

09/24/2017

The Perfect Storm

Buy 1/3 UAL United Airlines

(new position, 1/3 total – Trade Alert sent 9/7/17)*

Sell 1/3 XOP Oil & Gas Exploration & Production ETF

(holding 1/3 position)*

Sell 1/3 XLE Energy Select Sector ETF

(holding 2/3 position)*

Sell 1/3 OIH Oil Services ETF

(holding 2/3 position)*

***Sent in Real Time to our clients in WhatsApp Trade Alerts**

"If we are to avoid the mistakes of the past, it is important to have an accurate assessment of what those past mistakes were. The severity of the Recession of 1937-38 was not due to contractionary fiscal policy or higher reserve requirements. By contrast, the policy tightening associated with gold sterilization was not modest – it did not simply reduce the growth of the monetary base by a few percentage points, it stopped its growth altogether. While the Federal Reserve is often blamed for its poor policy choices during the Great Depression, the Treasury Department was responsible for this particular policy error. The recession of 1937-38 occurred long ago, but it does have policy lessons for today. It suggests that, in a weak recovery, a pre-emptive monetary strike against inflation (which was very low at the time, as it is today) is capable of producing a devastating recession."

Douglas A. Irwin, Gold Sterilization and the Recession of 1937–1938



In this Note:

- **Washington's Impact:** Wall Street's current (low) expectations for tax cuts (and reform) is stuck looking through a healthcare experience lens - this is a big mistake. Clients should NOT underestimate the capabilities of Treasury Secretary Steve Mnuchin and National Economic Council Director Gary Cohn - this is NOT the team who dropped the ball on ACA Repeal and Replace. We believe a tax bill will pass through Congress in Q4 - individual and corporate tax cuts will be addressed at the same time in our view. **Here's a recording of this week's tax reform client call (available only for a few days), [click here](#)**. With an eye on Washington, we stand by our view on bonds from September 10th: "Looking ahead, with conviction we believe the 10 year U.S. Treasury bond will be closer to 3% than 2% by year's end." Heading toward Q4, we're US dollar bulls - we believe emerging markets and interest rate sensitive sectors (utilities and REITS) should be underweight in positioning.

- **The Road Ahead:** Historically, we've learned the unintended consequences of ill-timed fiscal stimulus can play games with market expectations around Fed policy. A most disruptive experience is found in classic - "late cycle" fiscal stimulus which delivers an inflation shock - triggering a recession. At the end of the day, the secular forces suppressing inflation expectations **are WELL advertised**, so well that the **smallest piece** of evidence to the contrary would inflict a market shock. In the words of George Soros, "capital gains are achieved by discounting the obvious while placing capital on the unexpected." Clearly, the lower for longer thinking - "inflation is the least of our worries" camp - is more than obvious. What's **NOT SO OBVIOUS** are the future side effects of tax cuts/repatriation, a \$100B fiscal rebuild (Harvey and Irma), a US Treasury deregulation boost coming from the financial sector and the plunging dollar's positive impact on global growth feeding back reflation to the US. And "oh, by the way" - the Federal Reserve is about to experiment with reduction of their \$4.5T balance sheet. A perfect storm is coming at us, we must prepare for what's ahead.

- **Inflation Bump:** **As we head toward Q4, one of the most important questions comes down to global growth and commodity prices - what's the follow-on impact back over to US inflation?** Labor Department said the Consumer Price index rose 0.4% last month after edging up 0.1% in July. August's gain is the largest in seven months and lifted the year-on-year increase in the CPI to 1.9% from 1.7% in July. Core consumer prices increased 0.2% in August. This followed a lame, four straight monthly increases of just 0.1%. With the low market expectations on the back of recent inflation weakness, **we think the risks to US inflation are skewed to the upside**. Bottom Line: The throughput from Brent oil (up 27% since June) - as well as surging production metals to China PPI (producer prices), has yet to be felt back in the US. As a result, US CPI (super mean reversion) upside is alive and well. Sleepy expectations of future inflation are still ignoring this train coming down the tracks - the **Fed is facing a wake-up call in the months ahead**.

- **A Bar Too Low for Interest Rates:** With interest rate expectations in mind, two to three times a year the Street becomes huddled up in extremes. We believe early September will mark the low in US Treasury bond yields for the year - an extreme point in crowded market psychology. Two U.S. GDP destructive (Cat 4) hurricanes, a threat of Nuclear war and Washington's fiscal policy gridlock - all couldn't knock U.S. Treasuries below 2%. Keep in mind, in July 2016 - Brexit risk alone ripped bond yields down to 1.33%. As we stressed late last month, a colossal shift in interest rate expectations is upon us - the Street is NOT positioned for what's coming. Of the last 6 major hurricanes - all witnessed higher yields four to six months after the initial economic disruption, the average rise was 42 basis points in yield. Couple this

with an expectations bar for tax reform repatriation and infrastructure spending that's two feet high - there's a lot of room for yield disruption as we receive any signs of positive execution results from Washington in the months ahead.

Lost in the Dark: This year, the Fed's explanation of lingering low inflation data has been a riddle from the Fed. The first excuse was "it's transitory." Then they lectured us "it's idiosyncratic." This week, we were told "it's a mystery." **Which begs the question - if they don't have a clue as to what's holding down inflation - how in God's name do they know where R* (the point where they should stop hiking rates) should be?** You cannot confidently claim you know where to stop hiking (R*) if you can't solve for the inflation side of the equation.

- The Global Feedback Loop Strikes Again: To add another element of risk to the rates equation we look at the global growth feedback loop, centered in China. With a U.S. dollar in an eight-month (11%) free fall - emerging market economies and commodity prices are throwing yield pressure back to the U.S. See our CNBC [video recap here](#). Global dollar-denominated debt sales have surged 165% from this time in 2016, YOY. A weak US dollar Federal Reserve is funding the fastest annual start on record, according to data compiled by Bloomberg going back to 1999. The overseas leverage binge has boosted the total foreign **corporate debt** (not sovereign) due in the next five years to \$1.7T, according to the Institute of International Finance. More than 80% of which is dollar denominated. Over 106 Chinese real estate companies were issuing close to \$25B of gross dollar-denominated debt per quarter by early 2015. As the U.S. dollar surged, this number fell sharply in 2016, but it began rising again this year as the dollar plunged. **Let's NOT kid ourselves, the side effect of - easy money - US Fed policy is still VERY global, and its impact is coming back to the US.**

- The market impact of Hurricanes Harvey and Irma: The need for Federal relief aid has already fostered a deal between the Democrats in Congress and the White House - they've avoided a government shutdown and a contentious fight over the debt ceiling. The \$120B of combined federal relief is likely to boost GDP later this year. We believe that this confluence of events is refueling the reflation trade. We also discuss the hurricane impact on the refiners, the airlines and other industries.

- The Fed Vacuum: We're looking at a possible Fed leadership vacuum in the coming months. Vice Chair Stanley Fischer has announced his resignation and Gary Cohn is, according to various media reports, no longer the front-runner to replace Yellen as the next Chair. We think the uncertainty regarding the (Fed) board's future makeup is playing a big role in markets, especially at the front end of the yield curve. Considering where financial conditions are (easy money - near the 2014 lows) - it's surprising Mr. Market is pricing in so little Fed action after the December meeting this year (one hike over 18 months). A big reason for this is, the market doesn't know what the makeup of the board is going to be. We know it will be a Trump Fed, but what does that mean? In our view, the difference between top contender Kevin Warsh and Chair Yellen is quite significant. We think the market is looking for a bit more clarity on the direction of the FOMC makeup before it's comfortable pricing in more hikes in '18 and '19. In Q4, once this clarity is delivered from the White House, we have yet another piece to the perfect storm puzzle putting pressure on higher yields.

- More Bullish Oil Signals: For the first time in three months, Brent crude futures spread for June 2018 / December 2018 traded on the Intercontinental Exchange into backwardation this week. On the heels of growing optimism around the global oil market rebalancing process,

some believe this will drive the price structure higher. More market participants are starting to wander over to this way of thinking. Strong estimates of oil demand by IEA and OPEC, driven by China and the US, continue to make their way through the market. See our August 18 note, [Capitulation Climax in Energy here](#). After the nice leg higher, we've taken some of our oil longs off the table - but this data above **gives us confidence** over the medium term. Bottom line: The latest bear market rally in the energy equity sector may have more legs than others we've witnessed in 2017.

- **Fed Balance Sheet Role of the Dice:** A colossal risk the Street is ignoring comes down to the Fed exiting its vol suppression role. Next month, the US central bank will shift from a buyer of market volatility (bond and otherwise) to a seller. Over the last decade, the FOMC has been the largest buyer of bond volatility in the world - arresting it and broad market vol in the process. By taking down their contribution - the responsibility of more vol buying flows into the market. This is the wildcard at the heart of the Fed's balance sheet experiment.

US Natural Disasters - Opportunities in a Crisis

Today, we're focused on the near-term economic consequences of hurricanes Irma and Harvey. Irma's path was centered on Southern Florida, home of approximately 7M people. The worst hurricane to hit Florida after WWII was Andrew in 1992. This beast delivered a total economic loss near \$50B (in today's dollars). Ultimately, the damage brought by Irma could exceed Andrew - given that the population has grown by 50% since then. According to CoreLogic, the total insured and uninsured loss for both residential and commercial properties are estimated to be between \$42B and \$65B.

AccuWeather Predicts Economic Cost of Harvey, Irma to be \$290B

The Texas governor has asked for a total of \$180B in federal funding for the recovery post-Hurricane Harvey. This is a steep request, given that total federal funding delivered after Katrina in 2005 was \$120B. Total funding for Harvey, together with insurance payouts, could end up north of \$150B. In the wake of this dual tragedy, the US economy could feel a boost in federal spending equal to 1% of GDP. Following of these horrific tragedies - the US Congress eager to act and provide prompt relief rather than to bicker over the debt ceiling and a federal shutdown. The Trump administration has already agreed with Democrats on a three-month budget resolution and debt ceiling suspension. If we look at total economic losses from Irma and Harvey, a picture of the second-worst US natural disaster in decades appears behind only Katrina. As we made clear in our [September 10th Bear Traps Report](#), we believe the bond market has yet to digest the full implications of this historic period of natural disasters. Higher bond yields are coming to a theater near you.

Bloomberg Headline, Journalists are All Over the Obvious

"Who Killed U.S. Inflation? Here Are Suspects in Yellen's Mystery"

"Was it technology, in the factory sector, with wage deflation?"

"From foreign workers to Amazon and airfare, suspects abound"

A Bar Far Too Low



In August, American consumers predicted that inflation would stand still in three years' time, marking a historic low in this monthly survey conducted by the Federal Reserve Bank of New York. Expectations are a living breathing thing. They come in all shapes and sizes. From time to time they become very well defined, the point where the mob is near unanimously bought into the wrong conclusion. That's where we are today with inflation expectations - an extreme place where just a hint of higher prices can develop into colossal impact. In asset prices, there is a high degree of reflexivity when it comes to expectations. As inflation has slowed this year, market participants have toned down their expectations for future inflationary pressures. "Inflation is dead, it doesn't exist" is the dominating conventional wisdom. In our view, these surveys (NY Fed above) are more reactionary than predictive, if prices trend higher into year-end, expectations will shift dramatically. As we view Irma and Harvey's impact on inflation - given the devastation of supply (automobiles and homes), we think risks are skewed substantially to the upside. We're looking at an injection of 0.08% YoY to core inflation and 0.30% YoY to headline data in the months ahead.

