# The Damped Spring Report

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

10/27/2021

**The most hated asset in the world has gone on sale and we are going max long today. That asset is the government bond, in our case the long-term US government bond futures contract. Our view is that risk premiums will remain under pressure as QE continues through the first half of 2022 driving all assets higher, while inflation expectations will moderate after a panic jump over the last few months. We remain max long equities and continue to pound the table that equity markets are cheap and will rally through the end of the year. We also maintain our long in USD vs EUR and JPY. However, we have giving up on Gold and are selling our long position as central banks have made it clear for now that they will fight inflation and take away some of the fiat debasement risk that is the fuel for further rallies in Gold.**

The Fed and other central banks are taking the rise in inflation expectations seriously. We believe that the spike in inflation expectations will correct in November while the actual liquidity available in the market continues to flow. Flow into bonds is picking up sharply and Commercial Banks, The Fed, Broker Dealers, and Levered funds have more to buy. Lastly mortgage hedgers represent some negative convexity driver which is more likely to have, and asymmetric response biased to the lower rates side.

## Inflation Expectations have spiked

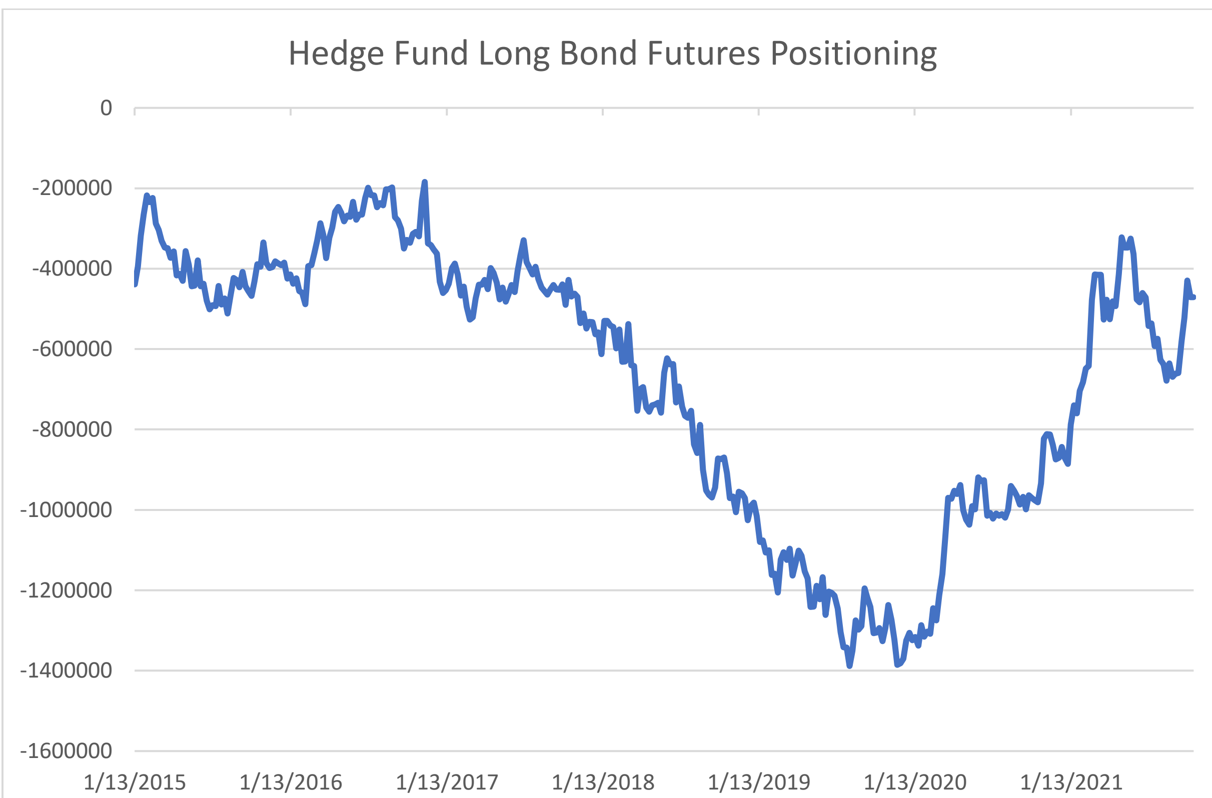
The Fed's preferred metric of market-based inflation expectations has made new highs not seen since the taper tantrum of 2013.

