The Damped Spring Report

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

3/10/2020

Full court press against the virus

Last night President Trump provided the correct medicine to fight the virus. A large-scale fiscal stimulus that is targeted toward helping the businesses and workers that are impacted by the virus and providing broad stimulus to the consumer. Ignoring his lack of passion for admitting the US has a problem it was the lever that had to be pulled. We expect that this lever will be pulled around the globe and central bankers will both lower rates further and restart or increase the size of QE programs to monetize the debt created by the fiscal stimulus.

We have repeatedly said that politics doesn't matter to markets. Our reasoning is that most of the time the differences between right and left policies on the economy are small. More importantly, all politicians when faced with a crisis of this magnitude behave the same way regardless of political leanings. They borrow and spend. This is not a critique of the idea of borrowing and spending in fact as we have said it was inevitable.

We know that the path is set. Fiscal stimulus, monetary stimulus, coordinated monetization of the debt. Unfortunately, the noise of the implementation will make the terrain the path takes treacherous. It is worth a reminder that Tarp failed to pass on its first vote, passed on its second and ultimately was used in a completely different way than was intended when the money was spent. It would be naïve to believe that given the US political environment that Trump's proposal will pass the house without significant political wrangling. Its an election year. The President is vulnerable. Something will pass because all politicians will borrow and spend. But along the way anything could happen. This applies to all economies except possibly China. We will get large scale fiscal spending and debt monetization by the central banks, but it will be a volatile noisy process. We will do our best to avoid comment on the noise.

The catalyst, to the crisis, the coronavirus will also generate noise. Its impact is yet unknown. Italy has shut down the entire country. Our local school system is closed. Last night, NYC recommended not traveling by public transportation. It looks like the President and a bunch of Republicans have directly or indirectly had contact with an infected audience member of the AIPAC meeting. We expect more headlines and more steps to contain the virus here and abroad.

How do these true signals of a deflationary downturn and massive policy counter measures add up to markets? Firstly, as we have said above the bad news for global economy will keep coming with volatile impact, this force is active in the economy as we speak. As for the policy responses they are lagging, in formal announcements, the political process of implementations, and the inherent delay with which even coordinated fiscal and monetary policy operates.

But what is priced in matters.

Growth has been heavily discounted as can be seen by the green line which is the pro-growth 60/40 portfolio performance. But the growth neutral portfolio which is levered long bonds is still lower over the past few days. This is suggesting two major points

- Demand for cash is increasing despite lower rates
- Portfolio risk is becoming higher as both individual asset volatility is higher, and the diversifying benefit of bonds is decreasing as bond reach their lower bound yield.

As for short rates

It is certainly possible that there remains upside to Jan 2021 fed funds futures, but the pricing is consistent with a very high probability of rates at zero by year end if not before. That suggests that the Fed is only going to disappoint or meet expectations for short rates which will result in tightening when the world needs easing.

We expect that the Fed will not meet expectations on short rates but will embark on a round of QE to offset the supply of UST issuance required to fund the eventual spending bill. The US will engage in implicit if not explicit debt monetization in 2020

As to timing. The virus is active and impacting the economy. Fiscal policy is at its nascent stage but coming in the next few months. The money won't reach those in need until the second half of the year at best. The Fed will not meet expectations. Needs for cash will tighten not ease in the near term. Portfolios are not diversified and are riskier. For these reasons, the trend for assets is poor. The growth neutral portfolio will not perform well. Expressing a view on growth will remain quite volatile. But given the timing of the virus and the fiscal and monetary response the trend for growth assets will trend lower. Gold is an asset. Given the debt monetization in the future gold will do very well but for now it is an asset to be sold as part of any other portfolio asset.

Current Model Portfolio performance and Recommendations

When we add this all up and compare to prices in the market, current liquidity, and general volatility of both news on the virus and economic countermeasures we respect that we don't know enough right now to recommend anything other than light positioning. However, given the extreme level of volatility in the markets we are recommending a small short position in both OTM put and call spreads sales on all assets with a mild bias toward bearishness on equities

In aggregate we are selling 1.5% of capital of premium and if we experience the max loss on one wing, we lose 2.2% of capital. New positions noted in chart.

Assumed Portfolio size	100,000,000		
LTD P/L	10,150,558		
Total Return	10.15%		
Today's Date	3/10/2020	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
2/26/2020	TY Apr 132.5/133.5 Call Spread	0.484375	-1939	1,000,000	1	(1,000,000)	Open
1/15/2020	GBP 131/129 Put Spread 4/15/20209	0.5	(66,666,667)	1,000,000	0.76	(173,333)	Open
3/10/2020	SPX April 2500/2400 Put Spread	25.5	-67	500,000	25.5	-	New
3/10/2020	SPX April 2900/3000 Call Spread	44	-134	750,000	44	-	New
2/26/2020	GCJ April 1625/1575 Put Spread	13.7	-275	1,000,000	13	19,284	Open
3/10/2020	GCJ April 1700/1750 Call Spread	8	-119	500,000	8	-	New
9/18/2109	TY June 136/1135 Put Spread	0.390625	-821	500,000	0.390625	-	New
9/18/2109	TY June 140/141 Call Spread	0.390625	-821	500,000	0.390625	-	New