The Damped Spring Report

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

12/2/2019

Synthesis

At Damped Spring Advisors we believe that the principle drivers for global stocks, bonds, commodities, and currencies are the shifts in expectations regarding future growth and inflation in the local and global economy.

While various assets respond differently to these shifts, all assets are impacted by the relative return offered by holding cash. When money and credit is cheap and plentiful investors bid up assets. When cash and credit is hard to come by and expensive investors sell assets to pay off debts or fund consumption. The return on a balanced to inflation and growth and highly diversified portfolio depends almost entirely on the daily carry provided to those who hold risky assets instead of cash, and the shift of the amount of carry one is likely to receive going forward through time. The last part is often called the contraction or expansion of risk premiums.

Since the lows of Christmas Eve, 2018 virtually all assets have rallied providing markedly better returns than holding cash. Risk premiums have contracted. However, there were two distinct phases of this contraction. The first phase was driven by the radical pivot by central banks. The second phase was the pause by central banks.

Since the pause a growth/inflation neutral portfolio has had zero return.

Other investment vehicles are a more pure expression of the realtive attractiveness of fiat money. Gold and Bitcoin rallied sharply as the fed pivoted. Lately as a traditional balanced asset portfolio has generated zero returns since the central banks paused, bitcoin and gold have fallen.

At exactly the same time as the central banks paused, the China/US trade war went from spiraling worse to a potential modest "Phase 1" deal. That was a fairly radical shift and pro growth assets performed well.

These observations seem logical and markets have been operating by and large correctly given the events that have transpired. But a few things concerned us over the last quarter regarding what is transpiring and based on pricing the odds now suggest a portfolio that is short assets in general and favoring short positions in assets that depend on further above trend growth for appreciation.

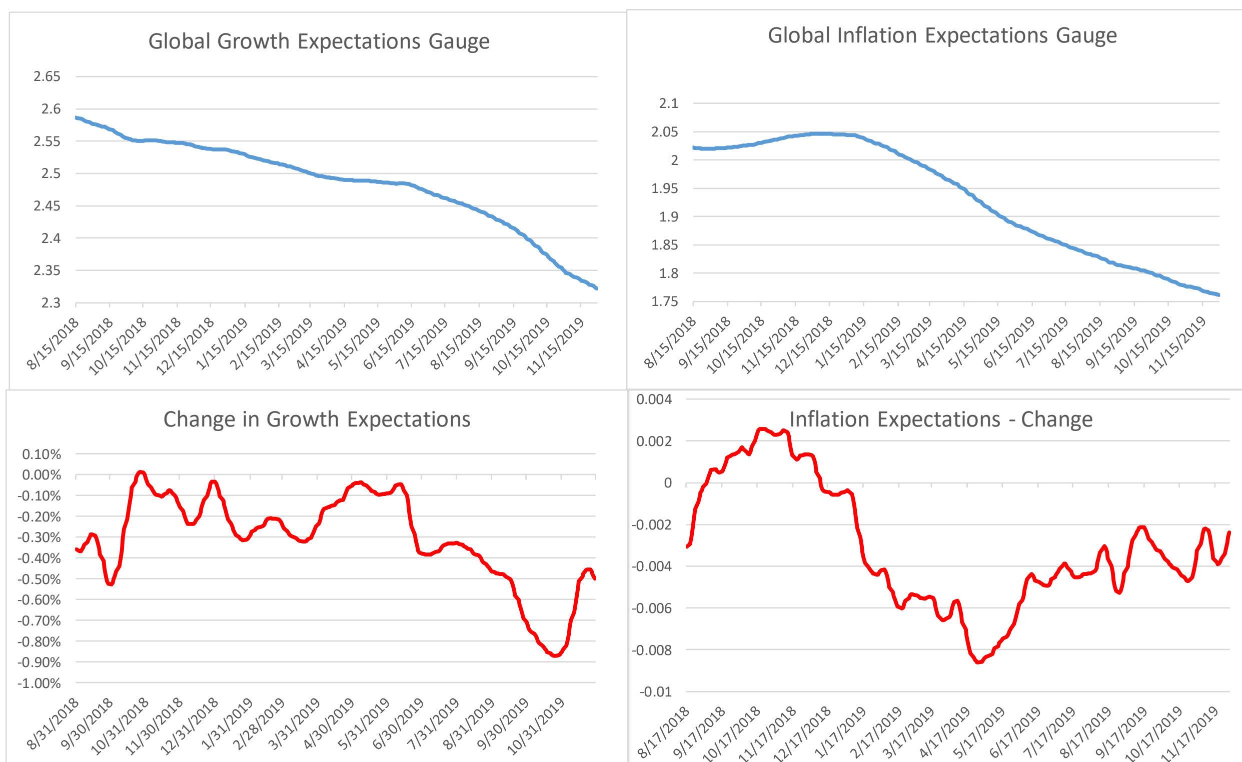
- We know very little about trade but like most believe a deal of some sort is likely. Phase 1 is more likely to occur than the parties once again going hostile.
- However, we do understand the direct impact of a signing of a phase 1 deal and believe strongly that above trend growth will not be the result of such a deal.
- Above trend growth depends on a combination of easy monetary policy and fiscal spending. We take the Fed and other central banks at their word and believe that they are on pause until a material change occurs. As for fiscal spending the "materiality" of a change would have to be extreme in order to move the northern europeans to spend and the US is stuck with gridlock at least to the election in November 2020
- While the US has more ammunition with further rate cuts and is building its balance sheet through repo activities, these efforts simply do not push money into the real economy as effectively as long term asset purchase. QE5 may be necessary but only after a material change in markets and/or the economy. On the positive side we expect that if the economy responds well to a phase 1 trade deal the Fed will be on pause throughout 2020. In either case just as gold and bitcoin have rolled over, assets in general will have negative returns given current pricing. Needless to say, but we will say it anyway, the ECB and BOJ have no ammunition and the fiscal side is not coming to the aid of the markets.

