The Damped Spring Report

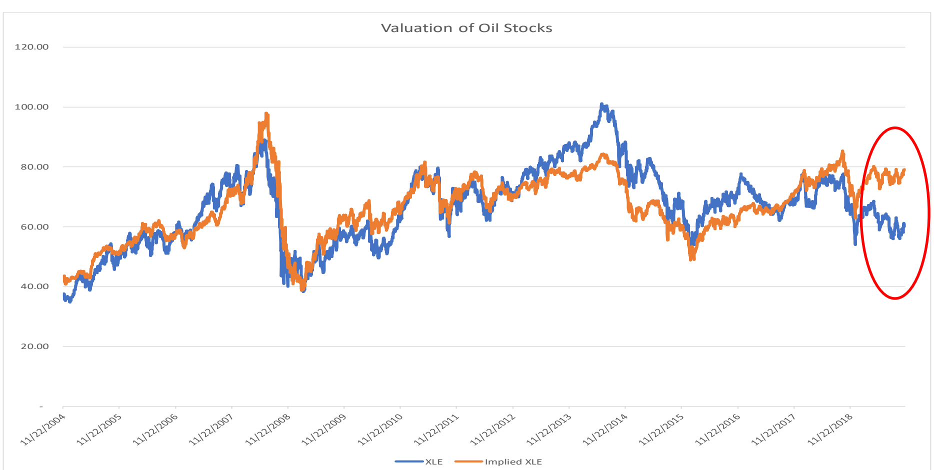
"Shifts in growth, inflation, risk premium and positioning all lead to opportunies in markets"

11/15/2019

Synthesis

Saudi Aramco and flows.

Saudi Arabia will sell $16BN of its holdings in Saudi Aramco in the weeks to come. This sale is an excellent example of the mechanics of flow. This large flow will require action by many market participants to provide the cash that the Saudi government will receive. The impact on global oil stocks has already begun to be discounted and will likely keep global oil stocks under pressure for an extended time. The flow will also impact equities in general over the next few weeks offsetting some of the year end bullish flows. The long-term crude futures curve is already depressed due to the shale oil revolution, but relative value investors indifferent to owning oil via a corporation or via the futures market will likely be reticent to step up in either markets. Oil and Oil Stock investors understand that a successful IPO will enable the Saudi's to execute their Vision 2030 plan which calls for divesting as much as 50% of Aramco. While the IPO has been on again off again for almost three years this weeks IPO will crystalize the overhang of as much as $1TN of future sales by the Saudi's and impact markets for the next decade. Over the next few weeks the markets will adjust to the short-term need of providing the Saudis with $16BN. We at Damped Spring Believe that understanding this flow will provide insight into the long-term impact of the overhang and future flows.



Before digging into the full flow picture of the IPO it is interesting to consider that over the past six to nine months oil stocks have significantly underperformed a fair value measure of oil stocks composed of crude oil and the broad equity market.

Note: The above chart shows XLE for simplicity. However, Saudi Aramco is much more of a pure play of owning oil in the ground. XLE is composed largely of integrated oil companies where refining and distribution represent significant portions of the underlying company's businesses. Crude oil is an international commodity and even a pure play US E&P company has both domestic and international exposure. Clearly, geopolitical risk regarding leases of reserves also needs to be considered when attempting to generate alpha from the above chart. We at Damped Spring have traded this relationship for 15 years and would be happy to discuss the specifics with subscribers.

The first step in considering the implication of the IPO is to look at the seller. When the transaction closes the Saudi Government will have cash. Based on the Vision 2030 plan, the cash will be both invested and spent. The investment portion will go to a wide variety of domestic projects and international and domestic business investment. Because this cash will flow back into the global financial system directly by purchasing financial assets and indirectly by generating revenue for corporation working on projects this cash will eventually return to the buyers of the IPO. As for the spending a portion of the proceeds will be a wealth transfer to Saudi Citizens and generate consumption. The specific amounts and timing of all this flow is relevant to consider the impact on global asset prices but clearly increased consumption will directly result in a net deficit of savings globally.

How will the buyers raise the $16BN? At a micro level this seems obvious. A portfolio manager interested in buying the IPO (with the assumption that the IPO is not impacting their overall asset allocation decision) will simply sell some global oil stocks and perhaps some of the rest of their equity portfolio and raise cash. The problem with this is to whom will they sell? At a macro level this real-life decision will generate a hot potato of assets. Ultimately the only way that brand-new cash can be generated is by some investor that is willing to leverage their investment and borrow. Of course, borrowing creates an asset itself. The hot potato ultimately lands at the foot of commercial banks who along with central bankers are the only entities that can create cash out of thin air.

Put simply, the sellers get cash and recycle some back into the financial system and the buyers lever up by borrowing from banks who print cash.

