The Damped Spring Report

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

01/04/2021

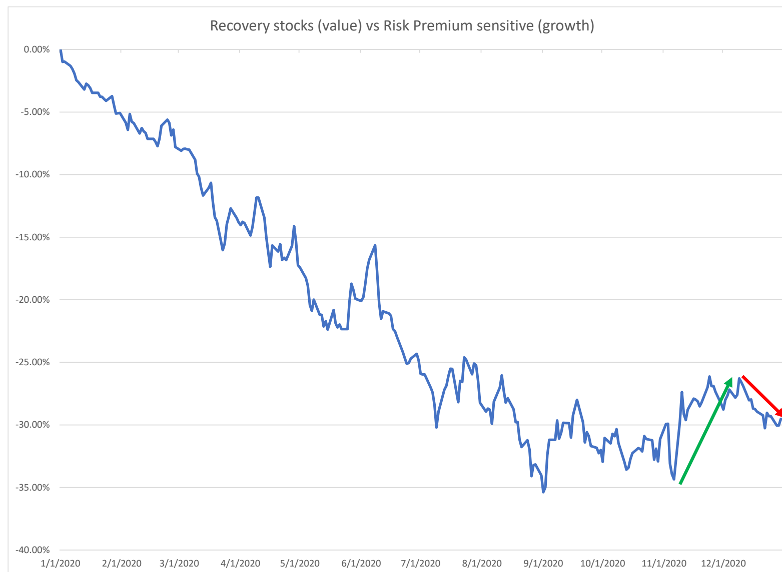
There is not enough monetary and fiscal stimulus to deliver above expectations growth AND risk premium contraction in the first quarter of 2021. All assets are vulnerable to risk premium expansion, but equities are the most vulnerable. Specific recommendations are to max short equities, sell max long gold position, sell B/E inflation expectations, and sell nominal bonds.

Santa Rally Recap:

Equity markets closed at an all-time high on New Year's Eve. The rally started with the announcement of the vaccine, which will eventually allow the world to normalize. Growth will almost certainly strengthen and, as a result, **expectations of growth jumped on the announcement**. In addition to the vaccine, the strong demand for risky assets was also driven by hope for a stimulus, flows chasing performance, and the desire for investors to avoiding selling to defer capital gain realization. In addition to equity markets, inflation expectations also soared, driving gold and crypto higher and the USD lower.

While most portfolios rallied, ones with a growth tilt rallied more sharply. However, by the end of the year, growth was no longer a driver and other forces took over.

Since the vaccine announcement, recovery (value) stocks that are particularly sensitive to short-term earnings, which have been trounced all year by stocks with high sensitivity to multiple expansion (growth), outperformed significantly



However, in the final weeks of the year, that outperformance retraced by half.

Three factors at play throughout November and December explain these moves:

- Vaccine news drove growth expectations higher, particularly recovery stocks
- QE purchases were large and stimulus financing did not happen, resulting in a rally of all diversified portfolios, including ones that were growth-neutral
- In the last few weeks of the year, the **lack of selling of the biggest winners by taxable shareholders** resulted in a short-term jump in those stocks relative to recovery stocks.

10-year nominal bond yields rose 16bp since the vaccine announcement. But more importantly, a 34bp rise in inflation expectations drove more than 200% of that increase. Bond markets are not quite as ready to expect growth to be strong as what is priced into the recovery stocks and the 60/40 portfolio. It is possible that risk premium contraction, which drove all assets higher, was responsible for the strength in nominal bonds, offsetting some of the rise in inflation expectations. It is also possible that the risk premium contraction offset more than the 18bp gap between the 34 and 16bp increases, but not likely much more. For that reason, **we believe that bonds and stocks are dislocated regarding growth expectations.**

The move in inflation expectations was confirmed in the currency, gold, and crypto markets as follows:

- The dollar (DXY) weakened by 3.5%
- Gold rallied by 3.6%
- Bitcoin doubled!

Given the current level of inflation expectations, we think that there will be a retracement in all these markets. As a result, **we recommend selling our max long gold position**. Note: Our specific position expired last week, generating 226bp of profit.

In summary, inflation expectations are much higher, growth expectations have risen overall, but are not clearly reflected in all markets, and risk premiums have contracted. We think that positioning and general consensus expect more of the same, and **we have a strong contrarian view to consensus.**

Economic Outlook

In the Fall, we provided an estimate of the stimulus we expected to be necessary to offset the end-of-April stimulus to be $1.5TN. Since then, conditions have worsened, but at least now, an end of the pandemic is more likely. We did not expect the $2,000 checks to be written, but if they had been, the stimulus would have been near our target. At $900BN, we expect significant economic hardship in the first half of the year.

