The Damped Spring Report

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

2/25/2021

Demand side sustainable inflation can happen, but virtually none of the conditions necessary for such inflation are present in the current US or global economy. The only condition that could flip and drive long term demand driven hyper-inflation, would be a global fiat currency crisis. Supply slack is likely to be significant for many years. Take the Fed at their words. They will remain highly accommodative.

Brief note on positioning

Our current positions have been wrong. The catalyst for our view was Yellen's decision to spend down the TGA instead of financing the deficit in the Treasury market. We expected a liquidity driven move into all USD assets by foreign and domestic investors as issuance supply disappeared. We correctly removed our max short in equities. But the decision to go long the USD vs EUR was wrong. While countries with large USD savings like Japan and Switzerland saw weakening currencies since the catalyst, the EUR and GBP have remained strong. As for the bond market clearly the lack of supply tailwind was overwhelmed by strong headwinds. We were wrong.

Synthesis of our current views

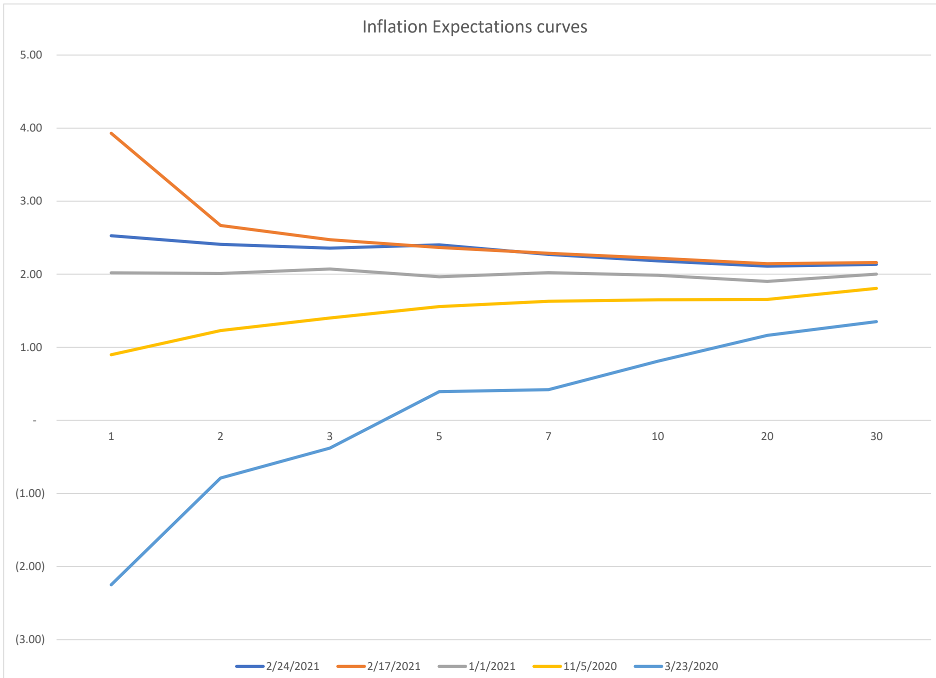
The dominant headwind impacting all assets is the rise in real yields, which have been up 32bp for the ten year in two weeks, driven by rising growth expectations. Inflation expectations are not much of a factor as forward b/e's are making a new low for the month, and not likely to rise as we will show as the focus of this report below. Risk premiums remain stable as:

- Portfolio volatility has been modest
- Portfolio leverage remains somewhat elevated
- Yet for the next two months the TGA decision will overwhelm supply concerns and deliver plenty of liquidity to support assets

This environment is benign and likely to stay benign for the balance of the Q1. For that reason, we have no strong views currently. The major catalysts to a shift in our view will be the details of a stimulus bill and the financing of that bill. As an aside we believe that the SLR will likely be extended to facilitate this financing but are view is not strong.

The Fed will remain accommodative as generating inflation is a tough job given current conditions

If one were to pay attention to general market chatter and near contract commodity prices, runaway inflation is around the corner. The hysteria regarding inflation seemed to have peaked with the steeply inverted curve on February 17 finally flattening. As of today, when looking at market expectations the outlook is much more anchored.



