

06/21/2017

Reflation Revival, Part I

Trade Alert:

Buy 1/3 Van Eck Steel Index SLX

Buy 1/3 U.S. Oil Fund USO

**Buy 2/3 Proshares UltraShort Treasury
TBT**

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jose@thebeartrapsreport.com*

In this Note

- Steel equities were one of the cornerstones of the Trump trade, doubling in value from the election to the dramatic February reversal. The group has since then given up most of its gains, as the Trump trade faded in the midst of the Washington focused reality check. Around the Street, once pounding the table bulls have become bears.

- Looking ahead at this summer, we see a short term reflation trade revival with a rally in bond yields, oil prices and steel sector equities. This is part one of a two part series
- we see political catalysts coming out of Washington contributing to near term tailwinds for steel, oil and rates. We believe the White House and GOP will use steel and infrastructure spending to place substantial political pressure on the Democrats

- particularly in the key (8) Senate races in red Trump states. Ahead of the 2018 midterms, political pressures are mounting on both sides - there's meaningful room for a positive progress surprise.

- In April, the Commerce department started an investigation into the threat of steel imports to the domestic steel and aluminum sector under section 232 of Trade Expansion Act. It is expected to present the findings of this investigation to President Trump in the coming weeks. Should it conclude that these imports are a threat to the domestic steel and aluminum sector, Trump has about two months to report its finding to Congress and implement measures to protect the domestic steel and aluminum industries. One of Trump's major campaign pledges was to protect and support the domestic steel sector and other heavy industries and we therefore deem it likely that Trump will act promptly on the Commerce department findings. The consequential tariffs

U.S. Steel X



Last week, U.S. Steel surged 22% from the May lows, she's given back some of those gains, but still 12% better.

Trump's Love for the Rustbelt

One of the hallmarks of Trump campaign was his insistence that as President, he would address the chronic US trade deficit in manufactured goods. Trumps strategy to win the elections was in part based on capturing a disproportionately large share of the Rustbelt vote relative to other recent Republican presidential candidates. Since 1988, Republicans have lost a majority of States in the traditional industrial heartland of America (Rustbelt), **in part due to their unwavering support for free trade**. But Trump deviated from the traditional Republican free trade playbook by highlighting the persistent U.S. trade deficit in goods and blamed the alleged trade abuses that give foreign based manufacturers a competitive advantage over domestic rivals.

Wage Growth, Trump and Populism

Amazon: 6.2%*

U.S. 2.7%

Swing States: 0.8%

*warehouse employment shortage

NY Fed, Bloomberg, Barclays data

Since the inauguration, the Trump administration has been in a constant struggling with Congress on many legislative aspects of the Trump agenda, and much of the “Trump trade” has faded in the midst of this battle. While Congressional approval is needed for proposals such as tax and healthcare reform, **Congress has surrendered much of the Trade authority to the executive branch**. This allows Trump to act **unilaterally and quickly on trade without the need for Congressional approval**. As soon as Congress approved the US Trade Representative and Commerce Secretary, the Trump administration ordered an investigation into a host of alleged trade abuses and violations. A key priority for Trump is the aluminum and steel industry, which is being investigated since April under section 232 of the 1962 Trade Expansion Act. This Act allows the President to impose import restrictions to protect US national security if imports are a threat to US national security (a) "by fostering U.S. dependence on unreliable or unsafe imports"; or (b) "by fundamentally threatening the ability of U.S. domestic industries to satisfy national security needs." The administration argues that the investigation is necessary because if there is a lack of domestic producers, it could impede US defense procurement for its armed forces as well as for strategically important infrastructure.

In search for a quick and decisive victory, **Trump has even expedited the investigation** by demanding a report in 30-50 days from the start of the investigation rather than the customary 270-day window. As such the Commerce secretary and US Trade Representative (USTR) are expected to submit their findings by the end of this week.

