The Damped Spring Report

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

6/29/2022

This Damped Spring report will be a bit of a smorgasbord. There are many topics to deal with and instead of focusing on one we will hit on some key topics which we will expand upon in July. However, before we leave June, we will describe the flows we expect for month end as they are quite significant. We will cover tactical and developing topics and, in a follow, up DSR next week discuss the implications for portfolios. Happy Fourth.

Tactical Topics

- **Month end global investor rebalances are a strong equity buy**
- **The specific mechanics of the JHEQX Put Spread Collar Roll resulting in a concentrated equity buy**

Month end global rebalances are a strong equity buy

We estimate that investors with hard or effectively hard benchmarks, control 2TN of assets with monthly rebalance schedules and 750BN with quarter end rebalances. These numbers are quite conservative and are lower than street estimates. We believe the street always overestimates this flow and volatility like seen yesterday is the inevitable consequence of this flaw. That said, this number is meaningful relative to our own signal history and the sell off yesterday provides a real opportunity. Particularly given the JHEQX roll described below.

	Month Return	May Portfolio	June Portfolio	Desired	Rebalance	Benchmarked quantity in BN	Flow
Equity	-6.9%	60%	56%	57%	1%	2000	20.8
Bond	-2.6%	40%	39%	38%	-1%	2000	(20.8)
		100%	95%	95%			
	Quarrter Return	**March Portfolio**	**June Portfolio**	**Desired**	**Rebalance**	**Benchmarked quantity in BN**	**Flow**
Equity	-15.1%	60%	51%	53%	2%	750	18.2
Bond	-5.0%	40%	38%	36%	-2%	750	(18.2)
		100%	89%	89%			
					Total Rebalance Flows		
						Equity	**39.07**
						Bond	**(39.07)**

What is the JHEQX Roll and why does it matter

Every quarter a 20BN dollar mutual fund company rolls an overlay position to its active long only SPX outperformance portfolio. The idea for this mutual fund is to hedge some of the downside of its portfolio by buying put spreads and "paying" for the premium it spends by selling upside calls on the portfolio. This overlay is called a put spread collar. The fund has a very specific mandate and schedule for rolling this collar. On the last trading day of each calendar quarter, it rolls its expiring collar into a new collar expiring on the last trading day of the following quarter. In this case the June 30th Collar is expiring, and the Sept 30 Collar will be traded on Thursday morning.

The June 30th collar is struck at 3620/4285 for the put spread and 4695 for the call. The 3620 and 4695 puts and calls are both worthless. However, the 4285 put is the one that the Mutual fund bought, and dealers sold 3 months ago, and is deep in the money.

The mutual fund will receive cash based on the market close on June 30th and will have hedge the downside of their fund investors long portfolio. They will then enter into a new collar, expiring Sept 30th struck at 80/95% of spot on the put and about 103.5% (subject to dealer pricing) for the call they will sell. Otherwise, they have no undesired market risk.

The hedge provider for the original collar will roll to the new collar. However, currently the existing collar has a 20BN positive delta and the dealer is hedged by being short 20BN of futures. The new collar will not be in the money on any of the strikes and its delta will be approximately 12BN. This means that the roll requires the hedge providers to beat the close on Thursday with an 8BN buy order. The games played on this well-known trade are significant and timing the actual buy is perilous but over the course of the next two days 8BN will be bought.