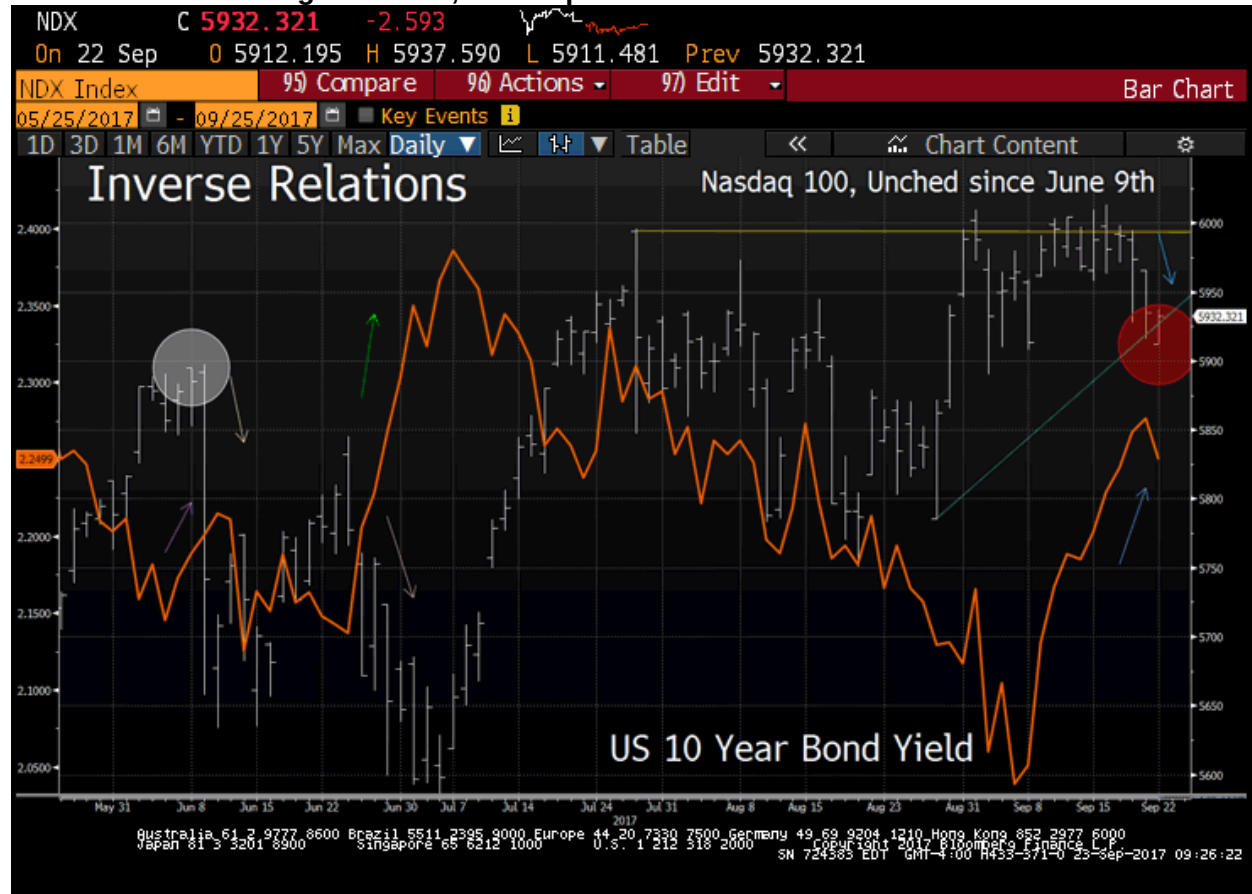
The Fed's Vacuum Problem

A review of historic hurricanes in the magnitude of Irma / Harvey, show an economy initially slowing but quickly accelerating when the federal relief funds get deployed. What is different this time is the uncertainty of the composition of the Federal Reserve. Vice Chair Fischer will resign from the Board of Governors after the November 1st meeting and Gary Cohn is apparently no longer the front-runner to replace Chair Yellen when her term is up in early 2018. Following Fischer's resignation, markets have been pricing in a reasonable probability that Yellen will



follow Fischer in the coming months. A Yellen exit would create an initial vacuum of leadership at the Fed, after which Trump appointees will fill the 4 (or 5 with Yellen) vacancies on the Board. This leadership vacuum coupled with a rapid change in inflation expectations spells trouble for bonds. In our view, Trump White House appointees will be far more conventional and loath to repeat the experimental monetary policy of the last eight years. In this initial vacuum in coming months, Treasuries could price in a significant acceleration of GDP growth unencumbered by preemptive Fed tightening.

After All the "New Highs" Noise, Nasdaq 100 is Unched since June 9th



If you're trading FAANGS (Facebook, Apple, Amazon, Netflix, Google) - please don't kid yourself - you're trading rates. Through the Spring and into the Summer, we've witnessed an interesting "inverse relationship" between the Nasdaq 100 and interest rates. As our friend Brian Yelvington reminds us, "when you discount future cash flows at higher yields you get lower present values." Since March, as valuations became stretched - equity prices in big tech have woken up to this reality. In recent weeks, we recommended clients sell or get short the Nasdaq 100 - it's been a frustrating trade. Since June 9th, it feels like endless sideways price action - we were clearly too early with this view. In July and August, as the Fed talked down rate hike expectation - stock prices have been supported by lower bond yields. We believe all that changed with this week's Fed meeting. In our view, the Fed is finally ready to pull back accommodation once again*. A focus on loose financial conditions over low inflation should do the trick - drive big tech lower and bond yields higher.

*In our view, the full balance sheet execution would ultimately raise the Treasury term premium by about 80-100bp in total, after Wednesday's Fed meeting some of this impact on 10-year

bond yields is already priced-in. A 25 bp move in the S&P 500 earnings yield would reduce forward P/E from the current 17.9x to 17.3x (-3.2%). Bottom line, Fed balance sheet action puts downward pressure on stock prices heading into year-end. A Fed more focused on loose financial conditions (ridiculously loose - after 4 rate hikes) than "mystery" inflation will attempt to let some air out of the balloon.

The New Trump Fed

Stanley Fischer's term was scheduled to end Mid 2018 but the Vice Chair decided for personal reasons to resign as of mid-October of this year. Trump now has to opportunity to fill 4 vacant seats and possibly replace Yellen as well, whose term is up in early February of 2018. The front-runner to replace Yellen was Gary Cohn, Chairman of the National Economic Council but according to the WSJ Trump is now looking at other candidates after Cohn's critical remarks over the White House response to Charlottesville. Candidates Trump is considering include former Fed member Kevin Warsh, John Taylor and former BB&T CEO John Allison. In addition the Chair, Trump can now pick a vice Chair as well as three candidates for the other vacant seats on the Board. In all, 5 out of 7 permanent voters on the Fed's Board of Governors are to be chosen by Trump and these are likely to be conservative policymakers who oppose the unconventional monetary policy of the last eight years. But until the Board is replenished, the Fed may have a vacuum of leadership dealing with the economic aftermath of what looks to be two hurricanes and potential significant near-term fiscal stimulus in the form of federal relief aid.

The market may, therefore, price in an acceleration of GDP growth with little immediate pushback from the Fed amidst a vacuum of leadership. We note that in the aftermath of major hurricanes since 1960, long bond yields surged ultimately to price-in the boost in GDP from the recovery.



US Two-Year, Highest Yield Since Lehman's Failure



We think the uncertainty regarding the (Fed) board's future makeup is playing a big role in markets, especially at the front end of the yield curve. Considering where financial conditions are (easier - bubble pumping - than when the FOMC started hiking) and the prospects of more inflationary pressure due to the weaker dollar, it is a bit surprising the market is pricing in so little Fed action after the December meeting this year. As we sit here today, the market doesn't know what the makeup of the board is going to look like. Sure, we know it will be a Trump Fed, but what does that mean? The difference between Warsh and Yellen is likely quite significant. We think the market is looking for a bit more clarity on the direction of the FOMC makeup before it is comfortable pricing in more hikes in '18 and '19.

"If we look back to hurricane Katrina in 2005, bonds rallied into the catastrophic storm - the 10 year Treasuries rallied 33bps lower in yield. We must keep in mind, six months after the tragedy bond yields were 75bps higher - driven by fiscal stimulus coming out of Washington. We believe an impressive interest rate reversal is upon us. Barring war on the Korean peninsula, looking at the 10-year U.S. Treasury we see near-term yield downside of 2.00%, with upside by year end of 2.75%. We are TBT BULLS - short bonds, they're a screaming sell."

The Bear Traps Report, September 9, 2017



Natural Disasters + US Political Risk + Geopolitical Risk Climax = a Bond Rally



From late July to September 8 bond yields plunged from 2.40% to 2.01% in ten-year Treasuries. It was a perfect storm support for bond bulls - higher bond prices came with lower bond yields in US Treasuries. There's still strong global demand for US dollars. In 2017, supported by a surge in overseas buying - we've seen record issuance and inflows focused on US investment grade bonds. Through September 16, we've witnessed a \$92B wall of cash coming into ETFs and mutual funds - that's 5.5x this year's US equity inflows (so much for the "great rotation"). US corporate bond buying from outside the US has surged by nearly 50% since 2015 to nearly \$4T. Over 40% of US corporate bonds outstanding are now owned by foreigners! **Bottom line: The late cycle capital has arrived, take down your exposure to US investment-grade corporate bonds.**

"Over the last month we've learned, two historic hurricanes and threats of nuclear war can put an amazing bid into bonds (sarcasm). Looking ahead, with conviction, we believe the 10-year U.S. Treasury bond yield will be closer to 3% than 2% by year's end. "

The Bear Traps Report, September 9, 2017



The Road Ahead for Treasuries and Corporate Bonds

Over the last 150 years, in nominal terms - corporate bonds and US Treasuries have NOT witnessed a negative return decade. On the other hand, since 1900, fifty percent of the decades have resulted in a negative real return for Treasuries. Over the last forty years, real bond returns have been colossal. Beware - each decade annualized returns, although positive, have been coming down. It's very clear to us, the great bull bond market is running out of gas - we are looking at a HIGH probability of negative real returns over the next ten years.

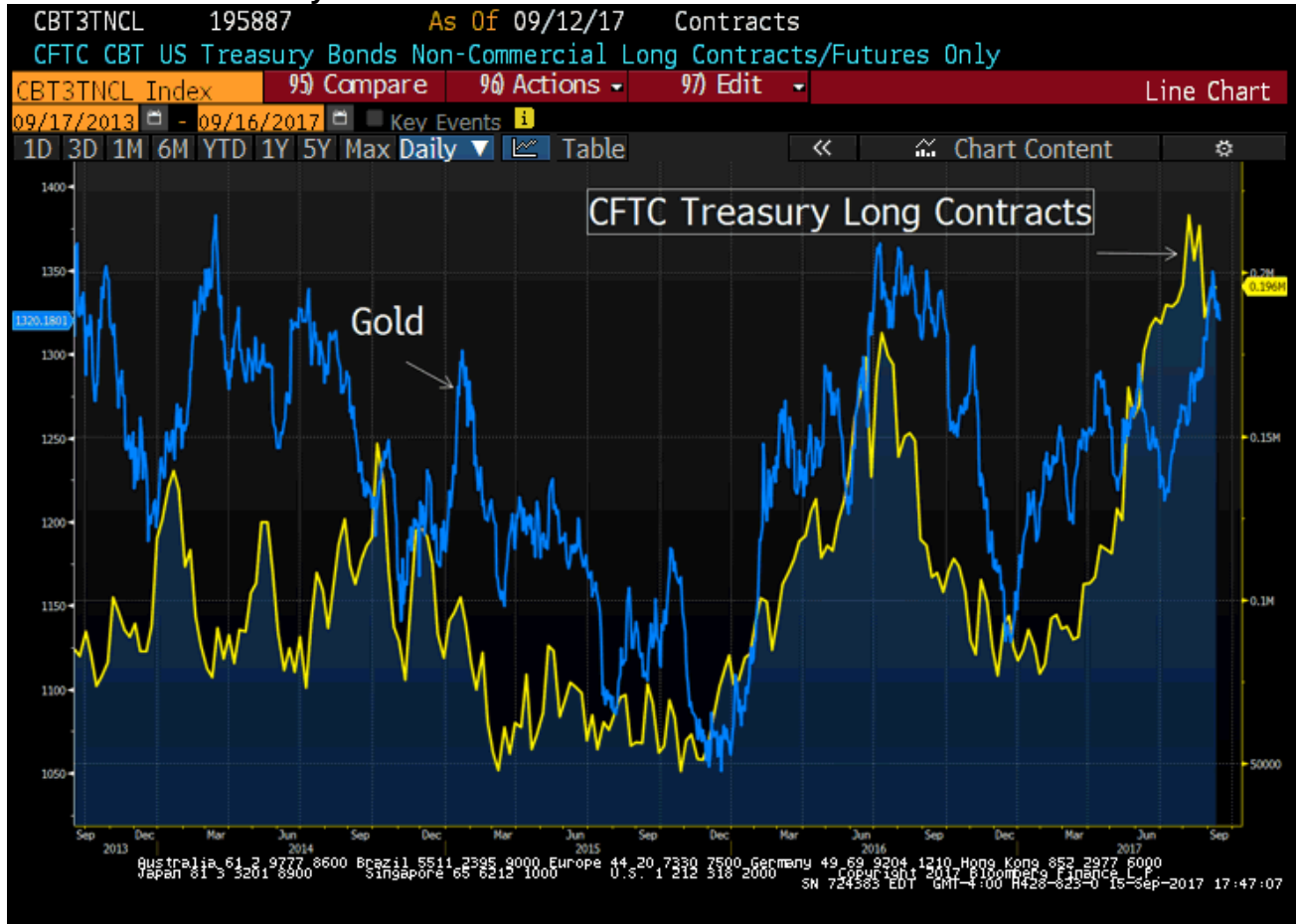
Gold and Rates



Relative Strength RSI: Since the September 7th low in US Treasury yields - gold is off 5.2%, with the miners 10% lower. As you can see above, RSI extremes (circles above in the lower box) are telling with gold - we've witnessed pullbacks between 9 and 15% from the circles above. In the last five years, only on one occasion (mid-2015) did the gold reach new highs following RSI extremes. Between 1900 and 1970, gold delivered only 0.8% nominal and a -1.5% real return. Over the last 47 years, returns are up at 7.9% and 3.8% respectively. In our view, there are still colossal secular tailwinds behind gold - but in the near term, there are challenges in rising rates. In recent years, higher bond yields led to lower gold prices.



