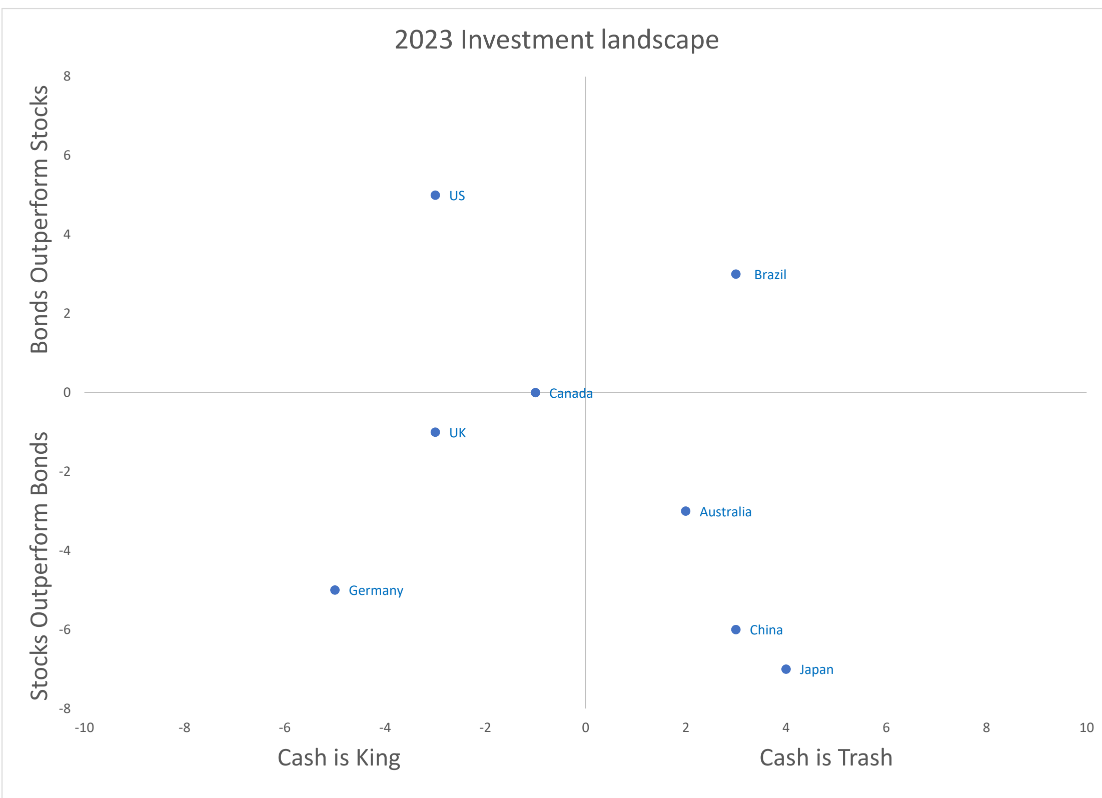
The Damped Spring Report

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

11/16/2022

The extension of the False Dawn Rally has surprised us. We continue to believe the Fed is committed to well and truly killing inflation and the CPI and PPI misses in no way change our view that inflation remains the problem. Real GDP Growth and Labor Market tightness will ensure inflation spikes again if not dealt with forcefully. This DSR will be about our longer-term outlook for assets across the globe. The factors at play for investors going forward are what countries have favorable conditions for investing and what countries have unfavorable conditions. Cash is King or Cash is Trash varies by country at this point. In addition, in most markets, bonds have significantly underperformed equites. Determining whether further divergence is likely, or a "Great Convergence" is about to start, will also be key in navigating 2023.

