The Damped Spring Report

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

9/18/2019

Synthesis

On September 4th, the global bond market began a violent selloff sending 10-year US Bond yields 40bp higher. The return on global long-term bond assets fell between 3 and 5% in just two weeks. Equity markets rallied less than 3%. Gold fell. Industrial commodities bounced. The Yen weakened. These market moves were clearly a reflection of improvements in global growth expectations. The cause of this shift was a softening of the bilateral rhetoric on trade between China and the US. We can debate whether a trade deal will occur in the next few weeks, But, given the current discussions the best-case outcome, a temporary détente, will be extremely narrow and unlikely to offset US and global growth slowdown pressures. What is much more important than the short-term trade talk related swings in growth expectations is the state of the drivers of risk/term premiums. Money got tighter over the last two weeks and term premiums expanded. We'll say this again. Money got tighter over the last two weeks despite the ECB firing a bazooka and the Fed highly likely to cut interest rates later today.

Over the next few months the combination of too tight monetary conditions despite significant central bank efforts to ease and at best a détente in trade will result in:

- A return to weakening growth expectations
- An expansion of risk/term premiums
- A need to deleverage portfolios due to above average volatility expectations, and less than expected portfolio diversification benefits
- By year end central banks will be discussing ways to begin or make more effective existing QE plans

If trade talks do not result in a détente, all of this will be expedited.

In the short term:

- Long term bonds are oversold due to negative convexity hedging flows
- Powerful Chinese buying of gold remains in place as the crowded spec long gets unwound

- Equity flows from corporates due to the pre earnings buyback blackout period are at their current low and will remain weak for the balance of September
- Month end flows are bearish equities and mildly bullish bonds
- President Trump has shown no fear in playing hardball with China during market peaks
- Various market dislocations including
    - Short term money market stresses
    - Possible escalations in middle east tensions between Saudi Arabia and Iran
    - Brexit
    - And an awful performance by IPO's with a potential shutting down of the market for the heavy calendar of issuance needed to be sold by private equity firms

  have arisen over the past two weeks that will take time to come out of the volatility markets making current implied vol levels high in bond and stock markets and realized likely to remain above average

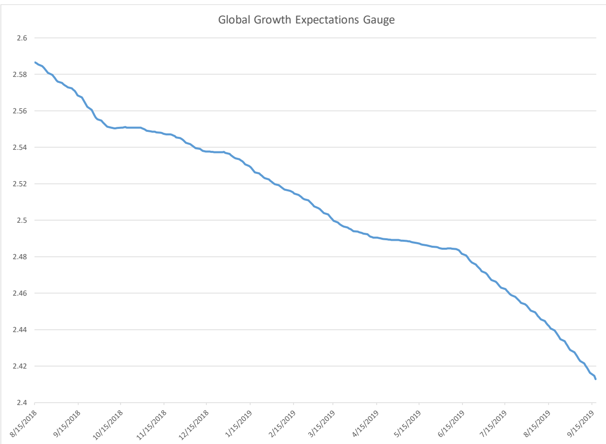
For these reasons we are recommending adding a few net short volatility positions to our Damped Spring Model Portfolio

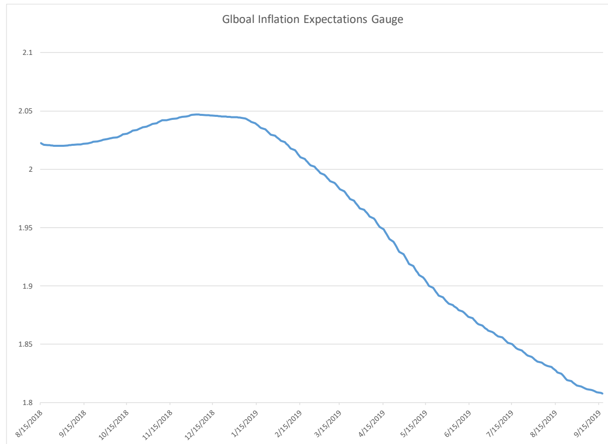
- Long US and German Bonds using short put spreads. Rising growth expectations should reverse, selling flow associated with convexity hedging appears near complete, short term money market stresses will be addressed by ample fed liquidity to lower repo rates into range, and European QE flows, while unlikely to reach the real economy will squeeze bonds higher. However, the higher-level impact of too tight overall monetary conditions and the supply overhang of financing needs by the US government will temper any significant rally
- Long Gold via the sale of put spreads. The fluff of the crowded gold trade is largely gone and the demand from China remains. Tight monetary conditions will limit upside, but downside is unlikely.

