The Damped Spring Report

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

1/14/2020

The Zombie Decade?

Have we entered the Zombie 20's? The term "Zombie" has been used in finance for decades, most often it refers to a company which is heavily indebted and is unwilling or unable to increase debt, to fund cap ex, do necessary research and development, or pursue talented employees and thus suffers a slow wearing away of its competitiveness. One might expect a zombie company to fail more quickly and in high interest rate environments where debt service cost is significant zombies don't really exist. However, in very low interest rate environments like in Japan for almost 40 years or the rest of the world for the last decade, zombies can "thrive." The shot to the head that kills a zombie, when debt service can't do the job, is the failure to be able refinance existing debt

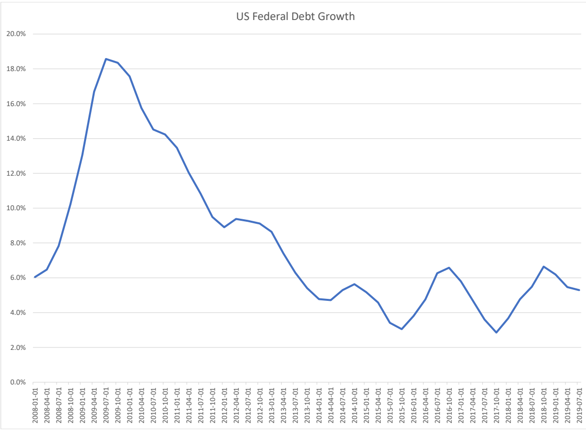
The current economic environment is one where zombies will likely thrive and for quite some time into the future debt refinancing will be possible. Nonetheless, the impact on the global economy will be a strong headwind against above trend growth and the risk of a seizing up of access to capital markets for the expanding zombie population will present downside risk.

But what about 2020?

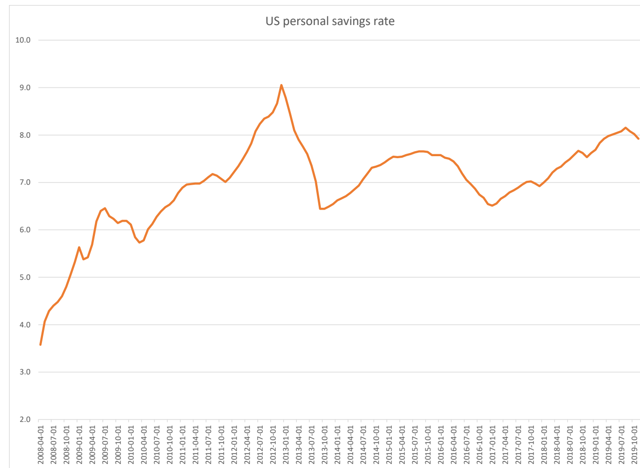
The well below trend growth of the private investment component of GDP in the US shows no sign of turning despite highly favorable corporate tax shifts in 2017, a pivot toward easing in 2019, and Phase 1 trade resolution in 2020.

2020 is an election year in the US, and the Democratic party led House will not likely agree with the Senate and President to increase fiscal stimulus. Growth of Government Expenditure has been below trend but increasing. That is not likely to continue in 2020

While Government Expenditure has increased, the national debt has increased at a far greater rate, well above GDP trend growth and clearly not effectively stimulative.



Conceptually as the economy grows savings grow and fund indebtedness growth. When debt growth outpaces economic growth savings rates coincidently increase

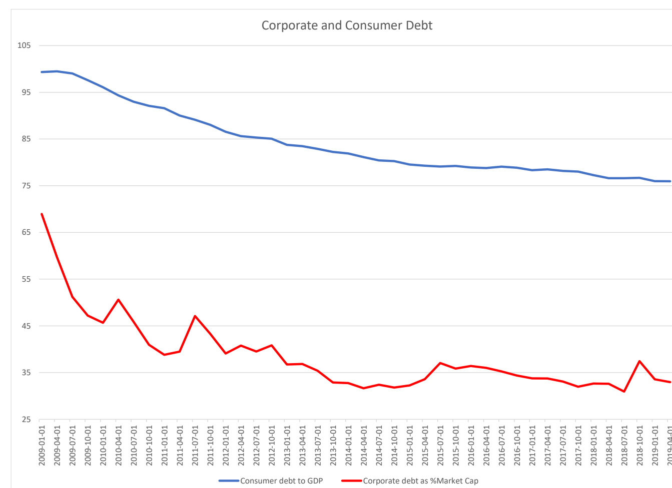


These charts tell an incomplete picture of what actually happens. For instance savings can drive debt creation (in fact the whole point of QE) when savers want to build nest eggs debt must be created to offset the new demand. When borrowers want to invest in the real economy they must offer incentive to savers to get cash.

