***SOM** Macro Strategies*

State Of the Markets: Recommended Trade Book

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April 2018

SOM Macro Strategies
State Of the Markets: Recommended Trade Book

Update on Performance, and the Portfolio

Historical Performance

Positions	Number Trades	Curr VAR	Market Value Orig	Market Value Curr/ At Close	Realized Sharpe Ratio	Realized Total Return
Open	8	43.8	290	329	1.0	13%
Closed	12		245	402	1.8	64%
Total	20		535	731	1.4	37%

Commentary

- The positions fell 3% in total return over the month
  - The fall in value of the equities positions from Strategies for Trumpanomics
    - Even banks underperformed despite the passage of S2155 by the Senate
- Realized Sharpe ratios for the closed trades is close to 2, with returns over 60%
- I added one trade and restructured two others
  - I added a long dollar trade as part of the "Return of the King"
    - I expect to add a few more to this theme in EM
  - I restructured the 1/5 2.5 strike payer swaption to extend the maturity for another year and moved the strike up to 3%
  - I moved from being short HY CDS to being short IG CDS
    - IG looks for attractive given the underperformance of the this sector vs HY during the widening
    - The HY still had a positive performance even with the widening given the power of carry

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State Of the Markets: Recommended Trades

Update of Current Recommended Trades (April 12, 2018)

Step 4: Find Asymmetric Trades

		Initial Position				Current Valuation			
SOM Strategy	Trade	Date	Notional (MM/Shares)	Price	Market Value (MM)	Price	Market Value (MM)	Realized Sharpe Ratio	Realized Total Return
The Return of The King: Long the Dollar	***Buy 9-month Euro Puts/Dollar Calls, 1.21 strike***	***2-Apr-18***	**500**	***1.0***	**5**	***1.0***	***5.0***	**0.0**	**0%**
The Normalization of The EMU	Long EMU Bank Equities	29-Dec-17	0.32	156.7	50	157.7	***50.5***	0.1	1%
Electric Metals as The New Oil	Long Electric Metals And Minors	29-Dec-17	50	100.0	50	100.0	***50.0***	0.0	0%
Credit is Not a Bubble	Short 5-yr IG CDS	22-Mar-18	1000	66	30	62	***32.0***	0.4	7%
Position For Higher Rates	1/5 Payer Swaption 3% Strike	22-Mar-18	556	0.9	5	0.9	***5.1***	0.0	2%
Strategies For Trumpanomics	Long Materials sector	9-Nov-16	1.0	48.3	50	58.1	***60.2***	2.0	20%
Strategies For Trumpanomics	Long Regional banks	9-Nov-16	1.1	46.5	50	60.4	***65.0***	3.0	30%
Strategies For Trumpanomics	Long Mortgage Insurers and Home Builders	9-Nov-16	2.3	21.7	50	26.7	***61.5***	2.3	23%

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State Of the Markets: Recommended Trades

Closed Recommended Trades

Step 4: Find Asymmetric Trades

		Initial Position				Closed Valuation/Performance				
SOM Strategy	Trade	Date	Notional (MM/Shares)	Price	Market Value (MM)	Date	Price	Market Value (MM)	Realized Sharpe Ratio	Realized Total Return
Abenomics	Long a 6-month Call 17000/19000 call spread on Nikkei	09/09/16	76.9	6.5	5	01/17/17	14.0	10.8	1.2	115%
Abenomics	Long a 6-month Call 15000/17000 call spread on Nikkei	06/24/16	62.5	8.0	5	09/09/16	18.5	11.6	1.3	131%
Brazil	Long Mxn Peso vs Short Brazilian Real	11/08/16	158.5	6.1	5	01/03/17	-5.0	0.0	-1.0	-100%
Brazil	Long a 6-month 61000 strike put on Bovespa	10/31/16	248.8	2.0	5	12/21/16	5.7	14.2	1.1	184%
Credit is Not a Bubble	Short 5-yr HY CDS	09/05/17	400.0	330	5	03/22/18	345	8.6	0.4	72%
Greece	Long 30yr GGBs	03/24/17	73.3	68.2	50	02/07/18	114	83.6	3.6	67%
Greece	Long basket of Greek banks	03/25/17	4494.8	1.1	50	08/15/17	2.1	95.5	4.5	91%
Position For Higher Rates	1/10 Payer Swaption 2.5% Strike	11/09/16	333.3	1.5	5	05/09/17	1.4	4.7	0.0	-7%
Position For Higher Rates	1/5 Payer Swaption 2.5 % Strike	05/09/17	625.0	0.8	5	03/22/18	1.5	9.4	0.9	88%
Strategies For BREXIT	Short GBP vs USD	07/01/16	159.0	1.33	5	10/11/16	1.22	18.4	2.8	268%
Strategies For Trumpanomics	Long S&P500	11/09/16	46.3	216.0	100	12/04/17	265	122.7	4.5	23%
Strategies For Trumpanomics	Best of Puts Euro, Yen vs USD	11/09/16	625.0	0.8	5	12/23/16	3.7	23.1	2.7	363%

Past performance is not indicative of future results

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State Of the Markets: Recommended Trades

Open Recommended Trades With Links

Trade	SOM Strategy/Link
Buy 9-month Euro Puts/Dollar Calls	The Return of The King—Positioning For A Stronger Dollar
Long EMU Bank Equities	The Normalization of The EMU
Long Electric Metals And Miners	Electric Metals as The New Oil
Short 5-yr HY CDS	Buy Corporate Debt
1/5 Payer Swaption 2.5 % Strike	Position For Higher Rates
Long Materials Sector	Strategies For Trumpanomics
Long Regional Banks	Strategies For Trumpanomics: Buy Regional Banks and Housing Related Equities
Long Mortgage Insuers and Home Builders	Strategies For Trumpanomics: Buy Regional Banks and Housing Related Equities

