The Damped Spring Report

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

11/11/2020 This week an effective vaccine was announced. This news has major implications for Fiscal and Monetary policy

The announcement of an effective vaccine on Monday will have major implications on fiscal and monetary policy. Expectations for fiscal policy will likely shift from a $2TN plus stimulus package delivered in Q1 to a more spread out and substantially smaller, in aggregate, set of packages. The Fed will likely taper QE cautiously but firmly by the second half of 2021.

The decrease in expectations for both fiscal and monetary support assumes that as the vaccine and therapeutics become widely available the private sector will open up and replace the government assistance with organic growth. As the United States has both the willingness and the ability to provide fiscal and monetary assistance, while the rest of the developed world has limited ability to provide either, the shift will have more impact in the US, but, we expect all governments and central banks to pull back on plans modestly over the coming year.

This important shift in expectations for policy is a headwind to overall GDP growth. The offset to that shift is the reopening of the global economy which now looks much more likely. These shifts will take time. The virus is not under control and the vaccines are not close to being available however the government policy support will wane, and the private sector activity will wax, as 2021 plays out.

The implications of this shift regarding risk premiums are much more important and knowable relative to the way that the picture for global growth plays out. Risk premiums expand and contract based on two factors

- The supply of money and credit vs the demand for money to purchase financial assets, invest in the real economy, and consume
- The expectation of future portfolio volatility

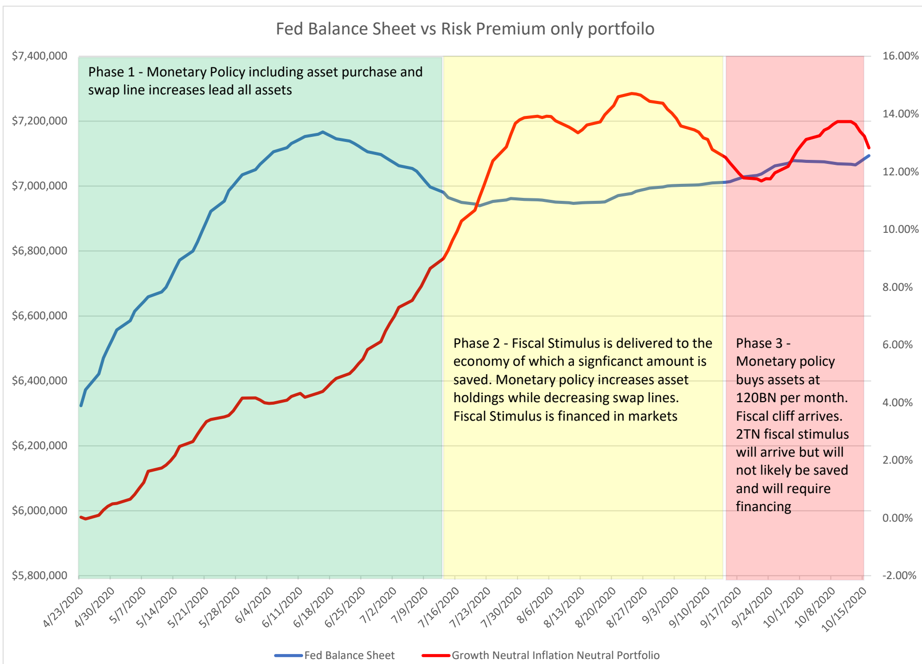
The shift in monetary and fiscal policy expectations has a direct impact on the supply and demand of money and credit. The vaccine, and the smaller shifts in money and credit supply and demand imbalances, will have a substantial impact on the expectations for future portfolio volatility.

As we have written recently, the outlook for supply and demand of money and credit was like a huge roller coaster due to the timing and size of Fed purchases and the lumpy financing of the fiscal stimulus.

During normal times, prior to 2008, the central banks and governments delivered often sizable but steady flows that rarely dominated. In the last few months, the flows dominated everything.

In April and May the Fed bought $3TN of bonds. This created a massive supply of money and credit which largely moved into other financial assets and propelled all assets substantially higher.

