Inflation Growth

The Damped Spring Report

A synthesis of market drivers

Flow Risk Premium

The news on China/US trade talks over the weekend has resulted in increased certainty regarding the type of potential deal that may get struck and, if not, the impact the escalation of the Trade War will likely have on the economy. We at Damped Spring Advisors believe that this news is a tipping point that will set the trend for currencies, rates, equities and commodities for the balance of 2019.

The news, itself, is modestly interesting as the frictions of a prolonged trade war will slow growth and increase prices. We also are humble regarding our ability to predict a sudden positive outcome to the trade war. We are confident however, that a Trump Victory/Chinese Capitulation was unlikely before the weekend and impossible since. For that reason, the upside tail for global economic growth with low inflation has almost certainly been eliminated. Because, the consequences of the trade war will take time to impact data, the trade talk milepost being pushed to June's G20 meeting, the robust health of most investor's portfolios in 2019, and positioning that is not meaningfully offside in any major market, we suspect that a trend is in place but will initially play out in a lower volatility way versus a sharp repricing.

The global markets reacted ahead of the weekend and followed through on Monday with a classic negative shift in growth expectations sort of move. Stocks and commodities fell, and bonds rallied. The market move was mild given what we believe are overly optimistic growth expectations reflected in the global equity markets. This is no surprise, as mentioned in the prior issue of DSR the conditions for significant and prolonged market volatility are not in place. Additionally, the US Fed pivot in January was effective in eliminating the significant headwind of quantitative tightening and short-term rate increases. Further reduction in growth expectations is our central case today.

The US economy remains strong with low unemployment and low inflation. Which leads us to believe that A significant negative growth shock will not develop over the next three months. The market consensus central case for trade remains a face-saving outcome for both parties. But the increased probability of a prolonged trade war and the elimination of a Trump victory adds up to a probability weighted slower growth higher inflation environment. Markets have yet to fully discount this reality.

We suspect that the trade war will be much more difficult given the leaders who are making the decisions. Regardless of the outcome, the negative tail scenario of markedly reduced growth expectations, declining equity margins, and/or higher consumer inflation will become discounted more fully over time.

We would be remiss at this point if we avoided discussing another trade war that we believe, again with low confidence, will begin in Europe next weekend. Trump is all-in on trade and has no downside at this stage to slapping Europe. It would be surprising to us if he is conciliatory.

We believe the economic tipping point has already occurred but has yet to be discounted. Over time, with yet to be determined amount of urgency, the global central banks are likely to be tested regarding this complicated set of circumstances. We think they will at best make some mistakes and at worst find themselves unable or unwilling to do what is necessary in the face of the now more likely negative tail scenario.

The Fed has pivoted significantly and has left the field for a few months as the data catches up and evolves. They will need to ease further, as growth expectations fall but they will be cautious due to the inflationary impact of tariffs. They will also have to deal with significant pressure from the administration. We do not envy their position. However, they are the only central bank in the developed economies who will be able to ease when needed. It is an open question whether the easing will be adequate to support the economy.

The ECB is unable to ease in the face of weakening growth. European growth has been underperforming US growth since the financial crisis and will likely continue to underperform. Investment flows into Europe have been slowing along with their economies and external investments to the EM and US have increased. However, the economy remains levered and it is our strong opinion that a combination of a US Fed that will and can ease and an ECB which cannot ease will result in a squeeze for EUR to pay off indebtedness that will drive the EUR significantly higher in the second half of 2019.

The ability for the FED to ease and unfortunately the potential for it to be influenced by the administration may weaken the dollar against other currencies as well. Besides the EUR we prefer gold as the expression of a weakening dollar. It hasn't gone unnoticed to us the strength in crypto but that is outside of our scope.

In synthesis over the next three months, and regardless of the outcome of trade talks we expect:

- Weakening global growth and growth expectations
- Modestly higher inflation expectations
- Declining equity margins
- Modestly tightening financial conditions
- Low volatility in rates and currency markets
- A slow repricing trend reflecting the slowing growth.

