The Damped Spring Report

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

2/26/2020

Position Update

Two days age we posted issue 21 of the Damped Spring Report. A copy is included below. As the global growth portfolio continues to collapse, we offer a status report of our shadow portfolio including its existing recommendations, its performance, and new recommendations. The new recommendations are based on the market moves, our economic outlook, and the positioning and flow of participants. We believe current dislocations offers opportunity.

Recommendations

- Re-short TY - Sell Apr 20 TY 132.5/133.5 call spread for 31"
- Re-buy gold - Sell Apr 1625/1575 put spread for 13.70
- Remain short SPX add - December 2800/2500 put spread at 50 – Need a bounce to get filled

We remain bearish on growth prospects and believe that central banks will cut aggressively. This was our off-consensus view just a month ago. But with 2.5 cuts priced into markets for 2020 we do not believe that there is any room for the short end to rally further and the long end is now massively overbought relative to even our bearish outlook on growth and inflation. As we have mentioned, we now believe there are strong headwinds on asset portfolios blowing as risk premiums on all assets need to expand to deal with both the reduction in the availability of money and credit and the portfolio deleveraging occurring.

- Fully priced in cuts
- Higher asset volatility
- Lower portfolio diversification benefit
- Recent levering up of perceived low risk portfolios

Interestingly, despite a strong rally in gold this asset is still an asset that can be sold to raise cash. Yesterday's selloff of gold during another anti-growth day, and the fairly remarkable lack of participation and out right selloff in crypto is proof of all assets being sold. As for bonds, reshorting is obviously inconsistent with falling growth however our flow indicators suggest overbought conditions and most importantly the **massive programmatic buy of mortgage hedgers** is likely to be nearing its end. We are still heavily levered to an anti-growth view in our equity bet, but hedging that bet given the overbought conditions in bonds may be a win win. **Our recommendation is the sale of ATM call spreads on TY.**

As for gold, and crypto for that matter, the asset portfolio is for sale and that is a headwind on gold. Gold has two uses in a portfolio, A diversifier that all portfolios should have and a bet against fiat currency printing. As a diversifier gold gets sold when portfolios delever. As a bet against fiat currency printing, a much larger than typical gold allocation is needed. We believe that gold is now experiencing the portfolio delevering part and has short term limited upside. However, given the potential need for fiat currency printing exposure we see gold as having almost no downside. **Our long recommendation is through the sale of OTM put spreads.**

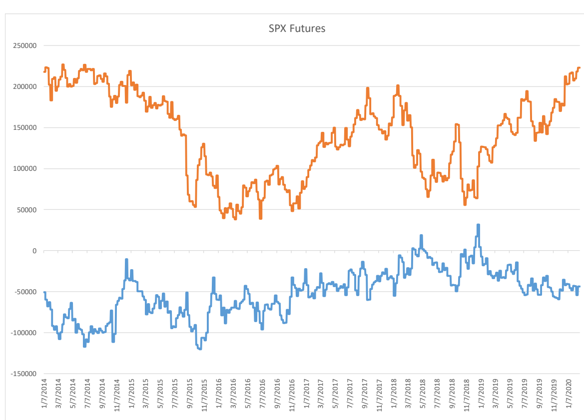
Performance and holdings

Strong performance in our gold and equity bets offset losses in our bond bet. New recommendations at available market prices and SPX order level included in table.

