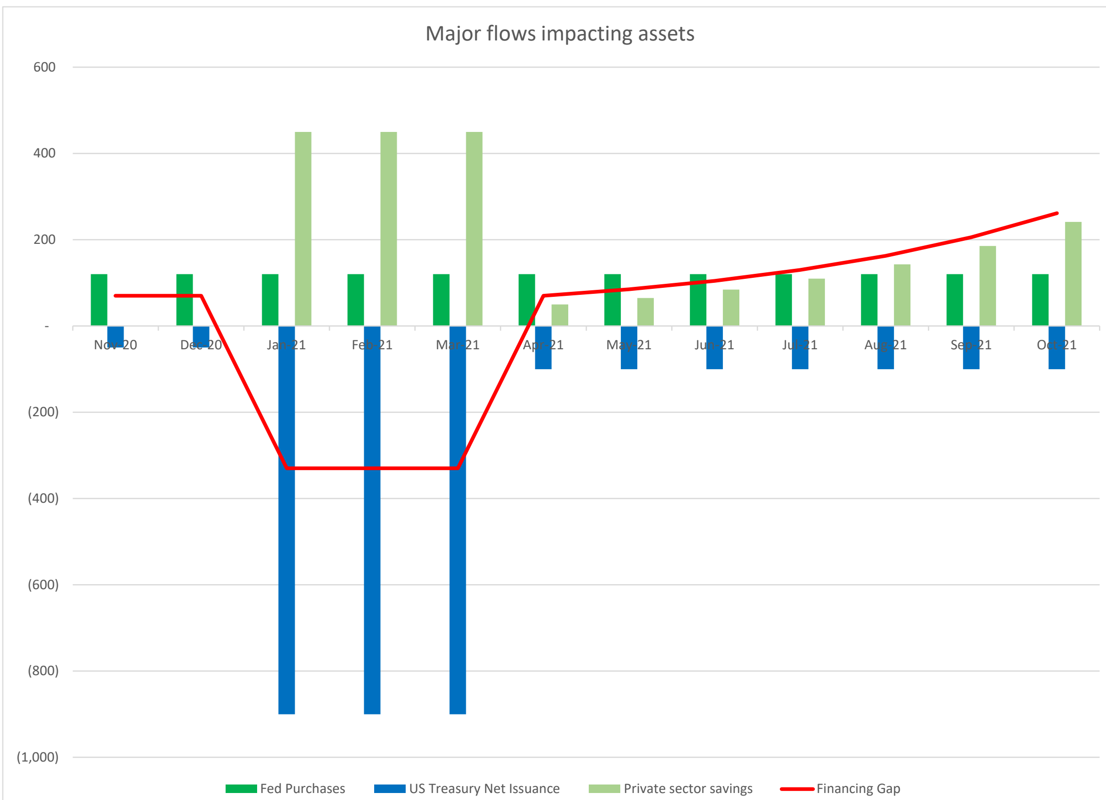
The Damped Spring Report

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

11/02/2020 The major flows impacting assets will shift significantly over the next year. During the first quarter asset prices of all sorts will face tremendous downward pressure. But short term, after the election is decided, there is a window for all assets particularly growth assets to improve.

