The Damped Spring Report

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

8/22/2019

Synthesis

Trapped in Jackson Hole. We do not envy the position of Fed Chairman Powell as he delivers his speech at the Jackson Hole Conference tomorrow. While we are quite certain that the US and Global Economy is slowing, and we believe that the Fed should at least match the market pricing for Fed rate cuts through 2020 we appreciate that Chairman Powell must be cautious. Last week in a brief update we suggested the speech should be titled "Yes, Yes, Yes, we can and will be very easy." Today, I would add the parenthetical "But we suspect if we ease President Trump will also stimulate aggressively and cause the economy to overheat." A snappier title might be "You first sir."

We are not Fed watchers at Damped Spring Advisors and our predictions are not driven by insights on what the Fed will do or say. However, we do believe that given market pricing that investors have low odds that they will hear more dovish notes from the Powell Speech than is priced into markets. Our expectation remains that the Fed will hold its ammunition until the economy truly sours or Trump moves decisively in one direction or another regarding trade. The Fed simply cannot be put in the position of easing aggressively only to have to rapidly reverse course if a trade deal materializes. Ironically, the passion that Trump seems to have for micro-managing the stock market via frequent hawkish and dovish statements and actions in the trade negotiations could be causing the Fed to remain on the sidelines when it otherwise might be responding to the slowdown. A clearer path on the outlook for trade regardless of direction would simplify the Fed's job. We don't expect such a path to evolve and believe this limits the Fed's options when it needs flexibility.

Stepping back from the noise of the next few days we observe continuing falling global growth and inflation expectations. Those expectations have been falling steadily but since the Fed last met they have accelerated lower. Bond yields have fallen sharply, and equity prices are down 3-5% since the Fed Rate cut decision and Powell press conference. Bond prices have clearly benefited from falling fundamental expectations. However, to justify the modest move for equities one must believe that either growth is going to rebound or that the Fed and the rest of the global central bankers will match and then exceed market expectations for

easing. We do not believe this will happen. However, we also recognize the level of uncertainty regarding monetary and fiscal policy is quite high. For that reason, we are at a low risk level in our recommended portfolio and see little short-term value in predicting the wiggles and noise. As we move toward actual market moving events like the September deadline for tariff increases, the next trade summit, and the central bank meetings, where decisions must occur, we suspect some of the uncertainty will be removed. For the balance of August and at least through the Powell speech tomorrow uncertainty will almost certainly continue. Not a time in our opinion for large size tactical bets.

The Damped Spring Model Portfolio unwound its long bond position last week into the feeding frenzy. We remain long term bullish US bonds. However, we can not justify long positions at this point. We also unwound our short out of the money call spreads on SX5E and SPX. That move driven by risk reward concerns and not a change in our bearishness on these markets proved fortuitous as markets bounced. We are bearish equities strategically and with implied volatility high, perhaps deservedly, we recommend short call spreads positions be reestablished at lower strikes and longer term to reflect our strategic bearishness and expectations of greater clarity on all matters into the fall.

We have been long Gold and, though we have de-risked our recommendation from max long by rolling up our call spread and taking profits, we continue to recommend holding a long gold position. Gold remains the best bet to express our view that eventually economic downside will need to be offset by coordinated fiscal policy and debt monetization by the central banks.

Our position long EUR remains frustrating, but we continue to hold that risk, expecting US easing to far exceed what Europe will be able to achieve and the capital flow into US assets (dollar bullish) will ebb given current pricing and likely forward return.