U.S. Wage Growth Since 1973

Populism and Globalism

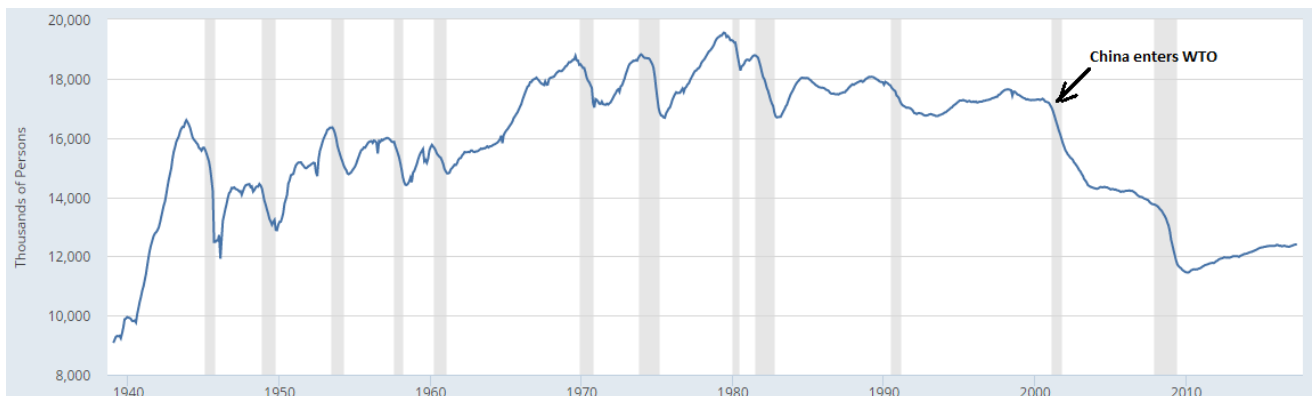
Upper / High Income: +52%
Everyone Else: -4.6%

Thomas & Dimsdale, "Three Centuries of Data"

Trump won the election by targeting the blue color workers in the Rustbelt states, which in the recent decades have become part of the Democratic base. Republican candidates are traditionally strong promoters of free trade. As a result, since 1988 **no Republican candidate has won the key Rustbelt (PA, MI, WI) states** as the democrats built up a strong firewall through their traditional ties with the unions. Trump targeted these voters because winning the Rustbelt would provide him a path to the 270 Electoral Votes needed to win the election. Over the years, the Rustbelt voters have become increasingly susceptible policies that protect domestic manufacturing due to the collapse in manufacturing jobs since 2000. While the overall economy has crawled its way out of the great recession of 2008, most of the Rustbelt has seen virtually no recovery and Trump played into the despair by advocating trade restrictions and support for domestic manufacturing.

In Michigan, Wisconsin and Pennsylvania; Trump received 620,000 more votes than Mitt Romney - 130,000 more than George Bush. This is Trump's base, we believe the White House will focus on using its trade authority to appeal directly to populist energy hot spots.

WTO Pain for Middle Class Working Families Across America



Manufacturing employment has collapsed by 30% since 2000, coinciding with the entry of China into the WTO. The decline is even more pronounced when comparing it to total US employment, which has risen by 18m over the last 17 years. So as a percentage, manufacturing employment has declined from 12.5% to 7.8% of total employment. While there are various reasons behind the precipitous decline in domestic manufacturing employment, notably the significant advances in productivity and

robotics, other advanced countries such as Japan and Germany have made similar advances and the percentage of manufacturing employment in these countries is still close to 20%. The consequences of this disproportionate decline does not only reverberates through the rest of the labor market, as each manufacturing job tends to create several services jobs around it, but also to the many communities that relied on manufacturing employment to prosper. Once a local manufacturing base is gone, these communities slide into an imminent downward economic spiral.

