The Damped Spring Report

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

6/7/2020 Raising SPX Target to 3300 by 7/15. Adding year end targets on SPX to 3650 and Long Bond Yield to 2%

On April 20th we predicted the SPX would rise from 2775 to 3150 by July 1st and added a max bullish position to our portfolio. The SPX closed at 3193 on Friday and surpassed our target and generated a 15% return since our max bullish stance. We are raising our short-term target to 3300 by mid-July and expect equities to rally to 3650 before year end. Our view, at the time of our recommendation, was that equities were cheap from a valuation standpoint and that the Money Tsunami would drive significant risk premium contraction/multiple expansion while bond yields were also supportive of higher valuations.

Recently:

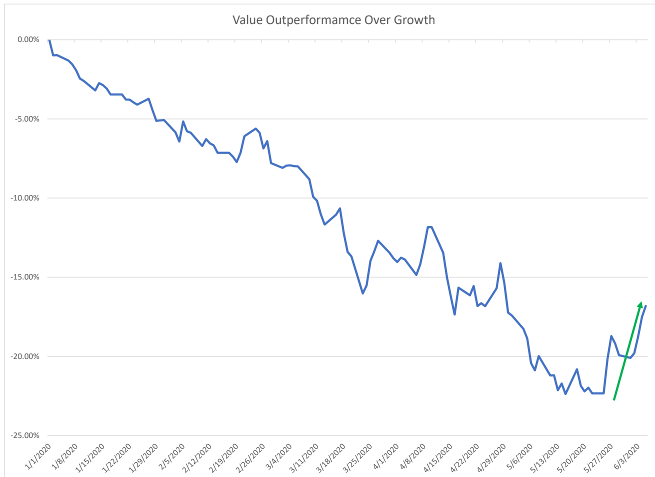
- The expected depth and length of the Covid recession has flattened
- The ECB has announced another bond buying effort to the Money Tsunami which when deployed will strengthen the already massive wave
- Though the Money Tsunami is temporarily being offset by a wave of issuance risk premiums continue to contract as asset volatility falls, portfolio leverage is being rebuilt from low levels, and diversification benefits are being realized.

Going forward:

- The expectations for the path of the virus and short-term economic outcomes to continue to shift unpredictably
- The flow of issuance will ebb into the summer while money printing will rage on and the real economy will receive and then invests or consumes the cash from the treasury borrowings driving:
    - Massive pent up demand which could result in rising inflation expectations
    - Financial assets of all sorts higher, as they will look more attractive than plentiful zero interest rate cash
    - Growth expectations higher as the virus-related volatility generates noise
- Healthy portfolios will continue to lever up

The expected depth and length of the Covid Recession has flattened

Notice Growth stocks have outperformed Value stocks until recently when Value stocks have led the rally. But why is an outperformance of value stocks a sign of rising growth expectation? Glad you asked.

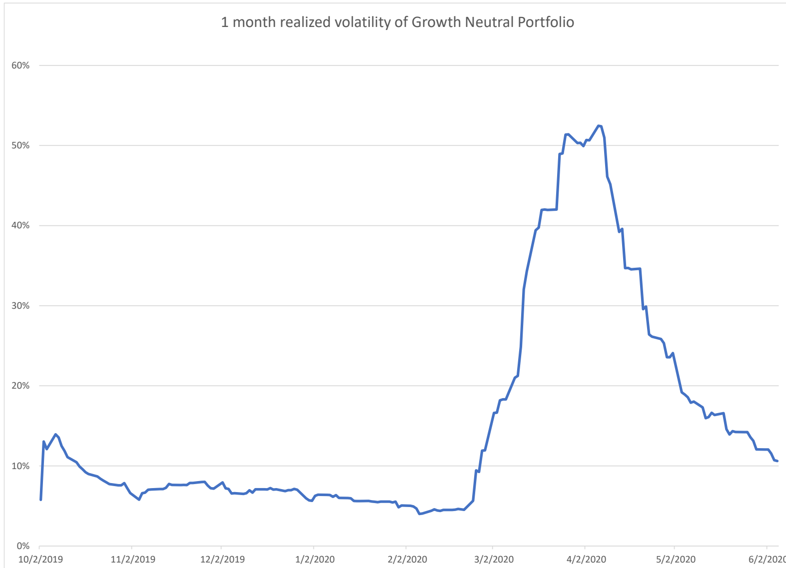


Ironically, given the names of the two groups, outperformance of value over growth is a sign of rising short-term growth expectations. Growth stocks are largely driven by long term potential earnings and risk premium contraction. **Value stocks depend on current earnings for price appreciation.** In other words, Growth stocks are a long duration asset and Value stocks are short duration. The potential depth and length of the current economic and earnings recession had destroyed value stocks while having much less effect on Growth stocks. This makes sense if your stock price is sensitive to the next two years of earnings. The recent outperformance of value stocks is consistent with rising optimism regarding the impact of the virus on the newly reopened economy.

