The Damped Spring Report

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

11/1/2019

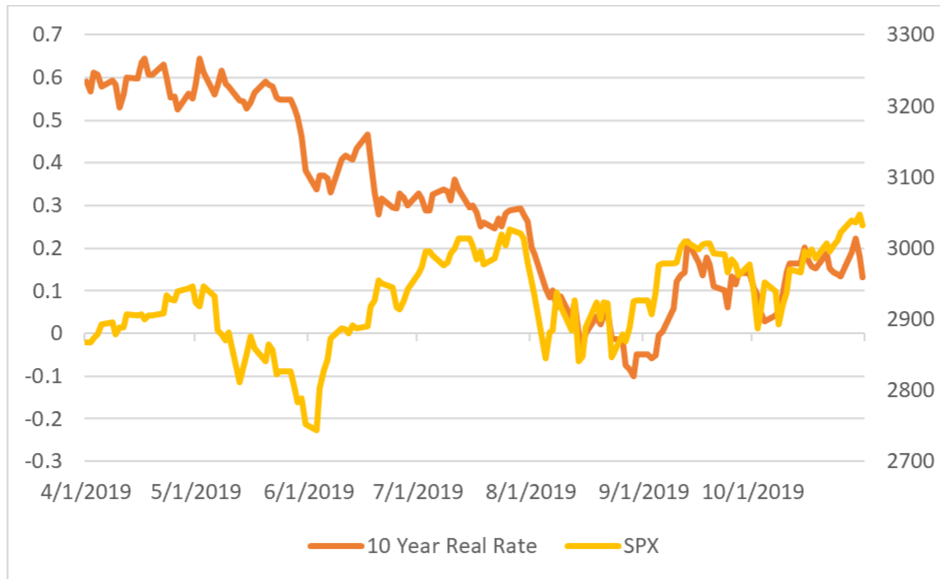
Synthesis

Done? The central banks are on a hard pause, is the US consumer going to keep spending? How about Santa Claus?

- Market based Growth Expectations have bounced and peaked.
- The Fed has gone from 3 or more cuts behind market expectations to sitting exactly on market expectations for 2020 which has resulted in modest risk premium contraction. Conceptually catching up to the curve is easing.
- Additional rate cuts are not going to be as effective.
- Actual economic growth has been driven by consumer growth almost entirely and consumers will not likely see as much employment growth or home price appreciation and though savings rates are high, consumer credit growth shows signs of slowing. Depending on further growth from consumers seems a poor risk to assume.
- Trade policy remains highly uncertain, however if resolution occurs Capex growth would potentially replace or enhance consumer growth. But that itself will take time to play out in the real economy
- Lastly, while we believe there are two legitimate fundamental reasons to believe that a Santa Claus rally may occur in US equities. We remain committed to our, so far quite wrong, equity market short and our long bond recommendations

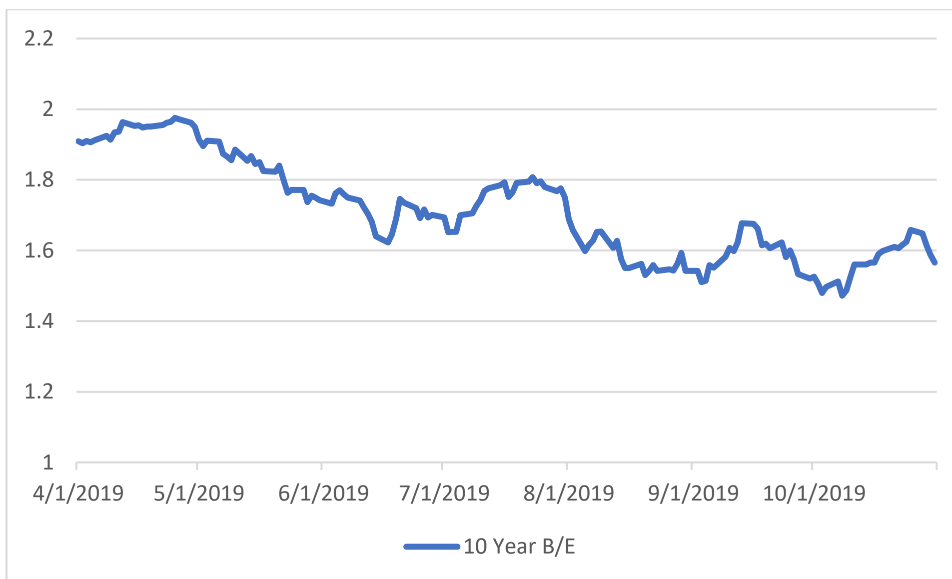
As we have mentioned in multiple reports the equity and bond markets have moved based on improvement in growth expectations due to trade talk softening and a small contraction in term premiums driven by aggressive action by the US Fed. What is new, and now clear based on pricing of Jan 2021 Futures, is that the Fed's monetary stance as described in the statement and in Powell's press conference are now almost perfectly aligned with market expectations. The Fed has delivered and is now no longer behind the curve but sitting right atop. The market expects a pause and the Fed is pausing.

