Inflation Growth

The Damped Spring Report

A synthesis of market drivers

Flow Risk Premium

This is the inaugural edition of the Damped Spring Report. The goal of the Damped Spring Report is to generate a synthesis of the major market drivers and a portfolio that is best suited to deliver alpha for investors based on that synthesis. The DSR method is to consider:

- Fundamentals in the global and local economies
- Positioning and expected flow of important market participants
- And
- The Damped Spring model output for future liquidity and volatility conditions

The DSR will focus on the most liquid developed market, currencies, rates, equities and commodities. We will hold ourselves accountable by making specific trade recommendations and maintaining a model portfolio of those recommendations. The model portfolio will be diversified and designed to be uncorrelated to the performance of typical diversified asset portfolios. We will use the performance of that portfolio to judge our success.

The DSR will offer a synthesis of current market news while also maintaining a consistent framework to evaluate markets through time. On a twice monthly basis the DSR will provide:

- Synthesis
- A summary of important Flow and positioning Data
- The output of the Damped Spring Model of forward liquidity and volatility conditions
- The DSR model portfolio and its performance
- Insight on our framework and timely deep dives into important issues

Along with occasional timely additional insights on breaking developments in the markets or the recommended portfolio and once quarterly custom single client research requests we expect the Damped Spring Product offering to be a useful addition to the tools our sophisticated portfolio manager clients use to tackle challenging markets

Synthesis

2018 was a year in which no portfolio was safe. Risk premiums on all financial assets expanded dramatically as the Global central banks misunderstood, or worse intentionally minimized in their rhetoric, the impact of reduced purchasing of assets and outright balance sheet unwind on risk premiums on all global assets and real economic activity. Global equity markets bore the brunt of this mistake cratering into Christmas as the combination of rapidly declining growth expectations, tight money and credit due to QT and portfolio unwinds created a triple whammy.

As 2019 started the Fed made an extreme pivot by both slowing/reversing rate hikes to much more importantly telegraphing and finally announcing a significantly sooner than expected halt of balance sheet unwind. It is certainly ironic that for years the impact of QT was kept on "Auto-Pilot" in all Fed communication but suddenly that is all that mattered. Perhaps it mattered all along.

Quickly the global central banks all pivoted as one. Global risk markets bounced and have continued to be strong. Risk premiums are driven by the attractiveness of cash and the level of future expected volatility and with the QT cash squeeze projected to be less severe, the rate of return on cash to longer rising, and forward volatility expectations declining risk premiums contracted. Equities, oil, industrial commodities and emerging markets assets have all benefitted from this risk premium contraction. It is important to note that long term bond prices have also rallied slightly. This is consistent with a risk/term premium contraction offset by growth expectations rising from dire before Christmas to merely at trend today and with inflation expectations rising sharply at least in the US. Major currency markets have been range bound consistent with a rapid and coincident pivot by the world central bankers.

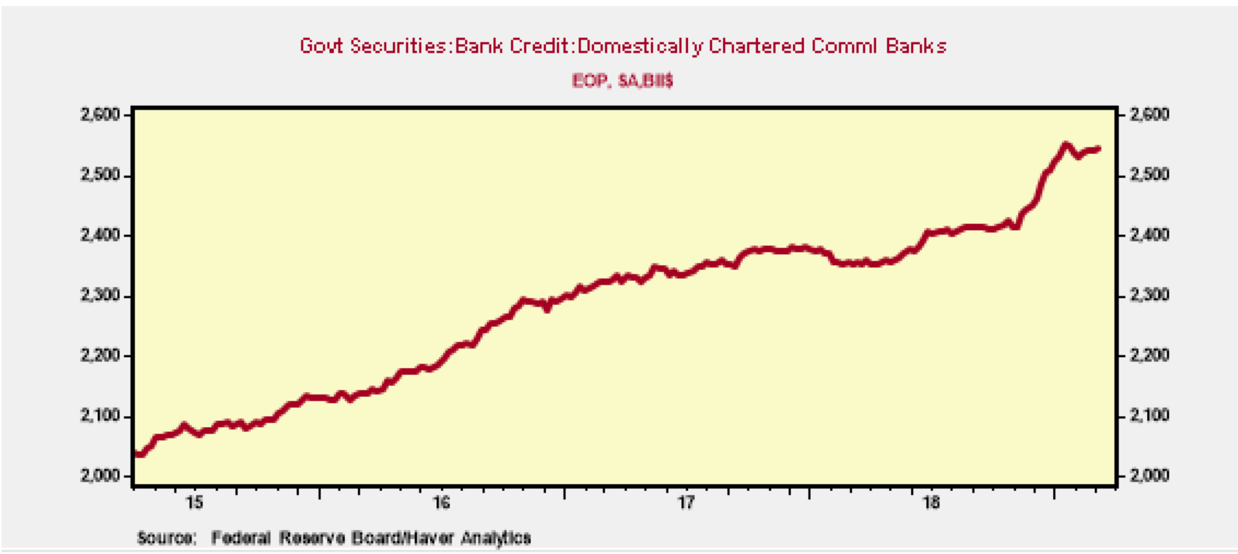
It is an interesting time. The global central bankers have essentially exited the playing field to watch developments unfold. Only a significant shift in the global economic outlook or more so than ever before a US stock market drop resulting in significant pressure on Powell from President Trump will bring the central bankers back to the field.

