The Damped Spring Report

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

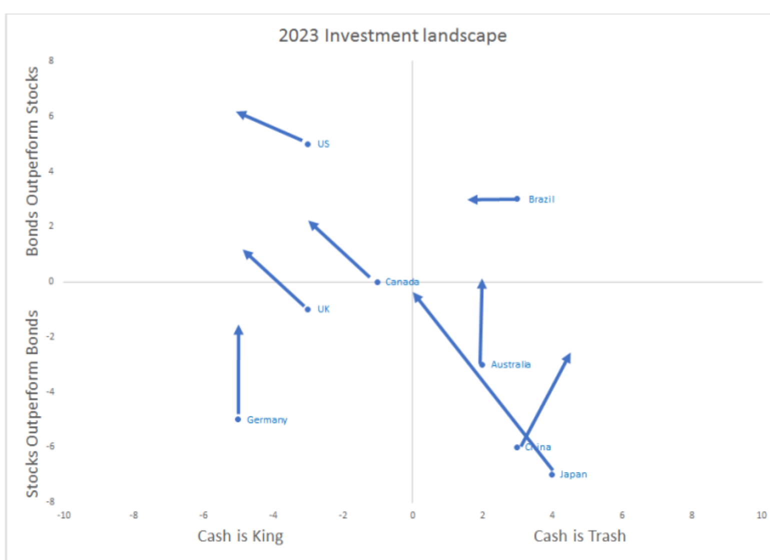
06/26/2023

The month of June has been notable for the breadth of surprises around the globe. Friday after markets closed, a potential coup in Russia jumped into the headlines. All month, central banks outside of the US surprised markets with, hikes in the UK, Canada, and Australia, and stimulative actions by policymakers in Japan and China. We have no insight on Russia except to say escalation of the military activities are inflationary, as war spending increases demand and supply chains tighten, and peace is inflationary as reconstruction spending far exceeds improvement in already rebuilt supply chains.

On 11/16/2022 we surveyed, local fiscal and monetary conditions, market pricing, and how both would likely evolve, across the most important economies. In this DSR we will revisit our calls and project current conditions through our framework to identify the value of holding diversified assets vs cash and within an asset portfolio which asset will outperform.

Outlook for asset markets by region

On 11/16 we predicted the likely returns of bonds vs stocks and assets vs cash for each of the major local economies. The arrows are an update of the conditions we see today. We will outline each change below.



How did we do over the past six months?

For each country in which we predicted bonds outperforming stocks, we modeled the return with an equal dollar pair of long bonds short stocks. For each country in which we predicted cash would outperform assets we compared the returns of a 50/50 portfolio of stocks and bonds vs the returns on cash. In aggregate our total return for the portfolio of all countries and all pairs averaged 10.7%. We were on target on eight out of sixteen pairs, wrong on three and 5 were scratch.

Damped Spring Projections

Bonds Outperfrom Stocks		Yes	No	Assets Outperform Cash	Yes	No
US		-7.2%		US		3.0%
Germany			-15.1%	Germany		2.3%
UK			-9.6%	UK		-4.8%
Japan			-18.7%	Japan	8.8%	
Australia			1.0%	Australia	-2.9%	
Canada			-0.2%	Canada		-4.3%
Brazil		5.9%		Brazil	7.0%	
China			-0.2%	China	0.1%	
Total	10.7%	-0.6%	-7.1%		3.3%	-0.9%

In the UK in assets underperformed cash by 480bp and stocks outperformed bonds by 960 bp. In the US, we wrote at the time that we doubted that a recession would happen in 2023 H1 and that a convergence between bonds and stocks was early, in fact that was very much true. US bonds underperformed stocks by 720bp and assets outperformed cash by 300bp. We believe it is still early and prefer short both bonds and stocks vs favoring long bonds in the US today. We have remained resolute that a soft landing is not likely in the US and that growth, inflation, and monetary policy will remain higher for longer. At some point over the next six months, it may be time for a great convergence between stocks and bonds in the US, but today is not that day.

A reminder of our framework

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 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

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. We also strongly believe that Asian markets must provide monetary and fiscal stimulus and likely will be quite easy. Cash is Trash in Asia.

Bonds or stock?