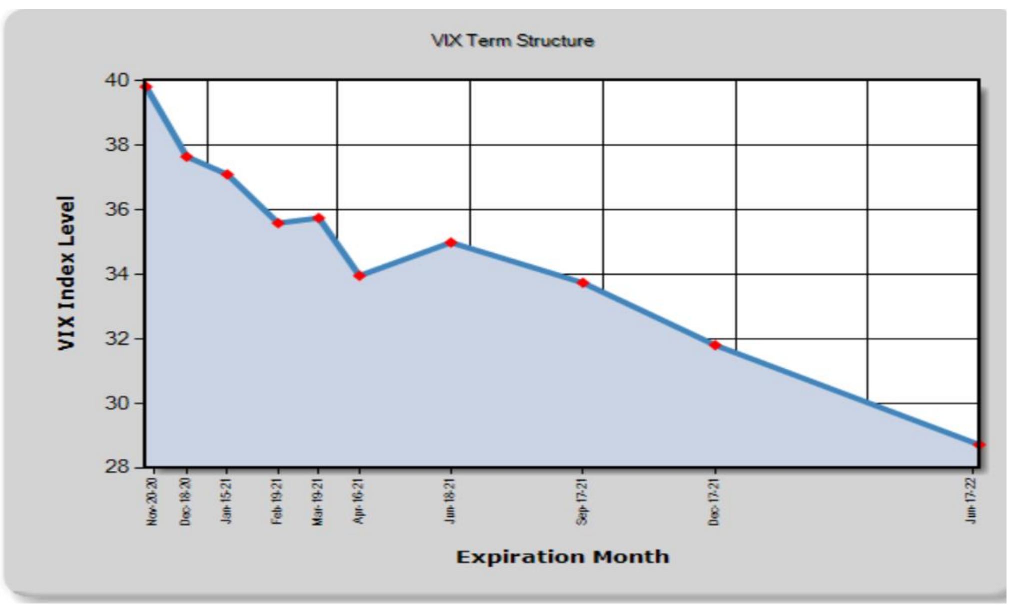


In this chart, which uses rough estimates and is only looking for 80/20 sort of accuracy, the Red Line shows the financing gap which will drive the risk premium on all assets (we define this portion of the risk premium as the intersection of the supply of money and credit from the Fed and from bank clients willing to borrow and the demand for money and credit to finance financial assets and real economic activity). The financing gap is currently modestly bullish assets. The pending stimulus financing, likely occurring in Q1 2021, will be a large bearish headwind. We assume that the private sector will immediately save and invest half of the stimulus related government outlays. As the rest of the money spent on consumption by the private sector generates wages and profits some of this will be saved.

In normal times the market would be able to significantly smooth the financing gap by prepositioning these flows. However, as we have seen in recent history these flows are simply to big to be meaningfully arbitraged away. **The Fed and the Government are delivering alpha in a way that has never been seen before. Pick it up.**

Our framework for evaluating shifts in risk premium has two pillars. Above we suggest the supply in money and credit generates a short-term tailwind for risk premium contraction and a massive headwind approaching followed by a smooth recovery. The other pillar is portfolio risk, which is composed of individual asset expected future volatility and diversification benefit.

The next few days or weeks is obviously uncertain due to the US election. Last week Europe locked down. The US is a few weeks behind Europe in Covid infections and will likely face short term difficult decisions. However, this is priced into markets and our expectation is individual asset volatility will fall



Temporarily, moving from risk premiums to growth and inflation which idiosyncratically drive individual asset classes, the path of the virus, potential vaccines and therapeutics, government policies to fight the virus, and the actual fiscal stimulus details will have a major impact on growth. Eventually as the stimulus money flows through the economy it is likely some inflationary pressures occur in scenarios where the world recovers from the virus. However, over the course of the next year we suspect the shifts in the unpredictable growth expectations will drive assets. As bonds and stocks are inversely correlated to growth, we believe that portfolio diversification will improve. Both decline in individual asset volatility and improvement in portfolio diversification are tailwinds for risk premium contraction.

What's New?

Our last report suggested that "Assets Suck" this remains our six-month view.

- SPX is down 6%
- Long term bonds are down 3 pts
- Gold is down over 1.5%

Clearly investors have moved to cash. However, the market move was not based on a shift in the supply and demand for money and credit. This shift as described at the top of today's report is months off and in fact events of the past week pushed off the start of the headwind.

What happened?