This all works seamlessly when banks are healthy and willing to leverage, but it pays to examine where the hot potato bounces along its path. We have shown in our first chart that those who own oil stocks have been discounting this flow and most likely the overhang of additional oil stock selling for some months now.

Those who are indifferent to owning oil via equities or via long term oil future, or are willing to arbitrage the difference have been transferring some of the expected sale into the long-term oil market

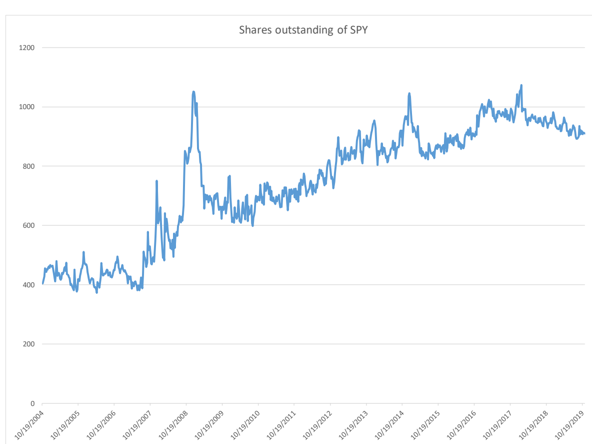
Notice since the announcement of Vision 2030, long term oil had continued to fall even as the front months have gone higher. While there is a ton of things going on in long term oil markets including shale, electric cars, cheaper renewables, etc. The idea that over the next decade 1TN of oil in the ground will be monetized by the Saudi's with proceeds used to buy non-oil assets and fuel consumption is potentially involved as well.

The size of the IPO is large but is not historically large (though the underlying company and the overhang is gigantic) The global equity markets have been rallying to recent or new all-time highs. Its useful to put in context the flow.

In the last few years there have been two IPO's larger that Aramco. Alibaba in 2014 and Facebook in 2012. In both cases equity markets were down 1% or so in the ten days surrounding the event. This is obviously not statistically significant.

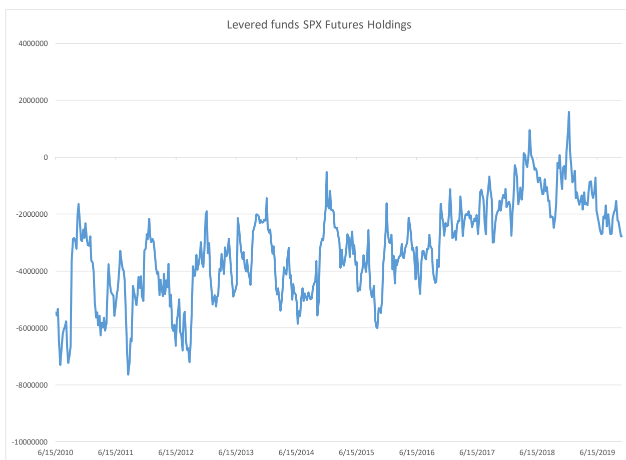
Corporate share repurchases average 2BN per day but are already widely discounted and understood

In 2019 64MM SPY have been redeemed which was worth about $19BN, which is tiny regarding net flow per day but interesting nonetheless given a perception that ETF investors are getting longer



As trade expectations have improved and central banks have eased Institutional money managers have purchase about $3.3BN per day of SPX Futures.

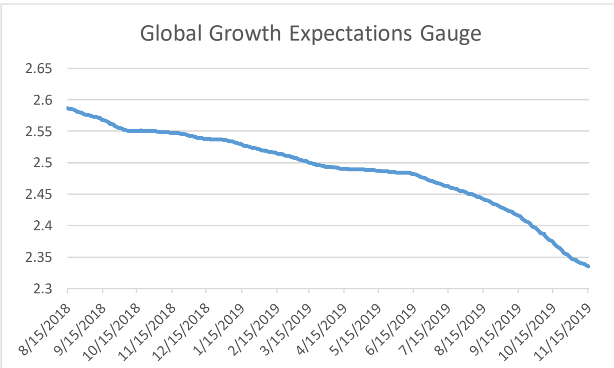
Hedge funds have been selling about $1BN per day and are modestly short fueling some market participant speculation of a meaningful Santa Claus rally