And if the trade war continues for some time, which is our expectation, we expect by year end 2019:

- Significantly tightening financial conditions particularly in Europe
- Which will cause the FED to ease aggressively but likely a bit late
- Causing a EUR squeeze, a flight toward gold, and dollar weakness
- Depending on the response/timeliness of the fed and the economic impact of the easing we expect
    - Lower global equity prices
    - Higher bond prices
    - Lower commodity prices ex gold
    - Underperformance of European Equities vs US equities

Recommended Portfolio

How does that add up to a portfolio?

Last week we recommended unwinding our short put spreads on TY and short call spreads on CLA. We remain short, now well out of the money, call spreads on SPX and SX5e and suggest covering due to the risk rewards associated with being short tails.

New recommendations reflect both our year end full outlook and our short-term view that markets will only slowly move to a lower growth equilibrium before a more rapid move can occur.

Equities

The mild correction has been accompanied by a significant jump in short term implied volatility in equity markets. We are particularly bearish on Sx5e given the above outlook and recommend **buying put spreads on Sx5e**. However, the SPX seems short term oversold, and we would finance the Sx5e put spread purchase with an **SPX put spread sale**. This is a tactical trade on the SPX side and does not reflect our view on the medium-term direction of the SPX or other global equity markets.

Bonds

Given our view, ideally, we would have a high upside trade in German bunds. However, they are pinned near zero. We recommend **buying TY call spreads** and financing them with a sale of RX put spreads. Both trades are bullish global bonds as a combination of falling growth and US easing will offset any rise in inflation expectations.

Currencies

To repeat we do not want to be long volatility in the portfolio. We are bearish the dollar. We would for that reason **sell put spreads on Gold** and **buy EURUSD call spreads.**

The specific trades and the performance of the portfolio are at the end of the DSR.

Flow and positioning

Reviewing the positioning supports the idea that markets are likely to adjust to the new equilibrium smoothly for now. By and large positioning is not offsides and is not particularly levered.

Bonds

- Financial institutions are large holders of bonds and are likely to add on any steepening.
- Levered investors remain short
- Institutional investors are long
- Inflows into bonds has returned
- QT ends at the end of the summer
- Issuance by governments remains quite large
- Corporate issuance is above average
- China
    - is not likely to sell treasuries as a trade war ploy as it would backfire as the Yuan would strengthen as they repatriate USD proceeds
    - may depreciate the currency as a trade war response but would then buy UST.

Currencies

- Balanced positioning by institutions except for GBP which remains over owned

Equities

- Anemic flows if any into Europe
- Continued share repurchases by US corporations
- Retail portfolios continue to de-equitize
- BOJ large buyer of Japanese Stocks

Current Model Portfolio performance and recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	2,513,353					
	Total Return	2.51%					

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
4/15/2019	CLA June 64/65 Calls	0.53	-4255	2,000,000	0.14	1,659,574	Closed
4/15/2019	TY June 123.5/122.5 Put	0.484375	-1939	1,000,000	0.171875	606,061	Closed
4/15/2019	SPX 2910/2960 June Calls	25.8	-207	500,000	16	202,479	Closed
4/15/2019	SX5E June 3500/3550	8	-1190	500,000	4.2	45,238	Closed
5/14/2019	TY July 124.5/125.5 Call Spread	0.359375	2783	1,000,000	0.359375	-	Open
5/14/2019	RX July 166.5/165.5 Put Spread	0.27	-1370	1,000,000	0.27	-	Open
5/14/2019	SPX July 2800/2750 Put Spread	14	-278	1,000,000	14	-	Open
5/14/2019	SX5E Sept 3200/3100 Put Spread	24	4167	1,000,000	24	-	Open
5/14/2019	GCZ9 Dec 1325/1275 Put Spread	24.7	-395	1,000,000	24.7	-	Open
5/14/2019	EURUSD Year end 1.15/1.2 Call spread	1.19	84,033,613	1,000,000	1.19	-	Open