The Damped Spring Report

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

7/18/2022

Today's DSR "False Dawn" will be the first in a trilogy. We see the summer evolving in three parts. Each episode in the trilogy is a part of that story arc. Interspersed into the trilogy will be other DSR's including, a detailed analysis of the impact of the upcoming quarterly refunding announcement on QT, an evaluation of the DM asset markets outside the US, and a review of our bad call on fading King Dollar considering if our thesis is wrong or early. It's a blockbuster summer.

False Dawn – Episode 1

A false dawn is a transient light that precedes the rising of the sun by an hour. It also refers to a promising situation which comes to nothing. In this episode extreme deleveraging over the last six months provides the catalyst for a rally in assets fueled by liquidity created by falling government bond issuance at a pace that more than offsets less buying by the Fed. This rally should be across both stocks and bonds, taking the SPX to as high as 4350, and 30 year bond yields well below 3%. However, the sun may not actually rise and exiting assets post the Quarterly Refunding Announcement or at our targets is recommended

Will the sun rise over Jackson? – Episode 2

At Jackson Hole on August 25-27th we expect that the Jay Powell will state clearly what the Fed's path will be. Our expectation is that will dash any hopes that the Fed will ease in 2023. While asset markets will not likely cheer hawkishness we believe it is critical for any sort of sustained bottom in markets to kill inflation. On the other hand, it is possible that the Fed will blink due to weakening economic conditions and move toward a balanced monetary policy. If so, stocks may cheer even bonds may briefly improve, however, we would expect significant risk to unanchoring of inflation expectations which could backfire completely plunging the global markets into extended night.

Zombies finally killed or with us for good - Episode 3

The countries and companies that had significant debt in 2019 or added significant debt in 2020-2021 are zombies. The decision to press on fighting inflation or fail to kill inflation by pivoting premature will determine the zombie's fate.

Trilogy Story Arc

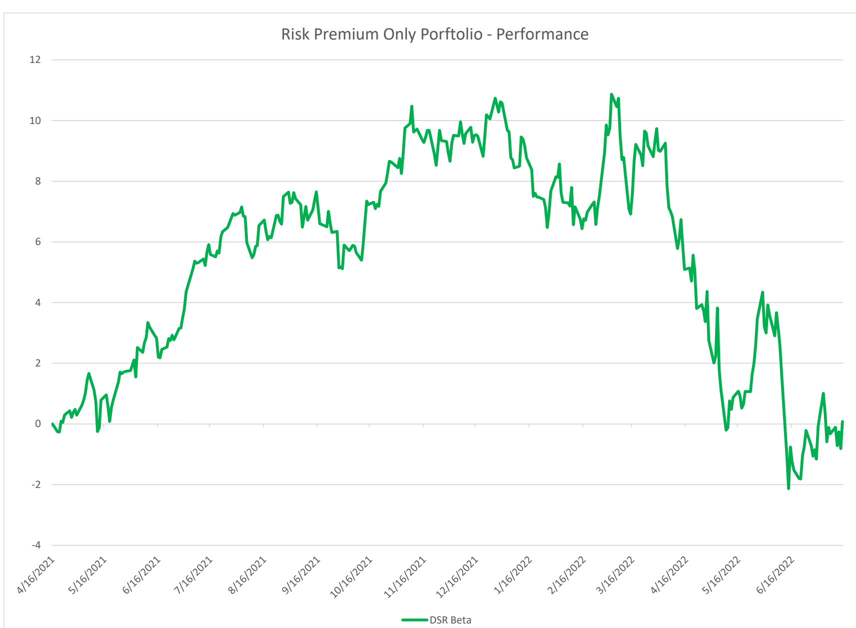
Since QT was hinted at last December, asset markets globally have fallen dramatically. Short term interest rates have now priced in restrictive monetary policy, the Fed and the ROW CB's have acted rapidly, and risk premiums on assets have expanded. But the economy has not had much time to adjust to the new monetary conditions. In fact, for six months now the economy has been remarkably consistent.

