The Damped Spring Report

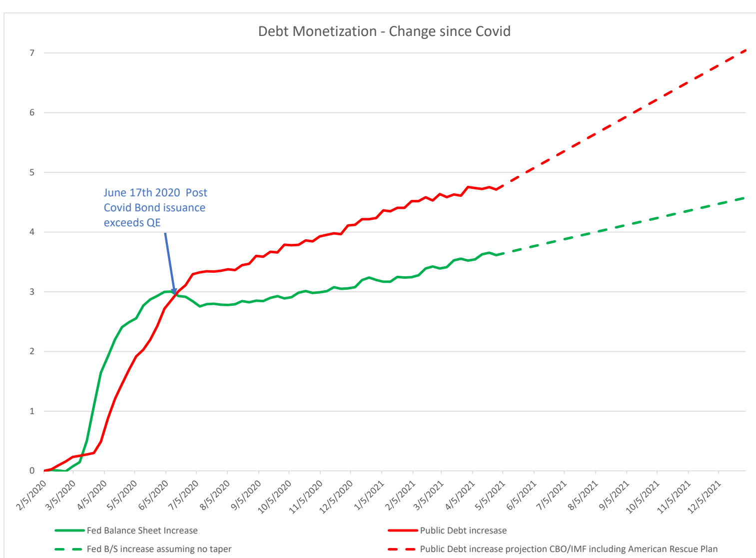
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

5/2/2021

Last Thursday, we added a short portfolio of assets including stocks, bonds, and gold to our Damped Spring Model Portfolio. The reason we changed our view is that the principal driver of risk premium contraction has flipped from what has become a largely ineffective tailwind to a headwind. That headwind could become particularly strong in this quarter. We will go to max short assets based on the size of the net debt issuance announced in the Quarterly Treasury Refunding released on Monday. Regardless of the size of the net debt issuance we will hold our short asset position. Risk premium contraction is over for the foreseeable future. Risk premium expansion will drive asset prices for the balance of 2021.

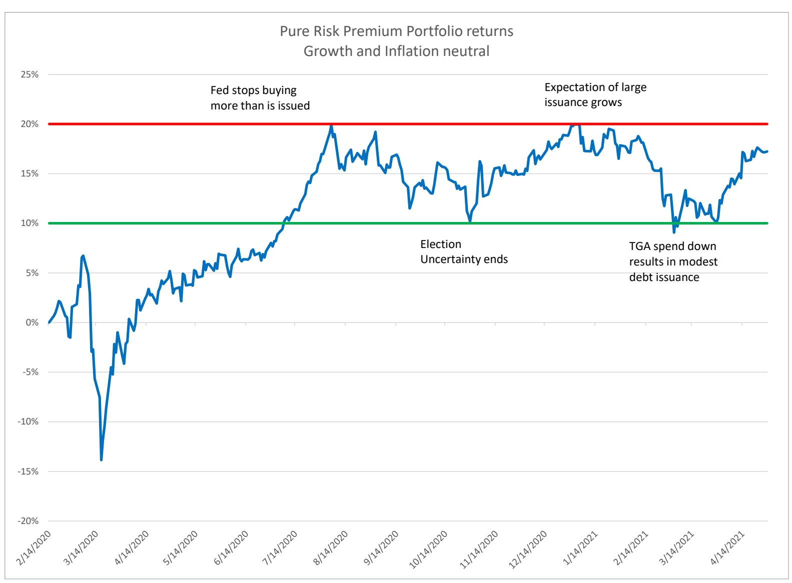
The supply of money and credit to purchase assets vs the amount of available assets is shifting.

Prior to June 17th 2020, Fed purchases of financial assets grew far faster than issuance. Most of the contraction in risk premium from the extremes in late March occurred prior to June 30th. Since then, US National debt has grown at a faster pace than Fed purchases. Risk premiums have continued to contract as some of the Government spending has gone to savers and offset the gap between Fed purchase and Government bond issuance. The tailwind was dramatic in Q2 2020 and has become a whisper today. The funding of the American Rescue plan will increase the gap by a significant amount flipping the tailwind to headwind as new bond issuance crowds out existing assets.