Since the beginning of September, when trade resolution expectations began to improve, real rates and the SPX have been driven by rising growth expectations.



As one can see by the chart it isn't always the case that real rates and equity prices are coincident. When they are coincident, growth expectations are the principle driver.

We know that Inflation expectations have been stable to falling for this same period

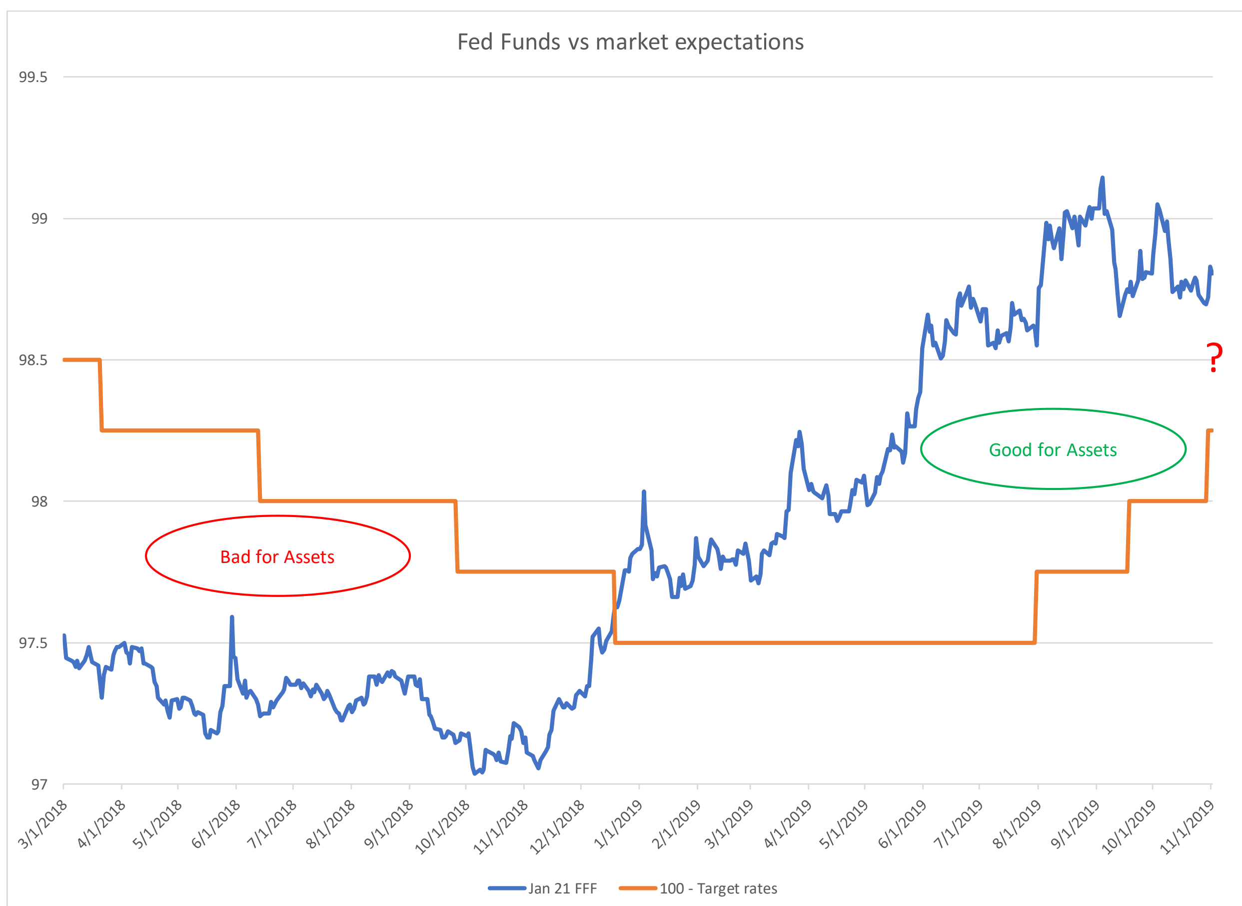


Which is consistent with stronger bonds and stocks. But we would not judge inflation as a recent driver.

During 2018, asset prices of all sorts performed badly. Growth was well supported by the 2017 tax cut and the economy was strong as a result of that cut and regulatory roll backs. The global central banks were withdrawing stimulus and raising rates. Asset prices performed badly due to tighter monetary conditions, essentially preference for cash over assets. Though unobservable directly, risk premiums, which had been contracting for a decade, rapidly expanded. The

December 2018 hike and almost immediate pivot by the Fed and ultimately all central bankers reversed this headwind. Asset prices have performed well for all of 2019.

