The Damped Spring Report

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

12/15/2020 We have strong views of what is needed from the Fed to bridge a weakening economy to the second half of 2020 when the vaccine will have been widely distributed. The Fed will probably not do what we think is needed.

Position Update

Because we think significant easing is needed, our portfolio is heavily biased by that view. It is inevitable that the Fed will need to ease further by increasing QE. This may happen at tomorrow's meeting or in meetings to come. As we have mentioned many times over the last few months, the increased bond purchases are necessary to offset debt issuance by the US Government which would otherwise cause crowding out of other assets. Despite our strong view that more easing is coming, we are tweaking our portfolio ahead of the Fed Meeting tactically due to flows in the equity market and positioning in the EUR.

- We are taking profits on half of our long SPX call spread and will re-establish our max long on Friday's close as we expect significant selling due to the rebalancing of the SPX and the inclusion of Tesla in the index.
- We have almost tripled our money on our long EUR position. We are closing that today. We remain bearish the USD but are already max long gold.

Our view of what is needed from the Fed

This is a fascinating time in history. The US and European economies are in the midst of a significant economic slowdown which will last until most people are vaccinated. What is fascinating is that these economies will almost certainly recover rapidly in the second half of 2021. Monetary policy makers usually do not have this foreknowledge regarding the next year. They operate the levers and observe the results. In this unusual case, any policymaker should be able to see a time when some policy accommodation will have to be removed. We suggest that the best way to handle this situation is to simultaneously announce an increase in QE and an intention to taper back this additional accommodation in the 2nd half of 2021.

Why increase QE now:

- The economy is weakening significantly

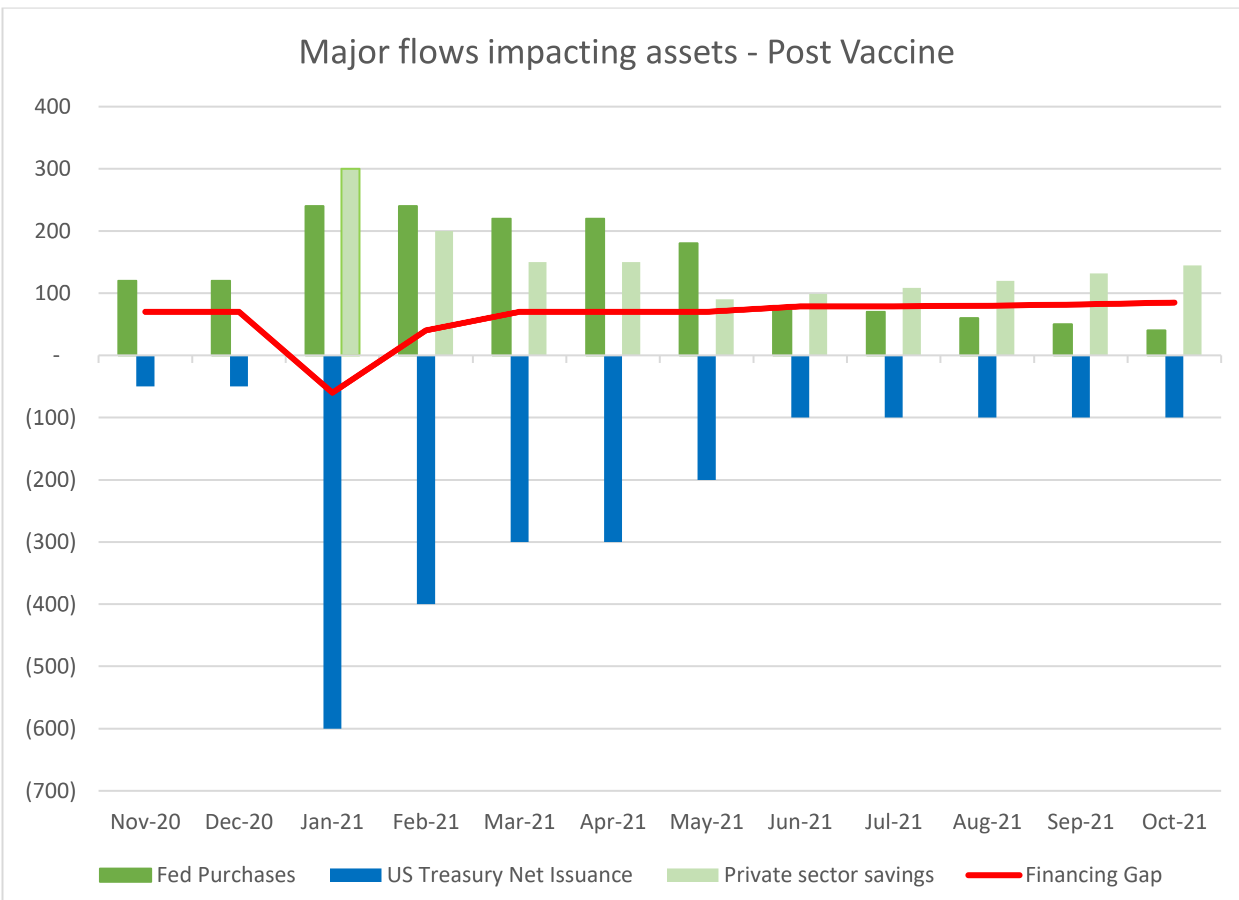
- A stimulus bill of $1TN is likely and will be financed in Q1, squeezing out other assets and depressing investment and consumption in the real economy until that stimulus money recycles into savings

Why taper in 2H 2021:

- The economy will recover without stimulus as vaccinated people return to normal life
- Fiscal spending will decrease, resulting in less issuance and less need to monetize debt

Why do both and announce the plan upfront?