Fundamental Drivers

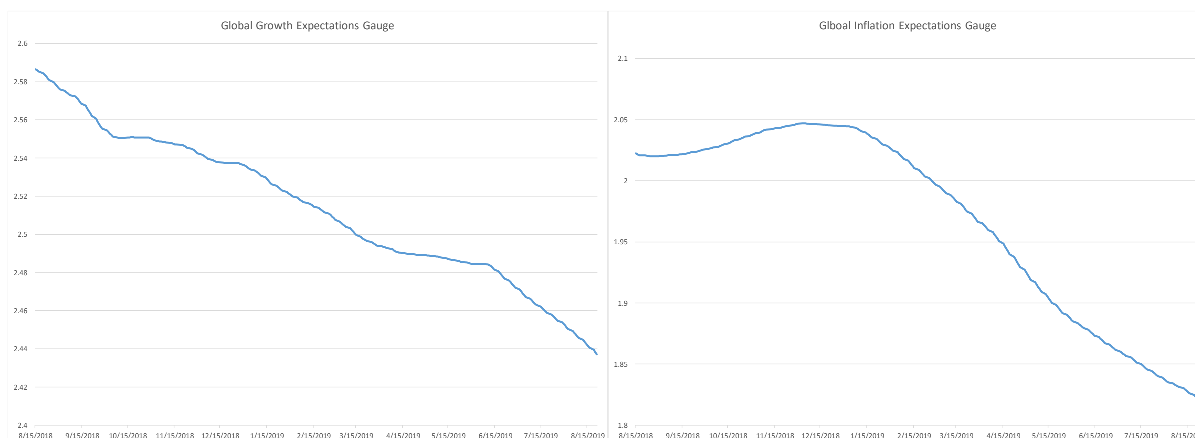
The Damped Spring Report observes three principle fundamental drivers of markets.

- Growth and Growth Expectations
- Inflation and Inflation Expectations
- Risk Premiums which are driven by
    - The supply of Money and Credit for investment and consumption and the demand of Money and Credit by investors, governments, and consumers.
    - Future expected volatility

We began publishing this report in April. Today global equity prices are unchanged to very slightly lower and essentially unchanged from a year ago. Bond yields US

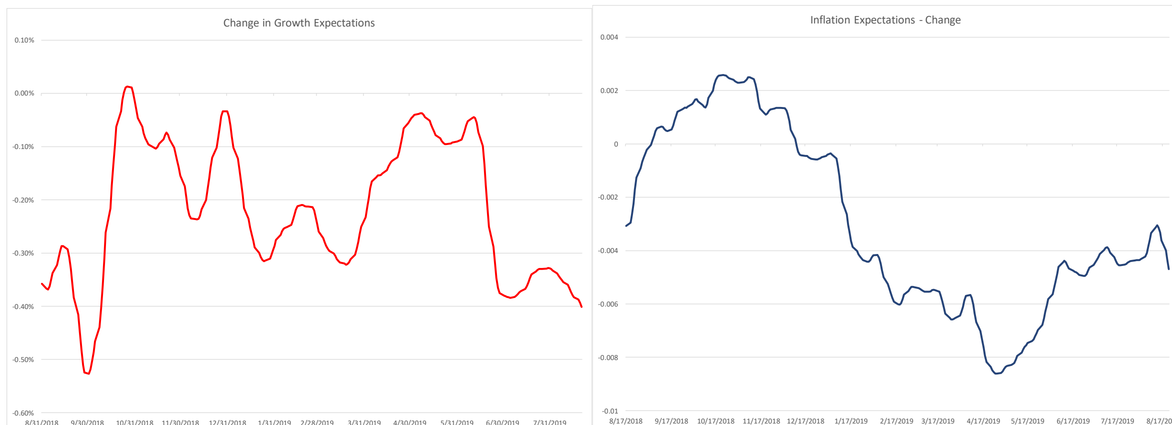
10-year US bond yields are 100bp lower since April and 150bp lower from the peak yield almost a year ago. German bond yields are 70bp lower since April and 120bp lower from the one-year peak. They also are at an all-time low and 40bp lower than during the financial crisis.

The long-term bond market certainly reflects the efforts of central banks to decrease the expected rate/price of money and credit and some of the rally must be credited to risk premium contraction. However, the principal drivers of a rally of this strength must be growth and inflation expectations. This shift is clearly reflected in the data



At current yields the global bond markets appear to reflect most, if not all, of future central bank cuts and the current shifts in fundamental expectations. However, with global equity prices essentially unchanged equity markets must believe that the bearish forces of slowing growth have been offset completely by the fall in real interest rates which discount future equity earnings. That bullish force is the result of falling inflation expectations which drops the discount rate used for valuing future earnings and also the flexibility that falling inflation expectations provide central bankers to print money and lower the price of money with a goal of generating excess supply of money and credit to stimulate investor demand. In the past this relationship would be true. Unchanged equity prices in the face of such a drop off in growth expectations is not unusual if simultaneously inflation expectations are low and central banks are perceived as willing and able to ease. However, we believe that DM central banks outside of the US are unable to ease with current tools and policies and that the US Fed has some but not enough ammunition to ease at its disposal. For that reason, we are strategically bearish equities.