The dramatic inversion since the lows was driven by expectations of a massive pent-up demand story of an economy emerging from a pandemic. However, long term inflation expectations hover modestly above 2%

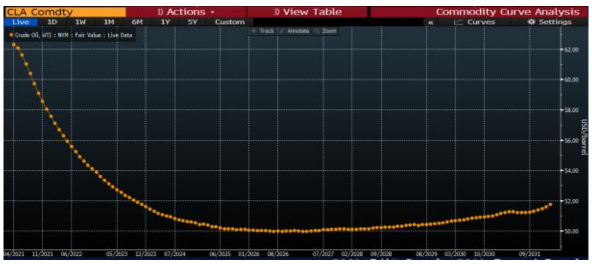
Forward inflation expectations have begun to moderate which suggests the difficulty in generating long term sustainable demand driven inflation given the conditions of the US and Global economy.

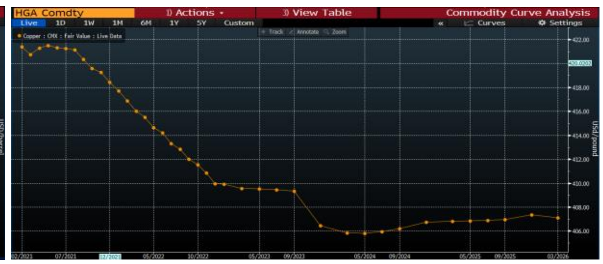
Supply

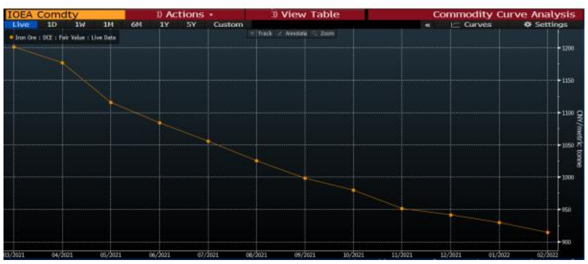
The supply side of prices are driven largely by input costs including commodities wages and productive capacity. It is obvious that demand for commodities and for goods and services will spike as the economy reopens. For sustainable long-term supply driven inflation, one would expect a radically different futures curve. This simply does not exist.

Commodity Inputs

Oil, Copper, Iron Ore, and Lumber are heavily backwardated and suggest no future supply constraints







Wages

No need for a chart to know that labor has virtually no leverage to increase wages given the unemployment rate at this point in the pandemic.

