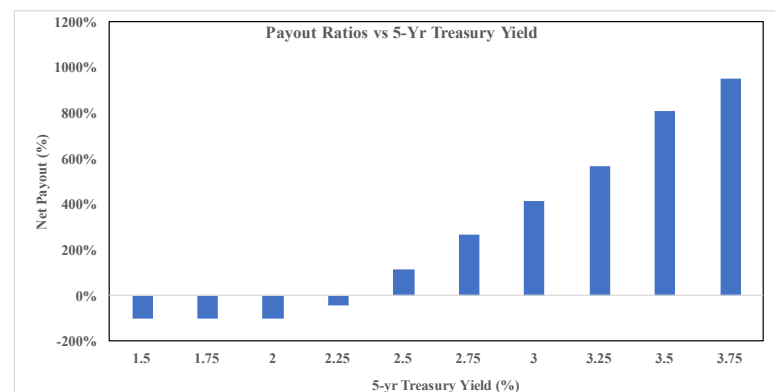


#### Implied Volatility Not Rich By Historical Standards<sup>1</sup>



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

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



Past performance is not indicative of future results

***SOM** Macro Strategies*  
Potential Macro Themes

# *SOM Macro Strategies*

## Potential Macro Themes: Electric Vehicles

- ***Step 1: Macro Theme: Electric Vehicle***
  - 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
  - Demand for EV metals could swamp near term supply
  - EV production 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 3: Find Potential Repricing Events***
  - None

# SOM Macro Strategies

## Electric Vehicle Metals As The Next Oil

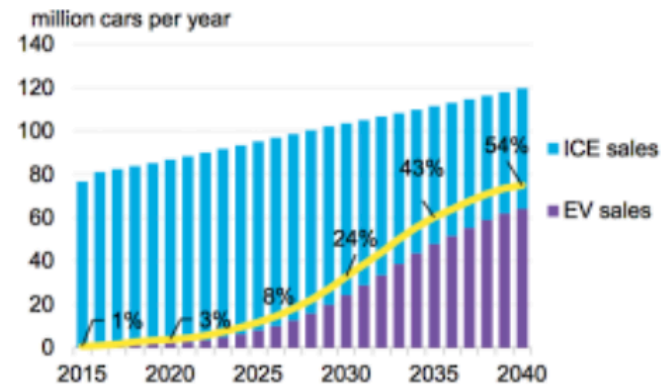
### Step 1: Macro Theme

### The Future of Electric Vehicles (EV) Battery Demand Overwhelm Supply

#### Theme Thesis

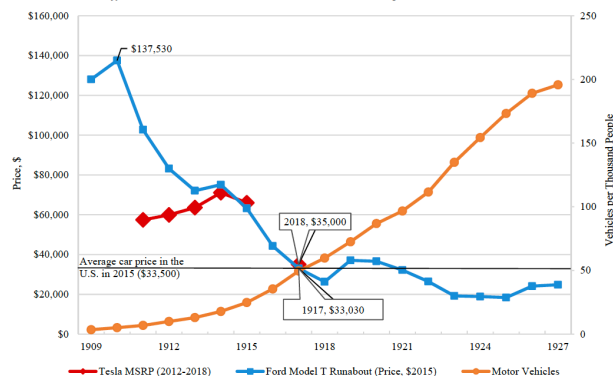
- Affordability puts EV demand at the cusp of exponential growth
  - EV as with absorption of other technical advancements has reached a take off point where demand explodes
  - As the internal combustion engine (ICE) rapidly replaced the horse, so to could the EV replace the ICE
- Demand for EVs could put substantial pressure on the existing transportation and energy infrastructure
  - Conversion to EV from ICE means new winners and losers
- Ultimately, EV gives way to autonomous vehicles (AV) then to transportation as a service (TaaS), and that is a game changer
  - Oil demand falls
  - Car demand falls

#### EV Demand Could Reshape the Landscape of the Auto Industry<sup>2</sup>



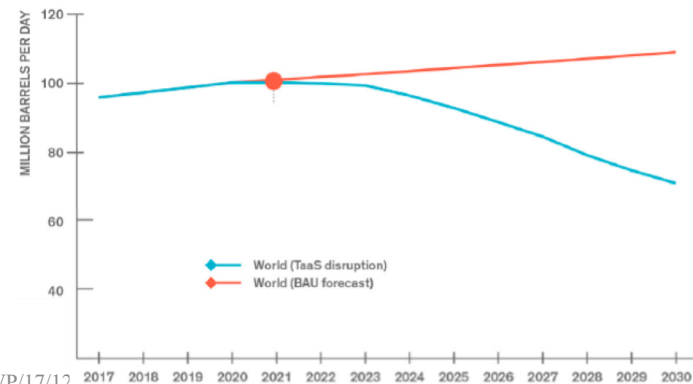
#### EV Affordability is Similar to Model-T Before ICE Demand Surged<sup>1</sup>

Figure 8: Electric and Motor Vehicles Adoption and Prices



#### EV => AV => TaaS => End of Oil?<sup>3</sup>

#### » Global oil-demand forecast



- Cherif, Hasanov, Pande, "Riding the Energy Transition: Oil Beyond 2040", IMF Working Paper, WP/17/12
- "New Energy Outlook 2018", Bloomberg New Energy Finance
- Arbib, Seba, "Rethinking Transportation 2020-2030: the Disruption of Transportation and the Collapse of the Internal-Combustion Vehicle and Oil Industries", RelthinkX Sector Disruption Report, May 2017

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