

SOM Macro Strategies

State of The Markets: Abenomics

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The Four Steps of the Investment Process

- Step 1: Identify the macro theme that could reprice markets
 - Abe had won an overwhelming mandate to change the Japanese economy at the end of 2012 with his “Three Arrows” called Abenomics
 - Would he implement any of his “Arrows” in 2013 given he had not the first time he was elected in 2007?
- Step 2: Build the Fundamental Framework for the theme
 - The economics of age in Japan would argue for no part of Abenomics being implemented
 - Deflation and appreciation of the currency are good for older and wealthy households, which dominated politics
 - Yet, these older households voted for Abe giving him a substantial mandate for change
 - So, the missing piece for why they voted for him and why 2013 would be different than 2007 was China
- Step 3: Identify events and the likelihood of those events being realized over the next 12 months
 - Event would be the BOJ implementing QE
 - Timing would be sometime in April or May after the replacement of the head of the BOJ
- Step 4: Find the best implementation
 - Japanese equities and JPY provided cheap asymmetries because these markets were not pricing in a high probability of QE, the first arrow of Abenomics
 - Buy Nikkei calls for May settlement and short the yen outright vs dollar both provide 5 to 10-1 payouts
 - Credit spreads would likely tighten and yields could be pushed lower by QE

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Step 1: Identify A Macro Theme

- Abe was elected with an overwhelming majority at the end of 2012 based on his economic and social plan to revitalize the Japanese economy
 - The three arrows of changes, which was called “Abenomics
 - He won despite the economics of age
- The market was not pricing in a high probability of Abenomics being implemented
 - Abe ran on the same program in 2007, yet nothing happened
 - Why would this time be any different?
- The macro theme became clear: The Three Arrows of Abenomics

Abenomics Three Arrows

- **First Arrow: QE**
 - **Inflation target of 2%**
 - **Double money supply in two years (QE)**
- Second Arrow: Fiscal Policy
- Third Arrow: Growth Strategy
 - Increase labor participation rate of women
 - **Change name of Defense Force to the Armed Forces**

Market Discounted The First Arrow

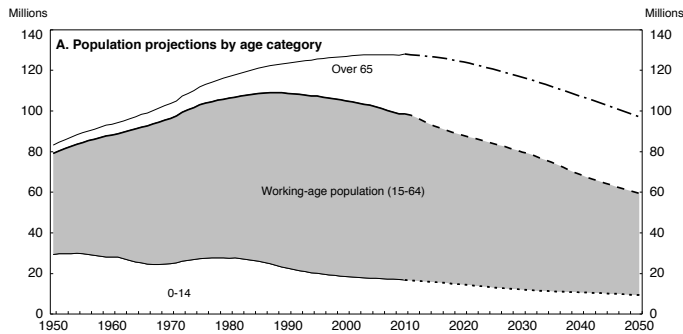


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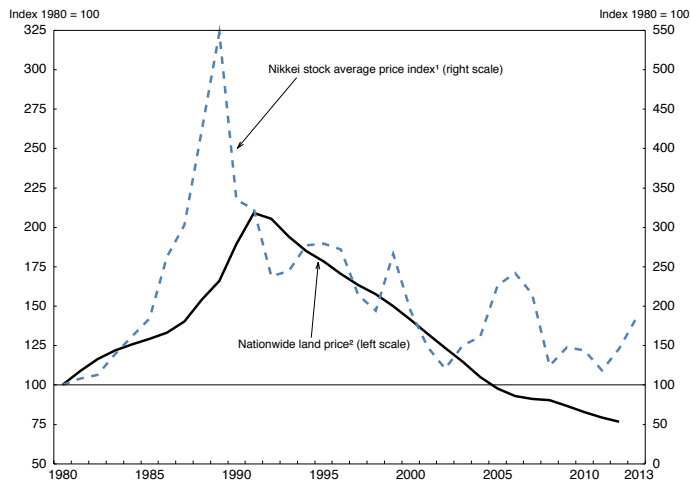
Step 2: Create a Fundamental Framework