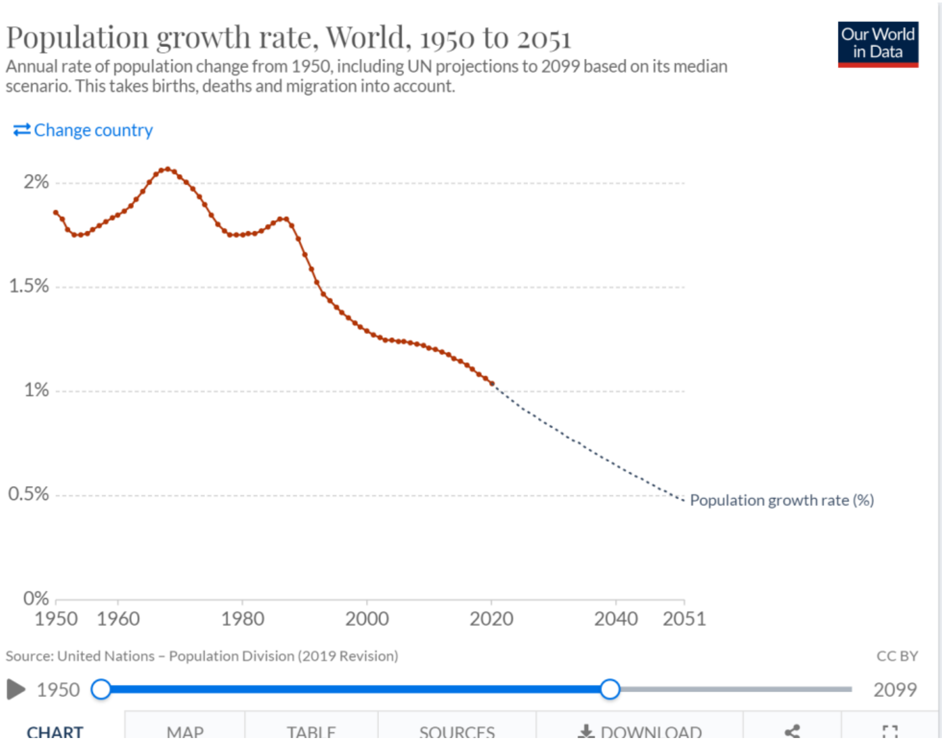
Demand

It is certainly likely that, as the global economy reopens, demand for all goods and services will spike ahead of the ability for suppliers of these goods and services to deliver. I think of it as a reverse toilet paper spike. It makes sense that prices would have a onetime adjustment against this demand. However, long term inflation means not just a onetime spike, but repeated price rises through time. The major drivers for sustainable long-term inflation are:

- Population growth
- Willingness and ability to leverage and dissave for extended time
- Expectations of long-term currency devaluation

Population growth

The world population growth rate is low and projected by the UN to continue to fall.



This decline in population is a significant deflationary force

Willingness and ability to spend for an extended time

As we have mentioned in past reports,

- Consumers have saved significantly during the pandemic as fiscal transfers have offset declines in income. They will dis-save near term, but savings have a limit thus dis-savings is not sustainable. For consumers to drive prices sustainably higher after an initial pop they will have to layer on more and more debt until the labor market becomes tight and workers have leverage to demand higher wages.
- Governments are unlikely to continue their spending trends after the pandemic relief bills end. Both political realities and debt capacity will pinch back government spending
- Corporations that were most impacted by the virus are much more in debt and less able to spend. We have mentioned the impact of these zombies in past reports

We believe that 2021-2022 will certainly see increased real consumption. But we do not believe this is sustainable after the initial dis-savings as debt loads are already high.

Currency devaluation

Clearly there have been currency crises where fiat money becomes worthless. The rally in crypto is more likely a speculative flow than driven by true concern in fiat. Gold has performed poorly which rejects this fear. Real estate seems to be rallying or falling based on idiosyncratic post pandemic preferences. Fiat currency pairs have been stable. We do respect that significant purchases of assets by the global central banks are perceived as printing and recognize the risk that if those central banks cancelled the debt that true printing would occur. However, recognizing that the balance sheets will be worked down rapidly in the face of above desired inflation means this printing will be reversed. One caveat, of grave concern, but, not in the cards for the moment, is the possibility that central bank independence is further compromised, and they become unwilling to slow economic growth to fight rising inflation if it were to occur.

One important point to note is that all currency crises in the past have occurred when a countries liabilities are mostly foreign currency denominated. This happened in the Weimar Republic and all EM currency devaluations occurred when foreign currency obligations weighed heavily on the domestic economy.

Our conclusion based on this work is that the market for inflation has by and large got this right. The fed has a tough job ahead and they will ignore the inflation hawks and gold bugs. The challenge will not be when to remove accommodation but will be whether the supply from the US Treasury, which has been put off by the TGA spend down inevitably comes to market in Q2 and the back half of 2021, needs monetization.

Current Model Portfolio Performance and Recommendations

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 19,533,561					
	Total Return	19.53%					
	Today's Date	2/25/2021		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case lo	MTM	P/L	Open/Closed
2/1/2021	EURUSD 5/1/2021 1.2/1.17 Put spreac	0.66	151,515,152	$1,000,000	0.1	$ (848,485)	Open
2/1/2021	USA April 167/165 Put Spread	0.734375	-790	$1,000,000	1.95	$ (960,494)	Open