Outlook for asset markets by region



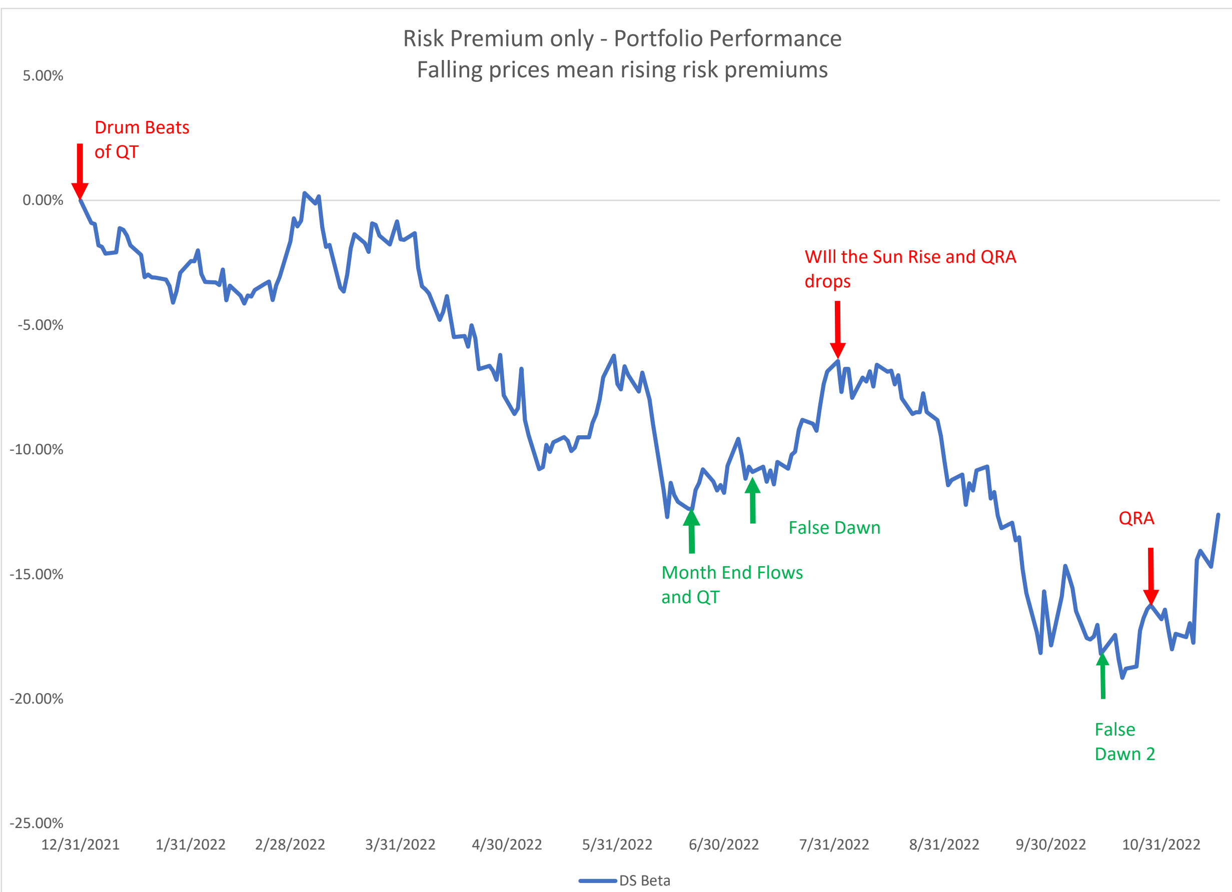
Is Cash King or Trash?

The Damped Spring Framework for determining which countries are investable looks at the principal drivers for asset returns and what is priced into markets in the particular country.

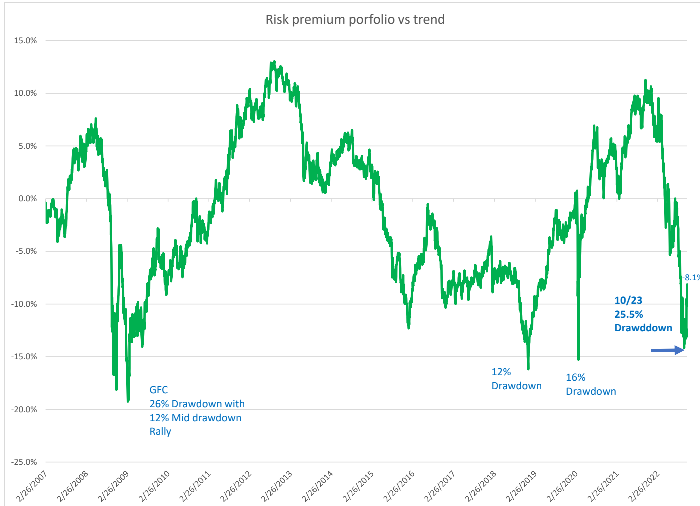
The conditions that lead to assets outperforming cash are:

- Easy Monetary policy
- Stimulative fiscal policy
- Competitive economy
- Resource rich
- Available credit
- Balanced investment options

