The Damped Spring Report

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

8/1/2020 Multiple Expansion is due to the Money Tsunami. Gold indicates the Money Tsunami is approaching again and will propel most assets higher

We sent this letter to subscribers last week.

> I took profits on my call of 3300 in July and went short on overly exuberant expectations of the impact of the money tsunami. I was wrong.
>
> Headlines:
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> - Raising year end forecast on SPX from 3600 to (probably 4000)
> - Closing SPX short and replacing with Long
> - Adding gold long
> - Adding to long term bond short
> - Expect a continued reflation and a spike in inflation

Since then gold has rallied 8.6% Equities are flat and long-term bond futures have rallied 1.25%. All in all, we are happy with our recommendation which was based firmly on the Money Tsunami rushing ashore. Earlier in the month our short-term momentum and value signals had indicated that equities may have topped as the markets may have gotten ahead of the money wave. These signals seem less useful during Covid. Stepping back, our outlook for the balance of the year remains bullish on equities and gold. We have refined our outlook on bonds. The drivers for our view are:

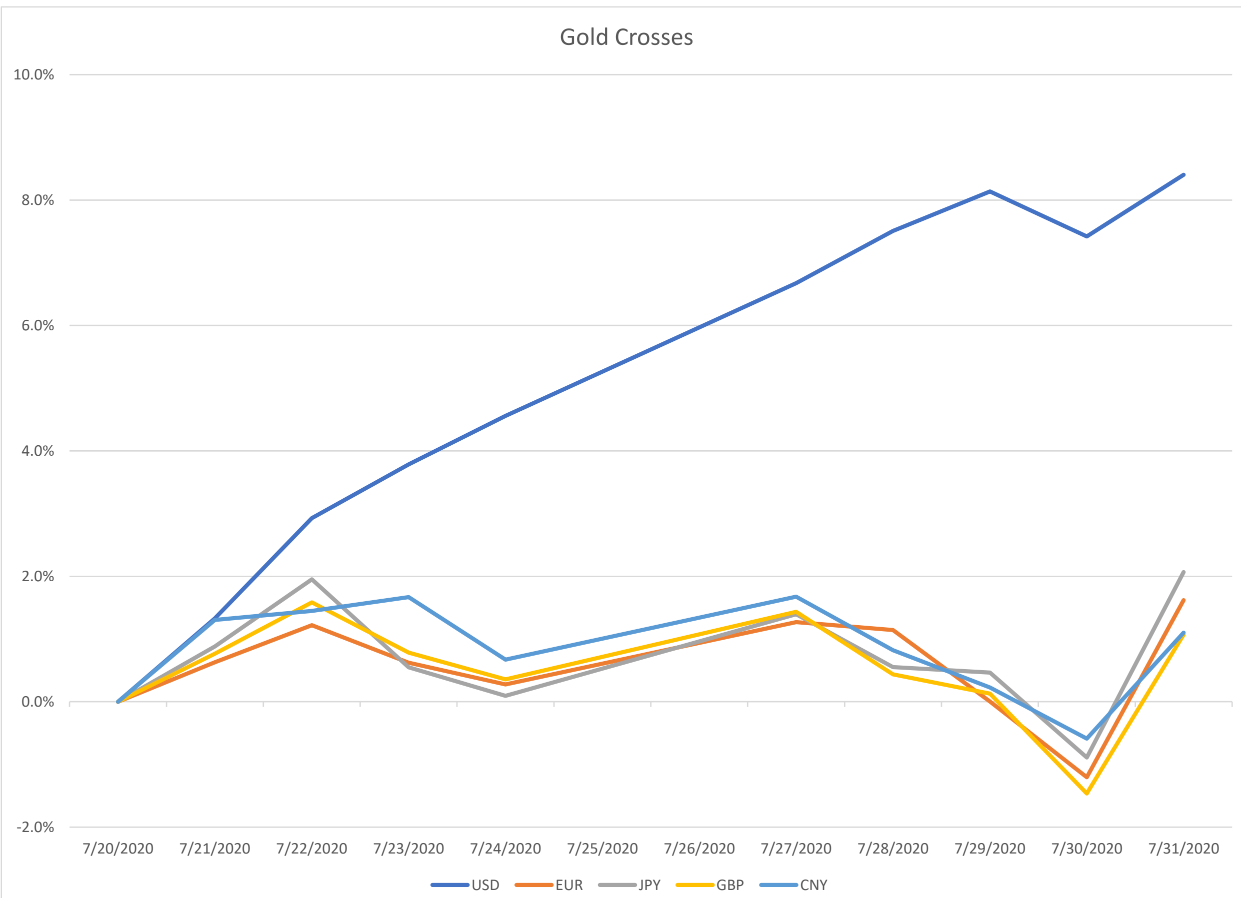
- Significant money printing – while this money printing impact is now widely understood, we believe that when the actual money is printed it will have a far greater impact on fiat currencies, asset prices, and real prices versus what is currently expected by market participants
- However, the impact of money printing will have a delayed impact on real economic growth. The transfer mechanism for money printing and low rates has typically been leveraging up by the private sector. Coordinated money printing and public sector spending requires well targeted and timely implementation. The fiscal policy portion of that balance remains slow to respond. This coordination is hard ordinarily and more so during the run up to a Presidential election. Though we are confident some agreement will be reached.