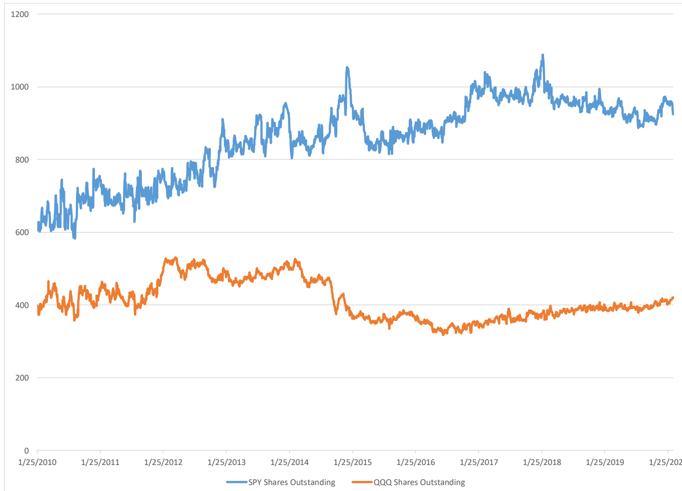
	Assumed Portfolio size	100,000,000					
	LTD P/L	7,385,164					
	Total Return	7.39%					
	Today's Date	2/26/2020		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
12/2/2019	SPX Mar 3150/3200 Call Spread	30	-500	1,000,000	23.6	320,000	Open
12/2/2019	SPX Mar 3050/2950 Put Spread	18	556	1,000,000	25.2	400,000	Open
2/26/2020	SPX Dec 2800/2500 Put Spread	50	0	-			Order
12/2/2019	TY Mar 130/131 Call Spread	0.21875	-1280	1,000,000	0.859375	(820,000)	Expired
12/2/2019	TY Mar 127/126 Put Spread	0.140625	7111	1,000,000	0	(1,000,000)	Expired
2/26/2020	TY Mar 132.5/133.5 Call Spread	0.484375	-1939	1,000,000	0.484375	-	Open
1/15/2020	GCH March 1600/1550 Put Spread	37	-769	1,000,000	0	2,846,154	Expired
1/15/2020	GBP 131/129 Put Spread 4/15/20209	0.5	(66,666,667)	1,000,000	0.64	(93,333)	Open
2/26/2020	GCJ April 1625/1575 Put Spread	13.7	-275	1,000,000	13.7	-	Open

Equity flow

Asset managers were massively long and levering up before the selloff and hedge funds were not short

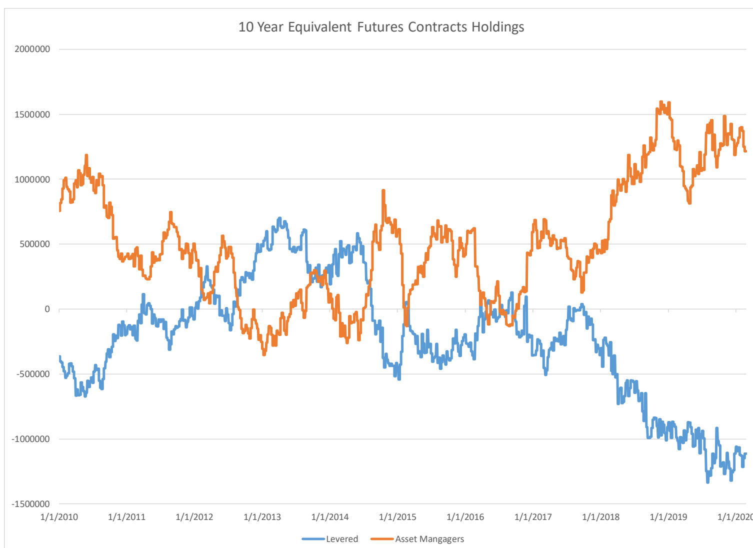


ETF Holdings have been stable and not growing indicating over-levered professional portfolios unsupported by retail inflows