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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 normalized 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 Catalysts***
  - 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

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State Of the Markets: *The Return of The King—Positioning For A Stronger Dollar*

Step 4: Find Asymmetric Trades

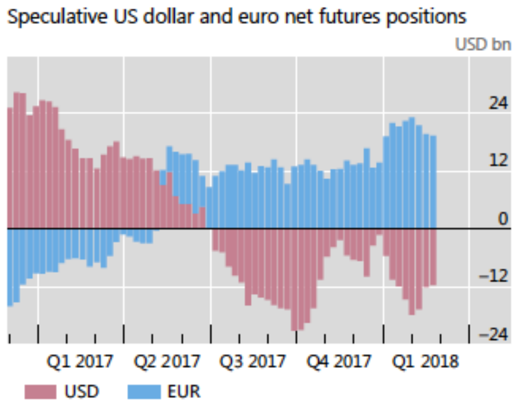
Trade 1: Position For A Stronger USD—Buy OTM EUR Puts/Dollar Calls

Trade Thesis

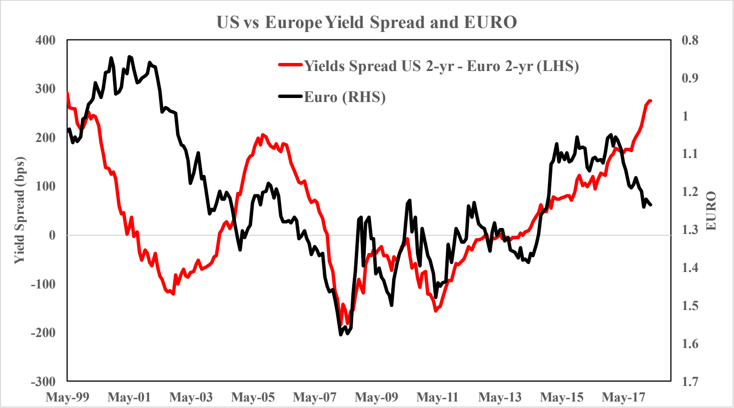
- USD could rebound from current weakness
  - Impact on USD from rising "Twin Deficits" from increasing federal borrowing could be offset by rising private savings
  - Continued Economic growth in the US/weakening growth in Europe could further widen interest rate differentials
  - World trade growth 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

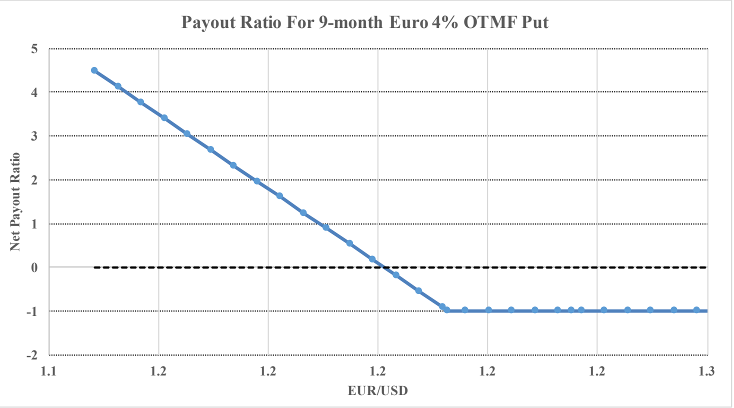
Rebound Could Be Swift Given Current Positioning[2]



Euro Looks Vulnerable if ECB Does Not Normalize Rates[1]



Potential Net Payouts of Euro Put/USD Calls



1. Bloomberg
2. BIS Quarterly review, March 2018

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State Of the Markets: The Normalization of The EMU

- ***Step 1: Macro Theme: The Normalization of the EMU***
  - Eight years after the start of the GIIPS crisis, economic growth in the EMU is normalizing and political risk is falling
  - Yet, valuations of EMU asset, particularly of the banks, have not
- ***Step 2: Fundamental Economic Framework***
  - EMU economic growth has rebounded and looks to accelerate
  - Yet, sovereign debt and NPLs, particularly for the GIIPS, is still a problem
  - More reforms are needed which could reignite political risk
    - Continuing low levels of inflation could put pressure on debt repayment
    - Employment rates are still high by historical standards
- ***Step 3: Find Potential Catalysts***
  - Accelerating world economic growth could provide tail wind to trade oriented EMU economies
    - German economic growth is accelerating
  - ECB is still supporting economic growth through monetary policy
  - Reforms have rebalanced the GIIPS economy supporting a further rebound of their economic growth
    - Belief in the EMU is growing
  - Economic growth could help solve the GIIPS NPL problem
- ***Step 4: Find Asymmetric Trade***
  - Trade 1: Buy EMU Banks
    - Profits rebound as economic growth and reforms solve NPL problem while accelerating credit originations

SOM Macro Strategies

State Of the Markets: The Normalization of The EMU

Step 4: Find Asymmetric Trade

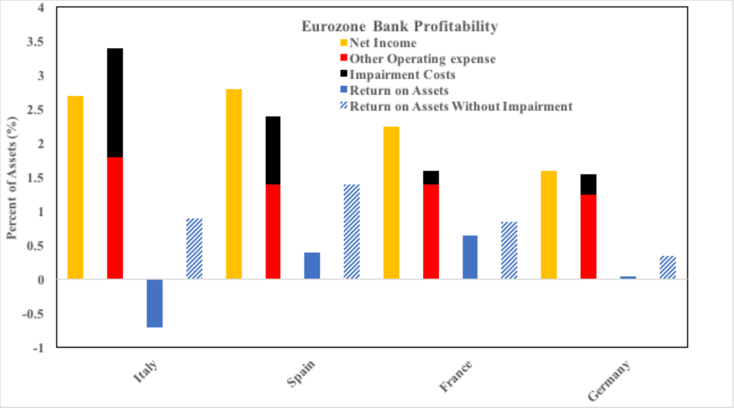
Trade : Buy European Banks—Growth Could Unleash Profits by Reducing NPLs[1]

