The Damped Spring Report

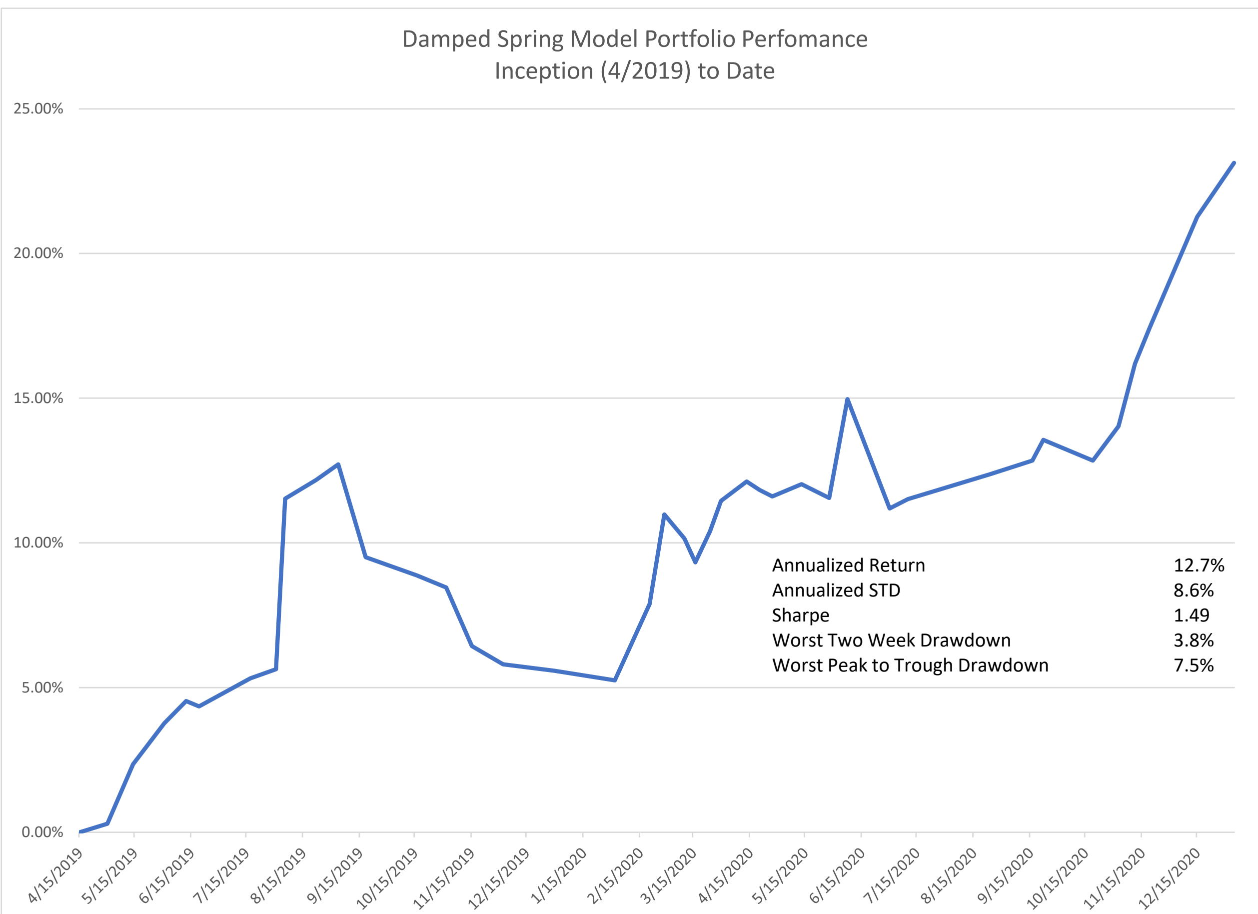
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