The Economics of Age in Japan

The Population of Japan Is Aging and Shrinking

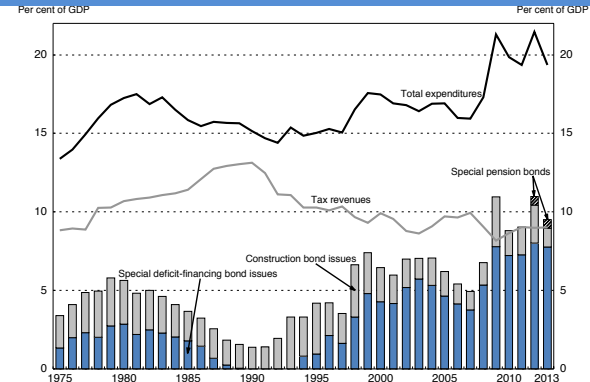


Aging is Generating Deflationary Pressures

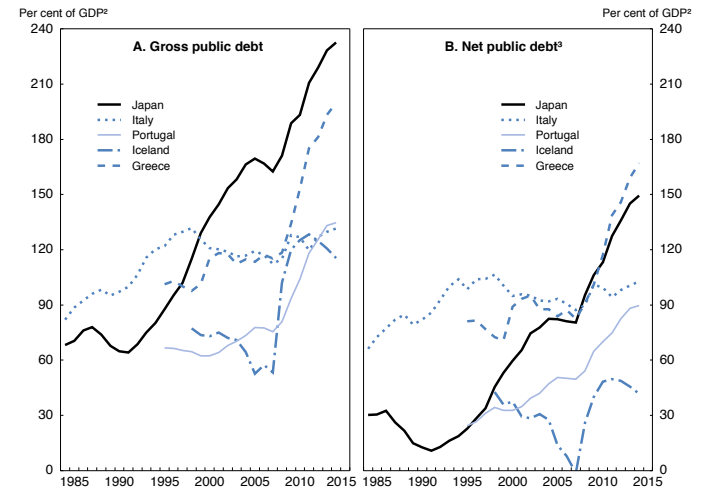


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Aging of Japan is Creating A Government Funding Imbalance



Imbalances are Creating Debt Sustainability Issues

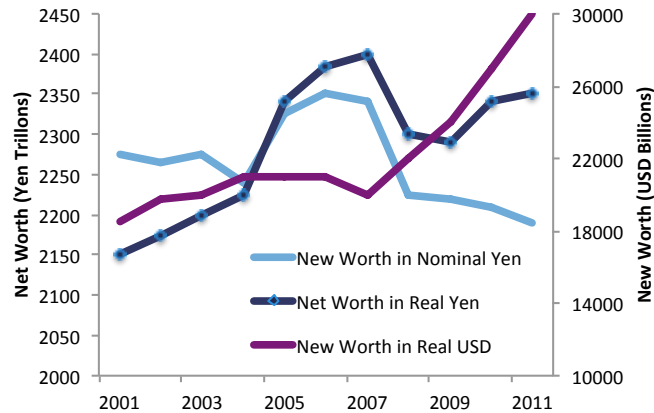


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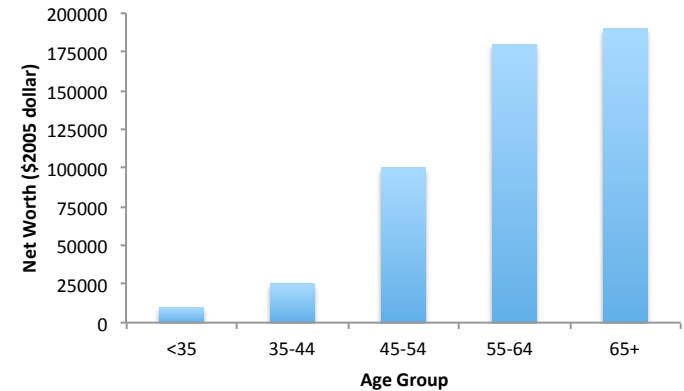
Step 2: Create a Fundamental Framework (Continued)

Why Did He Win, Given the Economics of Age?