Trade Thesis

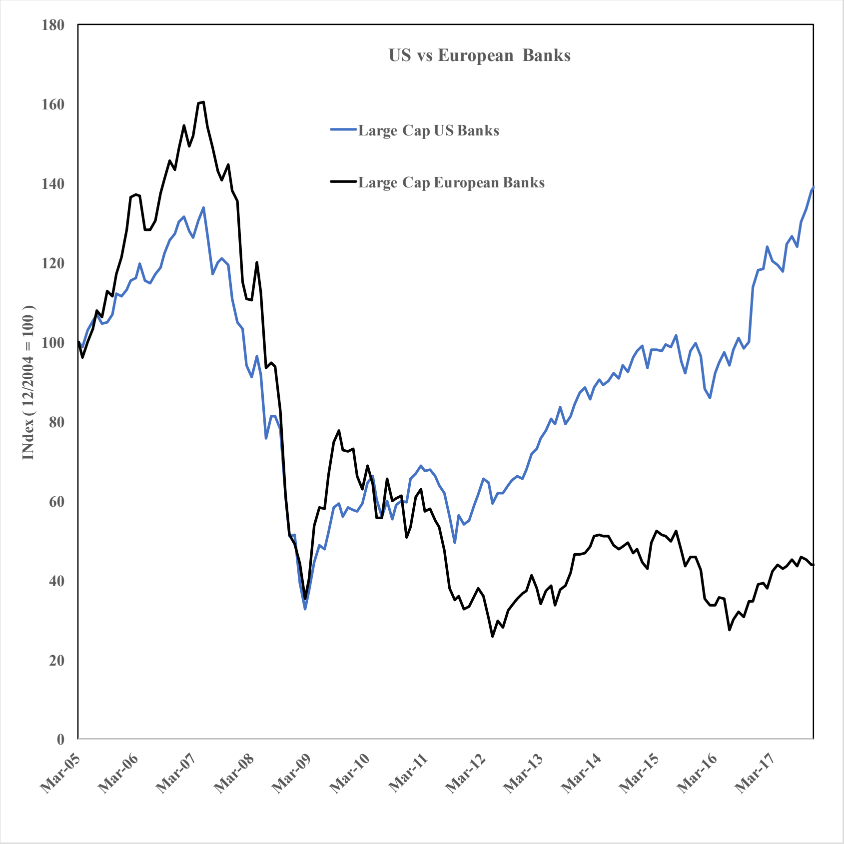
- EMU banks underperformance versus US banks could reverse as GIIPS issues are reduced
  - EMU banks have lagged US banks reflecting both the political risk as well as the GIIPS bank NPL problems
- Economic growth particularly in the GIIPS has reduced the political risk and potentially the NPL overhand
- EMU banks offer a asymmetric return profile
  - Current valuations more than reflect the potential impact of NPL losses but not the potential of substantial earnings growth as NPL provisions fall
  - Economic growth could also spur earnings growth from credit originations

Risk is GIIPS reforms fail, NPLs and political risk rises

Bank Prices Could Appreciate Substantially As NPLs Improve



European Banks Have Lagged US Banks Since the GIIPs Crises



1. Blomberg

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State Of the Markets: The Normalization of The EMU

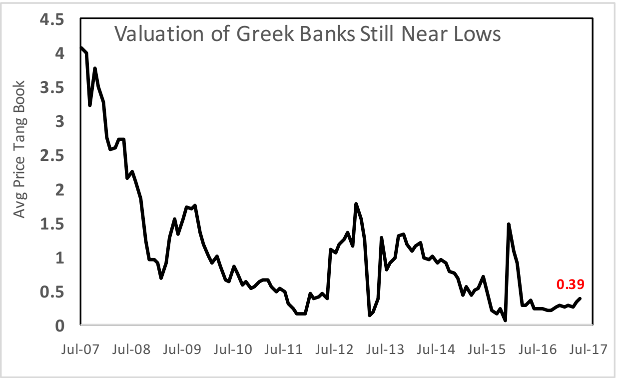
Step 4: Find Asymmetric Trade

Trade : Buy European Banks—Example of Greek Banks

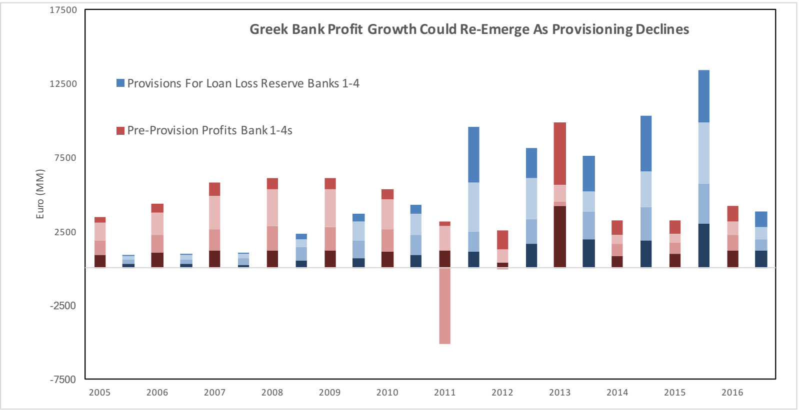
Trade Thesis

- The next EU/IMF Program will reduce Grexit risk
  - Deposits outflows should turn into inflows
  - Cost of funds/equity should fall
- Economic growth will reduce NPE risk
  - NPE growth should reverse
  - Defaults and severities should fall
- Greek banks are undervalued by many measures
  - Low price to tangible book should rebound as Gexit risk falls
  - Falling NPE reveal power of earnings engine
  - Loan loss reserves start flowing into capital making banks even cheaper