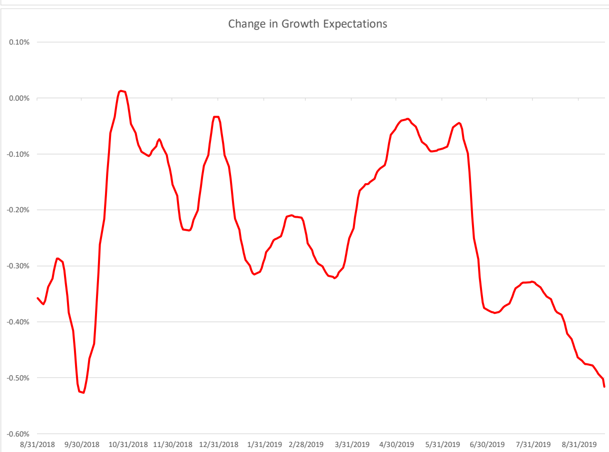
We were early going max short equities. We got out of long gold and long bonds in a timely fashion. Trade talk noise and tight money has resulted in overreactions in both stock and bond markets as the actual signal has been consistently negative growth. A combination of actual economic data, consensus analyst estimates, and a reasonable distribution of trade outcomes simply doesn't support the moves of the last two weeks. The ECB bazooka had virtually no impact on markets despite the QE surprise, in fact, risk premiums expanded instead of contracting. This afternoon the Fed will cut 25bp and could be modestly dovish but is more likely to be somewhat hawkish given the data and division amongst the Fed members. However, we will recommend unwinding our equity and bond positions if QE is put on the table. We think this is unlikely today despite our view that it is inevitable that significant QE and debt monetization will be necessary in 2020 and beyond. For now, we expect the Fed will remain trapped by Trump and trade uncertainty.

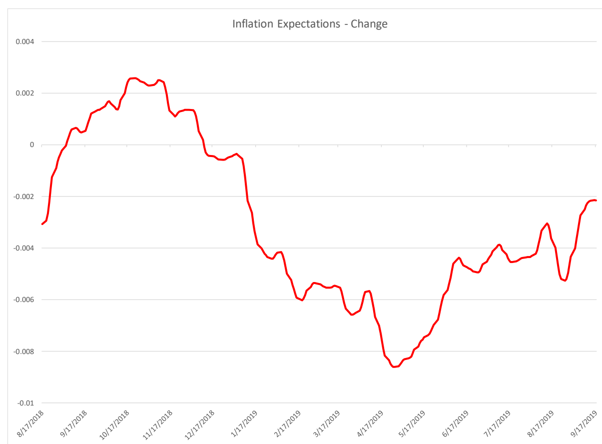
Fundamental Drivers

While markets reacted to trade noise, our indicators for growth and inflation expectations hardly noticed. These gauges use a variety of data sources and do consider the possible scenarios for trade but could be wrong if outlier trade resolutions occur. Nonetheless what is currently on the table is not an outlier and we expect the rapid shift in market-based growth expectations to revert and return to trend. Trend is weak. If anything, weakness is accelerating.