The Damped Spring Model is currently expecting low realized volatility to continue for the next few months. While the counter trend dampers of the central bankers are not on the field which would ordinarily be a concern for the volatility outlook, portfolio performance is strongly positive across almost all asset classes and small drawdowns are unlikely to generate major liquidity events. Banks particularly in the US are very healthy despite stock market underperformance. As for geo political noise as past readers know we at Damped Spring consider geo political events to be noise by and large. However, the markets react to that noise and I suspect have fully priced in the most likely outcome of China trade talks which in our opinion will be more of the same, a declared victory with very little economic consequence. Many outcomes are possible but at this point only an extraordinary concession by the Chinese to import significant amounts of stuff will move the needle for the US economy or its companies.

The Damped Spring outlook for the remainder of Q2 is for modestly widening risk premiums as the supply of assets rises from government funding increases and QT continues for the time being resulting in a modest concession to asset buyers. As for growth and inflation, growth expectations have jumped are still relatively weak, inflation expectations have jumped quite a bit in the US but not followed through in Europe. Our view on both is that expectations have risen rapidly and are likely to retrace a touch in the months to come.

Flow and positioning

Bond flows have been meaningful as Banks have slowed purchase of bonds



This slowdown gives banks the ability to once again buy bonds if the curve steepens.

The Fed continues to taper but the steep decline will flatten again in the months to come

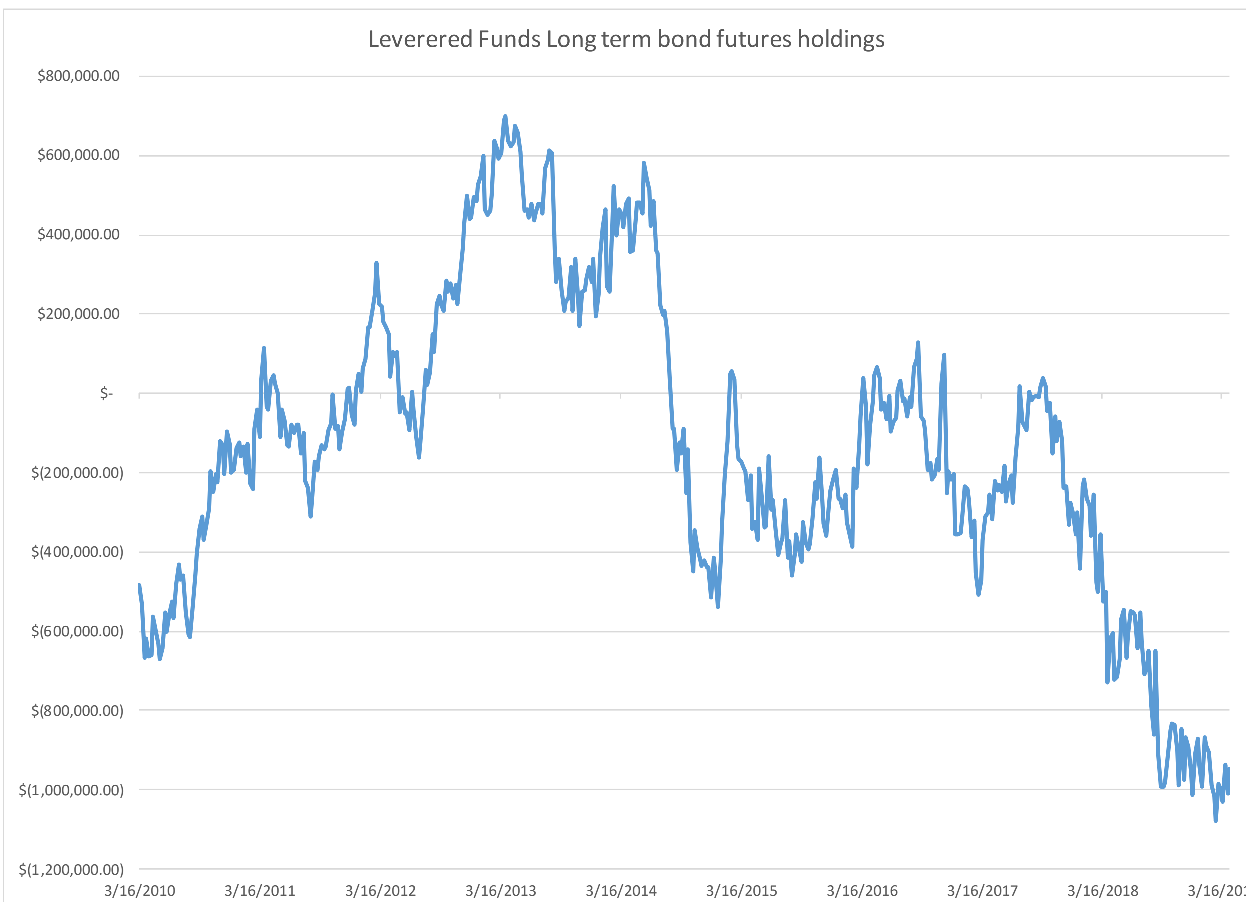
The ECB Balance sheet is stuck at its peak level for the foreseeable future

