

The Damped Spring Report

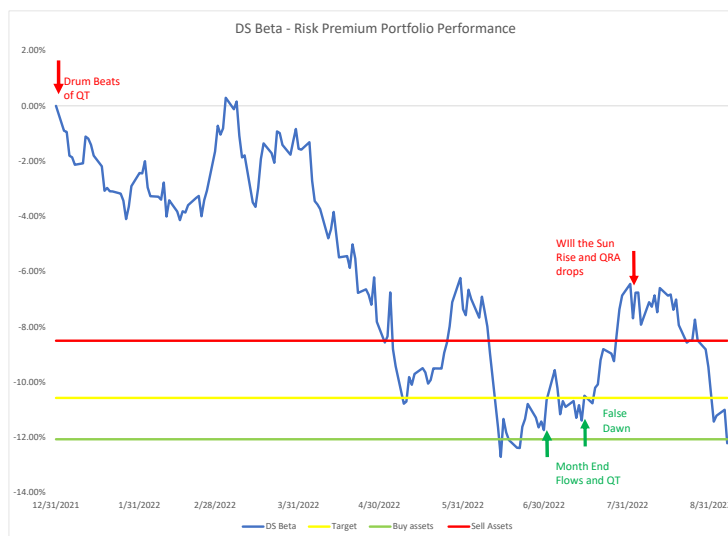
“Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets”

9/7/2022

Jay Powell took a long step down the Volcker Legacy path with his short and to the point speech in Jackson Hole. He said the words that were needed to be said. We expect for at least the balance of the year he will follow up with deeds. However, QT paired with significant UST issuance is the real signal and the selloff in assets has more to do with frontrunning QT than Powell’s hawkish speech. We were extremely well positioned in the market for the Powell speech catalyst because the reaction was inevitable given the headwind of QT. We covered our large equity shorts in SPX, NDX, SX5E and gold. As asset prices have fallen last week we have begun buying. This buying is tactical and opportunistic. Nonetheless the headwinds of QT will cap markets for the foreseeable future.

We will conclude the summer trilogy with “Zombies on the Run.” Zombie companies and countries have been on the run all year. The market has discounted their difficulties. We have created a Zombie/Human L/S basket and will be monitoring it as the economic and policy outlook evolves and not only will zombies remain on the run many will be shot dead.

Before we jump to the Zombies. In recent reports we estimated that higher issuance and QT ramping up would cause a 500bp cheapening of assets. This has come true. Quickly assets don’t suck anymore.



What are zombies and how will higher for longer impact their relative future?

Higher for longer, along with QT risk premium expansion headwinds will impact entities with high leverage and/or need to access capital markets to execute their business plan. Higher rates will cut margins and make refinancing maturing debt unattractive, expanding risk premiums will make raising cash to fund losses for capital intensive early-stage businesses extremely difficult. Countries face the same difficulties. Those countries and companies that own or produce commodities will have a distinct advantage in the coming years as the Fed attempts to create demand destruction in general while fiscal policy makers attempt to subsidize demand for energy and invest in all forms of energy infrastructure.

Who are the zombies?

Companies and countries of all sorts are zombies. We have chosen a set that fit our definition for purposes of tracking the general trend. We will refine our list over time, and we suggest each investor categorize their investments in this way. Our framework looks at Currency, Equity Index, Equity Sector, and Credit Zombies.

Zombies	Humans
Currency	
EUR	USD
GBP	CAD
JPY	AUD
Equity Index	
Eurostoxx 50	SPX
Nikkei	FTSE
Kospi	FXI
Equity Sector	
Airlines	Defense
Autos	Energy
Housing	Mega Cap
Credit	
Itraxx Cross over	Itraxx IG
CDX HY	CDX IG

Currencies

Our zombies are short energy and commodities and involved in a war. Our longs are energy and commodity independent and even exporters

Equity Index

Our zombies depend on liquidity and are consumers of commodities. Our longs are the superpowers and the FTSE which has a favorable composition of both commodities and energy and significant foreign earnings