- Strong labor conditions
- Low or negative real GDP
- High inflation

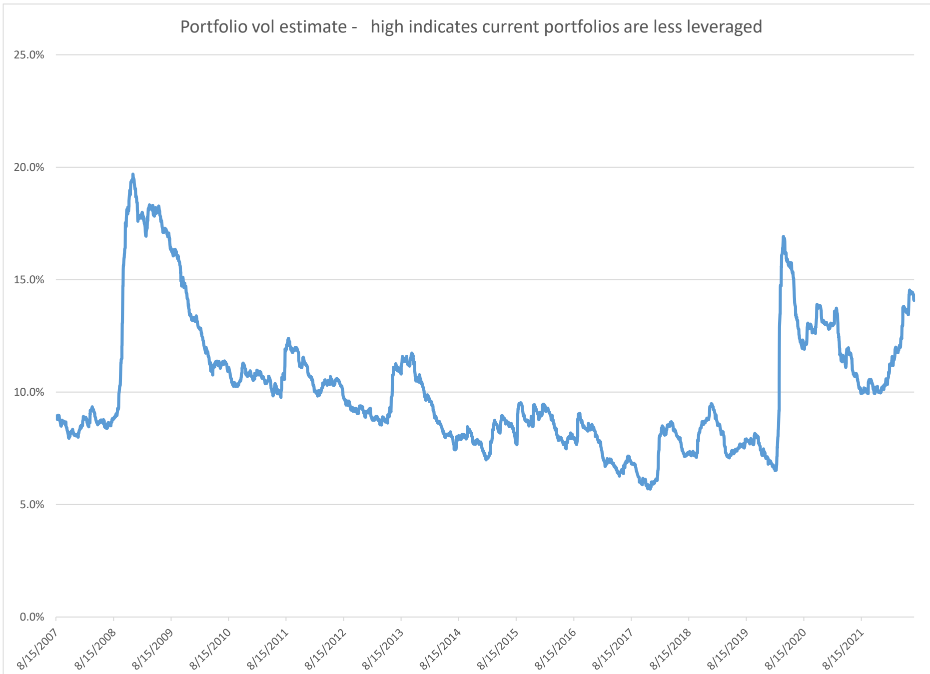
That brings us to the Trilogy. We see the next three months as evolving in a way that may surprise markets and require a more aggressive Fed to deal with inflation that takes longer to respond. We are also not particularly concerned about the negative GDP prints. Only when the employment situation weakens substantively will the Fed blink. It is possible that we are wrong and will pay attention to what they say and what they do, but we believe that current pricing of rate cuts beginning in 2023 is wildly optimistic if inflation fighting is a priority. Our story arc this summer is one of a prolonged battle with inflation. A battle that will not be easily won and where retreat will lead to extremely bad outcomes.

The False Dawn – Episode 1

The forces of deleveraging have had a major impact on global asset markets. As investors sell, due to higher portfolio volatility driven by, higher single asset market volatility and weak diversification benefits between asset classes. Risk premiums paid to those willing to provide liquidity to exiting investors have risen dramatically and portfolios that are designed to harvest risk premium have had poor year to date performance