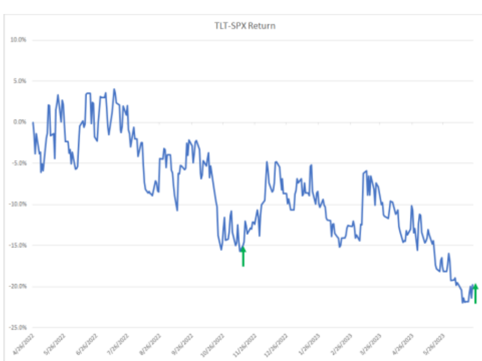
Our criteria for bond outperformance vs stocks are:

- Relatively high growth and inflation expectations giving room to fall.
- 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

Over the last six months, inflation in the US has proven quite resilient, growth remains close to trend, employment is tight, and the effects of QT has been offset by Janet’s choice of bills issuance. However, the rates curve continues to price in significant cuts and inflation expectations are at target. The impact of this suspicion regarding on Fed projected rate policy leaves the real economy with easier than desired financial conditions and a significantly negative term premium for long term bonds. Essentially, long term bonds remain rich. As we have mentioned the lack of supply from issuance by Treasury and significant demand from those who expect an imminent recession has lowered the effective discount rate on equities and generated strong relative performance. We have been in the higher for longer camp for almost a year. We are confident that the Fed will do what it takes to reduce core inflation to target. However, until supply from Treasury arrives, or recession enthusiasts capitulate, the economy will remain stronger than expected. Stock market strength driven by low discount rates and ok earnings will not generate meaningful job cuts. Without jobs cuts, demand will stay high. We believe that long term rates rising to cycle highs leads to falling equity prices, which leads to job cuts which leads to demand destruction which leads to falling growth and inflation. Without a selloff in the long end of the US Treasury market, there is no reason for equities to fall and thus no reason for job cuts to follow. For these reasons it is clear the Fed has quite a bit of work ahead. Cash is King in the US and Assets are trash. Though we expect by year end it will be appropriate to buy bonds and sell stocks it remains too early.



Germany

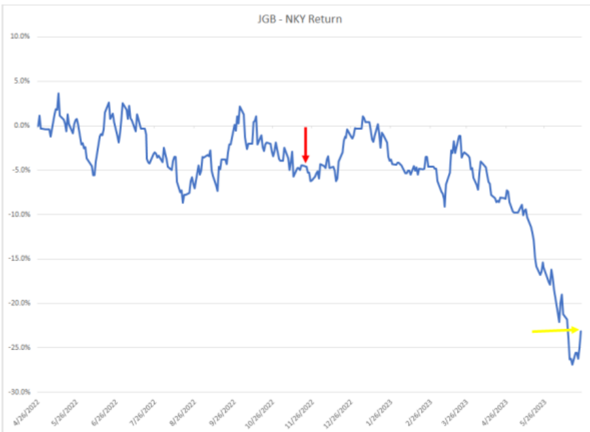
Eurozone monetary policy has not come close to being restrictive. Long-term real yields have just become positive. The balance sheet policy of the ECB has finally stopped APP reinvestment. The economy is already expected to be or is in a recession. Europe has a stagflation problem. They also have a single mandate. 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 has just begun to catch up. 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. Over the last six months we have been early in this call. Assets did ok primarily due to stock price moves. We expect the rest of 2023 will be unkind to assets. We were very optimistic about European equities six months ago particularly versus bonds. We are more balanced at this stage and while we still favor equities over bonds our view on assets is a stronger negative signal today than our relative asset signal.

UK

The UK has recovered from the LDI crisis, however the path of the battle to fight inflation remains long and difficult. A large stock market outperformance has led to better valuation in bonds. Assets have underperformed cash, yet the UK has the steepest front end yield curve of all developed markets. Bonds price economic strength as do equities. We are less sure about assets but favor bonds over stocks.