In synthesis global markets have rallied on easier money. Pro growth assets have lead the move and a trade détente will be a minor positive for pro growth assets and a negative to anti growth assets (like government bonds) but most of the move in those assets has already occurred and all of the monetary policy pivot move has long ago been priced by markets. If the Phase 1 deal unravels equities will reprice lower and bonds will rally but not as much as one might expect given the lack of further monetary easing.

A portfolio designed for the possibilities outlined is overweight bearish equities underweight bearish bonds. Specific portfolio recommendations are outlined below.

Fundamental Drivers

The enthusiasm expressed in markets has been purely pro growth since the trade détente in September. There has been some data that has supported that enthusiasm but DSA forward guages continue to weaken regarding future growth and inflation. It is possible and in fact likely that a phase 1 deal will have a modest positive impact on growth but markets have gotten well ahead of that and growth will have to bounce more meaningfully than we expect to support current pricing

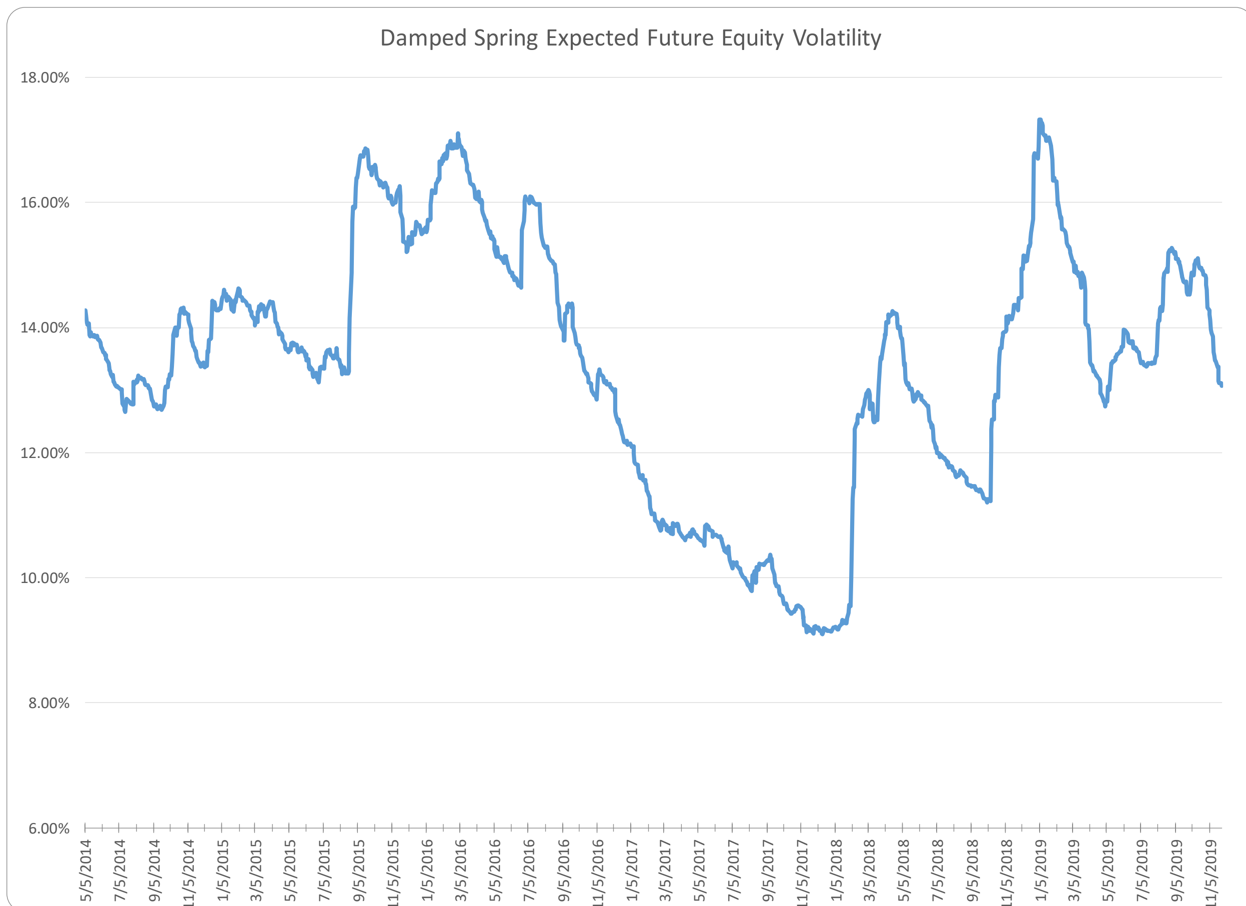


Damped Spring Volatility Model

The damped spring volatility model depends on understanding of market moving news, health of participants, and actions of those who can counter market moves with action. Currently the factors that stand out are:

- A few scheduled news events will occur including British elections and the year end financing stress and central bank meetings. By and large with exception of the British vote, these items have little market moving potential
- As for Trade we expect largely positive noise including a kicking the can down the road for the implementation of December tariffs. But you never know how things unwind. Given pricing more happy talk leading to a phase 1 deal is priced in and required for continued pro-growth asset strength.