01/25/2021

Review of performance and current thoughts

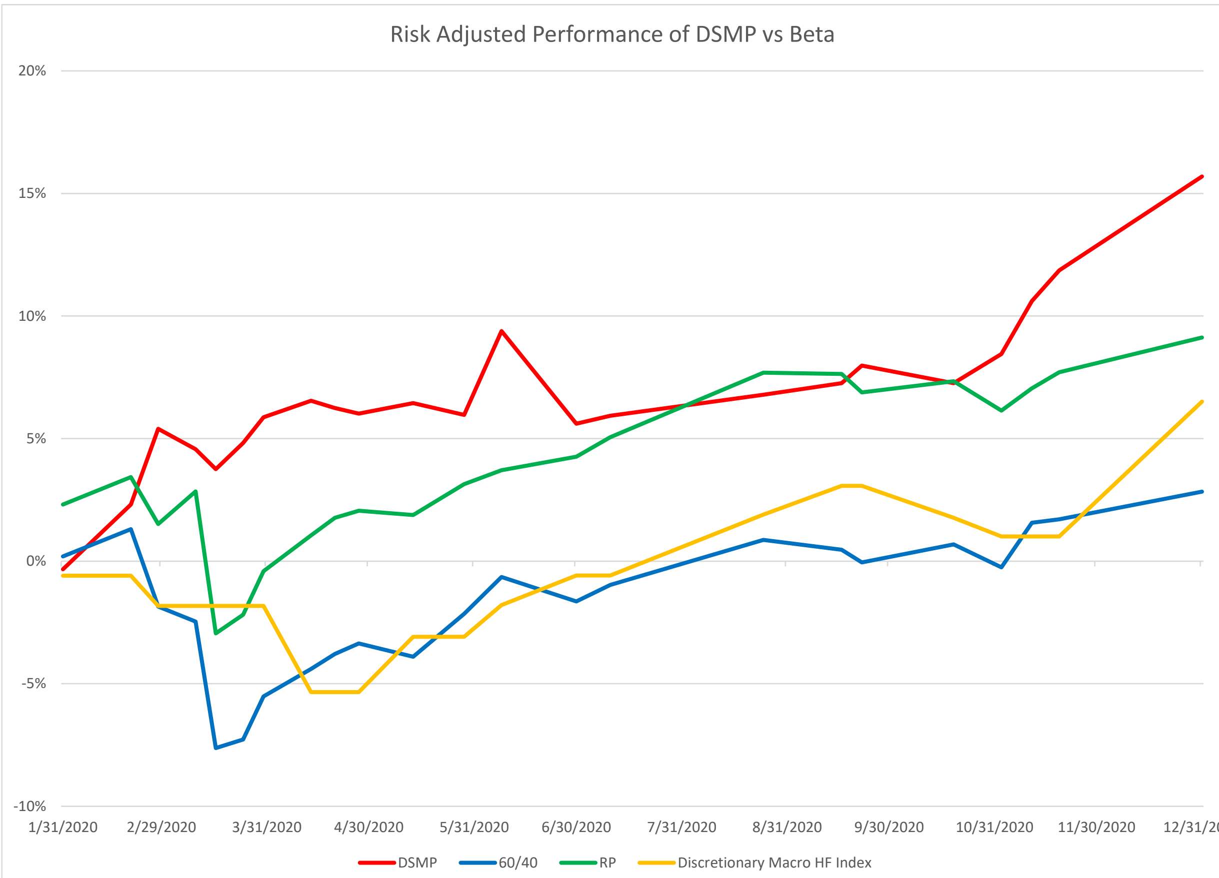
The Damped Spring Model Portfolio generated 15.7% return in 2020. The worst peak-to-trough drawdown was 3.6%. With what we believe to be a blowoff rally today, we are adding a short in QQQ by purchasing a Feb 19th 2020 320/310 Put Spread for 1.87. Though correlated to our underwater short in SPX our overall risk level is quite low and our conviction is quite high.

Strong Performance Since Inception



Uncorrelated Alpha

Beta portfolios, including 60/40 and risk parity portfolios (and even macro hedge fund indices) had significant correlated drawdowns during 2020. Correlation between DSMP and these three major indices ranged from 0.11 - 0.23



Hit Ratio

In 2020, we provided our clients with 45 specific trade recommendations; over 75% of those trades were money-makers.