China continues to slowly sell US bonds which has a QT impact on risk premiums.

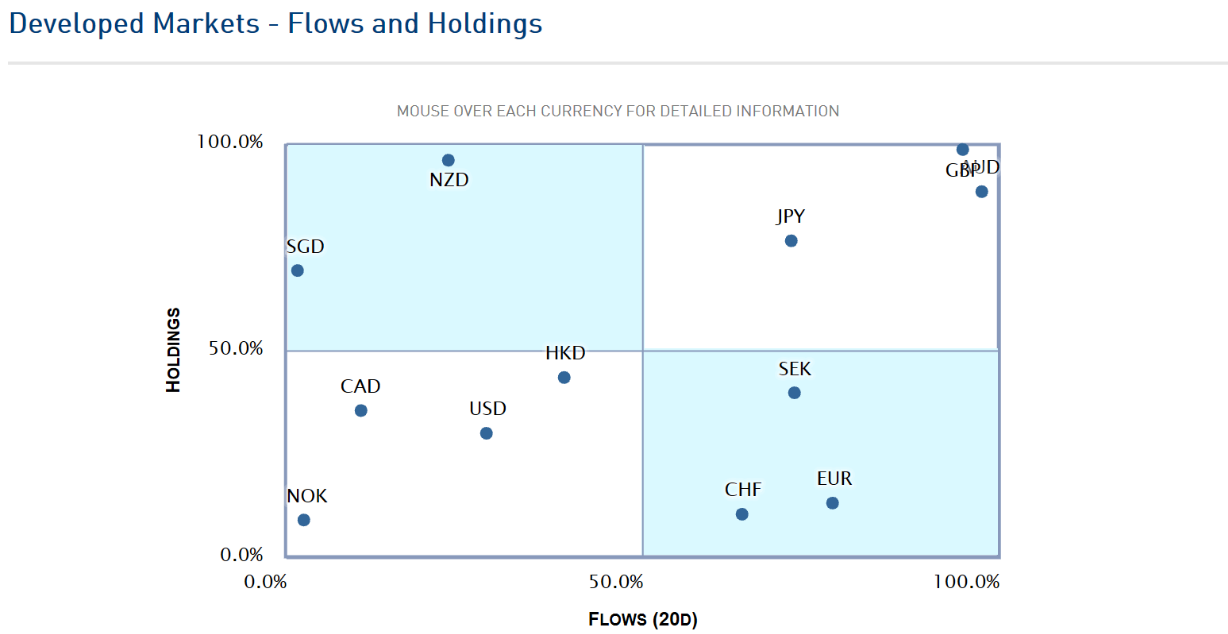
Institutional Bond flows have rebounded dramatically primarily in credit products.

The buying is likely not sustainable.

