The Damped Spring Report

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

1/31/2020

It's not about the virus

In the last Damped Spring Report, we outlined our framework for the future of the US and Global economies for the next decade. We believe we have entered the Zombie 20's. In a Bloomberg News interview from the World Economic Forum in Davos, Bob Prince, Co-CEO of Bridgewater Associates, made a widely quoted statement that the Bomb/Bust Cycle is over. The news media reported the statement missing the key clause. Perhaps the headline is better click bait without the clause. The important part of his statement was "As we know it". We have no special knowledge of Bob's meaning but suspect that Zombie corporations and economies walking the earth is the "new bust". The "new boom"? money printing and debt monetization with the potential for significant inflation.

For 2020 We made a few significant predictions

- 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.

The coronavirus has certainly influenced some of our predictions. Stock markets are well below all-time highs. Pricing for two Fed rate cuts in 2020 has jumped from 15 to 30% since we made our prediction. The odds of an LTRO have not changed much and are still a non-consensus prediction.

Short term, we have been extremely concerned about overly robust growth expectations built into stock and bond prices. The catalyst of the Coronavirus has taken some of the fluff out of the market pricing of future growth but, along with that fluff came expectations for rate cuts in 2020 which temporarily supported all asset prices. Equities have fallen less than expected and in the bond market a combination of both Fed Rate cuts, and slower growth have resulted in a monster rally. Lastly, fiat money has taken a hit on expectations of easing, with both Gold rallying to near 1600 and Crypto at recent highs. The virus will certainly have an impact on actual growth in the first quarter and possibly longer but as it burns out

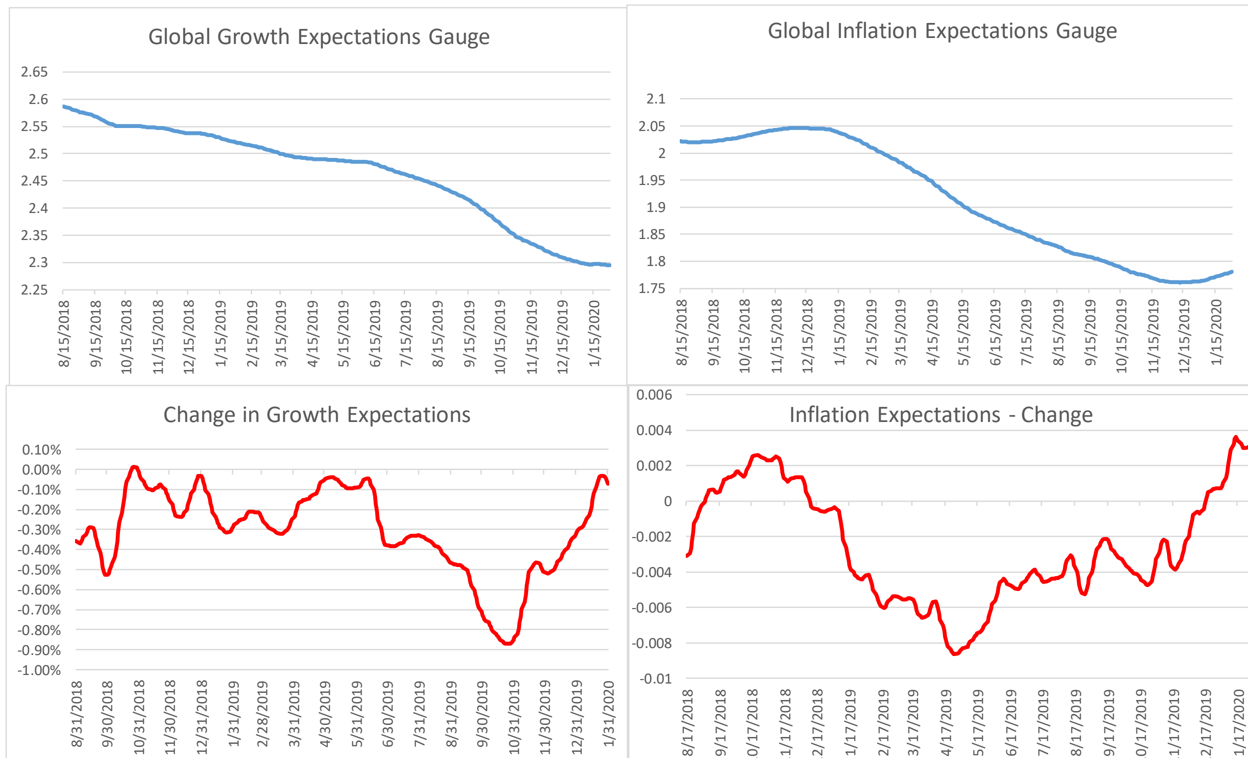
the world will go back to normal. The question for investor in assets is whether the virus is a root cause for slowing growth expectations or a catalyst for a rethinking of market pricing on growth and the ability for the global economy to achieve at or above trend growth in the back half of 2020 and beyond? Our call is that it isn't the virus. The virus is a catalyst and when it is behind us the reality of the Zombie decade will drive market pricing, portfolio holdings, monetary police, and fiscal policy