Equity Sectors

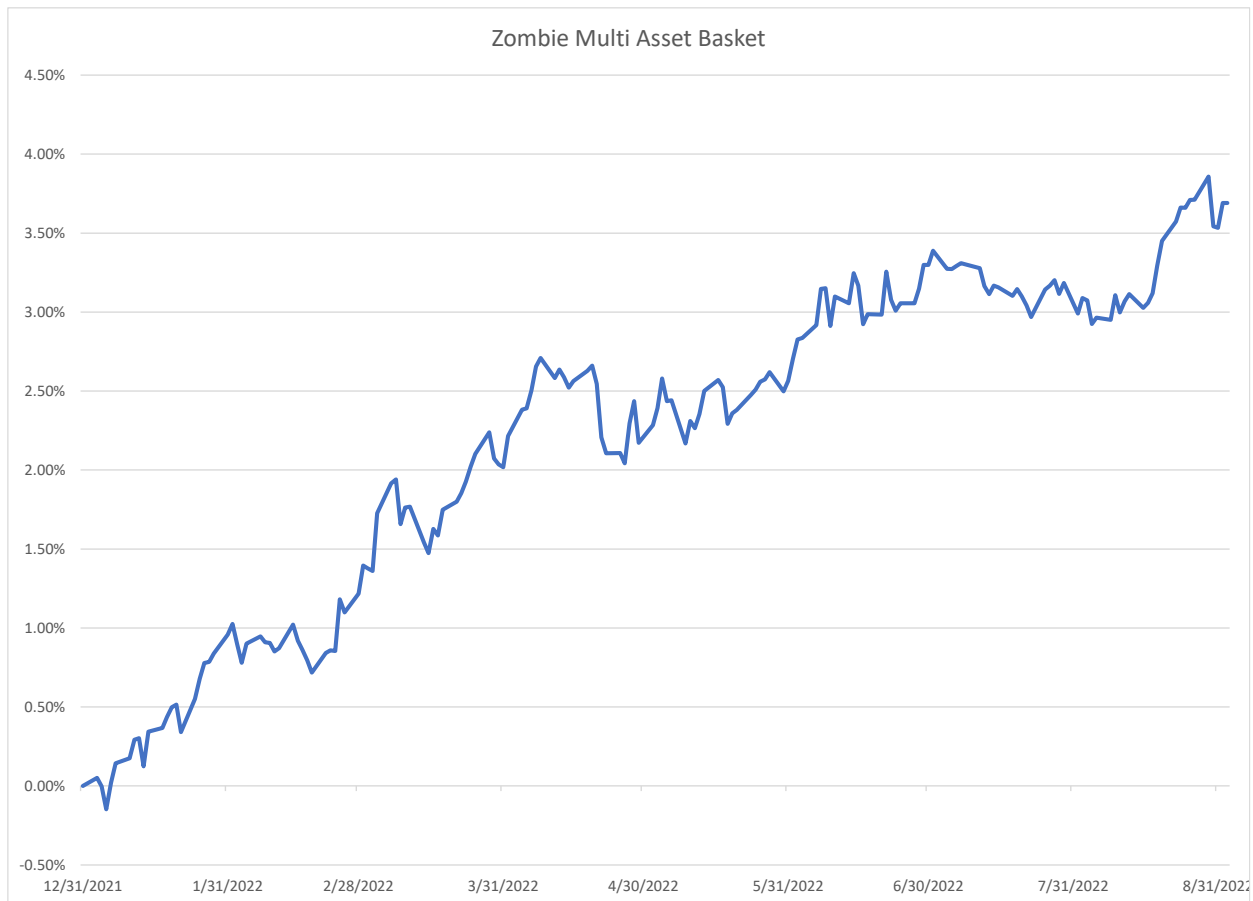
Sector Zombies depend on low interest rates and open funding channels. Our longs are where future government spending is likely to occur or where balance sheets are pristine

Credit

This one is simple Weaker credits are likely to underperform

Andy this basket is naïve. Its already moved a ton

Yes, this basket has moved a ton.



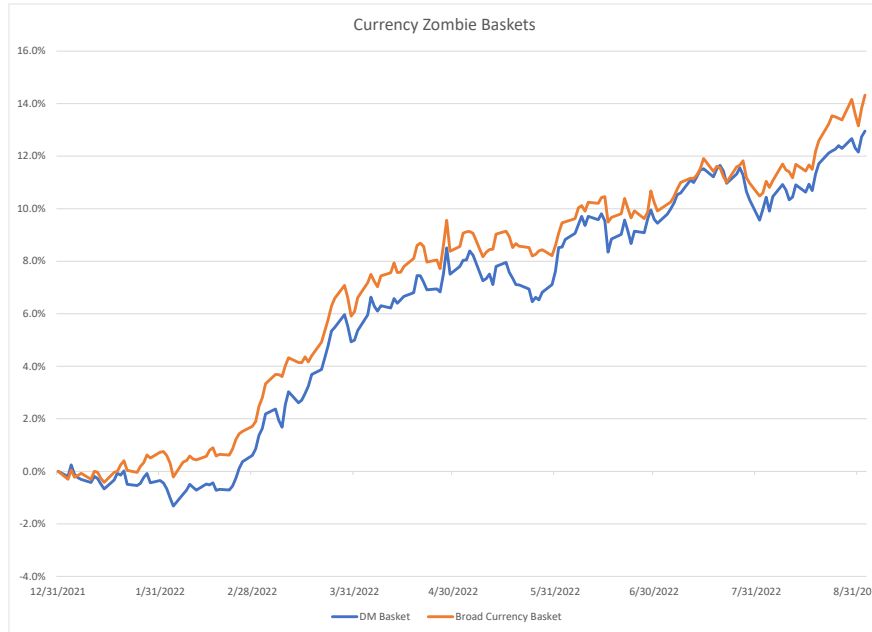
Since QT was hinted at in the Dec 15th press conference a risk weighted basket of short zombies and long humans has had positive alpha of 375bp this theme has been occurring throughout all the downs and ups of the year. It has been the one market constant.