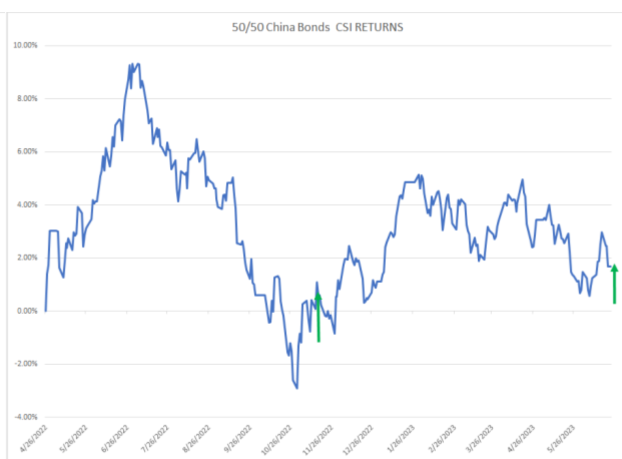
Japan

Japan ticks virtually all our boxes for Cash is Trash except investment balance given the JGB market is uninvestable. But equities have gone substantially higher, generating significant returns vs cash and bonds. This was our call, but we can no longer support assets in Japan nor the equity market over bonds due to excessive valuation and a likely foreign flight as the Yen continues to weaken. We have gone from cash is trash and equities over bonds to neutral on both the asset market and equities markets.



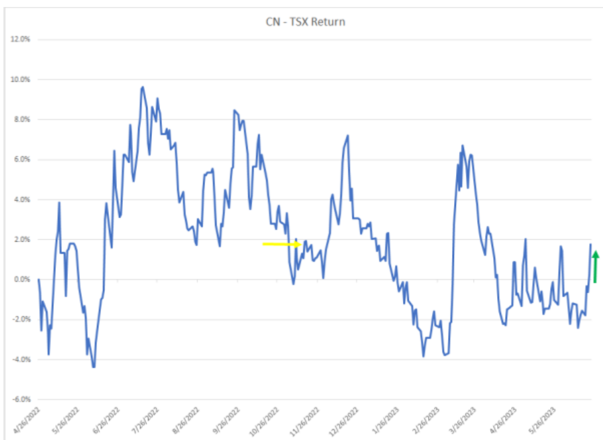
China

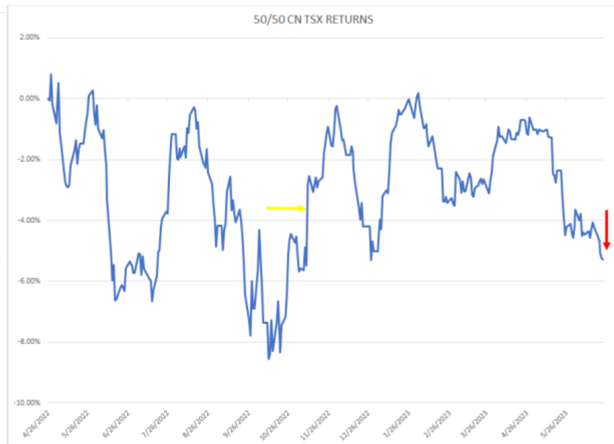
China represents a classic dilemma; this market is optimal in basically all ways for investing. Except the biggies of rule of law and capital controls. We take seriously those obvious problems. Nonetheless we consider China exposure to be so attractive and priced so cheaply that investing in China makes sense to us in 2023. We would have China in the far lower right of our investment landscape chart but for these barriers. We are highly concerned about CNY and expect considerable weakness in the next six months. However, on a currency hedged basis, we favor equities over bonds and assets vs cash.



Canada

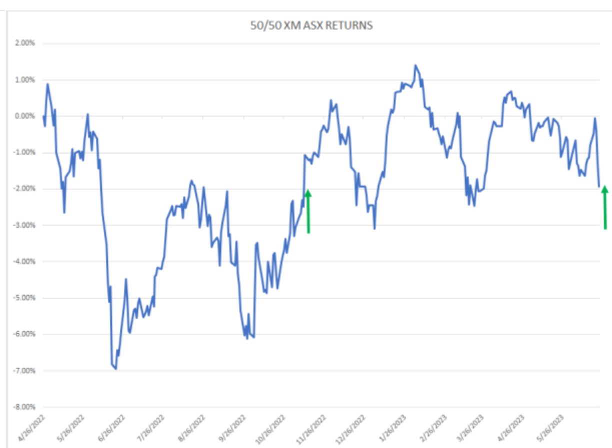
The recent surprise hike in interest rates and a more serious attempt to cool the Canadian economy has flipped our indicators to favor bonds over stocks and cash over assets from neutral. We don't have a strong view on the Canadian market but eventually the economy will weaken, and cash is king.





