The Damped Spring Report

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

5/18/2020

We are doubling up on our bond position and adding short SPX.

Global equity markets are spiking based on two positive news items

- Chair Powell's appearance on 60 Minutes
- News of early positive results on a vaccine from Moderna

As you know from the report below reprinted from last week, we sold out of our long equity and gold positions which we have held since early April. On Thursday we sent a brief note recommending a position short long bonds via put spreads. Today we suggest doubling up on the long bond spreads to a max position and starting a short on the SPX through the purchase of Sept 2800/2500 Put Spreads.

As mentioned below we continue to believe that the money tsunami and valuation will ultimately drive the SPX to 3150 and bonds to meaningfully higher yield levels driven by medium term risk premium contraction and demand side inflation. However, we do know that the Fed has tapered purchases of financial assets meaningfully, while over the next few weeks government issuance will be quite large requiring other assets to be sold or investor leverage to be increased in order to accommodate the necessary cash to fund the stimulus financing. Further we expect the stimulus money to slowly reach consumers and investors. That imbalance will generate a risk premium expansion creating a headwind on all financial assets over the next six weeks.

We are max short bonds both at the front and the back of the curve. The asset headwind will hurt bond prices, additionally if we are wrong on growth expectations it will be toward higher expectations as economic unlocking and virus prospects improve growth. If we are wrong on the money tsunami being temporarily overwhelmed by supply inflationary pressures will replace risk premium headwinds. Either way bonds weaken.

Our view on equities is developing. Tactically we believe the risk premium headwind is the largest driver short term. Additionally, we expect the optimism of today's drivers to fade. For those reasons we are adding the tactical (not max) SPX Short.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	11,621,135					
	Total Return	11.62%					
	Today's Date	5/18/2020		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
4/13/2020	FV Sept 124/122 Put Spread	0.296875	3368	1,000,000	0.09	(684,211)	Open
4/13/2020	FV Sept 124/122 Put Spread	0.234375	4267	1,000,000	0.09	(600,000)	Open
5/14/2020	US Sept 175/170 Put Spread	1.015625	985	1,000,000	1.203125	184,615	Open
5/18/2020	SPX Sept 2800/2500 Put Spread	67	149	1,000,000	67	-	New
5/18/2020	US Sept 175/170 Put Spread	1.203125	831	1,000,000	1.203125	-	New

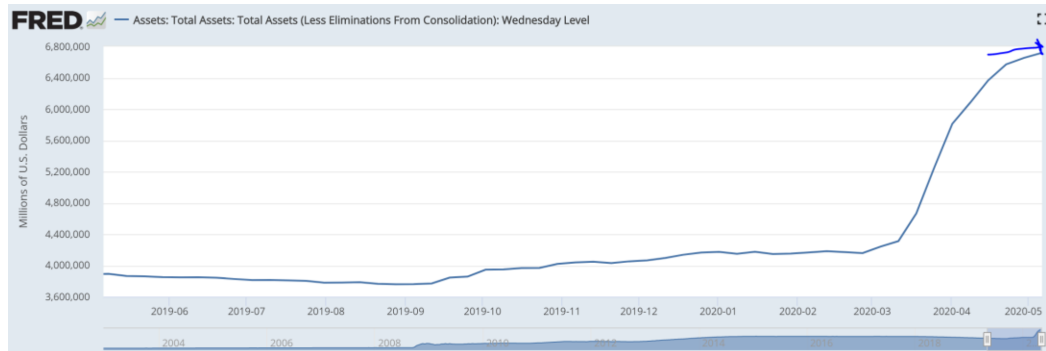
5/13/2020

Money is getting tight as the Fed buys less and Treasury issues more.

Since the Fed unleashed the Money Tsunami and the Treasury announced massive stimulus, we have been max bullish equities. We have also valued equities using a quite bearish earnings outlook and yet found equities to be worth about 3150. We believe that equities are still "cheap" but given the short term flows we are no longer bullish equities.

Our principle reason for being long equities, and gold for that matter, has been the huge wave of money being printed and handed to those in the real economy. But as we have said in the past, the wave of money ebbs and flows. With that motion, asset price risk premiums contract and expand.

Risk premiums are likely to expand over the next 6 weeks as corporate issuance is exploding and 3TN of UST are going to be sold, while asset purchases/money printing by the Fed is slowing. The Fed will step up the pace as the issuance comes through but short term crowding out is our base case.



Our 2020 outlook for the financial markets remains intact. When stepping back and viewing the impact of monetary and fiscal policy we believe asset markets will be supported by excess printing relative to needs in the real economy resulting in risk premium contraction and asset price inflation. We also predict that an inflation scare will drive inflation expectations above target as demand picks up with little wage pressure or materials inflation. A combination of excess liquidity, nominal revenue growth, and margin expansion will support equity prices driving equities higher over the next six months. Gold should also benefit from excess liquidity and an inflation scare. However, the timing and size of the flows matters to our short-term outlook. Though some of the flows are well known, their sheer size means that the market impact cannot be fully discounted by market participants ahead of the flow. They will leave a mark.