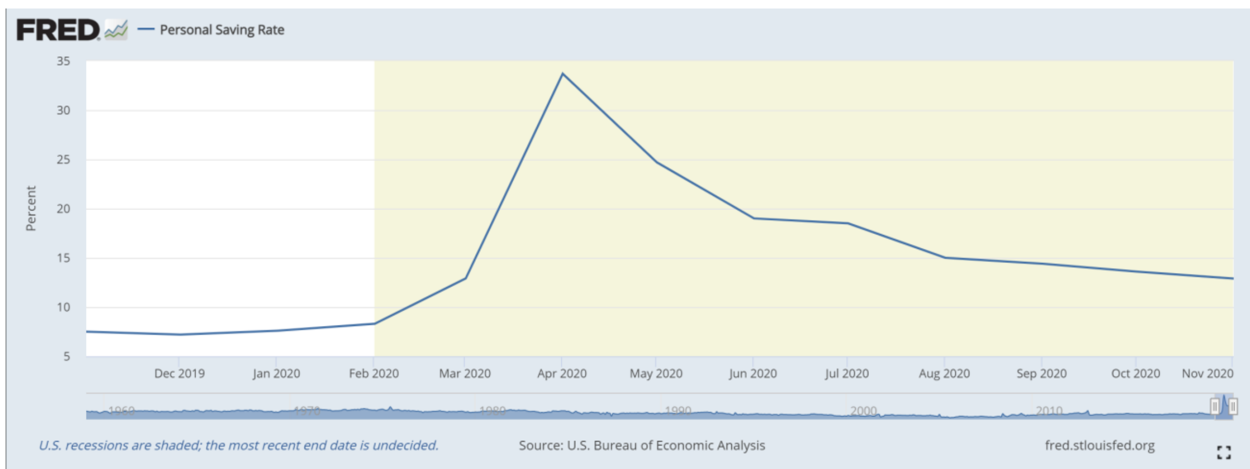
The good news, if there is any given the economic hardship we expect, is that the financing of this stimulus will be less impactful on assets than a larger stimulus. Nonetheless, just as the fiscal stimulus is not enough to improve growth, the monetary stimulus is not large enough to offset the new issuance in the 1Q. (See 11/02/20 Department of Treasury press release in Appendix below).

The Treasury has not yet specified the impact on the issuance of the additional $900BN of new legislation, but, using its most recent assumption of 1.13TN of issuance (while the Fed continues to purchase the same $360BN per quarter) results in a gap that will grow by close to a half trillion dollars. **It is inevitable that this huge gap will result in an expansion of risk premiums across all assets as investors are forced to lever up portfolios to accommodate supply.**

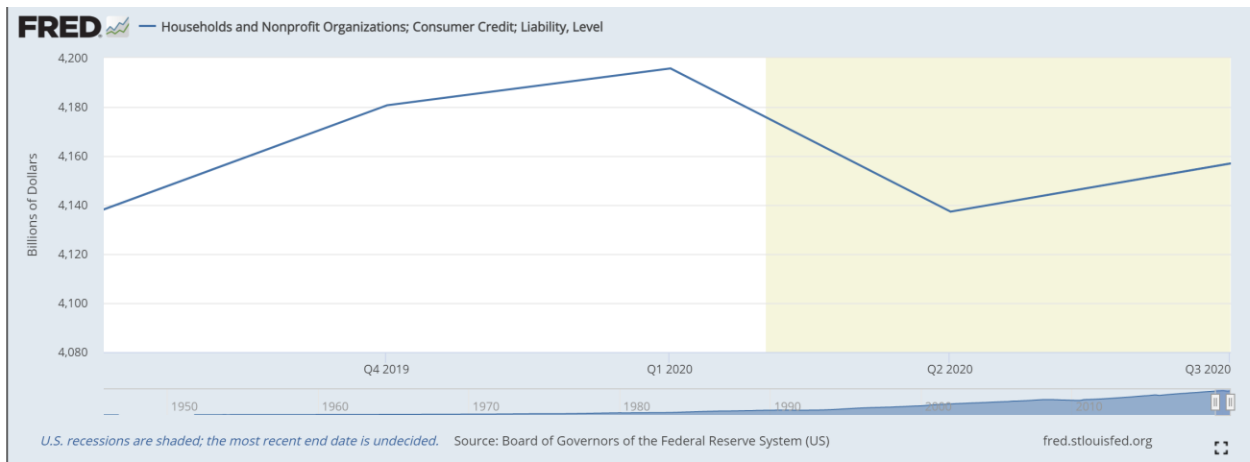
The specifics of the stimulus bill and what people may do with the money they receive has some impact on the gap. If saved or used to pay off debt, the gap will be narrower, but growth will be softer. If spent, the gap will be wider until the money flows back to savers in wages and private sector profit, but growth will be less soft.