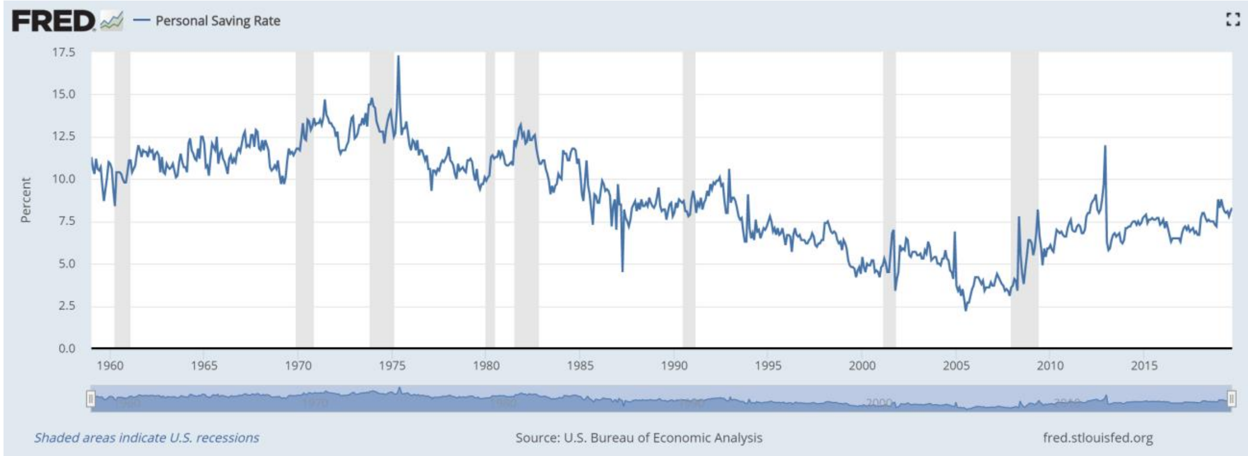
We at Damped Spring believe that the Fed is particularly effective in its activities when the current funds rate diverges significantly from the market expectations for the forward fund rate. When the Fed is significantly behind the curve, they hold ammunition to affect change. Currently the Fed's statement and Powell's press conference leaves monetary conditions for the next year virtually on top of market expectations through the end of 2020. The Fed has little ammo and the outlook for asset prices and risk premiums is at best neutral. Below is a simplified version of the concept we are illustrating



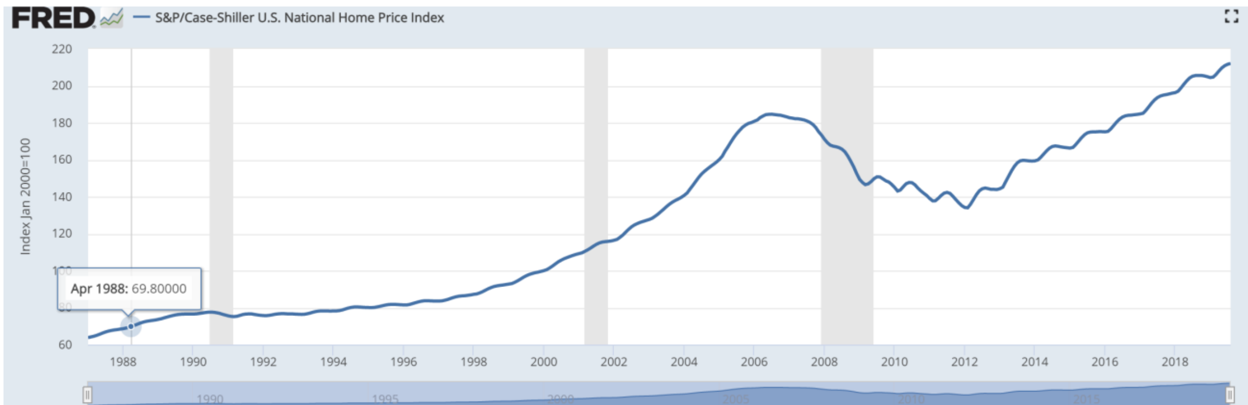
Perhaps, monetary conditions will not be as accommodative as the Fed hopes. We believe that without a new version of QE the Fed's monetary powers are extremely limited.

As for the real economy recent GDP figures indicate reaffirm that the US consumer is the sole driver of GDP growth. Modest growth in government expenditures is offsetting weakness in Net exports and Investment leaving the Consumer to hold the bag.

