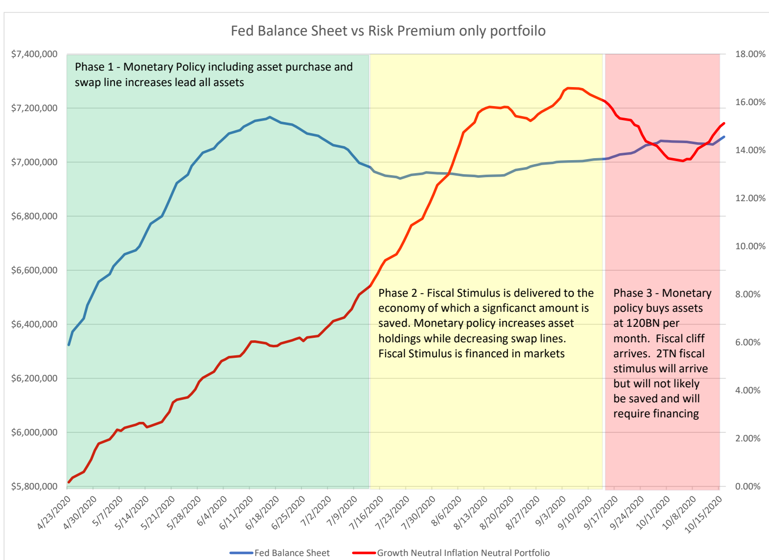
The Damped Spring Report

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

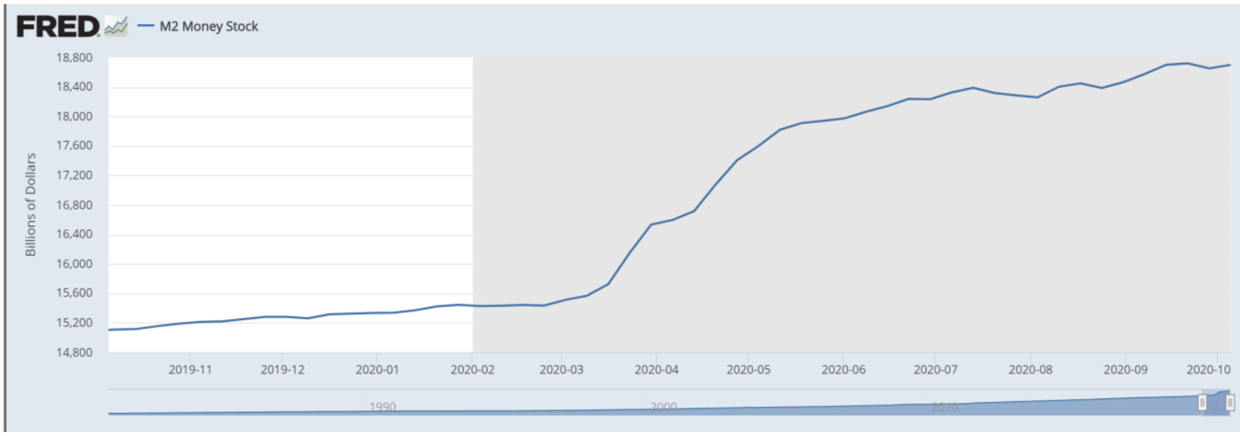
10/19/2020 When one follows the money it helps to count it up and compare the amount to what is necessary, in this report we will count the money and also address our stock year end target which we reset today to $3360

Our overall view is that further risk premium contraction for assets is highly unlikely. The Fed has committed to QE at the current pace or more for "the coming months" but seems unwilling to give long term forward guidance. In the months of April and May the Fed printed $750BN per month. The current pace is $120BN per month, which is huge vs any other level pre-Covid, but is no longer enough given the US government budget financing needs. A large stimulus in the $2TN range is inevitable and the massive issuance will compete with other assets for cash. Its possible the Fed will increase radically the pace of buying but given the surprising strength of the recovery and the near all time highs for financial assets it is our view that they will keep that level of buying on reserve for a second leg down in the economy or any other crisis.