By June, the financing of the $3TN government stimulus came to market and slowed and finally capped the rise of assets which until today remains capped



In our report from late October where we declared "Assets suck" we predicted that the massive oversupply of government fiscal stimulus financing would tighten money and credit in the US resulting in weakness in all assets despite meaningful but inadequate QE from the Fed. In October we defined three phases post Covid

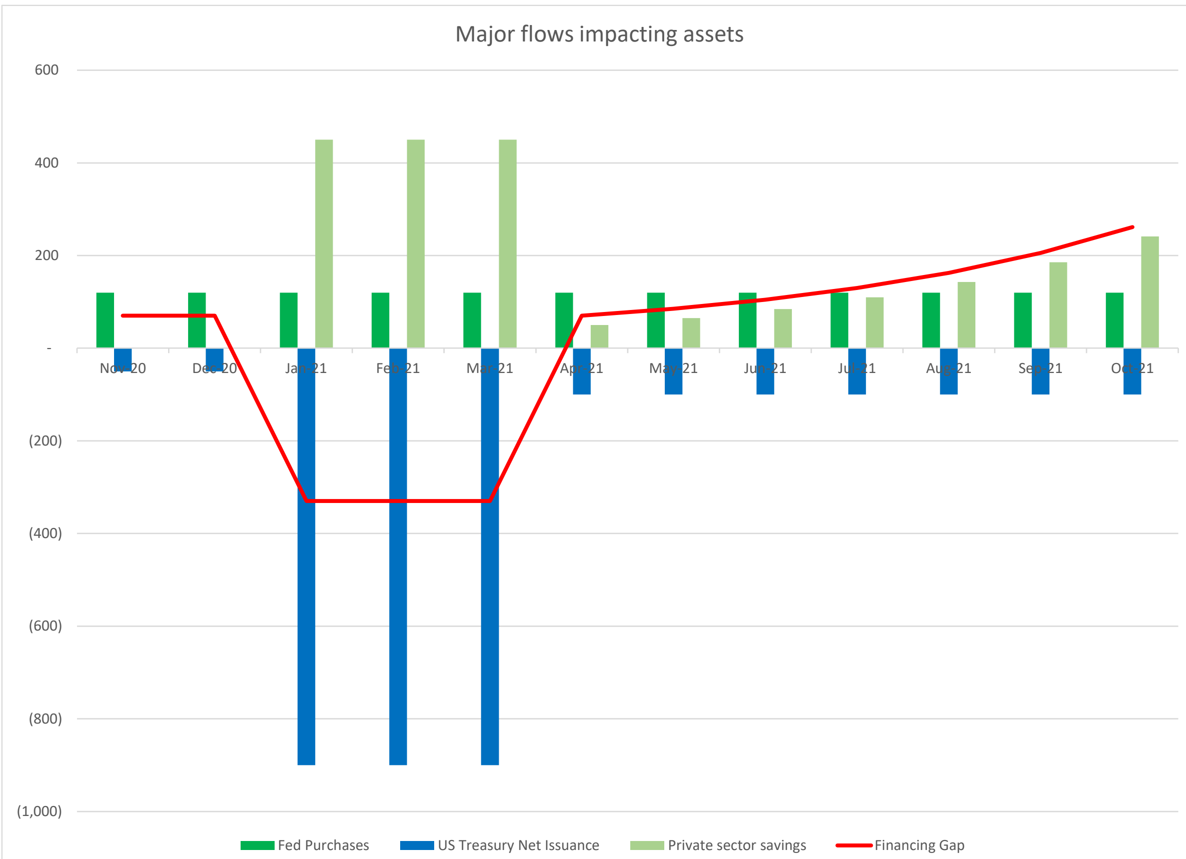
- Phase 1 was Fed purchases overwhelming asset supply,
- Phase 2 was government issuance capping further appreciation
- Phase 3 was expected to be a significant weakening of financial assets due to massive oversupply with only modest tailwind from remaining QE.

Today given our expectations Phase 3 will be much more of a holding pattern smoothing out asset returns, reducing risk, and allowing for assets to capture existing risk premiums without much volatility regarding movements in the level of those risk premiums. Of course, the shifts in growth and inflation will move various asset classes differently, but the overall market portfolio is likely to earn an excess over cash without much volatility. Long term assets are ok. Modest risk premium contraction during 2021 is likely in such an environment.

