The Damped Spring Report

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

5/15/2022

Over the last year the dollar index (DXY) has rallied 16%.

We were fortunate to be long USD against Yen from 109 to 125 and vs EUR from 1.19 to 1.09. Lately, we have reversed our view on the USD and have bought GBP, EUR, and AUD. In this DSR we will provide our framework for currencies, focusing on what we think is most important in today's markets. Our view is we are at the late stage of King Dollar and expect a retracement to below 98 on DXY over the next three months.

Month	Sep-21	Oct-21	Nov-21	Dec-21	Jan-22	Feb-22	Mar-22	Apr-22	May-22	Jun-22	Jul-22	Aug-22	Sep-22	Oct-22	Nov-22	Dec-22
DXY	94.2	94.1	96.0	95.7	96.5	96.7	98.3	103.0	104.6	102.5	100.0	98.0	...	...	...	...
Reasons to Buy USD																
USD Assets are more attractive than ROW																
Energy prices are rising																
ROW Deleveraging USD Debt																
Reasons to Sell USD																
USD Weaponization																
Trade																
Oversupply of USD Assets QT																
USD Assets are less attractive than ROW																

Timeline of what has and may move USD

Our basic framework for currency markets is that a currency is driven by two factors

- Trade flows
- Financial flows

These are the basis of all frameworks as they are complete regarding all international transactions of any importance. Large diplomatic payments are not considered at this time.

What has mattered lately and what may matter

Since September, major financial flows have driven currency markets. In the chart on Page 1 of this DSR we name these drivers and our estimates for the strength of each driver in the past and how we expect these drivers to evolve over the next few months.

Reasons to buy USD

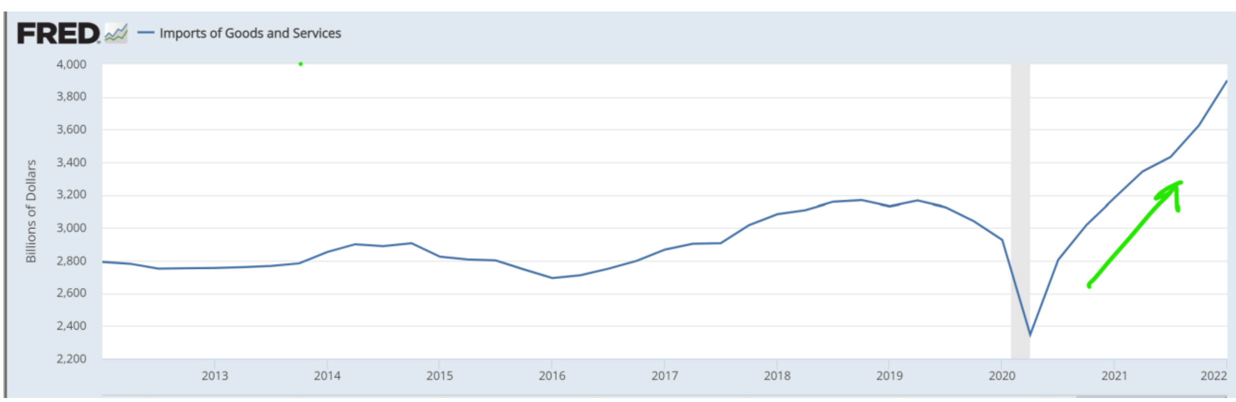
- Preference to hold USD Assets
- Buy Oil
- Pay off USD Indebtedness

Reasons to sell USD

- Weaponization of USD driving countries out of USD Reserves
- Trade
- Expectation of excess supply of USD assets
- Preference to hold ROW Assets

Back drop to the big moves in the USD that started in September

Last summer we wrote about "The Bridge" in this report we pointed out that Covid had created a chasm that required global central banks and fiscal policymakers to "print and spend" to hand money to consumers to offset lost wages. But each country or region had different priors and different responses. It was our estimate that the US had done far more than the rest of the world (ROW). Because the US consumer had money to spend imports spiked rapidly and remain high as imports continue to cheapen.



