The Damped Spring Report

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

8/05/2019

Synthesis

Trade wars escalate. The Chinese responded to Trump's new tariff's by suspending agriculture purchases from the United States and by weakening the Yuan to below 7.0, though not admitting the latter explicitly. We are not surprised the Yuan weakened as we had called for that to happen in issue #6. However, we expected economic weakness and standard central bank easing to be the catalyst.

It seems a particularly good day to expose to our readers our thinking on the mechanics of currency intervention in general, the case at hand, and the likely impact on markets of intervention if the Chinese pursue this path. To be clear since the Trump administration raised tariffs last week, we believe that China will pursue further weakness in the currency using all its tools including, PBOC policy, government intervention, and shifts in capital controls.

We also noticed Nowotny's parting comments regarding QE and will cover the mechanism that we (and the Bank of England) believe makes QE effective and largely agree that mechanism was inadequate in Europe and hence the QE was far less effective than in the US and Japan. We also think that even with tweaking the capital key to overweight periphery countries the mechanism remains flawed and agree with Nowotny that further standard QE will not be effective. However, we wildly disagree with the Governor that further stimulus is not warranted. In fact, we believe a major shift in QE strategy where money hops the broken mechanism and goes straight into the stock market is necessary for Europe but do not think that the European Commission is prepared for such a shift.

The DSR Model Portfolio is now up **11.53%** since its inception in April. We will recommend some risk management steps regarding the portfolio at the end of the report as today's 300bp profit has taken us above our mandated worst possible case drawdown and requires profit taking to place less capital at risk. However, our recommendations are as strong as before if not stronger. We remain:

- Max Bullish Gold
- Bearish Equities particularly in Europe but also in the US
- Bullish EURUSD
- Bullish US Bonds.

We are all quite familiar with how the tools of central bankers can impact currency markets. However, when governments determine they must act to defend or weaken their currency they use two primary methods. Currency intervention is a direct purchase or sale by the government, typically by the treasury or ministry of finance, of the local currency. Less direct but often equally effective a country may relax or strengthen capital controls which limit foreign ownership of local assets or limit domestic investment in foreign assets. In China's case we expect that they will use both methods as needed and when the circumstances of an escalating trade war require.

Currency intervention comes in two basic forms. By far the most common is when a country is attempting to stabilize its own currency from rapid weakening by selling foreign assets it holds in reserve and using the foreign currency raised from the sale to purchase its local currency. Less common is when a country believes it must weaken its currency to remain competitive in global trade. This less common example is the case at hand with China. It is important to understand the mechanisms regarding each case in order to determine the impact on currency markets and asset markets denominated in each relevant currency involved.

The risk of intervention is not symmetric. When a country defends its currency, it must sell existing foreign assets held in reserve. Those reserves have a known practical limit. When they are used up the intervention will fail. Emerging market traders and those who remember Soros and the Bank of England know this playbook. When a country attempts to weaken its currency and it has a printing press to do so, there are no short-term practical limitations to their actions. Of course, as we have seen most recently with the Swiss Franc and occasionally the Japanese Yen this form of intervention can also fail due to political shifts and other monetary consequences. However, short-term weakening one's local currency through printing is a much stronger form of intervention.

As for the mechanics of currency intervention we must remind our readers that when a country prints its currency it then must sell its currency and buy foreign currency. That foreign currency is not coins and bills. It must be invested in assets denominated in the foreign currency. Typically, and in China's case they invest in a basket of foreign currency denominated assets that may change at the margin but by and large is diversified across their biggest trading partners and if anything favors US Treasuries. If China wants to weaken its currency and in order to keep the currency at a level that is below the "but for their intervention" level, they will end up with a bunch of USD and buy a bunch of UST. Given the trade war rhetoric this is probably not a desired position for China. Nonetheless they have owned a lot more foreign reserves than they do today. It also provides more ammunition if in the years to come they find themselves needing to support their currency.

China may also employ various capital control shifts in order to weaken the Yuan. Easing domestic restrictions on moving currency offshore and/or increasing restriction on foreign ownership of domestic assets could be used. However, these

methods are blunter and riskier in implementation and panic selling of domestic assets could result. As we see the current headlines, we suspect no shift now for capital controls which to us indicates a willingness for some domestic capital flight to achieve the weakening goal without actively printing and intervening.

