The Damped Spring Report

"Shifts in growth, inflation, risk premium and positioning all lead to opportunies in markets"

9/03/2019

Synthesis

Max short equities. As we suggested prior to the Jackson Hole address by Chairman Powell he did indeed put the burden on President Trump. "You first sir" was our prediction for the title of the speech and this was about what we got. The Fed is unwilling to ease aggressively without a meaningful slowdown. They won't provide cover, politically, for Trump by easing to take the pain away from trade policy related slowdown. The Fed simply can't afford to ease and then have the trade talks miraculously conclude with a positive outcome and be forced to withdraw stimulus. The big point is, it seems clear to most Fed officials, that ammunition is limited and must be conserved for a true crisis. As we have said we believe that regardless of a wide distribution of trade talk outcomes the Fed should be easing more aggressively already but we respect their desire to be cautious given the lack of clarity on trade.

The Powell put exists, but it is struck well below the current market level and will be less effective than prior Fed Puts given the Fed's own tools and the inability for other major central banks to assist. What is clear is the Trump Cap is firmly in place and Tariff Man may have once again capped the market and economy.

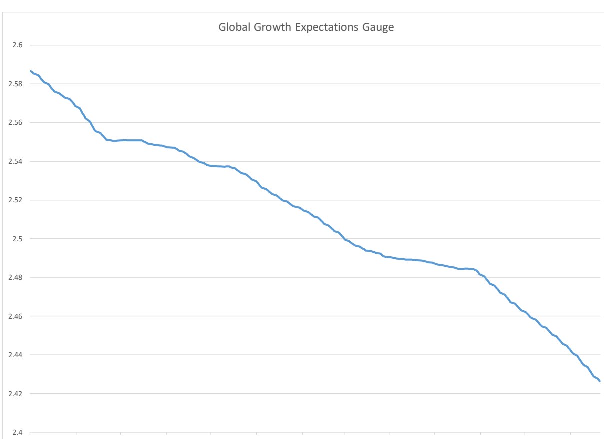
The next milestone on the path of this trade war is whether the US and China will agree to meet. Perhaps they will agree, the date will certainly be after the Fed's next meeting. Regardless of the timing, there will be no trade clarity before the 18th of September. This leaves the Fed with few options except to disappoint the market and remain largely on the sidelines. They may cut 25bp of course but, if so, it will be as hawkish a cut as can be manufactured. The 80%+ probability priced into the September meeting cut seems about right given our outlook. The strong rally in the US dollar also reflects the Fed on "effective" pause until trade resolution. However, US and European equity markets expect some combination of dovishness and, sooner than later, trade resolution. We have moved from bearish equities to max bearish equities based on our expectations on the trapped Fed, trade resolution timing, and the fundamental, flow, and risk premium outlook described below.

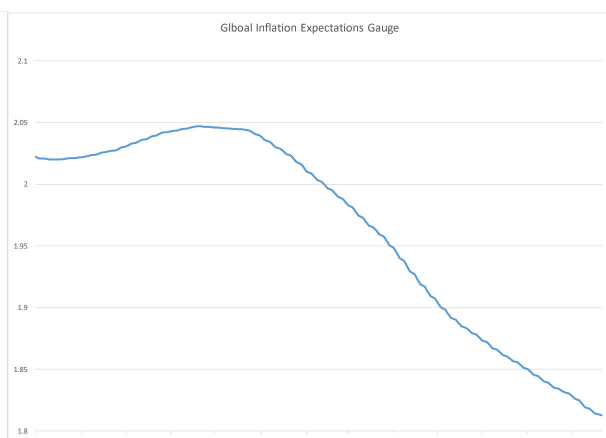
It is also important to mention that the trapped Fed will likely lead to continued USD strength and slowing US and global growth. We suggest, taking losses in our long EUR and realizing gains on our max long gold, recommendations.