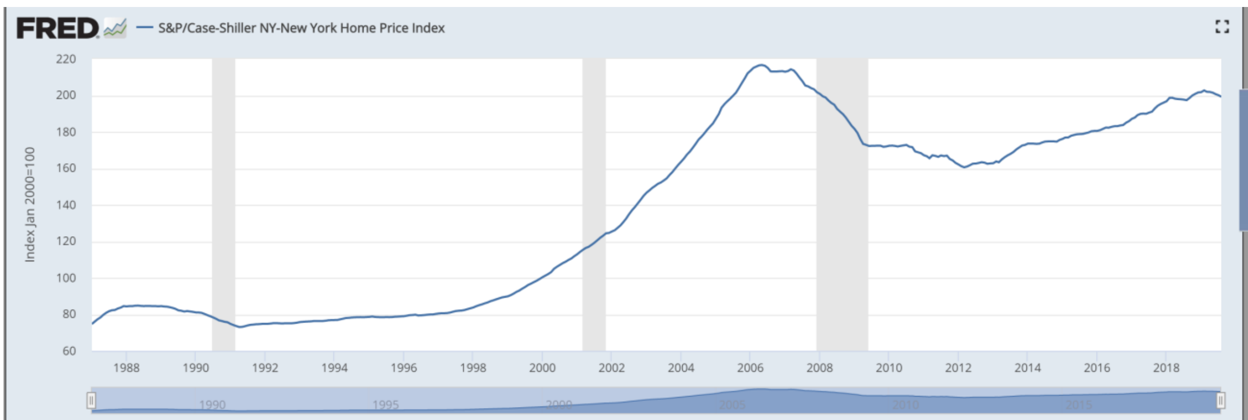
Admittedly the consumer has been in good shape. Employment numbers are strong, but one must assume that further growth in employment will have less impact on growth as full employment is approached. Employment has fueled consumption and savings. Savings rates are above average which gives consumers some buffer from a slow down



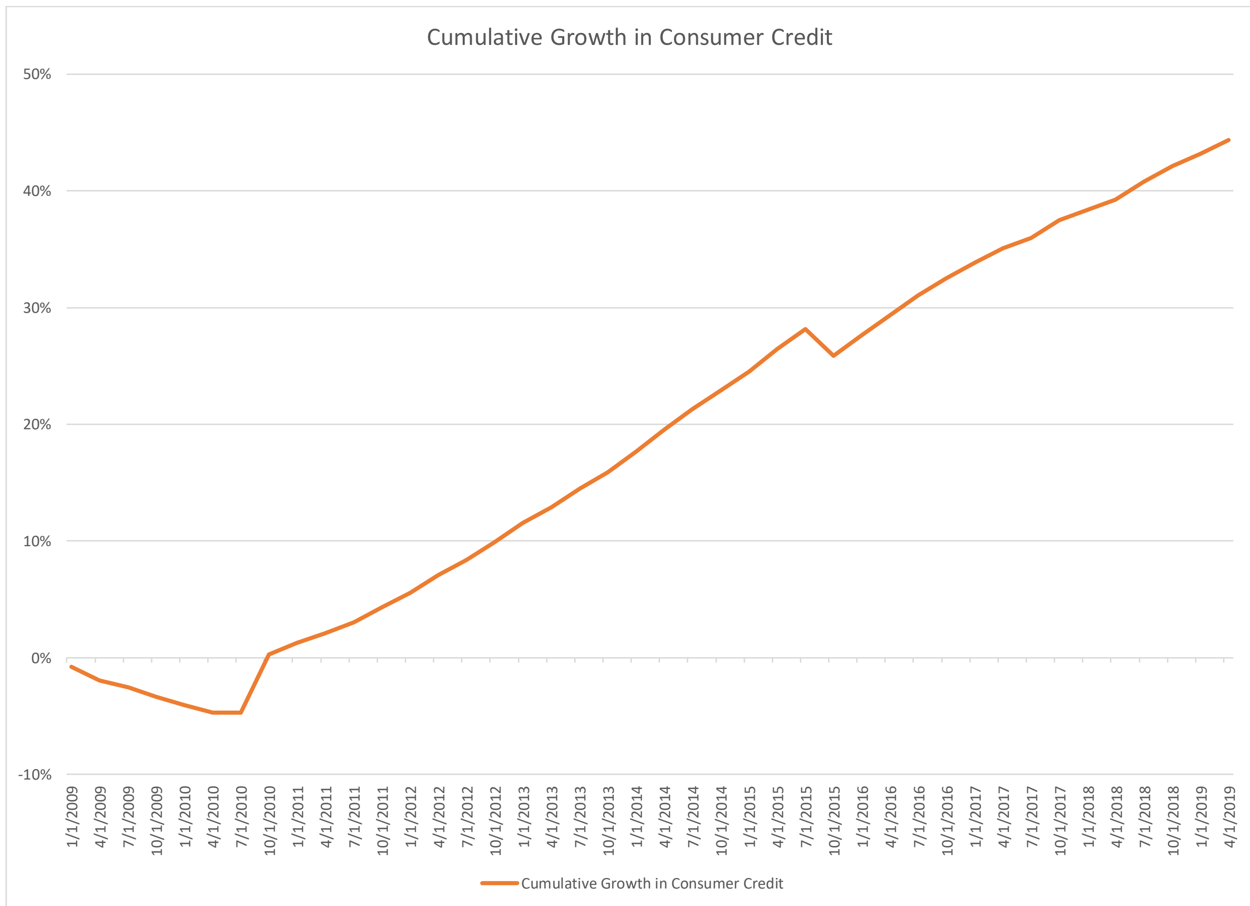
Median home prices have been steadily rising but regional weakness has become a concern