The Long US Treasuries Trade is too Crowded Relative to a Surprise from Washington on Tax Reform Probability



As we moved into September, investors continued to pile into the "crowded" long bond trade. Visions of a White House' Gary Cohn exit were flashing across Bloomberg terminals - the dollar plunged and investors couldn't get enough US Treasuries. We believed these fears were misplaced - the expectations bar is **far too low** on tax reform, repatriation and cuts - bonds are still mispriced relative to upside risks to yields coming from Washington.



Hurricanes and Recessions

- Hurricane Camille in 1969 preceded the 1969-1970 recession.
- **Hurricane Agnes in 1972 preceded the 1973-1975 recession and equity bear market.**
- Hurricane David in 1979, which occurred six months after the last total solar eclipse, preceded the 1980-1982 double-dip recession.
- **Hurricane Hugo and the San Francisco Earthquake in 1989 preceded a recession in 1990-1991.**
- Hurricane Floyd in 1999 preceded the dot-com peak in 2000 and recession in 2001.
- **Hurricanes Katrina, Wilma and Rita in 2005 preceded the housing peak in 2006**, which subsequently contributed to the Great Recession beginning in 2007.

*Historically, we've learned the unintended consequences of ill-timed fiscal stimulus can play games with market expectations around Fed policy. A most disruptive experience is found in classic - "late cycle" fiscal stimulus which delivers an inflation shock - triggering a recession. At the end of the day, the secular forces suppressing inflation expectations **are WELL advertised**, so well that the **smallest piece** of evidence to the contrary would inflict a market shock. In the words of George Soros, "capital gains are achieved by discounting the obvious while placing capital on the unexpected." Clearly, the lower for longer thinking - "inflation is the least of our worries" camp - is more than obvious. What's **NOT SO OBVIOUS** are the future side effects of tax cuts/repatriation, a \$100B fiscal rebuild (Harvey and Irma), a US Treasury deregulation boost coming from the financial sector and the plunging dollar's positive impact on global growth - feeding back reflation to the US. A perfect storm is coming at us, we must prepare for what's ahead.*

The Market Impact of Harvey

The impact of Harvey will continue to reverberate through markets in the next several months. The most significant effects of the disaster have been found in concerns over a government shutdown (fight over the debt ceiling), now these risks have moved to the background. Furthermore, the federal funding for hurricane relief will boost GDP growth - this will be arriving in Q4. In the near term, certain economic indicators will be negatively impacted. Sectors that benefit from the hurricane are first and foremost the refiners. US independent refiners will continue to benefit from crack spreads that could stay elevated for several more weeks. Even European refiners have been receiving a boost from the hurricane as they supply the US and Latin American markets with gasoline.



Lumber and Rates



On the heels of Harvey and Irma, companies that supply building materials (lumber) and industrial equipment will benefit from the rebuilding of the affected region. Next, the US auto market (steel - see below at the bottom of this report) is poised to see a short-term benefit from the hurricane, which not only affects new car sales but also second-hand car pricing.

IHS Markit U.S. Services PMI and the IHS Markit U.S. Manufacturing PMI

US manufacturing input price inflation is the highest since 2012 - amid Hurricane Harvey induced supply chain disruptions. This week, private sector cost inflation edged up to its strongest since June 2015. Increased cost pressures reflected the steepest rise in manufacturing input prices for almost five years.



Rate Bottoms and Hurricanes



As a percentage of US GDP impact, the one-two punch of Irma and Harvey will go down as the second worst hurricane event in 75 years. At nearly \$90B, Harvey damages are close to 50bps of GDP. Combined, the colossal impact will be right up there with Katrina, at 90bps of GDP. We looked at all the Category 4 hurricanes since 1950. First, the economy typically hits a soft patch - but the bond market (Treasury) immediately prices in the news. The economic contraction lasts one to three months, with a substantial 3-4 quarter snap back to the upside in response to the fiscal relief spending coming from Washington. In terms of impact on 2017 GDP, we see Irma and Harvey slicing 1.1% from Q3 growth. As we look forward to Q4 and early next year the fiscal upside response should be close to +1.5%. Bottom line, US 10 year bond yield should be close to 3% by Q1 2018 in our view.

A Fraction of What's to Come

Hurricane Harvey has made a deal possible between the White House and the bipartisan leadership in Congress whereby relief funding is combined with a temporary extension of the debt ceiling and a continuing resolution to avoid a government shutdown. The initial relief bill (\$7.9B) contains just a fraction of what we believe will be a total federal funding that could exceed \$100B for Harvey alone.

In order to measure the economic effects of Irma - Harvey we compare this hurricane to Katrina in 2005. While Katrina was worse than Harvey, the comparison is relevant because it has affected largely the same industries (oil & gas and chemical) and both hurricanes have been characterized by severe flooding.



After Storm Season, Follow On Higher Bond Yield Trends



A look at Andrew comes with several lessons over the broad macro impact. At first, there's incremental weakness in economic data over the short term. Looking back over the last 60 years at the major Category 4 hurricanes - we believe market participants will see through the expected soft weakness. As you can see from the Andrew lesson above, rational market expectations (economic downside) get priced in quickly as the storm dominates the news cycle. With the fiscal response in mind, we place more weight on the robust net increase in growth activity that we foresee in the quarters ahead.

Data Distortions

Historical patterns suggest some evidence that markets struggle to see through the noise. When we look at market pricing around the eight biggest natural disasters of the past 50 years in the US (a small sample, we would emphasize), we see what appears to be a 'plateau' in the S&P 500 for 1-2 months, followed by a renewed rally. Similarly, for 3-month rates (using a shorter sample with only six major events), we see a very modest pause or dip in yields followed by a subsequent increase. We do not make too much of these results but cite them simply to point out that, on the margin, markets may struggle to de-noise the data distortions caused by Harvey and Irma.



Sandy and Rates



In the Sandy experience, we witnessed a sharp rally in treasuries, lower yields - only to sell off by 45bps by January of 2013. Similar to the Sandy experience, in the aftermath of Katrina the Federal government spent \$120B on repairs and reconstruction of the affected area. Insurance companies paid out another \$30B in claims. The total amount was the equivalent of 1% of US GDP. The governor of the state of Texas has asked for Federal assistance that should "far exceed Katrina and Sandy." Even if total rescue funding reaches \$150B, it would only be 0.7% of current GDP - but with Irma and Maria, we'll be well north of 1% by the end of Q4.



Airline Capitulation and Jetfuel



The airlines have been hit by a triple whammy of increased competition (Low-Cost Long Distance Carriers), the surge in jet fuel after Harvey knocked out 25% of US' refining capacity and then Irma's impact on Caribbean and Florida, a major tourist destination. For almost a week, Florida was a no-fly-zone. None of the legacy carriers have any meaningful hedges in place to protect against a significant surge in jet fuel. On average, fuel costs are about 15% of total costs for airlines. After a 30% move lower, JPMorgan lowered United to "neutral" this week. The downgrade is based on United's prospects given domestic pricing weakness and higher fuel costs.

Downgrades a Plenty

After a nearly a 30% decline since July, street analysts are falling all over themselves in an effort to downgrade United UAL shares. Analysts reference worries over incremental weakness in Pacific bookings, UAL's ability to execute successfully on domestic revenue and a re-acceleration of 50-seat regional jet flying. There's clear uncertainty looking over fare wars and potential for further discounting. All these factors make the UAL narrative difficult in the near term.



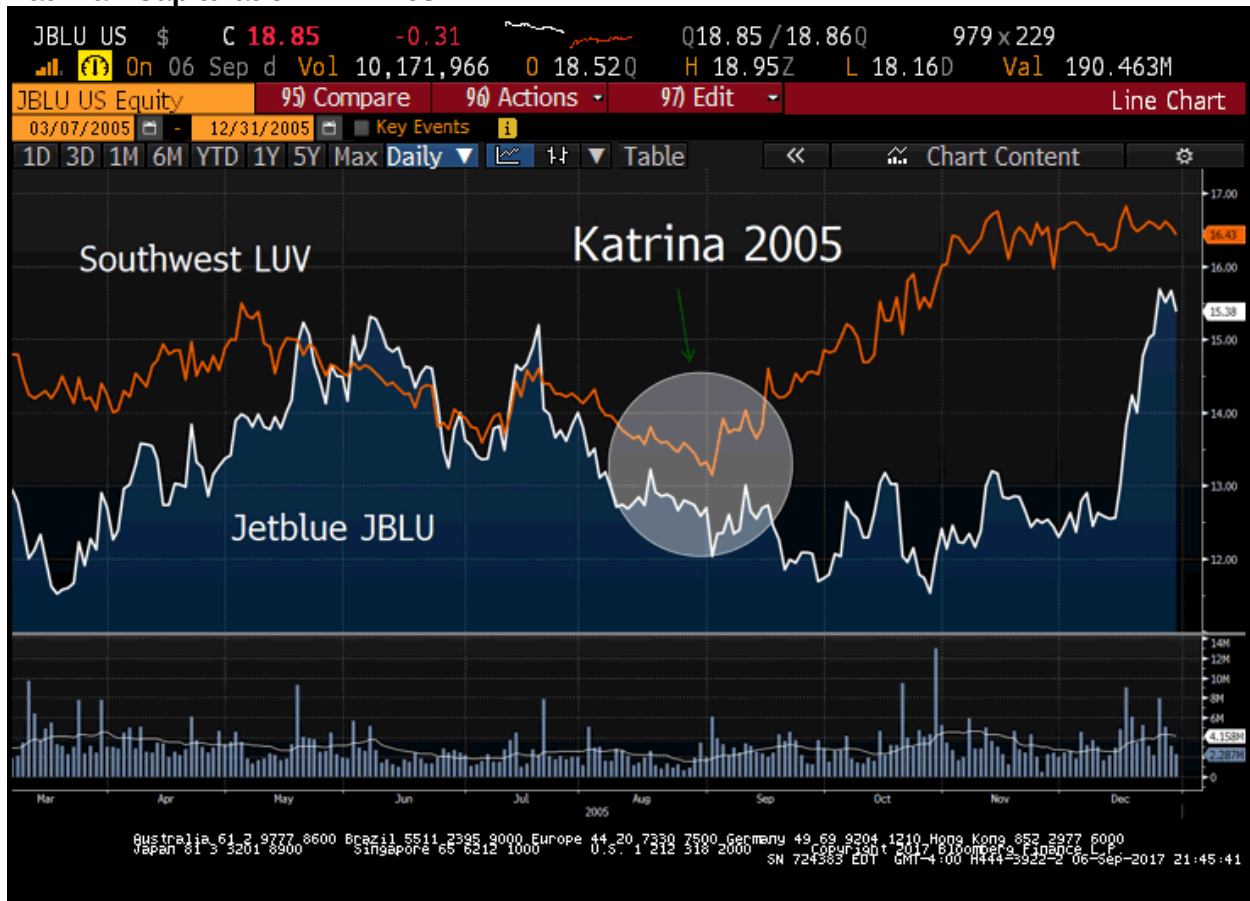
UAL Pain



A look at the green line above shows Warren Buffett's cost basis. Berkshire is the broad owner of nearly 30m UAL shares, about 10% of the airline. This month, as Irma was bearing down on Florida - United moved into high capitulation, the crowd was heading for the exits. In our view, the month of September has delivered the most substantial capitulation since 2012. The risk-reward over the next 60 days is very attractive. According to the forecast by the Airlines for America, approximately 236 million passengers will be transported worldwide by U.S. airlines this year, up 4% from the 2016 levels. Notably, air travel projection for summer is of 2.54 million fliers per day. Keep in mind, GDP outside the US stands at \$62B, inside \$18B - nearly 42% of UAL's revenues are outside the U.S., supported by a weaker dollar.



Katrina - Capitulation - Airlines



Over the last 50 years, if all you ever did was buy airlines during major hurricanes and sell them months later into Washington's fiscal stimulus love, there would be smiles all around. In the two months into Katrina, Southwest LUV lost 12%, only to surge 30% into year-end. JetBlue JBLU was more extreme, -24% / +47%.

CPI Boost

Hurricane Katrina caused a 0.3% decline in industrial production in the subsequent month and a 0.2% increase in the unemployment rate. Monthly payrolls lost about 150K workers for two months as the workers in the affected area claimed unemployment due to their inability to get to work. The destruction led to a downward revision in GDP in the second half of 2005 but an upwards revision of GDP in H1 of 2006, thanks to the recovery spending. The rate of inflation did get a significant temporary boost from the surge in gasoline prices. **CPI jumped 100bp in the month after Katrina hit as gasoline prices jumped 30% after the disaster.** After Harvey's landing, gasoline prices surged 10-12% in Texas.



