The Damped Spring Report

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

6/29/2020 Covid fears hurt growth and Money Tsunami stalls. Great opportunity to this fear as Money Tsunami is about to rage.

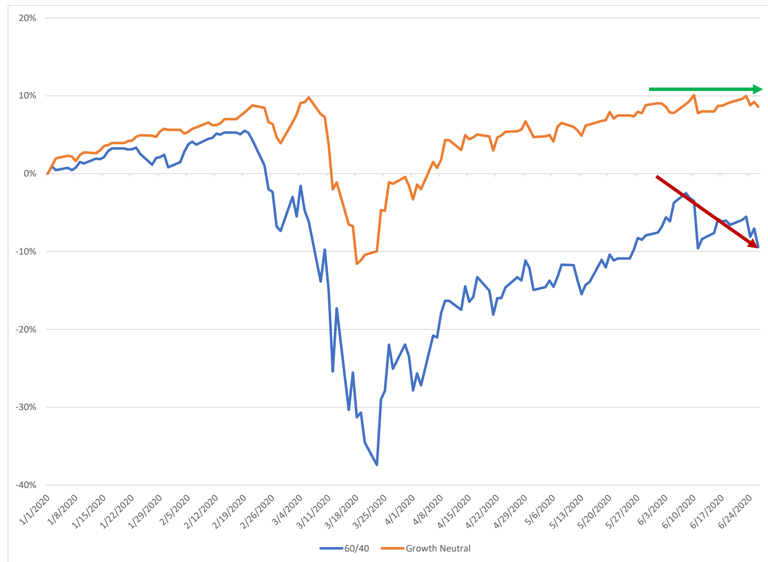
Soon after raising our short-term target to 3300 by 7/15, the SPX peaked 2% short of that level. Since then the SPX has fallen 6.8%. The cause of this selloff is almost certainly the ratcheting down of growth expectations driven by increases in Covid infections and hospitalizations. Our earnings expectations for 2020 and 2021 are still aggressively below analyst consensus and frankly the market selloff is an opportunity to add. However, we are at max risk so **can only pound the table**.

We reiterate our view that US equities are cheap even assuming a meaningful second wave of virus-related negative growth impulses. Furthermore we maintain our short term aggressive target for 7/15 of 3300 simply due to the relative over sold nature of the equity market today, strong fiscal and monetary support likely to overwhelm the virus fears, and a strong short term outlook for rebalancing flows that will be neutral at worst and possibly bullish given the repricing of the market catching month end short sellers offsides.

In this report we will:

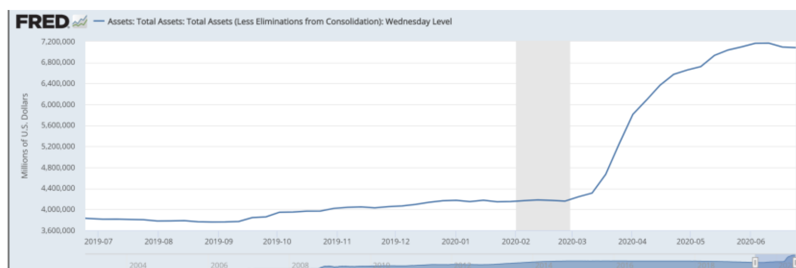
- Look back at the month of June to evaluate what drove the markets
- Provide a more detailed look at how stocks are valued, focused particularly on the "Value" stocks sensitivity to short term earnings and the "Growth" stocks sensitivity to risk premiums and interest rates
- Remind our readers of the powerful impact of both fiscal and monetary stimulus and our expectations that both will be driving risk premiums lower in the coming months regardless of the wiggles in the upward path of growth

Over the last month growth expectations fell while risk premia were unchanged. The 60/40 portfolio which is pro-growth given its heavy equity allocation fell. A growth neutral portfolio designed to benefit from risk premium contraction while unexposed to shifts in growth or inflation expectations was unchanged

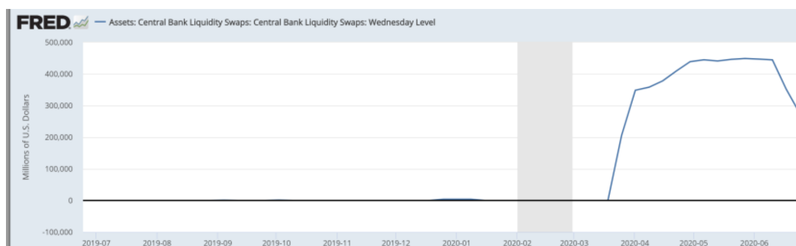


Factors impacting risk premium were mixed consistent with the zero return of the Growth neutral portfolio.

