The Damped Spring Report

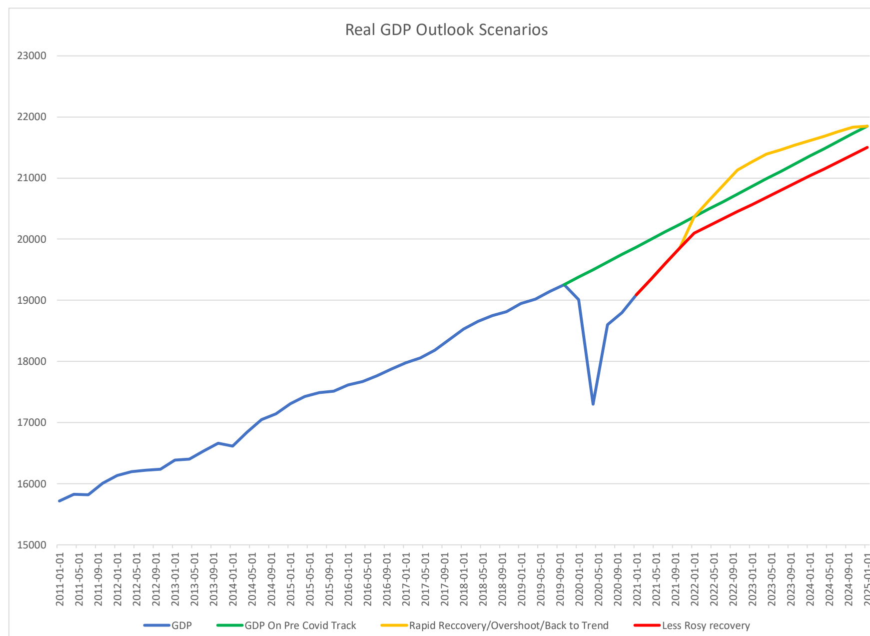
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

5/18/2021

What if? That is the question most investors are asking as they try to navigate markets as the economy reopens. What if the roaring 20's is ahead, and growth runs hot for years? What if inflation is not transitory? What if the Fed tapers? We went bearish all assets at the turn of the month based on our view that the issuance of government bonds would cause a summer long squeeze on available money and credit and a widening of risk premiums on all assets. We remain positioned in this way. However, all these "what if" questions remain for investors and the answers will determine individual asset price as they are all impacted by changes in economic expectations and the Fed's responses. Our view is that the market is priced correctly for transitory inflation, equities are priced for higher growth than bonds and gold is rich to real rates.

The headline is stocks are more vulnerable to a sell-off than gold, and bonds are the least likely to have a sell off. Nonetheless our higher point is all assets have a strong headwind preventing a rally. We are taking a step back and looking at the world through a wider lens and trying to have answers for the "What ifs."

What if this is the beginning of the next roaring 20's?

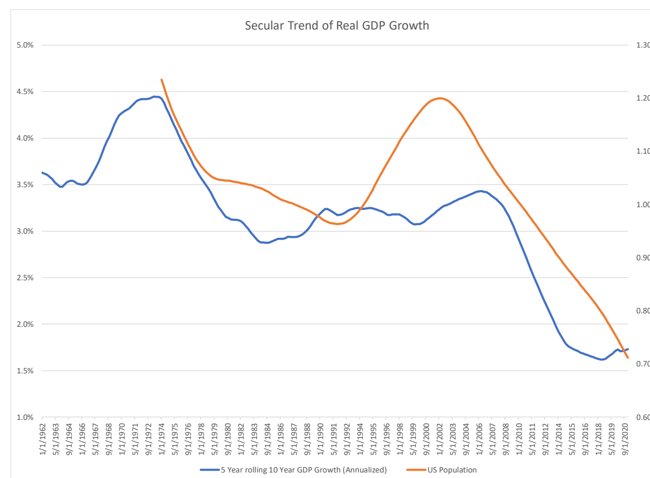


In the chart above we suggest two possible outcomes for growth.