Assets have sold off vs cash. Risk premium expansion due to Quantitative Tightening and rate hikes can be seen in the performance of virtually any diversified long only portfolio. We overestimated the impact of the most recent quarterly refunding announcement and remain surprised at the response by equity markets in particular to the ice cold inflation numbers but it remains true that asset portfolios have had significant drawdowns



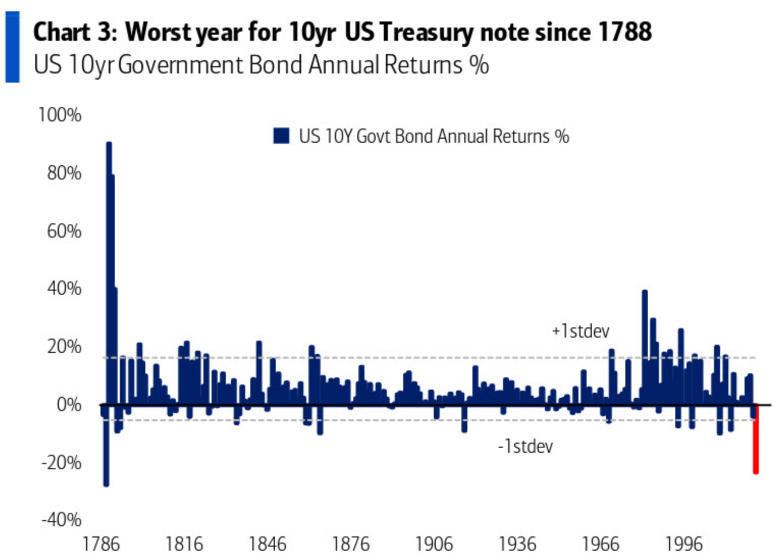
Put in context vs recent "Cash is King" periods the current environment shows continued poor performance of assets with an aggressive bounce in the last few days.



We believe that most DM markets remain Cash is King. But each market is at a different stage in that evolution and investors need to be conscious of where things stand in allocating cash to the global markets

"Great Convergence" or further divergence?

In 2022, Global Developed Market Government bonds have sold off in a historic way.



Source: BofA Global Investment Strategy, Bloomberg, GDF Finaeon.

BofA GLOBAL RESEARCH

Equity markets have massively outperformed bond markets. What has sparked the big bond underperformance has been high inflation expectations, high realized inflation and stronger than expected growth. Each country is in a different phase of economic growth and inflation and policy makers are acting consistently with their own countries conditions. We believe that 2023 will see a great convergence begin where equity markets underperform bond markets in the US and Brazil. However, the Great Convergence is unlikely to occur in other major economies before further bond underperformance vs stocks. As for the US and Brazil this our outlook for 2023 and at the moment we are not betting the convergence is underway. The recent spike in the US Government bond market leaves bonds overbought. We will look to buy bonds and remain short equities opportunistically as the year ends and enter 2023 with a Great Convergence position.

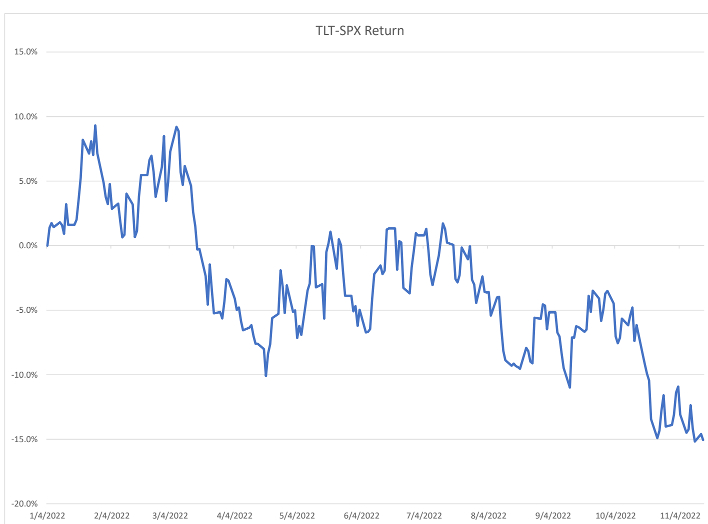
Our criteria for bond outperformance vs stocks are:

- Relatively high growth and inflation
- Restrictive monetary tightening to slow economy
- High equity valuations and end of the inflation driven margin sweet spot
- High deficit political gridlock on spending, higher taxes, or austerity in place