The 30 Year B/E is at new highs.

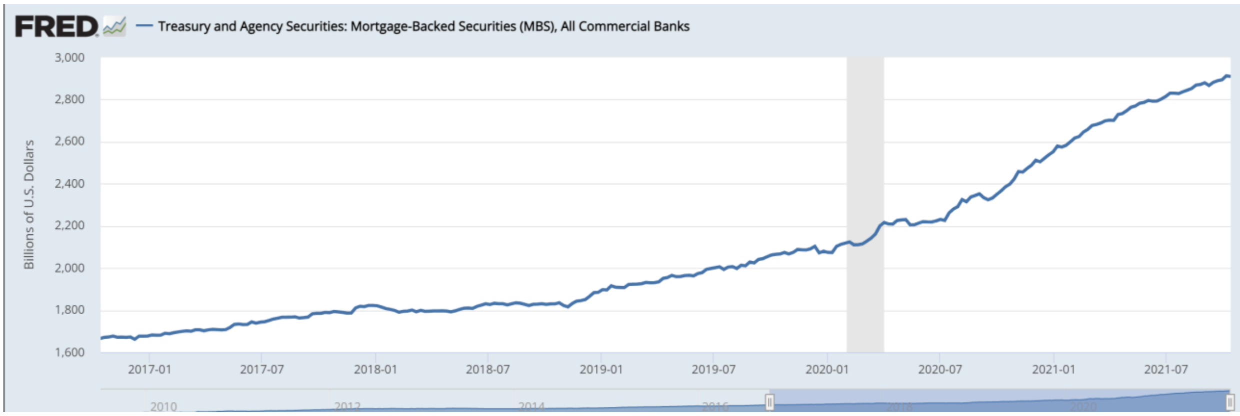

Flow and positioning flows have been bullish nonetheless

The Fed will continue to buy 640BN of Bonds

Hedge funds are covering shorts after getting destroyed in March 2020 and getting levered up short in September again



Banks continue to buy UST as loan growth remains weak




## Foreign Demand

China is highly unlikely to sell USD assets they have the opposite problem. The strong Yuan encourages the PBOC to print yuan, sell yuan for USD and buy UST.


As for ROW savers like Japan and Europe USD assets have clearly been bought as the USD strengthening indicates.

## Mortgage convexity

Mortgage hedgers are fully hedged up at 1.70 and as 10-year rates fall the convexity is sharper on the way down creating aggressive buying like the aggressive selling from 1.3 to 1.6.

Fundamentals

- Growth expectations are falling
- Inflation expectations are peaking
- Risk premiums are well supported by remaining QE and private savings growth

**The combination of positioning unwinds and fundamentals of the asset most hated suggests to us a sharp move lower in rates. We think 1.80 on the long bond by year end is a reasonable possibility. We have sold the Jan USH2 159/157 put spread to express our view. We are at max size on this bet.**

In March of this year, we wrote our DSR "Inflation and why its likely transitory." In that report which called the top in March we made the case that inflation prints were going to be high in 2021 and 2022. Base effects led the move but clearly reopening released significant pent-up demand. Private and public spending chased goods prices higher. We did not explicitly describe the supply chain disruption as a root cause of the pent-up demand pushing prices. But something was destined to break and to be blunt the inflation is not that bad given the outcomes.