- Market participants are in excellent shape as returns on all assets have been positive and we expect little forced liquidations for the balance of 2019
- Central banks are on pause and we expect no dampening actions to occur to counter act market moves. However, we do expect some noise around repo during year end.

Adding up the important model factors we believe that volatility is low but likely to stay low for the next month. Positions that are neutral to shifts in volatility are encouraged vs those that are net long options.



Current Model Portfolio performance and recommendations

New recommendations include a high delta short SPX position and a low delta shot TY position to reflect bearishness on assets in general and an overall anti-growth outlook. Currency markets are not currently interesting to us due to synchronous policy and global macro growth weakness.

- Short Call Spread on SPX
- Long Put Spread on SPX also notice the OTM short put leg of this trade is near the Bridgewater Put open interest. Something I have mentioned to our readers in a note.
- Long Put Spread on TY with significant leverage to hedge overall portfolio risk in the event of major trade progress. In such a world, equities go up a bit and bonds go down a lot based on a combination of FED pivoting toward removing accommodation and growth.
- Short Call Spread on TY. While we are clearly anti-growth given current pricing, the fed pause is not likely to allow bonds to rally much.

	Assumed Portfolio size	100,000,000					
	LTD P/L	5,798,848					
	Total Return	5.80%					
	Today's Date	12/2/2019		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	1	(967,742)	Open
9/3/2019	SPX Ded 2700/2500 Put Spread	29.2	342	1,000,000	1	(965,753)	Open
12/2/2019	SPX Mar 3150/3200 Call Spread	30	-500	1,000,000	30	0	Open
12/2/2019	SPX Mar 3050/2950 Put Spread	18	556	1,000,000	18	0	Open
12/2/2019	TY Mar 130/131 Call Spread	0.21875	-1280	1,000,000	0.21875	0	Open
12/2/2019	TY Mar 127/126 Put Spread	0.140625	7111	1,000,000	0.140625	0	Open