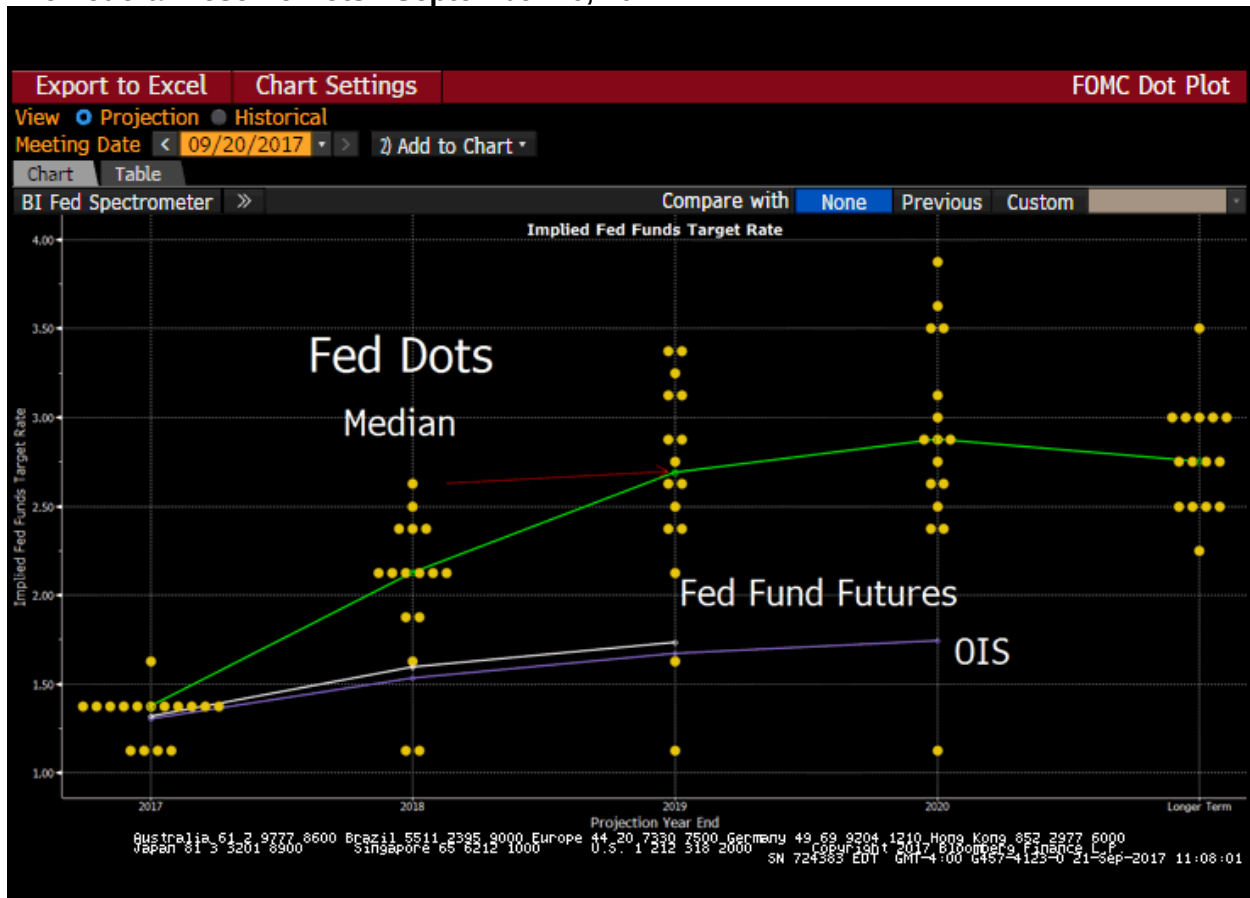
U.S. Economic Data is Mean Reverting, Before Tax Cuts and Infrastructure Spending



The Citi Economic Surprise Index is on a roll. As we've stressed in recent months - mean reversion here is a highly likely interest rate driver to the upside. Without geopolitical risks and hurricanes slicing 1% from Q3 GDP (Goldman's estimate), U.S. 10 year bond yield would be up at 2.50% in our view. The latest US Inventories, PPI, consumer credit, and CPI are driving this bounce. Inflation expectations (US 10 year breakevens) and the Citi Economic Surprise Index have diverged. Both touched lows early in the Summer and CESI (above) has marched higher while US 10 year yields have not followed suit. In our view, the fall in US yields which began at the start of Q3 had nothing to do with the global growth story (robust) but rather driven by more exogenous events and positioning (short covering developments).



The Federal Reserve Dots - September 20, 2017



The dot plot is published after each Fed meeting, shows the projections of the 16 members of the Federal Open Market Committee (the rate-setting body within the Fed). Heading into this week's meeting where did Wall Street get it wrong? The Street was looking for the median '18 dot (above) to come down substantially - that didn't happen. The street is waking up to the fact that the Fed is shifting away from inflation targeting, toward FCI (financial conditions) targeting. In our view, the Fed doesn't mind an overshoot of the long run neutral rate (R^* or rate hike equilibrium). The Fed has publicly admitted they're lost when it comes to secularly soft inflation in recent years. This year, the Fed's explanation of lingering low inflation data has been a riddle from the Fed. The first excuse was "it's transitory." Then they lectured "it's idiosyncratic." This week, we were told "it's a mystery." **Which begs the question - if they don't have a clue as to what's holding down inflation - how in God's name do they know where R^* (the point where they should stop hiking rates) should be?** A look at the Fed's summary of economic projections points to US unemployment falling to 4.1% over the next two years (what a bold call - sarcasm). At the same time, the Fed's estimate of how low unemployment has to fall to trigger inflation (NAIRU*) is unched at 4.6%. Bottom line: the Street is coming to the conclusion, the Fed may have to keep pulling back accommodation. Blind in the dark, they're struggling to identify the true R^* .

*NAIRU is an acronym for non-accelerating inflation rate of unemployment and refers to a level of unemployment below which inflation rises.



The Dots, Before and After

2017 range 1.125%-1.625%, unchanged
2018 range 1.125%-2.725% vs 1.125%-3.125% in June
2019 range 1.125%-3.375% vs 1.125%-4.125% in June
2020 range 1.125%-3.875%
Long-run range 2.25%-2.5% vs 2.5%-3.5% in June

Center of the committee remains in December rate hike mode for sure. Long end dots came down as expected - just terminal rate, not a big deal, we know they can't solve NAIRU anyway. This is so important for equity prices - if the Fed is shifting to financial conditions targeting, turning a blind eye to stubbornly low inflation - look out below.

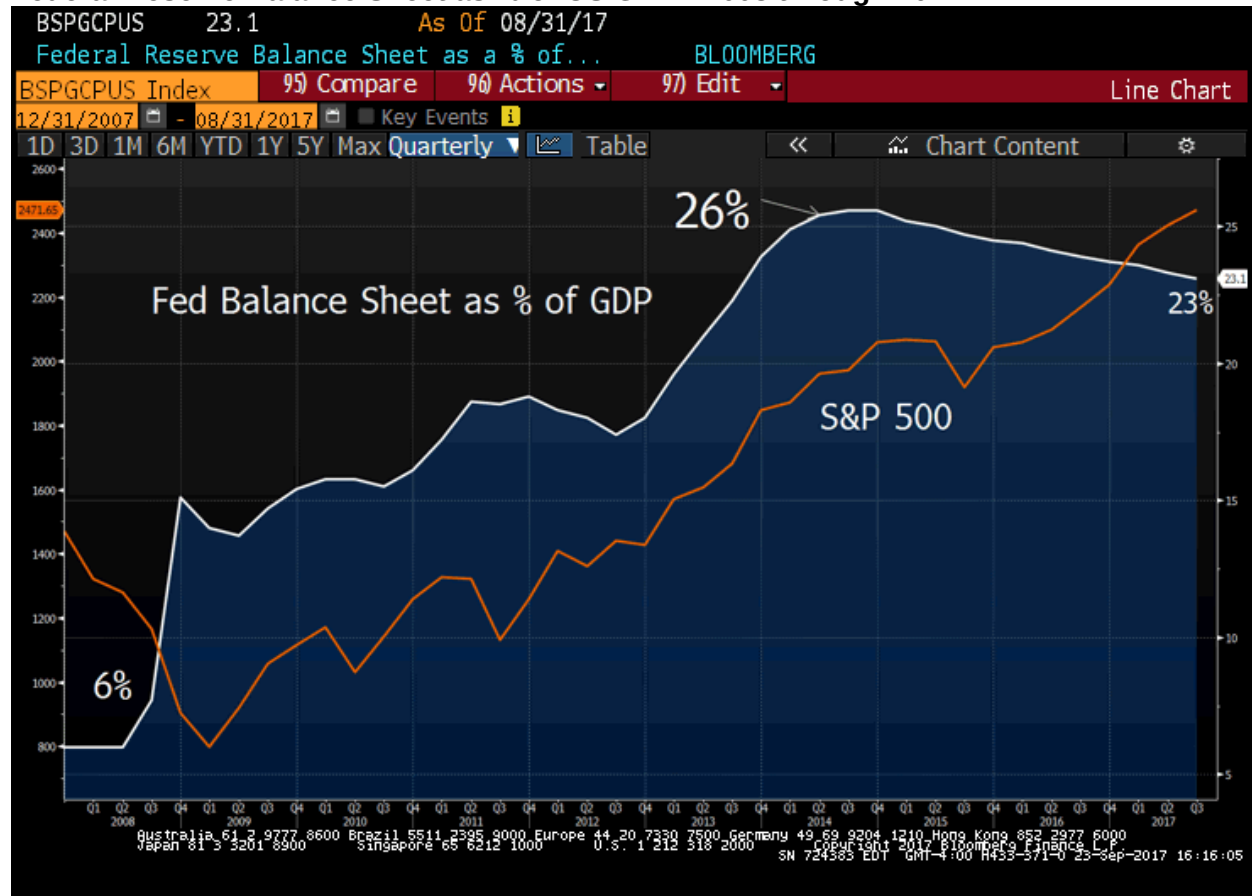
The Fed's Kaplan the Week

*KAPLAN: GLOBAL ECONOMY SEEN MOSTLY POSITIVE SURPRISES THIS YEAR
*KAPLAN: OPEN-MINDED TOWARD DECEMBER INTEREST-RATE INCREASE
*KAPLAN: SOME OF INFLATION SLOWDOWN ISN'T TRANSITORY

Looking ahead to Q4, we expect more "global economy" chatter from the FOMC as an excuse to lean hawkish. Again, the global economy will likely alter the current expected policy path from the FOMC.



Federal Reserve Balance Sheet as % of US GDP - 2008 through 2017



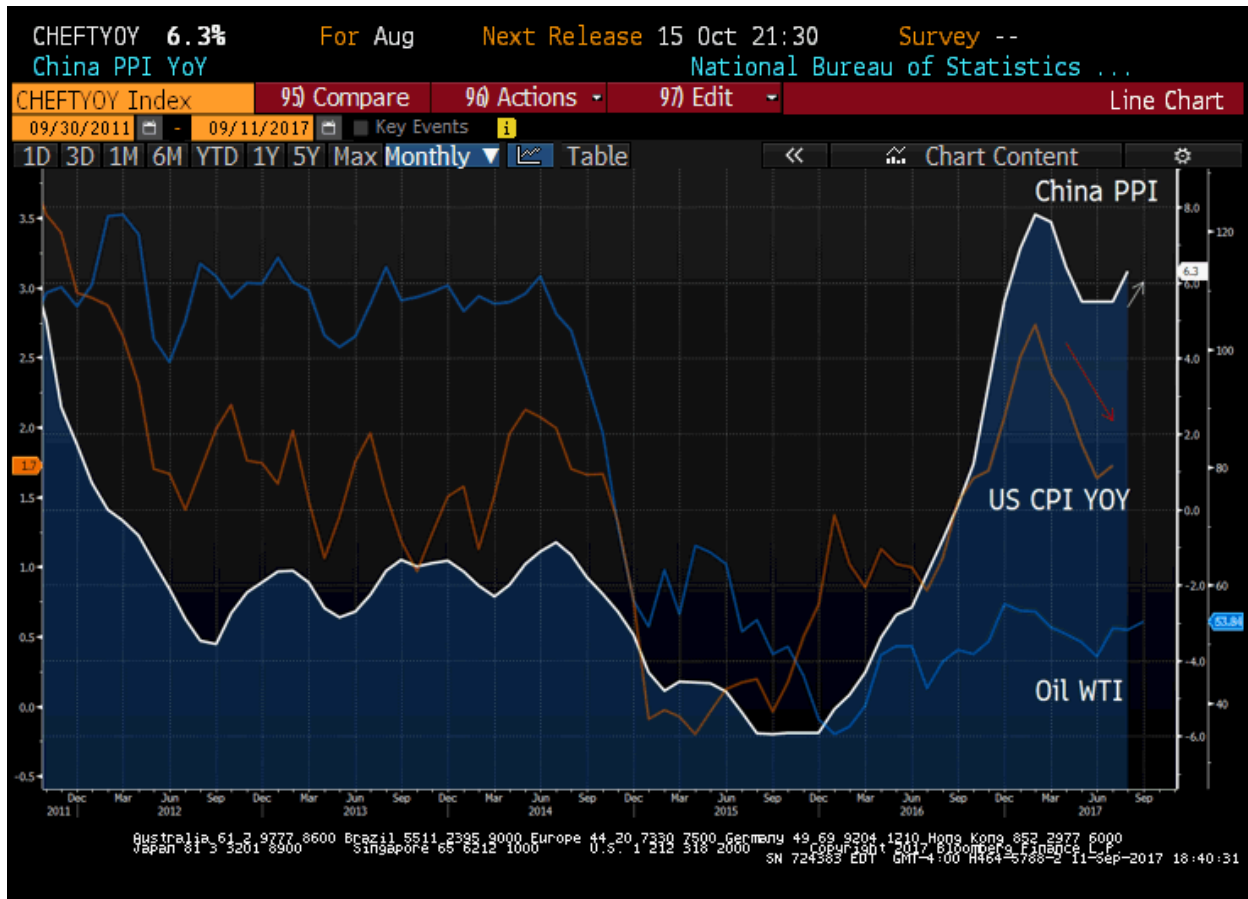
The entire street expects the Fed to gently "normalize" its balance sheet next month - the complacency around this historic event is OFF THE CHARTS. Since Lehman's failure - the Fed's war chest has surged from \$750B to \$4.5T. As you can see above, up from 6% - she's nearly 24% of US GDP (compared to 40% for the ECB and 94% for the Bank of Japan). In recent years, as mortgage-backed securities and US Treasuries matured - the Fed reinvests the proceeds and coupons to the tune of \$16B to \$26B a month on average. It's NOT well advertised but US QE (asset purchases) never ended. **A colossal risk the Street is ignoring comes down to the Fed exiting its vol suppression role. Next month, the Fed will shift from a buyer of market volatility (bond and otherwise) to a seller. Over the last decade, the FOMC has been the largest buyer of bond volatility in the world - arresting it and broad market vol in the process. By taking down their contribution - the responsibility of more vol buying flows into the market. This is the wildcard at the heart of the Fed's balance sheet experiment.** The US central bank will kickoff the reductions process with a cap on the monthly runoff of \$10B - that surges by \$10B every quarter until reaching \$50B in October 2018. With the tooth fairy in mind, the street believes the process will end in 2021 with a terminal balance sheet size of around \$3T or 12.8% of GDP. We must appreciate this beautiful, Kumbaya moment in modern finance. The mob is unanimously bought in - "because the Fed has been so delicate and transparent nothing can go wrong" - is the pervasive thinking. In May 2013, Fed Chair Ben Bernanke spilled the beans on QE tapering. That year we learned - even with the best, most well-planned intentions - a lot can go wrong when you're dealing with a serpent in the market that demands satisfaction and accommodation. That year, stocks plunged by nearly 7% and we witnessed a 115bps rise in the US 10-year Treasury bond yield. The 2013 "taper tantrum" came without tax cuts, a global - strong dollar deflation



