The Damped Spring Report

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

12/29/2021

Headline: The big call for next year is the SPX will make its high for 2022 in late January. Latent bullish flows will drive the market to 4900-5000 range as underperforming stocks (Our "No touch" basket) drive the overall market higher. The faint QT Drumbeat has been and will be ignored. No change in positioning is recommend and we are still max long SPX. However, the faint drumbeat will grow louder at the next Fed Meeting.

The big deal about the December 2021 Fed meeting was not the faster taper, it was not the dot plot and the path of short-term rates, it was this!

December 15, 2021 Chair Powell's Press Conference PRELIMINARY

CHAIR POWELL. So, you know, with the balance sheet, we did have a balance sheet discussion or sort of a prelim -- first discussion of balance sheet issues today, sheet issues at our meeting this week. We'll have another at the next meeting and another after the meeting -- at the meeting after that. I suspect these are interesting issues to discuss, didn't make any decisions

Every meeting, going forward, the Fed will discuss the timing and execution of Quantitative Tightening. This is the QT Drumbeat of 2022. If, and when, QT happens risk premiums will expand. Cash will be king! Assets of all sorts will suck! The drumbeat will start, and the eventual actual QT will sustain, an inflation of risk premiums of all sorts.

What's the impact? If current, priced in, inflation and growth expectations are exactly realized we predict that risk premiums on 30-year yields will increase by 15bp and equity risk premium by 30bp. These risk premium expansions will generate a 2% headwind on long bond prices and a 10% headwind for equity prices. As for our positioning recommendations we remain max bullish equities and long the USD vs JPY and EUR. However, if our thesis plays out, we will be selling our equities and going max short by month end. Hopefully, the rally we expect in equities will be accompanied by a bond sell off and we will be able to enter a long 30-year treasury position at a yield of 2.10 or higher. Lastly, we will be selling our USD exposure when we make these other portfolio shifts.