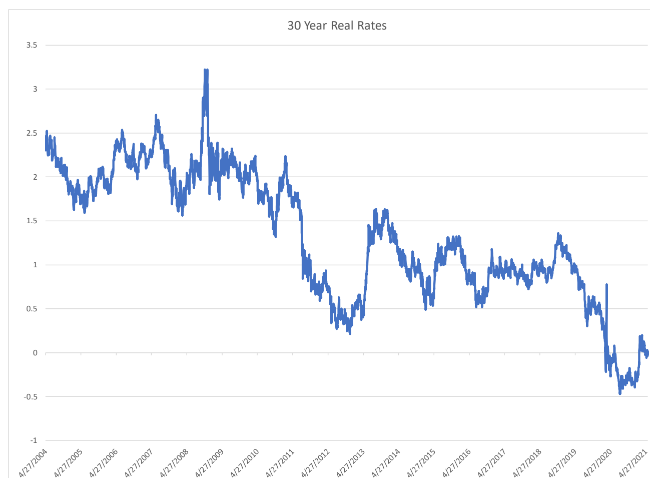
- An overshoot and return to trend growth
- An undershoot and slower than past trend growth.

We believe that US equities are priced at a minimum at the yellow line and possibly even more optimistically. Our own outlook is between the yellow and red line. That case looks like a rapid recovery and then a longer term slower than recent trend growth.

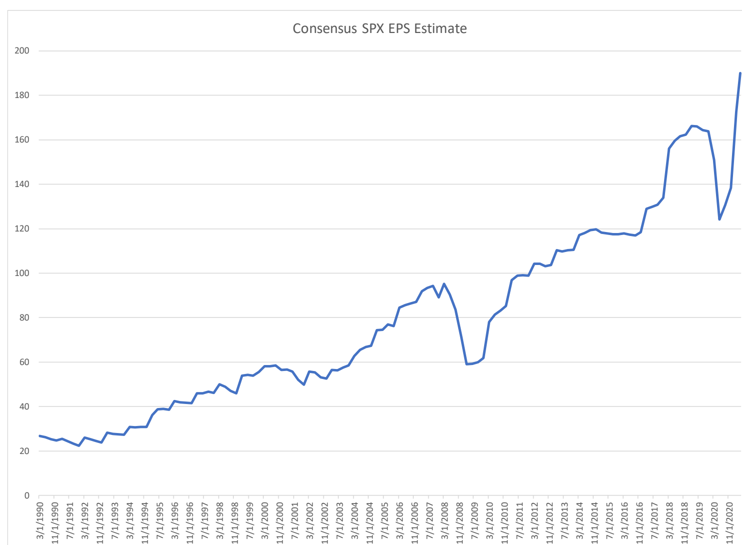
Who knows about the speed of the short-term recovery? We do not. However, long term growth is driven by population growth and productivity improvements. If you look at our past work The Zombie Reawakens you know that we are concerned about the ability for innovation and investment in productive capacity by the government and many companies based on the incredible debt growth required to bridge the pandemic. The trends for population growth are even more dire.