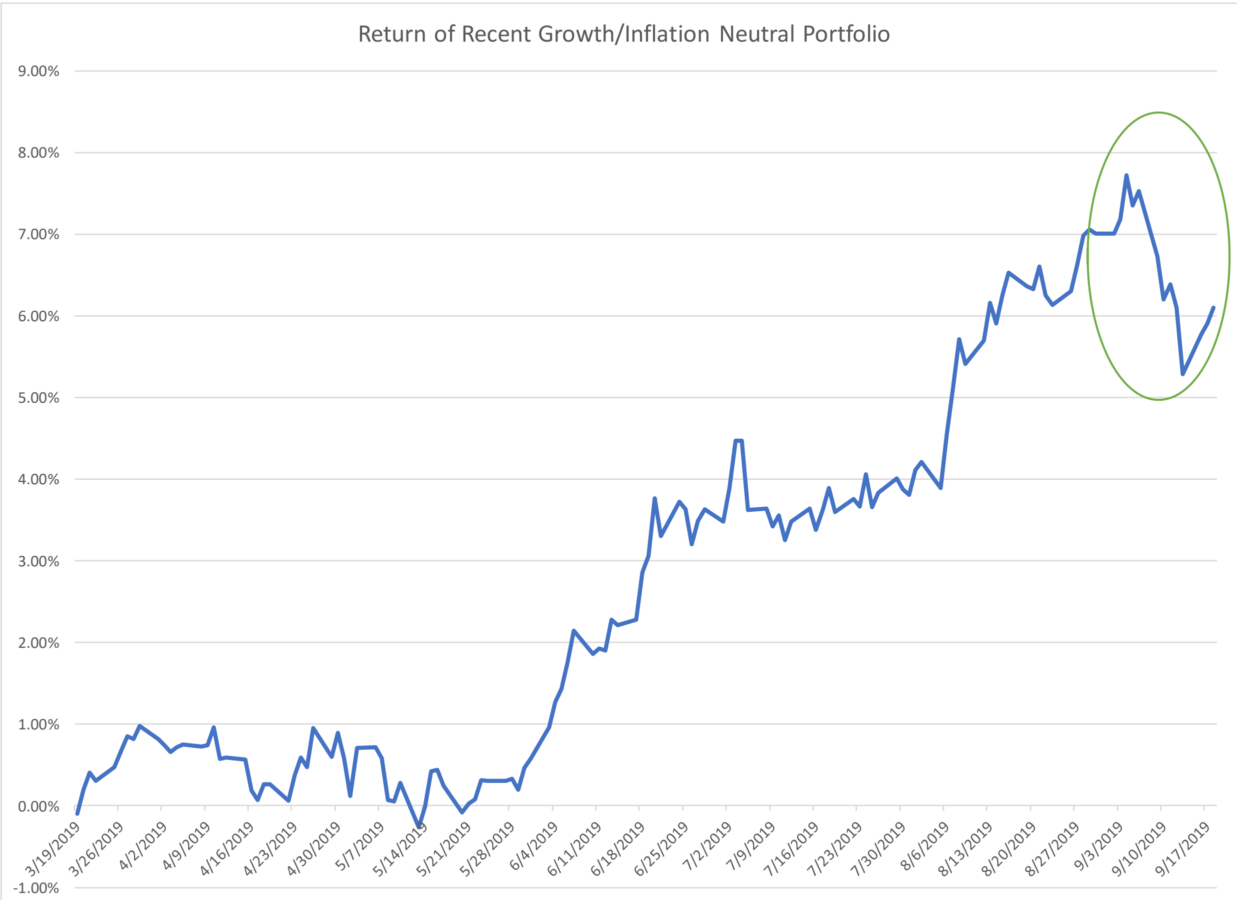








Of greater concern is the pressure for expansion of risk premiums. Expansion of risk premiums is caused by some combination of demand for cash vs owning assets, expected future volatility, and portfolio diversification benefits falling. Currently, central banks are attempting to devalue cash but are unable to achieve that result given current tools. This is reflected in two weeks of poor performance in the risk parity growth and inflation neutral portfolio



The portfolio is up over the last six months but while the ECB fired its bazooka it fell meaningfully. That move is a representation of cash becoming king.

Below we describe our outlook for future volatility in the Damped Spring volatility model framework.

We can't yet be sure how much of the portfolio diversification benefit reduction has taken place yet, but we expect the set of idiosyncratic extreme moves in EM, Bonds, Oil, Money Markets, and Growth stock/Eco sensitive portfolio rotation will damage some players and force liquidations.

