The Damped Spring Report

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

2/19/2020

What are we missing? Stepping back to review our framework.

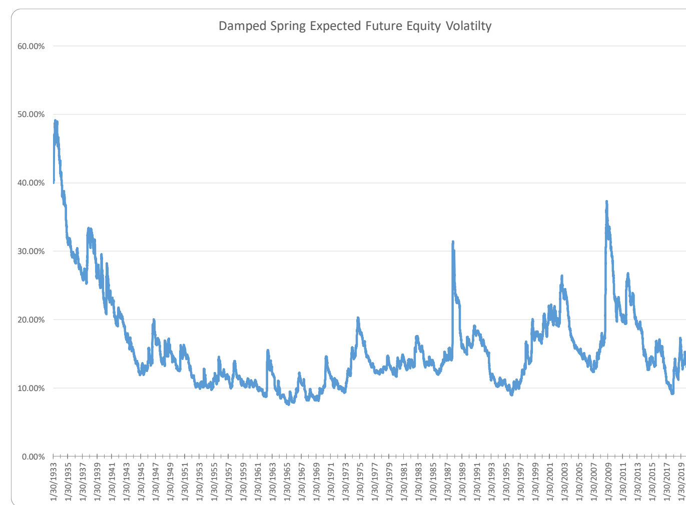
As we correctly predicted the markets looked through the short-term impact of the Coronavirus. However, they found on the other side a world where asset prices get bid up across the board and growth expectations continue to recover. This happened in our estimation ridiculously quickly. As can be seen in the chart below, since October, growth heavy portfolios have outperformed growth neutral portfolios by 400bp as trade war fears have abated. In general, asset prices rose as central banks delivered on promised monetary accommodation. Most recently (in red oval) the Coronavirus scare and its impact on growth was discounted and then ignored. What is notable is that all asset prices continue to rally.

As our readers know, we believe that holders of all long-term financial assets receive a return above cash returns simply by providing money to those who invest in the real economy or consume. In order to generate significant returns over cash like the growth and inflation neutral portfolio above (blue line), risk premiums must also contract. When the supply of money and credit exceeds the demand, risk premiums offered to investors fall. Of course, shifting one's portfolio expecting

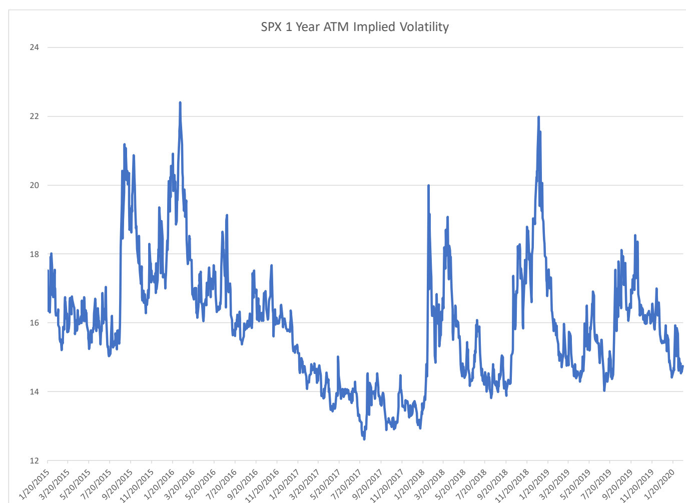
rising growth can also generate returns in environments when risk premiums contract and if one is correct in predicting rising growth excess return (alpha) can be generated.

The other major driver of risk premium is the expected risk of a portfolio of long-term assets. As expected, risk falls, risk premiums on the constituent assets fall as investors bid up assets by levering portfolio holdings to achieve desired risk return goals. Measures of portfolio risk include realized and implied volatility, credit spreads, and correlation across asset classes. All these risk measures are at multi-year low levels and have fallen since the trade war tensions abated.