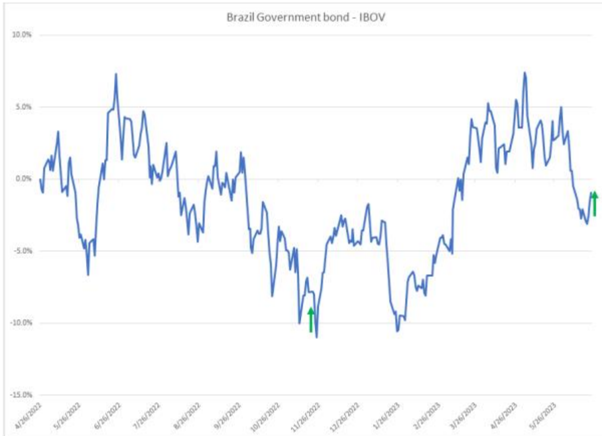
Australia

Australia is at risk to the generally weakening Asian economies. China and Japan will need significant fiscal and monetary stimulus but have yet to do enough. Over the next six months assets have a tailwind due to expectations of easing Asian conditions but it will be mild. We are modestly positive assets in Australia but neutral stocks vs bonds.



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 economies have had persistent inflation and too easy financial conditions leading to modest gains in assets over cash and strong gains in equity over bonds. We believe that over the next six months conditions will tighten favoring cash over assets and various economies will slow. Equity valuations are high in almost every equity market and as the local economies slow bonds will begin to offer favorable returns over equity. However, that may be toward the end of the next six months as central banks finally reach restrictive levels of policy. Today our positioning remains short assets and only after a selloff in long term bonds across the globe will we shift from short assets to the great convergence positioning of short equities and long bonds. All out metrics indicate all global markets are reaching an inflection toward this sort of positioning except China where significant easing and fiscal stimulus will make Chinese assets attractive and Yuan absolute trash.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 48,263,488		
Total Return	48.26%	YTD Return	2.96%
Today's Date	6/26/2023	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Close
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	0.05	$ (976,190)	Open
5/24/2023	SPX June 30th 4000 Put	42.75	468	$ 2,000,000	1	$ (1,953,216)	Open
5/24/2023	NDX June 30 13250 Put	199.00	25	$ 500,000	1	$ (497,487)	Open
5/25/2023	NDX August 13000 Put	250.00	60	$ 1,500,000	50	$ (1,200,000)	Open
6/2/2023	SPX Iron Condor 6/30 4290/4320/4350 JHEQX	25.50	-2225	$ 1,000,000	25.5	$ -	Open
6/9/2023	SPX Call Spread August 4320/4400	48.00	-625	$ 2,000,000	51	$ (187,500)	Open
6/9/2023	SPX August 4185 Put	48.00	625	$ -	34	$ (875,000)	Open
6/15/2023	SPX Iron Condor Put Wing Trade	5.00	2225	$ -	7	$ 445,000	Open
2/1/2023	SFRZ4 ShortTwos and Spoos	97.085	-1600	$ 2,000,000	96.25	$ 3,340,000	Open
5/18/2023	ZNU August 112.5/116.5 Call Spread	1	-333	$ 1,000,000	1	$ -	Open
5/31/2023	ZF AUGUST 107.5 Puts 7/21/2023 Expiry	0.4921875	4063	$ 2,000,000	0.5	$ 31,746	Open
5/17/2023	NVDA 280/300 Call Spread	11	-111	$ 100,000	15.5	$ (50,000)	Open
5/17/2023	AAPL 160/175 Call Spread	9.8	-192	$ 100,000	13.89	$ (78,654)	Open
5/17/2023	AMZN 105/115 Call Spread	6.42	-279	$ 100,000	8.85	$ (67,877)	Open
5/17/2023	GOOG 110/120 Call Spread	6.57	-292	$ 100,000	7.4	$ (24,198)	Open
5/17/2023	META 230/245 Call Spread	8.4	-152	$ 100,000	10.9	$ (37,879)	Open
5/17/2023	MSFT 300/315 Call Spread	9.47	-181	$ 100,000	12.84	$ (60,940)	Open
6/15/2023	DS Beta Short Component GLD	181.87	(50,621)		178.2	$ 185,779	Open
6/15/2023	DS Beta Short Component SPY	443.13	(5,498)	$ 500,000	433.21	$ 54,544	Open
6/15/2023	DS Beta Short Component TIP	107.905	(23,169)		107.89	$ 348	Open
6/15/2023	DS Beta Short Component GSG	19.7547	(50,621)		19.53	$ 11,375	Open
6/15/2023	DS Beta Short Component TLT	102.825	(29,176)		103.33	$ (14,734)	Open