The History of US Tariffs and Trade Restrictions

Since the Trade Expansion Act's passage in 1962, there have been 26 investigations with a handful resulting in the imposition of import restrictions. In recent years, the law was used twice - to investigate oil in 1999 and iron and steel in 2001 – but in both cases the conclusion was that there was no threat to national security. Still the Bush administration did protect the domestic steel industry that year by imposing steel tariffs under section 201 of the Trade Act of 1974, with tariffs between 5 to 30% tariffs on imported steel.

Steel vs Big Tech



Over the last three months, Steel stocks are 18% lower while the Nasdaq 100 is nearly

8% higher. We believe this divergence is unsustainable - we see a reflation trade revival over the summer with a rally in bond yields, oil prices and Steel sector equities.

Still, the domestic steel industry can receive government support with and/or without official trade restrictions. In 1986, President Reagan ordered the negotiation of voluntary restraint agreements (VRAs) with foreign machine tool suppliers and directed Commerce and Defense to initiate a program to help revitalize the domestic industry by improving the industry's integration into the defense procurement process.

In early February, the Trump administration imposed trade tariffs on certain types of steel products from China. The problem is that, even though China has by far the largest steel capacity, the direct steel imports from China into the US are not that large. China tends to import steel into the US via NAFTA countries, or as a finished product. For example, China imports the steel to Mexico and then onto the U.S. under favorable NAFTA trade conditions. Alternatively, China imports the steel to Mexico-based car makers, who export their final product to the U.S.. China is also accused of importing into the US via countries such as Vietnam to avoid U.S. duties and scrutiny. Lastly, China may import its steel into countries that are major steel producers themselves and these local steel producers, facing a local glut in steel supply from the imports, turn around and export their product to the US.

Atlanta Fed Wage Growth Tracker

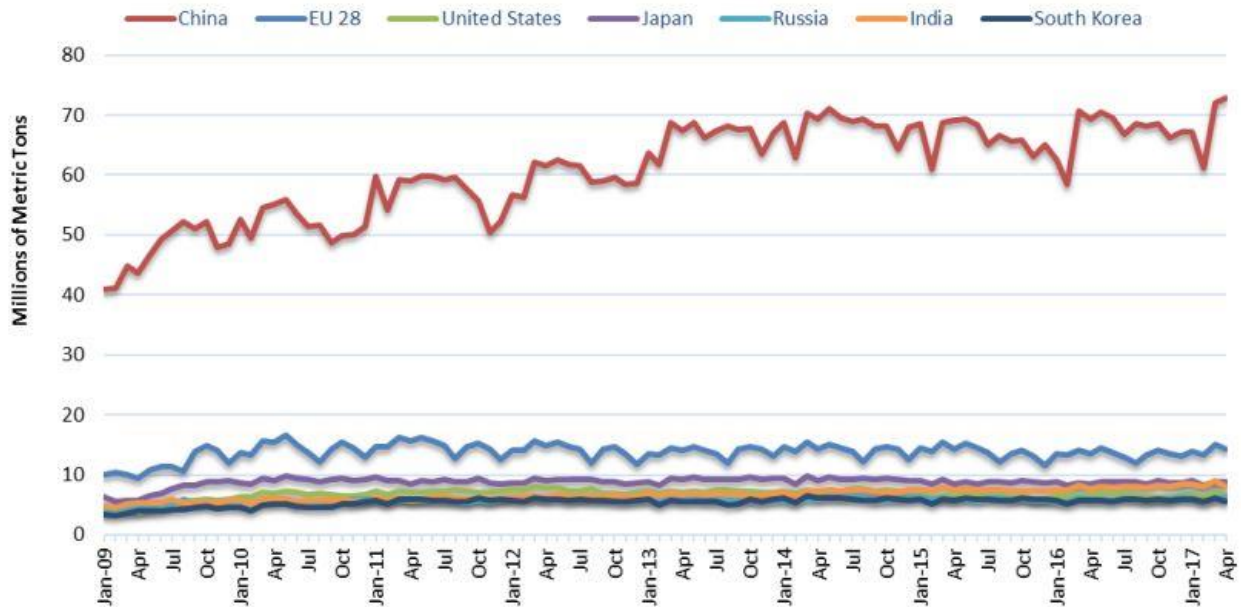
2010s: 2.5%*
2000s: 3.9%
1990s: 4.6%

*Populism's rage genesis resides here.