Rates Flow

Futures holdings in long term assets are not particularly unusual

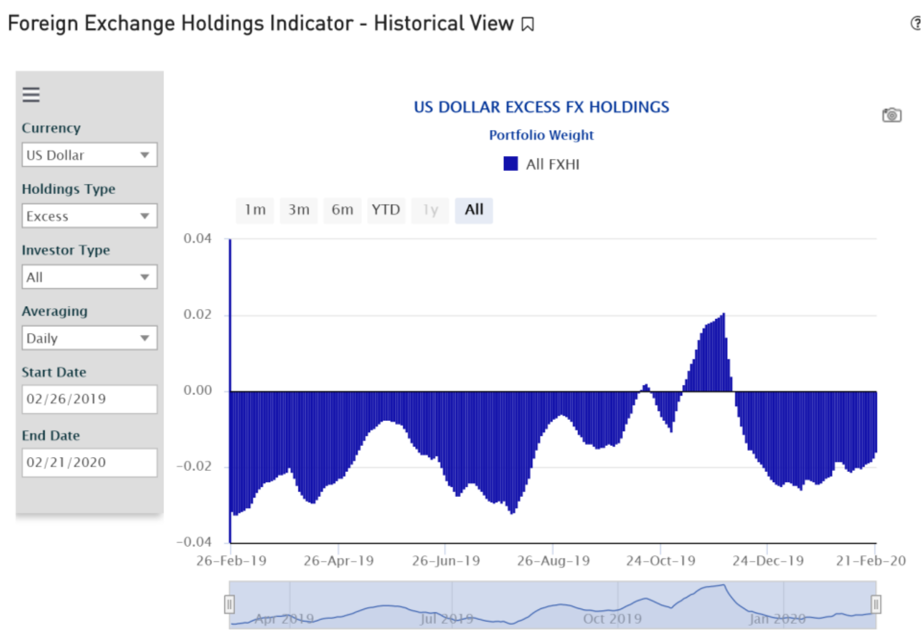


But commercial banks, the largest active market participant, had stopped buying and started selling and now are offside relative to their mortgage risk. Stress in the funding market is consistent with banks having sold. They have been short and gamma short during this move. They have likely pushed bonds too far

Dollar strength also is bearish UST as China needs to sell USD to buy Yuan if they plan on supporting weakened currency.

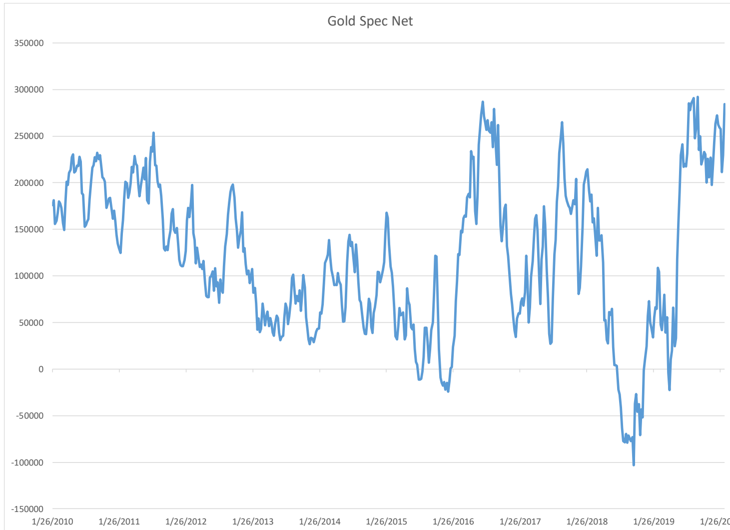
Currency Flow

While we are bullish GBP outright USD strength against all others remains likely given the short end has already priced in 2.5 cuts. Global portfolio delevering and the need for USD money and credit should support the USD and the flow from underweight will likely continue