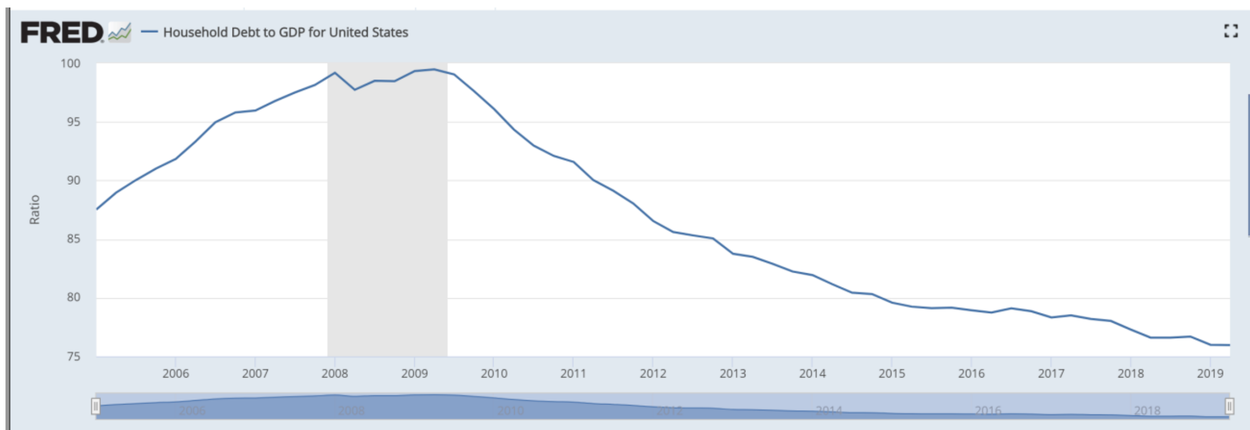
For instance, New York (and other east coast cities) is amid a downturn



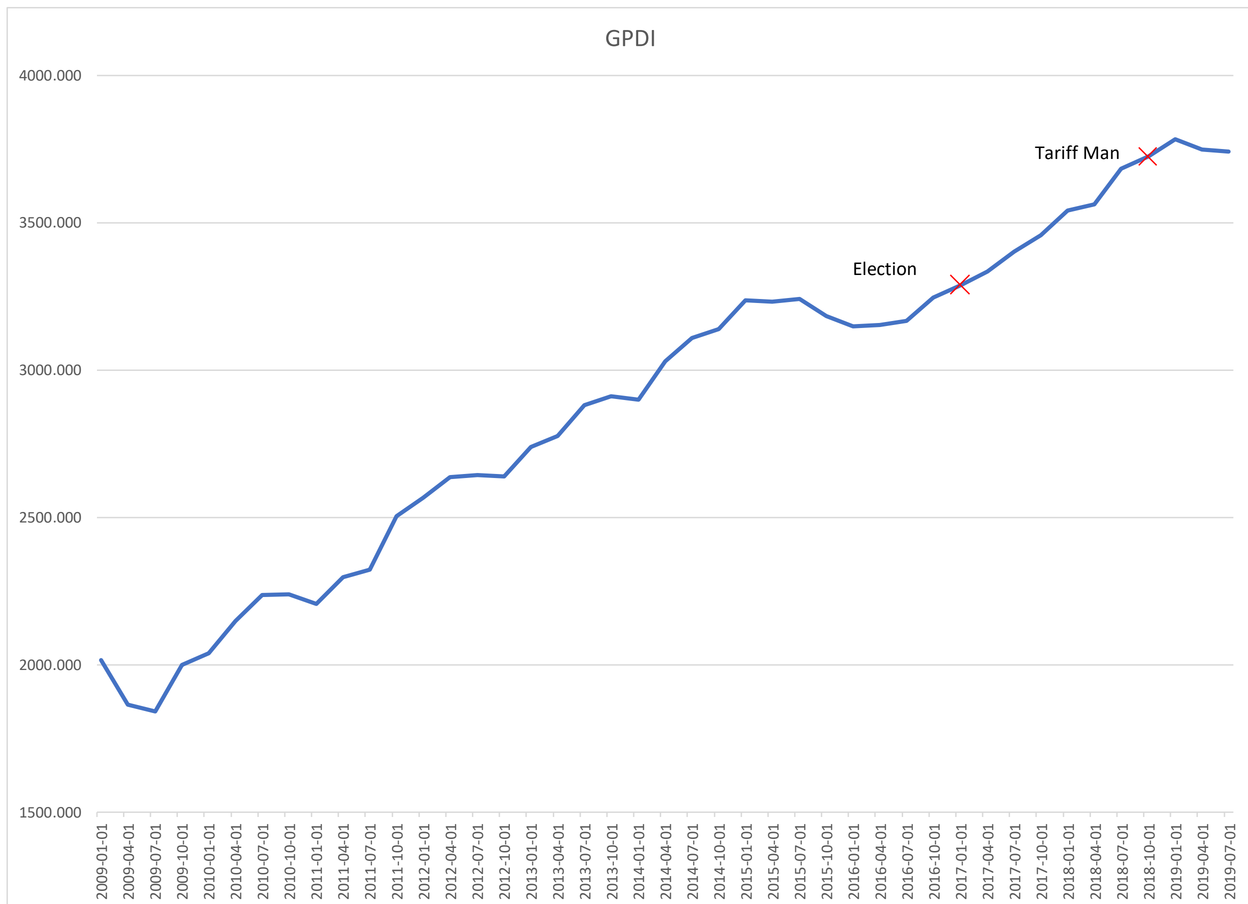
Consumer credit has risen quite a bit as cumulative growth is up over 44%