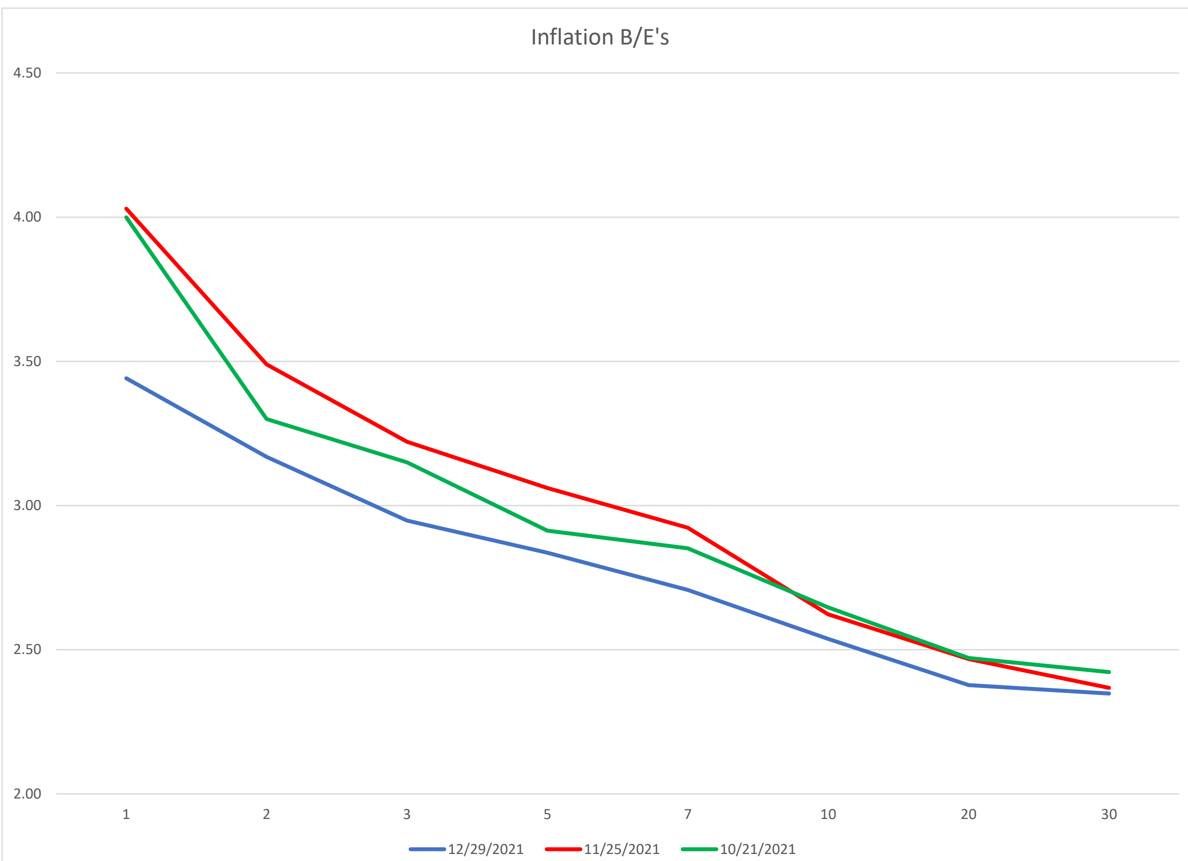
Outlook on the economy

Prior to actual QT, the drumbeat for QT will intensify and fade with the data.

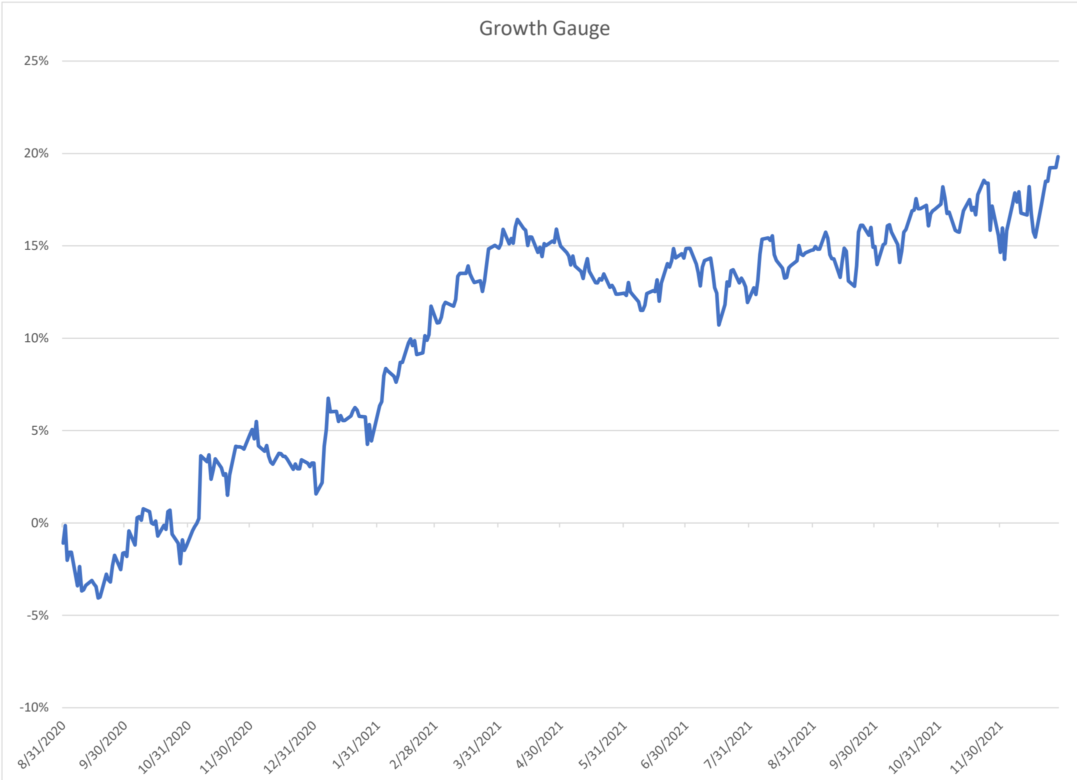
- We expect a strong first half of the year for growth. The economy is quite hot, and we expect growth to exceed consensus.
- We have said, and continue to believe, that inflation will moderate from Q4 2021 peaks and fall throughout 2022.
- We expect risk premiums to be stable for the next month as taper is tuned well vs private savings growth, bills liquidity availability from RRP, and deficit funding needs. But begin to inflate as QT Drumbeat gets louder.
- The lack of additional liquidity provided by Fed purchase will also remove a damper for the market and the economy keeping asset volatility well bid, while also causing asset diversification benefit to fall, generating rising portfolio volatility and the risk premium demanded to hold assets.

What's priced in?