Valuations Still At Historical Lows[2]



Solving NPL Problem Could Generate Substantial Earnings Growth [1]



Realistic NPL Realization Makes Greek Banks Look Even Cheaper [3]

Price To Remaining Tangible Book + LL Reserve After Scenario				
	Default Rate			
Severity	100%	76%	50%	25%
100%	-0.53	1.41	0.29	0.16
65%	0.53	0.28	0.19	0.14
50%	0.29	0.21	0.16	0.13
25%	0.16	0.15	0.13	0.12

1. Major Bank Earnings Reports 2004-2016
2. Bloomberg
3. Calculation by Author

Past performance is not indicative of future results

***SOM** Macro Strategies*
State Of the Markets: Electric Vehicle Metals As The Next Oil

- ***Step 1: Macro Theme: Electric Vehicle Metals As The New Oil***
  - 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
  - Metal supply for EV engines and batteries could be substantial
- ***Step 3: Find Potential Catalysts***
  - Demand for EV metals could swamp near term supply
  - Near term EV sales 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 4: Find Asymmetric Trade***
  - Trade 1: Buy EV metals and miners
  - Trade 2: Sell transportation industry

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State Of the Markets: Electric Vehicle Metals As The Next Oil

Step 4: Find Asymmetric Trade

Trade: Buy Battery Metals and Miners—Electric Vehicles (EV) Battery Demand Overwhelm Supply

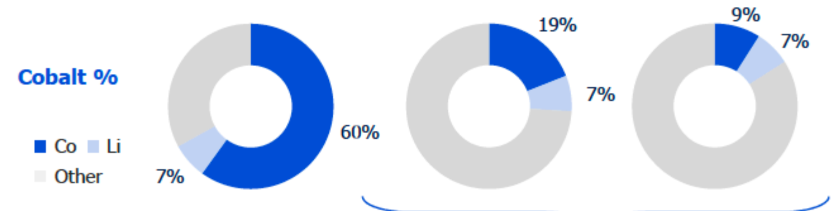
Trade Thesis

- 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
  - EV needs metals for the engine and for the battery
- As demand takes off, prices for key EV metals such as cobalt, lithium and copper could surge given limited near term supply
  - Earnings of miners of copper and lithium could rise as well
- Buy a portfolio of miners and metals exposed to EV

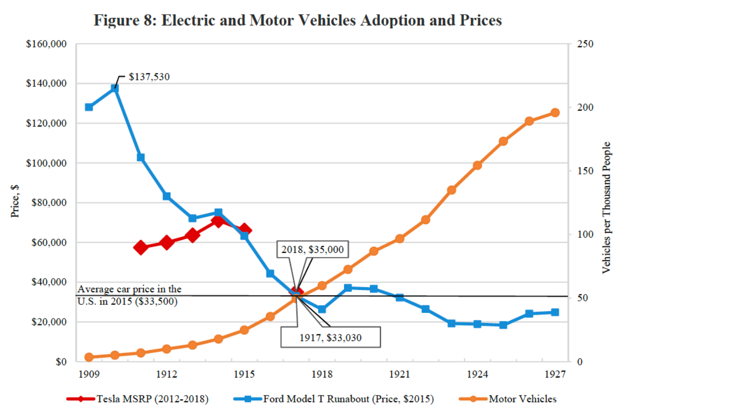
Risk is that it is too early in the cycle for EV

Batteries For EV Need Metals Particularly Lithium and Cobalt[2]

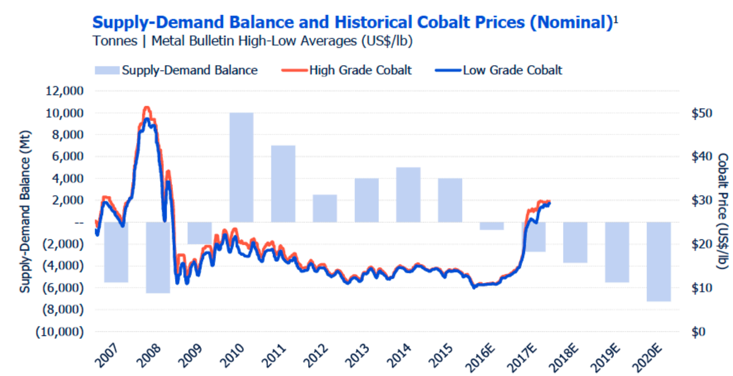
Common Uses & Features			
	▪ Uses: smartphones, laptops, tablets, cameras, wearables ▪ Higher energy density, shorter life span	▪ Uses: EVs, grid storage, power tools, medical devices ▪ Higher life span, higher power	▪ Uses: EVs, e-bikes, portable computers, grid storage ▪ Higher energy density, higher cost



EV Affordability Has Reached the Same Stage as the Model-T Before Demand Surged[1]



Demand Surge Could Swamp Near Terms Supply Pushing Up Prices[2]



1. Cherif, Hasanov, Pande, "Riding the Energy Transition: Oil Beyond 2040", IMF Working Paper, WP/17/120, May 2017
2. Cobalt27, Presentation to Investors, September 2017