But as a percent of GDP consumer debt growth is quite low indicating additional debt capacity and possible further strength in consumption



While the consumer may continue to increase consumption and support GDP growth the weakness in Investment as part of GDP remains a concern and an open question due to trade uncertainty.



Between the Election and the "I am Tariff Man" quote Investment (Capex) grew 7.5% annually. Since the Trade war began Investment growth is flat and trending lower. The Corporate Tax cut of 2017 was extremely stimulative to Investment and fueled a significant jump in GDP. The trade war has obviously resulted in a slowdown. The open question is whether the trade war will be resolved (we think if it is it will be a return to status quo) and if resolved whether Capex growth can return to a GDP driver WITHOUT stimulative fiscal policy. We can imagine improvement in Capex growth easily but believe further weakness is more likely and return to 2017 style growth is out of the question.

Tis the season and we believe in Santa Claus. Our reasoning is simple. There are two real life fundamental drivers for a Santa Claus Rally.

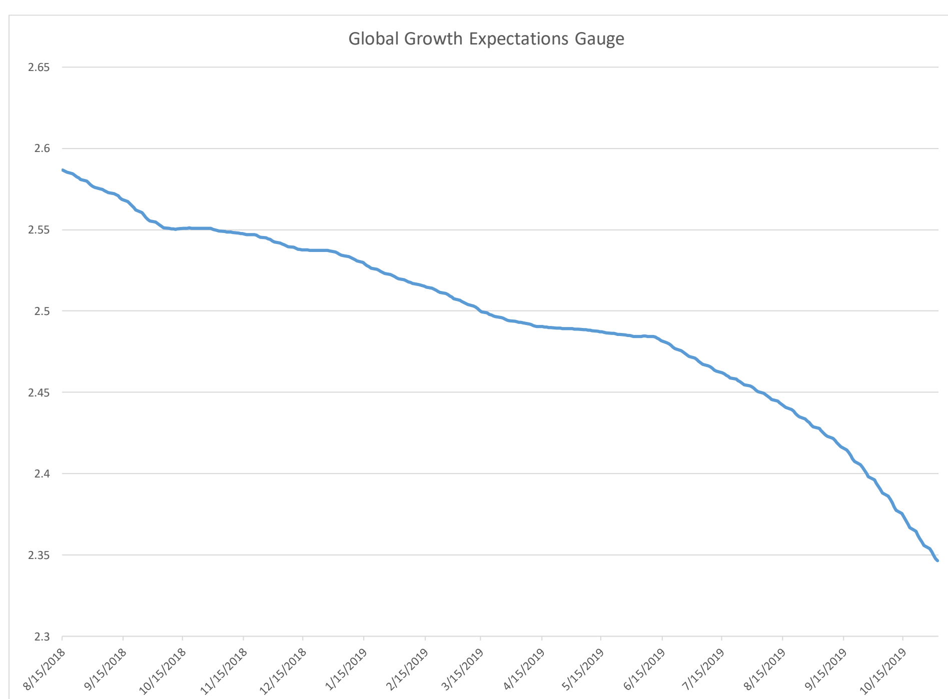
1. When markets rally over the course of a year as year-end approaches active managers who may have underperformed chase the rally
2. Selling winners at year end and realizing capital gains makes little sense vs holding through year end and differing taxes on those gains

