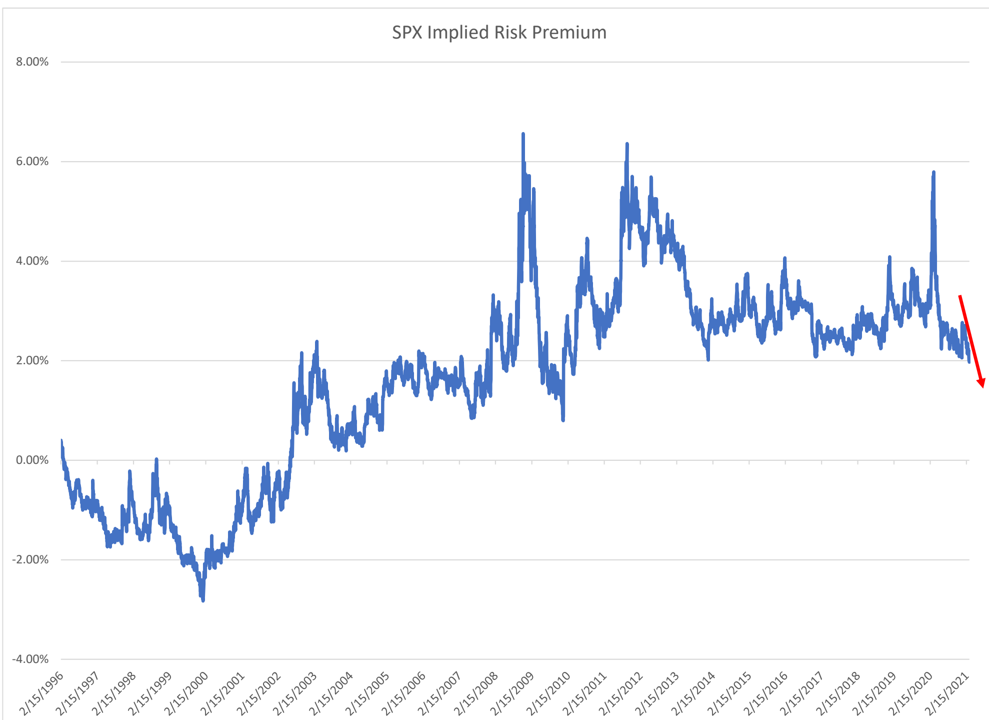
The Damped Spring Report

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

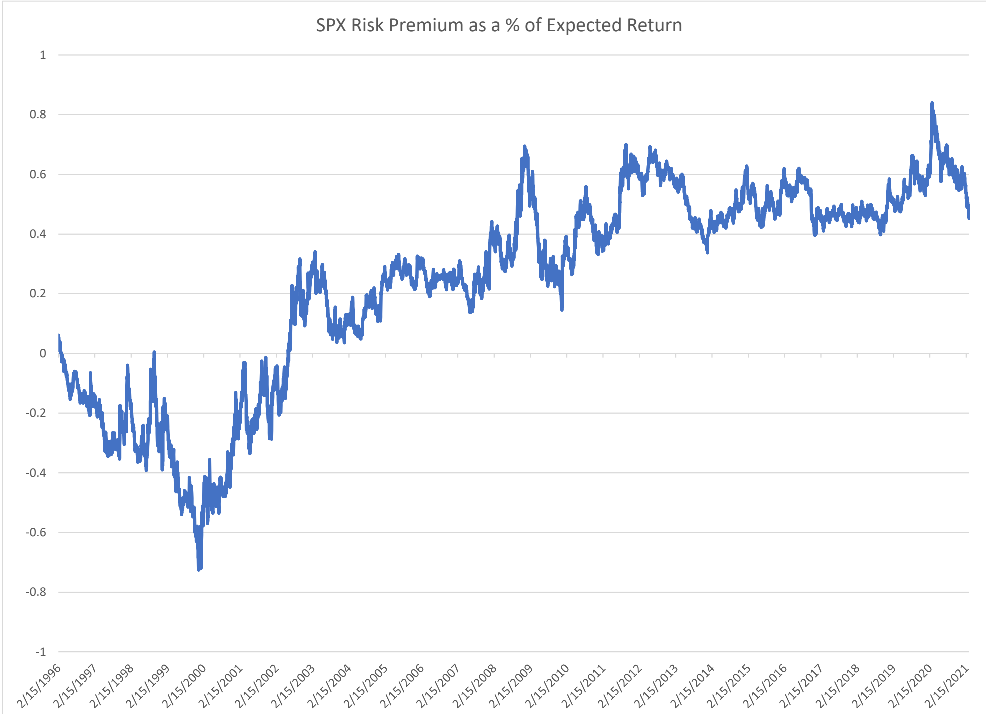
3/17/2021

Since our last report on the inflation hysteria, we have gone max long equities. Additionally, we bought bonds and gold on the recent dip. Emails sent to clients on 2/25 and 3/4 describe the specifics of our new recommendations. The reason we are so bullish on stocks and other diversifying assets is simple: we expect significant risk premium contraction over the next two months. We are particularly bullish on equities and expect the SPX to rally to $4,350 by May 1.

Risk Premium Contraction



Our model for risk premium defines equity risk premium as the excess return for investing in equities vs. long-term US treasuries. Given our current outlook regarding the two principal drivers of risk premium, we expect risk premiums to drop by at least 25bp. While many in the market consider equities to be overvalued as they were in 2000, this is far from the truth. In fact, equities appear to be cheaper than they have been in 20 of the last 30 years. The contraction of risk premiums will also support bond and gold prices as well as continue to be bullish USD, as foreign investors buy the limited supply of US assets.



We believe that risk premiums on assets scale linearly with the level of expected return. The chart above shows that there is substantially more room for risk premium contraction, even based on recent history, when viewed through the lens that risk premiums should be lower when expected returns are lower.

Risk Premium Framework

Risk premiums are excess returns for those willing to loan cash and thus delay consumption to those who want to consume today. Whether this cash is exchanged for stock, corporate bonds, or government bonds, the lender takes on market risk, and if they one day need cash, they are exposed to price volatility. Alternatively, if this cash is simply reinvested daily, currently it earns zero, but market expectations