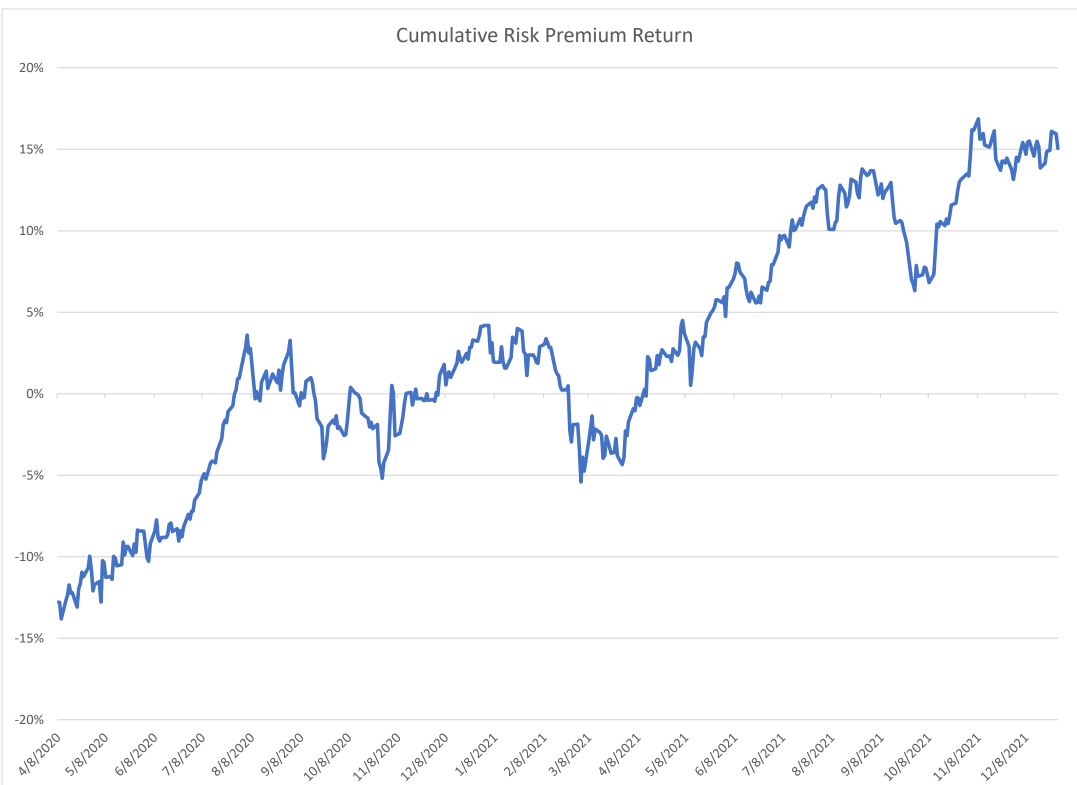
The most noticeable change in market pricing has happened in inflation expectations which are now lower and flatter than the last two recent inflation peaks



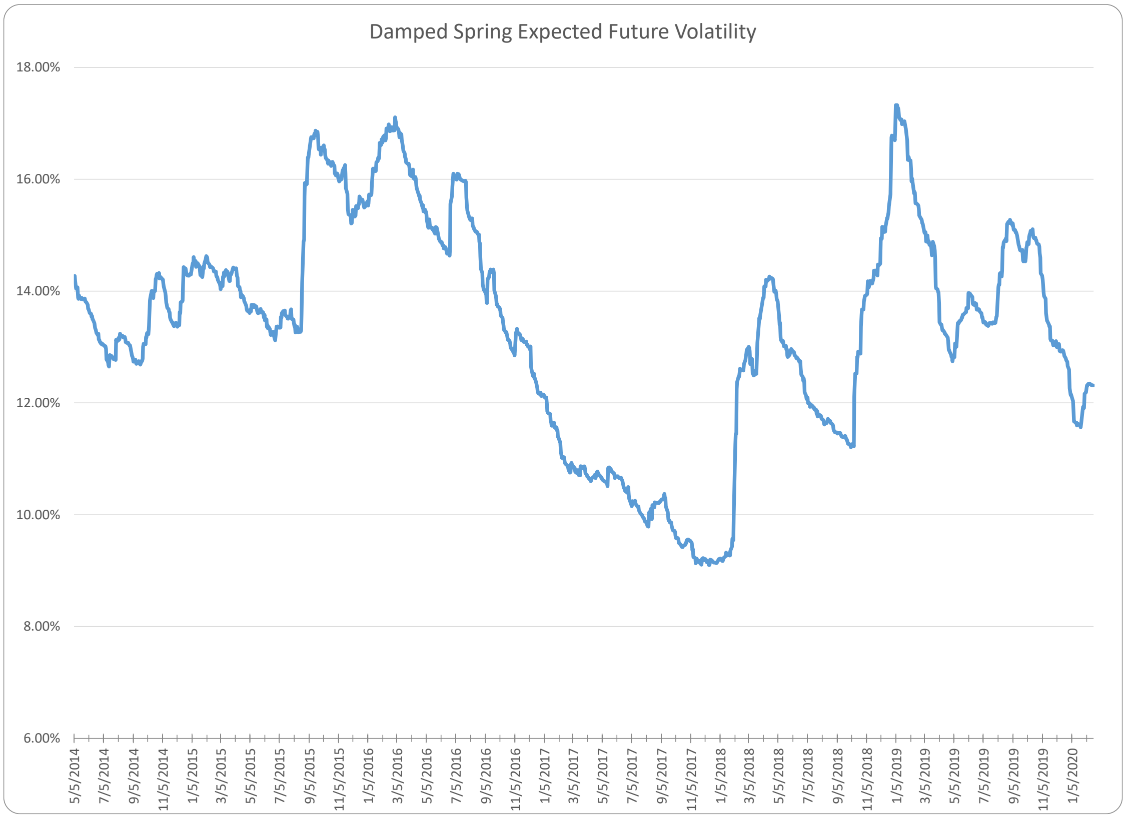
Our growth gauge indicates continued momentum in earnings which we expect to continue through Q1 earnings release