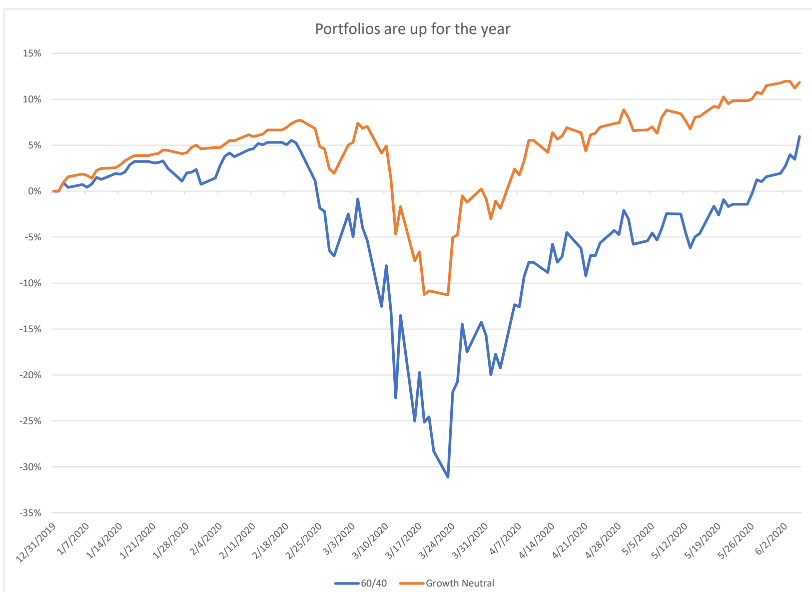
Asset volatility continues to fall, and portfolios are in good shape

SPX long term Vol makes new lows

But more importantly realized vol for portfolios continues to drop rapidly allowing portfolios to lever up



While it is unlikely that declining volatility will be a portfolio influence in the long term, as volatility falls to average again, currently as a measure of capacity to lever up and the strong performance of diversified portfolios, portfolio health is excellent.



New targets

Since our report in April where we laid out our valuation framework and established a conservative target of 3150 the SPX has rallied from 2800 to 3192. At the same time long term interest rates have been risen 50bp to 1.66% from 1.16%. All else being equal that increase in the discount rate should have lowered our target. Nonetheless we are raising our target significantly.

The 3150 target was based on an assumption that risk premiums would rise by the same amount as they did from the peak of 2008 to the bottom in 2009 **Our new**

target simply assumes that the the Money Tsunami will restore the risk premium to its Pre Covid levels by July 15. We are not increasing our extremely conservative earnings estimates for 2020 and 2021 despite the earlier discussed jump in short term growth expectations. Using the Pre Covid risk premium and current long-term interest rates we now discount future earnings at 4.06% from 4.25% in our earlier target. When put these changes through our model it delivers our July 15 target of 3300

To generate 3650 by year end we assumed a few things.

- Long term interest rates driven by both higher growth and inflation expectations but constrained by risk premium contraction will move to **2%**
- The Real economy would recover along with consensus expectations including the possibility of a moderate reinfection wave and monetary and fiscal policy would continue to be highly stimulative
- We retained our assumption that earnings would be half of 2019 levels for two years and wrote down the SPX by the current price to book multiple.
- Because of the Money Tsunami risk premiums will contract by 72bp

There remains significant upside to our targets. If earnings come in at three quarters of the 2019 level (consensus by the way) for the next two years that would result in a 150-point increase to our target. **More importantly if the Fed remains highly stimulative into 2021 or beyond the target could be many hundreds of points higher.**

Because we fully expect the Fed will not shift its stance until at least after the election we think equities are cheap and should easily meet our targets. Furthermore, long term bond yield will rise dramatically as growth and inflation expectations ratchet up.

We expect this weeks Fed meeting to be neutral. Essentially a victory dance and a repeat of past messages. We will reconsider our view if the Fed hints at any withdrawal of stimulus, but for this weeks meeting that is extremely unlikely.

Current Model Portfolio performance and Recommendations

Portfolio generated a 3.4% gain over the past two weeks. Recommendations remain the same.

	Assumed Portfolio size	100,000,000				
	LTD P/L	14,966,921				
	Total Return	14.97%				
	Today's Date	6/7/2020		Portfolio Created		4/15/2019
Date	**Position**	**Entry Price**	**Amount**	**Worst case loss**	**MTM**	**P/L**
5/18/2020	FV Sept 124/122 Put Spread	0.296875	3368	1,000,000	0.171875	(421,053)
5/18/2020	FV Sept 124/122 Put Spread	0.234375	4267	1,000,000	0.171875	(266,667)
5/14/2020	US Sept 175/170 Put Spread	1.015625	985	1,000,000	2.53125	1,492,308
5/14/2020	US Sept 175/170 Put Spread	1.203125	831	1,000,000	2.53125	1,103,896
4/13/2020	SPX Sept 3050/3250 call spread	100	200	2,000,000	129	580,000