Since the 1950's when tax regimes and investment vehicles are comparable to today 80% of the time when returns are positive through today holding stocks through year end is profitable and generates a 5.8% return over the next 2 months on average. 20% of the time a loss that averages 2.2% with a worst drawdown of

8% which happened last year as we are sure many remember. The Santa Claus effect is a real thing however the statistics stated above though compelling are frankly not statistically significant. Our view this season is that reason 1 above is a weak driver which is pointing toward a rally and reason 2 is a strong driver which may not have much impact if any this year given the limited amount of capital gains accumulated over the last 2 years of mediocre stock performance. It's a net positive flow for sure and we cannot ignore it. However, given our overall view mentioned above we are not betting long on Santa.

Fundamental Drivers

Global growth expectations are rising based on market pricing. However, our growth gauges continue to deteriorate. We have been examining this discrepancy and after review continue to believe markets are overly optimistic on the growth picture



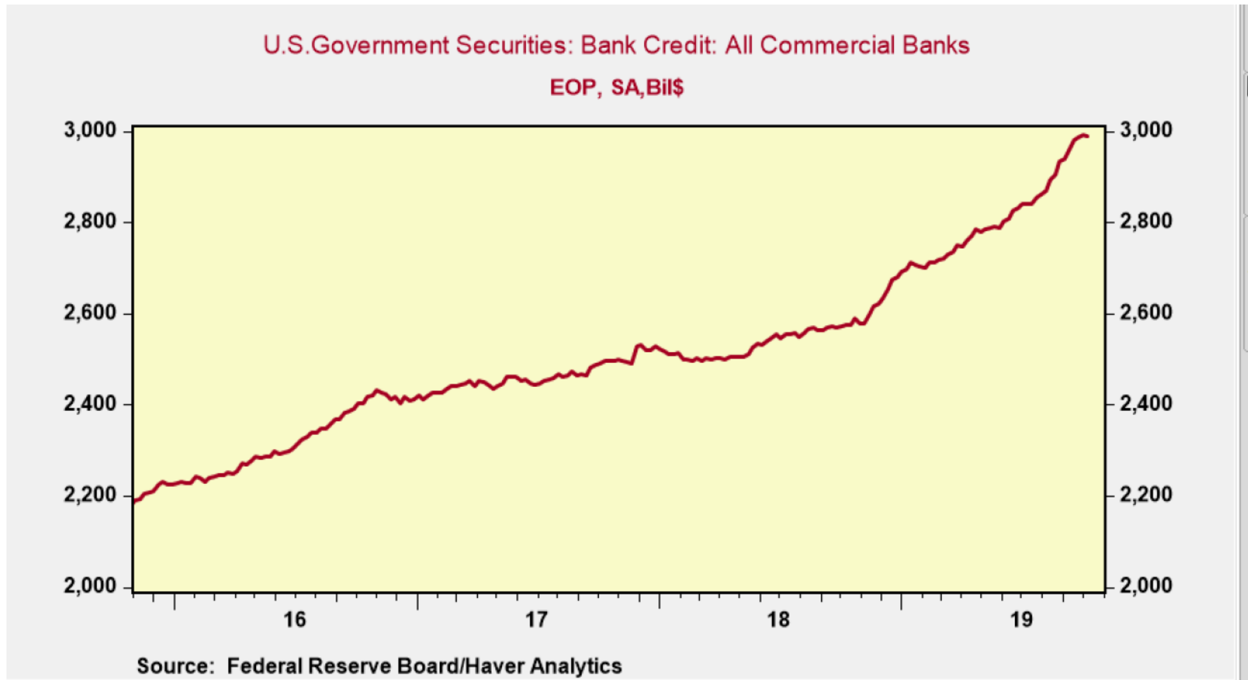
Damped Spring Volatility Model

As mentioned above the Central banks are on pause and the interest rate curve anticipates precisely that pause. For that reason, we are bullish volatility based on any action by the Fed resulting in a surprise to markets. That action would likely occur if a trade deal occurs or fails. We anticipate that strong employment numbers and new highs in the equity market generate leverage for the President and his Trade delegation and we expect him to use that leverage. We cannot predict the outcome but do not anticipate anything much better for global trade