Appreciating Currency and Deflation Added to Wealth
(New Worth in Japan by Various Measure)



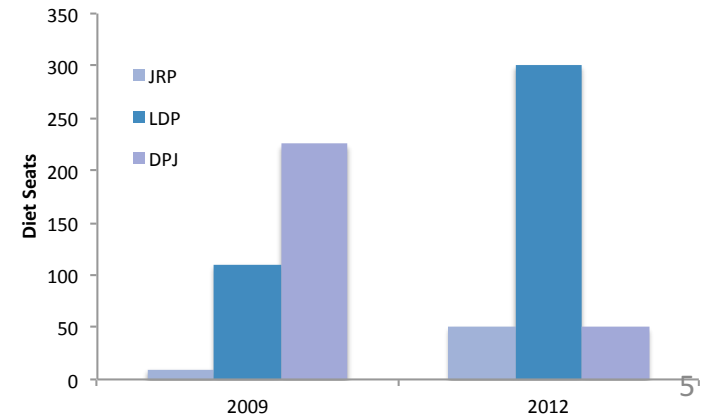
Older Households Own Most of the Wealth
(Japan Net Wealth by Age Group)



Personal Income Was Fine Adjusting For Population
(Per Capita Income, USD)

Country	1994-8	1999-2003	2004-2008	2009-13
Japan	39.4	43.1	46.1	46.7
Germany	40.3	40.2	44.3	41.8
USA	47	48.4	49.9	51.8

Yet, Abe Was Going To Win An Overwhelming Majority



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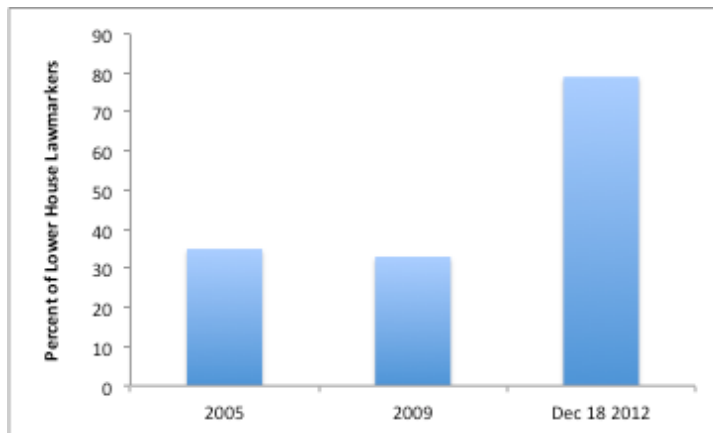
Step 3: Determine A Catalyst

China Threat Offset Economics of Age And Abe Would Shoot the First Arrow

The Key Insight Was China And The Third Arrow

- The Third arrow
 - Increase labor force participation rate of women
 - Eliminate guaranteed lifetime employment
 - **Change name of Self-Defense Force to the Armed Forces**
- The Senkaku vs the Diaoyu Islands

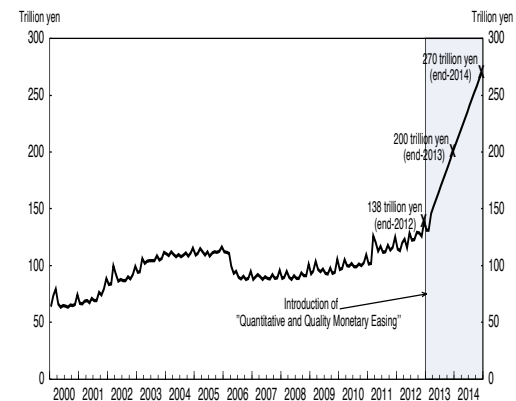
Japanese Lower House Members That Support Changing the Name of the Self-Defense Forces



Net Step For Abenomics Was April 26th

- Dec 16, 2012, lower house of diet selected
- Feb-Mar 2013, selection of BOJ governor (likely Koroda)
- April 8, 2013 Current BOJ governor Shirakawa's term ends
- April 26, 2013 BOJ Monetary Policy Meeting (QE or not to QE)

QE Was The First Arrow



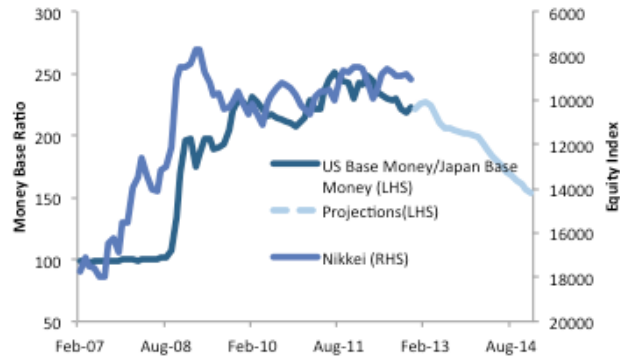
Source: Bank of Japan.