Fundamental Drivers

The escalation of the China/US trade war throws additional sand in the machinery of the global economy. Brexit which will become much more news worth in September and October remains a risk to Europe, Britain, and their trading partners. As we have shown multiple times in past issues, the expectations for global growth and inflation continue to deteriorate. This will continue to be a trend for the balance of 2019 without some sort of miracle that settles the trade issues that dominate the news

Damped Spring Volatility Model

We expected August to be more benign as we believed that Trump would cap the upside of both markets and the global economy by ratcheting up the trade war if things looked good. This weekend we were proven wrong and Trump has shown, as have the Chinese as of today, that downside in both the market and economy is acceptable. Trump had been a damper to market volatility. He is no longer such a damper. However, when we look at major market participants and banks who provided those participants with leverage, we see strength which is unlikely to result in major market downside. Furthermore, Jackson hole and other central bank communications opportunities can and likely will be used to remind investors of the ability of the central banks to act. Our biggest call of all is that the central banks are willing but unable to offset the shifts in the global economy with their limited tools. However, along the way to that outcome we would not be surprised if markets respond favorably on occasion to easing both in words and in actions. For these reasons we do not expect massive volatility.

Flow and Positioning

The Chinese will likely intervene directly in the currency market and be left with USD. What they do with the USD is up to debate and we will not be able to see directly for months what they have done. However, it would be our expectation that they would buy a similar basket of global short-term bonds to what they have bought in the past. As they typically buy bonds that have maturities from 2-5 years it would be our expectation that all else being equal their flow would result in a steepening bias. Clearly, they could shift moderately toward more UST than other foreign bonds, but they may not want to signal this shift given its optics of buying American. They also could shift to fewer UST and more European and Japanese bonds but that would potential mute the CNYUSD impact and weaken the Yuan more against other currencies not involved directly in the trade war. We won't know. What we do know is where on the curve they will spend their foreign currency. The more the Yuan is printed the steeper global interest rate curves will

get. Adding to the flow impact, the fundamental picture of more sand grinding the gears of the economy, strengthens our prediction that all global bonds will continue to rally.

Which brings us to Novotny's recent comments. First let's review how QE works. We at Damped Spring believe that economic stimulus comes from giving money to people who will invest in the real economy or consuming. Those people are risk takers and typically are holders of equities or businesses directly. In order to give these people money by simply having the central bank buy government bonds this mechanism must be in place

CB buys bonds

Seller of bonds goes out on the risk curve a bit and buys credit

Seller of credit goes out on the risk curve and buys equities

Finally, seller of equity invests in plant or equipment or consumes. Stimulus is achieved.

In red we highlight an important step. This one is tricky because the holders of equity are often quite different than the holders of credit. There are many frictions for an investor to shift assets from bonds into stocks. While we firmly believe that adequate capital exists to arbitrage over the medium to long-term any overvaluation of credit and undervaluation of equities if temporarily the QE money gets trapped, we note that short-term there is limited capital deployed in "capital structure" arbitrage trading strategies which would act as the linkage. In the US markets there has been a major player turning cash and credit sale proceeds into equity purchases. Corporate share repurchase activity is part of the fabric of markets in the US and it comes as no surprise to us that QE worked smoothly in the US as the red step had US corporates acting as seller of credit and buyer of equities. They were not alone, and other arbitrage does occur both in the US and globally, but we believe for European QE to be effective more capital needs to engage in this step and European Corporates are unlikely to step up. For this reason, we believe that current QE in Europe is indeed broken and shifts to the capital key will not solve the essential problem. However, two solutions do exist.

1. Directly purchase stocks (Japan has long since crossed this bridge)
2. Accelerate fiscal spending and monetize the debt

We expect when markets fall meaningfully and/or economies have an extended below trend growth outcome all global central banks will have to engage in both forms of stimulus. Pure monetary printing of currency and purchase of equities will get money into consumers and real economy investors directly. Debt monetization coordinated with fiscal spending given directly to same will ultimately be required. Hence our interest in owning gold long term.

Current Model Portfolio performance and recommendations

We are happy with our current recommendations: But for risk management purposes are rolling our gold options and our TY options up to higher strikes to lower specific risk of each back down to 1% of the portfolio worst case loss and bring the overall risk below 10% worst case loss

- 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	11,525,907					
	Total Return	11.53%					
	Today's Date	8/5/2019		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	17.6	(266,667)	Open
6/19/2019	GCZ9 Dec 1400/1500 Call Spread	17	588	1,000,000	50	1,941,176	Closed
8/5/2019	GCZ9 Dec 1500/1600 Call Spread	20	500	1,000,000	20	-	Open
5/14/2019	EURUSD Year end 1.15/1.2 Call spread	1.19	84,033,613	1,000,000	0.79	(336,134)	Open
7/17/2019	SPX Sept 3000/3050 Call Spreads	26.6	-427	1,000,000	11.7	636,752	Open
7/17/2019	SX5E Sept 3500/3600 CallSpread	43	-2381	1,000,000	9.5	797,619	Open
7/17/2019	TY Sept 128/129 Call Spread	0.21875	4571	1,000,000	0.75	2,428,571	Closed
8/5/2019	TY Sept 128/129 Call Spread	0.25	4000	1,000,000	0.25	-	Open