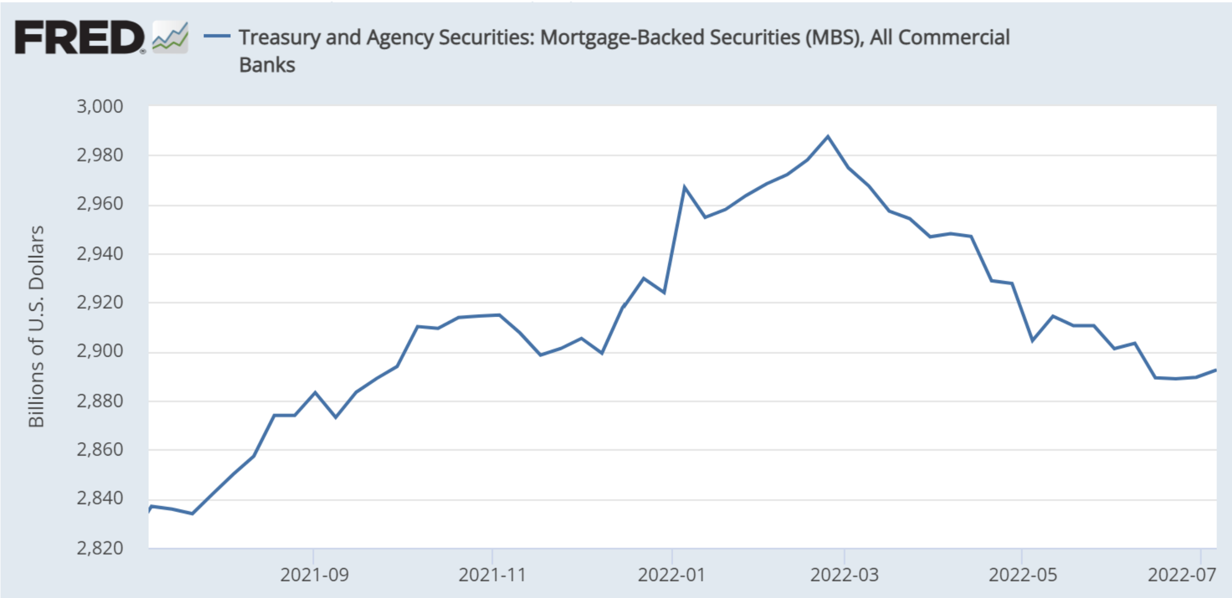
Global investors set their leverage based on a forward-looking expected portfolio volatility built from individual asset risk and diversification benefit. Various funds use different methods of rebalancing portfolios based on these estimates of risk. Some are highly systematic and fast-moving others are extremely slow moving. Nonetheless this deleveraging has happened and is likely to be near an end as our predicative model of what institutions use for their forward risk estimate is at an extreme level.



Since QT was announced unlevered funds have sold [$145 Billion of S&P futures](#). Other metrics of flow and positioning we use confirm broad deleveraging across all asset classes

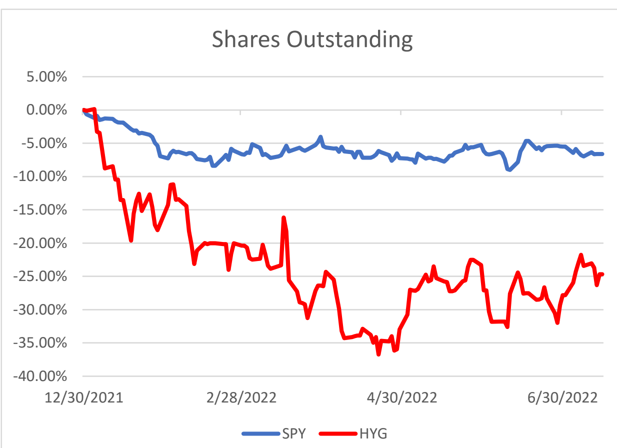
The selling of long equity futures by real money institutions pictured above is the largest in market value in the history of the data set.

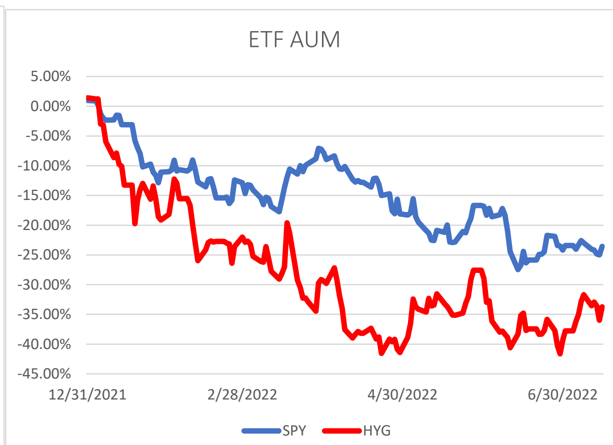
Commercial banks have sold over 100BN of US Treasuries and Mortgages in less than 5 months. Even during the GFC when bank balance sheets were impaired banks did not sell that fast or that much. It is unprecedented.