The Major Flows Pre and Post vaccine news

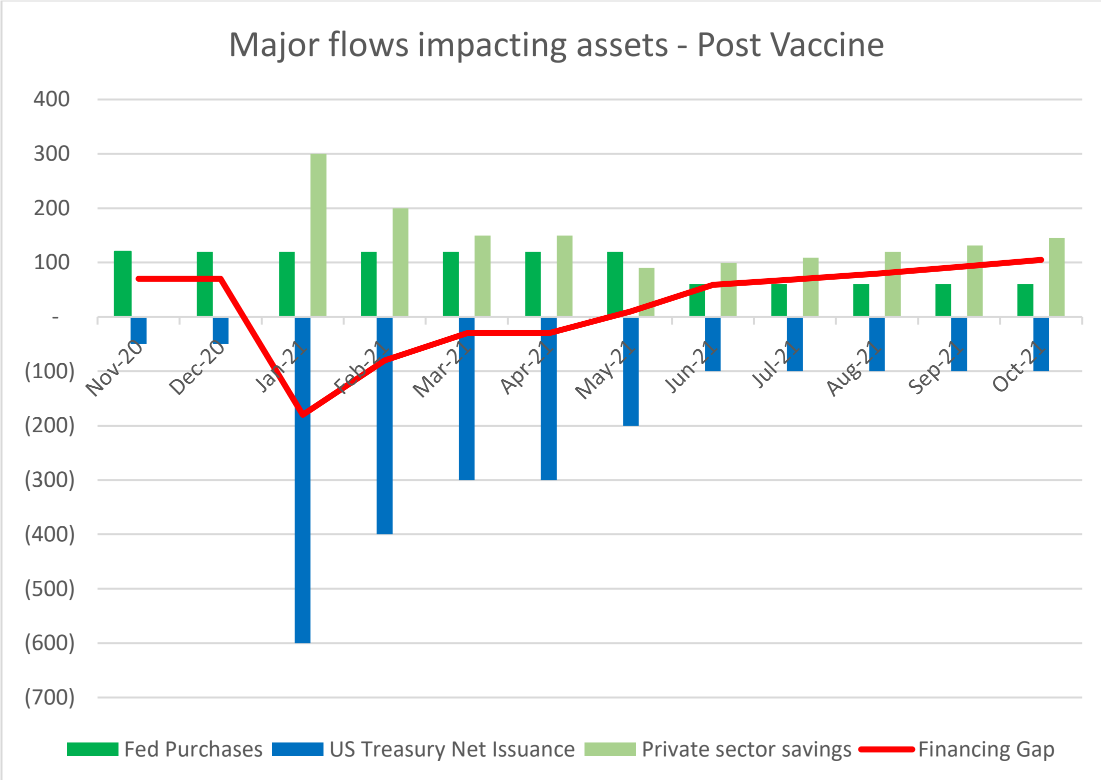
We have mentioned recently that November and December would have positive tailwinds from large Fed purchases without the headwind of financing of a fiscal stimulus package. But, the financing that would have occurred in Q1 would have swamped both the Fed's purchases and any savings that investors could put to work, requiring a significant widening of risk premiums and a fall in the USD.

