The Damped Spring Report

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

8/24/2020 Inflation Expectations are rising. What does this mean for assets? Bullish Stocks and gold. Inflation expectations also will rise.

Inflation expectations are rising.

Nominal bonds have steadied at low yields while real rates, which have been falling for decades, fell further.

Driving real yields lower to push investors to consume or invest in the real economy and driving inflation higher relieving the pressure on debtors is exactly what monetary policy is attempting to do during the Covid crisis. Rising inflation expectations are driven by many factors. Understanding which factors are the drivers in this case, and how those factors will drive future asset returns, is the topic of this note.

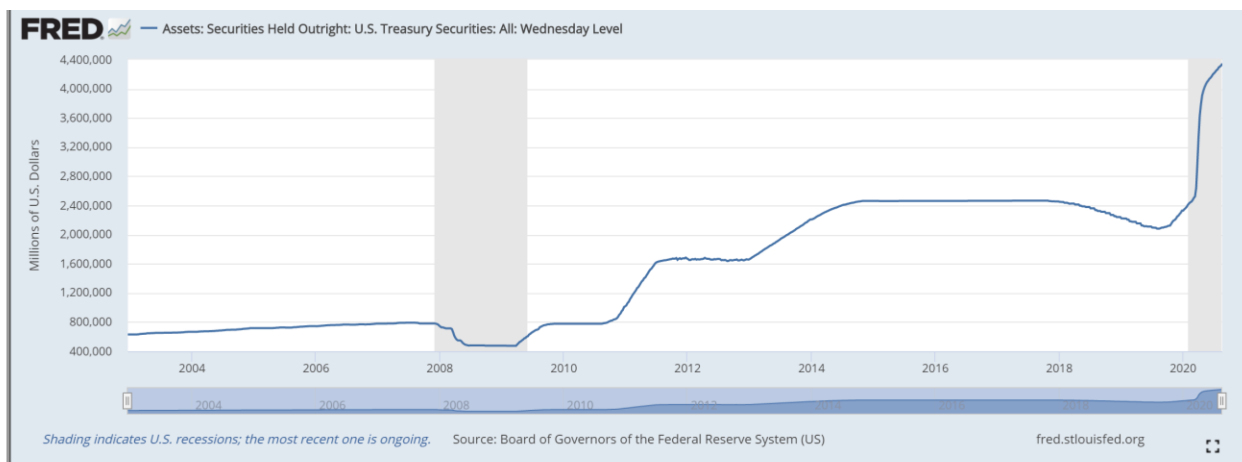
Untangling the three principle economic drivers of asset prices to isolate inflation.

Inflation never occurs in isolation. Economic growth and risk premiums are always shifting. One level down risk premiums are heavily impacted by the availability of money and credit vs. the need for money and credit in financial markets and the real economy. Risk premiums are also dependent on expected future volatility of individual asset classes and the benefit of portfolio diversification. Today and throughout history all three principle factors are shifting rapidly.

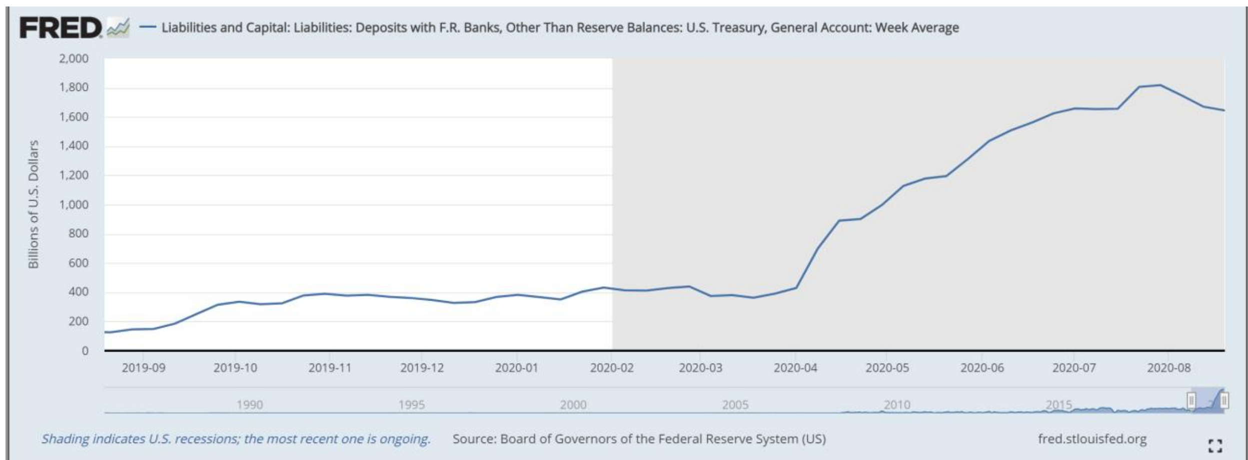
In our view, Risk premiums are likely to contract significantly over the next six months as the Fed prints, the Treasury hands money to all sectors of the economy, and asset volatility falls from high levels, and diversification benefits also may improve.   Growth is somewhat harder to predict except to say things will get better with some peaks and valleys as the virus, mitigation tactics, a vaccine, another stimulus bill, and the US Elections, creates bumps along the road to growth. Inflation however is a one-way train higher.