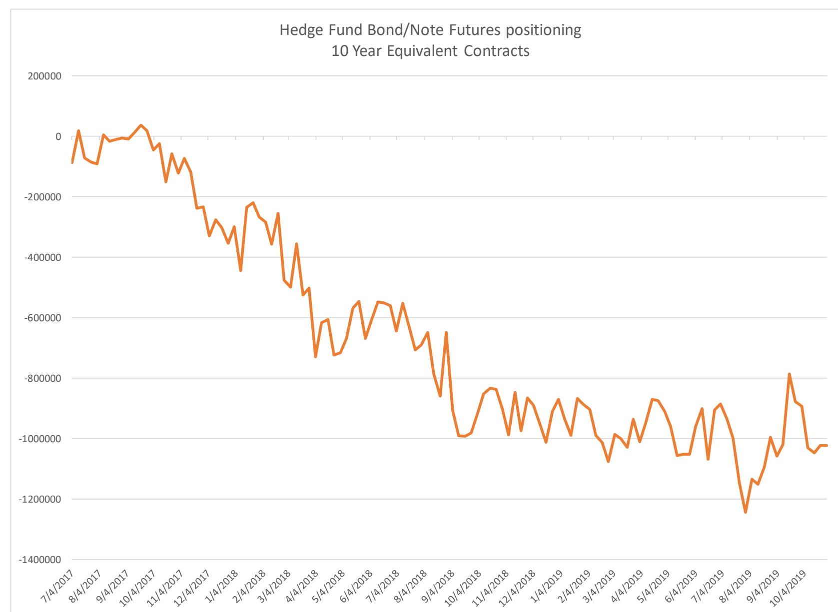
than a return to status quo. Perhaps market-based growth indicators are more bullish on trade scenarios.

Flow and Positioning

Banks slowed purchases of bonds, have somewhat large holdings, yet have favorably steep curves

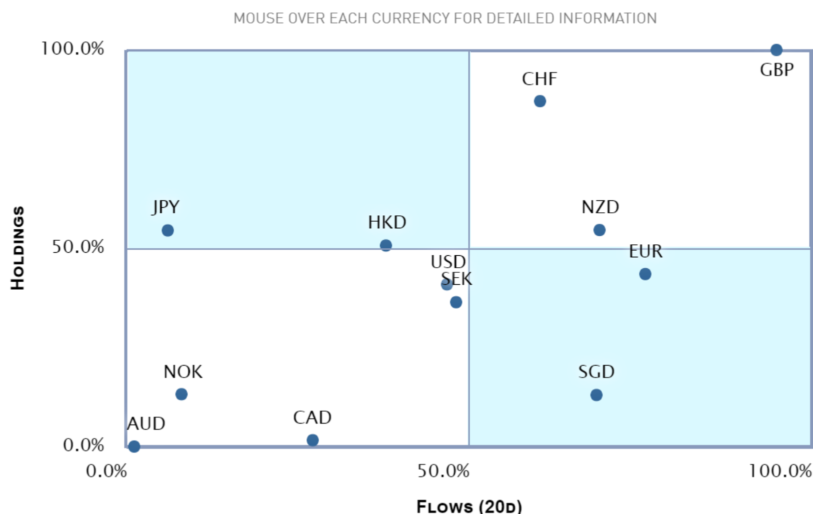


Levered funds once again have large short positions in bonds



Currency markets are becoming more interesting

Developed Markets - Flows and Holdings



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

The Brexit enthusiasm has generated a huge inflow to near max position size. Perhaps the GBP is vulnerable to weakness. The AUD on the other hand is now oversold and under-owned.

Current Model Portfolio performance and recommendations

Our wrong way bet on equities is now very far out of the money. With very little except bad trade news to disrupt the equity market and potential Santa Claus tailwinds we are not reupping this bet. However, we remain confident that growth is too robustly priced into markets. With the fed on pause and recently having cut we believe that risk premiums could contract a little more even as growth expectations flag and much prefer bonds to make that bet.

	Assumed Portfolio size	100,000,000					
	LTD P/L	8,456,855					
	Total Returm	8.46%					
	Today's Date	11/1/2019		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
9/3/2019	SX5E Dec 3200/3000 Put Spread	31	3226	1,000,000	2	(935,484)	Open
9/3/2019	SPX Ded 2700/2500 Put Spread	29.2	342	1,000,000	3	(897,260)	Open
9/18/2109	GCZ9 Dec 1500/1450 Put Spread	18.3	-315	1,000,000	8.8	299,685	Open
9/18/2109	TY Dec 129.5/128.5 Put Spread	0.390625	-1641	1,000,000	0.171875	358,974	Open
9/18/2019	RX Dec 173/172 Put Spread	0.37	-1587	1,000,000	0.62	(396,825)	Open
10/16/2019	TY Dec 131/132 Call Spread	0.21875	4571	1,000,000	0.15625	(285,714)	Open
10/16/2019	RX Dec 172/173 Call Spread	0.38	2632	1,000,000	0.38	-	Open