All these import flows to ROW resulted in exporters selling dollars

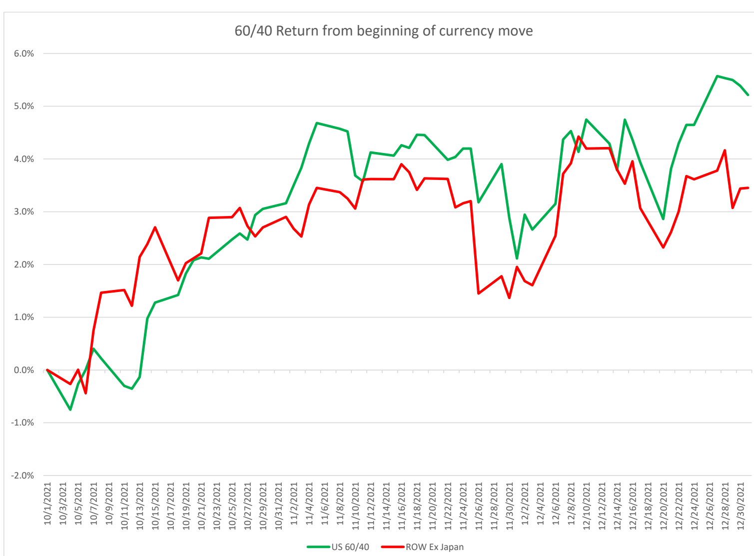
In addition, this USD liquidity encouraged some ROW savers to lend their USD locally for real economy and financial investing enhanced with leverage. We will come back to this leveraged USD financed investment soon.

Reasons to buy USD

Preference to hold USD Assets

As the US economy was supported by more printing and spending, and as vaccines were administered rapidly, the US came out of September (despite a fiscal cliff) in much better shape than ROW. Asset markets noticed and began to chase USD investments. This chase drove the beginning of the large rally in the USD.

The market was broadly correct in anticipating better US Asset performance through year end. I have excluded Japan and in this whole report exclude Japan because all asset markets locally, and the Yen, are impacted by continued BOJ intervention and potentially MOF currency intervention.



Buy Oil

The strong US economy and the clear over stimulation done by monetary and fiscal policymakers resulted in strong demand for energy. After a brief dip during the Thanksgiving massacre (ill advised SPR Release) Oil climbed rapidly and then went parabolic after Russia invaded Ukraine.

It is important to remember that in order to buy oil one has to buy USD. However, the relationship between USD demand and the price of oil is far more complex. It depends on:

- Who is selling the USD and how willuing they are to hold the ROW currency they receive in exchange?
- Who is selling the Oil and what currency do they want to hold?

Given the economic back drop and the increase in oil prices in every currency USD demand exceeded the supply from those willing to hold ROW currency and those who sold the oil still preferred USD savings. The latter may not last. The sanctions placed on Russia has resulted in a potential acceleration in the slow-moving trend of ROW attempting to diversify their reserves away from the USD. We will come back to this point soon.

Pay off USD indebtedness

Since January, a global selloff in all financial assets has driven the USD higher. In this case the fiscal spending which fueled US consumption, which led to US and ROW savings, which led to a global leveraging up of investment financed with USD is unwinding. The unwind has been a tremendous pressure for FX rates as "margin calls" in global assets then generate immediate FX conversion to USD in order to pay off USD loans. We believe that equity and debt markets have made major corrections and are bullish both assets. If we are correct on this outlook the deleveraging pressure and USD chasing will ebb. At a minimum, our view is that margin calls have been made aggressively and those that remain long assets are underleveraged or have bought recently. Any multi week rally in the global equity markets is likely to result in USD weakness

Reasons to sell USD

Weaponization of USD driving countries out of USD reserves

Countries with a trade surplus with the US accumulate USD reserves. As we have seen in the last few months this makes a country vulnerable to seizure by the US government of USD denominated assets that the ROW private and public sector owns. While this weaponization of the USD has gotten a lot of attention the trend to diversify reserves has been going on for many years. However, it is quite difficult to reduce USD assets held by ROW. There are three basic ways:

- Reverse the trade deficit – Which would only happen with a weaker USD
- Encourage investment domestically by the US – Which would happen with lower asset prices in ROW
- Hand one's USD reserves to another country in exchange for a hard commodity or asset owned by that country. The receiving country would also prefer to not own USD reserves and that would put downward pressure on the USD as ROW tosses the hot potato of unwanted USD.