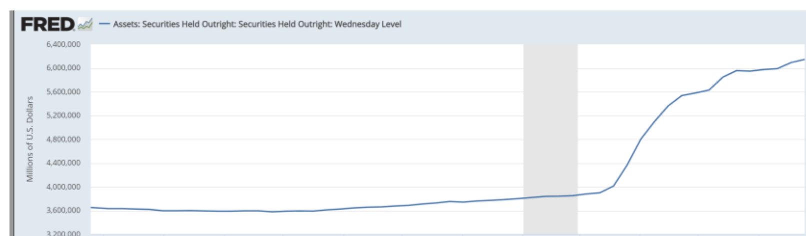
The Fed balance sheet fell which would suggest a tightening of money and credit



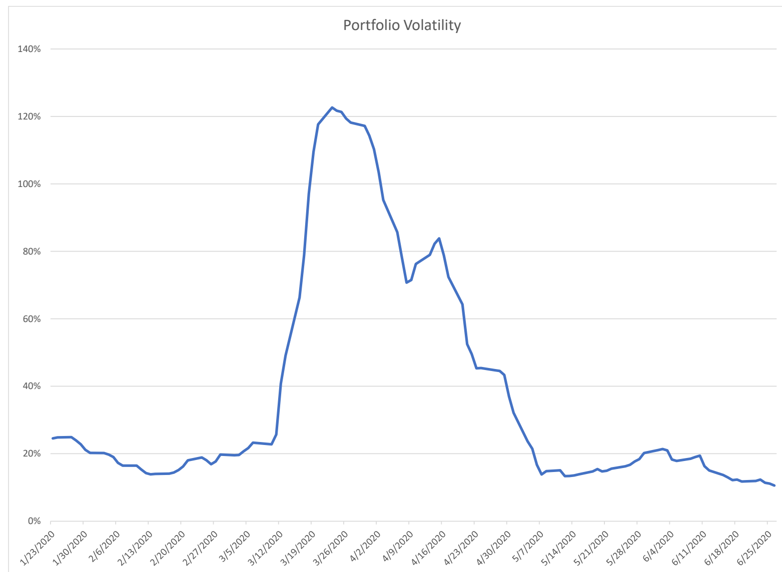
But the balance sheet fell primarily due to swap lines to foreign CB's which are a less direct form of liquidity



While Mortgage, ETF, and UST purchases continued directly impacting risk premiums



Portfolio volatility, the other driver of risk premium, continued to fall as portfolio diversification benefit was excellent while individual asset volatility rose



In synthesis, risk premia and the growth neutral portfolio that best expresses that pure risk behaved consistently with the flows and market actions that drive them. This is the big signal and will only strengthen in the months to come.

Clearly the impact of rising Covid cases in the US were evident in market action over the month. As shown above the 60/40 portfolio underperformed the growth neutral portfolio. Digging down into the move, when looking at value stocks short term earnings are quite important while interest rates and risk premia which is used to discount future flows are less important for growth stocks.

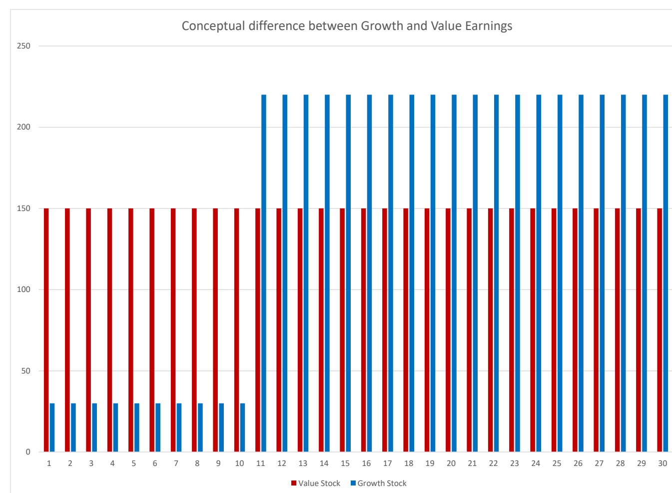
Expectations for the reopening trade got ahead of themselves. We have been quite bearish on earnings for 2020 and 2021 and were surprised that the market got so excited about growth. We have no strong opinion on the outlook for growth. The

impact of the virus will remain unpredictable. Nonetheless the reopening trade is now at its worst level since the beginning of the virus. This is bullish for equities and bearish for bonds in our opinion as fears of the virus ebb and reopening continues in the Northeast.