feedback loop, and \$120B of hurricane relief. In our view, the FOMC has an unmanageable pile of levers to deal with in the months ahead.

U.S. CPI with China PPI and Oil

A look at China PPI, the pass-through from higher commodity prices over the summer is here. The interesting factor is oil - he was late to the party and just entered the room. If global growth remains at current trend and dollar weakness persists - the consequences for higher U.S. CPI inflation are ominous. **This chart below is a prime example of how much a global inflationary force is found in a weaker dollar.** If the dollar is to remain stubbornly weak, the prospects of continued strength in the industrial commodity market would increase price pressures in the U.S. In this scenario, the duration would have to adjust to increased inflation and the likelihood of a more hawkish Fed. Keeping an eye on prices in China - they will be key to judging how inflation will unfold in the U.S. going into year end. In our view, these developments have major implications for US stocks and bonds.



Last week we learned OPEC now forecasts demand for its output to average 32.7 million b/d in 2017, a rise of 200,000 b/d from its estimate in July, and sees demand in 2018 at 32.83 million b/d, up 400,000 b/d from its July forecast. OPEC said that it sees signs of higher demand and tightening supplies. The IEA lifted its estimate of 2017 oil demand growth for the third month in a row, to 1.6 million b/d. OECD demand growth continues to be much stronger than expected, particularly in Europe and the US. **As we head toward Q4, one of the most important questions comes down to global growth and commodity prices, what's the follow-on impact over to US inflation?** Labor Department said the Consumer Price index rose 0.4% last



month after edging up 0.1% in July. August's gain as the largest in seven months and lifted the year-on-year increase in the CPI to 1.9% from 1.7% in July. Core consumer prices increased 0.2% in August. This followed a lame four straight monthly increases of just a 0.1%. With the low market expectations on the back of recent inflation weakness, **we think the risks to US inflation are skewed to the upside**. Bottom Line: keep in mind in the chart above, all the lines are based on year over year change. The throughput from Brent oil (up 27% since June) and production metals to China PPI and thus to US CPI is alive and well and expectations of future inflation are still ignoring it - **this will surprise the Fed in the months ahead in our view**.

Ahead of this week's Fed meeting, we made this point in [Super Mean Reversion](#) - calling for higher bond yields.

Oil, Short Term Sell Signals



On August 18th we released our Bear Traps Report, [Capitulation Climax in Energy](#). We witnessed a noticeable under-performance of energy sector equities when compared with the commodity. That week we issued Trade Alert buys on OIH, XLE and XOP - we received a strong buy from our capitulation model. Today, we believe the trade has more legs on the long side, but short term a pullback is likely. It's interesting to note the outperformance of the leveraged oil sector equities. In this Bear Market rally, oil service and exploration companies are outperforming the oil commodity. We've cut the energy position in half and see near-term downside, post the OPEC meeting - followed by another leg higher.



From the August 18 Lows

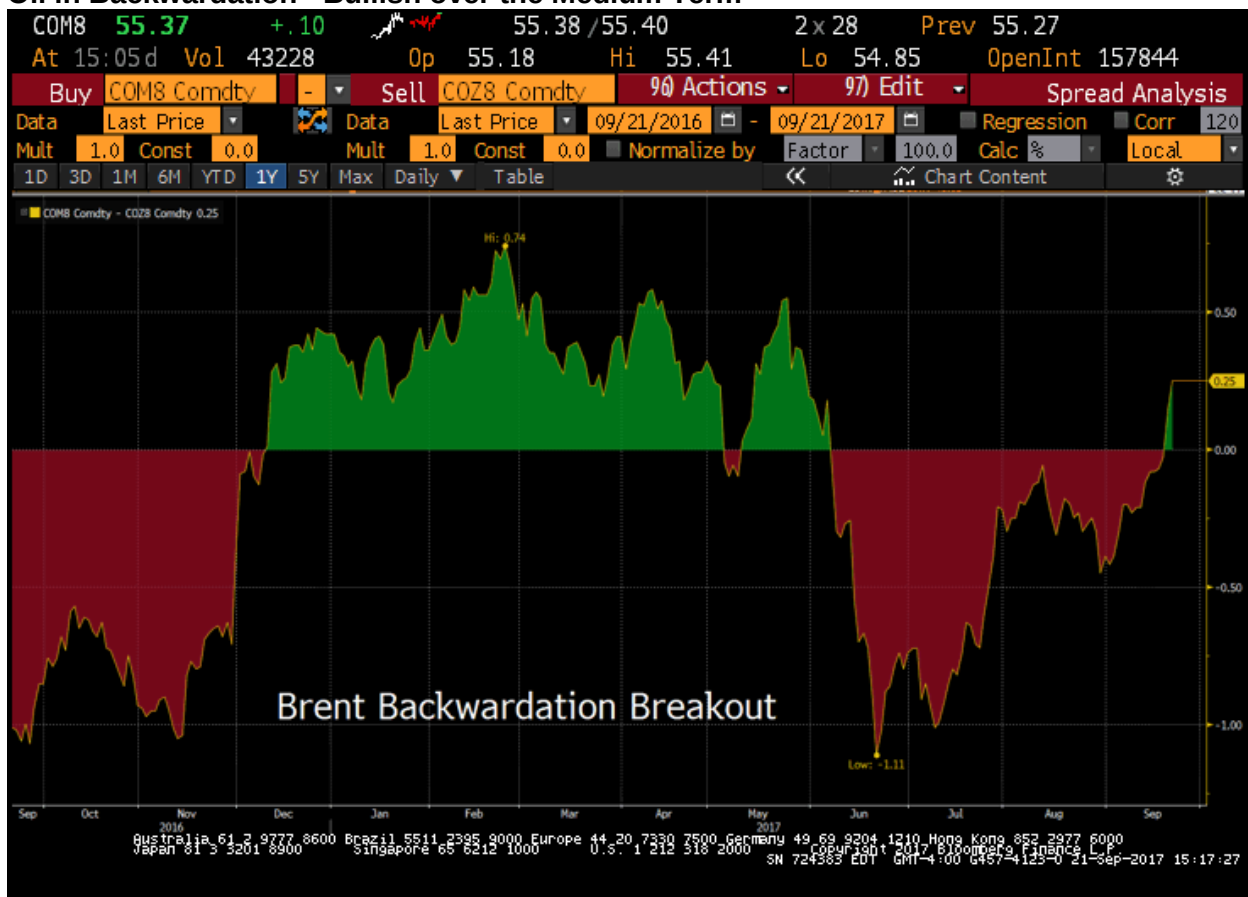
OIH: 15.9%
XOP: 14.3%
Brent: 13.1%
WTI: 11.3%
XLE: 8.7%

Bloomberg data

Oil Logistics, Harvey Side Effects

A number of gasoline tankers have been booked over the past several days out of Europe to the US and Latin America (the US normally supplies refined product to Latin America due to refining capacity shortage in that region). Approximately 12.5M barrels is expected to leave the region in coming weeks, sharply higher than usual flows. Mexico's national oil company, which is also short refining capacity and normally imports refined product from the US Gulf coast, has booked around 2ml barrels of gasoline from Europe and Asia.

Oil in Backwardation - Bullish over the Medium Term



Bullish Signals: the Brent crude futures spread for June 2018 / December 2018 traded on the Intercontinental Exchange shifted into backwardation this week for the first time in three months. On the heels of growing optimism around the global oil market rebalancing process, some believe this will drive the price structure higher. More market participants are starting to



wander over to this way of thinking. Strong estimates of oil demand by IEA and OPEC, driven by China and the US, continue to make their way through the market. See our August 18 note, [Capitulation Climax in Energy here](#). We've taken some of our oil longs off the table - but this data above **gives us confidence** over the medium term. Bottom line: this bear market rally in the energy equity sector may have more legs than others we've seen in 2017.

The Harvey Rebuild

According to current estimates, approximately 30% of Harris County (Houston - 4.5M population) has been flooded, compared to 80% of New Orleans in 2005. But the population in the greater Houston area is 4x as large as that of New Orleans before Katrina. An estimated 100,000 homes have been flooded by 8ft of water or more and many of these homes would require structural repairs or need to be torn down. Most homes in the US are made from wood and water damage causes structural damage and severe mold risk which requires entire or partial home replacement in many instances. In 2005, about 1M homes were destroyed. We believe that the building materials sector could see a short-term boost from the repair efforts. The refining industry has also incurred severe damage, and the oil services sector may see a pickup in demand as a result.

China Imports and German Rates



Inside the last 12 months, China for the first time became Germany's leading trading partner, overtaking the United States, which fell back to third place behind France. Per the Federal Statistics Office, German imports from and exports to China rose to 180B euros (\$195B) last year. Given higher metals prices, oil prices - elevated China PPI and Imports - something has



to give with low German bond yields. Deep inside the Federal Reserve, there's a growing concern. Commodity prices are rising at the fastest pace in five years - 11% dollar plunged in eight months do come with a price (side effects). The global deflation picture is nearly on the Fed's doorstep. In our view, there's a surging probability the Fed gets thrown off track in 2H 2017. They are behind the curve relative to **suppressed market expectations** (outlook for low inflation in anemic) – which the Fed has **fostered, embraced and enabled**. Over the last decade, we've learned academics at central banks are poor risk managers – especially when it comes to misjudging sharp moves in the U.S. dollar. Thanks to dovish Fed guidance (leaving the punch bowl filled at the party far too long – more accommodation), the interest rates futures market now sees September 2018 (yes 2018!) as the earliest FOMC rate hike (with >50% chance of Fed hike). A year from now, the FOMC will have serious regrets looking back on their latest policy moves. Nearly 10 years after Lehman, it's sad – they have **NOT learned** the error of their ways.

Industrial Commodities and Rates



In recent months, the Copper/Gold Ratio has been surging, this speaks to the high demand for industrial over precious metals. After a strong summer, there are signs of cooling. China's August activity and spending data point to a pullback which started in July. More specifically, in the short term, softer infrastructure spending point to tired metals demand. As we look towards next year (after the 19th Congress), we expect China's economy to cool as a result of policy tightening, this will have negative implications for most metals prices in 2018.