Since the 4th quarter the 60/40 portfolio has had fantastic returns as robust growth expectations drove performance. The balanced portfolio, neutral to growth, had good returns vs cash driven principally by continued accommodative policy. Since the virus scare obviously the 60/40 portfolio has done poorly. Yet it is clear by continued positive returns of the growth neutral portfolio, that risk premiums remain well behaved on assets and are not expanding. When thinking about the market portfolio and what is occurring to the sum total of all investors it is important to remember that the market portfolio is pro-growth.

Of course, the rally in Eurodollar futures, gold and bitcoin are further indication of expectations of rate cuts. While we strongly believe that 2 rate cuts will occur in 2020. our higher-level point is that it will not be effective in constraining risk

premium expansion or fueling growth as cash will become desired vs consumption or investment despite lower rates.

As for our gauges of growth and inflation expectations, growth expectations ended the month and the recent history at new lows and the rate of change of shifts in growth expectations topped, suggesting a potential for a downward shift in growth expectations accelerating once again. Inflation expectations tilted upward. In the unlikely event that inflation expectations move meaningfully higher the consequence to the stock market and assets in general would be quite severe.



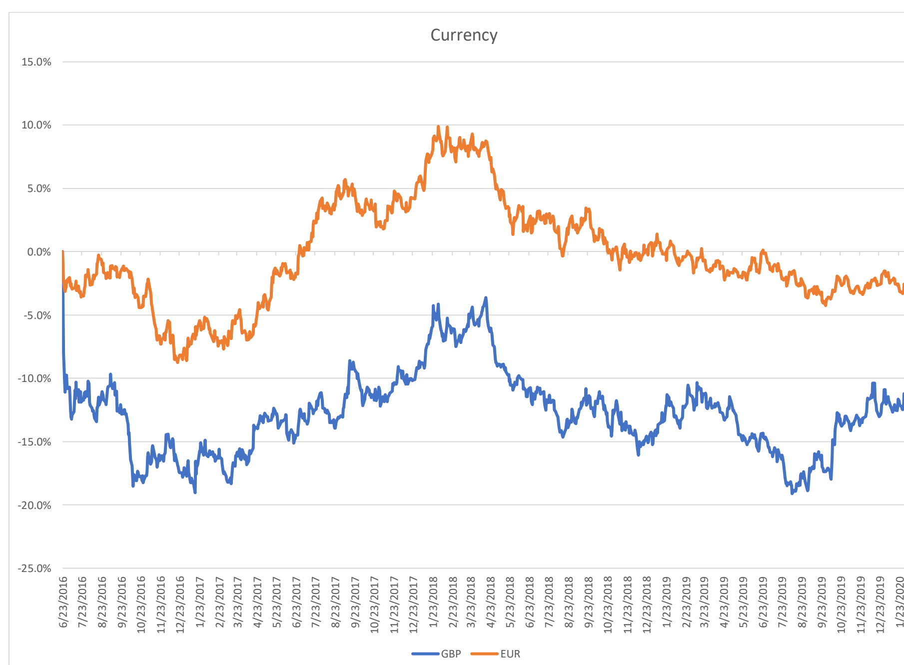
The continued falling of growth expectations both before and since corona virus has been our most significant signal that market pricing for future growth was, and is for equity markets, way out whack with reality. The bond market has largely corrected. Rising inflation expectations and a significant shift toward our forecast of 2 rate cuts leave the bond market needing visible signs of further lower growth to generate additional rallies. While this is our 2020 forecast, we suspect that near term further bond market rallies are not in the cards. Perhaps the bond market (like us) is looking through the coronavirus growth scare and sees the world as below trend growth in the back half of 2020 and beyond. If so, further bond market rallies are possible. But it is our view that a short in the bond market hedging a max short in the equity market is warranted as the coronavirus fades to the past and the economy bounces on the slow path to long term lower growth and the zombie decade.