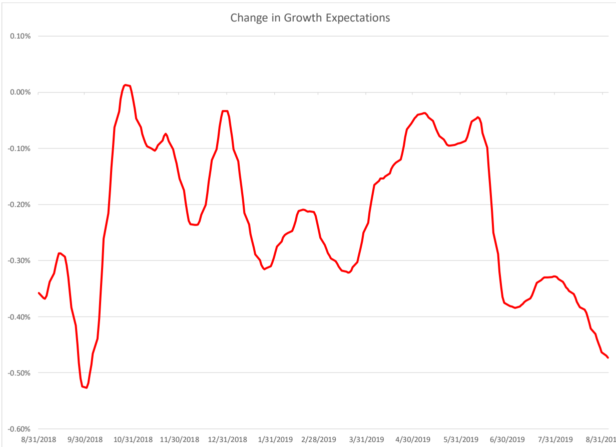
As for global bond markets the trapped Fed, portfolio deleveraging, and large supply of new financial assets during the 4th quarter, will generate a rush to cash which will widen term premiums. Bonds have crosswinds, however, as global growth and inflation will be under pressure leaving our bond recommendations neutral at this point. As long as the Fed is trapped, and supply of paper grows, cash is king and assets suck.

Fundamental Drivers

Since our last report growth expectations continued to fall and accelerated, while inflation expectations fell but decelerated.







As can be seen above changes in growth and inflation expectations have remained solidly negative over the last year but looking to the far right seem to have rolled over and moved lower since July. Trade talk expectations have in our minds been largely noise. The impact of trade expectations matters regarding the steepness of the slowdown, but larger macro drivers are predominately responsible for the trend. We simply look back at our own notes regarding trade and don't particularly see much of a difference between today, last month or many months ago. Trade will be resolved with a meaningless "victory" claimed by both sides or drag on. Neither outcome will overcome the macro trend at play. We are now confident that the Fed will cut and pause or not cut at all in in two weeks and the trade war will not be resolved. Prior to the Jackson Hole speech and the September 1 Tariff increase we recommended only a tactical short in equities. With that uncertainty behind past we recommend a max short equity position. Growth and Inflation are weak. regardless of trade outcome and monetary policy is behind the curve and likely to stay there for the balance of 2019. Tight money falling growth and as we will describe unfavorable flow and positioning are a triple whammy for equities.

Damped Spring Volatility Model

The graph on page 1 is the best representation for our expectations for future volatility. Growth is capped at the money and floored quite a bit out of the money. The traditional dampers to volatility are largely on the sidelines. As the economy is capped upside equity volatility and downside bond market volatility will be low. The equity market is vulnerable to high downside volatility while the bond market given some idea of a negative floor is not likely to experience high volatility on the upside.