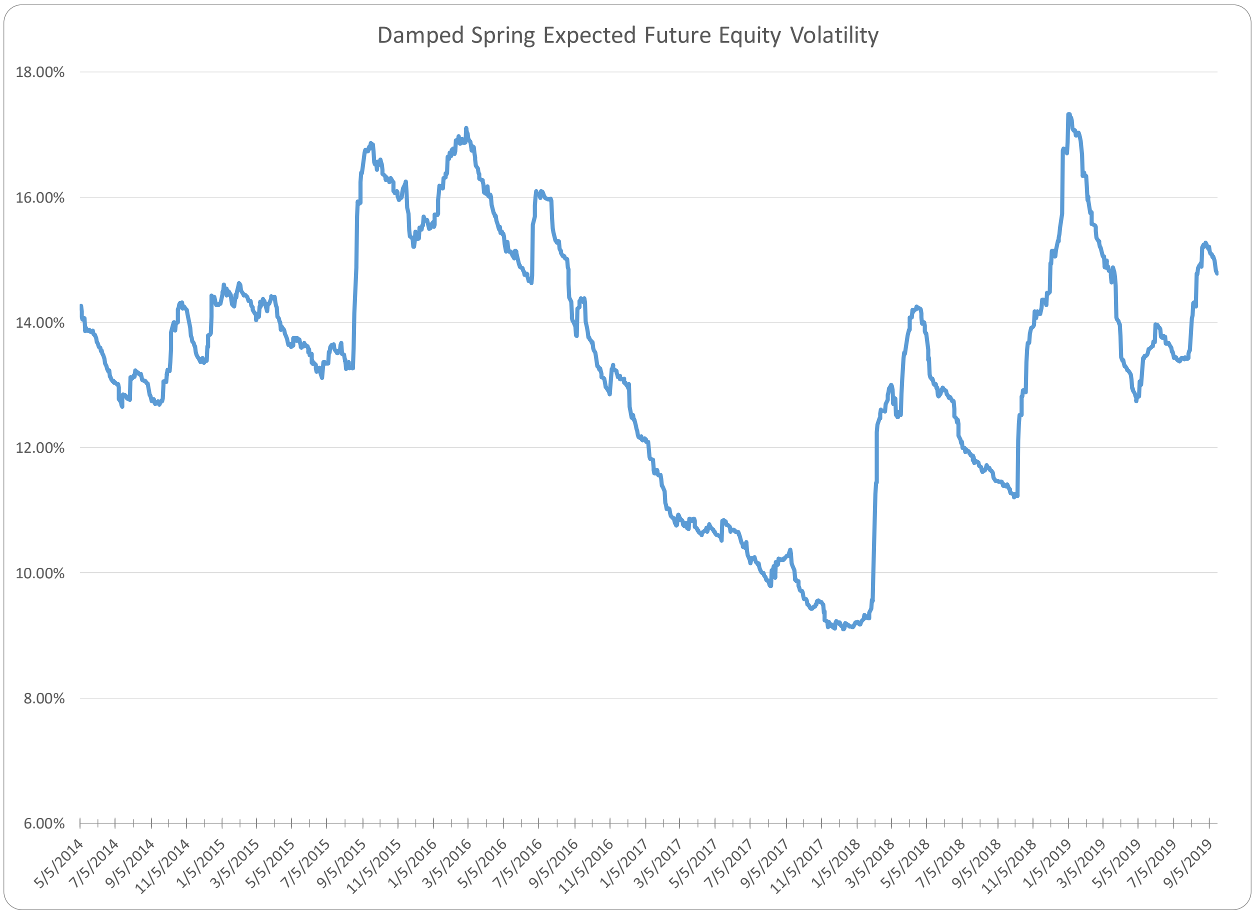
Damped Spring Volatility Model

In the Damped Spring Volatility model framework, we believe

- Market moving future news has grown more concerning and 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 have already sold off extensively and deleveraging contagion will likely spread