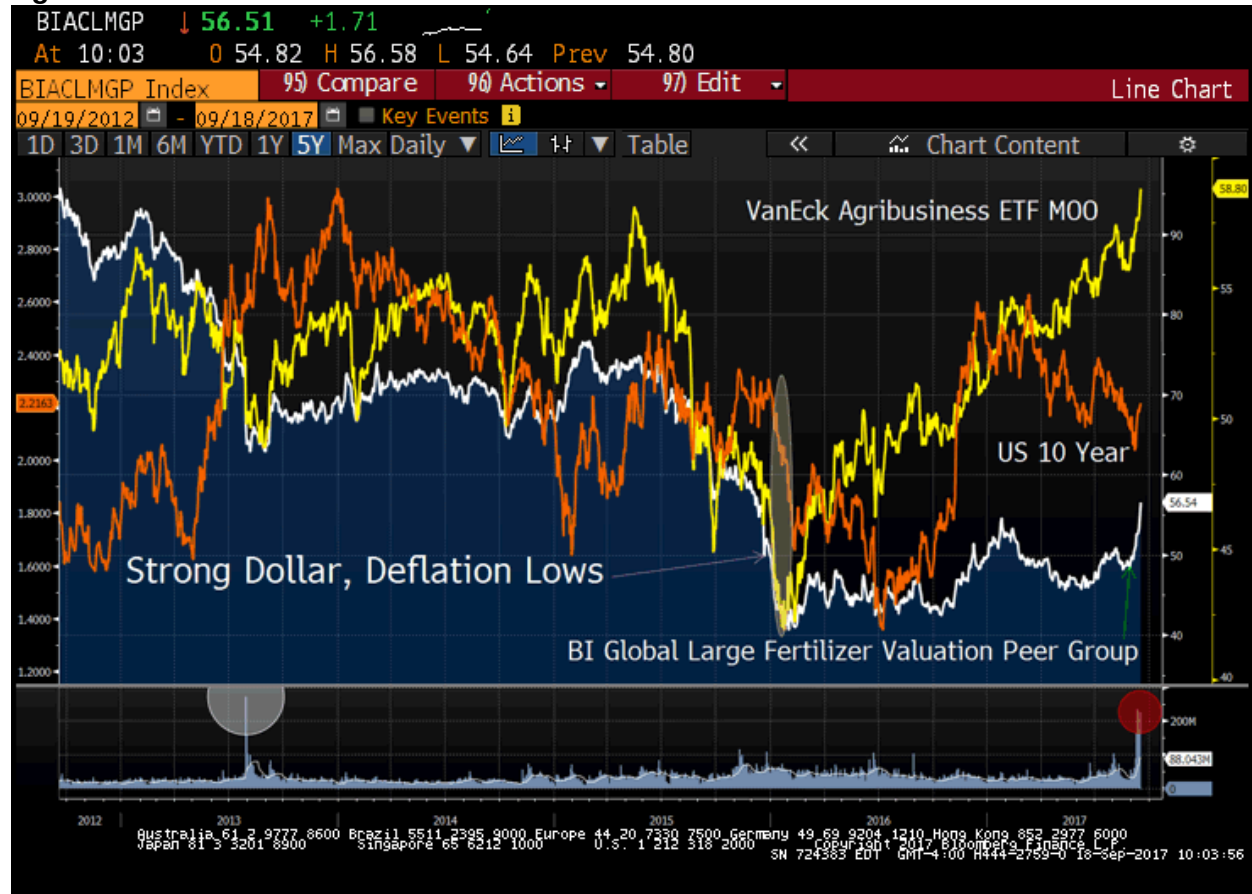


JPMorgan Global Manufacturing PMI

2017: 53.10*
 2016: 50.50
 2015: 50.75
 2014: 52.10

**Global Manufacturing PMI covers over 12,200 purchasing executives in over 43 countries accounting for an estimated 95% of global manufacturing output. Supported by a weak dollar, Global Manufacturing PMI touched nearly a seven-year high in August.*

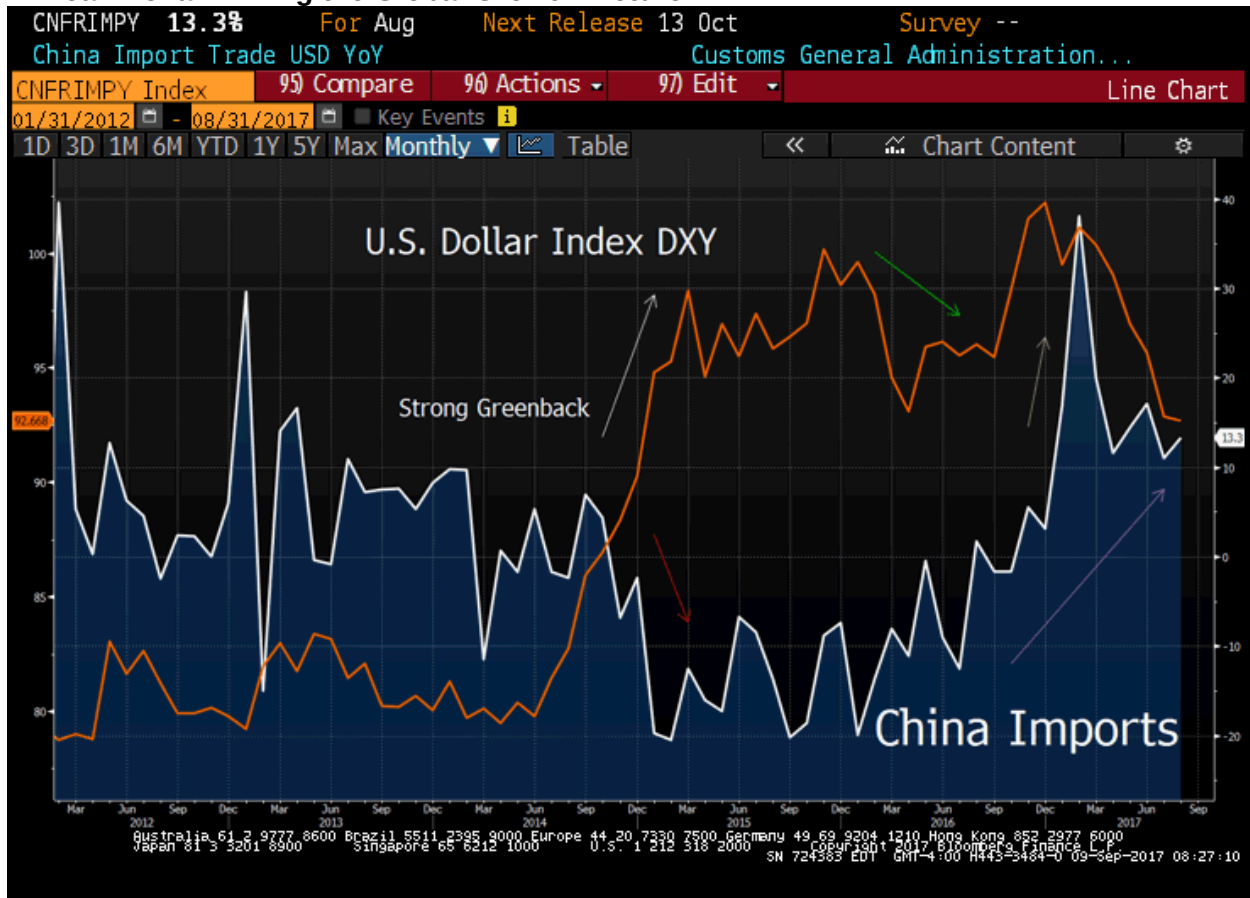
Agra Reflation and US Rates



The last time the global Agra (agriculture) space was this well bid - US treasury yields were a lot higher. Since the dollar's 2016 peak - deflation risk highs (shaded oval above), the demand for agricultural commodities and fertilizer has been on fire. Thanks to a weak greenback, the Fed has a concerned eye on global price feedback pressures in our view.



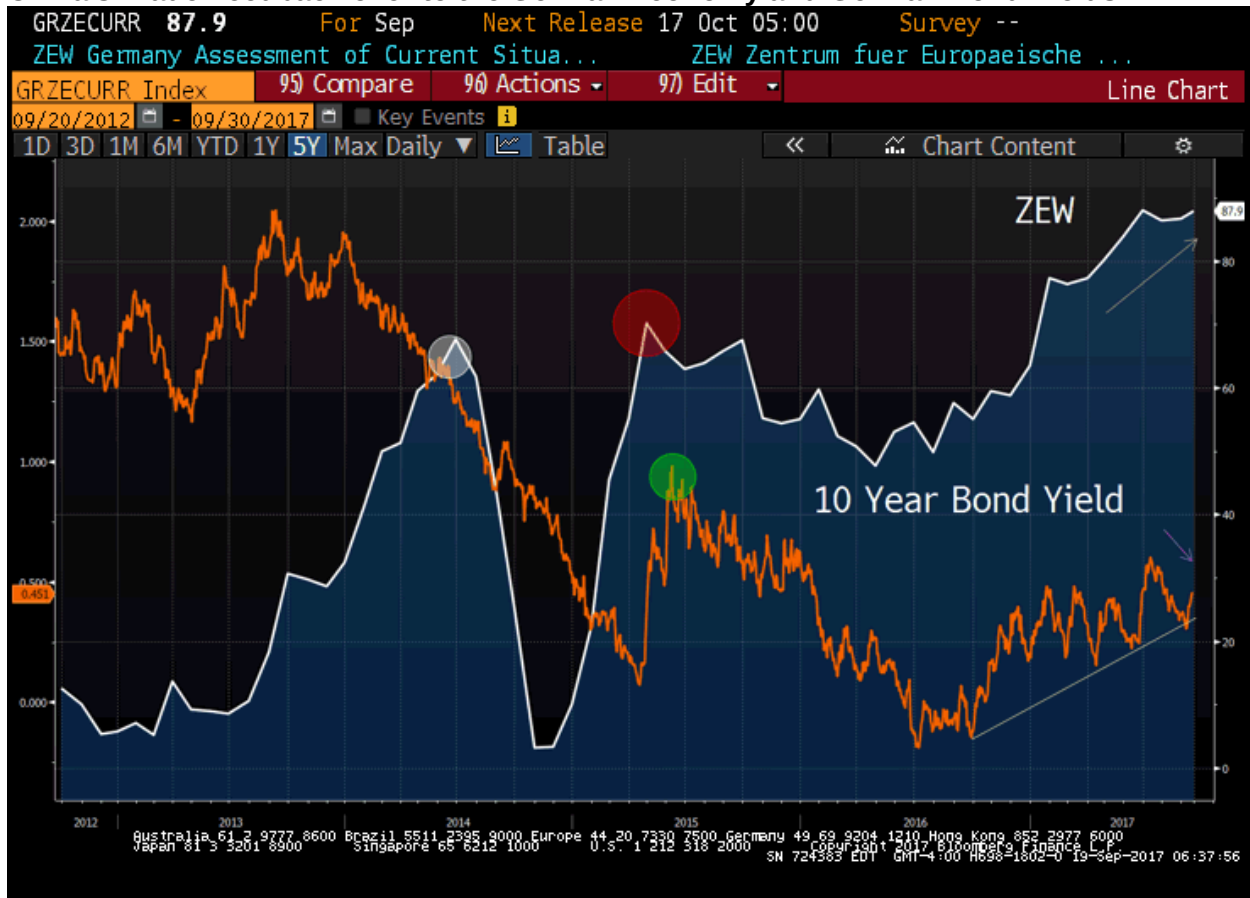
A Weak Dollar Driving the Global Growth Picture



Through the recent yield suppression in the US bond market, there's creeping disconnected relative to the global growth picture since July. On the heels of geopolitics, natural disasters, and short covering - bond yields should be higher in our view. Through all the drama, we are seeing early signals US yields starting to acknowledge the global stage. In our view, these risks point to higher bond yields going forward.



China's Trade Feedback over to the German Economy and German Bond Yields



We expect a positive feedback loop more broadly back to the US from global fixed income, especially from Germany. Back in July of 2016, the Cass Freight Index was suffering from a 17th straight month of YOY decline. Since that time, freight volumes and expenditures have improved substantially on the back of e-commerce, and an improving oil patch. This week, the German ZEW Economic Sentiment surged to 17.0 points, easily beating the forecast of 12.3 points. The question remains - will hot global trade data coming out of China - spill over and drive German bond yields higher? The German economy continues to look strong. The ZEW report noted that growth in the second quarter remained robust, and both the public and private sectors were marked by increased investment. Likewise, global demand remained steady. Reuters notes this summer, German business morale hit a record high as "euphoric" manufacturers, shrugging off the impact of a strong euro, anticipated a surge in already robust exports from Europe's biggest economy.