GBP

Great Britain has left the Eurozone. As we are recommending a modestly bullish position long the GBP, reviewing what has happened in asset markets since the Brexit referendum seems timely. When we add up what has happened, we believe that most of the capital reallocation away from GBP asset has already occurred and a return to GBP assets will occur over the next few months. We see signs in flow data that suggests growing and fairly large investor positions in GBP and so we are not early with this call however, we expect the positioning to go toward crowded on meaningful buying. That combination requires a price concession from the buyers as the marginal seller demands appreciation before selling.

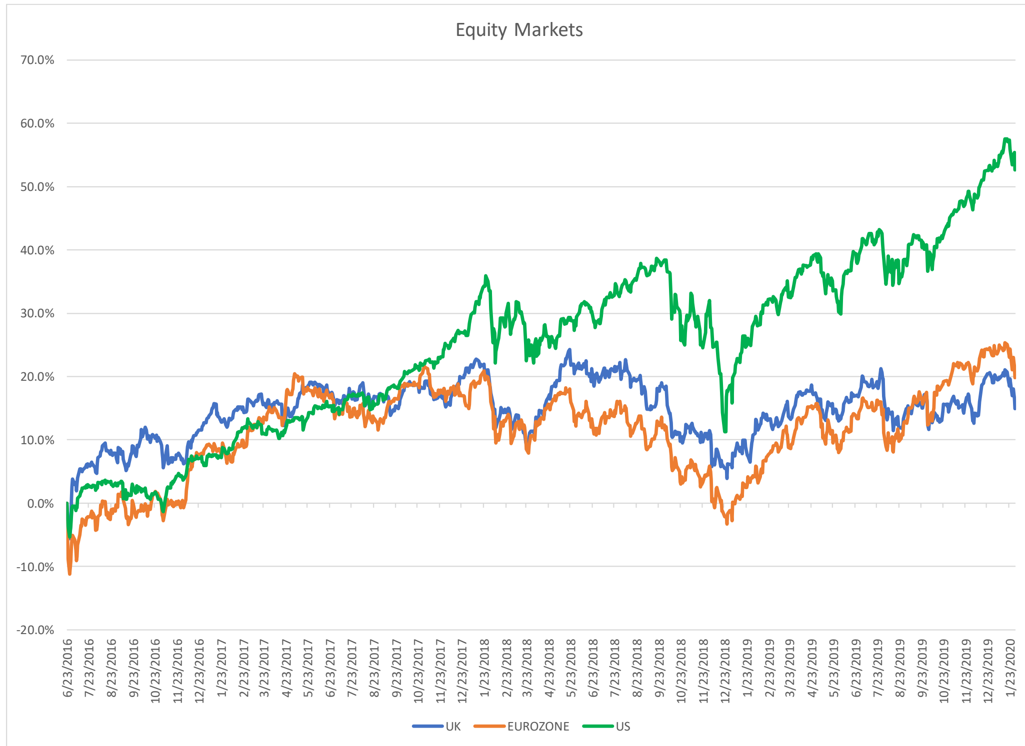
Since the referendum, we expected capital flows out of British assets to the rest of the world with some preference for European Assets. These flows would weaken the GBP and cause underperformance of both the UK economy and growth-related risky assets. What has occurred is consistent with these expectations. UK GDP has expanded by 5% while Europe and the US has had 10% GDP Growth over the period.