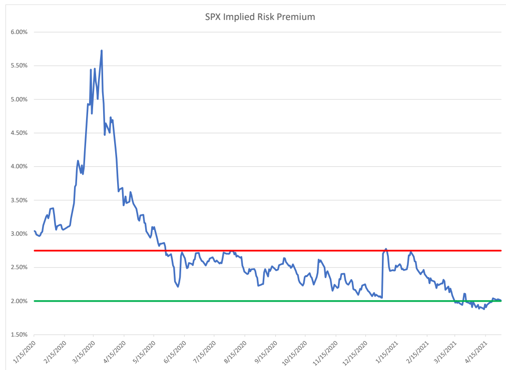


Our projections assume that the Fed will not taper in 2021 and that whatever comes from the two Presidential proposals currently working through Congress is paid for by increases in revenue. We will say more about the impact on asset markets due to these proposals as details emerge, but we think that it is almost certain that more debt financing will be required in both. This will support our case, but our case ignores this additional headwind to assets.

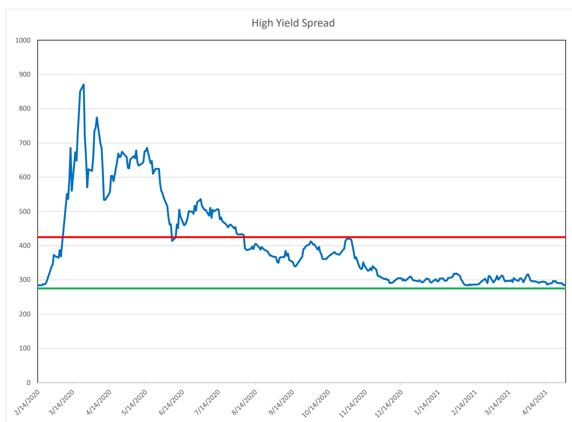
Let us rewind the year and observe the returns on a portfolio designed to make money in environment when risk premiums contract and lose when they expand. There are many commercially available products in the market that have this feature including the All-Weather fund from Bridgewater and many funds offered with the name risk parity. As can be seen below portfolios of this sort which are designed to be neutral to changes in expectations for growth and inflation did incredibly well from the bottom of the Covid Crisis until the Fed stopped buying more assets than the Government issued. Prior to the election the other driver of risk premiums also came into play. Risk premiums expanded ahead of the Presidential elections and collapsed after the election was decided as uncertainty faded. This year as the various spending bills were passed and the money spent risk premiums again expanded and asset prices collapsed. Then Janet Yellen surprised the markets by delaying additional issuance and spending already financed cash from the Treasury General Account. Risk premiums reacted as expected and assets of all sorts rallied. On Monday, the Quarterly Refunding Announcement will see Janet Yellen using some or all of the last chunk of cash, but the American Relief Act will overwhelm that cash, possibly by a large factor. Regardless of the details the die is cast. Over the course of this year issuance will overwhelm Fed purchase and any savings generated by the fiscal spend. Perhaps Janet will kick this problem down the road for another quarter. But as the impact is inevitable one must consider politics and when the administration would prefer a bit of market turmoil. Our view is sooner rather than later.



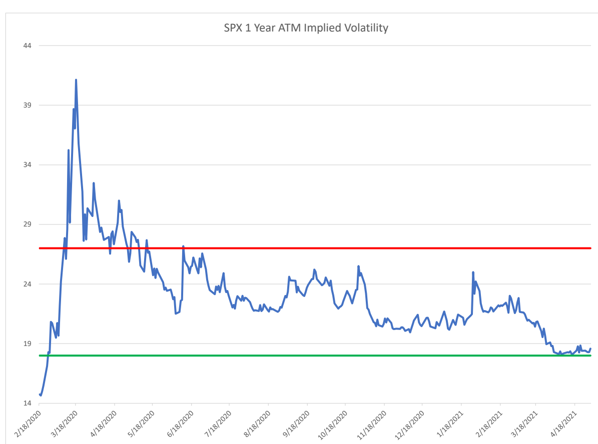
While the pure risk premium portfolio is the best way to understand the dual factors of money and credit relative to issuance and expected portfolio risk, other measurements of risk premium also have had amazing Q2 2020 moves followed by flatlines lately. There is just little juice for additional risk premium contractions. Risk Premiums are extremely low, and the tailwind is turning to a serious headwind. SPX implied risk premiums are low and not going down. Unbelievable earnings last week by the major tech companies have been followed by multiple contraction.