Gold Flow

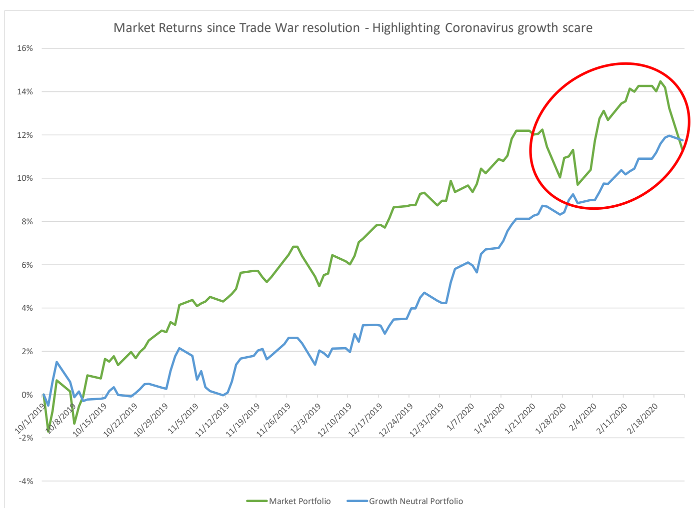
Those who are long gold as a risk asset or portfolio diversifier are prone to deleveraging risk from losses in other parts of their portfolio. Some of the excess long reported below is likely being worked down. But as money printing to offset economic weakness becomes a more obvious necessity the need for gold will grow quite a bit. Little downside but short term not much upside. Sell puts



REPRINT OF Monday's DSR

2/24/2020

<u>Two Cuts priced into 2020 – Growth portfolio collapses</u>



Over the last few days the Bernievirus and the Coronoavirus have resulted in a modest correction of the extreme pricing of growth assets. Since the US/China Trade War détente the market portfolio has outperformed a growth neutral portfolio. The last few days have eliminated that outperformance.

Reviewing Damped Spring Advisors predictions for 2020

- January will be the high for the US stock market – We were wrong but possibly only a few weeks early
- The US Fed will cut rates two times for sure and possibly three -Two cuts is now fully priced into markets as the central case. At 2.5 cuts the short end will become rich.
- 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. Four oversubscribed Fed liquidity injections in a row before the growth selloff and inevitable demand for carry it the selloff has created. Beware the Ides of March as Japan Fiscal year end may test liquidity further. **There will be an LTRO by summertime.**

We have repeatedly said that the coronavirus is almost certainly a short term hit to growth and a bounce in growth expectations when it burns itself out is likely. However, the conditions for growth look poor to us regardless of the virus consequence. Equity markets have strongly disagreed with our view. See Issue 20 of the DSR for the charts and pictures but in outline our view on growth is:

- Central banks are unable to stimulate economy through monetary means or are unable due to lack of traditional tools
- Fiscal policy except in China is limited due to gridlock due because of elections, large debt and/or deficits and not yet embracing MMT style debt monetization
- After a brief bounce PMI's are weak again
- Wage rise has slowed
- Job openings have fallen
- Consumers and Corporates are holding cash vs consumption and investment in Cap Ex and R&D

We predict growth will be well below trend in 2020 regardless of the coronavirus outcome.

Issue 20 of the DSR reviewed factors that drive portfolio risk. All these factors were indicating that portfolio risk HAD been quite low.

- The availability of money and credit vs the demand for money and credit by the financial markets and the real economy was accommodative as one or less, cuts were priced in, giving the Fed room to surprise.
- The level of volatility was extremely low on most assets.
- The pricing of drawdown risk was extremely low.
- The recent portfolio diversification benefit experience by owners of assets bonds and stocks had recently been significantly negatively correlated offering high diversification benefit.

As of today, the move to our prediction of two rate cuts in 2020 as consensus removes any benefit from the Fed delivering said cuts. While this is supportive of assets the fact that there is little further easing likely to occur results in significant risk. As for measures of risk volatility and drawdown risk measures have spiked. After the massive rally in bonds both due to front end easing expectations and falling growth and inflation measures, we are not optimistic about the necessary diversification benefit of bonds. While they will most certainly rally during further growth expectations weakness the rally will be inadequate for the growth heavy market portfolio and possibly even for the niche growth neutral portfolio.

In synthesis, the past few months have seen all asset prices rise on both optimism on growth and leveraging up of seemingly low risk portfolios. We believe this will need to be unwound as YTD returns of the market portfolio go negative.