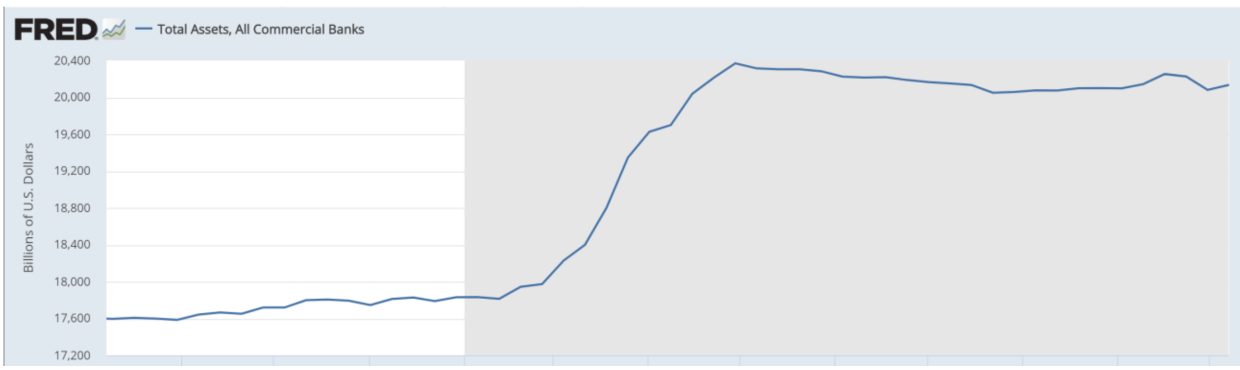
Let's dig a bit deeper into the mechanisms of the Money Tsunami that we have promoted since March when we went bullish assets. As of September 16th, we have become bearish all assets. The Fed has slowed just as the demand for cash is soon to be highest.



It is clear that asset prices were most impacted by pure QE in Phase 1. Over $3TN was printed by the Fed. Money supply grew by 3TN.



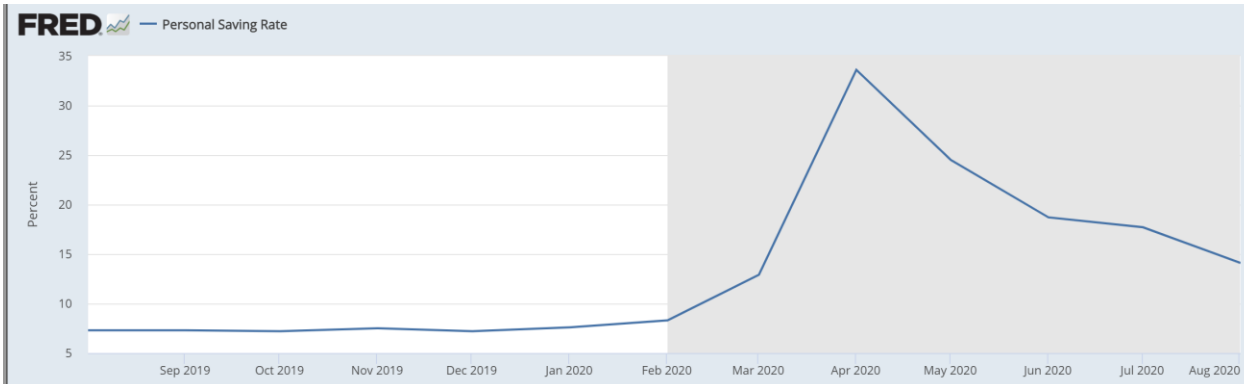
Showing up on bank balance sheets



The pace of all this money printing was $1.5TN per month. The current pace (if it is maintained will print 1.5TN over and entire year!

The first phase of the Money Tsunami was a 3TN increase in the Fed balance sheet accomplished by massive buying of US Treasuries and Mortgages. That printing of cash handed to UST and Mortgage sellers was reinvested in financial assets resulting in a contraction of risk premiums. Without fiscal stimulus funding the Monetary policy response impacted financial assets while having no real impact on the economy.

As the market continued to recover on the back of the Money Tsunami Phase 2 began. In Phase 2 the fiscal stimulus checks were financed in the public markets and sent to a wide range of economic interests. Importantly, a significant amount of the fiscal stimulus went into savings. The economy was closed down and spending dropped rapidly on many goods and services. This can be seen in a sharp rise in savings rate and the high savings rate currently despite the significant softness over the last few months



Phase Two saw the peak of growth neutral portfolio. This was in part due to the front-loaded monetary stimulus and its lagged impact on markets and part due to the need for investment of the saved money delivered by the fiscal stimulus. But Financial markets were also constrained by the significant issuance to finance the fiscal stimulus.