Since the Brexit vote the GBP is down 11.2% against the USD and the EUR is down modestly. The GBP has weakened by almost 9% vs the Euro.

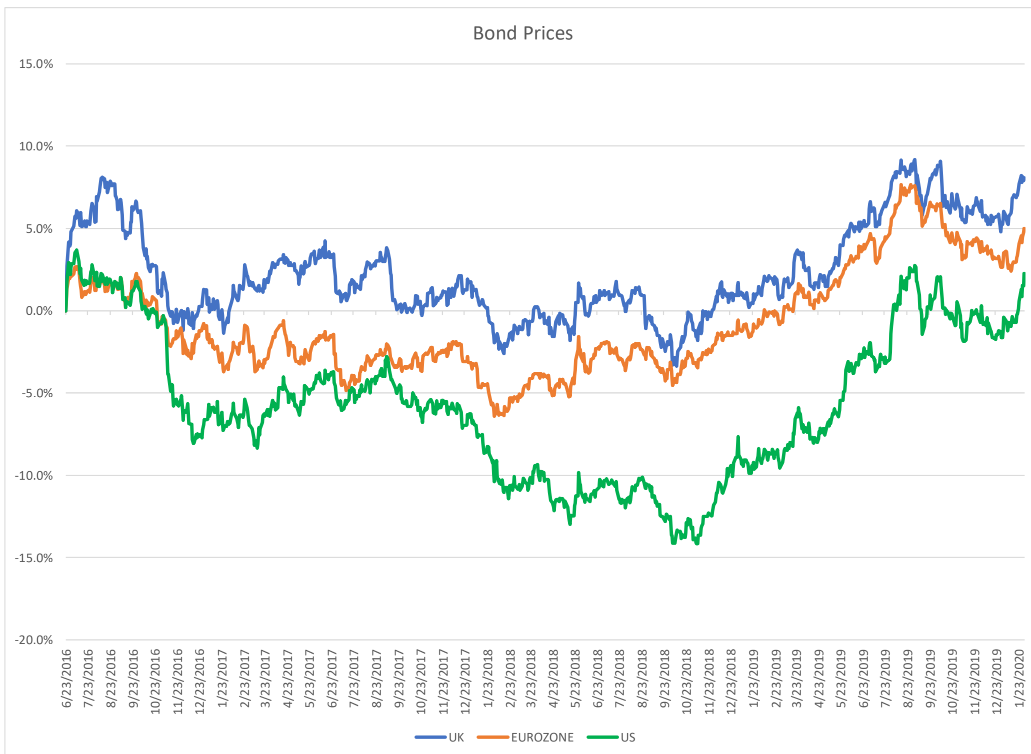


Growth assets in both UK have performed poorly relative both the US and the Euro Area, though notably the US has been the clear beneficiary of easy US monetary policy outperforming Europe dramatically.

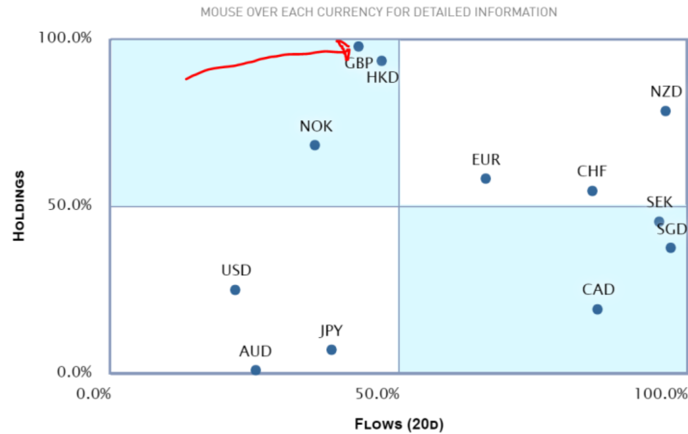
*For more details on why the US equity markets are so much stronger than the rest of the globe see our work on, central bank willingness and ability to stimulate, equity ownership culture and the strong divergence in share repurchase activity in prior Damped Spring Reports.



