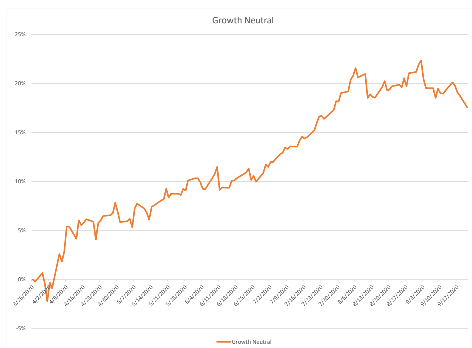
The Damped Spring Report

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

9/22/2020 The Reflation trade is dead. Powell's post Fed meeting press conference hid a subtle shift in the Fed's willingness to pursue unlimited QE which has been the driver for the reflation trade.

Based on our observation of this shift, we sent a timely note to our subscribers immediately after the press conference recommending liquidating the entire DSR portfolio of recommendations. Since then the Growth Neutral Portfolio we have created which had peaked in the beginning of September fell sharply after the Fed Press conference



The growth neutral portfolio is also inflation neutral and is a pure expression of risk premium which expanded on Powell's comment. More specifically, the S&P 500 fell 5%, Gold fell 3% and B/E inflation fell 7bp.

We have been a strong believer in the impact of coordinated fiscal and monetary policy since the lows in March. We described it as a "Money Tsunami" that would sweep all asset prices higher, despite the deep recession and consequent unemployment caused by the Covid 19 virus. Asset markets responded. Multiples on equities expanded, inflation expectations rose, and gold rallied to all-time highs. The economy improved at a much greater pace than would otherwise have occurred.

Today in front of congress Fed chair Powell may attempt to revive the wave by walking back the "lower" purchases comment and throwing the gauntlet down on immediate fiscal spending. The markets will need more than he can do. We are in cash as we mentioned in our note and will make new recommendations after the Q&A. But the headline is the reflation trade is dead.

DSR Framework for coordinated fiscal and monetary policy

The DSR framework for coordinated fiscal and monetary policy depends on some basic concepts of financial markets.

- Large scale issuance of securities (Treasury bonds in this case) requires a concession paid to investors in the form of a cheapening of the asset to clear the market
- Large central bank purchases (Treasury bonds and mortgages) requires a concession paid to investors in the form of richening the asset to clear the market
- A concession paid to investors in the form of richening or cheapening the assets is spread across all assets as the cash spent or raised on the impacted assets is raised or spent on all other assets
- Over time as large issuers or buyers leave the market some, or all, of the concession is realized by a return to the equilibrium value of the impacted asset and the other assets. This occurs as smaller issuers sell richened securities and buyers of cheap assets leverage or dis-save to seize opportunity

Before moving on, note that the fiscal stimulus created by Treasury issuance is handed to people to spend or invest and the details matter to the balance of who gets how much. We will leave this topic for another day as we are certain that no deal will occur before the election and the details will depend on the outcome

How does coordinated fiscal and monetary policy work?

- Crisis level fiscal spending is designed to offset the loss in income of corporations and individuals due to Covid 19. Proper sizing of this spending will bridge the economy to the post Covid future. This spending requires issuance which results in a weight on all financial assets even though certain fiscal spending does increase savings.
- Crisis level QE by the Fed is designed to both the liquidation of portfolios to fund consumption and more importantly to offset the issuance of Treasuries impact on assets. Proper sizing results in stability in valuations of financial assets.
- In reality, the massive flows from Fed purchases and Treasury Issuance happen at different times resulting in some noise and are of differing size and it is unlikely that both policymakers will get it exactly right

What are the possible mismatches for fiscal and monetary policy vs "Just Right" and how do those mismatches impact the economy and financial markets?

1. Not enough of both and you have deflationary recession. This was the March sell off case

2. Too much of both and you have asset inflation, real economy reflation and hot relative growth despite Covid. Essentially this was the "Money Tsunami"

that saved the economy from a deep depression and rallied all asset

3. Too much QE relative to fiscal and you have financial market disconnect with real economy. This case occurred in the late summer and was exacerbated as QE continued while chances of a fiscal stimulus bill fell rapidly. Remember the fiscal stimulus depends on issuance and as imminent issuance was delayed markets spiked higher

4. Too much fiscal vs QE you have financial assets squeezed out by Treasury issuance while real economy improves with growth and no inflation. This case has yet to occur.

In order to get case 2 again where the economy improves and risk premiums contract the fiscal spending bill will have to pass and QE will have to continue at at least the pace that has occurred since the crisis began and persist for the foreseeable future.

We are confident that after the election a spending bill will occur and would not get too worried about the delay or the composition of the eventual bill.

However, the Fed has made a statement which is likely to have been intentional regardless of any walk back we see later today. That message is that QE should not go on forever at current pace. One would have to be blind to not notice the disconnect of the financial markets with the real economy. There are speculative excesses and extreme valuations. The Fed must understand its impact on this environment. But much more importantly, the Fed must want to retain firepower in case the virus has a second wave, or the fiscal bill is inadequate or wrongly focused resulting in another down leg in the real economy. Given the level of financial markets we expect that the Fed recognizes the room it has to be a touch hawkish and to lay the gauntlet more at the feet of Fiscal policymakers.

The market has corrected meaningfully since we liquidated our reflation trade. We expect some walk back on the "Lower" comment and a rally in reflation assets. We will send fade that rally and establish a deflationary recession portfolio later today and send out our recommendations. It is highly unlikely that Powell will be able to revive the reflation trade, but we will let our readers know quickly if we are wrong.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	13,563,378					
	Total Return	13.56%					
	Today's Date	9/22/2020		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
7/21/2020	GCZ Dec 1900/2100 Call Spread	41	244	1,000,000	108	1,634,146	Closed
7/21/2020	SPX Dec 3300/3600 Call Spread	124	161	2,000,000	172	774,194	Closed
7/21/2020	10 Year B/E swap $50k per bp	1.47	50	1,000,000	1.7	1,150,000	Closed

All Positions closed