The Damped Spring Report

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

9/16/2020 The fiscal cliff and almost certain delay of a meaningful spending bill until after the election delivered a powerful headwind that temporarily deflated asset prices. The Money Tsunami has overwhelmed those influences. Stocks, Gold, B/E inflation back on track.

The big things for markets are:

- The FED will print a ton of money regardless of today's meeting noise
- Sometime in 2020 a stimulus bill will be enacted in adequate size to ease the pandemic pain
- Short term, the lack of a stimulus bill and the fiscal cliff are headwinds to reflation but based on the first two bullets are temporary

The election is not a big thing for markets despite the rhetoric and focus. The election represents a digital event based on corporate taxes. Isolating that specific impact is useful though it does not include less predictable long-term socioeconomic results of the election. Acknowledging the narrowness of this measure and using rough odds and tax rate shifts, the impact of the election is a most likely range of 406 pts around current SPX level with downside of 10%

Impact of the November Election on the SPX Fair value	Odds of occuring	Corporate Tax rate shift	Impact on PV of SPX
Democratic Sweep	20%	10%	(338)
Biden and Republican Senate	30%	5%	(169)
Trump and Republican Senate	50%	0%	237

But the important point here is that the elections most likely outcomes are net bullish and a Biden win with a Republican Senate is only a 5% hit. Before we leave politics which we mostly consider noise we think that the Democrats are implicitly short the stock market and the economy until Inauguration day or a Presidential loss. Knowing this fact, the Republicans can hold tight with an inadequate spending bill and point fingers. For this reason, our expectation is there is little chance of a pre-election spending bill.

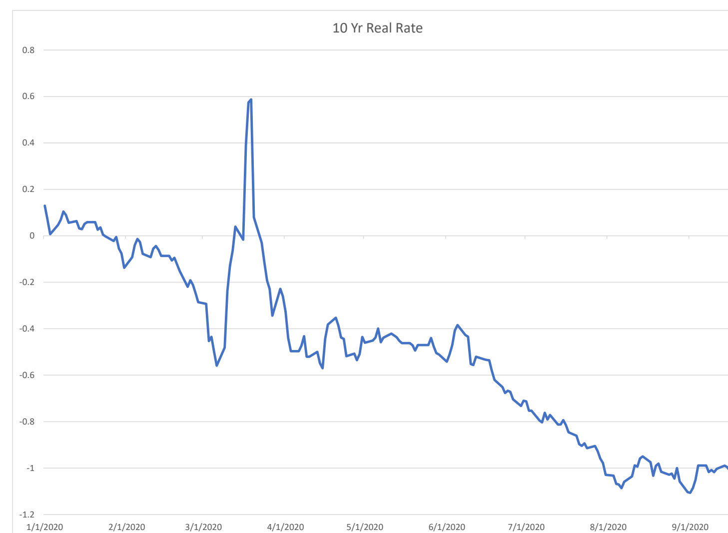
However, a delay in the spending bill is not at all the same as No spending bill. Short- term economic numbers will soften, money may have tightened, and reflation may have dipped short term. But the Fed is printing, and the the fiscal side will deliver in 2020. Buy the dip on reflationary assets today if the Fed is not adequately dovish but we think that is unlikely and believe the reflationary positions we recommend will deliver through year end.

Over the past week, the reflation trade which we believe is the long-term trend took a step back. This step back was a reaction to a combination of factors including:

- The fiscal cliff that began as the huge stimulus from April and ended in September which will likely
  - Result in softer economic data over the next few months
  - A dis-saving by consumers and corporations to offset the lack of government transfers tightening money for financial assets
- The market has sensibly moved expectations of a meaningful spending bill prior to the election to highly unlikely
- A 25-basis point rise in long term interest rates

These three factors have resulted in a short-term monetary tightening. All reflationary assets have gotten hit. Importantly nominal bonds have also gotten hit. This indicates that the factor that is impacting assets is risk premium contraction and NOT growth expectations weakening.

Reflationary assets fell sharply led by gold and importantly by stocks that as we have mentioned are most exposed to monetary tightening. The catalyst for this set back appears to be the pushing back of expectations for a spending bill to offset the immediate impact of the fiscal cliff on both economic data and dis-savings. Resulting in risk premium contraction. As the Fiscal Cliff approached real rates have both made a cycle low but have also stalled 10bp higher than the cycle low.



This back up in real rates gives the Fed some opportunity to over deliver relative to expectations but at the minimum makes the Fed disappointment risk lower.

Long term interest rates rose 25bp over the past month. This move is also part of the stock market retreat as the risk-free portion of the equity discount rate rose. Not surprisingly the long duration stocks we have highlighted as most exposed underperformed.

Today we reduce our target for the SPX for year end to from 3800 to 3600 due to long term interest rates only. Despite the target reduction we remain bullish and if another dip occurs post the Fed meeting, we will be adding a short put spread on QQQ as the ideal representation of our view.

Reducing our target is a mechanical outcome of the rise in long term interest rates. However, we also remind our readers that our valuation assumes 50/50 odds on the Presidential Election with only a 20% chance of a Democratic sweep and resultant meaningful corporate tax changes. Our target also continues to include highly conservative earnings expectations for 2020 and 2021. We can easily make the case for upside above 4000 if earnings deliver better than our expectations, the Money Tsunami remains in place, a vaccine is found, and an almost certain spending bill is delivered post-election.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000				
	LTD P/L	12,842,764				
	Total Return	12.84%				
	Today's Date	9/16/2020		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	77	878,049
7/21/2020	SPX Dec 3300/3600 Call Spread	124	161	2,000,000	168	709,677
7/21/2020	10 Year B/E swap $50k per bp	1.47	50	1,000,000	1.72	1,250,000