Evidence provided to us by Prime Brokers also supports a massive degrossing of **hedge fund** balance sheets

Retail has also deleveraged and holds less exposure as seen by both AUM and Shares Outstanding of popular ETF's

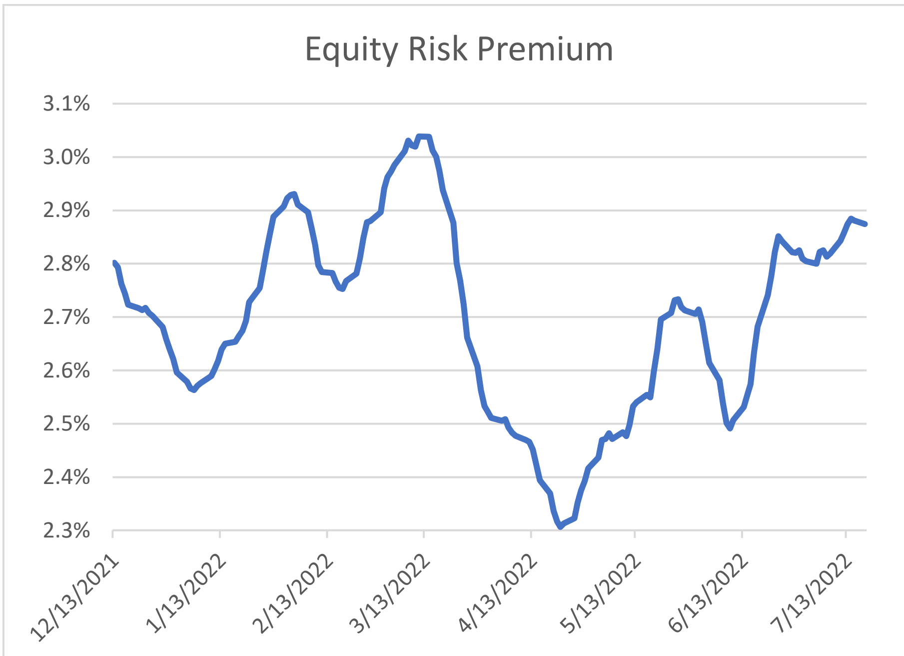




How about valuations?

We have described the reasons for the massive deleveraging as portfolios have been riskier, we have shown evidence of deleveraging across relevant market participants. In addition, those who have taken the opposite side of the deleveraging are demanding higher returns for assuming risk. This can be seen in various measures of risk premium

Equity Risk Premiums have been volatile and are now rising again just as QT's impact due to lower need for deficit spending is falling



Credit spreads have risen though seem to have peaked

Fixed income implied remains elevated

Equity Implieds however have been surprisingly low which is of some concern for the contrarian

Adding all this up we believe that buying stocks and bonds makes sense right here.