The third option is being aggressively pursued but can only move as fast as asset sales can occur or commodities can be shipped and stored. Remember commodity trading occurs already. In order to make a dent on USD reserves a country would have to purchase and store these commodities in excess of their needs. We believe that though the weaponization of the USD has long term consequences for our enemies, in particular, we do not believe that this is a new trend or likely to accelerate much. Perhaps it is best to think of this as a headwind for the USD over time.

Trade

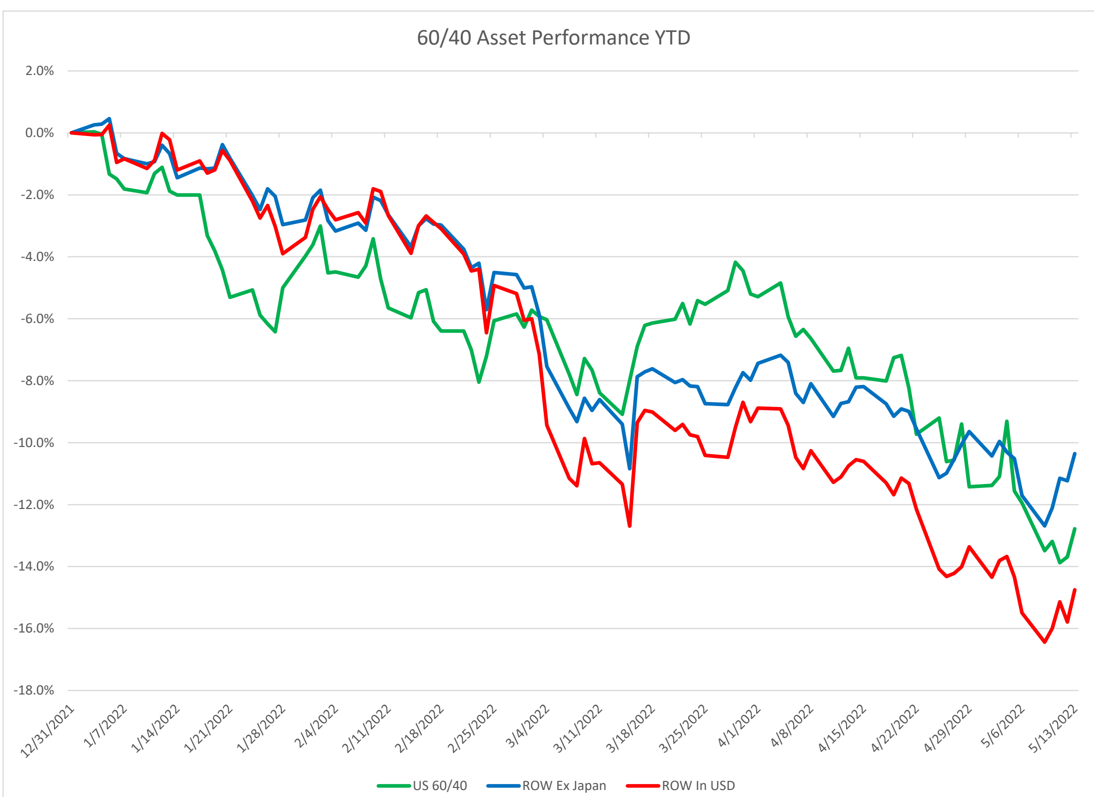
The Fed is currently attempting to tighten monetary policy to generate demand destruction. The rest of the world is experiencing less inflation and is taking longer to emerge from the covid crisis. At current levels of global currency markets. US Goods are extremely expensive and ROW goods are relatively attractive. Given the macroeconomic conditions it is more likely that US consumers will source products from the rest of the globe exporting USD that isn't particularly cheap which may result in some weakness. Trade's impact on currencies is quite slow moving. We do not expect a major impact on the USD through this linkage but if oil does peak and US wages improve the pressure on the USD is likely to grow.