Personal Expenditures: Recently Weakened

Savings Rates: Still Above Average, But Far Lower than Peak, and Falling



Consumer Debt: Fell After First Stimulus Checks Hit and Personal Expenditures Plummeted, But Increased Again



We expect that a good portion of the direct checks and unemployment benefits will be saved or used to pay off debt. This will offset some of the Treasury issuance supply, but will also not stimulate much growth.

Not enough! There has not been enough fiscal stimulus to spur growth, and there has not been enough monetary policy to keep risk premiums from expanding.

Implications for Markets:

We expect that the primary 1Q21 market drivers and implications will be as follows:

- Risk premium expansion will hurt all assets due to an oversupply of treasury bonds
- Growth expectations will fall due to lack of effective fiscal stimulus
- Inflation expectations will fall due to lack of spending, existing strong secular deflationary forces, and no additional Fed response as of yet.

In addition, the Georgia election will have additional market impact:

- A Democratic sweep will lead to:
  - Higher corporate taxes, which will hurt equity valuations
  - Higher stimulus, which will help growth, help equities, and hurt bonds
- If Republicans retain the Senate or if Georgia turns blue, but Democrats have difficulty enacting legislation:
  - No additional stimulus will hurt growth, hurt equities, but help bonds.

Equities:

The headwinds are clearly against equities. All three of the principal macro drivers are negative for equities. The only positive we see for growth expectations is a Blue wave. But the implication for equities is still net negative due to corporate tax relief rollbacks. **As mentioned in a brief note at the end of last year, we took sizable profits on our max long position which we had held since the vaccine announcement, went short, and then went max short equities on 12/31/2020.**

We have been bullish on equities since early April. Our view was in part valuation-related and in part flow-related (Fed printing). Above, we describe that the Fed printing, while large, is not enough to keep risk premiums from expanding. Valuation is also no longer a tailwind. **Our current target for SPX is $3,500 if Democrats can both repeal the corporate tax relief of 2017 and deliver fiscal stimulus, which would be good for 1% in additional GDP growth and $3,600 if gridlock is retained post-election.** In either case, our target is a modest drop in target vs. current levels, but still quite worse than the consensus.

Bonds:

Given that we expect inflation expectations to get hit, and given that we do not think bonds sold off hard enough on rising growth expectations, we are not super

excited either way by nominal bonds. **We are selling out of our long bond position at a profit, due principally to theta. We are recommending a position short 10 yr B/E inflation.**

Due to our expectations of risk premium expansion and the general need to delever portfolios to meet treasury issuance supply, we are **no longer bullish on gold** after catching a 12% rally. The same view impacts Crypto, but we are out of our depth on this asset class. (It seems nuts to us, and I personally owned a bunch until $24K).

Current Model Portfolio Performance and Recommendations:

	Assumed Portfolio size	100,000,000					
	LTD P/L	23,138,487					
	Total Return	23.14%					
	Today's Date	1/4/2021		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	(1,000,000)	Expired
11/23/2020	GCA JAN 1800/1900 Call Spread	38	526	2,000,000	80	2,210,526	Expired
12/7/2020	USA Feb 172/171 Put Spread	0.3125	-1455	1,000,000	0.296875	22,727	Closed
12/28/2020	SPX Feb 3650/3550 Put Spread	21.6	463	1,000,000	29	342,593	Open
12/31/2020	SPX Feb 3650/3550 Put Spread	19	526	1,000,000	29	526,316	Open
1/4/2021	10 Year B/E swap $50k per bp	2	-50	1,000,000	2	-	Open

Appendix

Most recent press release from US Department of Treasury 11/02/2020

WASHINGTON -- The U.S. Department of the Treasury today announced its current estimates of privately-held net marketable borrowing [1] for the October - December 2020 and January - March 2021 quarters [2].

- During the October – December 2020 quarter, Treasury expects to borrow $617 billion in privately-held net marketable debt, assuming an end-of-December cash balance of $800 billion. The borrowing estimate is $599 billion lower than announced in August 2020. The decrease in privately held net marketable borrowing is primarily driven by a high beginning-of-October cash balance, [3] partially offset by assumptions for higher expenditures in new legislation.
- During the January – March 2021 quarter, Treasury expects to borrow $1.127 trillion in privately-held net marketable debt, assuming an end-of-March cash balance of $800 billion.

In the Q4 the Fed purchased 360BN of Bonds and the US treasury expected to issue 617BN. Risk premiums contracted which suggests the Fed purchases were adequate to avoid the flood of issuance squeezing out other assets.