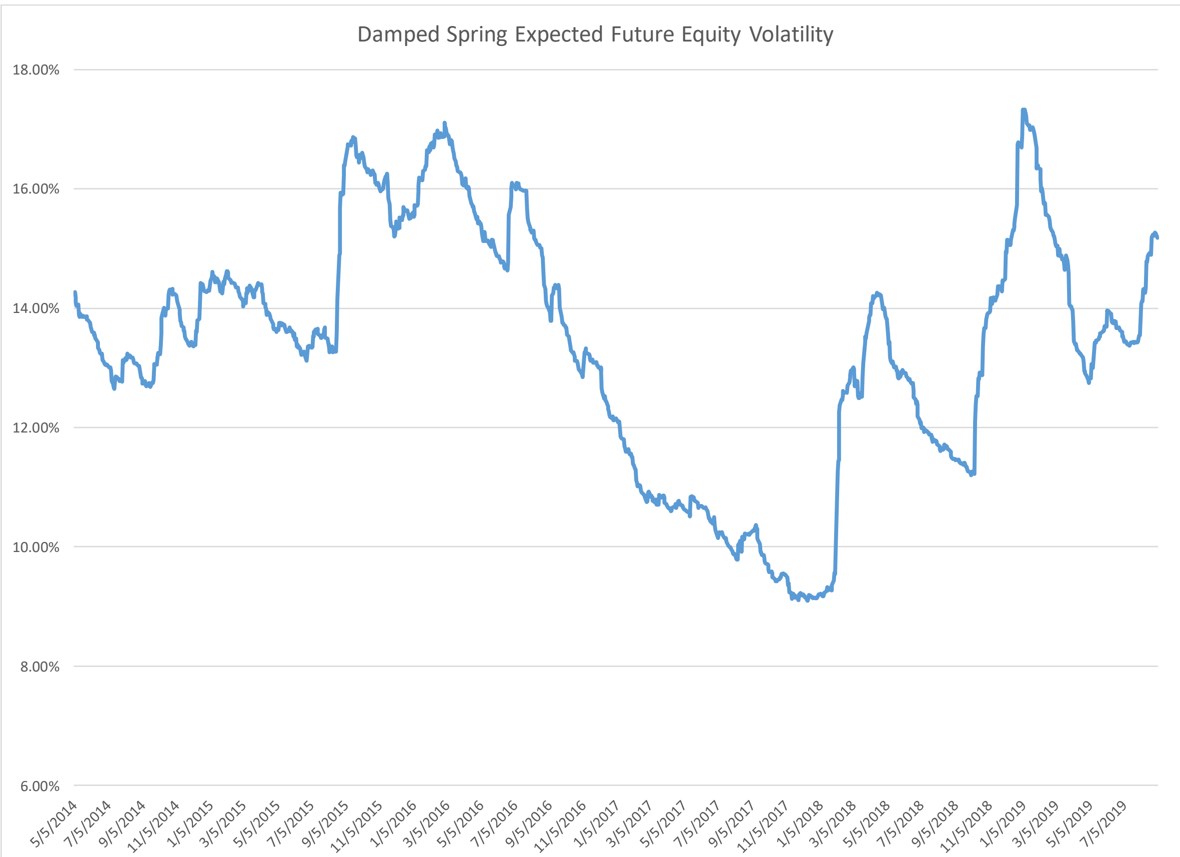
In the Damped Spring Volatility model framework, we believe

- Market moving future news is likely to be above average
- Market participants while in good shape are going to experience additional volatility and lower portfolio diversification as cash becomes king due to too

tight central banks and continued high new issuances. Bonds will not offer much protection resulting in portfolio deleveraging.

- Most traditional leverage providers are in excellent shape in the US and ok shape elsewhere
- We are concerned about the level of debt across non-bank corporates on which share repurchase demand rests but low interest rates and deep liquidity for rolling that debt are for the time being open.
- Trump has burned his bridges regarding propping up the market with happy talk. Only concrete outcomes will work.
- Central banks are willing to ease market fears short term but unable to offset major moves with current tools

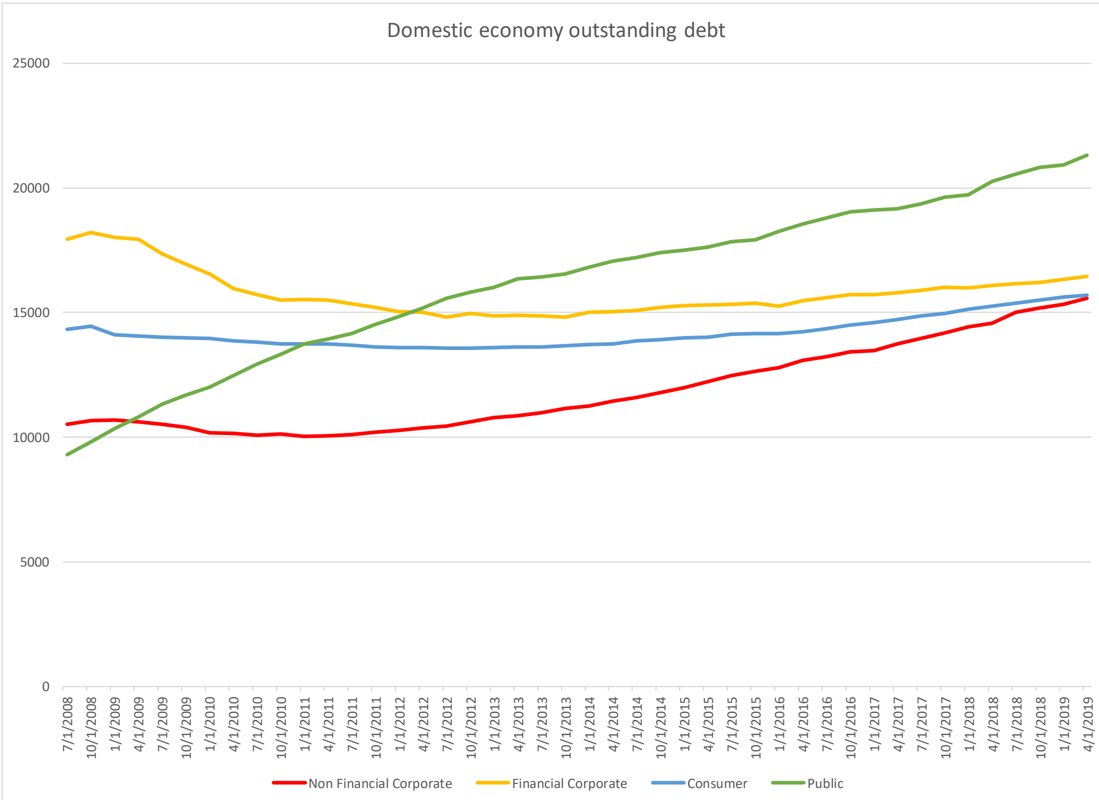
When we add that up, we expect average volatility conditions for the next few months with equity downside spikes dominating and other markets less volatile.