***SOM** Macro Strategies*

State Of the Markets: Strategies for Trumpanomics

- ***Step 1: Macro Theme: Trumpanomics***
  - How much upside is their left in bank valuations after the “Trump” rally?
- ***Step 2: Fundamental Economic Framework***
  - Both large and small banks valuations have been adversely affected by the Dodd-Frank stress testing and new complex regulation
  - The adverse severe scenario is too severe and is the driving factor in getting banks to add capital and de-risk
    - Severe versus realistic adverse stress scenarios
    - Severe versus adverse stress scenarios used for European banks
  - Dodd-Frank has constrained economic growth
    - Forced smaller banks to reduce lending to small businesses
    - Regulations on qualified mortgages has reduced residential investment by almost eliminating mortgage lending to non-prime borrowers
  - Dodd-Frank dose highlight the need for GSE reform
- ***Step 3: Find Potential Catalyst***
  - Future Fed rate hikes could support further upside in bank valuations by increasing their NIMs
    - Bank rally reflects more the recent rate hikes than Trump policies
  - Corporate Tax cut should push up earnings for banks
  - Dodd-Frank reform seems more likely for regional banks (assets < $250 bil) because of political bipartisan support
    - Regional banks could then increase ROTE by increasing leverage
    - Regional banks could then increase multiples through mergers
    - Regional banks could then increase earnings by starting to originate higher margin mortgage products
  - Mortgage reform could unlock access to mortgages for 4 to 5 million non-prime borrowers
  - GSE reform along with mortgage reform could create strong additional demand for private mortgage insurance
- ***Step 4: Find Asymmetric Trade***
  - Buy US Regional Bank
  - Buy Mortgage Insurers
  - Buy Home Builders

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State Of the Markets: Strategies for Trumpanomics

Step 4: Find Asymmetric Trade

Trade: Buy Regional Banks—Trumpanomics Still Not Fully Reflected in Valuations

Trade Thesis

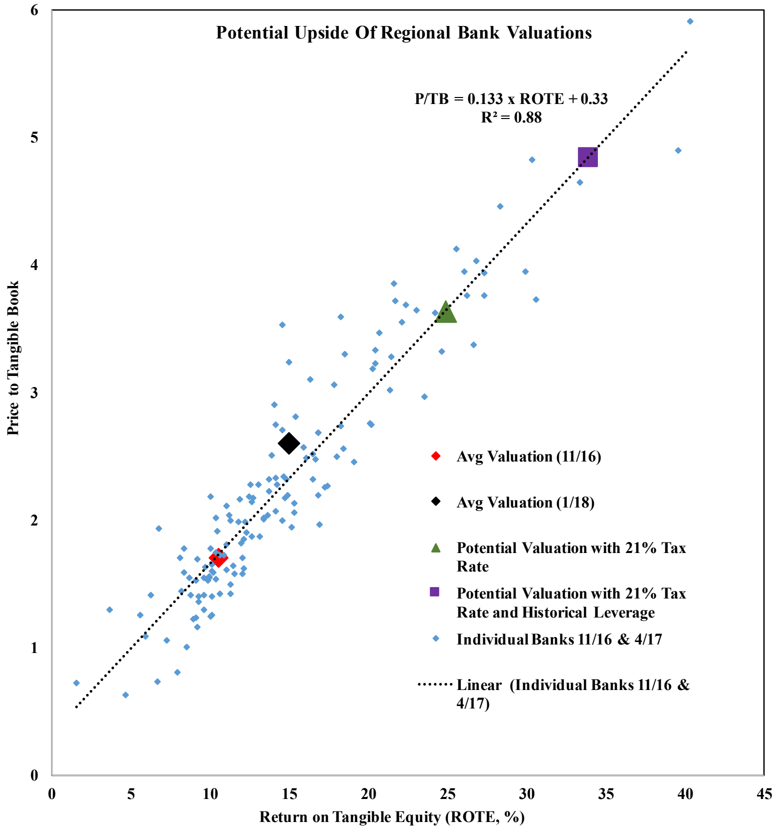
- Trumpanomics could increase earnings of banks
  - Lower tax rates would push banks earnings higher since they pay near the full statutory rate
  - DF reform could push up earnings by allowing banks to increase leverage
    - More likely for regional banks than the money center banks
  - Other benefits from DF reform could also increase bank earnings through lowering regulatory costs, opening up lending to riskier but higher margin borrowers (non-prime mortgages)
- Downside is limited as current rally reflects fundamentals of higher current

  Risk is that reform does not happen

Bank Valuation Analysis

- Potential impact of Trumpanomics on regional bank pricing shown on the right
  - Analysis of historical regional bank pricing, 11/16, 4/17, 1/18
- Breakdown of potential upside
  - Higher rates explain move from 11/16 to 1/18
  - Potential 30% upside from current valuations from lower tax rate
  - Potential 90% upside from current valuations from lower tax rate & Dodd-Frank reform
- Sources of potential additional upside
  - DF reform allows higher valuations from mergers of regional banks
  - Mortgage reform pushes earnings higher from bank originations of higher margin mortgages
  - Faster than expect Fed rate hikes

Reduction of Capital Needs From Loser Regulatory[1,2]



1. Bloomberg Regional Bank Index
2. Author's Calculation

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State Of the Markets: Strategies for Trumpanomics

