The Damped Spring Report

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

7/31/2019

Synthesis

Will the Fed get the message? The global central bankers could not have been more clear with regard to their pleas over the last few days. "We are low on ammunition and won't fire any bullets until we are in crisis. Help me Obiwan Powell you're my only hope" While the Dark Sith Lord Trump continues to throw sand in the wheels of the global economy by ratcheting up trade wars, we all await this afternoon's easing by Jedi Knight Powell. Unfortunately, it will not be enough.

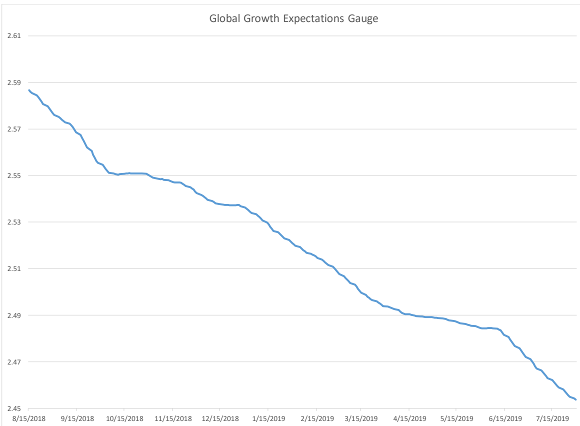
For what its worth, our prediction at Damped Spring Advisor will be that the Fed will cut 25bp and immediately end QT ahead of schedule. Other reasonable outcomes are just a 25bp cut or an unlikely aggressive 50bp cut. The outcome to witch we place zero weight is the one and done idea. Under no circumstances do we expect the Fed to signal that they are done. At worst they will go to the standard data dependent outlook. More likely, they will acknowledge the weakening global picture and indicate further cuts may be needed.

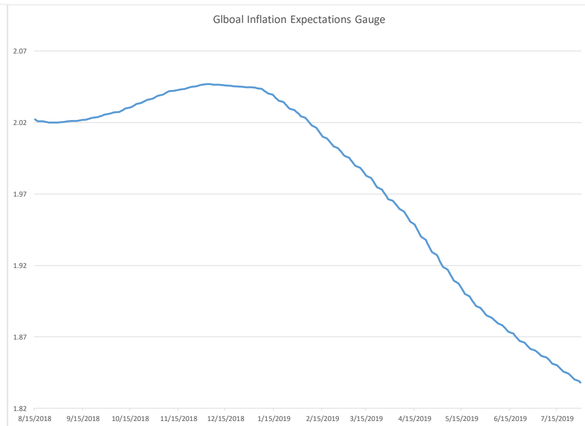
We will know the Fed's move soon enough. What is more important is to look at the slowing global economy and recognize regardless of the news of the day more accommodation will be necessary. President Trump continues to use stock market strength, labor market strength and the Chinese economic slowdown as leverage limiting any economic or equity market upside in the near term. This could change if a deal was reached but that looks less likely as each day passes. President Trump indicated that the Chinese are looking to delay until the election. My guess is that he is partly correct but mostly projecting his desire to milk fighting the Chinese for his reelection strategy. He must know that this strategy imperils the economic story that he most depends on for reelection, so it is no surprise that he is aggressively pushing the Fed for help.

Today we will get some sort of easing and at worse a data dependent outlook. This will have little impact on risk premiums which have contracted across all financial assets since the 4th quarter expansion and subsequent Fed led global central bank pivot in January. Our reasoning is that this is widely priced into markets. In fact, after the easing the Fed will probably remain behind the curve, which is a good place for the Fed to position itself. If too aggressive in easing, they will need to spend a precious bullet that they could have kept in reserve if a crisis were to occur. Remaining behind the curve will provide reassurance that they are ready to act aggressively if needed.

Fundamental Drivers

The market expectations for growth and inflation continue to fall. Eurozone GDP and German employment most recently showed substantial weakness and China has been quite weak— we do not see a shift in momentum in either key expectations measure.





While it is true that the bond market has retraced a bit to higher yields and higher b/e that is driven by the overbought nature of the bond market due to gamma rehedging that we pointed out at the time.

The other main driver of markets is risk premium. As you know our framework for evaluating potential shifts in risk premium depends on three components.

- The supply of money and credit from savers vs. the demand of cash by consumers and investors in the real economy and investors in financial markets.
- The diversification benefit of assets which impacts portfolio risk levels
- The expected volatility of assets (DSVM section below)

Above we mention that the easing today will have little impact on the supply and demand for cash. We are seriously concerned about the ability to weaken cash and generate supply of credit given the global central banks current set of tools and we are also equally concerned about the demand from the US government for cash to finance huge and growing twin deficits. Our concern is serious yet is offset short term by the end of QT due at worst in September. But in the short term is almost certain that little change to this driver of risk premium will occur.

As for portfolios we believe that they are in great shape and can experience some drawdowns without deleveraging pressure short term. However, if we are correct and central banks are unable to ease and stimulate credit supply cash will be king once again as it was in 4Q 2018 and portfolios will be undiversified and thus over leveraged.