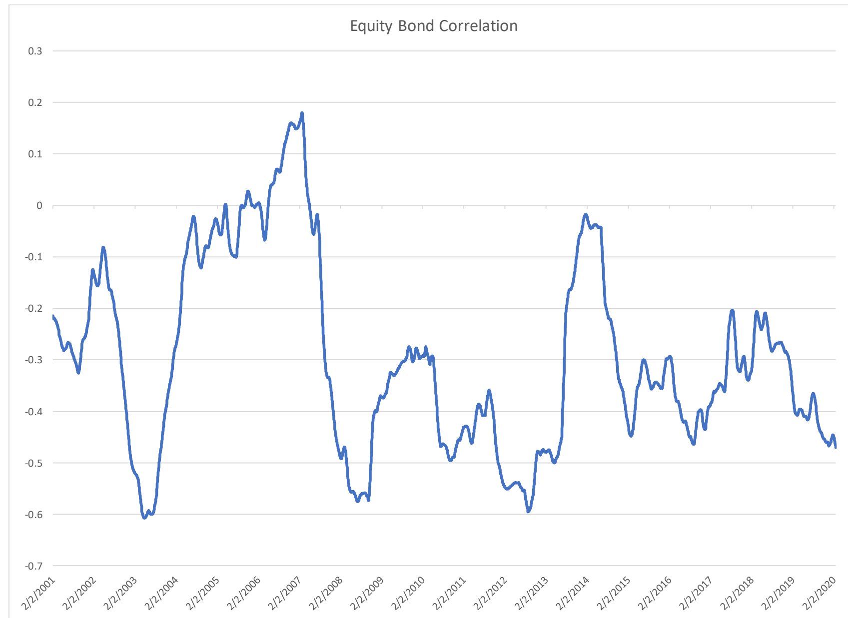
Damped Spring's Expected Future Equity Volatility is near the low of long-term history



While volatility can remain low for a long time, we believe 2020 levels will not continue to fall due to the US Presidential election. Implied volatility levels have fallen dramatically but are not at lows reflecting the election as well.



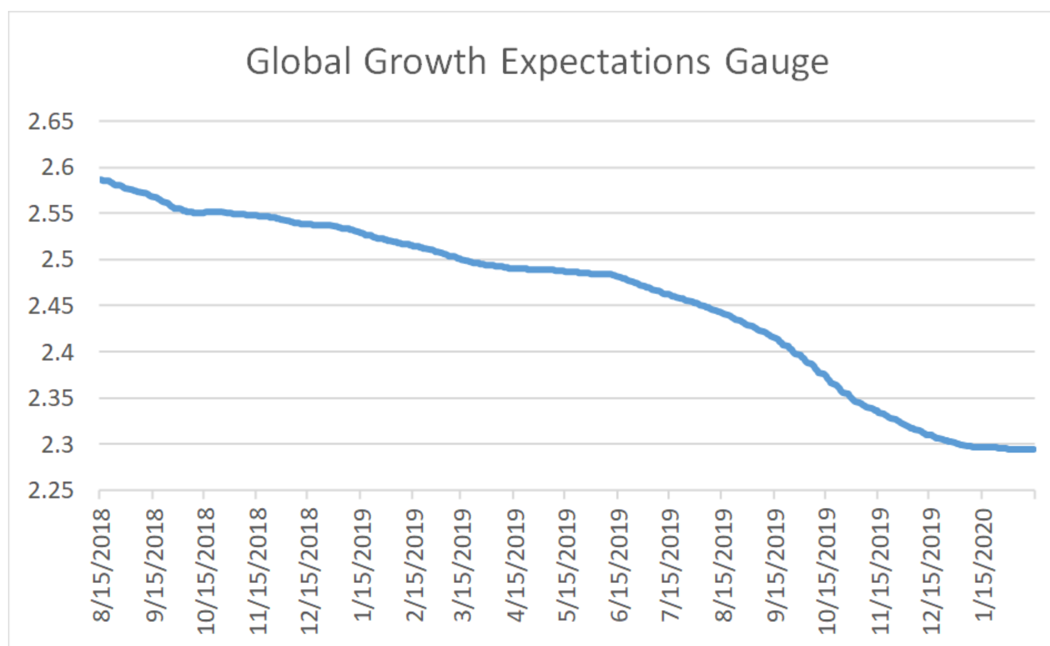
Portfolio volatility depends on both individual asset volatility and correlations between assets. Portfolio volatility has been quite low as equity bond correlations are at five-year lows and near the low of this century.



Another measure of portfolio risk is high grade credit spreads which reflect asymmetric draw down risk. Credit spreads are at a 15-year low reflecting expectations of limited probability of meaningful drawdowns.