Step 4: Find Asymmetric Trade

Trade : Buy Mortgage Insurers

Trade Thesis

- 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

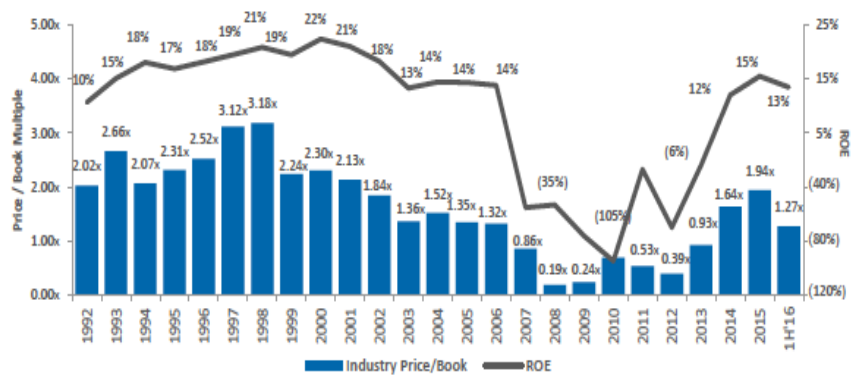
Risk is no GSE reform

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



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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State Of the Markets: Strategies for Trumpanomics

Step 4: Find Asymmetric Trade

Trade : Buy Home Builders

Trade Thesis

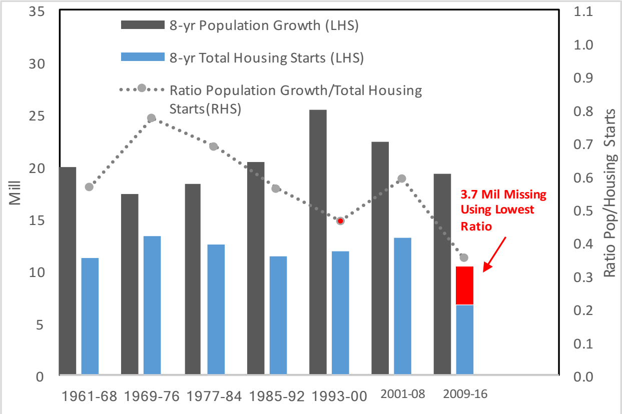
- Financial Regulatory Reform could open up non-prime lending
  - Non-prime lending has dried up given Dodd-Frank
  - Non-prime borrows one reason housing starts are so low vs historical norms
  - These borrowers have been going to for rent vs for sale
- For sale housing could surge if these non-prime 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

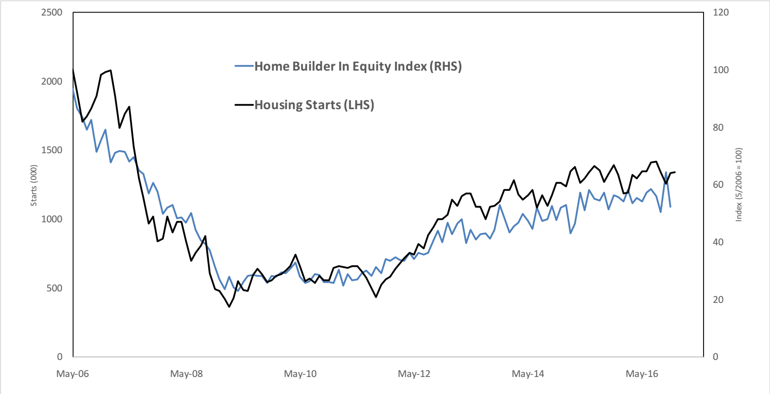
Starts Are Low As Non-Prime Borrowers Cannot Get Loans [2]

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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State Of the Markets: Strategies for Trumpanomics

Step 4: Find Asymmetric Trade

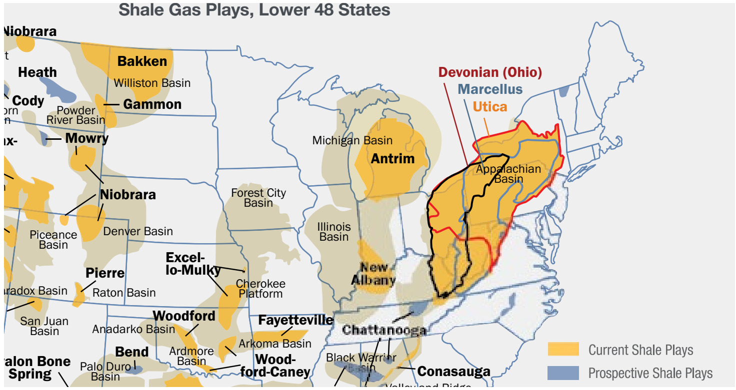
Trade : Buy Equities Exposed to Energy Investment--- The Manufacturing Renaissance of the Rust Belt

Trade Thesis

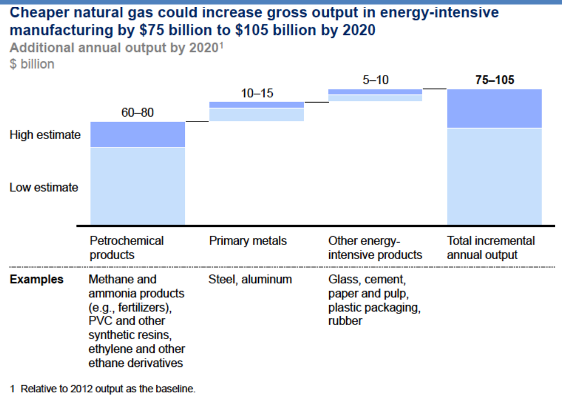
- The Rust Belt elected Trump
- Trumpanomics could solidify that vote by focusing on fostering a manufacturing renaissance of the Rust Belt based on nat gas
  - Marcellus is the new coal fields of the rust belt
  - Industry and cities can be rebuilt based on cheap and abundant Nat gas
  - 100% expensing of capital investment could turbo charge growth
- Buy equities that would benefit from this focus
  - Both upstream and downstream Nat gas companies
  - US steel related companies that will build the infrastructure
  - Chemical and other downstream companies that will use it