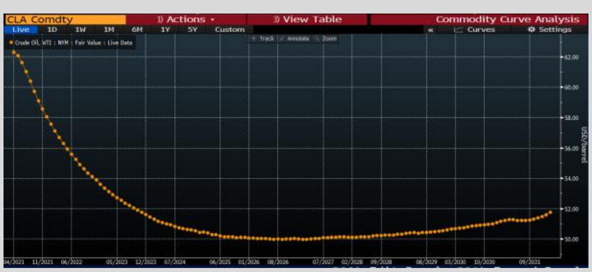
Here is a reprint of the inflation section of the March report as it was meant to express our view through next year and still applies.

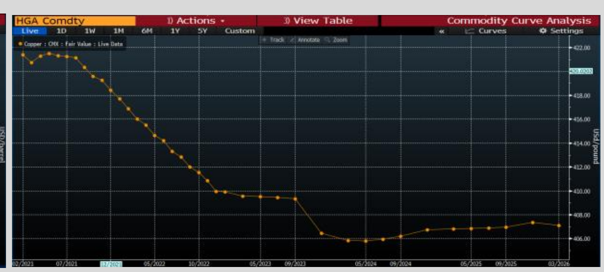
**Supply**

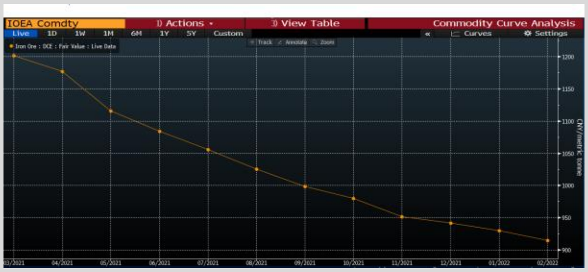
The supply side of prices are driven largely by input costs including commodities wages and productive capacity. It is obvious that demand for commodities and for goods and services will spike as the economy reopens. For sustainable long-term supply driven inflation, one would expect a radically different futures curve. This simply does not exist.

Commodity Inputs

Oil, Copper, Iron Ore, and Lumber are heavily backwardated and suggest no future supply constraints




## Wages

No need for a chart to know that labor has virtually no leverage to increase wages given the unemployment rate at this point in the pandemic.