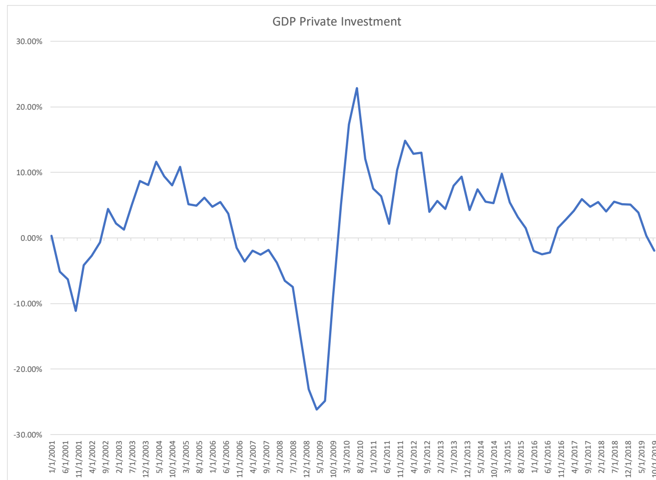
Asset returns have been driven by risk premium contraction which in turn has been driven by oversupply of money and credit and reduced portfolio risk. Equities have outperformed other assets indicating investor expectations of improved growth.

Fundamentally we acknowledge the positive outcome of the Phase 1 Trade deal with China removed some growth uncertainty. But the deal was narrow and did very little to remove tariffs. Any additional deal with China before the election is extremely unlikely. The Coronavirus has essentially put the global economy and China back on its heels once again. As we have said one should look through the short-term impact of potential pandemic when considering the global economy. However, on the other side we do not see fiscal stimulus outside of China and expecting consumer growth or corporate cap ex to drive the economy to at or above trend growth seems to us too much to ask. Our growth expectation gauge has potentially bottomed, but at a well below trend level.

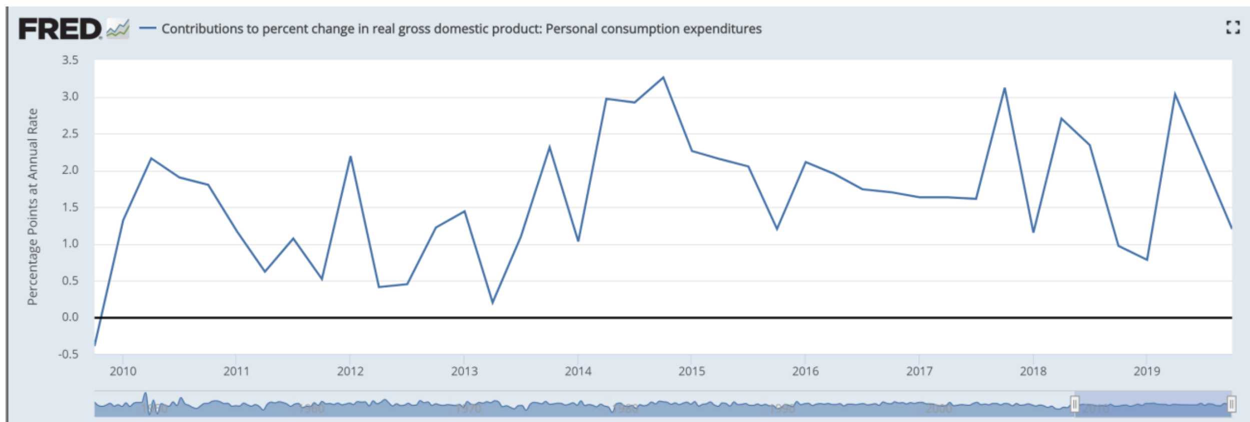


We see the impact on financial assets due to monetary easing and low volatility. Classically, as long-term financial assets are bid up and borrowing costs fall investors who sell these financial assets consume or invest in the real economy. This is the transmission mechanism that generates real economic activity. Perhaps this real economy is lagging this impulse more than normal and we are wrong and growth assets are discounting properly.

We believe that the transmission mechanism is either extremely insensitive or outright broken. The private sector is extremely hesitant to lever up and invest in R&D or plant and equipment. Perhaps corporations will take advantage of low interest rates and tight credit spreads and build something instead of buying back stock. But for the moment we see no sign of this action.

