The Damped Spring Report

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

2/1/2021

The Zombies Reawaken? The 2020's will be a decade of zombies. The virus has exacerbated this trend as already struggling industries were hit. Other industries have lost an entire year of revenue infecting them with Zombie like attributes. These companies have massively increased their indebtedness. As the situation for companies became desperate G-7 countries provided enormous stimulus plunging them into further debt and risking Zombiehood. Yet lately as vaccine prospects improved many of these companies outperformed the broader equity markets and nominal bond prices fell indicating confidence in economic growth. The companies leading the market are Zombies. Beware.

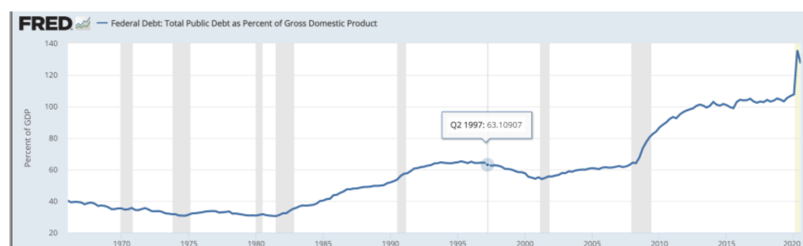
One year ago, we asked this question:

"Have we entered the Zombie 20's?" The term "Zombie" has been used in finance for decades. Most often, it refers to a company that is heavily indebted and unwilling or unable to increase debt, fund cap ex, perform necessary research and development, and/or pursue talented employees; as a result, it suffers a slow wearing-away of its competitiveness. One might expect a zombie company to fail more quickly, and in high interest rate environments zombies do not really exists as debt service costs kill companies. However, in exceptionally low interest rate environments, like Japan for almost 40 years or the rest of the world for the last decade, zombies can "thrive." The shot-to-the-head that kills a zombie, when debt service cannot do the job, is the failure to be able refinance existing debt.

Today, as the massive global fiscal injections continue to raise global government debt and companies most impacted by the virus continue to layer on additional debt, countries are now joining the Zombie Population, and existing zombies are becoming even more leveraged.

Governments

US Debt-to-GDP has Spiked:



Japan's debt-to-GDP ratio peaked at 250%. In the Eurozone, many countries have debt-to-GDP ratios of greater than 100%. In the UK, the-debt-to-GDP ratio is now greater than 100%. We fully expect more fiscal stimulus to be enacted in 2021 and for the US to run an extremely large regular annual deficit for the foreseeable future. However, the debt-fueled portion of the recovery that we expect to see in the second half of 2021 will slow as short-term tolerance for additional debt financing will fall rapidly. There will be a meaningful fiscal cliff in the second half of 2021. Hopefully, the vaccine will deliver adequate protection to offset some of that impact. Perhaps some of this slug of stimulus will make us more competitive on the global stage by stirring investment in infrastructure and long-term investment in our workforce. However, offsetting drops in short-term consumption has been the only stimulus to date.

Corporations

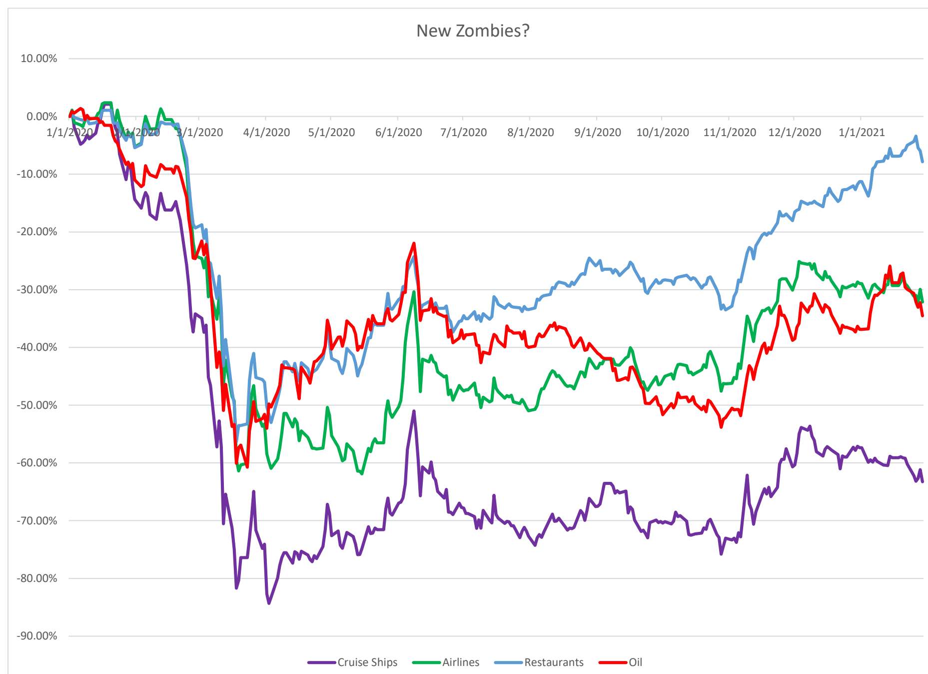
In the last year, US Corporations have added debt of $600BN. However, due to the incredible price rise of companies with low indebtedness, the Debt/Mkt value of equity has fallen. As they like, the zombies are hidden from view.