Risk is that reform never happens

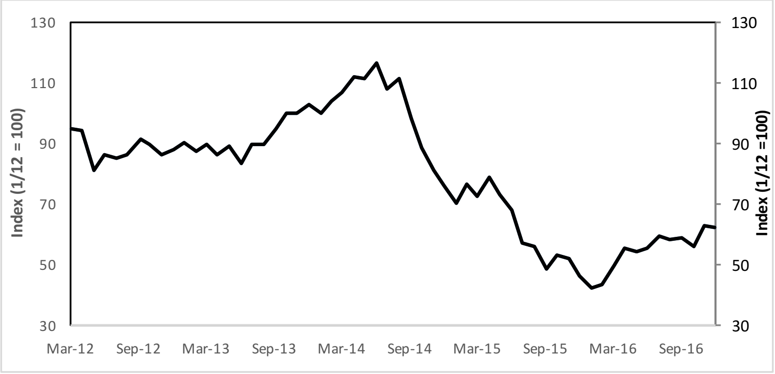
The Largest Source of Nat Gas is the Rust Belt: The New Coal [2]



Nat Gas Develop [1]



Portfolio Focused on These Industries Has Substantial Upside



1. Mckinsey Global Institute, "Game Changers: Five opportunities for US growth and renewal" July 2013 `
2. API, "Hydraulic Fracturing: Unlocking America's Natural Gas Resources" July 2016

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***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 Catalysts***
  - 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

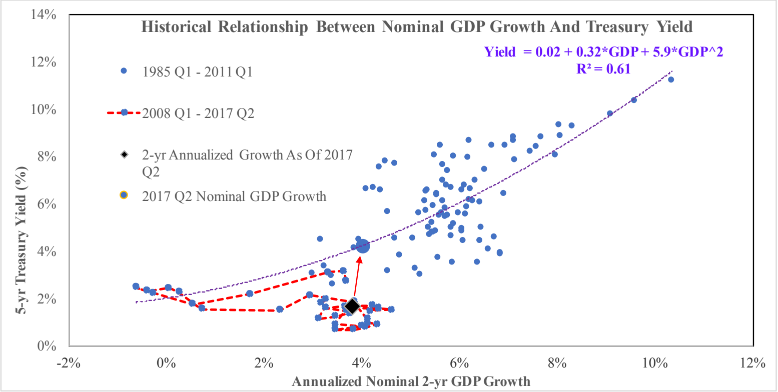
Trade : Position For Higher Rates--Buy Out-of-The Money 1y/5y Payer Swaptions

Trade Thesis

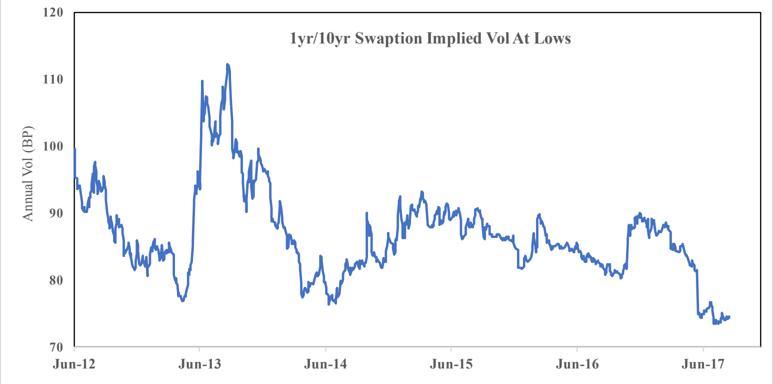
- Interest rates are below normal given current economic conditions
- Rates could move higher closer to norms
  - Real growth pickup, e.g. Trumpanomics
  - Tight job market or deficit spending pushes up inflation
  - QE unwind or financial reform reduces demand for duration
- Payer Swaptions are compelling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

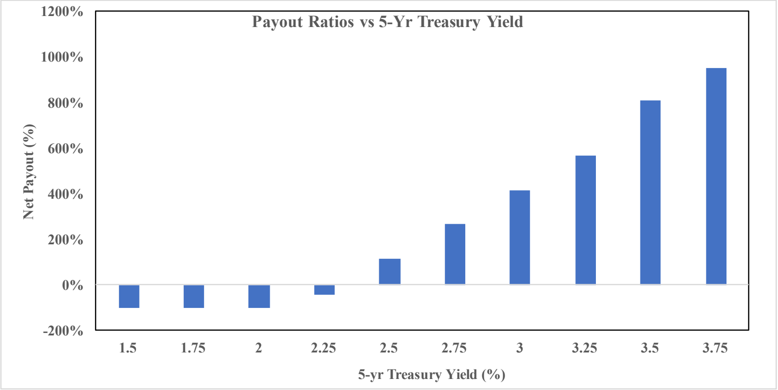
Nominal Growth Will Push Rates Higher [1,2]



Implied Volatility Not Rich By Historical Standards[1]



Performance of 1/5 Swaption [3]