Quick scan of Country/Region conditions and pricing

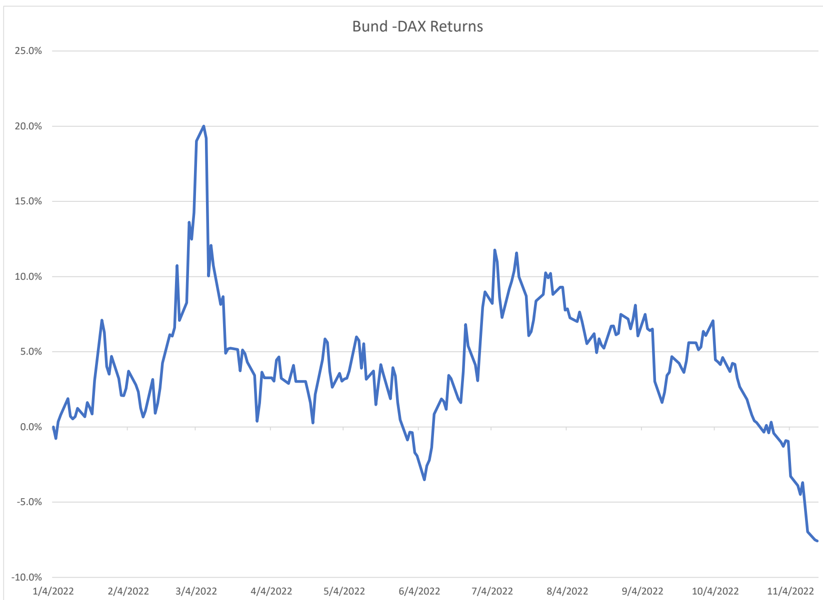
US

The US fiscal response to the COVID pandemic was far bigger and more broadly distributed than any other country on the globe. The consequence of that policy has been and will continue to be significant demand driven inflation. Of all countries we scan the US Fed also has the most difficult job taming inflation given the lower sensitivity to interest rate hikes due to fixed rate mortgages, and wealth effect channels impacting those with relatively high wealth. For that reason we expect the Fed will continue with QT and any hike pause is at least as likely to result in an additional hiking cycle vs a rapid cutting cycle. Monetary policy will be tight in 2023. The rest of our cash is king/trash framework is mixed regarding US conditions. Nonetheless we expect 2023 to continue to be a challenging year for assets overall. However, given the criteria for a "Great Convergence" The US is almost certainly going to be the country that first sees a recovery of bonds relative to stocks. We are looking to enter a long bond short stock position in DS Alpha



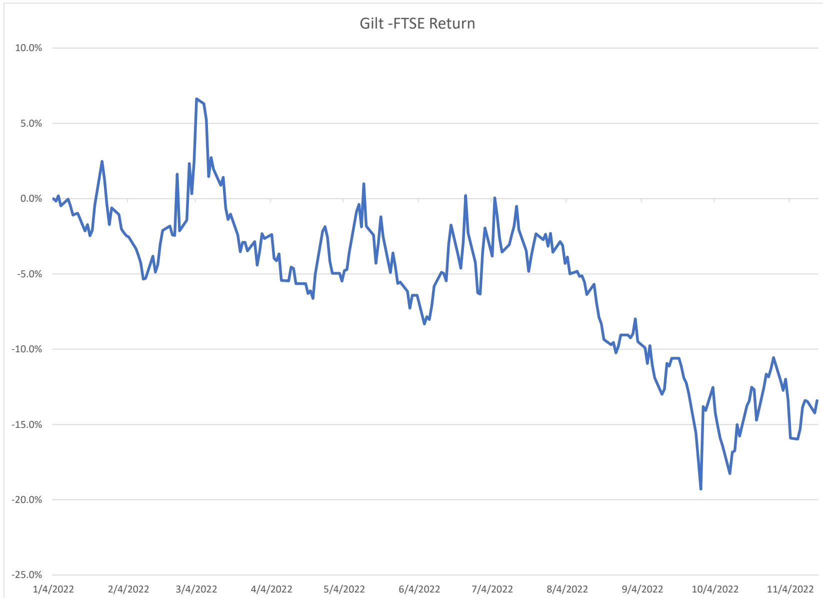
Germany

Eurozone monetary policy has not come close to being restrictive. Long-term real yields remain negative. The balance sheet policy of the ECB is not a factor for the Eurozone. The economy is already expected to be or is in a recession. In order to kill inflation, the Eurozone will have to do some tightening. Clearly the tightening may be less than the US but the tightening cycle is just beginning. Observe asset returns when winding back the clock by six months to where the US started its tightening, and we expect assets in Germany and the rest of the EU in general to deliver quite negative performance. However many of the same factors that drove the US Bond Stock divergence are now in place in Europe. Pricing is also far more attractive for both divergence and for shorting assets. Bonds are down 10% less than US bonds and equity divergence is dramatically less and trending toward bund underperformance



