The Damped Spring Report

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

2/21/2024

The Year of The Dragon has just begun. Damped Spring has gone long Chinese equities as a moderate confidence contrarian play – a bet that over the course of 2024, extreme international bearishness on China's economy and asset markets may reverse. A reversal in sentiment will be caused by China's top economic policymakers acting to begin engineering a "beautiful deleveraging". Will they succeed? That is a question for later in the year. Investing in China is a challenge for all investors. Like all investors, we should approach China with low confidence, having patiently avoided China for years. While we are confident that China's policymakers have the means to address the economy's current painful deleveraging, we are not yet confident that they are willing to take the necessary steps. Our contrarian investment assumes market participants are incorrect in their current belief that policymakers are both unable and unwilling to act.

The specific catalyst for buying Chinese equities late last month was primarily a technical one related to the unwind of "Snowball" structured products. However, we have also noticed the drumbeats of policymakers shifting toward support for the markets and the economy in a way that is consistent in turning what has been an ugly deleveraging phase into, as Ray Dalio described for the US in the GFC, a "Beautiful Deleveraging". We are betting in a small way that the equity markets will rally 10-20% in the near term. If, in fact, the deleveraging turns beautiful, China will become a legitimate place to deploy beta capital. Its early in the Year of the Dragon.

China has performed horribly for asset holders for over a year.

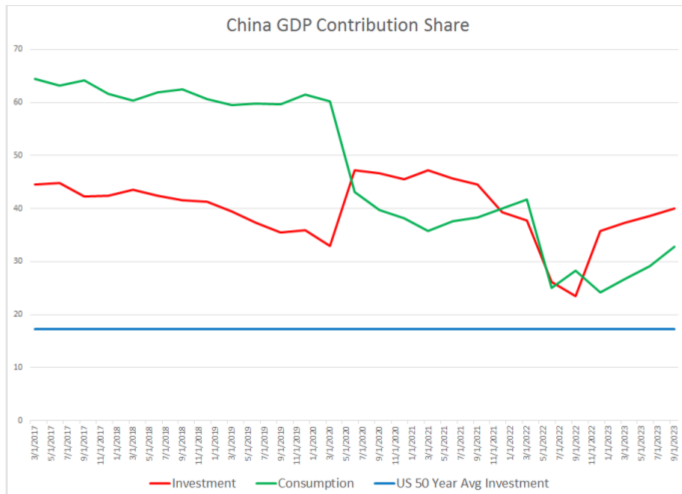
Since Covid only Chinese and UK assets are down

Chinese stock markets are at new lows.

Institutional holdings of Chinese equities are at a long-term low.

China’s asset performance reflects the deleveraging

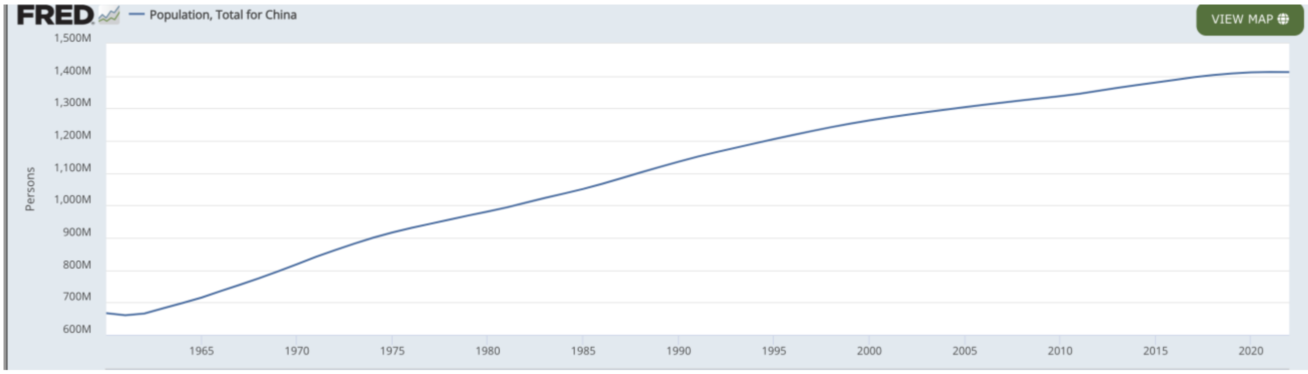
The poor asset performance, led by a 60% decline in China’s equity markets since the post-Covid peak, makes complete sense in the context of a balance sheet deleveraging. China’s economy has for decades been driven by Private Investment as a matter of Chinese government policy priority. That has led to great prosperity and improvement in the living conditions of the Chinese society, but also to a bubble in real assets. China has overbuilt and over-leveraged its economy to finance that build out.



