The Damped Spring Report

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

6/28/2021

The bridge to the other side of the pandemic has spanned the chasm. While the global economy is still crossing that bridge, there is little doubt that it will make the other side. We want to take a step back and look at where the economy will land by year end 2021.

The headline: Over the last two years the negative economic impact of the pandemic has been successfully overcome by debt monetization of government spending by global central banks. The supply of bonds has had no impact on asset prices and the wave of growing private sector savings will not ebb for years. A portfolio that has a pro inflation tilt should do extremely well in late 2021 and into 2022. Volatility should remain depressed. One day the central banks may actually reduce their balance sheets, but a taper and a rate rise will not be enough to slow the bull market for risky assets, inflation linked bonds, commodities, and currencies where relative inflation is low. Nominal Bonds should trade in a narrow range.

Note: We have been warning of a liquidity withdrawal as large US Treasury issuance will squeeze out other assets in August and September and we have been cautious about growth as the fiscal cliff in September approaches. We will address these concerns in the second section of the report, but our view has changed, and we expect a less severe sell off in assets which may be difficult to time.

Stepping Back

The Fed, the US government and their colleagues across the globe began erecting the bridge when the pandemic hit, and the economy was shut down. No one knew at the time when our lives would return to normal. Thanks to rapid effective vaccine development and distribution it appears that we are almost on the other side of this deep chasm. Of course, the next pandemic is always possible but let's save that for another day.

As we reach the other side of the bridge there will be bumps. But by year end we would expect that the combination of the ending of EUI, schools reopening and less fear of personal risk of covid death, will have resulted in a significant matching of jobs offered with those unemployed.

We expect the following conditions to be present at year end

- Employment dramatically on its way to full employment
- Long term inflation expectations well anchored
- Economic growth above trend but falling and likely to fluctuate around trend
- An accommodative central bank albeit without increasing emergency support
- A neutral fiscal policy relative to 2020-2021

The important insight of these sets of expectations is that it will look like the late 2019 economic outlook. Which itself was supportive to financial assets. As of year-end 2019

- 30-year bond yields were 2.25% consistent with anchored inflation expectations and trend growth.
- The SPX was at 3300 with expected 2020 earnings of 150 generating an equity risk premium of 2.2% over the long bond
- Lastly gold was $1530

For year-end 2021 we expect

- The 30-year b/e inflation rate will remain well anchored. At the current level of 2.31% we suspect limited upside on that rate and our expectation is for it to drift lower over the year. As for real rates, at the end of 2019 real 30-year rates were 0.50%, current real rates of -0.19% should drift higher as the economy normalizes. **2.25 30-year would seem about right to us but could be modestly higher.**
- Current consensus earnings for the SPX is 213 for 2022. Using an extremely conservative risk premium equal to the 2019 year end risk premium, generates **our new year-end target for the SPX of 4630**
- **Our target for gold remains 1690.** This bearish target combines our expectation for real rates and continued increase in Fed credibility

Which brings us to the key difference between the end of 2019 and the end of 2021. The pandemic bridge was built by debt monetization by the Fed in cahoots with the US treasury. By the time we are on the other side of the bridge the Fed will have bought about $5Tn in debt and that will be about equal to the emergency spending done by the US Treasury. That emergency spending was effectively monetized.

We have filled the pages of many Damped Spring Reports by examining the timing of issuance relative to Fed QE. But when viewed over the 2-year period impact from that factor will appear as wiggles. What is important is the fact that all the fiscal spending, that has replaced income during the deep chasm of the pandemic shut down, was financed by the Fed, and resulted in having no crowding out impact on other financial assets.

In fact, quite the opposite. Some of the spending went directly into corporate, state, local, and consumer savings and was invested in the real economy or financial assets. The balance of the spending was used for consumption, but that consumption generated wages, profits, and converted raw commodity assets into cash savings for the owners of those assets. That process continues, until most of the entire spending by the US government (and other global government who also monetized their debt) ends up as savings. **Our target for SPX assumes that risk premiums are exactly the same as they were in 2019. However, this extra 5TN of savings has nowhere near that amount of extra assets to chase because those assets are on the Fed's balance sheet and are currently not available for sale. The 5TN has and will continue to crowd into assets. Risk Premiums could go significantly tighter than end of 2019 levels.**

Savings will continue to build for quite some time as this process works through the economy. Assets should remain well supported by these savings for 2022. Private sector savings have grown by approximately 3TN since 2019 as the direct payments and indirect stimulus has filled corporate coffers and consumer savings accounts and investment accounts. We expect significant continued savings growth.

In order to reverse these asset inflation forces the Global central banks will not only have to taper but reduce their balance sheets while raising rates to make cash more valuable. QT seems highly unlikely for 2022. Assuming that QT is far off. All assets will have a tailwind from savings growth.

In our report of March 2021 "Inflation and why it is likely transitory" we outlined the strong secular deflationary forces which remain present in the economy. We suggested that the supply chain clogs, and commodity price rises were typical of an economy opening up. One of our key expectations is that the labor shortage will be resolved by the end of Q4 which will increase productive capacity also slowing price increases of goods and service.