Last week we made this forecast of the major flows that will drive markets

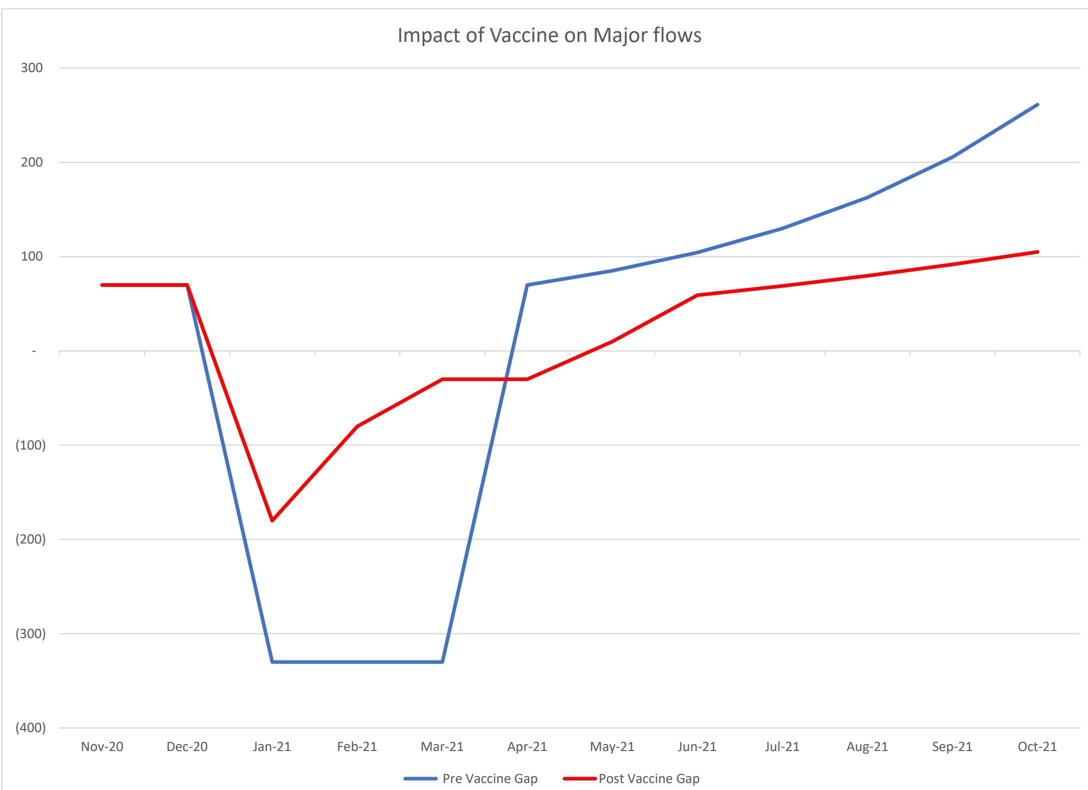


Today we believe that markets will begin to price in less and more spread out fiscal support. The Fed will taper asset purchases in the back half of 2021.

In the next chart we assume a stimulus package that is 2/3 of the pre vaccine package and 6 months of 120BN QE purchases tapered to 60BN for the following six months.



The timing of the flows which would have been highly disruptive in the first quarter are significantly smoother and less disruptive to risk premiums now.



Current Model Portfolio performance and Recommendations

On Monday morning we unwound our bond short, equity long, gold short, and inflation expectation short. We are less happy than when entered with our long EUR and JPY trades as the supply of treasuries in Q1 will likely be well smaller requiring less USD depreciation to attract the less needed foreign buyer. We believe that short term the USD will depreciate a bit as money is printed without supply and Europe and Japan will themselves reduce expectations of accommodation however we are looking for an exit not looking for a place to add.

Assumed Portfolio size	100,000,000		
LTD P/L	16,186,550		
Total Return	16.19%		
Today's Date	11/11/2020	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
9/24/2020	10 Year B/E swap $50k per bp	1.65	-50	1,000,000	1.68	(150,000)	Closed
9/24/2020	GCZ Dec 1850/1750 Put Spread	27	370	1,000,000	18	(333,333)	Closed
9/30/2020	USA Dec 176/178 Call Spread	0.953125	-955	1,000,000	0.03125	880,597	Closed
10/15/2020	USA Dec 176/178 Call Spread	0.984375	-985	1,000,000	0.03125	938,462	Closed
10/28/2020	SPX Year End 3600/3800 Call Spread	19.5	256	500,000	93	1,884,615	Closed
10/28/2020	USDJPY Year End 103/100 Put Spread	0.64	156,250,000	1,000,000	0.26	(593,750)	Open
10/28/2020	EURUSD Year end 1.18/1.21 Call sprea	0.78	128,205,128	1,000,000	0.69	(115,385)	Open

We do not have strong views on equities, bonds, or gold at this point, so we are not recommending any positions for the time being. Our low commitment signals on flow, inflation, growth, and risk premiums are causing us to lean in the following ways looking for entry points.

Short Volatility

Short volatility is our strongest signal as

- Risk premiums are capped due to large QE and portfolio risk declines
- Event risk regarding vaccines, elections, stimulus, are not likely to provide surprises in 2020
- 2021 financing gaps look much tamer

Equity

Looking to buy.

- QE flows
- No need for tax gain selling/Return chasing by active funds (Santa rally)
- Valuation – Stocks are still cheap
- Potential top line revenue inflation without wage inflation expanding margins

Bonds

Looking to buy long term bonds

- Growth will be slow until stimulus despite vaccine hopes
- Inflation may rise but only slightly until reopening
- Risk premiums are capped
- Prices have significantly improved