Private sector credit as a % of GDP has now stalled at over twice GDP:

China’s real estate bubble burst long ago:

Stepping way back, population has flatlined:



Growth has declined sharply:

Inflation, which never rose as it did in the West, has shifted to deflation.

The Chinese economy has all the characteristics of an overbuilt economy with high leverage in a debt deleveraging phase.

Beautiful Deleveraging?

Ray Dalio described in his book "Principles for Navigating Big Debt Crises" the mechanics of deleveragings and policymakers' choices which can lead to an ugly or "beautiful" deleveraging. Instead of paraphrasing his words and doing them an injustice, here they are. We think China is nearing a crossroads in the Depression phase of their deleveraging and are looking for signs that they will manage the next step well. We are confident they have the ability. We will see about the willingness.

In summary, when all is said and done, only a few things distinguish whether a deleveraging is managed well or poorly. I have outlined them below. A lot of pain can be avoided if policy makers can learn from the common pitfalls and understand the policies characteristic of beautiful deleveragings.

	Well Managed	Poorly Managed
Bubble	• Central banks consider growth in debt and its effects on asset markets in managing policy. If they can prevent the bubble, they can prevent the bust. • Central banks use macroprudential policies to target restraints in debt growth where bubbles are emerging and allow debt growth where it is not excessive. • Fiscal policies are tightened.	• Big bubbles are fueled by speculators and lenders over-extrapolating past successes and making further debt-financed investments, and by central banks focusing just on inflation and/or growth and not considering debt bubbles in investment assets, thus keeping credit cheap for too long.
Top	• Central banks constrict the bubble either with the control of broad monetary policy or with well-chosen macroprudential policies and then ease selectively (via macroprudential policies).	• Central banks continue to tighten well after bursting the bubble.
Depression	• Central banks provide ample liquidity, ease short rates quickly until they hit 0%, and then pursue aggressive monetizations, using aggressive targeted macroprudential policies. • Governments pursue aggressive and sustained fiscal stimulus, easing past the turn. • Systemically important institutions are protected.	• Central banks are slower to cut rates, provide more limited liquidity, and tighten too early. They also wait too long to pursue aggressive monetization. • Governments pursue austerity without adequately easing. • Systemically important institutions are left damaged or failed.
Beautiful Deleveraging	• Reflations begin with aggressive monetizations through asset purchases or big currency declines, enough to bring nominal growth above nominal rates. • Stimulative macroprudential policies are targeted to protect systemically important entities and to stimulate high-quality credit growth. • Nonsystemically important institutions are allowed to fail in an orderly way. • Policy makers balance the depressive forces of defaults and austerity with the reflationary forces of debt monetization, currency declines, and fiscal stimulus.	• Initial monetizations stutter and start. Asset purchases are more muted and consist more of cash-like instruments rather than risky assets, so that purchases don't produce a wealth effect. Stimulation of the central bank is undermined by fiscal austerity. • Overindebted entities are protected even though they are not systemically important, leading to zombie banks and malaise. • Ugly inflationary depressions arise in cases where policy makers allow faith in the currency to collapse and print too much money.

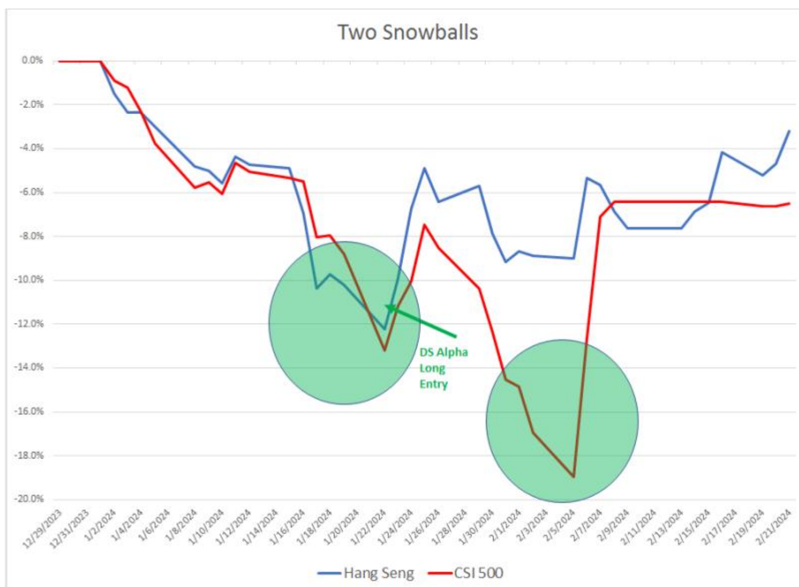
Sentiment, on the other hand, is heavily bearish on the outlook for the Chinese economy. We see in front of our own eyes all the negatives:

- Declining population growth.
- Capital flight.
- The vilification of entrepreneurs, e.g., Jack Ma.
- Command economy and its frictions.
- The sheer size of the deleveraging.
- Xi's goals have conflicted with traditional economic goals.
- Geopolitical uncertainty.

The obstacles are large and obvious and stand in the way of long-term investing in China. We have low confidence on the timing and effectiveness but believe that China's policymakers, unlike those in other countries, have tremendous resources, that have accrued to them for decades, to execute. The market seems to discount both Chinese leadership's ability (given the obstacles) AND willingness. We think that's enough to enter a position long Chinese equities and have done so. Why now? We think the equity markets have been distorted lower due to structured product related selling that gave us a good entry. We will add if we see signs of policymaker actions that reinforce actions taken over the past few weeks. If so, we will add equity risk and perhaps bond risk and also add these assets to our DS Beta portfolio. Currency hedging is for later in the year. For now, we are willing to be exposed to currency as we expect the PBOC to use some of its resources to support the currency.

Snowball

Damped Spring has deep understanding of the impact of structured options product on the underlying markets they reference. In late January, first the Hang Seng and then the CSI 500 small cap index were impacted by options hedging flows related to what are called Snowball notes. More details here.



The barrier options in these structures were all triggered during these drawdowns (likely the owners of the barriers had something to do with the drawdown). During the first washout, we went long FXI. We intended to add but did not get our level. We believe that any residual exposure is minimal or supportive. We like the entry.

Synthesis

We have entered a long position in Chinese equities due to the technical unwind of the Snowball structure and our view that policymakers' actions over the past three weeks, including rate changes, a commitment to provide funding for technology investment, and less effective market manipulation measures, bode well for more forceful action in the months to come to shift the ongoing deleveraging from ugly to the beginnings of beautiful.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 61,806,895		
Total Return	61.81%	YTD Return in excess of cash	2.93%
Today's Date	2/21/2024	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
2/8/2024	CLK4 Long 80 Call	2.13	469	$ 1,000,000	2.14	$ 4,695	Open
12/13/2023	ESH4 Two's and SPOOS (doubled on 1/12/24)	4,764.00	-200		4985	$ (2,210,000)	Open
1/19/2024	NDX 3/15/2024 17000/16300 Put Spread	89.00	112	$ 1,000,000	100	$ 123,596	Open
12/22/2023	SPX 3/15/2024 4600 Put	54.40	184	$ 1,000,000	6.21	$ (885,846)	Open
2/2/2024	SPX 3/15/2024 4600 Put	14.00	714	$ 1,000,000	6.21	$ (556,429)	Open
2/15/2024	SPX 3/15/2024 4950/4750 Put Spread	26.00	192	$ 500,000	40	$ 269,231	Open
2/7/2024	"David Hunter" +7/24 5400 C - 12/24 5400/5600 CS	(22.00)	500		-23.43	$ (71,500)	Open
1/23/2024	FXI	22.80	438596	$ 500,000	23.6	$ 350,877	Open
2/13/2024	ZBM4 3/24/24 117/115 Put Spread	0.5625	6400	$ 3,600,000	0.58	$ 100,000	Open
2/13/2024	ZNM4 3/24/2024 108 Put	0.2582	5070	$ 1,309,074	0.21875	$ (200,012)	Open
11/28/2023	ZTH4 Two's and Spoo's (doubled on 1/12/24)	102.58	-450		102.00	$ 520,313	Open
12/27/2023	"Sell All Assets Basket" SPY	475.80	-15763		496.03	$ (318,884)	Open
			Risk	9.909%		7.3%	