Global Debt Denominated in Dollars

2016: \$52T*
 2010: \$31T
 2005: \$22T

BIS data

*Global dollar-denominated debt sales have surged 165% from this time in 2016, YOY. Our weak dollar Fed is funding the fastest annual start on record, according to data compiled by

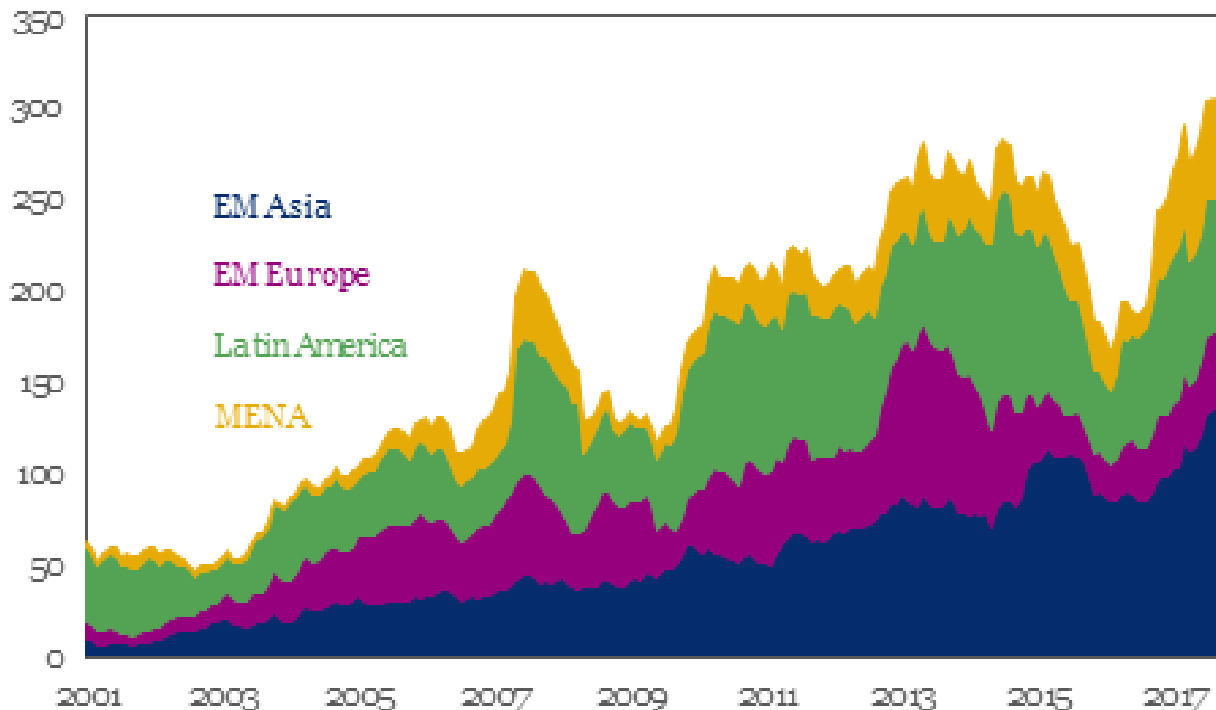


Bloomberg going back to 1999. The overseas debt binge has boosted the total foreign **corporate debt** (not sovereign) due in the next five years to \$1.7T, according to the Institute of International Finance. More than 80% of which is dollar denominated. Over 106 Chinese real estate companies were issuing close to \$25B of gross dollar-denominated debt per quarter by early 2015. As the U.S. dollar surged, this number fell sharply in 2016, **but it began rising again this year as the dollar plunged**. Adding insult to injury, the global sovereign debt load is likely understated by more than \$2T. Per the BIS, accounting conventions leave it mostly off-balance sheet, as a derivative, even though it is in effect a secured loan with the principal to be repaid in full at maturity. Swaps and forwards amounted to more than \$3T a day last year, that's the equivalent to more than 60% of total FX turnover. More than 90% of the market was in dollars and FX swaps accounted for 75% of the total - BIS. **Let's NOT kid ourselves, the side effect of easy money US Fed policy is still VERY global!!!**

Weak Dollar Side Effects = Emerging Market Debt Issuance Orgy

Persistent rebound in EM bond issuance in foreign currency

USD billion, 12-month moving sum

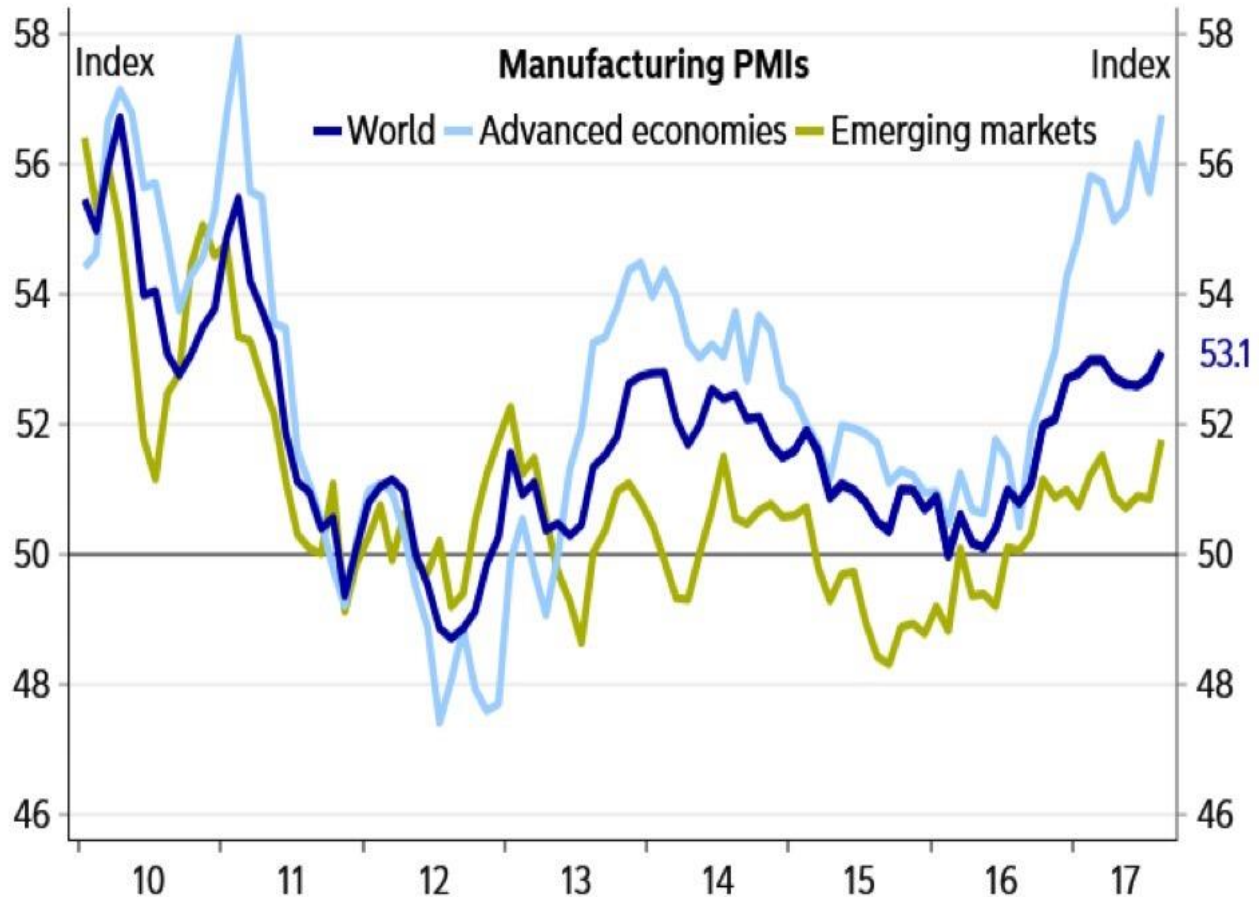


Source: IIF, Thomson One

Do you believe a weak US dollar provides juice to global leverage and economic growth? Since 2009, emerging-market non-bank borrowers have accumulated nearly \$4T in dollar-denominated debt, according to Bank for International Settlements data. Top right above, as the US dollar surged 2014-2016 - EM debt issuance plunged. **In March of 2017 - as the Fed talked the number of future rate hikes lower, the follow-on weak dollar brought the "punch bowl" back into the living room, party on.** As a result, we've seen a sharp pickup in debt issuance. Likewise, on the heels of a weak greenback, the MSCI Emerging Markets stock index has returned more than 30% this year, compared with 15% for the developed-market

MSCI World Index and 13% for the MSCI USA. Clearly, a weaker dollar eases global financial conditions - allows the debt bubble to re-inflate. Thanks, Janet Yellen! Next, US dollar debt issuance in Asia excluding Japan and Australia hit a record high of \$40B for the months of July and August, fuelled by robust appetite in China, according to data from Dealogic.

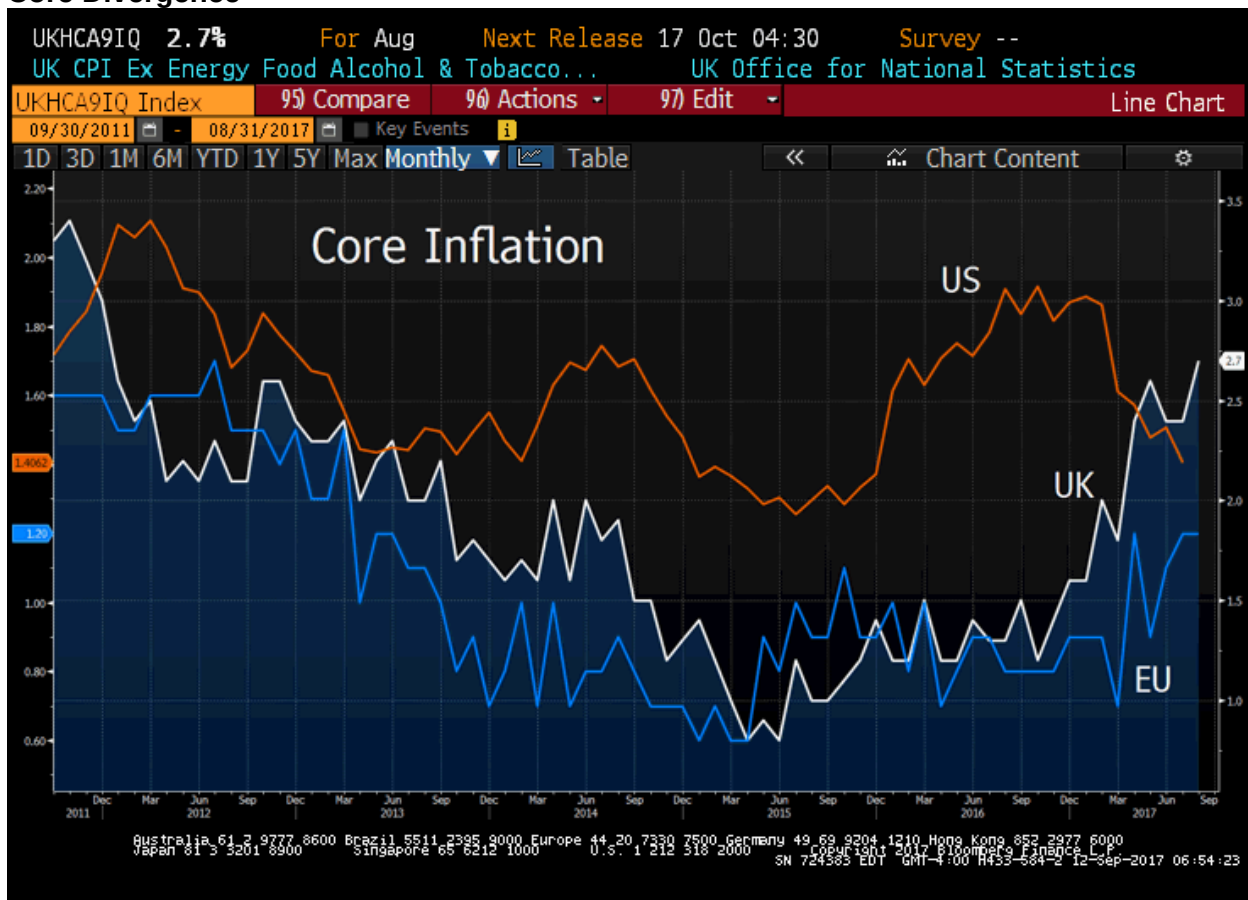
Dollar's Plunge - Fueling Global Growth and Leverage



In 2017, global economic strength has been weak dollar driven - just look at Manufacturing PMIs above. As the Federal Reserve lowers rate hike expectations (as they've done all year - weakening the dollar) the creepy side effect is even more emerging market leverage. This year, EM bonds issued in local currencies have returned nearly 20%, compared with 10% for bonds hard currencies (dollars or euros). Last week, China's issued a \$2B dollar-denominated bond, using the cash to reduce borrowing costs for its toxic State Owned Enterprises or SOEs. China is expected to target a 60 to 70 basis point premium over U.S. Treasuries. South Korean five-year dollar debt spreads average around 65 basis points. SOEs need to fund themselves in the open market, but it doesn't mean the government cannot help set a benchmark to give them a hand. China's goal here, taking advantage of a central bank induced - white hot credit market. Ultimately, if they can extend and pretend - reduce the borrowing costs of their highly leveraged SEOs - it makes for an upbeat room full of smiles at **October's 19th Congress in China***. Thank you, Janet Yellen.