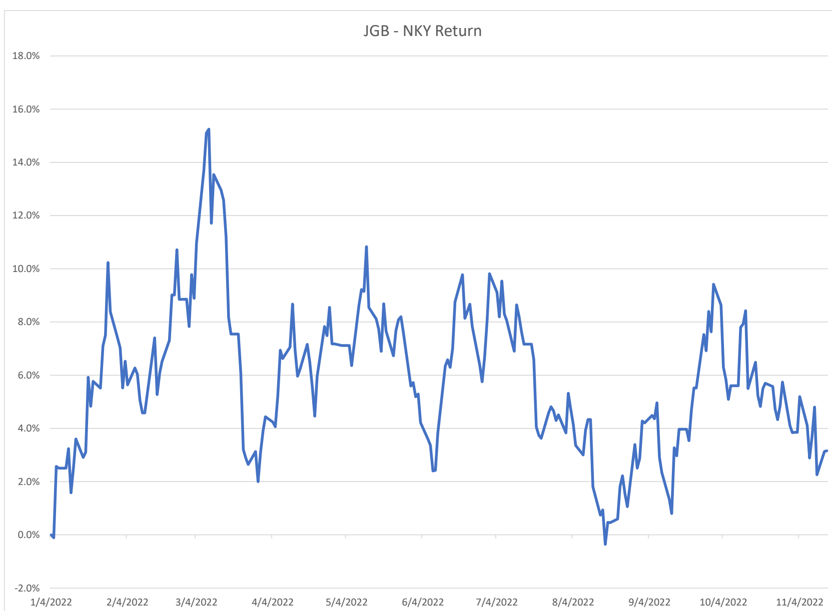
UK

The UK has been a bit of a basket case to say the least the last two months. However, the fiscal side seems to be stabilizing and the BOE is selling Gilts in QT albeit at a mild pace. Recession is widely expected. The FTSE has benefited from its composition and from a weak GBP. In fact, the FTSE is flat on the year. Once again monetary policy doesn’t have as heavy a lift to fight inflation as the US due to mortgages. Yet tightening has just begun. Fiscal stimulus is DOA given the recent Truss debacle, UK is neither resource rich nor particularly competitive as a global producer of goods and services. Given the conditions and the relative performance of UK assets to global assets we are modestly in favor of short asset positions. Given the FTSE’s composition the divergence/convergence metric is also impacted by global conditions vs local economic conditions For that reason we do prefer gilts over FTSE but are not prepared to make a big call either way



Japan

Japan ticks virtually all our boxes for Cash is Trash except investment balance given the uninvestable JGB market. The combination of easy monetary policy and fiscal policy that is finally becoming stimulative we think owning Japanese assets is a key part of any portfolio. Of course, any outperformance of bonds is by definition an outperformance of cash over equities. We clearly do not expect bonds to outperform stocks. At the same time maintaining a short in JGB is betting against Kuroda and we think that is a waste of a risk position until closer to his end of term. By year end we will be long Japanese equities.