Damped Spring Volatility Model

Our Damped Spring Volatility Model continues to indicate near term benign outcomes for volatility. However, a couple of trends are worrisome. We believe:

- The Fed will remain behind the curve providing a buffer to economic and risk asset weakness—this is good news
- The BOJ and ECB have made it clear they are prepared to ease but frankly we believe it will take more than we have seen to deploy what both entities know are almost certainly ineffective tools. For that reason, the damper effect in our model is weakening
- Trade is getting worse as a hard Brexit probability rises and a hard deadline appears on the horizon
- Trump currently could damper market upside and downside with trade tactics. However, the pressure on volatility seems upward based on the intensity of the impact that trade is having on the global slowdown
- Lastly, corporate share repurchase activity and commercial bank treasury and mortgage buying appear to be reaching unsustainable levels. A slowdown of either would pull support from equity and rates markets respectively

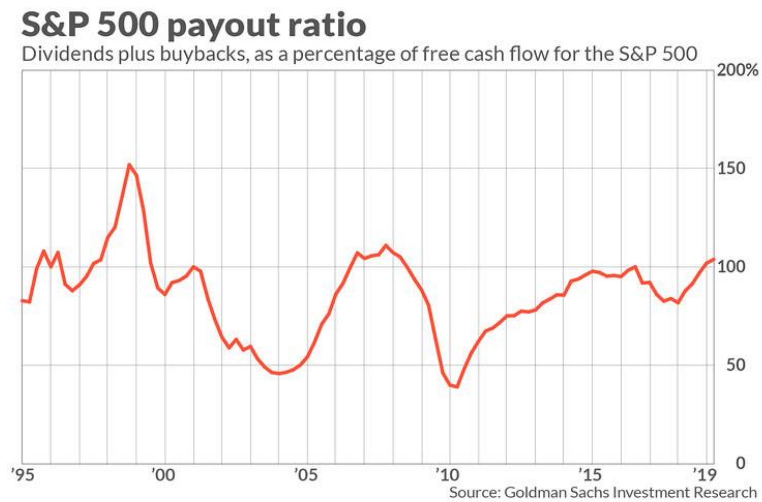
We believe that these factors are shifting slowly and in the short-term the level of market volatility will be benign, however we are keeping close watch for market opportunities and if we get a 50bp cut without a one and done indication we would expect implieds to fall while risk assets take a temporary and likely last gasp jump. If this is the case, we would look at a forward volatility purchase in many markets. As an example, the VIX Sept 19 Dec 19 spread looks interesting.

While this spread is on the "highish" side of recent history the pressure on September as August gets rolled and the fundamentals mentioned above keeping a bid on December is getting interesting to us. Other equity markets and asset classes as well as currency markets have similar pricing and characteristics.

Flow and Positioning

The flow and positioning pictures look benign at this point with the major trends still in place. However, we do want to highlight some interesting developments.

Share repurchase activity may be reaching unsustainable levels.



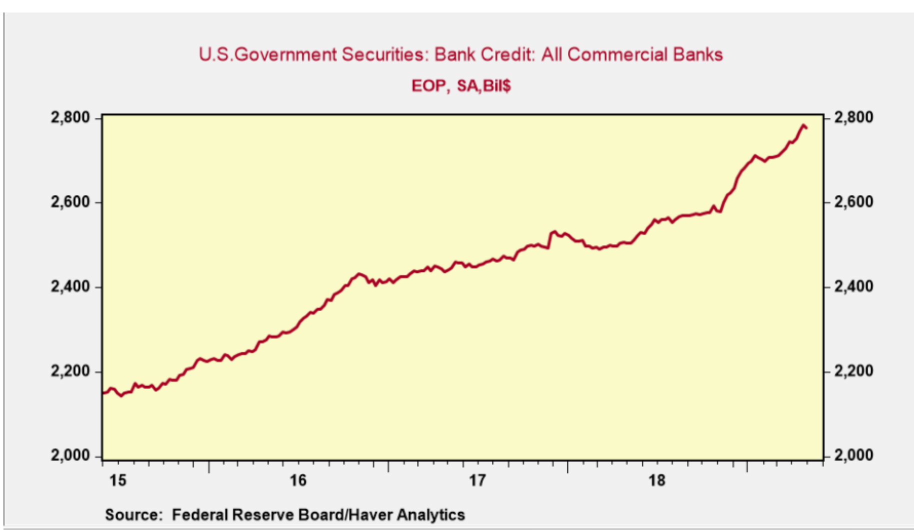
In this chart by Goldman Sachs, the total cash expenditure on dividends and share repurchase exceeds free cash flow generated. Companies are literally leveraging up to pay shareholders. This occurred twice before since the share repurchase binge started. Once at the end of 1999 and a second time at the end of 2008. In both cases not only did share repurchase slow but it also happened while free cash flow declined.

The fall in cash-on-hand and the increase in debt is also worrisome regarding share repurchase sustainability. Furthermore, corporate authorizations for new buyback plans are down 20%year over year. Lastly, the tax cut perversely made debt financing less attractive to equity financing as the interest deduction is less valuable. When we add these factors up, we predict that it will have minimal impact short term as open buyback authorizations remain huge.