- Assets are generally cheap
- Portfolios have done the selling necessary to deleverage based on the risk parameters set by their ex-ante systems

- Those risk parameters are at extreme levels and are likely to correct to more normal levels of risk generating a releveraging flow
- The Fed is locked in regarding rate hikes with a summer lull after doing 75 in July
- The QRA will likely show further reduction in coupon issuance
- The TGA is well funded
- The RRP liquidity remains untapped

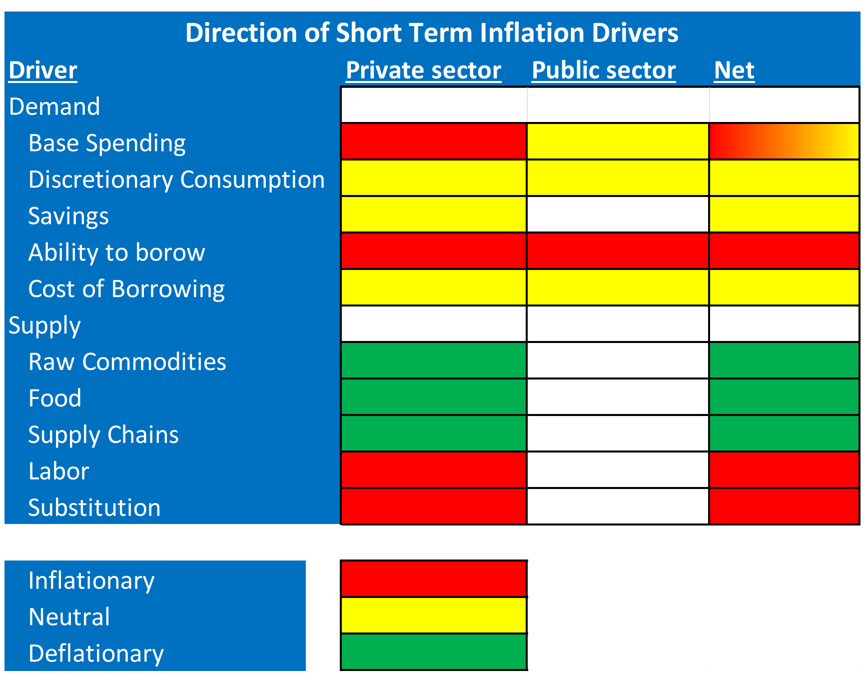
From a liquidity standpoint we are very bullish. However, we believe that this sunny time for markets will be brief. We intend to run long through the QRA and sell out our longs and depending on the level's short assets as the False Dawn is revealed

Why is it a false dawn?

It is all about inflation

Inflation is not dead. Backward looking it does not even show signs of abating. The Fed has been very clear what makes them uncomfortable about the path for inflation. It is demand. But not simply demand as represented by real GDP or by volatile commodity prices which have both demand impact and erratic supply chain bursts and lulls. It is about the accumulated savings of fiscal spending and the tight labor market resulting in so far inexhaustible demand.

Not one member of the central bank is worried about a recession. That is because of the labor force and the spending that a fully employed labor force can sustain particularly when they have wage leverage. They seem to ignore the almost certain two consecutive quarters of negative real GDP growth. That's because that isn't the problem. It is all about inflation. Besides the fall in commodity prices lately our Inflation drivers gauges are still either warm or hot.