are for that cash to one day have a positive nominal return. That positive nominal return is truly risk free, as the cash can be spent at any moment. However, that positive expected nominal return is not equal to the return of a long-term US treasury bond. The long-term US Treasury bond is volatile and thus one would expect it to offer a higher return to offset the risk. Similarly, while the equity expected return is unknown, it is reasonable to assume that its excess return scales with its risk. In other words, at any one moment, we assume that all assets have identical expected risk-adjusted returns. If they did not have the same expected risk-adjusted returns, we would think that flows into the superior asset would cause convergence.

When one owns assets, one collects that excess return every day. However, as we have seen particularly the last 12 months, the expected excess return can be highly volatile. When it expands, assets of all sorts fall. When it contracts, assets rally.

As we have described risk premium, it should be clear that the principal drivers of risk premium are risk, the amount of money and credit available to purchase assets, and the supply of assets.

Risk Premium Drivers Outlook

Supply and demand for money:

- On February 2, Janet Yellen did her part to compress risk premiums by deciding to delay issuance of $900BN of US Treasury bonds and using the TGA to fund deficit spending. Her action eliminated the asset overhang while the Fed continued to buy $120BN per month. This delay will last at least a month or so after 2Q begins, as the initial issuance will be absorbed by the market until the supply becomes overwhelming
- On March 10, President Biden signed the long-awaited stimulus act which is already distributing cash to the economy
- Tomorrow, the Fed will reiterate its dovishness and likely extend all or a portion of the SLR.

These three factors suggest that money and credit will stay plentiful, and supply will remain backloaded to later in the 2Q and back half of the year.

