Inflation | Growth

The Damped Spring Report

A synthesis of market drivers

Flow | Risk Premium

6/19/2019

Later today (this time for real despite my gaffe of last week) the Fed will release its June statement and Chairman Powell will have a press conference. The statement and press conference will be decidedly dovish. The words or less likely the deeds will not be enough to turn the global economy back toward above trend growth. As we have said for a long time, and certainly in print since our founding, the global central banks are likely unable to stimulate adequately to avoid a prolonged slowing in the global economy. To summarize our view of the circumstances for the individual central banks and the implication for the globe we made this visual.

Global Central Bank Circumstances

CB	Willing	Able	Enough to support economy in a downturn using existing tools	Enough to support risk premiums through 2019
Fed	Yes but not with "new" tools	Yes	Probably not	Maybe
ECB	Yes with limitations	No without breaking limitations	No	No
BOJ	Yes	No	No	Possibly if Equity buying is increased
PBoC	Yes	Yes	Maybe	No, currency flight risk of easing may impact assets
Globe	Yes	Yes	No	No

The US Fed is willing, able, and is being whipped by POTUS to ease. I do not expect a cut this afternoon, but cuts are inevitable given the slowdown in the ROW and weak inflation expectations in the US. The US Fed should ease. They were unsuccessful in adequately tightening to have the room they need to ease during a recession. They need to rev up the economy and get back to tightening and that should be the goal of an easing (including of course the goal of dealing with the slowdown that is upon us that could worsen). Unfortunately, the global conditions are not likely to improve and the other DM central bankers with the tools that they have available are not likely to play much of a part in providing stimulus. For these reasons we believe that global growth will continue to slow to levels significantly below trend growth. To deal briefly with trade, a bullish outcome of China/US trade talks is no longer our central case but if it were to occur the steepness of the slowdown might be lessened but it would not likely change the direction of growth.

Regardless of today's meeting outcome, we are now Max bullish Gold and are adding a long call spread on gold to our model portfolio. If they do, in fact, cut rates today that position is our favorite indirect bet on the outcome. Yet if they do not, the longer-term outlook is clearly bullish. If the Fed both cuts and is perceived as responding to political pressure this bet will pay off rapidly.

At the same time the Fed and the PBoC take steps to stimulate, the Europeans and Japanese are attempting to deal with their difficult circumstances. Earlier this week, Draghi was hyper-dovish. That dovishness had little and at best temporary impact and is consistent with a combination of difficult limitations the European Central Bank must deal with to actually stimulate. What are the limitations.

- The Capital Key making it difficult to push money where needed
- The lack of corporate buybacks that results in a broken transmission mechanism to equities and so on to the real economy of money printing
- Unwillingness to expand the tools to ease to include stocks or other assets.

Essentially the ECB has been out of ammunition for years and the war is coming onshore. Japan will likely continue to ease but they are so far away from accomplishing easing that we won't dwell on Japan except to say that it is a direct case study for what to expect from Europe and then in the coming years the US.

The case for the PBoC is fairly easy. They have tools and are willing to use them and they may be successful. However, the cost is the likely further depreciation vs the USD. The PBoC has a head-start and has more ammunition than the US and the market has responded, and the move is likely to continue as the PBoC deploys further stimulus. The implication for the Yuan is clear to us. Further weakness is desired as stimulus and despite what may result in Trump Tweets is an effective response to tariffs. However, the PBoC will not likely intervene in the markets to weaken the yuan. But instead will flood liquidity locally resulting in weakness.

Since the escalation of the trade war between the US and China a combination of weaker Yuan based goods and services, asset selling by investors requiring a concession to new buyers, and PBoC easing steps have resulted in a sharp drop in the Yuan. While a resolution of trade wars would obviously reverse some of this, we do not expect such a simple outcome and further expect any concession made to the US to result in USD demand by domestic Chinese for US exports. Thus, regardless of the outcome the Yuan seems particularly vulnerable to the overall global growth slowdown. We would expect a 7 handle on the Yuan this summer.

It pays now to review the implications on UST of PBoC buying and selling. Let’s focus on the mechanics.

- PBoC buying UST requires printing Yuan and entering the currency market selling yuan and buying USD then using that USD and buying a treasury security.
- PBoC selling of UST results in USD which must be sold for Yuan (if held as USD it would need to be invested in other riskier USD based assets)

Notice that buying of UST is bearish Yuan and Selling UST is bullish Yuan. Popular rhetoric suggests that the PBoC could dump UST as a trade tactic. It makes no sense however as that would result in a counterproductive strengthening in the Yuan and a tightening in financial conditions in China.

More likely, a weakening global economy with the PBoC easing aggressively will result in a weakening Yuan which for a combination of slowing/avoiding domestic capital flight and appeasing POTUS will be interrupted by periodic intervention. At that point UST will be sold by the PBOC. Initiating a UST sale seems ridiculous but selling to defend the currency is probable. I’ll place a bookmark here to review when the Yuan breaks 7 and we can then look at the rates flow and positioning to see if they market will need a concession to accept PBoC UST sales.

Our bearishness on the Yuan should not distract from our bullishness on the EUR. Over the next six months we expect the US to chase the market easier while all the ECB can do is talk. The ECB is stuck in the Japanese case study and has an even more difficult time due to the political realities of any easing steps and the broken mechanism of transfer of easing to the real economy. The Euro will be the unfortunate beneficiary.

<u>**Current Model Portfolio performance and recommendations**</u>

We recommend

- Unwinding the Short SPX Put Spread given the unfavorable pay off pattern and profit taking
- Adding a long December Expiry Gold Call spread to our existing gold short put spread to go to max bullish gold

- We are neutral on Rates and have no recommendation currently

	Assumed Portfolio size	100,000,000					
	LTD P/L	4,347,033					
	Total Returm	4.35%					
	Today's Date	6/19/2019		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
5/14/2019	SPX July 2800/2750 Put Spread	14	-278	1,000,000	5.4	238,889	Closed
5/14/2019	SX5E Sept 3200/3100 Put Spread	24	4167	1,000,000	9.5	(604,167)	Open
5/14/2019	GCZ9 Dec 1325/1275 Put Spread	24.7	-395	1,000,000	14.1	418,972	Open
6/19/2019	GCZ9 Dec 1400/1500 Call Spread	17	588	1,000,000	17	-	Open
5/14/2019	EURUSD Year end 1.15/1.2 Call spread	1.19	84,033,613	1,000,000	0.97	(184,874)	Open