However, when stepping back as we have today it is also clear that the growing private sector savings will leak into consumption. This is not a short-term transitory tailwind. Just as savings will support asset prices, savings will also support nominal prices. We strongly believe that the long-term inflation expectations will remain anchored but also could see a trading range around that anchor.

Issuance and Fiscal Cliff in August and September

We are resolutely bullish on assets which are neutral or benefit from rising inflation expectations. Stocks, IL bonds, and Commodities all look like key portfolio holdings. Nominal bonds less so and are better trading vehicles than investments at the moment. However, we have been warning of a meaningful correction in late July through September. The coming supply of US Coupon debt in late July through September and the inevitable frictions of getting everyone back to work in the fall remain concerning short term. But we expect the dip (if one were to occur) to be very short lived and fairly shallow given the wave of liquidity of continued private savings growth. For those reasons we are not likely to try to be too cute and short ahead of this weakness instead we are likely to buy the dip in our favorite assets

TGA, RRP, SLR reform, Bank Stress tests, and Q3 coupons vs bills issuance are important indicators to pay attention to as August approaches here are some of our high-level thoughts

Issuance vs Fed purchase presents a significant challenge for Assets in August and September. While July looks quite balanced.

TBAC RECOMMENDED US TREASURY FINANCING SCHEDULE FOR 3rd QUARTER 2021*
BILLIONS OF DOLLARS

					NEW MONEY
Net BILLS Issuance for the quarter					*157.88*

ISSUE	SETTLEMENT DATE	OFFERED AMOUNT	CHANGE^	MATURING AMOUNT**	NEW MONEY
COUPONS					
3-Year Note	*7/15*	*58.00*	*0.00*		
10-Year Note (r)	*7/15*	*38.00*	*0.00*		
30-Year Bond (r)	*7/15*	*24.00*	*0.00*	*55.39*	*64.61*
10-Year TIPS	*7/30*	*16.00*	*1.00*	*0.00*	*16.00*
20-Year Bond (r)	*8/2*	*24.00*	*0.00*		
2-Year Note	*8/2*	*60.00*	*0.00*		
2-Year FRN	*8/2*	*28.00*	*0.00*		
5-Year Note	*8/2*	*61.00*	*0.00*		
7-Year Note	*8/2*	*62.00*	*0.00*	*141.34*	*93.66*
3-Year Note	*8/16*	*58.00*	*0.00*		
10-Year Note	*8/16*	*41.00*	*0.00*		
30-Year Bond	*8/16*	*27.00*	*0.00*	*58.60*	*67.40*
2-Year FRN (r)	*8/27*	*26.00*	*0.00*	*0.00*	*26.00*
30-Year TIPS (r)	*8/31*	*8.00*	*1.00*		
20-Year Bond	*8/31*	*27.00*	*0.00*		
2-Year Note	*8/31*	*60.00*	*0.00*		
5-Year Note	*8/31*	*61.00*	*0.00*		
7-Year Note	*8/31*	*62.00*	*0.00*	*83.26*	*134.74*
3-Year Note	*9/15*	*58.00*	*0.00*		
10-Year Note (r)	*9/15*	*38.00*	*0.00*		
30-Year Bond (r)	*9/15*	*24.00*	*0.00*	*22.44*	*97.56*
2-Year FRN (r)	*9/24*	*26.00*	*0.00*	*0.00*	*26.00*
20-Year Bond (r)	*9/30*	*24.00*	*0.00*		
10-Year TIPS (r)	*9/30*	*14.00*	*1.00*		
2-Year Note	*9/30*	*60.00*	*0.00*		
5-Year Note	*9/30*	*61.00*	*0.00*		
7-Year Note	*9/30*	*62.00*	*0.00*	*83.85*	*137.15*
		1108.00		*444.88*	*663.12*