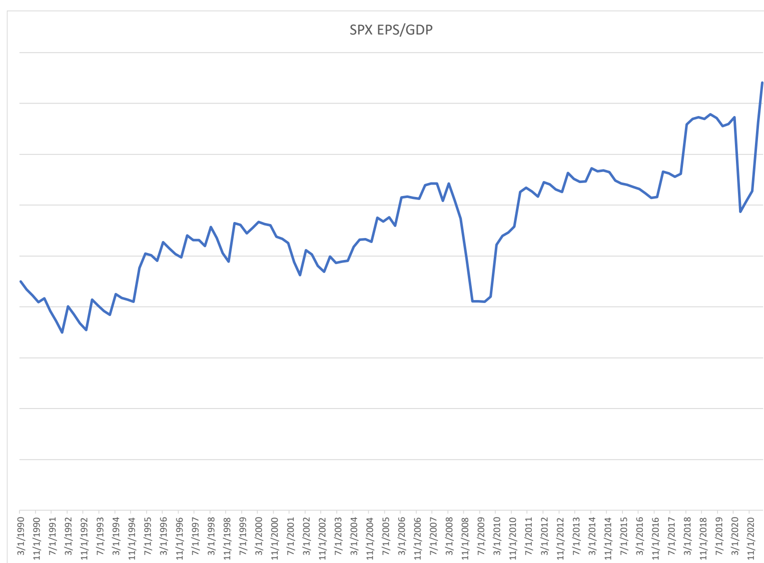
Future population growth is expected to continue to fall rapidly through 2050. The long-term real rate follows this trend well and at 0% today indicates that real rates may go up a bit but population growth and debt constrained investment in innovation and productivity are likely to be a headwind against much higher real rates.



Gun to our head, we expect a 50bp increase in real rates over the summer generated by risk premium increases and modest long term growth expectations. That is bearish gold and nominal bonds. For equities, its bearish from a discount rate standpoint and bullish from a growth expectations basis. However, earnings expectations which are the manifestation of nominal GDP growth are quite high and have jumped dramatically in the last 6 months.



As a percentage of Nominal GDP earnings expectations are also well above historic highs. This can be explained if inflation expectations are unanchored



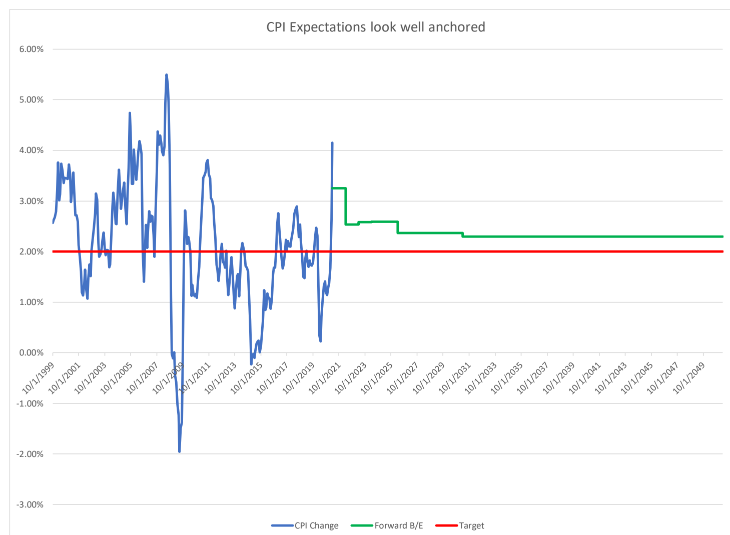
However, we do not believe inflation is at risk of becoming unanchored and thus the current growth estimates and more importantly the expectation that future growth will grow at least by the yellow line in chart 1 is required simply to generate our valuation target of $3900 on SPX which now remains 4% below the current spot. The yellow line is possible but unlikely in our view. If it occurs stocks are still a bit rich, and bonds and gold will suffer. This puts stocks as our least favorite asset. We

would be wrong and nominal earnings and equities could rally more than our expectations if inflation is not anchored.