Flow and Positioning

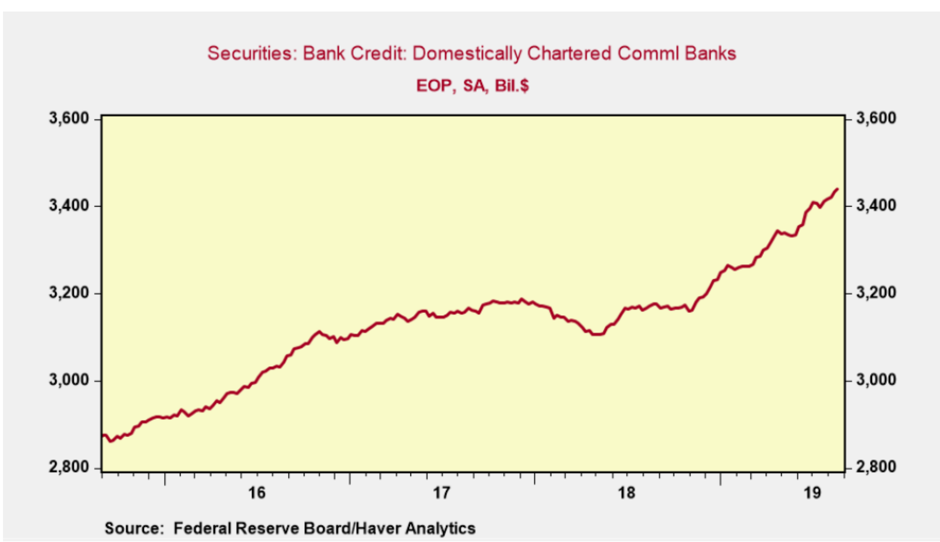
Market participant positioning imbalances are becoming a concern.

Supply is growing particularly in the public sector, but all sectors have been leveraging up creating assets at a pace quicker than trend growth can manufacture savings