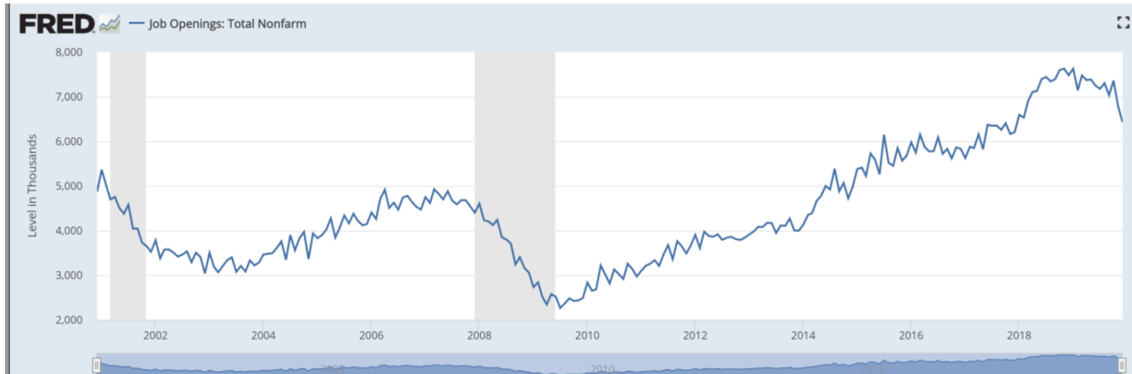


Typically, tight supply and significant consumer or government demand and rising prices leads capex. Expecting a broad government spending package in an election year is highly unlikely. The consumer has been driving the economy as a strong labor market and modest wage gains have resulted in occasional above trend growth. However, the most recent print was weak

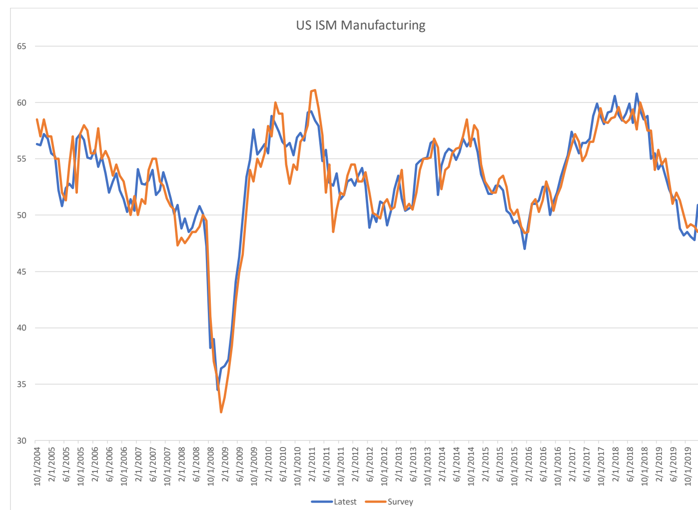


Wage Growth has been ok but has slowed

The most recent Jolts survey also was a surprise and may indicate slowing of employment as the demand side shrinks.



ISM manufacturing surprised dramatically in the most recent release propelling stocks, however it is unclear that this is a reversal



Non-Manufacturing has been in expansion and as a major part of the US economy supports positive GDP growth and has bounced in the past few months.

Damped Spring Framework Applied to Assets

Equity

Further equity upside requires rising growth, effective and further accommodation from monetary policy, and low input cost inflation resulting in modest sales growth and a recovery in margins plus continued flow from net repurchase by corporates and investor reinvested dividend income. Given the growth outlook and the already extreme contraction in risk premiums we believe equities are the most vulnerable asset in the market.

Bonds

Nominal bonds prices reflect expectations of modest growth, further accommodation from monetary policy that is not effective in stimulating above trend growth or rising inflation, central bank asset purchase remaining neutral to increasing, and demand from levered carry trade buyers to offset supply from corporates and governments financing growing budget deficits. Our growth outlook is positive for bonds while our view on risk premiums is negative. Given the current low level of breakeven inflation priced into bond markets we are mildly bearish bonds.

Commodities

Energy prices indicate a huge glut of uninterrupted supply or more likely weak real economic global growth. We see little reason to buy energy at this stage

Industrial commodity prices indicate poor economic global growth

Currencies

Gold and Crypto currencies indicate accommodative monetary policy but show no sign yet of fiat currency deflation due to excessive printing. We remain bullish gold and GBP. GBP as mentioned in past reports as a flow related long.