The UK bond market has performed better than its peers due primarily to slower growth

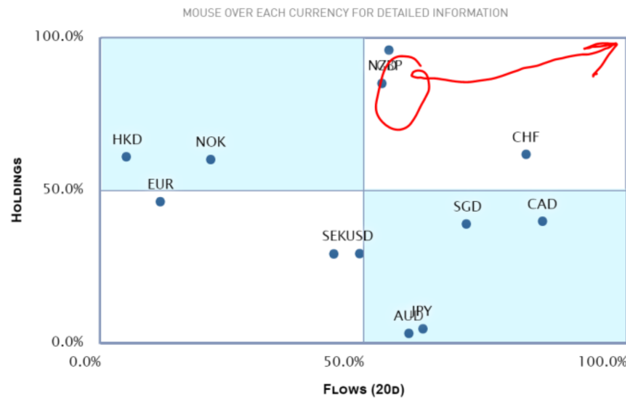


In the last Damped Spring Report, we observed the institutional flow data



Our arrow predicts a move to the right toward inflows and due to the outflows shown on the chart above we expected slightly lower over weighted positions. Once again, a harbinger of buying getting more aggressive and having the ability to add.

Today's data confirms our prediction and we now expect a move above 1.34 for the GBP over the next few weeks where the GBP dot moves to the upper right corner



Gold

Our gold holdings have performed well since adding a bullish position in mid-January. The reason for our holdings is that gold represents a fairly pure representation of expectations of easier monetary policy. Like Eurodollar futures which are the purest of bets on central bank rate path, but with the added benefit of a long-term asset that will hedge a short in rates and equities which we are max bearish. To be clear. We expect more cuts than the market and we also expect long term assets to all weaken as portfolio deleveraging occurs. We will hopefully see the signs of a broad expansion in risk premiums and unwind our gold long at the time. More likely our implementation of our gold long via a put spread sale will simply expire ahead of that event.

Current Model Portfolio performance and Recommendations

It’s not about the coronavirus. Growth expectations in the equity markets now are inconsistent not only with non-market data-based expectations of growth but even with bond market expectations. The coronavirus news will cause short term market fluctuations, but US equity prices remain overly elevated. We expect as the coronavirus fades out in the spring that the bond market will be around current levels and equities will be lower. We expect some volatility as our rate cut view becomes consensus but even with our dovish view we expect that when 2 cuts becomes consensus headwinds of portfolio deleveraging and lack of capital investment will prove 2 cuts to be inadequate to support the asset markets or the economy.

	Assumed Portfolio size	100,000,000				
	LTD P/L	5,246,591				
	Total Return	5.25%				
	Today's Date	2/1/2020		Portfolio Created		4/15/2019
Date	**Position**	**Entry Price**	**Amount**	**Worst case loss**	**MTM**	**P/L**
12/2/2019	SPX Mar 3150/3200 Call Spread	30	-500	1,000,000	31.1	(55,000)
12/2/2019	SPX Mar 3050/2950 Put Spread	18	556	1,000,000	13	(277,778)
12/2/2019	TY Mar 130/131 Call Spread	0.21875	-1280	1,000,000	0.765625	(700,000)
12/2/2019	TY Mar 127/126 Put Spread	0.140625	7111	1,000,000	0.03125	(777,778)
1/15/2020	GCH March 1600/1550 Put Spread	37	-769	1,000,000	21.9	1,161,538
1/15/2020	GBP 131/129 Put Spread 4/15/20209	0.53	(68,027,211)	1,000,000	0.29	163,265