Last week, European Lockdowns stoked Covid fears and all hope of a stimulus deal pre-election finally was lost. Perhaps shifts in the odds of the US Presidential election and Senate control impacted investors but that is harder to conclude. The result of the events was a fall in growth expectations. But a fall in growth expectations should have been bullish for bonds. The fall in bonds indicates a portfolio deleveraging. It seems straightforward global portfolios were vulnerable to increased expectations of future asset volatility.

We simply do not accept a W shaped recession as likely. The world will not tolerate significant further economic hardship to avoid potential infection. Just as in March and April when we said this virus will pass, we repeat that again with the coming winter second wave.

However, in the first wave the Fed printed 3TN dollars causing assets to massively recover. The economy followed eventually but with nowhere near the robust move that markets experienced. The second wave will almost certainly result in some convergence between the financial asset markets and the real economy. Shutdowns will be less draconian, Governments will direct funds more precisely, and the Fed and other central banks will participate but not lead unless both financial markets and the real economy tank.

For these reasons we are following the Red Line in our first graph. Financial assets will be trash in the 1Q of 2021. Which will be the worst is a question that requires insight that we do not have regarding the path of the virus and the fiscal stimulus to counteract that path.

What does this mean for our portfolio?

Short term, the delay in stimulus pushes back the stimulus funding supply which allows the $120BN of monthly Fed purchase to keep a cap on risk premiums and perhaps given the recent sell off some room for a bit of contraction.

Stocks have fallen 10% from peak while big cap stocks have reported good earnings. This cheapening in stocks and the negative news around Covid, and stimulus has likely run its course short term. In notes to clients we have unwound our max short position.

In fact, given the monetary conditions and the level of expected volatility, we think a swift year end rally to new highs is a real possibility as the Fed continues to print in excess of the need of the financial markets and volatility subsides. We see upside call 3600/3800 call spread at 19 for a possible 10-fold return to be excellent value as we believe the possibility for a year end rally is greater than 15%.

In the event of a blue sweep we have analyzed the impact of a retroactive capital gains tax increase and a return to a 28% corporate tax.

The capital gains tax rate shift is in the midst of being discounted as the stocks with the largest recent 2020 gains are underperforming the rest of the market. This will likely continue if the blue wave occurs but does not likely result in the overall market moving in one direction or another. Those who want to harvest gains will have to pay those who provide liquidity and that will show up in the spread between low gain and high gain stocks. That spread will reverse post year end.

The corporate tax increase is worth 10% on the SPX. In the last few weeks, the SPX has fallen by 10%. Obviously, it is not fully discounted until after the election, but a blue wave would relieve any election related uncertainty which might offset the subsequent hit to after tax earnings of a shift in policy. We are no longer bearish stocks and see a chance for significant upside.

We remain bearish bonds as the 1Q excess supply will first impact bond term premiums before expanding to other assets. We are short upside call spreads to express our view recognizing the high implied volatility in markets in general.

We added positions short USD a tad early but are committed to have a max short position over the next few weeks as we believe that the pending excess supply will require a lower dollar to attract European and Japanese investors.

Current Model Portfolio performance and Recommendations

	Assumed Portfolio size	100,000,000					
	LTD P/L	14,031,684					
	Total Return	14.03%					
	Today's Date	11/2/2020		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	24	(111,111)	Open
9/24/2020	SPX 3200/3000 Dec Put Spread	65	154	1,000,000	60	(76,923)	Closed
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	0.5	432,836	Open
9/30/2020	SPX 3200/3000 Dec Put Spread	45	222	1,000,000	53.5	188,889	Closed
10/15/2020	USA Dec 176/178 Call Spread	0.984375	-985	1,000,000	0.5	476,923	Open
10/28/2020	USDJPY Year End 103/100 Put Spread	0.64	156,250,000	1,000,000	0.64	-	New
10/28/2020	EURUSD Year end 1.18/1.21 Call sprea	0.78	128,205,128	1,000,000	0.63	(192,308)	New
9/30/2020	SPX Year End 3600/3800 Call Spread	19.5	256	500,000	19.5	-	New