The Damped Spring Report

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

10/15/2021

After a Taper Tantrum in a Teapot in over the last 4 weeks global asset markets including gold, equities and bonds are retracing some of the modest risk premium expansion caused by the moving forward of expectations of both taper start and 2022 lift off in the US and actual raising of rates in a variety of countries. We believe that expectations for taper can only be bullish assets at this point and a further moving forward of liftoff is blocked by the time it will take to taper. Perhaps the amount of liftoff could rise to 50bp in 2022 but that is already a 50% probability based on futures prices. The spring for assets is coiled toward risk premium contraction vs expansion.

We pounded the table to go max long equities we remain extremely bullish. Further we are very bullish USD vs Yen and EUR and have rolled up our USDYEN Position

The much more important point regarding our six-month outlook on risk premiums isn't about expectations. Liquidity will continue to power asset markets higher.

Risk Premiums fell sharply as Taper got discounted but have bounced. We expect new highs for assets.

Risk Premiums

The liquidity outlook is quite favorable

On the demand side

- The Fed will buy 640BN of assets
- The private sector particularly corporates and holders of hard commodities will continue to see significant cash inflows due to pent up consumer spending and deploy that savings in asset markets
- The RRP will provide plenty of bills demand as the debt ceiling gets resolved and TGA gets rebuilt more than offsetting government issuance on the short end of the curve
- Banks are willing and able to lend. Though demand is low given above

On the supply side

- We will see in the November Quarterly Refunding statement a significant drop in government financing back to a more normal level vs the massive funding demand of emergency financing
- Massive increases in tax revenue from an economy growing significantly above trend will shrink financing needs
- The Biden plans working their way slowly through Congress are certainly unlikely to be full paid for but are long term spends and impact current supply marginally

The other driver of risk premiums is portfolio risk. Portfolio risk is composed of individual asset risk and asset asset correlations.

- Asset implied and realized have risen over the last 4 weeks.
- Asset asset correlation has jumped as all assets corrected and provided limited portfolio diversification.

Our view is that expectations for future portfolio risk are now quite high and significant deleveraging and hedging downside has been executed. This once again provides a coiled spring for assets to rally.

As one of the four pillars of asset pricing drivers we are bullish assets based on our expectation of a good climate for risk premium collection and potential contraction of risk premiums as demand for assets outstrips supply.

Growth and Inflation

Macro-economic outlooks and their shifts provide two other drivers for assets, and they influence individual assets differently.

Growth expectations are sensibly coming down. We expect over the next two years growth to ultimately return to below trend due to high indebtedness in a secular long term down trend driven by continued falling population growth rates

Inflation expectations are rising across the curve making significant new highs in both long term B/E and 5Y5Y forward (a key Fed metric). Nonetheless expectations remain anchored

Our view stated 6 months ago that inflation is likely transitory remains our view. As an aside Transitory has always in our view to be over two years not two months. Transitory has become a meme. We are confident that a declining growth rate lots of slack in the labor market and secular deflationary trends plus what appears so far to be active central banks will maintain anchored inflation expectations with currently asymmetric pricing offering good entry into bets supported by our view. Various market pricing also indicates significant headwinds on inflation in the commodity complex. Drilling down one level on inflation we see top line pricing power as consumers have been willing to deal with higher energy prices and rents while still spending. But we are less bullish on wage gains over the next six months and believe that margins while high are not too high that they need to come in, given the differing impact of inflation on top line and costs at corporations.

The last pillar is flow and positioning

Some observations

- As we mentioned portfolios have deleveraged while leverage is quite available
- The Santa Claus effect is a powerful force for equities
- Asset performance across the board has had strong performance at the portfolio level and most assets are not in drawdown for the year
- US asset markets are far more attractive than other DMs and will continue to result in significant and fast-moving global investor asset allocation driving USD higher vs Yen and Eur

Noise

Fiscal policy, in particular taxes rising on corporations and capital gains, is obviously a threat to corporate valuations nonetheless capital gains are almost certainly going to be retroactive to 2021 and thus not going to be a catalyst Finally the actual tax rate being discussed continues to fall as Democrats seek a compromise. We expect a modest rise in corporate taxes and think that rise is priced

China, we see China having many tools to deal with the potential for contagion spreading from weakness in the Real Estate sector

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 27,535,233					
	Total Return	27.54%					
	Today's Date	10/15/2021		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case l	MTM	P/L	Open/Closed
7/16/2021	USA Nov 160/158 Put Spread	0.734375	-790	$1,000,000	0.9375	$ (160,494)	Open
7/16/2021	USA Nov 164/166 Call Spread	0.734375	-790	$1,000,000	0.03125	$ 555,556	Open
9/2/2021	SPX November 4600/4700	40	250	$1,000,000	14	$ (650,000)	Open
9/2/2021	GCA Dec 1900/1950	7	1429	$1,000,000	6	$ (142,857)	Open
9/13/2021	EURUSD 12/13/2021 Put Spread 1.145/1.185	0.7	142,857,143	$1,000,000	2.66	$ 2,800,000	Open
9/13/2021	USDJPY 12/13/2021 Call Spread 109.5/113.5	0.96	104,166,667	$1,000,000	2.72	$ 1,833,333	Closed
9/20/2021	SPX November 4500/4600	25	400	$1,000,000	34	$ 360,000	Open
9/13/2021	USDJPY 12/13/2021 Call Spread 109.5/113.5	1	100,000,000	$1,000,000	1.29	$ 290,000	Open