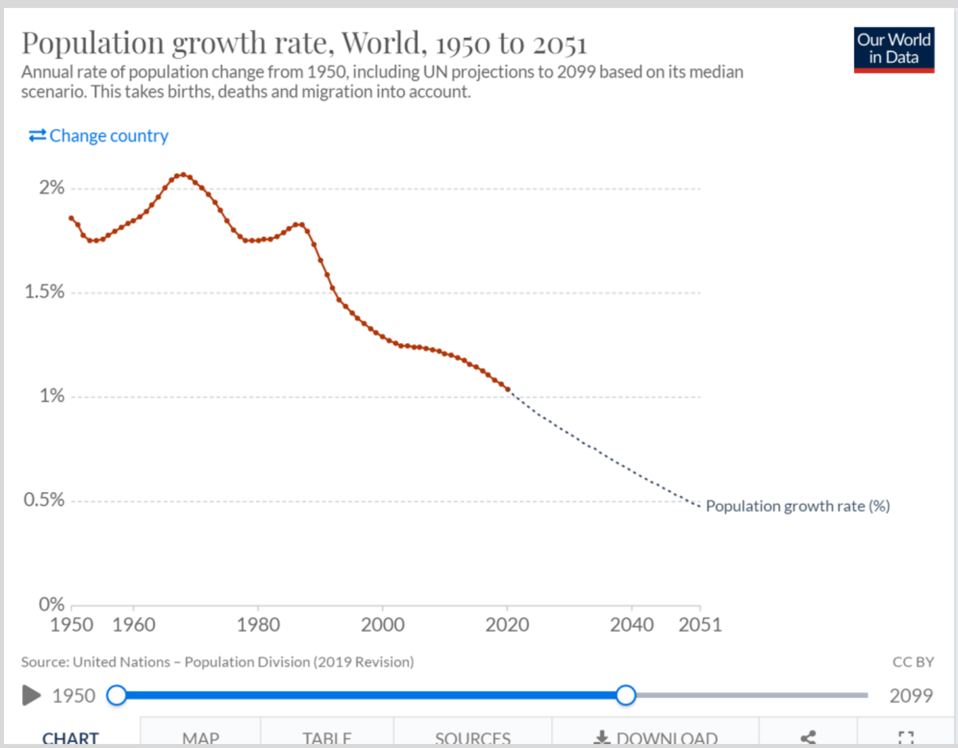
## **Demand**

It is certainly likely that, as the global economy reopens, demand for all goods and services will spike ahead of the ability for suppliers of these goods and services to deliver. I think of it as a reverse toilet paper spike. It makes sense that prices would have a onetime adjustment against this demand. However, long term inflation means not just a onetime spike, but repeated price rises through time. The major drivers for sustainable long-term inflation are:

- Population growth
- Willingness and ability to leverage and dissave for extended time
- Expectations of long-term currency devaluation

## Population growth

The world population growth rate is low and projected by the UN to continue to fall.




This decline in population is a significant deflationary force

## Willingness and ability to spend for an extended time

As we have mentioned in past reports,

- Consumers have saved significantly during the pandemic as fiscal transfers have offset declines in income. They will dis-save near term, but savings have a limit thus dis-savings is not sustainable. For consumers to drive prices sustainably higher after an initial pop they will have to layer on more and more debt until the labor market becomes tight and workers have leverage to demand higher wages.

- Governments are unlikely to continue their spending trends after the pandemic relief bills end. Both political realities and debt capacity will pinch back government spending
- Corporations that were most impacted by the virus are much more in debt and less able to spend. We have mentioned the impact of these zombies in past reports

We believe that 2021-2022 will certainly see increased real consumption. But we do not believe this is sustainable after the initial dis-savings as debt loads are already high.

### Currency devaluation

Clearly there have been currency crises where fiat money becomes worthless. The rally in crypto is more likely a speculative flow than driven by true concern in fiat. Gold has performed poorly which rejects this fear. Real estate seems to be rallying or falling based on idiosyncratic post pandemic preferences. Fiat currency pairs have been stable. We do respect that significant purchases of assets by the global central banks are perceived as printing and recognize the risk that if those central banks cancelled the debt that true printing would occur. However, recognizing that the balance sheets will be worked down rapidly in the face of above desired inflation means this printing will be reversed. One caveat of grave concern, but, not in the cards for the moment, is the possibility that central bank independence is further compromised, and they become unwilling to slow economic growth to fight rising inflation if it were to occur.

## **Current Portfolio and Performance**

### Closed Gold at a loss, Added USH2 Long

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Assumed Portfolio size | $ 100,000,000 | | | | | |
| | LTD P/L | $ 27,384,510 | | | | | |
| | Total Return | 27.38% | | | | | |
| | Today's Date | 10/27/2021 | | 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 | 1.72 | $ (778,765) | Closed |
| 7/16/2021 | USA Nov 164/166 Call Spread | 0.734375 | -790 | $1,000,000 | 0 | $ 580,247 | Closed |
| 9/2/2021 | GCA Dec 1900/1950 | 7 | 1429 | $1,000,000 | 5 | $ (285,714) | Closed |
| 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 |
| 9/2/2021 | SPX November 4600/4700 | 40 | 250 | $1,000,000 | 34 | $ (150,000) | Open |
| 9/13/2021 | EURUSD 12/13/2021 Put Spread 1.145/1.185 | 0.7 | 142,857,143 | $1,000,000 | 1.88 | $ 1,685,714 | Open |
| 9/20/2021 | SPX November 4500/4600 | 25 | 400 | $1,000,000 | 67 | $ 1,680,000 | Open |
| 10/12/2021 | USDJPY 12/13/2021 Call Spread 113.5/117.5 | 1 | 100,000,000 | $1,000,000 | 1.07 | $ 70,000 | Open |
| 10/27/2021 | USA Nov 160/158 Put Spread | 1 | -2000 | $2,000,000 | 0.95 | $ 100,000 | Open |