Tactically the story looks very bullish bonds and bearish stocks as these shifts in growth and inflation expectations have fallen sharply since the rate cute and “mid cycle adjustment” of late July



As can be seen above changes in growth and inflation expectations have remained solidly negative over the last year but looking to the far right seem to have rolled over and moved lower since July. Trade talk expectations have in our minds been largely noise. The impact of trade expectations matters regarding the steepness of the slowdown, but larger macro drivers are predominately responsible for the trend. We simply look back at our own notes regarding trade and don't particularly see much of a difference between today, last month or many months ago. Trade will be resolved with a meaningless "victory" claimed by both sides or drag on. Neither outcome will overcome the macro trend at play. Tactically, absent the noise of the Powell speech tomorrow, a large bet on short stocks is warranted and a moderate bet (given what is already discounted) long bonds would be recommended. However, as mentioned above the Fed is trapped by uncertainty around trade and is less predictable given those circumstances. Perhaps next week we will provide an update and it probably wouldn't surprise our readers what we may recommend.

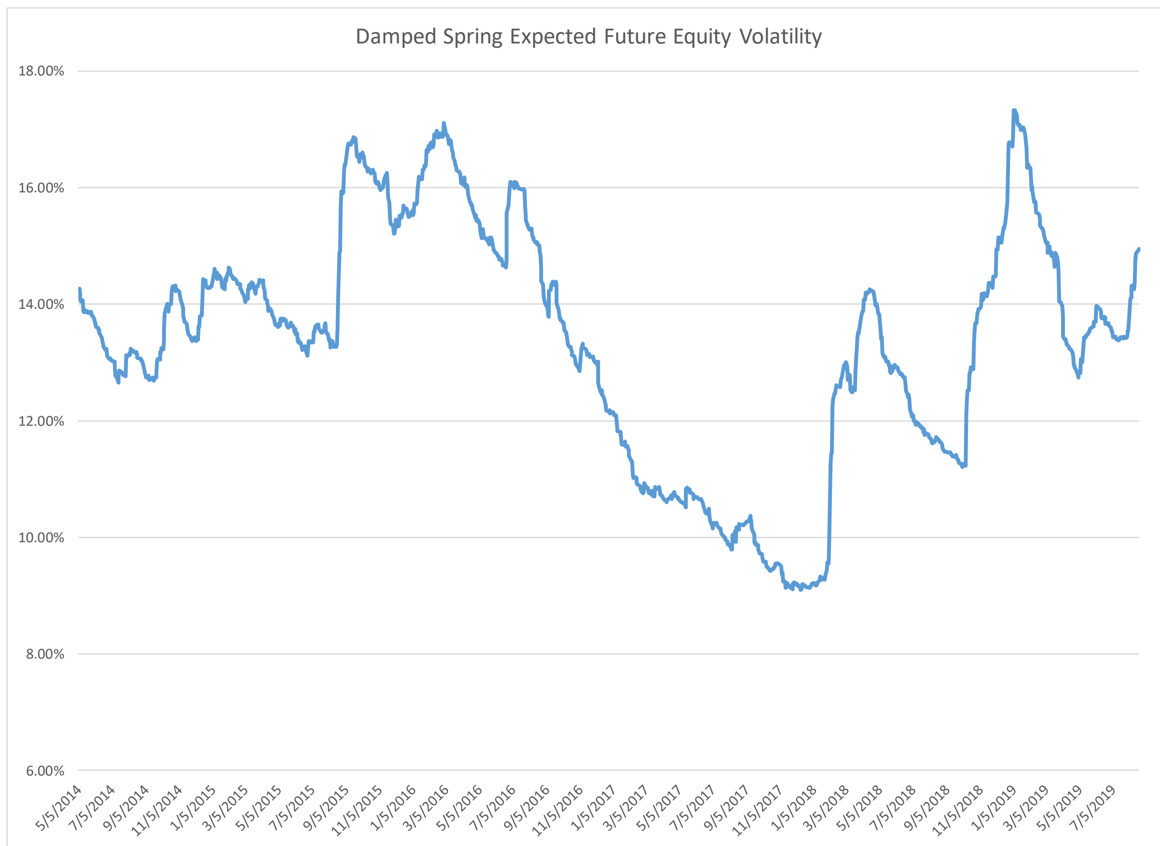
Damped Spring Volatility Model

As mentioned in prior reports, Trump has been willing to cap upside in both the economy and the equity markets by tightening the screws on trade when markets allow. This has not changed. By tightening the screws and weakening markets and the economy Trump also has depended on the Fed to play ball. The Fed has remained unwilling given the actual impact seen on the economy and the frankly ridiculous level of market micro-managing that in which Trump seems to be engaging. Hence our view of the speech tomorrow being titled "You first sir" With the fed trapped and thus smartly unwilling to react the strike price of the Powell put seems far below the current level of the market and economy. We don't expect an adequately dovish outcome of the speech because of the Trade uncertainty but own gold in case Powell caves. Remember we do believe the Fed should ease because the macro trend regardless of trade relies on easier conditions, but we respect their position and potential for a whipsaw from the administration.

In the Damped Spring Volatility model framework, we believe

- Market moving future news is likely to be above average
- Market participants remain in extremely good shape as the market portfolio has seen significant positive returns given the bond rally
- Market participant positions are not particularly leveraged
- Most traditional leverage providers are in excellent shape in the US and ok shape elsewhere