However, Hedge funds are quite short long term bonds

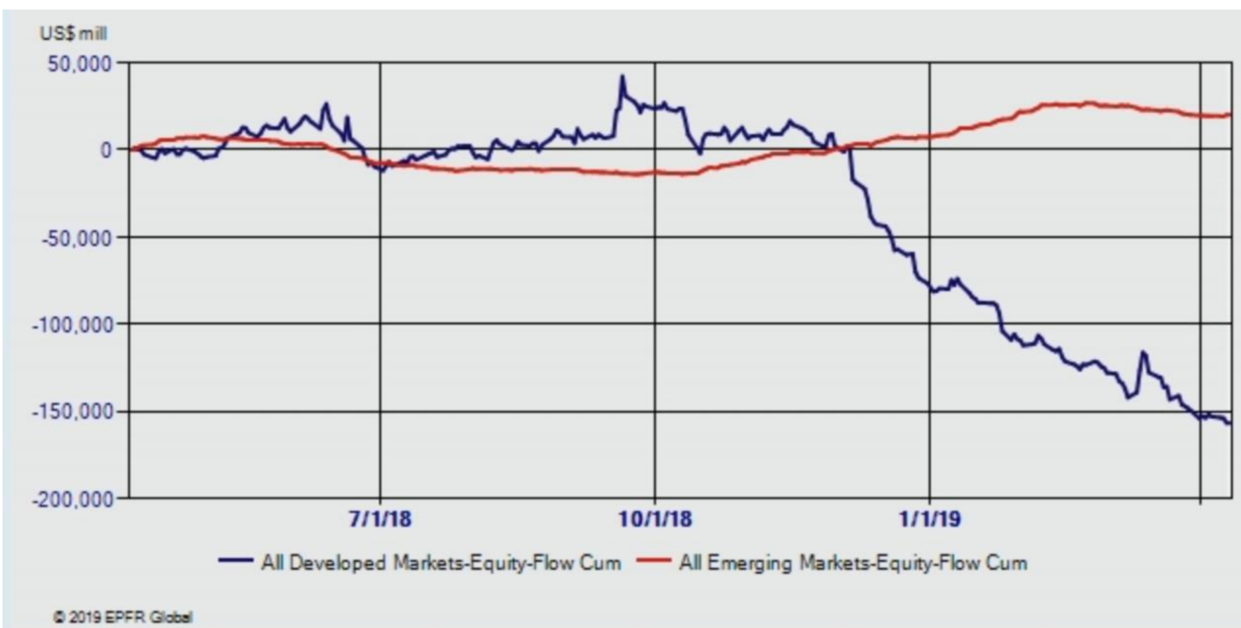


Currency markets are largely balanced with no large positions offsides besides the GBP which is massively over bought