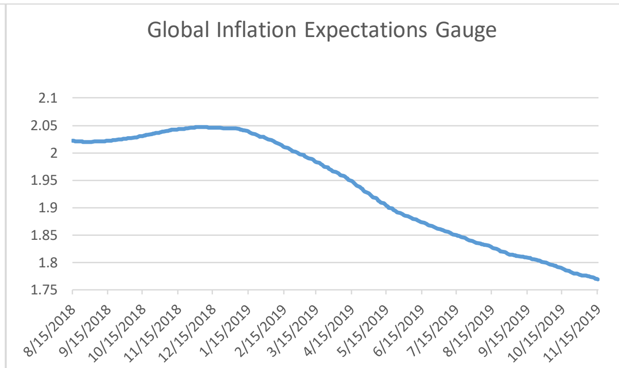


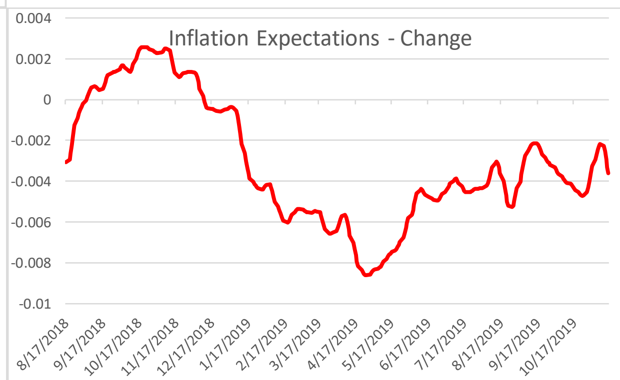
Fundamental Drivers

The Global markets continue to move as if driven by rising growth expectations, easy monetary conditions and low inflation. Equities are up and bonds are down modestly since our last report continuing a trend that confirms the drivers. The motivation for these shifts in market expectations seems based on improvement in the odds of a successful Phase 1 trade agreement. We know nothing about the odds, but it wouldn't surprise us to see the Phase 1 agreement. What continues to surprise us however is that the expectations for the impact of Phase 1 to be important. Based on the terms to date and even with some greater optimism that Phase 1 will be better than previously announced, the impact seems small and we repeat that fiscal stimulus is highly unlikely and central banks are done and out of ammunition in most cases. For that reason, one would have to expect that Phase 1 completion will result in a speedy and meaningful Phase 2 deal. Perhaps that is why markets are ignoring negative actual and survey data. We are betting that Phase 2 is going to be much harder.

Our indicators of forward growth and inflation have not changed much. Perhaps some pro-growth advocates are suggesting that a slowing but still negative shift in growth expectations is signs of a bottom, but we do not see the actual economic player who will return to above trend growth without fiscal or monetary support

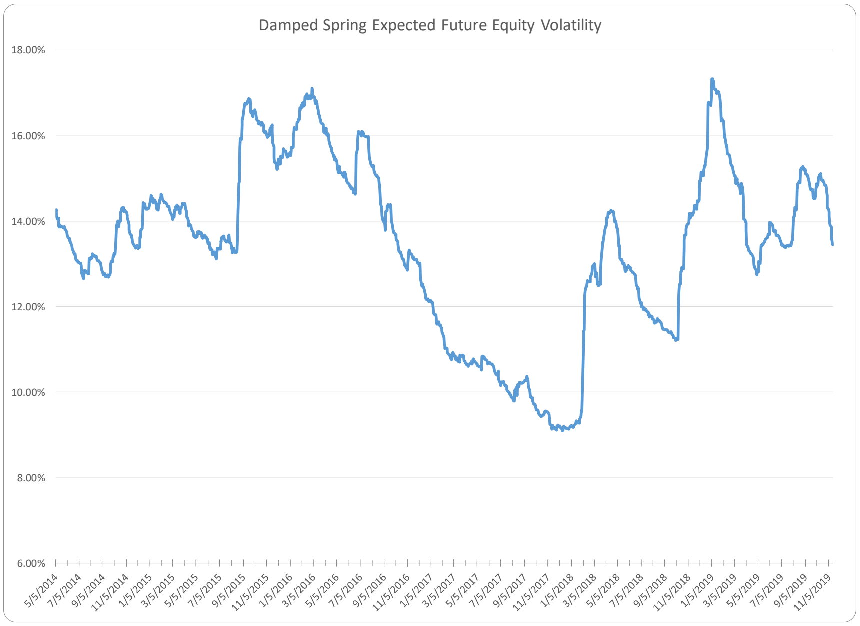






Damped Spring Volatility Model

Our expectations of forward volatility market have fallen. However, level of implieds in equity markets, in particular, have fallen quite a bit more. We are bullish on equity market volatility.



Current Model Portfolio performance and recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	6,432,588					
	Total Returm	6.43%					
	Today's Date	11/15/2019		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	4167	1,000,000	2	(1,208,333)	Open
9/3/2019	SPX Ded 2700/2500 Put Spread	29.2	342	1,000,000	5	(828,767)	Open
9/18/2109	GCZ9 Dec 1500/1450 Put Spread	18.3	-315	1,000,000	25	-211356	Open
9/18/2109	TY Dec 129.5/128.5 Put Spread	0.390625	-1641	1,000,000	0.35	66667	Open
10/16/2019	TY Dec 131/132 call Spread	0.21876	4571	1,000,000	0.1	-542878	Open
10/16/2019	RX Dec 173/172 Call Spread	0.38	2632	1,000,000	0.2	-473684	Open
9/18/2019	RX Dec 173/172 Put Spread	0.37	-1587	1,000,000	0.8	-682540	Open