- We are concerned about the level of debt across non-bank corporates on which share repurchase demand rests but low interest rates and deep liquidity for rolling that debt are for the time being open.
- Trump is no longer in our market stabilized bucket for the downside case
- Central banks are willing to ease market fears short term but unable to offset major moves with current tools

When we add that up, we expect average volatility conditions for the next few months. The recent spike in our forward estimate is likely to ebb but remain around average.



Flow and Positioning

Yesterday news regarding the budget deficit rising highlighted for us the macro picture of flow and the future of monetary and fiscal coordination. Long term we believe that existing tools available to central banks will prove inadequate to offset

a slowdown and new tools of fiscal spending funded by central bank debt monetization, money printing will be required. But as we have seen in Japan over the past five years fiscal stimulus and money printing in a coordinated fashion is something that is messy and hard to execute particularly when both parties to the coordination refuse to admit it is occurring. The US leads with spending as always. Perhaps the central bank will get the memo and monetize the debt that is now rapidly accumulating. Maybe one day, years from now, transparent coordination, and of course the loss of central bank independence will occur but for now expect prolonged messiness with political fits and starts on necessary fiscal stimulus and QE coming late. Today we see the flow of financial assets utilizing a greater share of supply of money and credit and limiting supply to consumers and the real economy.

Down a level, market participant positioning imbalances are not particularly concerning.

Current Model Portfolio performance and recommendations

The model portfolio is currently at a low risk consistent with our above view. We expect to raise the risk level somewhat, potentially as early as Monday but more likely in September as news on trade develops.

- Add a short call spread on both the SPX and SX5E reflecting our strategic view on equities and elevated implied volatility
- Long Gold
- Long EURUSD due to US easing ability relative to EUR

	Assumed Portfolio size	100,000,000					
	LTD P/L	12,165,763					
	Total Return	12.17%					
	Today's Date	8/22/2019		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	7.4	(691,667)	Open
8/22/2019	SPX Sept 2925/2975 Call Spreads	27	-435	1,000,000	27	-	Open
8/22/2019	SX5E Sept 3375/3475 CallSpread	49	-2381	1,000,000	49	-	Open
8/5/2019	GCZ9 Dec 1500/1600 Call Spread	20	500	1,000,000	26.5	325,000	Open
5/14/2019	EURUSD Year end 1.15/1.2 Call spread	1.19	84,033,613	1,000,000	0.49	(588,235)	Open