The Damped Spring Report

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

7/26/2022

The FOMC is meeting this week. We expect 75bp. There are a number of secondary news items that may get brought up in the statement or the press conference. We expect they will be dealt with hawkishly. However, the weakening economy and falling commodity prices will likely result in some acknowledgement that the tightening is working. We do not want or expect to see any sign of a pivot. However, we also do not think the Fed will send the harsh message that tightening will last longer than is priced without a new hot inflation print. As this data will not be released until August, we continue to believe that Stocks and Bonds are a good buy up until that release due to all the topics discussed in the last DSR.

Goldilocks and the three pivots.

We wrote a twitter thread that described the dilemma the Fed faces on pivoting. Follow us @dampedspring for spammy twitchy posts with occasional insightful threads.

Goldilocks and the Three Pivots - 101 This is a story of the Fed and its next moves What is a pivot? What does it mean for markets and the economy? Will it be "Just Right?" How is this one different than any in the last 38 years? All discussed here.

What is a pivot. Well, it's really simple. It's an action by the Fed. Not by what the markets are expecting of the Fed but by the Fed itself. In this case the Fed currently is tightening monetary policy using its tools. A pivot would be to a policy of neutrality. Not to easing. Of course, in very rare occasions a pivot from tightening to easing could occur but typically the first shift is to neutral policy and then a further pivot to easing policy. The market is forward looking so it prices all future actions by the Fed and currently prices a two-step pivot from tightening to easing starting in Q1 2023.

What does it mean to markets and the economy? Well that takes us back to the classic story.

- Papa Bears pivot is too hot and premature. Inflation has not yet been killed but because of the weakening of growth in the economy The Fed abandons its fight on inflation and attempts to support markets and the economy.
- Mama Bear's pivot is too cold. The Fed delays action until not only is inflation dead but the economy is also in deep recession.

- Little Bears is just right. The Fed kills inflation and pivots policy to neutral and the economy has either no recession or a shallow one.

How is this pivot different than any in the last 35 years and how may it be influenced by the pivots in the 70's? Since 1985 or so the world has had a massive secular deflationary wind impacting every Fed decision. This strong force has led to behavior of both Fed officials and markets. Essentially, when presented with a decision to pivot toward easing it paid off to go early while the porridge was hot.

The secular deflationary winds would bail out an early decision instead of penalizing it by igniting inflation. The markets figured this out and risk assets and even bonds would rally on pivots. Perhaps nothing has changed and going early is still riskless. If so, any pivot should generate a risk rally that would be sustained. We doubt it.

How is this one different than any in the last 38 years? We look back to the 70's Due to Nixon abandoning the gold standard and various energy embargoes inflation had a tailwind for the whole decade. Fed Chair Burns was simply overmatched and any pivot in his battle was met with a reignition of Inflation. Each inflation surge was even harder to tame, and the only cold porridge could do the trick. Volcker finally tamed inflation but stock markets and bond markets and the economy suffered tremendously.

Today it seems clear that inflation has at least cyclical tailwinds. The long-term deflationary headwind still blows but is mild in comparison. The Fed which has for 40 years had the luxury of pivoting early MUST be aware of the lessons of the 70's and the risks of not killing inflation.

How does that all add up? Too hot and inflation reignites pushing bond yields higher, and corporate margins lower, while growth does bounce, that further hurts bonds and only modestly helps equities.

We know that a knee jerk rally equity rally will happen whenever a pivot occurs as generations are trained to buy a pivot. But an early pivot would likely create a quick and deep reversal as inflation takes off and future tightening gets priced quickly. This is our worst-case scenario.

Our best case is “just right” but given the narrow landing place that seems highly unlikely. It would obviously be a pivot after inflation is killed with only a mild recession. It is unclear if that is even possible but regardless it's a narrow part of the distribution.

What we hope for is that the Fed will well and truly kill inflation by waiting to pivot far longer than is currently priced. If they succeed in killing inflation current bond yields can remain supportive of equity valuations, margins can begin expanding, despite a drop in top line growth during the inevitable slow patch. But the medicine will be long term bullish and at current levels leaves limited downside for equities who look forward through to a normal economy in 2024 and on.

Things to look for at the Fed meeting

The Fed will hike 75 bp. In the statement we are looking for

- Acknowledgement of the weakening economy
- No sign of inflation yet falling with some forward-looking optimism consistent with commodity prices falling
- A commitment to their primary objective of killing inflation
- Tight labor markets
- **Perhaps it is too soon but the surprise in the statement would be a plan for outright mortgage sales.**

In the press conference given the above and balancing a concern about the economy with the yet to move inflation numbers we expect Powell to be somewhere between generic hawkish to open mindedly hawkish (perceived possibly as dovish). We do not expect him to drop the hammer on the economy and inflation with a harsh hawkish outlook. However, he will likely have an opportunity to do this which we expect him to deflect.

That opportunity will come when a reporter asks him about the pricing of 50-100 bp of cuts beginning in early 2023. That is the most obvious question that any reporter could ask. Powell will be ready. Our bet is that he will deflect and say that is a long way off and The Fed will be watching the data. But we will email clients instantaneously if we hear a game changer that is either Papa Bear pivot or Mama Bear hawkish. We believe the time to drop the hammer is at Jackson hole after another hot inflation print. That's why the false dawn will likely last through the inflation prints and be supported by the QRA info on 8/1 and 8/3.

Before the QRA data we will have another short DSR discussing the details and then prepare for Episode 2 of our trilogy. "Will the sun rise over Jackson?"

Current Portfolio and Performance

We have hedged up some of our long bond and long SPX positions tactically. Performance has recovered.

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 35,252,509					
	Total Return	35.25%		YTD Return		3.96%	
	Today's Date	7/26/2022		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
6/28/2022	NDX August 12500/13500 Call Spread	175	114	$ 2,000,000	190	$ 171,429	Open
5/5/2022	SPX August 4200 Call	18	-320	Hedge	6	$ 384,000	Open
6/28/2022	SPX August 4000 Call	62.5	320	$ 2,000,000	52	$ (336,000)	Open
7/7/2022	EDZ2EDZ3 50bp stop loss	-0.65	1000	$ 500,000	-0.6	$ 50,000	Open
7/20/2022	TLT Short 113/116 Sept Put Spread	1.5	-6667	$ 1,000,000	0.9	$ 400,000	Open
7/20/2022	TLT 120 Sept Call	1.5	6667	$ 1,000,000	2.75	$ 833,333	Open
7/26/2022	TLT 125 Sept Call	1.5	-13333	Hedge	1.28	$ 293,333	Open
			Inception Risk	7.5%		9.432%	