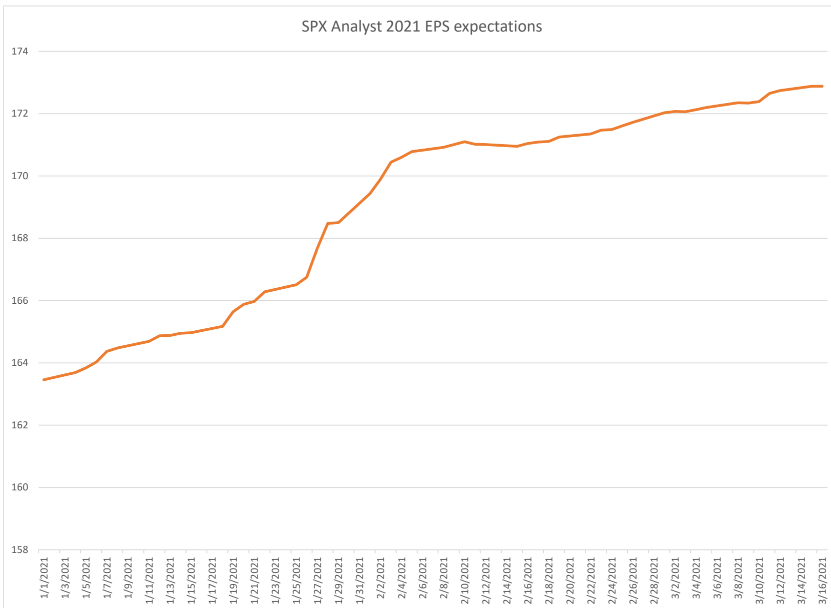
Volatility

During the 4Q, realized volatility dropped from 25 to 10, and equities rallied 13% as election uncertainty cleared. After a period of significant realized volatility, we expect the next few months to see significant clarity around the reopening of the economy, as the Fed pumps liquidity into the market and the stimulus bill flows into the economy. Recently, portfolio deleveraging and high realized volatility has kept risk premiums from contraction. A fall in perceived risk will be a powerful driver for risk premium contraction.

Equity Target Raised to $4,350 by May 1

As earnings season begins, we believe that companies will significantly outperform market earnings expectations. Four factors dominate our view:

- Reopening and stimulus will fuel higher-than-expected top line revenue
- Transitory inflation will also generate higher-than-expected top line
- No wage inflation will result in higher margins
- Companies will be more willing to provide forward earnings guidance which will likely be optimistic



Earnings expectations for the SPX have risen to $173, up 6% over the course of the last 2 months. We expect that strong 1Q results will drive earnings expectations to $180. Assuming no change in risk premium or interest rates, the SPX should rally to $4,120.

If risk premiums do contract, our fair value will jump to $4,350. We are bullish on all assets, but particularly bullish on US equities.

Current Model Portfolio Performance and Recommendations

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 20,896,198					
	Total Return	20.90%					
	Today's Date	3/16/2021		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	0.76	$ 151,515	Open
2/1/2021	USA April 167/165 Put Spread	0.734375	-790	$1,000,000	2	$ (1,000,000)	Closed
2/25/2021	USA June 160/162 Call Spread	0.78125	1280	$1,000,000	0.484375	$ (380,000)	Open
2/25/2021	QQQ JUN 310/325 Call Spread	8	1250	$1,000,000	9	$ 125,000	Open
2/25/2021	GCA JUN 1800/1825 Call Spread	10	1000	$1,000,000	5	$ (500,000)	Open
3/4/2021	USA June 160/162 Call Spread	0.4375	2286	$1,000,000	0.484375	$ 107,143	Open
3/4/2021	QQQ JUN 310/325 Call Spread	5	2000	$1,000,000	9	$ 800,000	Open
3/4/2021	GCA JAN 1800/1900 Call Spread	4	2500	$1,000,000	5	$ 250,000	Open