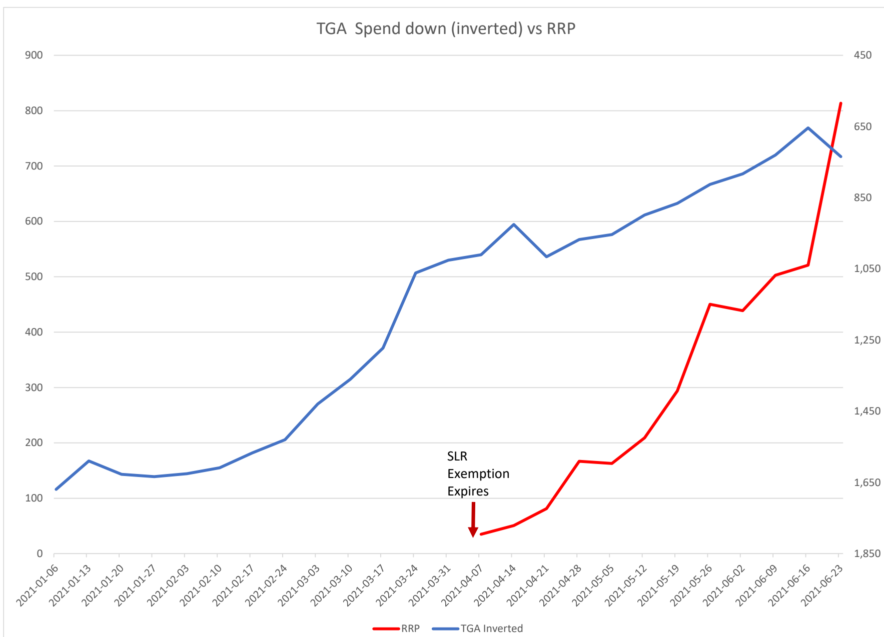
Estimates are italicized. r = Reopening

- The current best estimate of issuance shows new coupons in July will be less than the amounts purchased by the Fed.
- August issuance is 200BN more than Fed is purchasing
- September is 140BN more than Fed is purchasing

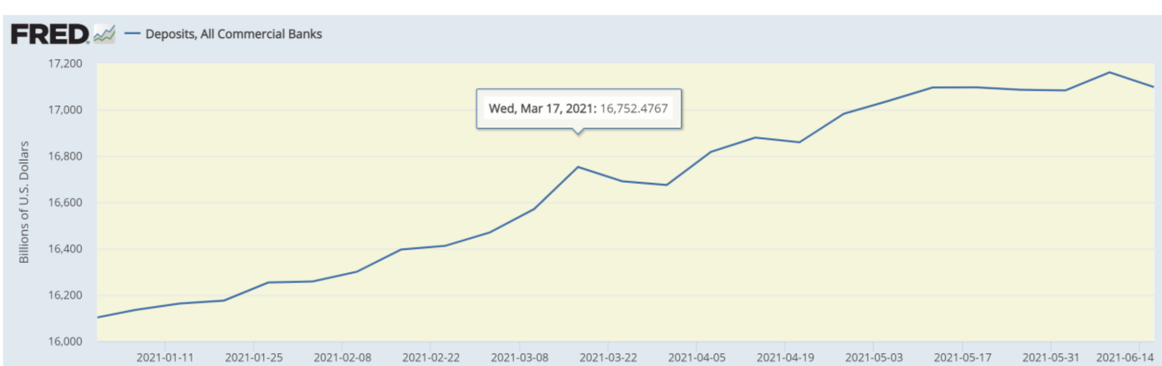
Importantly, the Treasury General Account will show significant volatility this summer. In July 300BN will fund spending in July. This is part of the reason why July issuance is low. This is due to the Bipartisan Budget Act of 2019 and the Debt ceiling suspension expiring July 31st.

For asset markets this mean stable to contracting risk premiums in July. In August and September assuming an increase in the debt ceiling the Treasury will rebuild the TGA back up to $750BN with a large amount of coupon issuance. This could result in a setback for risk premiums and possibly an expansion. Given our end of year view on assets we are less interested in going max short in July and instead may go tactically short and then regardless of the outcome end September aggressively long risk assets.

Our thoughts on the RRP are related to the TGA spenddown and its impact on money markets.



Since the TGA spend down began the cash in the account was spent in lieu of other cash sources. In particular bill issuance dropped significantly. The lack of bills resulted in increasing deposits at commercial banks which grew by 750BN rapidly up to the SLR exemption expiry.



Subsequently banks began pushing out wholesale deposits aggressively resulting in a demand for RRP which the Fed accommodated. As the bills shortage continued to be exacerbated by further TGA spend down, the RRP grew rapidly and now has essentially grown to equal the total spend down. As we expect the spend down to continue in July by 300BN and the Treasury issuance in Q3 to favor Coupons, we would expect that the RRP will peak around 1.2TN and slowly move back to bills over time.

The implication of slow deposit growth in banks since the SLR expiry is consistent with high quality retail deposit growth. Its possible that the Fed will be creative in addressing future capital rules for UST and Reserve treatment which could shrink the RRP dramatically. However as we view this program, deposits, and bills to be essentially cash substitutes for those who have no interest in longer term assets we take no signal from the developments in the money market for long term assets or financial conditions. The Banks have adequate high-quality deposits and excellent capital positions (confirmed by the stress tests) to leverage up and offer loans if demand surfaces. Closing that circle, the banks are most likely to immediately print money and leverage up by buying their own stock and increasing dividends. That flow pushes cash directly to equity owners who are likely to recycle the cash in stocks.

In synthesis – the issuance flow will be a headwind for assets in late summer early fall but the situation is far from dire. The RRP represents huge demand for Bills if the Treasury wants to raise more money than currently planned. SLR reform could solve the RRP balance issue. But the RRP issue is not a market signal. Banks have pushed out wholesale deposits and are well capitalized and at a minimum will be printing to buy their own stock. The third quarter outlook for assets will have a few wiggles but we do not expect to see a tradeable correction. We will stay short gold and buy dips on long term assets all summer.