- As we expect asset and price inflation without economic growth, we conclude that our central case is a modern version of stagflation.

Equities and gold can do extremely well in such environments. Asset inflation, currency devaluation, and margin expansion can drive these assets higher despite minimal real topline growth. Bonds, in general, will be supported by below trend growth and money printing, while nominal bonds will have the headwind of rising inflation expectations. For that reason, we would suggest simply expressing that view directly by going long IL bonds and short Nominal bonds.

Gold, Fiat Currencies, and the USD

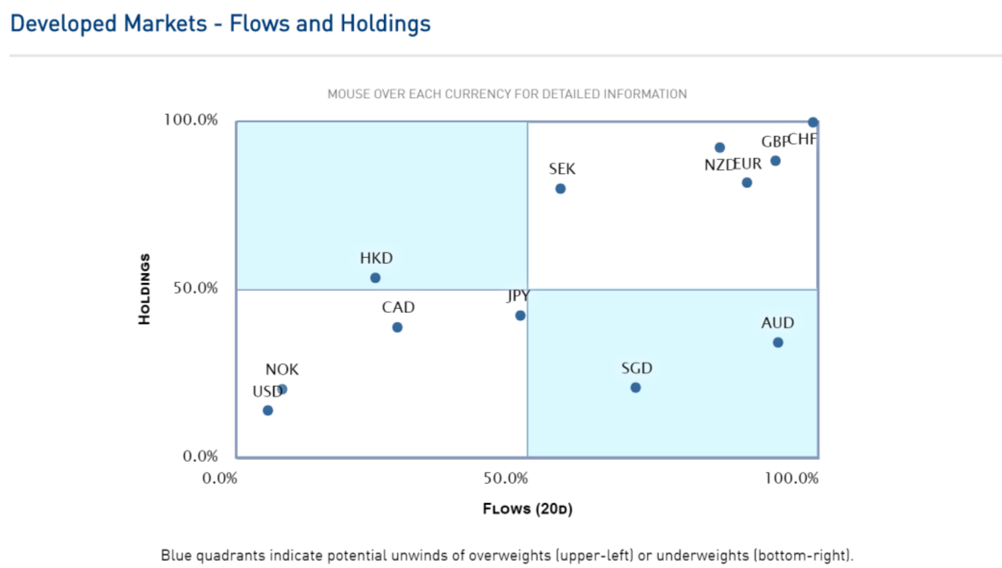
We are in no way gold bugs or Weimar Republic zealots. We do believe that gold is a currency and is impacted by pressures that influence any currency. Over the past week Gold has spiked to an all-time high.



While this move in gold has largely been a weak dollar story it is notable that all fiat currencies are down versus gold and gold is at an all-time high versus each. Gold rallying is driven by many factors but when all assets rally along with gold money printing is the most likely driver.

USD is beginning to look unsustainably oversold and underweighted vs EUR and GBP

Holdings of State Street Clients have shown significant selling flows in USD and underweighting.



The selling has also gone somewhat parabolic

We currently have no exposure to currency crosses and simply own gold. For our clients that have wisely been short USD vs anything we suspect that it is worthwhile to begin covering particularly in EUR and GBP due to the likely need for these central banks to increase stimulus to support their economies. Gold will benefit regardless.

New Target for SPX

Our current fair value for **SPX Year end is 3800 up from 3600.** Our estimate continues to be a conservative case which assumes

- 30-year yields will remain at current levels
- In 2020 and 2021 SPX EPS will be half of 2019 level
- Risk premiums will remain at around 2019 levels

30-year yields are likely to be fairly stable given positive fundamentals of weak growth and money printing and inflation headwinds preventing much of a rally. However, we see significant upside in our earnings estimate for 2020 and 2021 and risk premium contraction due to money printing seems inevitable.

Assuming earnings are 75% OF 2019 level and risk premiums contract by 25bp which are not crazy assumptions the SPX would be worth 4300.

Of course, the Presidential election will result in some volatility around these numbers. In particular a Democratic sweep would most likely result in corporate tax policy changes hitting equities by 10-15%. A split congress regardless of the Presidential result would largely be status quo regarding policy. With all that said, regardless of the election we are comfortable with 3800 minimum for SPX.

Short Nominal Bonds will not work. Shifting to B/E inflation

The Fed has been effective in increasing inflation expectations and lowering real yields. While Nominal bonds continue to rally this rally may have reached its peak. We have been bearish nominal bonds but the drop in real yields due to money printing and forward guidance has made that bet a loser. We expect significant further money printing and extension of forward guidance. Which should keep a bid in both nominal and IL linked bonds. However, as the economy recovers and reflates, we believe that a modern stagflation will take place. This means real rates will continue to be depressed by policy while inflation will spike Nominal bonds could fall but more likely will stay flat. For that reason, we expect the steady rise in inflation expectations to continue and like gold to spike in the months to come

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	11,331,454					
	Total Return	11.33%					
	Today's Date	8/1/2020		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
3/16/2020	GCZ Dec 1900/2100 Call Spread	41	244	1,000,000	81	975,610	Open
7/21/2020	SPX Dec 3300/3600 Call Spread	124	161	2,000,000	122.5	(24,194)	Open
7/21/2020	10 Year B/E swap $50k per bp	1.47	50	1,000,000	1.545	375,000	Open