But the mechanic is important and we suggests illustrates that the saver is now in the drivers seat regarding pricing. Governments, and the US in particular, are flooding markets while consumers and corporate issuers remain active but not particularly so. The saver is likely to demand an additional risk premium to fund this issuance.

Perhaps the stimulus of governments handing tax benefits to corporations, and increased government spending can provide adequate stimulus such that wage growth, demand growth, and price increase can convince the private sector to invest in productive assets and research and development and the zombie decade can be averted.

US corportations and consumers while at all time high debt levels actually have a fair degree of capacity to increase debt when measured by debt to market cap or debt to GDP.



The big question is will they? If the central banks are adequately aggressive and the governments are skilled at pushing the money to those who will actually spend or invest in the real economy the consumer and corporation will follow. A tall task.

A ten year outlook of a zombie decade may be right or wrong, but is not particularly useful for trading markets over the next 3 to 9 months. Consider our ten year outlook to be a headwind.

Strategically, we have some off consensus predictions for 2020.

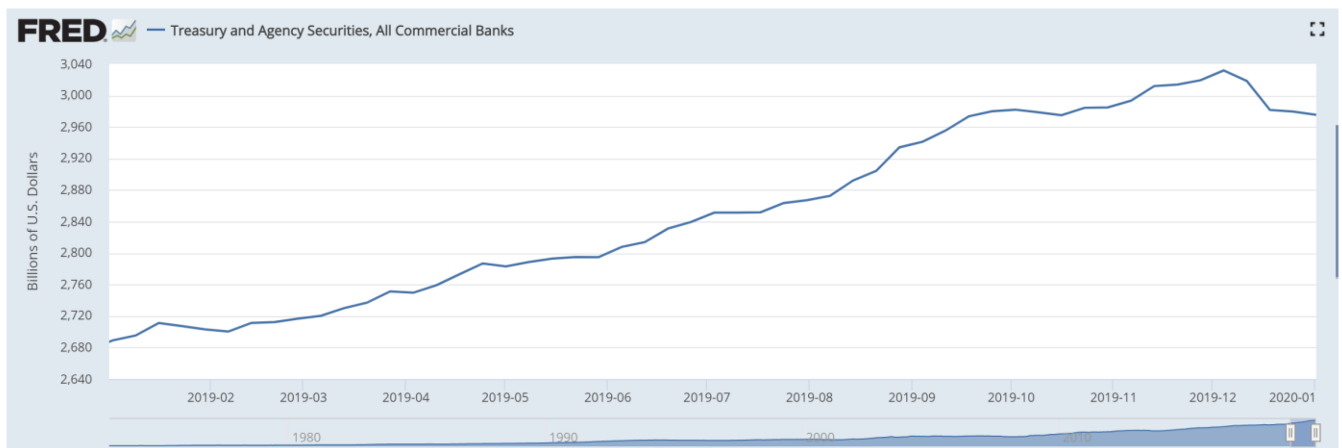
- January will be the high for the US stock market
- The US Fed will cut rates two times for sure and possibly three
- The US Fed will establish an LTRO like facility for managing short term interest rates which will be well subscribed and increase the Fed balance sheet, support bank NIM, and yet not be as effective as purchasing long term assets.

Theses predictions are based on both the long term headwind discussed above, and a 2020 outlook in which no further fiscal stimulus will occur. The LTRO prediction is the logical mechanical effort to fix the short term money markets.

What about flow and positioning?

Bonds

Over the course of the last few weeks a very rare flow has occurred. Commercial Banks, the largest consistent buyer of UST and mortgages across the curve have sold a total of 56BN over the last 6 weeks.