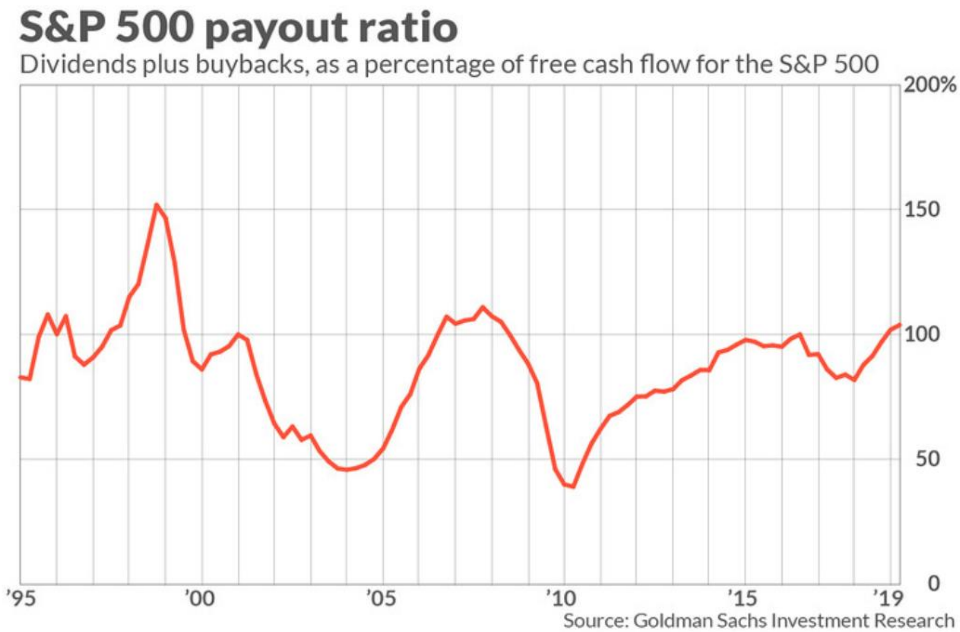


US Government debt is growing rapidly, and Corporates have been levering aggressively since the 2017 Corporate tax cut. Significant additional supply shows no signs of slowing as budget deficits are projected to rise

With the Fed on the sidelines Banks have been buying a lot of bonds but are reaching unsustainable buying levels along with the economic disincentive of inverted curves. A slowing of bank purchases with an increase in supply will result in term premium expansion after a meaningful contraction to since January.



Corporates have reached high and possibly unsustainable levels of leverage which may slow share repurchase demand which will already slow in a procyclical way in a declining equity market. Here Goldman shows total cash spent on dividends and buybacks exceeds 100% of fcf.



The global market portfolio is in good shape but a combination of emerging market losses, a strong USD, large new issuance supply of UST to fund the growing deficit, above average portfolio volatility and lower portfolio diversification benefit leaves portfolios at above average risk levels and will result in some portfolio deleveraging.

Gold is crowded and likely to pause until the Fed is released from its trap.

Current Model Portfolio performance and recommendations

After the changes recommended today the Damped Spring Model Portfolio is highly concentrated but at low level of absolute risk. We do not have strong views on currencies or bonds. We do not expect meaningful moves in either asset class. Overall portfolio worst case loss is 4.1%. Current LTD performance is 12.71%

Today we recommend

- Going max short equities by:
  - Buying SPX Dec 2700/2500 Puts spreads
  - Buying SX5e Dec 3200/3000 Put Spreads
- Selling for a loss the EUR call spread reflecting expectations that US easing will not happen as quickly as predicted.
- Selling for a large gain Gold call spread as USD strength makes gold rally vulnerable and trade appears crowded.

	Assumed Portfolio size	100,000,000					
	LTD P/L	12,709,805					
	Total Return	12.71%					
	Today's Date	9/3/2019		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
5/14/2019	SX5E Sept 3200/3100 Put Spread	24	4167	1,000,000	5	(791,667)	Open
8/22/2019	SPX Sept 2925/2975 Call Spreads	27	-435	1,000,000	21.8	226,087	Open
8/22/2019	SX5E Sept 3375/3475 CallSpread	49	-2381	1,000,000	59.6	(252,381)	Open
9/3/2019	SX5E Dec 3200/3000 Put Spread	31	4167	1,000,000	31	-	Open
9/3/2019	SPX Ded 2700/2500 Put Spread	29.2	342	1,000,000	29.2	0	Open
8/5/2019	GCZ9 Dec 1500/1600 Call Spread	20	500	1,000,000	43.1	1,155,000	Closed
5/14/2019	EURUSD Year end 1.15/1.2 Call spread	1.19	84,033,613	1,000,000	0.3	(747,899)	Closed