The inflation will not be like 70's style inflation when input costs, most notably wages and energy prices, drove inflation. Inflation in this case will be led by consumers and direct government spending as the government/Fed hands printed money to the real economy. High unemployment may indicate minimal consumer demand, but that demand hole is being filled by government transfers. It should be noted that certain prices, travel, gambling, leisure, and in person entertainment, have little or no demand and those prices and the industries that engage in these businesses are not likely to do well. However, the printed money will get spent and overall prices will rise.

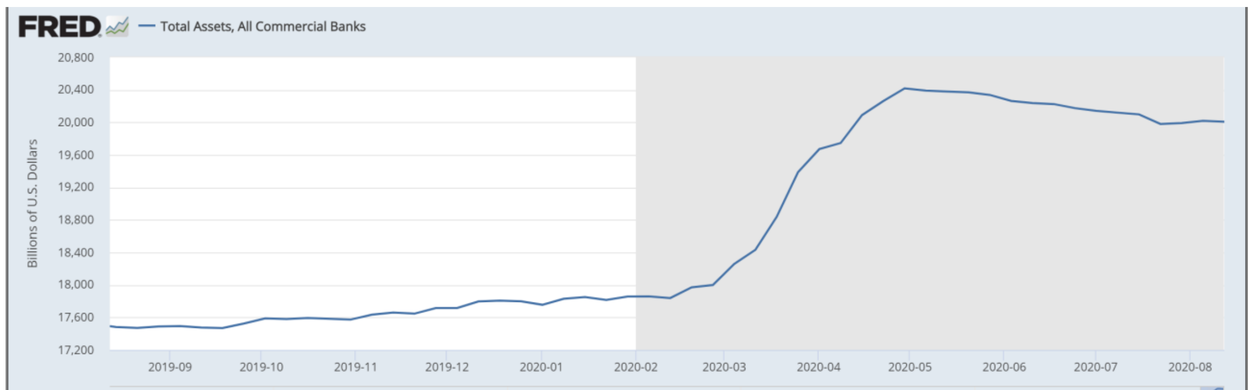
Fed Purchases are strong



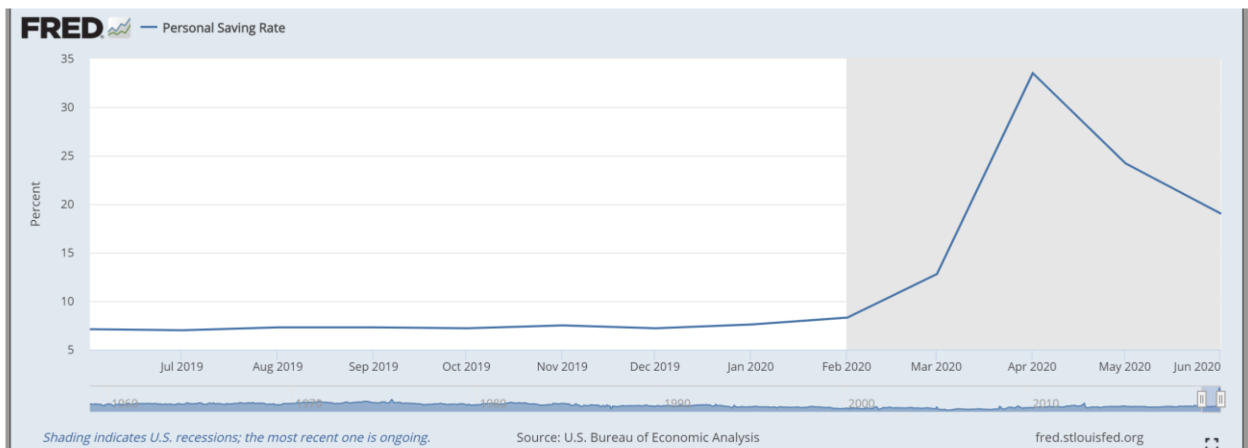
The US Treasury is just beginning to distribute funds some of which will be invested in securities and the rest to consumption and real economy investment by the recipients.



Banks have been non-factors in terms of printing money during the last three months. They may of may not build balance sheet, but they certainly have capacity to add liquidity



And as this money is distributed it will even further add to the high savings rate that exists today. Which peaked in April as consumption fell. But remains extremely high by any metric representing significant consumption soon and upward pressure on prices.



Of course, if the savings are invested in long term assets (which they aren't much) the dis-savings would be a mild headwind.

The point is:

- Corporates are flush with cash and getting more from the government through spending and tax relief they are not a source of meaningful supply.
- The US Treasury has completed its quarterly refunding. Months will go by until they represent a supply overhang.
- The US Treasury has just begun its distribution of money raised over the past few months.
- Consumers will likely dis-save near term.
- The Fed is buying at a rapid pace.

These factors suggest upward pressure on both assets (through risk premium contraction) and prices (through consumer and government spending).

Both Gold and Inflation expectations have had modest retracements during their strong rallies. We remain bullish on both.

Inflation and equities