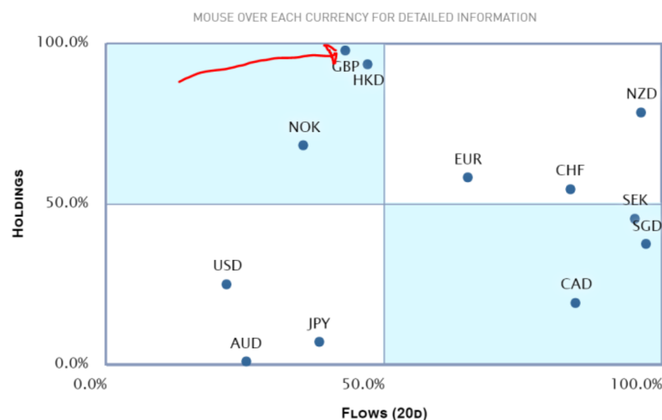


For context this sort of selling last happened in the taper tantrum period

Perhaps this was related to the funding issues at year end but we are keeping close eye on this flow. It is not obvious that the banks are levering up in other assets and a further deleveraging or frankly a steady state of holdings will be bad for all assets unless replaced by QE.

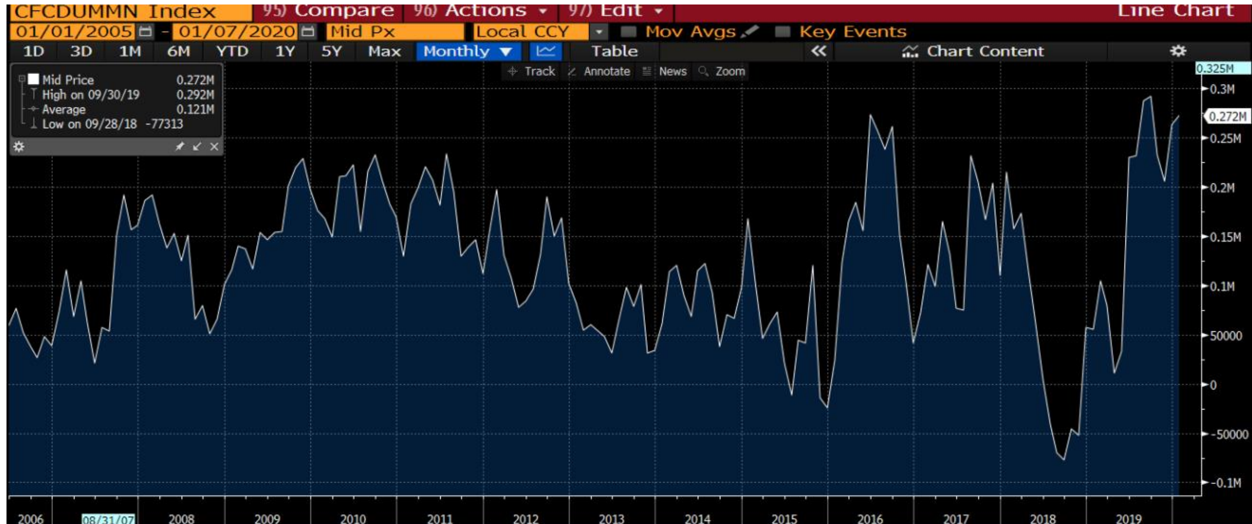
GBP

A new recommendation is to buy GBP as both a weak USD and strong GBP play. Fundamentally, we think the discounting of a cut makes some sense so we understand a pullback from recent highs. However, flow indicators suggest that while GBP is well owned there is a a number of weeks before we would be concerned about crowding and a shift toward new buying underway