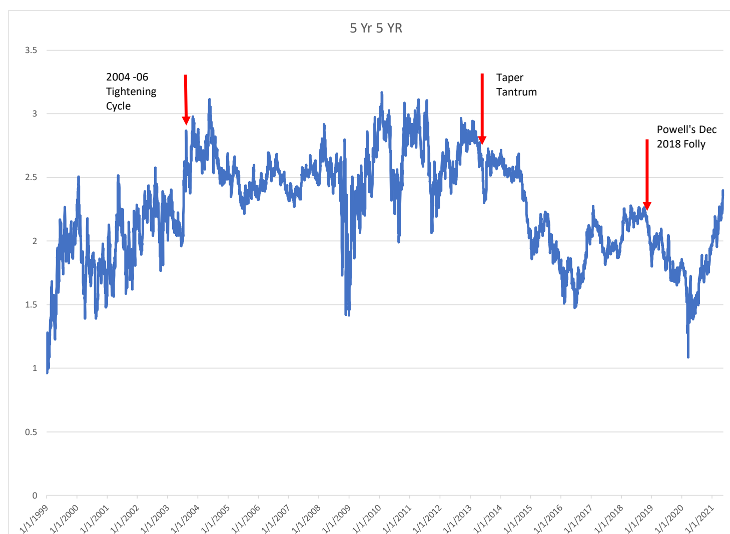
What if Inflation is not transitory

In our past report titled "Inflation and why its likely transitory" we lay out our fundamental macro reasons why a spike in prices in the near term is certain but persistent inflation is highly unlikely.

The market appears extremely well anchored in expectations



We think the market has adjusted to the new Fed framework and the current economic conditions. The snapshot above masks the big move that has already occurred. Below we show the spike in forward inflation expectations and point to the times when inflation expectations appeared to be unanchored. In 2004-2006 the impact of the tightening achieved its goal. However, both the taper tantrum and the Powell Folly in 2018 were failures. With forward inflation expectations just a few basis points above the level when Powell made his famous policy mistake, we are confident that the Fed will stick to its word until this chart prints 3%



What if the Fed Tapers?

Clearly, we do not think that the market conditions suggest a taper and based on the last chart we do not think there is much pressure on the Fed at all. However, if inflation expectations do rise to 3%. We may be wrong. Along the way to that event nominal bonds, which we are max short will do quite poorly, Gold would do well but tempered by rising real rates and equities would likely realize the Yellow line and could possibly rally modestly (remember our target is 3900 with current market expectations built in already). But given the amount of Debt supply that needs to be supported with QE the impact on risk premiums of a taper would be dramatic and massively increase the headwind on all assets. We think the path of inflation expectations is modestly higher over the next three months driven by continued high current CPI prints we also believe that the risk premium on nominal bonds widens due to factors mentioned in our high level point that assets suck. For that reason, nominal bonds are likely to trade lower to our target of at least 2.45 on the 30 year. But if we are wrong and the Fed does taper, any knee jerk selloff in bonds should be bought

Synthesis:

Assets suck. A short asset portfolio balanced to changes in inflation and growth expectations is the highest Sharpe Ratio way to play a portfolio deleveraging that should drive

- Stocks to our target of 3900 on SPX and 286 on QQQ
- US Long bond futures below 148
- Gold below 1750

Nonetheless we could be wrong on any of these assets as growth and inflation expectation changes drive them differently. Given our expectations of:

- A sharp rebound in growth followed by long-term GDP growth which is weaker than the recent decade,
- A sharp one time jump in CPI which remains anchored long term due to strong deflationary forces and a Fed likely to act 50bp from here.
- What is priced into assets?
    - Gold significantly outperforming its primary driver of the inverse of real rates
    - Equities valuations
    - Bonds pretty much getting it right

Our favorite short is equities followed by gold and lastly bonds. However, we know that we do not really know and for that reason are not adjusting our portfolio

Current Model Portfolio Performance and Recommendations

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 22,818,835					
	Total Return	22.82%					
	Today's Date	5/19/2021		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	6.45	$ 842,857	Open
4/29/2021	GCA August 1750/1700 Put Spread	17.5	571	$1,000,000	4	$ (771,429)	Open
4/29/2021	USA August 151/148 Put Spread	0.625	1600	$1,000,000	0.6	$ (40,000)	Open
5/3/2021	QQQ July 320/300 Put Spread	4.5	2222	$1,000,000	6.45	$ 433,333	Open
5/3/2021	GCA August 1750/1700 Put Spread	10	1000	$1,000,000	4	$ (600,000)	Open
5/3/2021	USA August 151/148 Put Spread	0.5	2000	$1,000,000	0.6	$ 200,000	Open