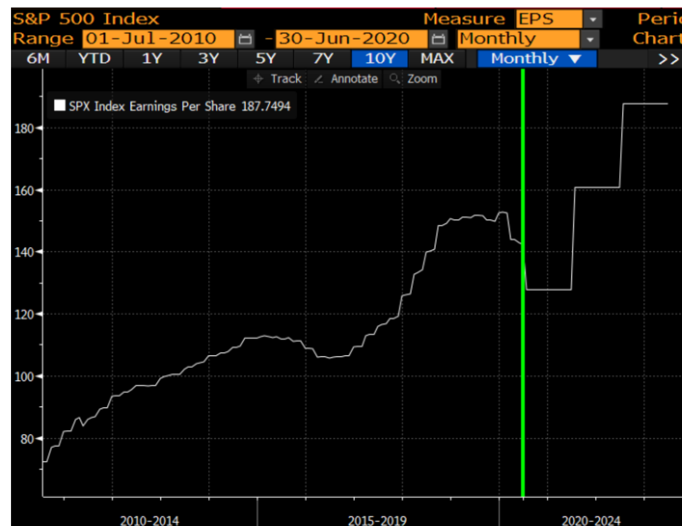
Why do we track growth vs value stocks?

The conceptual difference between "Value" stocks and "Growth" stocks offers a strong signal regarding the equity markets outlook for the path of the virus. This conceptual difference is always present but never quite as strong as it is currently.

Let's assume for this discussion that value stocks earnings are a perpetuity and growth stocks earnings are a heavily back loaded in time perpetuity. Something like this.



The path of the Covid is unknown. My assumption is that earnings will be cut in half in 2020 and 2021 and return to expected levels in 2022. Current Bloomberg Consensus forecast is wildly more bullish



The halving of earnings for value stocks in the next two years would reduce future cash flow by 150 pts. The halving of earnings for growth stocks would reduce future cash flows by 30 pts or 20% of the impact on value stocks. When value stocks outperform growth stocks such as a few weeks ago it is due to the 5x impact on earnings of a reopening.

Growth stocks are not sensitive to the short-term earnings hit. They are much more sensitive to a change in discount rate. The discount rate is a combination of long-term risk-free rates and risk premium. Since pre Covid 30-year bond yields have fallen dramatically

A drop of 50bp in the discount rate increases Growth stock NPV by 15% which is close to 40% more than it increases the NPV of value stocks. When adding the collapsing risk premium due to portfolio releveraging and aggressive FED liquidity injections the impact on Growth stocks is even larger.

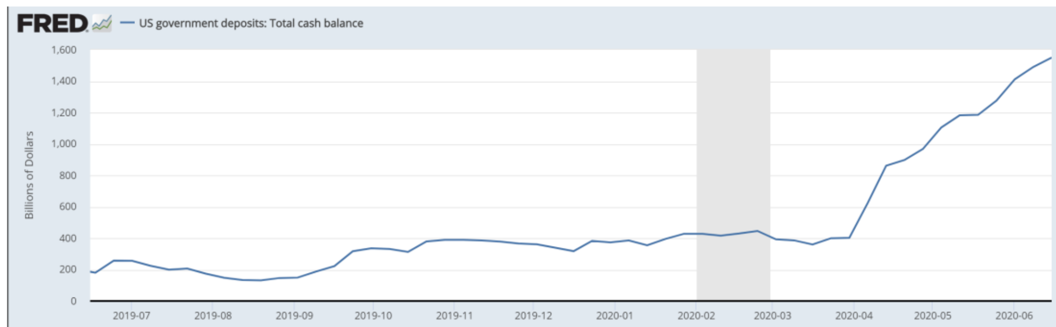
We are not sure how short-term earnings will play out but our conservative estimate of a halving of earnings for 2020 and 2021 along with portfolio releveraging and Fed printing push our estimate for year end to 3600 at least.

Please remember:

The US Treasury has borrowed and dispersed a large amount of cash swelling personal savings rates

Corporate cash was maxed at Covid bottom and will be dramatically larger in the next report

The US Treasury has a significant balance of undispersed borrowing destined for the real economy



The Fed has plans to increase its balance sheet by over $2TN by buying assets. As the employment picture remains weak and new Red States experience Covid spikes we suspect strongly that an extension of unemployment insurance benefits and another check will be sent during the summer.

Much of the UST and corporate borrowing has already occurred. The Money Tsunami is going to roll over the Covid reopening fears in the weeks to come. This will drive equities higher and when the cash gets into the real economy drive inflation spikes and growth higher. Bonds will suffer despite the liquidity injection.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	11,134,798					
	Total Return	11.13%					
	Today's Date	6/30/2020		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
5/18/2020	FV Sept 124/122 Put Spread	0.296875	3368	1,000,000	0.08	(730,526)	Open
5/18/2020	FV Sept 124/122 Put Spread	0.234375	4267	1,000,000	0.08	(658,667)	Open
5/14/2020	US Sept 175/170 Put Spread	1.015625	985	1,000,000	0.90625	(107,692)	Open
5/14/2020	US Sept 175/170 Put Spread	1.203125	831	1,000,000	0.90625	(246,753)	Open
4/13/2020	SPX Sept 3050/3250 call spread	100	200	2,000,000	120	400,000	Open