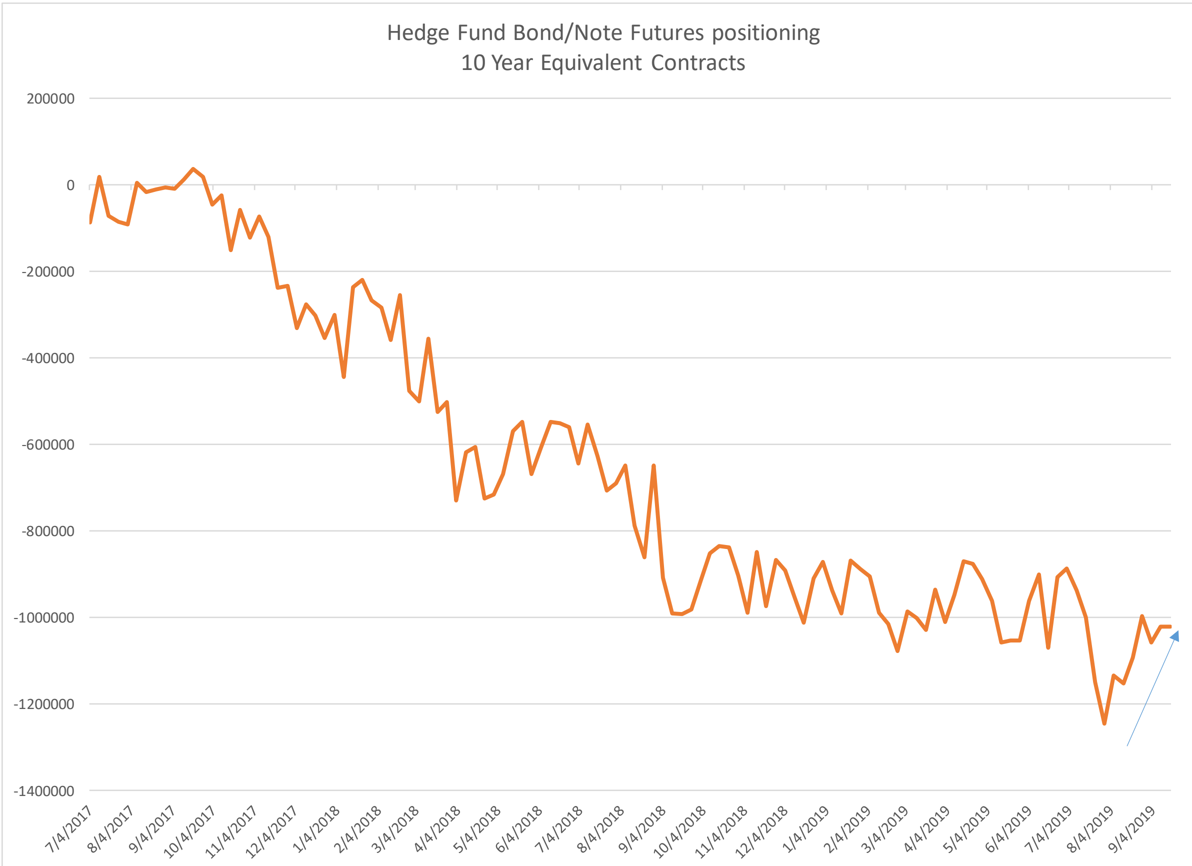
- Most traditional leverage providers are in excellent shape in the US and ok shape elsewhere. However, the recent spate of money market stress is a concern regarding the impact of past regulation and current Fed balance sheet levels on leverage providers
- We are concerned about the level of debt across 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 above average volatility conditions for the next few months.