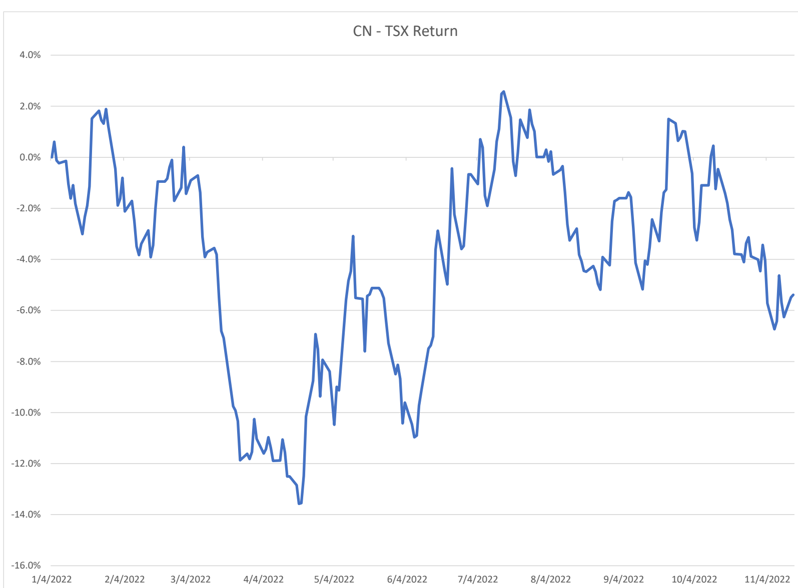


China

China represents a classic dilemma, This market is optimal in basically all ways for investing. Except the biggies of rule of law and capital controls. We take seriously those obvious problems. Nonetheless we consider China exposure to be so attractive and priced so cheaply that investing in China makes sense to us in 2023. We would have China in the far lower right of our investment landscape chart but for these barriers. In addition, we favor equities over bonds by a large margin.

Canada

Unfortunately while certain conditions in Canada favor investing including exposure to commodities and modestly more accommodative financial conditions. The economy and market pricing is heavily impacted by the US conditions and at the moment that makes us have no particular view on individual asset markets and a modest short in assets in general

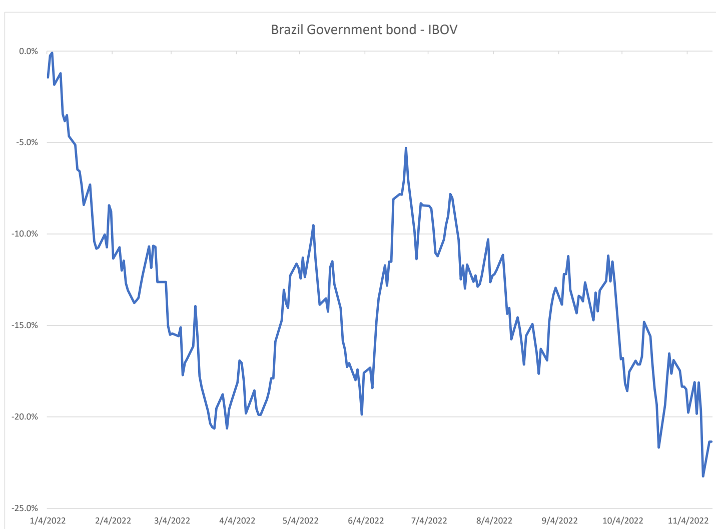


Australia

Australia benefits from the dual economic strength that will come from China eventually reopening and Japan providing economic stimulus. This tailwind should lead to positive portfolio gains. But with that backdrop and the difficulty raising rates adequately given the strong sensitivity to rate hikes of the local housing market. Our preference is to be long equities and short bonds vs long assets. We expect an Asia region asset rally will put upward pressure on local inflation and keep bond yields elevated. In addition, the bond and stock market's relative performance does not look out of balance in a way that would cause us to expect bonds to outperform.

Brazil

Brazil is not in our lane. But for symmetry of a country that ticks many Cash is trash boxes, has high local interest rates and overly buoyant stock market performance we include it for a possible portfolio holding for EM specialists looking for bonds to hold vs short equities.



In Synthesis, local macroeconomic conditions are not at all in sync. The US is far ahead of dealing with inflation, other countries are not experiencing inflation at all, Asset prices are broadly down. But the asynchronous conditions and pricing of individual asset suggest significant opportunity as 2023 unfolds. We are not changing our positioning at the moment but are looking toward 2023 and using the framework we have shared today to plot our course. The framework has implications for currencies as well. We will address those markets over the coming months.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 44,851,292					
	Total Return	44.85%		YTD Return			13.56%
	Today's Date	11/16/2022		Portfolio Created			4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM		P/L
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	2	$	(47,619)
10/31/2022	SPX Jan 3600 Put	75	267	$ 2,000,000	42	$	(880,000)
11/3/2022	NDX Jan 10500/10000 Put Spread	158	127	$ 2,000,000	60	$	(1,240,506)
11/1/2022	ZB Jan 122/124 Call Spread	0.90625	-9	$ 1,000,000	1.4	$	(451,429)
11/3/2022	ZB Jan 117/114 Put Spread	0.78125	13	$ 1,000,000	0.15	$	(808,000)
11/8/2022	USDJPY 147/150 Call Spread 2/8/2023 Call	0.61	163,934,426	$ 1,000,000	0.27	$	(557,377)
11/14/2022	GBPUSD 1.17/1.14 Put Spread	0.74	135,135,135	$ 1,000,000	0.79	$	67,568