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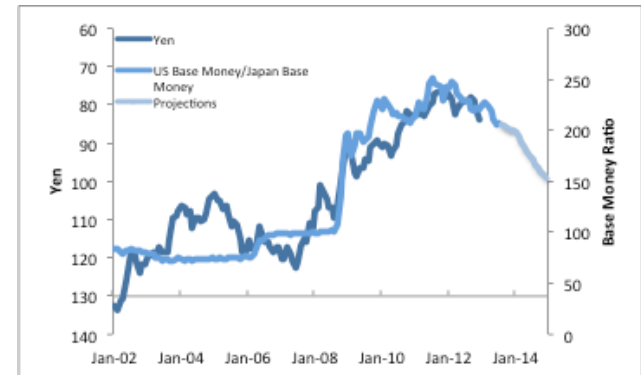
Step 4: Select Best Implementation

Focus on QE, Yen Puts and Nikkei Calls

QE Could Push Up Japanese Equities Prices



In The USA, QE Weakened Dollar But BOJ QE Could Strengthen It



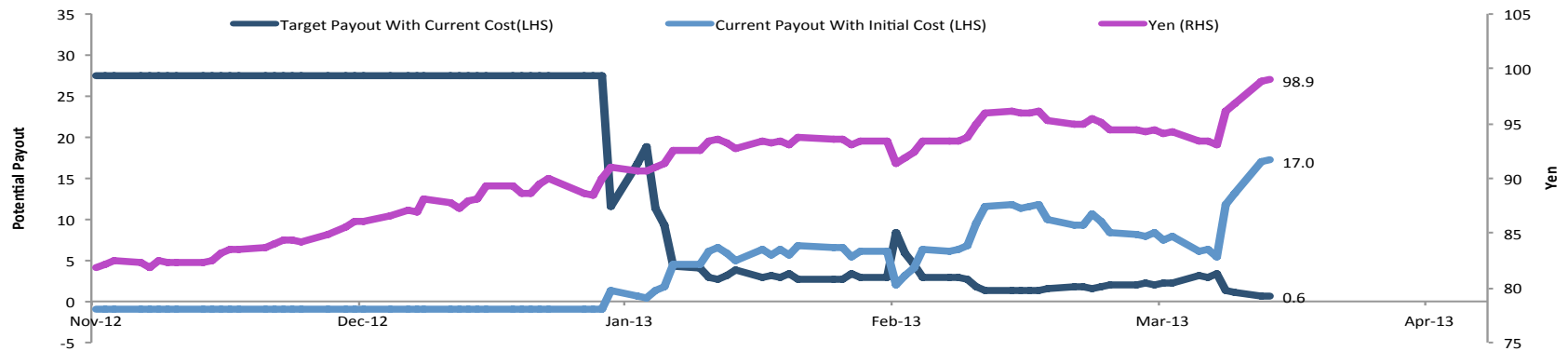
Trade	Spot (11/28/12)	Investment 6-month Horizon (5/28/13)		Potenital Net Payout	Ptotal Net Payout Ratio
		Downside Scenario/Stops	Upside Target		
Short Yen	82	72	105	-13.9	21.90
90 Strike 6-month USD Call/Yen Put (USD)	0.5	-0.5	14.3	-0.5	13.79
Long Nikkei (JPY)	9300	8200	14500		
Long Nikkei JPY Scenario		82	102	-13.4	28.74
10250 Strike 6-month Nikkei Call (USD)	1.8	-1.8	14500	-1.8	39.87

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Step 4: Closing Out a Position

Framework Also Gives Exit Points For the Investment: When Trades Become Linear

Trades Turned Into Directional Trades in April



Trade	Spot (4/9/13)	Investment Horizon (5/28/13)		Potential ROL	Net Payout	Potential Net Payout Ratio	Realized Net Payout Ratio
		Downside scearnio (stops)	Upside Target				
Short Yen	98.9	92	102	-7.5	3.0	41%	123%
90 Strike 6-month USD Call/Yen Put (USD)	9.0	2.2	14.3	-6.8	5.3	77%	1700%
Nikkei (JPY)	14300	12500	15000				
Nikkei JPY Scenario		92	102	-19.6	6.9	35%	377%
10250 Strike 6-month Nikkei Call (USD)	41.0	24.5	46.6	-16.5	5.6	34%	2175%

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