*The Chinese Communist Party will hold a once-every-five-years leadership reshuffle in October - a test of President Xi Jinping's power. About 2,300 delegates, including senior officials, will meet in Beijing for a party congress on October 18, per the New York Times. They are expected to confirm Mr. Xi for a second five-year term and to appoint a new collection of officials under him. Mr. Xi, already one of the most influential Chinese leaders in decades is likely to emerge from the meeting even more formidable. Once the big show is over and Xi's position is a certainty - look for a great deleveraging to kickoff next year. **We must NOT forget, the centenary of the founding of the Communist Party of China is in 2021, at which point, a full Xiaokang society (moderately well-off) would have been achieved. We believe the great planners will use 2018 as their colossal cleansing transition - deleveraging, cleaner air (see lithium and electric automobile growth estimates) and a good old regulatory Salem witch hunt. The implications for markets will be aplenty - a giant leg down for commodity prices late next year.**

Core Divergence

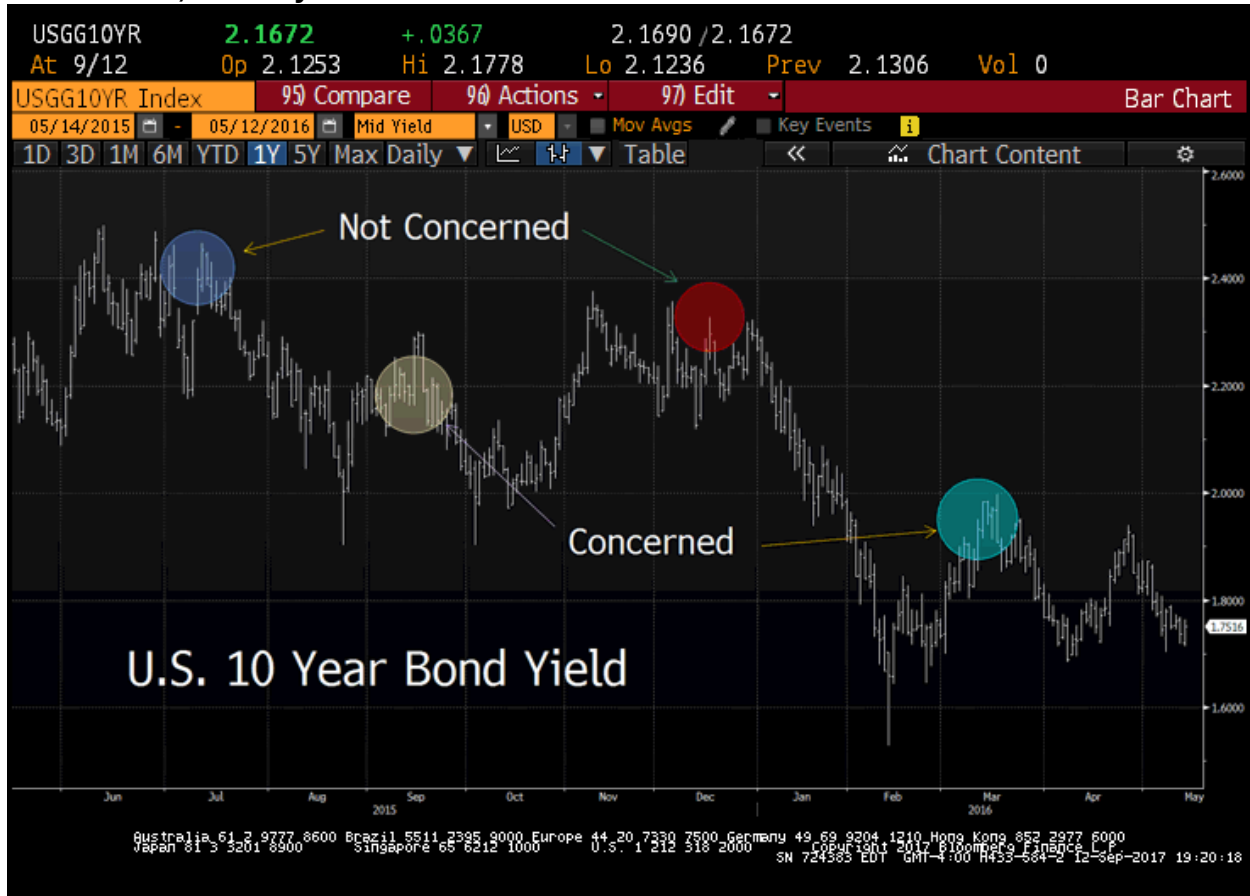


The UK consumer price index spiked to 2.9% in August, from 2.6%, matching May's four-year high. Core inflation in England rose to 2.7%, its highest level since 2011, putting more pressure on the Bank of England to consider an interest rate hike. There's rising concern the BoE could raise borrowing costs in the world's 5th largest economy. The pound is currently trading at a one-year high against the US dollar, near \$1.35, and a six-week high against the euro near €1.11. The problem the BoE has is, vs. its biggest trading partner, the Euro, the GBP has been very weak again this year. As we have discussed in past notes, the UK runs a considerable current account deficit which has put pressure on prices as the currency has weakened since Brexit. Now, as the Euro has appreciated on the expectation of continued economic growth in



the EMU and the beginning of ECB tightening, the EUR/GBP cross has shot higher. This has put Carney and the Bank of England in a precarious situation. They do not want to hike rates as wage growth is flat, there is still spare capacity and the prospects of hard Brexit still weigh on domestic investment. In Draghi's (ECB chair) view, it's not an economy that needs monetary tightening. However, these concerns have to be put on hold, as the recent BoE signal of a hike is about one thing, defending the currency and making sure future inflation comes in softer as a consequence. The BoE cannot afford the EUR/GBP cross to continue marching to parity and take UK inflation higher with it. With inflation near 3% in the UK, Carney had to step in and defend the GBP vs the EUR, despite the weaker internal dynamics in the British economy.

Yellen's Fed, Are they Concerned or NOT Concerned?



Global economic impact over-powering the Fed? Who could forget the Fed's "Concerned" and "NOT Concerned" comedy show in 2014-2016? Back then, the dollar's 18% surge fueled a global disinflation feedback loop over to the US. In April of 2016, the Fed said: "participants generally saw global economic and financial developments as continuing to pose risks to growth." Over 18 months we witnessed a disconnect between the Fed's "concerned" and "NOT concerned" perspective on global credit and currency risk tied to financial conditions and economic growth projections in the US. When the Fed expressed "concern" we were typically near market bottoms (they pushed down rate hike expectations), while their position of "not concerned" were always close to near-term market highs. Let us ask you a pointed question? If the global economic backdrop had such a profound impact on the 2014-2016 Fed policy path - isn't there a rising probability of another "concerned" moment? Ultimately, this time it's **NOT** a disinflation concern, but growth / inflationary worries (see China PPI, imports, commodity prices,



an 11% move lower in the dollar - side effects) feeding globally back to the US. **Bottom line: If global economic conditions clearly altered the Fed's perceived policy path before - we believe it's highly likely to happen again.**

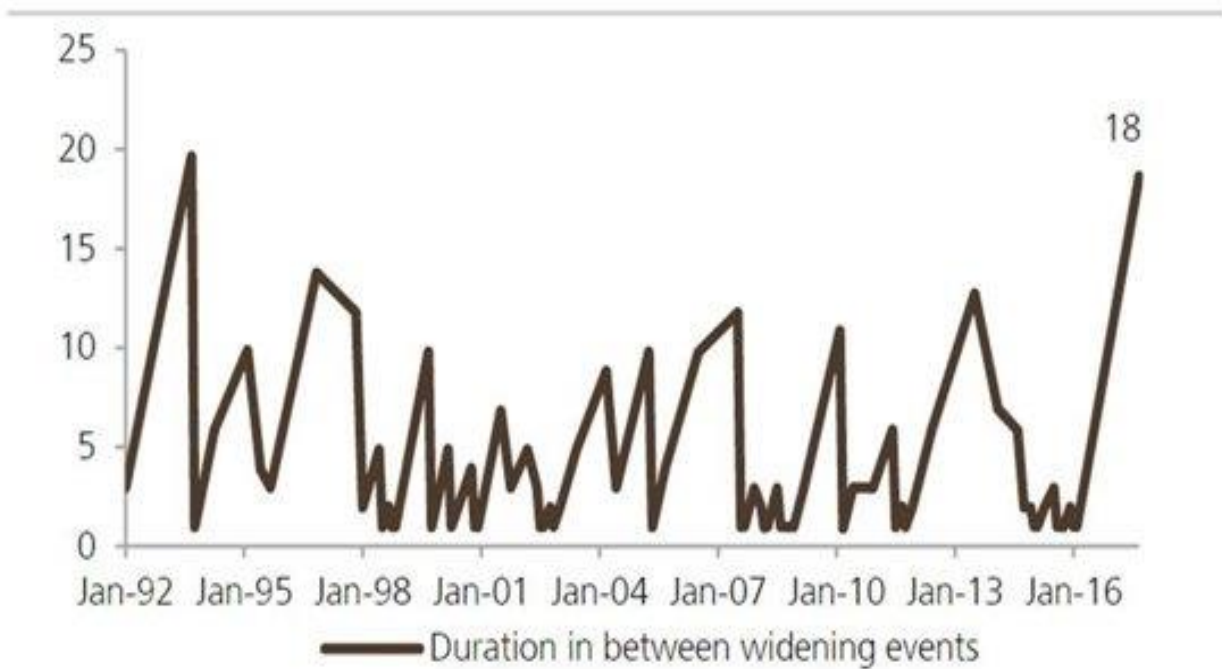
The Federal Reserve, "Concerned" and "NOT Concerned" Global Economic Risks

March 2016: concerned
 Dec 2015: **not** concerned
 Sept 2015: concerned
 July 2015: **not** concerned

FOMC Statements

The Great Enabler of Moral Hazard

Figure 1: Duration of stable periods for US credit spreads (count, months)



Source: UBS

Over the last 75 years, capital markets (ease of bond sales/issuance) have rarely been this wide open. Since Lehman's failure at the height of the great financial crisis, gross issuance of **US corporate debt is approaching \$11T**. Year after year - annual issuance breaks another record. The Fed has become the great enabler. When central banks (ECB, BOE, BOJ, FOMC) prevent the business cycle from functioning over long periods of time, the natural cleansing process is suppressed. The bottom line net result is you're stuck with mountains of cash with nowhere to go - of course, it ends up in the wrong place. Thanks for the ECB's \$60B a month of asset purchases - European countries have expanded their US corporate debt ownership by nearly 40% since 2014, Bloomberg data.

Regional Banks Love Higher Rates



When you're trading banks, you're actually in a rates trade. A steeper curve is desperately needed to drive the financials higher.

"Once again, the flat 2-10s curve has flattened dramatically, this has crushed the regional banks. With a view toward higher bond yields, we recommend clients overweight the financials relative to the S&P 500."

Bear Traps Report, September 10, 2017

Inflation Side Effects Found Post-Hurricane Periods

In 2005, it took more than a month for crack spreads to normalize even though much less capacity was compromised. This time, it may take much longer for the capacity to come back on-line in full, and refining margins may stay elevated. Besides US refiners, European independent refiners are poised to benefit from the spike in crack spreads. The US refiners with the least exposure to the Gulf Coast will likely see the largest benefit. These are **Andeavor** (formally Tesoro) and **HollyFrontier**.



Steel, Building Materials



According to Cox Automotive, an estimated 500,000 cars could be destroyed as a result of Harvey. That's a lot of steel. Water damage is often the cause for a car to be declared a total loss, due to potential rust and the damage to the ubiquitous electronics in modern cars. This would provide a short-term boost for new auto sales but also raise prices of second-hand cars. This could be a double benefit to the beleaguered car rental companies, which have suffered from the decline in second-hand car prices.



Steel: Irma - Harvey Upside



Commerce Secretary Wilbur Ross said the Trump administration has decided to defer a decision on steel tariffs as it focuses on getting tax reforms through Congress. "The policy decision has been made to postpone that until the tax bill," Ross told Bloomberg Friday. Shares of major U.S. steelmakers declined after Ross's remarks. U.S. Steel Corp. dropped the most, falling as much as 6.1% and extending its two-day decline, while Nucor Corp., AK Steel Holding Corp. and Steel Dynamics Inc. also fell. In Bear Traps trade alerts this year we were buyers of Steel names. Fortunately, we exited the position when we felt equities ran ahead of policy execution risk coming out of Washington.

Harvey and Steel

Many people who lost their cars will temporarily rent a car. In addition, a reversal in the second-hand car market will also boost the residual value of their fleet of cars. Car rental companies have suffered over the last year as the second-hand car market has slumped from the wall of leases that have started to come off. A rebound in second-hand car prices would be a welcome relief for these companies. Another beneficiary of this is the recycled steel companies such as Nucor. A surge in scrap cars from the storm leads to lower input costs for Nucor. As more scrap steel comes to the yards, prices come down and this allows recycled steelmakers such as Nucor to lower their input costs.



Best Regards,

The Bear Traps Report Team

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