Risk Premiums returns have stalled



Our Portfolio Volatility model has begun to tilt up from a fairly low level. We expect that to continue higher as assets underperform cash and portfolio diversification benefit is impacted.



January is the pivot

Over the next few weeks, we expect stocks to rally as investors earnings expectations become more optimistic. January 19th Equity Options expiration which includes lots of LEAP contracts will be a catalyst for a squeeze rally and a post OpEx sell off. Earnings season will then begin, and The Fed meeting will end the month. We expect chop in the post OpEx, pre fed, period providing an opportunity to shift our almost two-year theme of bullish equities to bearish. Hopefully, we can also grab some 30-year bonds at a healthy yield and sell our USD for a tactical risk off trade. Until QT is abandoned, we will be selling rallies on equities.

Our outlook on long term bonds is consistent with inflation expectations that are now too anchored and are far more likely to become unanchored to the upside vs the downside. Growth which will be strong and risk premiums will expand. Not a pretty picture for bonds in 2022. However, this will not play out immediately and any riskoff in equities at the end of the month will rally bonds and afford us the opportunity to trade tactically from the long side before going short strategically.

Tightening monetary policy is a death knell for gold. Until the economy craters and policymakers are forced to reverse course gold is a short.

Lastly a risk off will be bad for the USD initially, hence our tactical profit taking. However, if global policy tightens non-US stocks and EM will suck wind even worse and that will squeeze people into dollars despite the US asset performance becoming weak. Our currency view will develop over time but leans long USD secularly.

QT and the economy

Drumbeats of QT will keep pressure on assets but will have virtually no impact on the real economy directly. Actual QT will be quite bearish for assets AND will have a flow through to the real economy.

Our long-term view is that secular headwinds for both growth and inflation remain strong and in fact have been strengthened by the liquidity provided and indebtedness that resulted. The increased indebtedness of governments, and many corporations, will limit fiscal spending and corporate capital investment. While certain extraordinarily healthy companies will be able to spend, they will be cautious. This caution will limit growth. Once the various supply shocks abate inflation will also return to trend. A fundamental driver for unanchored upside in inflation is the ability for governments, corporations, and consumers to lever again and again. We do not think this will happen.

2022 will be the first year of risk premium expansion until QT is abandoned. Perhaps the growth will be strong, and inflation will stay high for the whole year. If so, stocks can offset some of the 10% negative headwind of risk premium expansion. In that case, bond yields will climb fueled by a triple whammy of risk premium expansion and above expectation growth and inflation. Perhaps growth and inflation will converge back to trend or below rapidly. If so, bonds will over come some of their risk premium expansion headwind but stocks, oof.

We have summarized a variety of tactical trades in January. We also expect good things from our January Effect "No Touch" Basket. Assuming the drumbeat intensifies we will ultimately be short bonds, stocks, and gold for a run to cash that will dominate 2022.

In our next report over the weekend, we will detail the Damped Spring Portfolio Performance for 2022

Happy New Year and thank you for your support

Andy