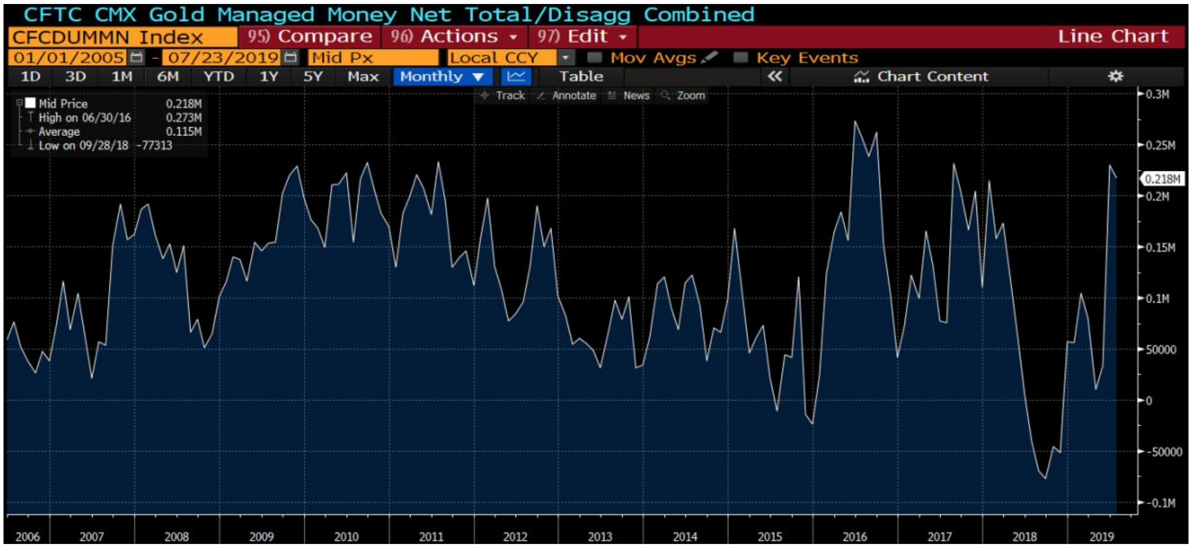
We remind our readers that share repurchase are the critical link for QE policy. Without corporations issuing debt to investors who have sold their bonds to the Fed and then using the proceeds to buy stock from investors who then use the proceeds to consume or invest in the real economy, QE money dies. We have seen this happen in Europe where share repurchase is rate. We have seen this happen in Japan where the BOJ finally had to step in and buy stocks directly. If this mechanism breaks down in the US QE will be substantially less effective.

It is critical to understand the procyclical nature of most share repurchase programs. While there are some companies that are in slowly dying businesses where share repurchase are an effective return of capital strategy for shareholders, a majority including the big tech companies, buy back shares to replace shares given as compensation to employees. This factor depends on a rising market. Unless the Employee Stock Options are in the money the share count does not rise and share repurchase are not needed to offset dilution. Hence the procyclicality of share repurchase activity. When we look forward to a weaker growth environment with reduced free cash flow and already high corporate indebtedness, we are increasingly concerned about the buyer of most of the stock sold into the market buy others over the past decades. This is a developing issue which we expect to exacerbate some of the downside to equities in a weak economy unable to be stimulated by central banks.

Commercial banks have bought 80BN UST and Mortgages over the last few months and may have reached a new level of balance sheet leverage. We expect some slowdown in buying.



Gold is beginning to look crowded, but we remain Max bullish.



Current Model Portfolio performance and recommendations

We are happy with our current recommendations:

- Max gold due to short term easing bias
- Long EURUSD due to US easing ability relative to EUR
- Short European stocks due to weakening growth and inability to ease by ECB
- Short US stocks due to weakening growth and Trump willingness to play tough on trade while markets are high
- Long US bonds due to triple whammy of falling growth and inflation expectations and central banks easing

	Assumed Portfolio size	100,000,000					
	LTD P/L	5,628,577					
	Total Returm	5.63%					
	Today's Date	7/31/2019		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
5/14/2019	SX5E Sept 3200/3100 Put Spread	24	4167	1,000,000	5.9	(754,167)	Open
5/14/2019	GCZ9 Dec 1325/1275 Put Spread	24.7	-395	1,000,000	1.8	905,138	Open
6/19/2019	GCZ9 Dec 1400/1500 Call Spread	17	588	1,000,000	37.5	1,205,882	Open
5/14/2019	EURUSD Year end 1.15/1.2 Call spread	1.19	84,033,613	1,000,000	0.66	(445,378)	Open
7/17/2019	SPX Sept 3000/3050 Call Spreads	26.6	-427	1,000,000	28.2	(68,376)	Open
7/17/2019	SX5E Sept 3500/3600 CallSpread	43	-2381	1,000,000	32	261,905	Open
7/17/2019	TY Sept 127.5/126.5 Put Spread	0.4375	-1778	1,000,000	0.390625	83,333	Open
7/17/2019	TY Sept 128/129 Call Spread	0.21875	4571	1,000,000	0.203125	(71,429)	Open