Expectation of excess supply of USD assets

The big event that has driven all asset prices since 2022 began is the beginning of quantitative tightening by the Federal reserve. Other countries are also on the path to reducing balance sheets, but the US will be biggest and first. The Fed will reduce their balance sheet by choosing to not reinvest the proceeds of maturity payments of existing holdings back into the market. The US Treasury will need to find new buyers for the bonds it issues. In June that supply those markets will need to absorb will be $50BN USD and will grow to $95BN (of which some will be outright sales of mortgages by the Fed). The domestic buyer will be paid an incentive in higher risk premiums. If that demand is inadequate the foreign investor will see supply of USD paper which will result in USD weakness. Most global asset markets have priced in risk premium expansion due to QT. However, the USD is at a peak. During the summer we expect USD asset oversupply to reverse USD strength.

Preference to hold ROW Assets

Just as USD strength occurred as global investors chased US Assets as the US economy led the global economy out of the Covid chasm, the next leg of asset returns is more likely in countries that remain relatively easy and where the economy is still lagging. ROW Assets have fallen almost in line with the US portfolio. However, in USD the performance of ROW assets has been notably worse. This performance leaves ROW assets more attractive than US assets for a US investor. Any relative strength in asset prices for ROW over the US will result in some ROW currency chasing and USD weakening



In synthesis the factors that have been driving USD strength are weakening and those that will drive weakness are likely to become stronger. King Dollar has been our favorite trade over the past 8 months. No longer.

Current Recommendations and Performance

Assumed Portfolio size	$ 100,000,000			
LTD P/L	$ 37,425,295			
Total Return	37.43%		YTD Return	6.14%
Today's Date	5/15/2022		Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case l	MTM	P/L	Open/Closed
4/19/2022	SPX May 4460/4560 Call Spread	46	217	$1,000,000	1	$ (978,261)	Open
4/19/2022	NDX May 14200/14700 Call Spread	230	43	$1,000,000	4	$ (982,609)	Open
1/1/1900	NDX May 14200/14700 Call Spread	215	47	$1,000,000	4	$ (981,395)	Open
4/20/2022	SPX May 4460/4560 Call Spread	40	250	$1,000,000	1	$ (975,000)	Open
4/20/2022	SPX May 4460/4560 Call Spread	40	250	$1,000,000	1	$ (975,000)	Open
4/26/2022	AUDUSD .7175/.7375 Call Spread	1.12	44,642,857	$ 500,000	0.63	$ (218,750)	Open
4/26/2022	EURUSD 1.07/1.10 Call Spread	1.02	49,019,608	$ 500,000	0.52	$ (245,098)	Open
4/26/2022	GBPUSD 126.5/129.5 Call Spread	0.92	54,347,826	$ 500,000	0.48	$ (239,130)	Open
5/5/2022	TLT 115/112 July Put Spread	1.35	-606	$1,000,000	1.15	$ 121,212	Open
5/5/2022	GLD 175/172 Put Spread	1.4	-6250	$1,000,000	1.9	$ (312,500)	Open
5/5/2022	NDX July 13000/12500 Put Spread	208	-34	$1,000,000	235	$ (92,466)	Open
5/5/2022	SPX July 4200/4000 Put Spread	79	-83	$1,000,000	95	$ (132,231)	Open
5/11/2022	ZBU August 139 Call	2.2	455	$1,000,000	2.8125	$ 278,409	Open
5/11/2022	AUDUSD .7175/.7375 Call Spread	0.63	79,365,079	$ 500,000	0.63	$ -	Open
5/11/2022	EURUSD 1.07/1.10 Call Spread	0.6	83,333,333	$ 500,000	0.52	$ (66,667)	Open
5/11/2022	GBPUSD 126.5/129.5 Call Spread	0.48	104,166,667	$ 500,000	0.48	$ -	Open
5/11/2022	NDX July 13000 Call	350	29	$1,000,000	361	$ 31,429	Open
5/11/2022	SPX July 4200 Calll	80	125	$1,000,000	76	$ (50,000)	Open