As Phase 2 transitioned into Phase 3, Risk premium contraction ultimately bottomed and the fiscal cliff (the end of PPP, airline rescue, and unemployment benefits) resulted in unwinding of investment savings to fund the gap while the Fed showed no interest in providing increased QE at the September meeting. Asset prices have been squeezed ever since Phase 3 began.

Today Fed purchases are running at $120BN per month. This amount of monetary stimulus has been inadequate to cause risk premiums to contract. While risk premiums have not expanded the relative dis-savings that is occurring in order for the private economy to fund its expenditures during the gap in fiscal support has offset any impact of asset purchase.

In the months to come a large fiscal stimulus will be passed. When it is passed, we expect it to be spent. The economy is much more open than during the late spring and the gap in fiscal stimulus leaves household finances in worse shape than prior to the last stimulus. For that reason, we do not expect significant savings and investment by stimulus recipients. That spending could impact real economy prices potentially causing an inflationary spike.

However, the financing of the fiscal stimulus will not have the tailwind of a $3TN two-month balance sheet explosion it had in the Spring. The net of new issuance vs Fed purchases during the Q4 2020 and the Q1 2021 will be roughly $250-300BN per month for 5-6 months net issuance over printing. Assuming 20% of the stimulus is saved and invested the net will be $200-250BN of net issuance. Either way, that will blow out risk premiums. Asset suck. Be short gold, spx, and long-term bonds. Money and $USD is going to get tight.

SPX Fair Value Update

Above, we stress that we are max bearish all assets including stocks; however, stocks are still fairly cheap. We are max short and expect a decent correction due to short term risk premium expansion, but the downside is limited.

In January

We went max bearish stocks due to valuation and the tightening of monetary conditions.

- SPX Level was 3350
- 30 Year was at 2.4%
- Trailing SPX earnings were $150 Per share

In April

We went max bullish due to the money tsunami

- SPX Level was 2836
- 30 Year was at 1.16%
- Our expectation for earnings in 2020 and 2021 would be $75 per share

Our fair value was 3150 due to the shift in long term interest rates with no expectation of risk premium contraction and very conservative earnings forecast

In June

- We upped are target to 3300
- SPX Level was 3192
- 30 Year level was 1.66%
- Our expectations for earnings remained conservative

Our fair value rose due to our assumption that the money tsunami had more than offset the increase in long term interest rates

On August 1st

- We upped our yearend target to 3800
- SPX Level was 3250
- 30 Year level had once again fallen to 1.16%
- Earnings had been less bad than we had forecasted, and we raised our earnings forecast to $115 Per share in 2020 and 2021

Our fair value rose due both to earnings forecast increases and the fall in long-term risk-free rates

On September 16th, 2020

We recommended liquidating our max long reflation trade selling equities due to a shift in commitment to QE by the Fed. We mechanically decreased our year end 3800 target to 3600 due to the increase in interest rates

Today

- The SPX sits at 3400
- 30 Year rates are 1.55%
- Risk Premiums are likely to expand instead of contract
- Our earnings assumption of $115 for 2020 and 2021 is conservative if a vaccine is delivered sometime in 2021

Our fair value for year end is 3360

We see mixed impacts on our year end target which we will outline briefly

- Earnings are likely to be better post stimulus due to pricing power inflating the top line while high unemployment keeps pressure on wages
- Risk premiums are expected to rise
- Long term interest rates are likely to rise on inflation and risk premium expansion
- Corporate tax increases will generate 400Pts of negative impact on long term earnings. A Trump victory will avoid this hit. But the impact is unquestionable, and the market has already priced in at least 200 pts of this impact.

When we add all this up, we expect the risk premium expansion to be the primary short-term driver until the election is decided and thus think stocks are about fair but prone to significant short-term pressure

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	12,842,102					
	Total Return	12.84%					
	Today's Date	10/19/2020		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
9/24/2020	GCZ Dec 1850/1750 Put Spread	27	370	1,000,000	17.6	(348,148)	Open
9/24/2020	SPX 3200/3000 Dec Put Spread	65	154	1,000,000	37	(430,769)	Open
9/24/2020	10 Year B/E swap $50k per bp	1.65	-50	1,000,000	1.7	(250,000)	Open
9/30/2020	USA Dec 176/178 Call Spread	0.953125	-955	1,000,000	0.71875	223,881	Open
9/30/2020	SPX 3200/3000 Dec Put Spread	45	222	1,000,000	37	(177,778)	Open
10/15/2020	USA Dec 176/178 Call Spread	0.984375	-985	1,000,000	0.71875	261,538	NEW