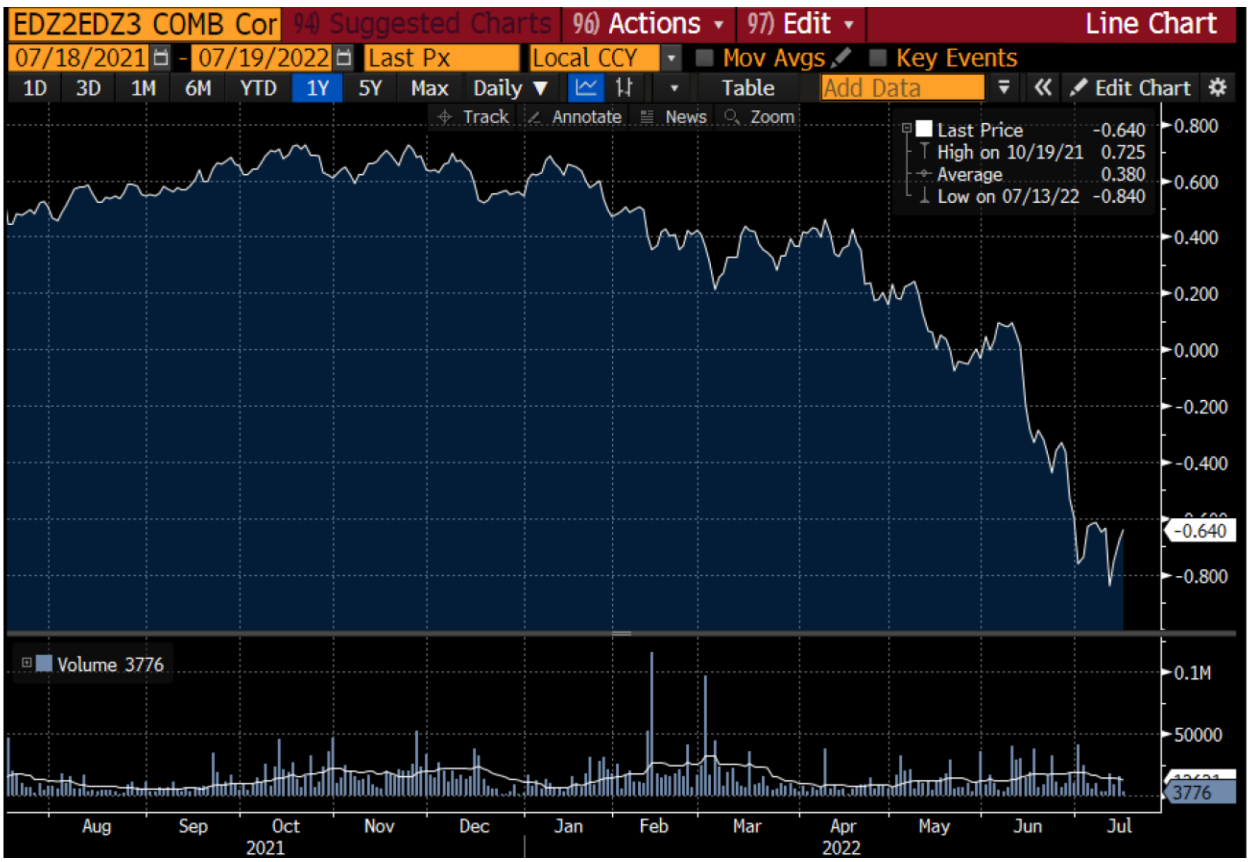


The public sector is neutral as the US government is in gridlock. The Private sector however is able and willing to spend despite higher borrowing costs. Of course, in certain sectors borrowing costs are becoming or have become restrictive but its early.

Its job that matter. If the Fed is serious about taming inflation, they will not stop until they kill jobs. This is why we expect the rally in assets to be limited. While worth riding the wave for now, we are cautious that the Fed will be put in a perilous position as the the economy weakens and inflation remains volatile.

Our greatest concern for markets starts with the Fed declaring victory in the battle over inflation prematurely. Without parsing the tone or words of the various Fed governors it is clear in pricing that the hiking cycle is six months from ending.

In just two months the market has moved from small hikes in 2023 to meaningful cuts.



Three paths

Our central thesis is that the Fed needs to kill inflation in order for assets of all sorts to have a long-term bottom. We think that is a path which does not include cuts in rates in 2023. It is a difficult path as it will cause short term economic hardship. Perhaps there is a goldilocks path and what's priced in is simply a world where inflation responds to the hikes and by year end inflation is dead. We accept that as possibility but think it is remote. The third path is the one that gives us the most concern. It is declaring victory over inflation prematurely. In the short-term asset markets may respond favorably to a “pivot” toward balanced policy. But we expect a premature pivot would rapidly spike already quite compressed inflation expectations and cause a sharp selloff in long term nominal bonds and all the asset that use those yield for a discount rate. Yeah, pretty much all assets.