Traditional measures such as anti-dumping cases and targeted tariffs on Chinese steel imports are often woefully inadequate. In the words of Commerce secretary Ross "*The problem with countervailing duty and anti-dumping cases is that they're very limited in nature, to a very, very specific product form one specific country,*". And even if the US takes action, importers can evade the penalties by shifting to another product, or shipping it through a third country, he said.

Trump's Director of Trade and Industrial Policy Peter Navarro stated that China also engages in the massive dumping of select products such as aluminum and steel below cost. It is currently dumping over 100 million tons of steel alone into global markets. China is hardly the only cheater in the world; it's just the biggest. Tariffs will be used not as an end game but rather as a negotiating tool to encourage our trading partners to cease cheating.

Steel Production

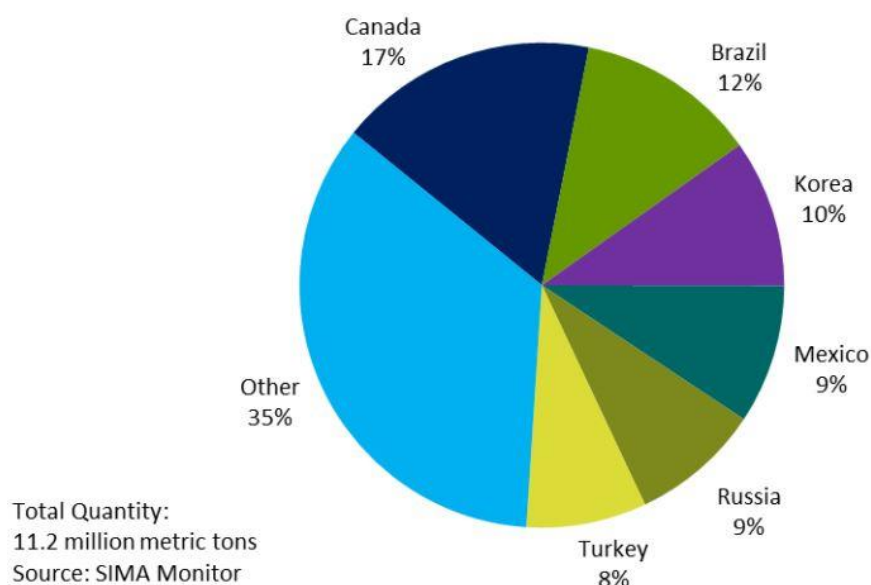


Source: World Steel Association.

Note: Figures are estimates and subject to revision.

China is by far the largest steel producer in the world and makes far more of the metal than it consumes. It sells excess output overseas, often undercutting the prices offered by producers in the importing nations, according to U.S. steel companies. The OECD estimates that there are currently about 700ml mt of excess steel capacity globally. China's government-owned and -supported steel industry represents almost half of the world's steelmaking and more than half of the world's overcapacity. Between 2000 and 2014, Chinese steel production increased a whopping 540%, while U.S. production declined 13%.