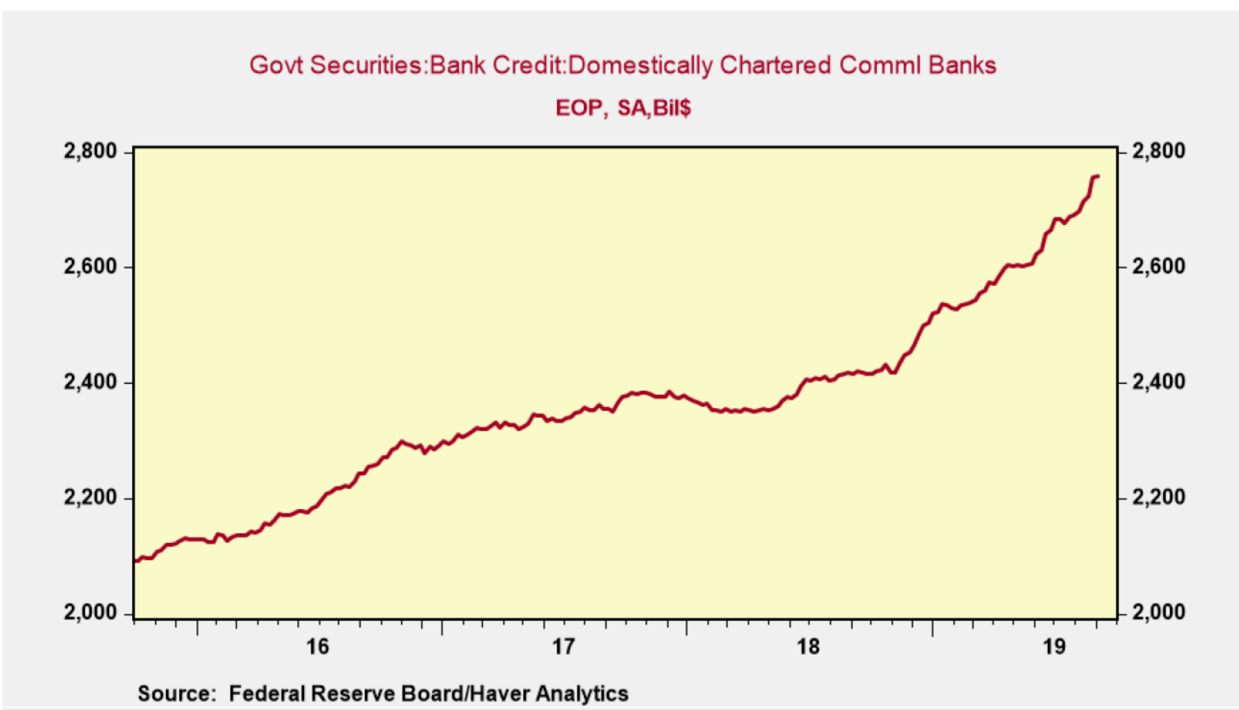


Flow and Positioning

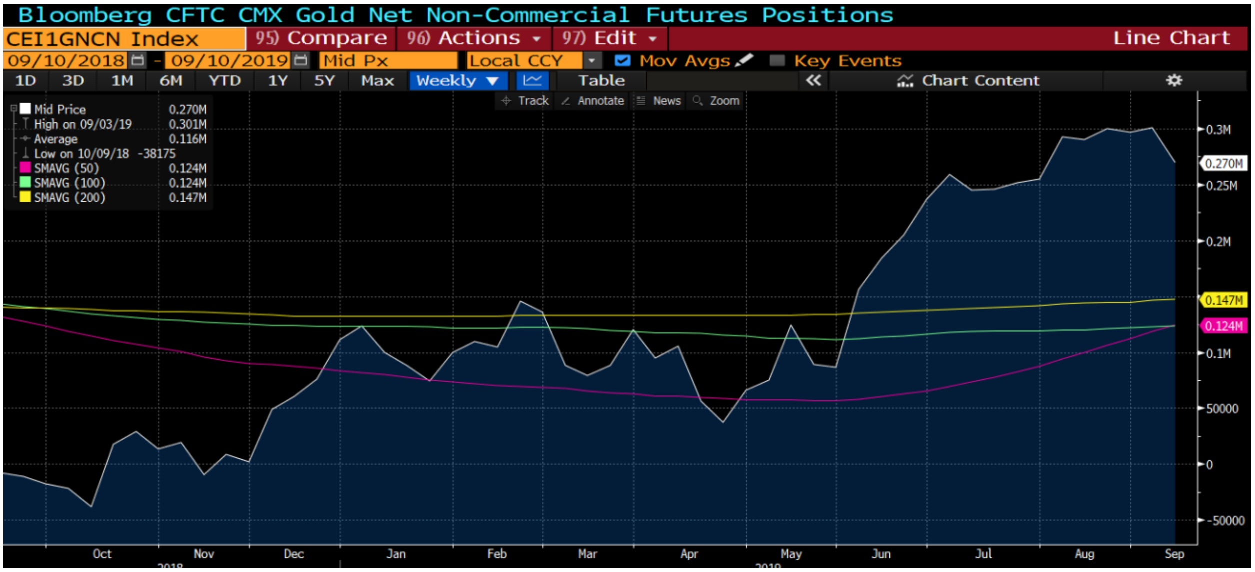
Hedge funds took profit on short bond positions buying 22BN 10-year equivalents.