This is a different world in the past when inflation was not a problem a pivot to easing was simply bullish. Good for growth, compresses risk premiums, all good. Today growth and risk premiums are secondary. Easing prematurely means failing to kill inflation. That is a recipe for much harsher environments to come and the need to reestablish inflation fighting credibility with more aggressive action.

We think Jay Powell is aware of all this and we have hope that he will stay the course. If he does, that will be good long term for asset markets and the economy but short term perhaps less so.

At Jackson Hole, it seems the perfect time as additional data flows in, to recommit to killing inflation in a direct attempt to counteract any pivot pricing already in the market and extend the time frame for well and truly succeeding. Alternatively, any equivocation and Inflation expectations unanchor.

The Jackson Hole speech and its implications is the story for Episode 2 “Will the sun rise over Jackson” Look for that DSR in Mid-August.

Next up will be the QRA/QT balance in late July

Current Portfolio and Performance

The DS Alpha portfolio has had a very rough 5 weeks falling 6%. Current risks are about half max. Our fixed income trading has been good, but we were too early declaring the end of the USD strength. Our equity long also suffered.

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 32,502,855		
Total Return	32.50%	YTD Return	1.21%
Today's Date	7/17/2022	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
5/5/2022	NDX July 13000/12500 Put Spread	208	-34	$ 1,000,000	500	$ (1,000,000)	Closed
5/5/2022	SPX July 4200/4000 Put Spread	79	-83	$ 1,000,000	200	$ (1,000,000)	Closed
5/11/2022	NDX July 13000 Call	350	29	$ 1,000,000	0	$ (1,000,000)	Closed
5/11/2022	SPX July 4200 Calll	80	125	$ 1,000,000	0	$ (1,000,000)	Closed
5/5/2022	TLT 115/112 July Put Spread	1.35	-606	$ 1,000,000	0	$ 818,182	Closed
5/24/2022	ZBU August 145 Call	1.359375	-455	Hedge	0	$ 618,516	Closed
5/24/2022	ZBU August 145/147 Call Spread	0.4375	-640	Hedge	0	$ 280,000	Closed
6/12/2022	EDZ2 50bp Stop Loss	96.35	2000	$ 1,000,000	96.44	$ 180,000	Closed
6/13/2022	EDZ2 25bp Stop Loss	95.85	2000	$ 1,000,000	96.44	$ 1,180,000	Closed
4/26/2022	AUDUSD .7175/.7375 Call Spread	1.12	44,642,857	$ 500,000	0	$ (500,000)	Closed
4/26/2022	EURUSD 1.07/1.10 Call Spread	1.02	49,019,608	$ 500,000	0	$ (500,000)	Closed
4/26/2022	GBPUSD 126.5/129.5 Call Spread	0.92	54,347,826	$ 500,000	0	$ (500,000)	Closed
5/5/2022	GLD 175/172 Put Spread	1.4	-6250	$ 1,000,000	3	$ (1,000,000)	Closed
5/11/2022	AUDUSD .7175/.7375 Call Spread	0.63	79,365,079	$ 500,000	0	$ (500,000)	Closed
5/11/2022	EURUSD 1.07/1.10 Call Spread	0.6	83,333,333	$ 500,000	0	$ (500,000)	Closed
5/11/2022	GBPUSD 126.5/129.5 Call Spread	0.48	104,166,667	$ 500,000	0	$ (500,000)	Closed
6/28/2022	NDX August 12500/13500 Call Spread	175	114	$ 2,000,000	172	$ (34,286)	Open
6/28/2022	SPX August 4000 Call	62.5	320	$ 2,000,000	44	$ (592,000)	Open
7/7/2022	EDZ2EDZ3 50bp stop loss	-0.65	1000	$ 500,000	-0.75	$ (100,000)	Open
5/11/2022	ZBU August 139 Call	2.2	455	$ 1,000,000	2	$ (90,909)	Open
			Inception Risk	5.5%		4.683%	