U.S. Steel Imports by Region



Most of US' imports of steel come from NAFTA countries (Canada and Mexico) and from other countries which are significant destinations of China steel exports

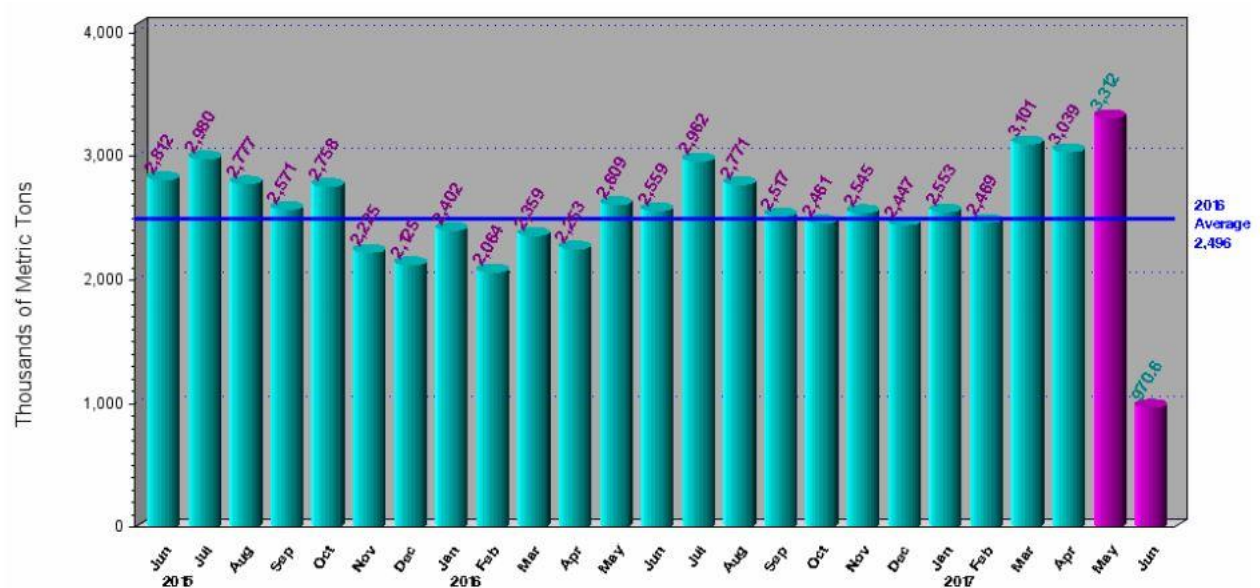
Key Steel Trade Data - Imports are Crushing Domestic Steel Makers

In April 2017:

- Steel imports were up 34.9% y/y and up 21.8% from the 2016 average monthly volume of 2.5ml mt.
- YTD US imports of steel mill products amounted to 11.2ml mt, a 23% y/y increase
- In value terms, imports increased slightly more than tonnage, up 28.8% y/y to \$8.9ml mt.
- Canada accounted for the largest share of US imports at 17%, followed by Brazil (12%) and Korea (10%).
- The US imported 3.9ml mt of flat products YTD, accounting for 35% of total steel mill imports, followed by semi-finished steel at 2.6 million metric tons or 23% of total imports.
- Import penetration for steel mill products increased slightly to 27.8 % in April 2017 from 27.3% in March. This marks a 4.1ppt increase from a year ago.
- According to the latest available data from the three NAFTA countries, total steel mill imports into NAFTA countries increased 12.1% to 8.1ml mt in YTD 2017

China's share of total monthly world steel production increased slightly to 51% in April 2017 from 50% in March 2017, accounting for roughly half of monthly total world production, while the U.S. ranked fifth behind India at 5%.