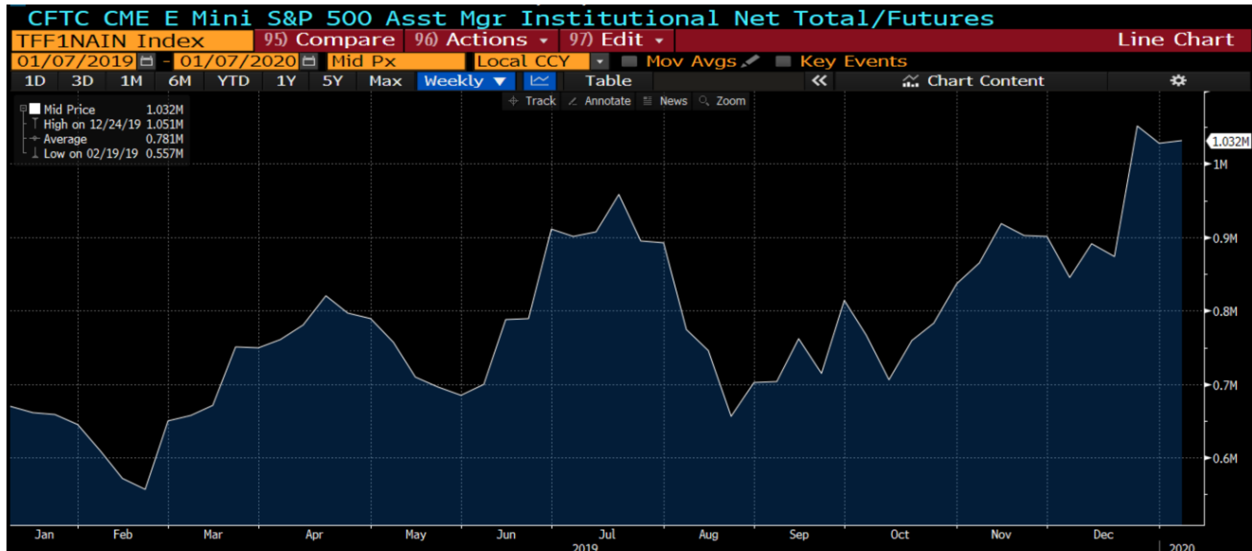
Gold

Our new Gold Recommendation is also a weak dollar outlook. Demand has been high and accelerating but the fluff of the Iran incident has been removed from the price for the moment

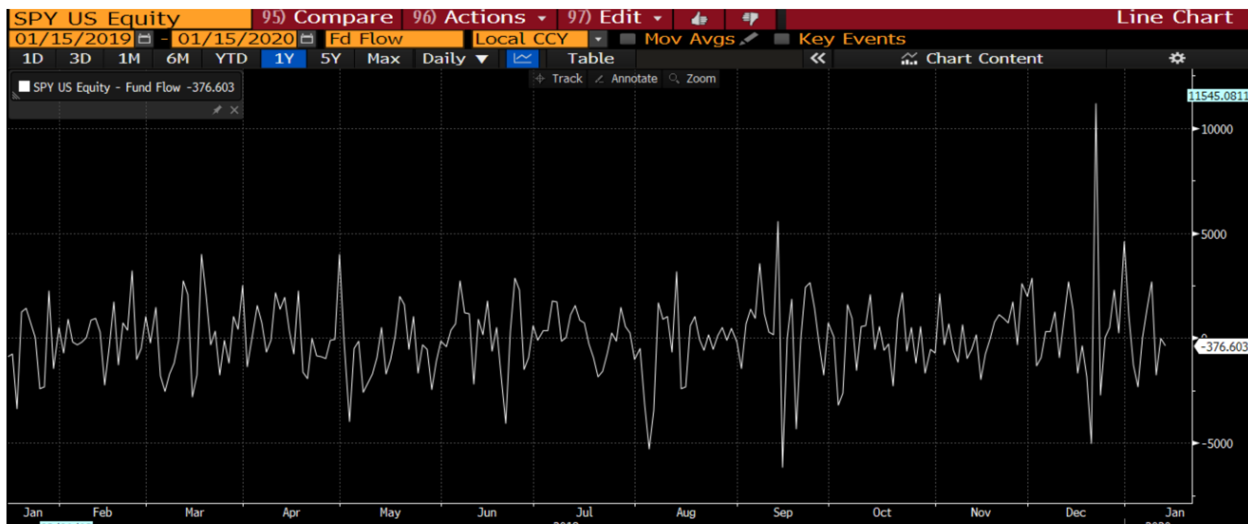


Stocks

Equity Inflows by institutions have slowed



SPY inflows after a huge Santa purchase ahead of Xmas have abated



Current Model Portfolio performance and Recommendations

When our long term outlook, year ahead outlook, and short term valuation and positioning analysis all come together we feel strongly about our recommendations. We believe the asset markets are inflated (particularly equities) by a longer lasting year end flow and a more persistent improvement in growth outlook than we expected. Currently, except in Japan, central bank debt monetization is extremely limited. While we expect that to shift fairly radically by year end today we expect a crowding out of assets by governement issuance to put pressure on all asset returns. As we have said over the course of 2019 we believe that US fed has some ability and potentially some willingness to ease while the rest of the world has used all of its traditional bullets and can not ease without new methods. For that reason we expect USD to underperform Gold and DMFX as expectations of additional easing get baked into the market.

Clearly the timing is important, If the Fed moves to ease sooner and more forcibly than market expectations and our more extreme view, then asset prices will be ok. The Dollar will be weaker in such circumstances. However, we suspect the timing will be more cautious and the blow off top in equities and relatively strong overall asset prices will have to correct first.

Our position recommendations given today's pricing

- We remain max bearish on both stocks and bonds
- We recommend selling ATM put spreads on Gold
- We recommend a bullish position on GBP selling put spreads