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

Past performance is not indicative of future results

***SOM** Macro Strategies*
State Of the Markets: Buy Corporate Debt--It's Not A Bubble

- ***Step 1: Macro Theme: Is Corporate Debt A Bubble?***
  - Corporate debt has almost double in the last 10 years
  - Yet spreads, if anything, have tightened
  - Corporate credit fundamentals by some measures seem to have deteriorating close to recessionary levels
- ***Step 2: Fundamental Economic Framework***
  - On a fundamental basis nonfinancial corporate debt is not a bubble, credit risk has been falling and spreads if anything are too wide
    - With the exception of the energy sector
  - While debt has grown, leverage-–a prime indicator of potential credit risk—has fallen as equity market cap has grown even faster
  - Spreads are reasonable given fundamentals and current leverage levels unless leverage itself changes
  - A structural model of the optimal capital structure captures the linkages between leverage with the tax benefit of debt (see appendix)
- ***Step 3: Find Potential Catalyst***
  - Trump corporate tax reform has the potential to substantially reprice corporate debt by reducing the tax incentives for corporates to leverage
    - Trump plan is to cut corporate tax rates to 15% from its statutory 35%
    - Trump plan incorporates some reduction in the deductibility of the interest expense
    - Tax reform could reduce optimal leverage substantially
- ***Step 4: Find Asymmetric Trade***
  - Trade 1; Buy US Equities
    - Tax reform pushes up earnings and ultimately equity prices
    - Buy 30 delta 3-month calls
  - Trade 2: Buy IG corporates
    - Tax reform driven equity rally reduces leverage which could tighten IG spreads
  - Trade 3: Buy HY bond
    - Reform could drive a substantial deleveraging particularly of highly levered firms which could tighten spreads substantially
    - The tax shield is basically the only justification for having debt as part of the optimal capital structure
    - Reducing marginal tax rates and/or reducing interest expense deductibility could reduce the incentive to issue debt

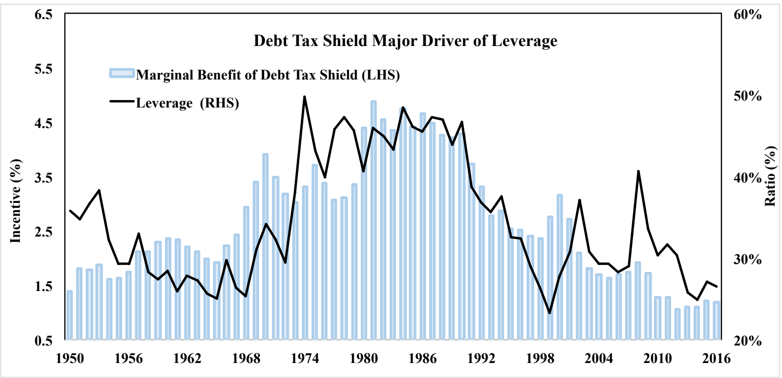
SOM Macro Strategies

State Of the Markets: Buy Corporate Debt--It's Not A Bubble

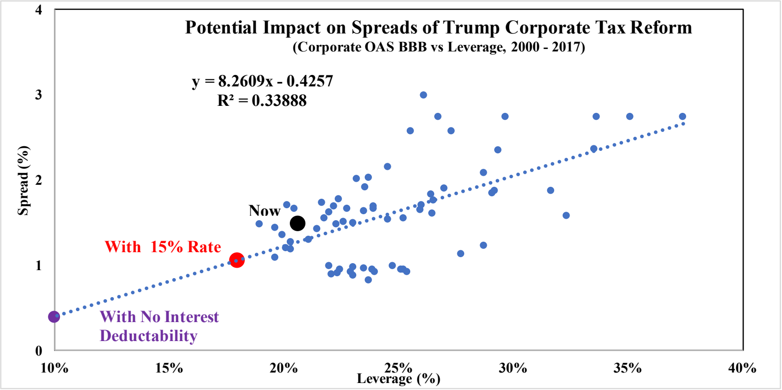
Step 4: Find Asymmetric Trade

Trade : Buy High Yield--- Spreads Could Tighten Substantially as Firms Reduce Leverage After Tax Cut

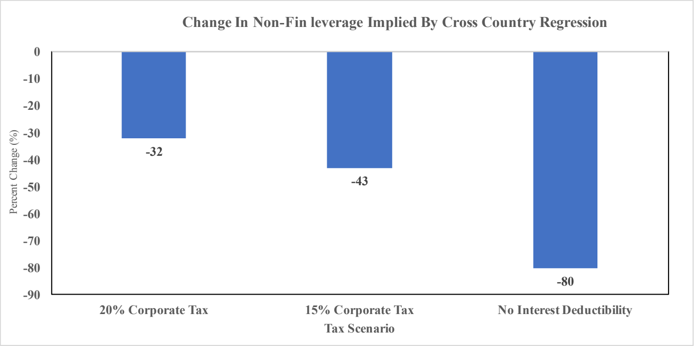
Historically, Leverage is Highly Correlated With Tax Benefits [1,2,3]



Based On US Data, Spreads Could Tighten Substantially[1,2,3,5]



Based On Other Countries, Deleveraging Could Be Substantial [4]



Based On Structural Models, HY Could Tighten More Than IG [5,6]

	Current			After Trump Tax Cuts And Optimal Leleveraging				
Rating	ICR	Leverage	CDS	Net Income Chng	Leverage	ICR	New CDS	Spread Tightening
A	8.5	33%	40	26%	15%	15.95	25	-38%
BBB	5.6	50%	100	21%	20%	12.64	50	-50%
BB	2.5	50%	165	15%	25%	4.74	65	-61%
B	1.6	73%	300	8%	35%	3.21	100	-67%

1. Board of Governors of the Federal Reserve, Z1 Data
2. Marginal Benefit is equal to Corporate yield x the effective marginal tax rate
3. Federal Reserve Bank of St. Louis, FRED Data
4. OFI Global Newsletter & Barclays Capital
5. Authors Calculations
6. Bloomberg DRSK Calculator

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