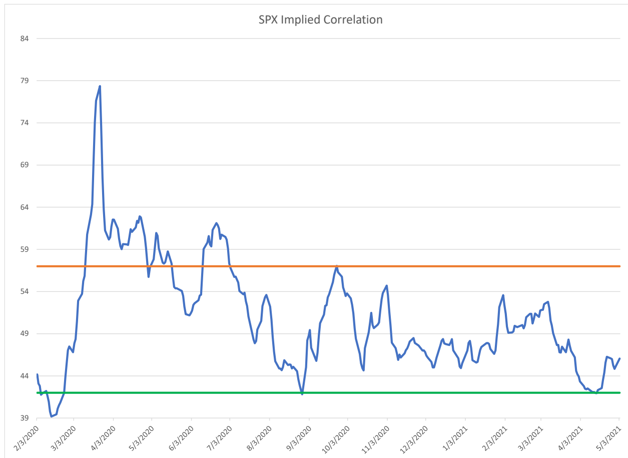
Credit spreads are a mirror to equities. Most of the rally was in Q2 2020 and flatlined lately



SPX Long Term Implied Volatility similar picture



One interesting aspect of the level of volatility in the equity market is that over the course of the last year dispersion and sector rotation have been extreme. Stocks directly impacted by the virus were hit the hardest and have recovered the most. Stocks benefiting from stay at home did great and have since fallen dramatically. Lastly, high multiple stocks did extremely well due to risk premium contraction. This led to high realized and implied volatility in individual stocks relative to the overall market volatility.



This chart shows that correlation implied by the prices of individual options vs index options is quite low. This can resolve by falling individual stock volatility or rising SPX volatility. We suspect that given the extreme forces working on individual stocks they will remain volatile and the coming headwind on all assets will drive correlation higher having a meaningful impact on SPX implieds.

Yellen can still pull levers – Craven political speculation section – Ignore if you like

On Monday, the Quarterly Refunding Announcement will be the next opportunity for Yellen to directly influence the market. While there are some important boundaries established by Congress that influence the spending down of the TGA she has some flexibility. We do not know exactly how much debt will be issued and how much of the TGA will be used to fund the normal deficit and the American Rescue Plan, but the numbers are both going to be large. A political calculation is being made. Friday was the end of the first 100 days of the Biden Administration. The Administration has had the good fortune of the of a 9.3% rally in the market since inauguration and a 25% increase since election day. During that time, they have proposed an increase in the corporate tax rate and an increase in capital gains for the wealthy. Both of those proposals have an impact on the valuation of the stock market but those are now discounted in the market price and are politically distant from any market fall that may come in the next few months. Biden has been clear about his agenda to improve conditions for labor and address the wealth gap in America. The idea that he cares about the level of the stock market simply does not exist in his mind. However, timing matters. Its not too early to look to the 2022 elections. Inevitably the election will be impacted by the stock market as, while Biden may not care much, the voters pay attention. It would be quite bad for the Equity market to be making lows a year from now. The sooner the market corrects the better the probability that the market recovers by election day. We believe that the Biden Administration understands the political reality and advantage they have built with a strong post-election equity market. At a minimum Janet Yellen both understands the lever she holds and the political impact of the timing of a market decline. Whenever she chooses to issue a bunch of bonds and spend the minimum amount of her checking account the market will react. We will see if she wants to push this to next quarter or let the market dip into the summer. She has flexibility but eventually her checking account will run low, and the bonds will have to come to market. Be short assets ahead of the Quarterly Refunding Announcement as we have described and go max short if she chooses to pull her lever and flood the market on Monday.

Targets

Our estimate of the impact of the tightening of monetary conditions associated with the gap between fed purchases and bond supply for the 30-year bond is an increase of 15bp of the risk premium portion of the bond yield. This would take the yield on 30-year bonds back to the post crisis high of **2.45%, our new target**. While shifts in inflation and growth expectations will move real rates and inflation expectations up or down, we expect the total yield to rise by 15 bp without any view on the shift in economic conditions.