Commercial banks despite the lengthening of their mortgage holdings showed capacity to buy bonds as the curve steepens.



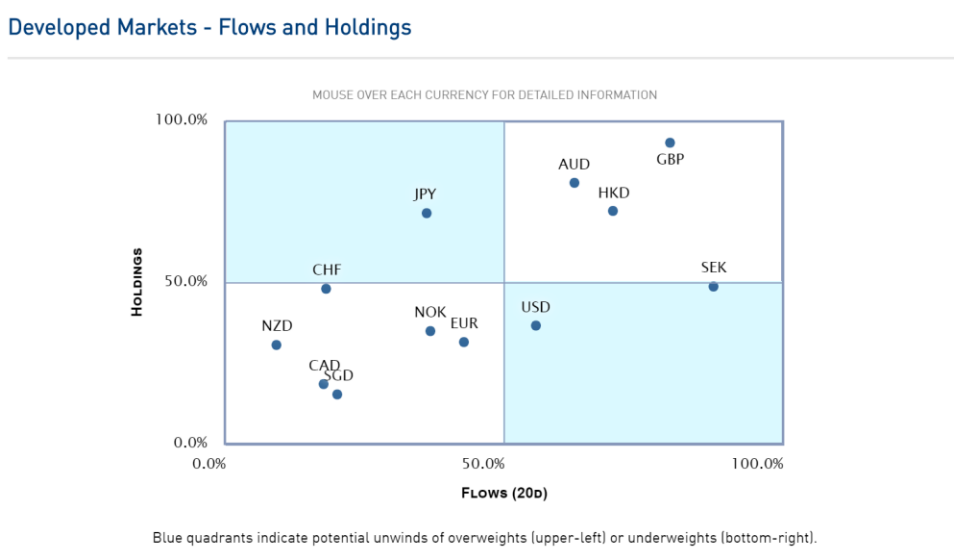
Gold is no longer as crowded



Equity markets have three short term flow issues

- Poor performance of IPO's and overhang of private equity issuance
- Though share buyback blackout window does not have provable alpha on its own, potentially offset by expectation management around earnings and the "beat" estimate outcome typical of earning seasons, if coupled with earnings misses the lack of buying may be noticed.
- September month end will show rebalance outflows

As for currencies positions remain neutral consistent with coincident monetary policy easing



Data provided by State Street

Current Model Portfolio performance and recommendations

After the changes recommended today the Damped Spring Model Portfolio is tilted toward downward shifts in growth expectations. It is balance toward inflation expectation shifts and it is neutral toward tightening monetary conditions as despite our view that monetary conditions need to be much looser it is in fact true that the central banks have delivered easing. Overall portfolio worst case loss is 4.1%. Current LTD performance is 12.71%

Today we recommend

- Going long bonds by
  - Selling TY Dec 129.5/128.5 Puts spreads
  - Selling RX Dec 173/172 Put Spreads
- Going long gold by
  - Selling Dec 1500/1450 Put spreads

	Assumed Portfolio size	100,000,000					
	LTD P/L	9,500,531					
	Total Returm	9.50%					
	Today's Date	9/18/2019		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	0.1	(995,833)	Open
8/22/2019	SPX Sept 2925/2975 Call Spreads	27	-435	1,000,000	45	(782,609)	Open
8/22/2019	SX5E Sept 3375/3475 CallSpread	49	-2381	1,000,000	97	(1,142,857)	Open
9/3/2019	SX5E Dec 3200/3000 Put Spread	31	4167	1,000,000	15.8	(633,333)	Open
9/3/2019	SPX Ded 2700/2500 Put Spread	29.2	342	1,000,000	15.4	(472,603)	Open
9/18/2109	GCZ9 Dec 1500/1450 Put Spread	18.3	-315	1,000,000	18.3	0	Open
9/18/2109	TY Dec 129.5/128.5 Put Spread	0.390625	-1641	1,000,000	0.390625	0	Open
9/18/2019	RX Dec 173/172 Put Spread	0.37	-1587	1,000,000	0.37	0	Open