Risk Management

Our portfolio strategy limits position size using vanilla long options, long option spreads, and short option spreads to define the worst-case loss we could possibly experience if every position experienced its worst-case loss at once (ignoring any cross-asset correlation benefit). We have a limit of 10% of AUM for the DSMP and 2% for any specific underlying asset. During 2020, we were always well within the portfolio limit. Our max limit usage in 2020 was 6% of AUM, and our average was 4.3% of AUM. Our portfolio is always protected against tails and has a low risk by construction.

Current Model Portfolio Performance and Recommendations:

	Assumed Portfolio size	100,000,000					
	LTD P/L	21,153,497					
	Total Return	21.15%					
	Today's Date	1/22/2021		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
12/28/2020	SPX Feb 3650/3550 Put Spread	21.6	463	1,000,000	15	(305,556)	Open
12/31/2020	SPX Feb 3650/3550 Put Spread	19	526	1,000,000	15	(210,526)	Open
1/4/2021	10 Year B/E swap $50k per bp	2	-50	1,000,000	2.12	(600,000)	Open

Our Current Outlook

Our framework for macro investing depends on shifts in expectations of economic growth and inflation, risk premium shifts, and positioning. We will detail our full thoughts with data and synthesis in our next report titled "The Zombies Awaken" by month-end. However, our current outlook for each driver is as follows:

- Economic Growth expectations are elevated and have greater risk to the downside due to, the consensus of strong recovery in as early as the second quarter 2021. Vaccine delivery risk, less stimulus than expected, vaccine resistant mutations, and economic scarring. Downside risks we do not believe are adequately priced into growth expectations
- Inflation expectations are now extremely high relative to conditions and particularly high even for long-term expectations. We recognized that if the optimistic consensus growth case is realized, then in 2021 we would expect demand push to result in a one-time ratcheting up in prices, but due to the secular disinflationary forces, we believe that projecting year-after-year price increases is premature
- Risk premiums move based on the attractiveness of cash relative to assets and the expectations of future portfolio volatility
    - We are very pessimistic on assets in general and expect risk premium expansion as governments crowd out all other assets with bond issuance. This week, over $185bn UST will be issued in the intermediate part of the curve. Despite our expectation that the Fed will not taper for all of 2021, they are not going to increase their purchases above $120BN per month and that amount is woefully inadequate given the supply of assets and relatively high existing portfolio leverage
    - Our views on expected portfolio volatility are mixed. Implied volatility levels are low relative to recent history, but a bit elevated over a longer time window. Recent realized volatility, in particular, is below implied in most markets. Trump-generated volatility is non-existent. But virus-volatility remains high and stimulus expectations will likely shift. The picture is mixed

- Positioning against the dollar in the form of currencies, crypto, and even gold is highly concerning. There is equity exposure in levered funds, and retail is showing frothy behavior. Unlevered funds are shifting toward Zombies as they Reawaken, which is a meaningful concern to us. Consensus outlook and the positioning of underweight bonds seems extreme

When we look at our outlook relative to expectations, it is clear that the three fundamental drivers for equities signal in the same direction, and for that reason we remain max bearish, although we are in a mild drawdown on that view. Inflation expectations seemed to have a blow-off top last week, and we may have seen the first quarter peak in some of those measures. We are looking to add a long position in long-term US Treasuries. We think the expansion of risk premiums is a headwind to the outlook, particularly due to this week's issuance. However, by the end of the week, we will be going long, as we expect both growth and inflation expectations to moderate. Lastly, we expect repatriating investment flows back to US assets as worldwide conditions weaken more aggressively in the developed market, ex US. The positioning short the USD is extreme, and we will add a long USD vs EUR position later this week. Further, despite the fall in gold, we will be shorting gold call spreads later this week, as tight monetary conditions due to excess supply cap any unlikely rally in gold. Crypto is too small to be directly impacted by macro conditions, and idiosyncratic factors dominate, but we are hoping to get long again (not part of DSMP), below $25,000 on BTC. We believe we will have that opportunity

For more details regarding the Damped Spring Model Portfolio, including its asset allocation, risk management structure, and the signals that drive the recommendations, please see archival reports at www.dampedspringadvisors.com