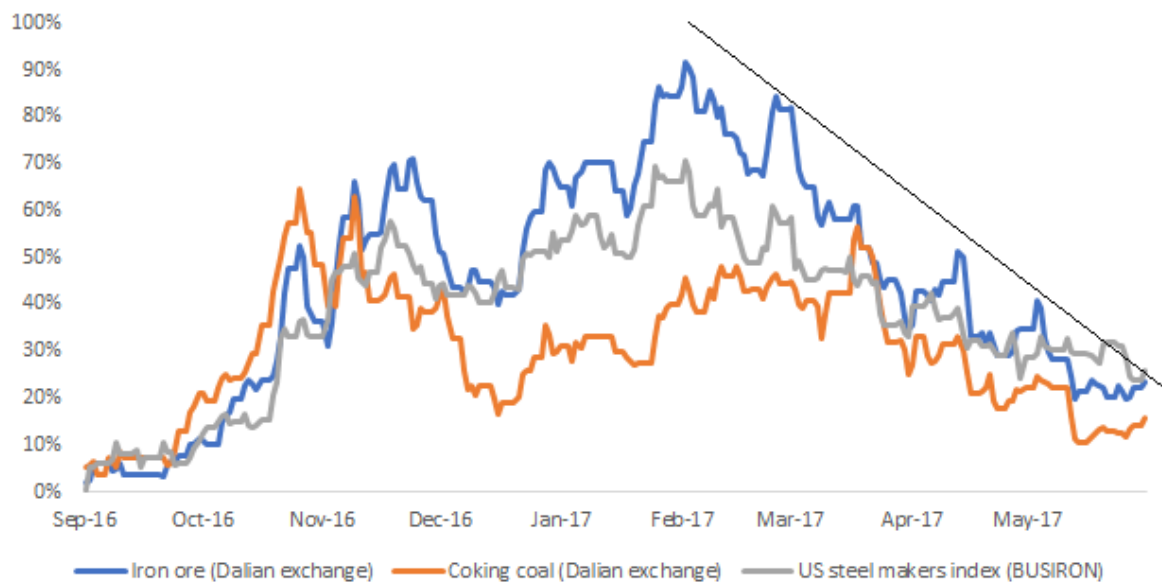
U.S. Steel Imports



SOURCE: U.S. Department of Commerce, Enforcement and Compliance

Incredulously, steel imports into the US continue to increase despite the threat of import restrictions from the Trump Administration.

Commodity Prices



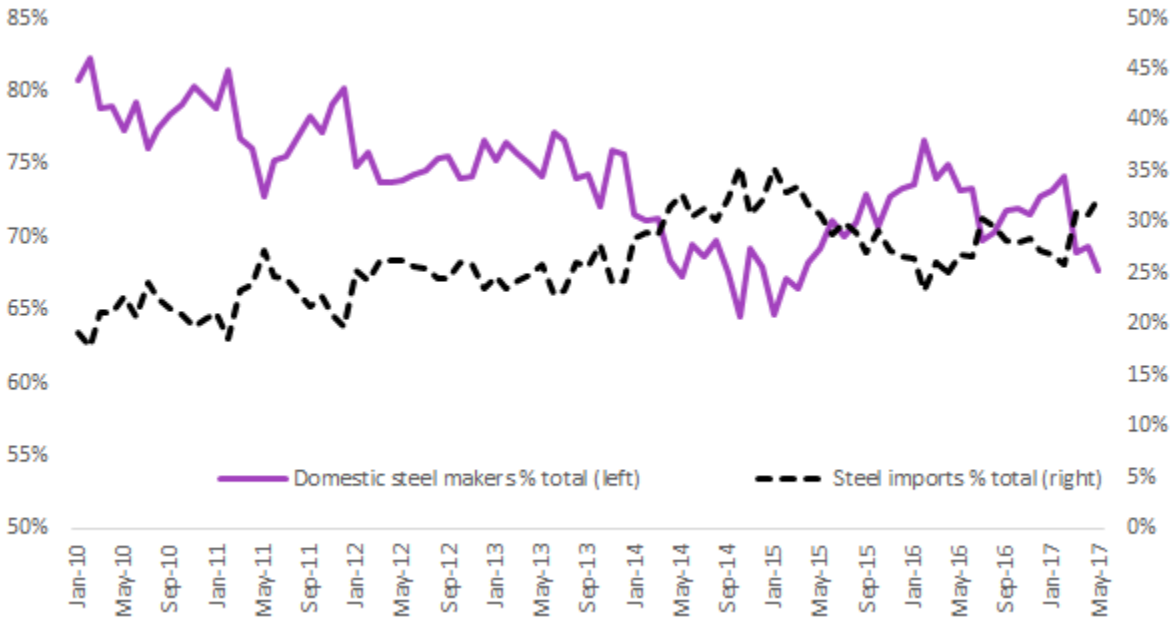
The decline in steel stocks is in part driven by the fading Trump trade, but also by the growing concerns of Chinese demand/supply dynamics. A significant slowdown in Chinese demand for steel puts downward pressure on steel commodities as well as global steel stocks from the threat of more Chinese steel exports. Part of the fear of a