Zombies are on the run

Will it continue? The headwinds are extremely strong and zombie death occurs suddenly and sharply. Today we would not enter the trade given the move, but we are monitoring it closely. However, it does pay to look more closely at the subcomponents of the basket

Currencies

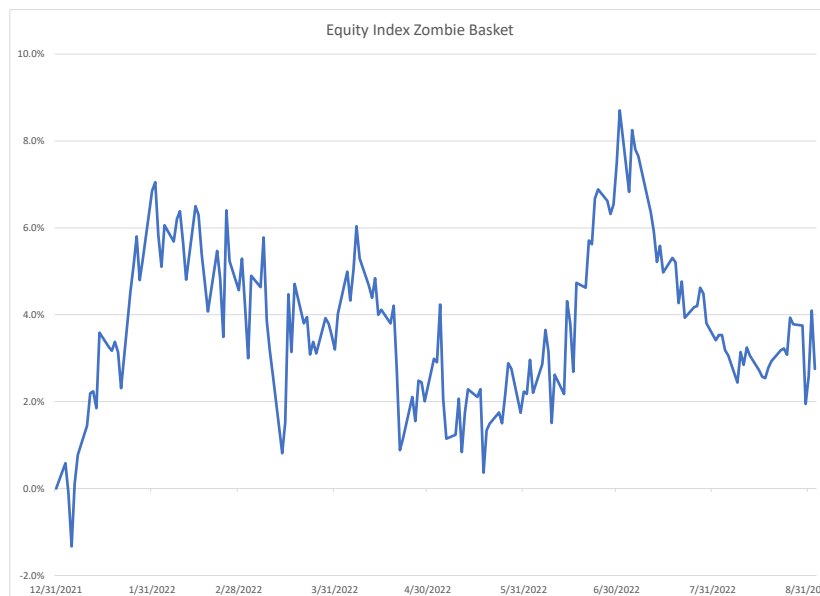
A significant portion of the underperformance of the Zombie basket has been the strength of the USD vs everything but particularly the zombies



We fully expect the USD to continue to have the wind at its back. However, our macro signals do not currently suggest a trade. This zombie aspect is not enough for us to place a bet.

Equity Index

Pretty much all the global equity indices have fallen but the factors driving our zombie thesis have had only modest impact



Owning the Human index Portfolio and Short the zombies looks attractive to us

Equity Sector

Individual equities of all sorts and the sectors they reside have had significant volatility and those that barely made it through the pandemic, those with sales but no profits or cash flow who need financing, those in industries requiring commodities inputs, and those who sell goods needing financing have clearly underperformed high quality balance sheets, defense, and energy. While today may not be the time to enter this trade the headwind could generate some asymmetric returns in the year to come. Notice in the False Dawn of July a great entry point occurred.



Credit

Credit is the big surprise as IG and HY tracked almost perfectly on a risk adjusted basis all year. This is an opportunity we suspect.



The summer trilogy fades with a predictable ending episode. Zombies are on the run particularly in currency markets and sectors. While credit and equity indices seem to not differentiate. We will be carefully monitoring each of these asset classes and refining and broadening our baskets of relative winners and losers. The losers have much more tail exposure and asymmetric payouts. If inflation remains sticky for higherer and longerer as we are leaning towards in our outlook these asymmetric responses will kill a whole lot of zombies.

Current Portfolio and Performance

Assumed Portfolio size	\$	100,000,000						
LTD P/L	\$	47,358,359						
Total Return		47.36%	YTD Return			16.07%		
Today's Date		9/6/2022	Portfolio Created			4/15/2019		
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed	
8/30/2022	SPX Call Spread 3950/4000 9/30/2022	28	357	\$ 1,000,000	20	\$ (285,714)	Open	
9/2/2022	SPX Call Spread 3950/4000 9/30/2022	28	357	\$ 1,000,000	20	\$ (285,714)	Open	
7/7/2022	EDZ2EDZ3 50bp stop loss	-0.65	2000	\$ 1,000,000	-0.32	\$ 660,000	Open	
8/5/2022	TLT Short 113/116 Sept Put Spread	1.2	-5556	\$ 1,000,000	3	\$ (1,000,000)	Open	
8/11/2022	TLT Short 113/116 Sept Put Spread	1.3	-5882	\$ 1,000,000	3	\$ (1,000,000)	Open	
9/2/2022	TLT October 109/114 Put Spread	2.15	4651	\$ 1,000,000	1.25	\$ (418,605)	Open	
	Inception Risk			6.0%		3.670%		