- By coordinating the timing of Fed purchases to US Treasury issuance, you decrease the market impact of the issuance/purchase timing.
- Increase confidence in the Fed and the USD



The Fed has shown concern about the increase in their balance sheet in the Fall. Logically, they also wanted to hold back on further stimulus to save bullets, particularly when fiscal policy floundered. Holding back fire power when there is no crisis is sensible policy. The second wave was always a possible crisis, and now it is upon us. The Fed has said they will act, and they need to act. They have a few options:

- Stay the course and continue to buy $120BN in assets a month
- Twist
- Increase QE

It is possible that the Fed will stay the course. This will disappoint all assets and strengthen the Dollar against gold. The cause of this market reaction will be a much larger than expected financing gap in Q1. Assets of all sorts will be squeezed out of the market as cash is raised to finance a stimulus bill. Why would the Fed pursue this option given the short-term economic outlook and the potential structural damage of recently quite weak job market? Perhaps the Fed is concerned about the balance sheet and a continues to hold back powder for a greater crisis. We think this is a bad reason to withhold additional stimulus, but it speaks to the issues facing the Fed and its balance sheet.

Most likely the Fed will twist. By buying longer duration assets, they will do better pushing money into the real economy, but given the relative flatness of the curve, this seems likely to have minimal impact on the economy and will do nothing to offset new issuance. Survey based market expectations seems to favor this "half a loaf" of stimulative policy. But a twist is meant to stimulate while maintaining balance sheet discipline, suggesting once again that the Fed is conscious of its balance sheet.

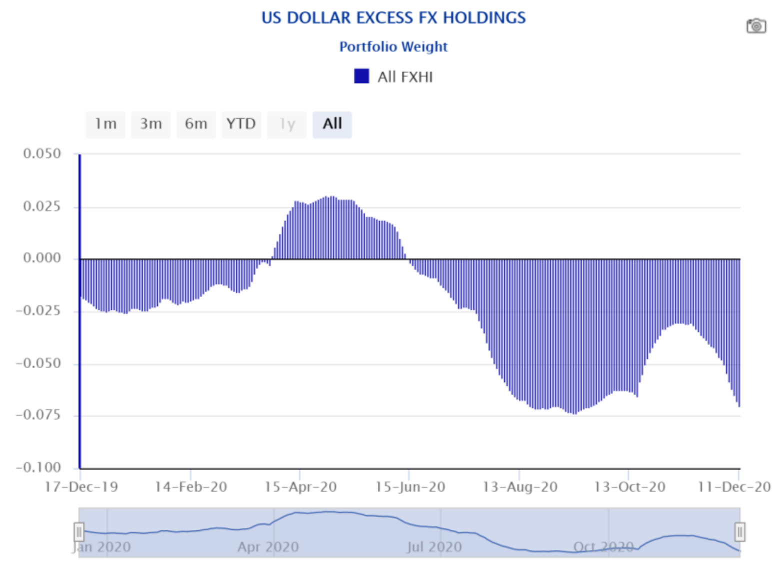
Increasing QE is clearly stimulative as it will directly offset new issuance. Unfortunately, it requires spending dry powder and expanding the balance sheet rapidly.

To both address the concern about unlimited balance sheet growth while actively providing additional accommodation to deal with the second wave economic implications, the Fed can both increase and project a taper in the 2H 2021. The existence of the vaccine provides a unique opportunity that simply has not existed before. We hope the Fed will recognize the moment and provide a bridge to the vaccine while also addressing the growth of the balance sheet. We are not naïve. This is unlikely to occur, but what we think it is needed.

Tactics

EUR

We are closing our year end EUR 1.18/1.21 call spread after tripling our money. The ECB took fairly strong actions last week. Regardless of what the Fed does tomorrow, the US pre-election stimulus plan has been halved. This leaves a much smaller financing gap than when we got bearish USD. Lastly, the trade is now extremely crowded by most metrics



Institutional underweights have grown substantially in the USD and the selling seems short term unsustainable.

SPX

We are cutting our max long SPX Dec 31, 3600/3800 call spread in half taking profits ahead of the Fed as we expect that all we get is a twist despite our view of what is needed. But much more importantly, we are lightening our long with the full intent of going max long again on the close Friday. In the last issue of the Damped Spring Report we discussed in depth the $45BN of SPX index that needs to be sold to beat the close on Friday in order to fund the purchase of $45BN in Tesla shares added to the index. Buying the close will be a great entry point regardless of the Fed's move.

Current Model Portfolio performance and Recommendations

Year to date return 15.67%

Inception to date total return 21.27%

	Assumed Portfolio size	100,000,000					
	LTD P/L	21,270,606					
	Total Return	21.27%					
	Today's Date	12/15/2020		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
10/28/2020	USDJPY Year End 103/100 Put Spread	0.64	156,250,000	1,000,000	0.27	(578,125)	Open
10/28/2020	EURUSD Year end 1.18/1.21 Call sprea	0.78	128,205,128	1,000,000	2.2	1,820,513	Closed
11/12/2020	SPX Year End 3600/3800 Call Spread	51	196	1,000,000	110.5	1,166,667	Closed
11/23/2020	GCA JAN 1800/1900 Call Spread	38	526	2,000,000	52.8	778,947	Open
11/23/2020	SPX Year End 3600/3800 Call Spread	49	204	1,000,000	110.5	1,255,102	Open
12/7/2020	USA Feb 172/171 Put Spread	0.3125	-1455	1,000,000	0.359375	(68,182)	Open