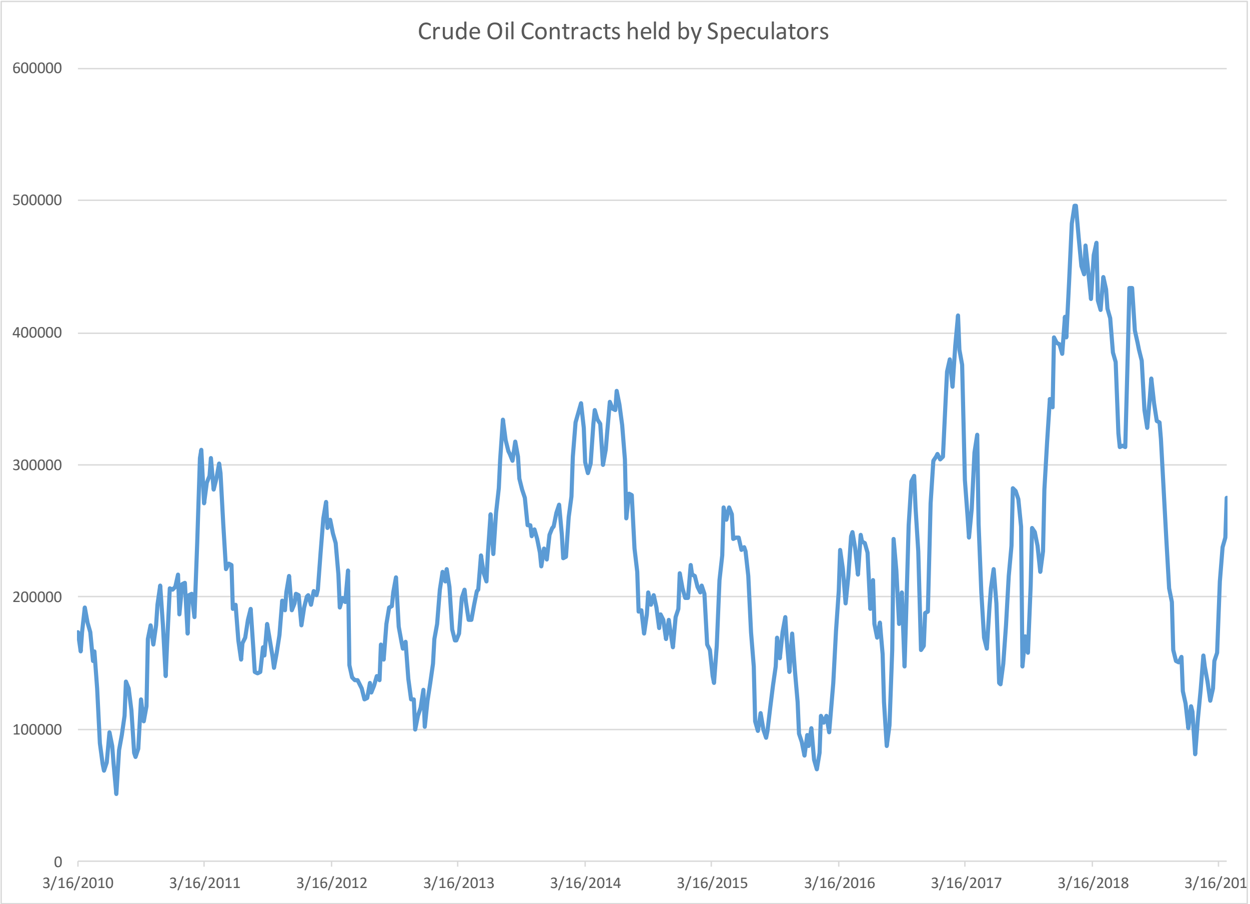


Blue quadrants indicate potential unwinds of overweights (upper-left) or underweights (bottom-right).

Equity markets continue to be dominated by the same trends as massive US share buybacks offset institutional portfolio equity exposure cutting



The oil market has had a huge runup in this rising growth contracting risk premium environment and aggressive buying by hedge funds is unsustainable.



<u>Recommended Portfolio</u>

How does that add up to a portfolio?

- Weakening growth expectations is bullish bonds and bearish stocks and commodities,
- Weakening inflation expectations is bullish bonds and stocks, and bearish commodities
- Risk premium expansion is bearish all assets.

That combination of fundamental views is modestly bullish bonds, and modestly bearish stocks and a triple whammy to commodities.

Volatility is low but as mentioned above is likely to realize even lower over this quarter for that reason I suggest positions using short atm put and call spreads to be certain of your downside while collecting premium as markets are likely not going to move much in the near term

Current portfolio

- Short put spreads on USH
- Short call spreads on SPX
- Short call spreads on Eurostoxx
- No recommendations on currency due to coincident central bank policy and neutral positioning
- Max short call spreads on Oil due to triple whammy of fundamentals and overbought conditions

Framework

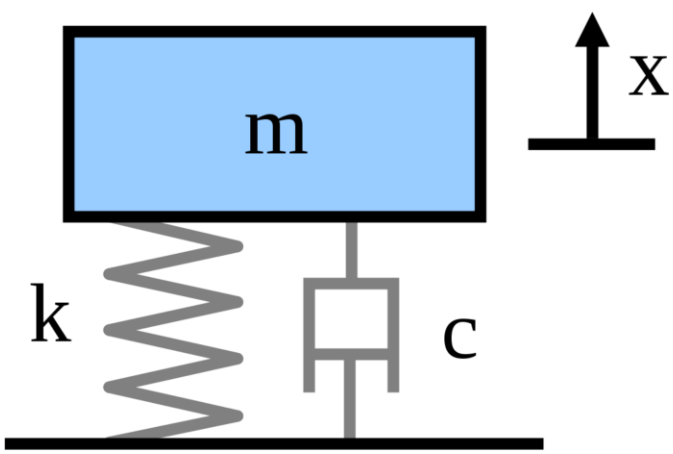
As this report is somewhat long already, we will briefly introduce the Damped Spring Framework. Over the next series of reports, we will further outline the framework and apply it again and again.

The Damped Spring Framework has four basic principles:

- Changes in expectations drive market prices
- Market prices can overshoot and undershoot “fair value”
- Positioning and Investor conditions can impact flow which can lead to mispricing
- The Damped Spring Model is useful in understanding market, market participant and market dampening participant conditions

The inputs for analysis are taken from a wide range of data sources and systemized where possible. Graphs of relevant data will be provided throughout the report.

The Damped Spring Model describes markets as a physical system.



Where

- m is the market
- x is a market moving influence

- k is the springiness of the market and its ability to incorporate the market moving influence
- c is the damper of various participants and market structure elements which counteract volatility created by market moving influence and market participants seeking new price equilibrium

I will go in depth on each of these various elements of the model over time.