Chinese slowdown is driven by the clampdown of the shadow banking system by Chinese authorities. The shadow banking market has been an essential provider of cheap capital to support GDP growth and the clampdown has instilled fear of a slowdown. The reality is however that the authorities have forced the banks to reduce Wealth Management Products and Entrusted Loans, and replace it by bank lending. So one source of financing was replaced by another. Accordingly, the fears of a credit-induced drastic slowdown of the Chinese economy are unwarranted.

Will Tariffs Benefit the Domestic Steel Sector?

The advantage of 232 provisions is that it allows the administration to impose tariffs irrespective of geography, a so called blanket tariff. So whether the steel comes from China or Mexico or Turkey, a tariffs is imposed on the product at the US port of entry. Previous tariff structures have failed to address the systemic problems as they were either too narrow, or country specific, which allowed the steel to come to the US via third countries. According to Secretary Ross, the administration is considering either a blanket increase in tariffs for imported steel or a hybrid model whereby domestic buyers would pay an additional duty for foreign made steel once a specific quota is reached.

Market Share



As a percentage of total US steel consumption the domestic steel industry has seen its market share decline from 75% of to 68% in recent years as imports have taken an increasing market share

We believe that the Administration, through a combination of blanket tariffs and quotas, allows domestic manufacturers to regain a significant percentage of the market share they lost in recent years. If the domestic steel companies return to the 2013 levels of a 75% market share, it could boost domestic steel shipments by 11%. Domestic inventories are exceptionally low, and restrictions on steel imports provides an ideal background for the domestic steel industry to raise prices. The last time the domestic industry enjoyed such a tailwind was in 2011 when weekly steel production rates went from ~7ml mt to 9ml mt, driving prices to \$900 per metric ton. Today prices for flat rolled are around \$740.

Steel Focused Equities

Symbol	Name	Market cap	EV	EV/EBITDA	Current P/E	Est P/E	Est P/E
NUE US Equity	NUCOR CORP	\$ 17,803	\$ 20,817	8.6	12.3	12.2	0.88
CMC US Equity	COMMERCIAL METAL	\$ 2,173	\$ 2,842	10.9	15.8	12.4	0.42
X US Equity	US STEEL CORP	\$ 3,633	\$ 5,341	10.4	11.1	10.6	0.30
AKS US Equity	AK STEEL HLDG	\$ 1,977	\$ 4,008	7.5	9.1	7.9	0.32
STLD US Equity	STEEL DYNAMICS	\$ 7,945	\$ 9,295	7.6	11.1	10.9	0.84
MT NA Equity	ARCELORMITTAL	\$ 18,803	\$ 35,239	4.2	n/a	7.7	n/a

Best Regards,

The Bear Traps Report Team

Larry McDonald is the New York Times bestselling author of "A Colossal Failure of Common Sense," CNBC contributor and Political Risk Expert. He is the Editor of The Bear Traps Report, a weekly independent investment letter focusing on global political and systemic risk with actionable trade ideas. Former Head of U.S. Macro Strategy at Societe Generale and former vice president of distress debt and convertible securities at Lehman Brothers. He is one of the most well-respected risk managers on Wall Street.

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The Bear Traps Report
450 West 42nd Street, 50 floor, New York, NY 10036