Reviewing QE

Quantitative Easing of the post GFC variety is no longer viable. The Covid related slowdown has required coordinated monetization of aggressive debt financed fiscal spending.

QE worked in the US but was mostly a failure in Europe and Japan. For QE to work the central bank buys treasuries and the seller buys something riskier like a corporate bond. In the US the seller of the corporate bond was the issuer themselves who then purchased equity. The seller of the equity either consumed or invested in the real economy and the printed money had its desired stimulative effect.

Outside of the US this mechanism stalled as investors were simply unwilling to take on additional risk and the corporate levered share repurchase activity was not present. QE in the US became less effective as risk premiums contracted and it is possible the share repurchase mechanism is temporarily out of order due to political consideration.

Debt monetization

Coordinated monetization of debt financed fiscal spending avoids the middleman of the market. The Treasury hands money directly to real economy consumers and investors and the debt used to finance the spending is bought by the Fed with printed money. To the extent that consumption occurs that contributes to GDP and to the extent the money is saved or used to pay down debt it is invested in the real economy or the financial markets. The machine operates effectively and directly. The hard currency implications will be discussed in another DSR.

The framework for understanding the debt monetization process depends on:

- The size of the Fiscal Spending
- Who gets the money and what do they do with it
- How much does the Fed print
- The timing of the above factors

Playing with this framework

Case 1: Treasury hands all the money to savers, Fed does nothing. Too Cold.

> In this case savers recycle the money into financial assets and real economy investments. The recycled money flows back into the treasury market and buys up all the debt the treasury has issued. This case has limited economic impact and limited impact on financial assets

Case 2: Treasury hands all the money to consumers, Fed does nothing. Too Hot.

> In this case the economy roars as consumers spend. However, investors suffer significant losses as Treasury issuance to fund the consumption crowds out other forms of investment and results in significant risk premium expansion

Case 3: Treasury hands money to a mix of savers and consumers and Fed prints. Just Right.

> Goldilocks. When the Fed magically prints exactly the amount of money to fund consumption, the economy grows and the net issuance above the Fed purchases is purchased by the recycled savings of the balance of the Treasury money gift. As there is no crowding out effect from the issuance risk premiums are stable.

DSR Case: Treasury hands money to a mix of savers and consumers. Fed overprints

> Our base case is that the mix of savers and consumer in the existing Fiscal policy favors savers, including those paying off debt, over consumers and the Fed printing further levers this imbalance with excess printing over the amount necessary to consume. The impact on economic activity is muted due to the balance of savings and consumption but positive nonetheless (perhaps another round of spending will correct that balance). But, the impact on financial markets is meaningful as liquidity from the printing drives risk premium contraction.

Notice in all the cases we did not discuss timing

Given the huge size of these flows.

- 3-5x times the already large budget deficit in issuance
- 2-4 times the increase in the Fed balance sheet
- Unprecedented unemployment and consumption options shutdowns resulting in complex consumer/saver behavior

The timing of all these flows really matters.

So far, some of the fed money printing has been implemented without any other meaningful flows. That has driven risk premium contraction, a multiple expansion rally in equity prices, a rally in gold, and has cushioned any sell off in UST due to the negative impact of the receding of the first wave of the virus.

Some of the fiscal spending has been doled out, however as most would have expected the money has not literally been delivered by a helicopter and has been a bit chaotic. We expect that the money will be delivered through time, but that impact will be more spread out than other flows. Consumers will spend as the money is delivered and savers will first pay down debt and then invest.

The issuance flow is highly concentrated into the next two months. Its well known but again is simply too large to be fully priced into markets. Investors would need to have liquidated a good portion of the net supply over Fed purchases already, to have made room for the issuance. That simply has not occurred. Thus, as the supply comes to market other assets will need to be sold, and portfolios will need to increase leverage to absorb supply. For that reason, we are no longer bullish equities or gold and remain bearish bonds as all assets reprice. It is important to note that we do strongly believe that all these assets will be absorbed by the market at a discount to current prices but not a substantial discount like in March. The Fed money printing will overwhelm these supply-oriented forces over the coming months and the money handed to savers and those who sell stuff to consumers will ultimately get reinvested into the financial markets. Our essential shift is to take profits on equities and gold and be ready to buy the dip in mid-June.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	12,033,010					
	Total Return	12.03%					
	Today's Date	5/13/2020		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
4/13/2020	SPX Sept 2800/3000 call spread	104	96	1,000,000	127	221,154	Closed
4/13/2020	GCU Sept 1750/1850 Call Spread	34	294	1,000,000	35	29,412	Closed
4/13/2020	FV Sept 124/122 Put Spread	0.296875	3368	1,000,000	0.171875	(421,053)	Open
4/13/2020	SPX Sept 2800/3000 call spread	111	90	1,000,000	127	144,144	Closed
4/13/2020	GCU Sept 1750/1850 Call Spread	29	345	1,000,000	35	206,897	Closed
4/13/2020	FV Sept 124/122 Put Spread	0.234375	4267	1,000,000	0.171875	(266,667)	Open