As we mentioned above Inflation never happens in isolation. While we do not have an off-consensus view of the path of growth, we are strongly off consensus on inflation and its impact on equities. Our target is 3800 by year end. This has nothing to do with our outlook on inflation. When we consider inflation impact, we believe that Equity markets have significant upside above our target if our inflation outlook plays out.

In the 70's inflation was driven from input costs. Though money had recently been untethered from Gold it was not easy nor was much printing done to offset the Stagflation that occurred. Most importantly when became a problem Fed tightening occurred despite the slow growth. Volcker killed inflation. Will Powell. NO WAY!

In the early 1975 after the first oil crisis driven inflationary spike as inflation fell equities rose. Many take that as an indicator that inflation is inversely correlated to equities.

Further In the late 70's inflation rose, and stocks essentially did not rally and only began to rally after Volcker broke the back of inflation.

Since 1980 stocks have gone in one direction as inflation has fallen and turn to deflation. This further supports the negative correlation expectation most hold for inflation. However, the correlation does not imply causation. We believe that all these moves in markets was based on expectation shifts and actions by the Fed.

When central banks are unable to tighten to fight inflation, think Weimar or EM, equities explode upward in inflationary environments

Today high unemployment is unlikely to recover quickly and wages will remain weak. However, due to demand from printed money and transfers to consumers the demand will be strong. In this environment significant upside in margin for big cap companies is likely. More importantly with current fed dovishness to be extremely unlikely to change meaningfully if at all the threat of less tight money is low. A combination of easy money, low volatility of assets, rising margin could be an extremely strong tailwind to propel equities well above our 3800 target.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000				
	LTD P/L	12,372,859				
	Total Return	12.37%				
	Today's Date	8/24/2020		Portfolio Created		4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L
7/21/2020	GCZ Dec 1900/2100 Call Spread	41	244	1,000,000	66	609,756
7/21/2020	SPX Dec 3300/3600 Call Spread	124	161	2,000,000	171	758,065
7/21/2020	10 Year B/E swap $50k per bp	1.47	50	1,000,000	1.67	1,000,000