The companies that were particularly hard-hit from the virus levered up significantly. Restaurants like Darden, owner of Olive Garden, Airlines like Delta, Oil companies like Exxon Mobil, and Cruise lines like Carnival issued huge amounts of debt.

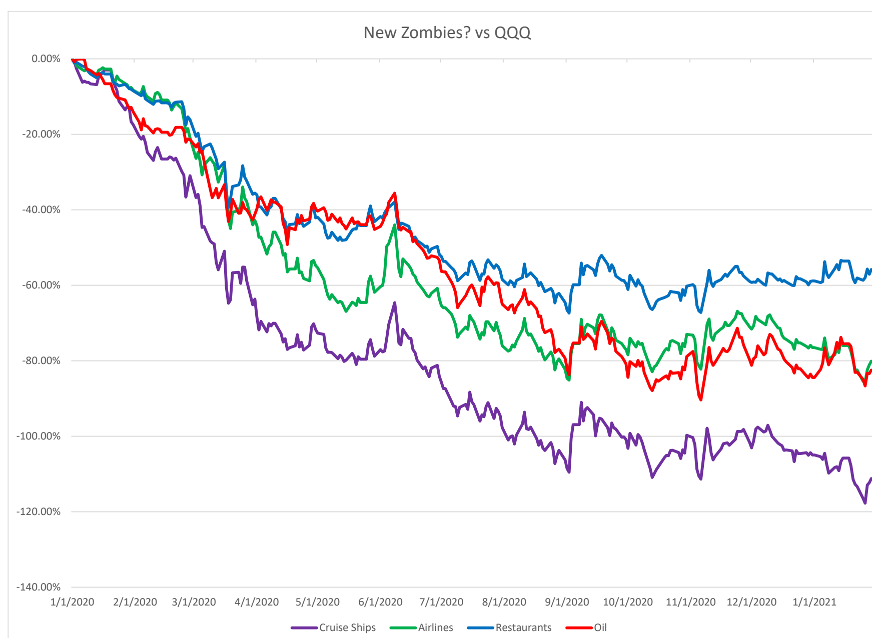
A recovery may be possible for these industries and that will deliver increased enterprise value. But the increased indebtedness will significantly dilute returns available to shareholders.

Over the past few months, as the vaccine and fiscal stimulus news have fueled "reopening" narratives, the small capitalization stocks that benefit most directly from a return-to-normal have recovered some of their miserable underperformance.

Even stocks that were most impacted by the virus, and levered up the most, rallied.



But these Zombies were not the stocks that generated outperformance vs. big cap tech. In fact, these industries continued to underperform, some ending near their lows.



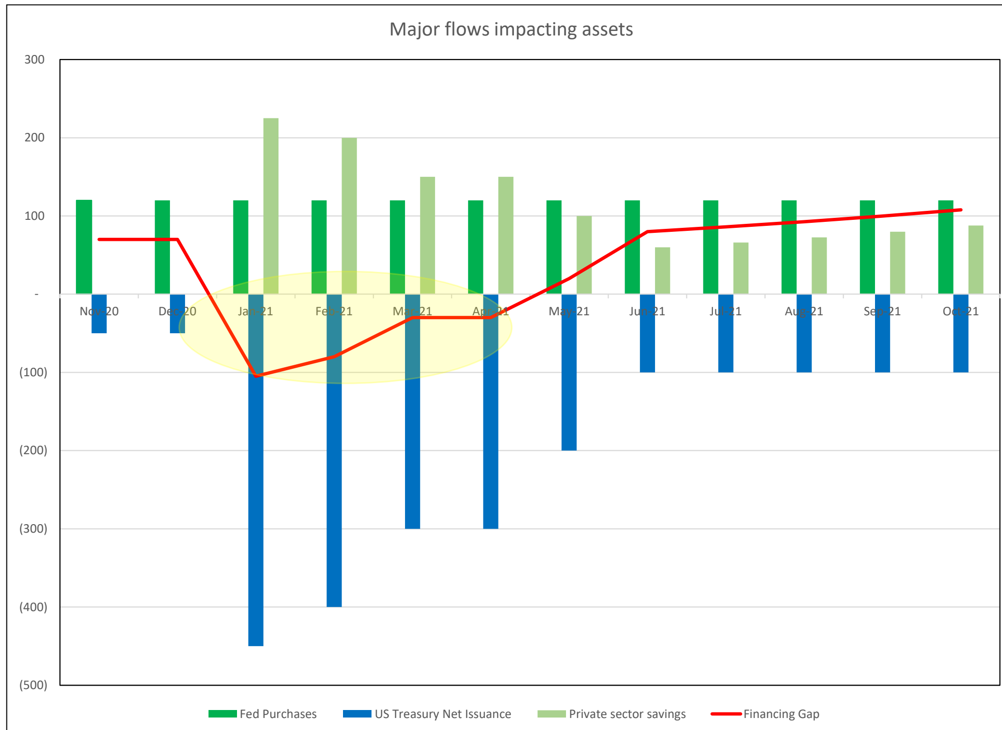
Companies in the Russell that drove the rally were ones that survived the pandemic and stayed in business while not layering on additional debt. They were exposed to rises in growth expectations without the debt burden. We do not expect growth expectations to continue to rise, driving these sectors higher given current pricing, and we are more certain that the incredible debt burden of the zombie sectors will prevent those sectors from assuming leadership.