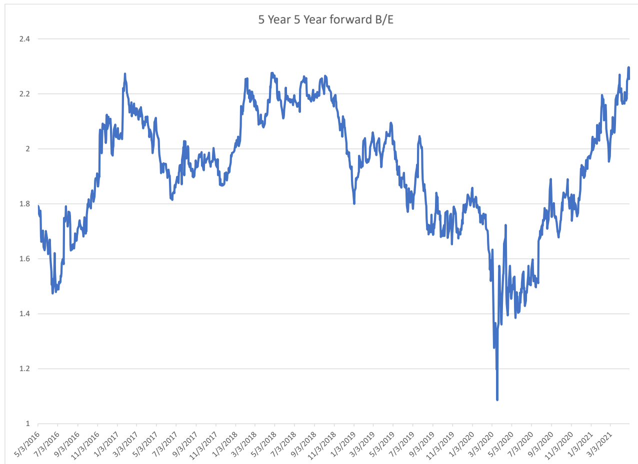
As for equities the change in risk premium will be magnified by the relative risk of equities vs bonds. We estimate a change of 35 bp in risk premium. The combination of the two risk premium expansions on 30-year bonds and equities combine to a discount rate rise of 50bp. Based on the extremely strong earnings for 2021 Q1, we have already set our EPS expectations for SPX to $1.85. Our old target of 4,350 falls to **our current target of 3,895** when adjusted by 50bp of risk premium expansion.

Gold responds primarily to changes in real yields. We agree with most gold bugs that one day it could respond to a fiat currency crisis but that is a tail impact, and we see no reason to change the level of tail risk in gold. The long-term correlation coefficient of gold to long term real yields is -82% Assuming half of the rise in risk premium is in real yields the **gold should fall to our target of $1675**

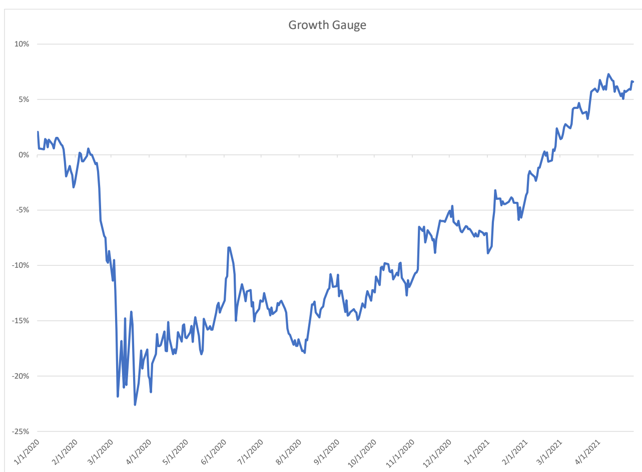
A review of underlying economic conditions

Importantly, our call to go short assets of all sorts is due to risk premium expansion. We are not making a bet on shifts in inflation or growth expectations. Obviously, the shifts in underlying economic conditions will impact each of the assets we are short differently. Our views on long term conditions have been described in two of our recent reports, "Inflation and why its likely transitory" and "The Zombies Reawaken." Both reports recognize the likely significant spikes in short term growth and short-term inflation but also suggest that the secular deflationary forces and the incredible debt load will keep long term inflation at bay and trend growth under pressure. Currently both growth and inflation expectations built into market prices are at post crisis highs. This makes sense and we do not know if these expectations are going higher or lower. But we suspect eventually there will be pressure on both. This makes us favor an equity and gold short over bonds as falling growth and inflation would buoy bond prices. But as we do not have confidence in our short-term outlook for these key economic conditions, we recommend all shorts in all three.

Inflation expectations have hit a 5-year peak



Our growth gauge has also peaked



Current Model Portfolio Performance and Recommendations

On Thursday 4/29 we sent an email to our readers suggesting the new positions below. Monday after the Quarterly Refunding Announcement we will either maintain these positions or double to max.

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 22,754,073					
	Total Return	22.75%					
	Today's Date	5/2/2021		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case l(	MTM	P/L	Open/Closed
4/29/2021	QQQ July 320/300 Put Spread	3.5	2857	$1,000,000	3.5	$ -	New
4/29/2021	GCA August 1750/1700 Put Spread	17.5	571	$1,000,000	17.5	$ -	New
4/29/2021	USA August 151/148 Put Spread	0.625	1600	$1,000,000	0.625	$ -	New