As we broaden these observations to reflect the overall stock market, we have dealt with:

- Zombies that are too indebted to invest in rebuilding their business forever and whose recovery in enterprise value will be used to pay down debt, leaving little to pay to shareholders
- Companies that have avoided indebtedness and whose stocks have rallied significantly on vaccine and fiscal stimulus-related rises in short-term economic growth expectations.

But the mega cap leaders of the market remain vulnerable and, despite unbelievably good earnings reported last week by AAPL, MSFT and FB fell post earnings, significantly in AAPL's case.

As readers know, we believe that January was a tipping point for the major flows that have dominated financial markets since the pandemic began. Those flows are the purchasing of assets by the Fed and the supply of assets from debt issuance from the US government to fund stimulus (net of that which is saved by recipients).



January was a transition month, as excess buying vs. issuance, which ended in December, worked its way through the system. Equity prices held near their all-time highs. As the incredible monetary stimulus peaked, examples of frothiness appeared all over the markets, particularly in IPO volumes, aftermarket performance of IPO's, SPAC's, and of course last week's Reddit stock rallies. We have been doing this for a long time and therefore have nuanced thoughts about the implications (which we may share later or which we can discuss directly with readers), but for purposes of this DSR, we will merely state that we have never seen anything like what happened last week.

The Fed's excess purchases inflated the value of all assets since October. Now the supply demand has shifted for the next four months and may become even more extreme if the stimulus legislation proposed by the Biden Administration materializes. Assets will need to deflate to provide incentives to asset owners to lever up already fairly leveraged portfolios. In the equity markets, stocks that have generated most of the gain since the bottom in March 2020 have done so via Fed-induced multiple expansion. Those stocks will lead the market lower. Bond markets have both headwinds associated as the supply demand for asset shifts, and tailwinds from what may become too optimistic growth and inflation expectations.

Outlook

In synthesis:

- The economic recovery is doing okay; fiscal and monetary policy, while not well coordinated, are doing their respective parts; we expect policymakers to continue to provide support for in the near term

- However, our measures of market-based growth and our inflation expectations are much more optimistic than what is likely to be realized, despite this strong support by policymakers
- The supply of new issuance will be much larger than the available money and credit to purchase those assets, resulting in a strong headwind on all asset performance for much of the first half of 2021
- As we mentioned in our last correspondence, we believe that realized and implied volatility has reached a near term low. As the speculative frenzy continues to unwind over the next few weeks, we expect pressure on portfolios to deleverage, compounding the already short supply of cash available to fund fiscal policy.

Implications

- We are already max short SPX, and we added a short QQQ to our recommendations last week. Our target is $3,450 on SPX which would imply a return to risk premiums seen in October 2020. There is a lot of froth on risk premiums and we are quite bearish. Adding our view that growth and inflation expectations are also elevated, we see a triple whammy hurting stocks
- We are directly recommending betting against long-term inflation expectations. When Zombie countries rule the world and debt loads, the hurdle for the Central Bank is quite high. We will discuss this in detail in our next DSR
- At his point, we are neutral on the USD, Bonds, and Gold.

Current Model Portfolio Performance and Recommendations

	Assumed Portfolio size	$ 100,000,000				
	LTD P/L	$ 22,787,174				
	Total Return	22.79%				
	Today's Date	2/1/2021		Portfolio Created		4/15/2019
Date	**Position**	**Entry Price**	**Amount**	**Worst case l**	**MTM**	**P/L**
12/28/2020	SPX Feb 3650/3550 Put Spread	21.6	463	$1,000,000	20	$ (74,074)
12/31/2020	SPX Feb 3650/3550 Put Spread	19	526	$1,000,000	20	$ 52,632
1/25/2020	QQQ Feb 320/310 Put Spread	1.87	5348	$1,000,000	4	$ 1,139,037
1/4/2021	10 Year B/E swap $50k per bp	2	-50	$1,000,000	2.12	$ (600,000)