We are making a two-day bet on a rally through the close tactically

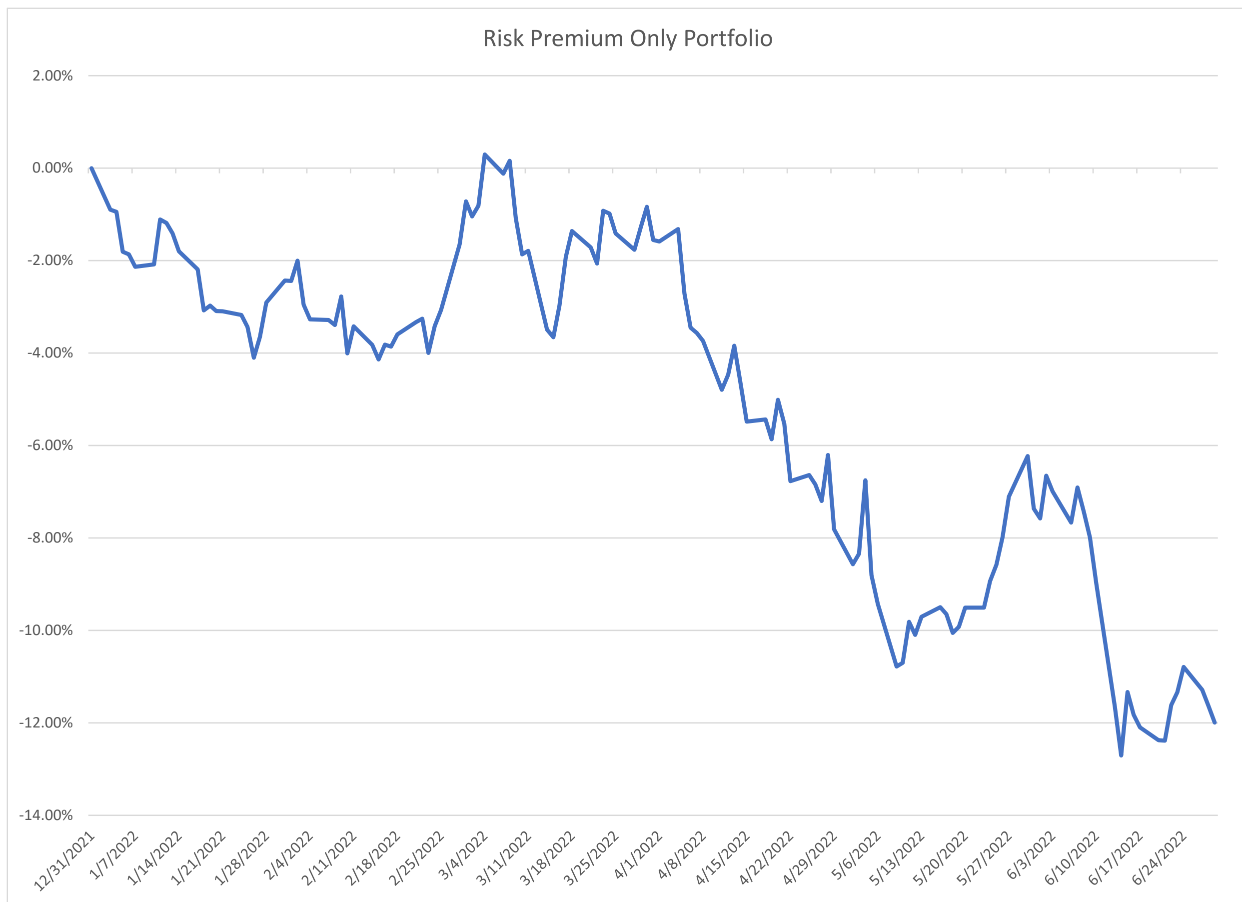
Key developing topics – impacting the Damped Spring Framework

- **QT Impact is now fully discounted and will no longer be a major driver of risk premiums**
- **The Fed is done for the summer (hawkish rate path isn't getting more hawkish) which should result in falling asset volatility**
- **The "recession" has already started growth has been falling**
- **Earnings and NGDP, Why Bonds and Stocks will be good hedges for each other over the near term. Inflation could go either way**

QT Impact

As we have stated since December 29th, QT remains the most important force to understand to trade the global asset market. Throughout the last six months risk premiums on asset portfolios have expanded. Market participants correctly

anticipated the impact of the Fed reducing its balance sheet. A portfolio balanced to shifts in inflation and growth but exposed to risk premium expansion is down 12% for the year



QT on the other hand just began. The obvious question is whether the frontrunning of QT has fully priced in the actual impact of QT.

When looking at the sheer magnitude of the balance sheet reduction both in total reduction amounts and pace the immediate answer and one that we believe is consensus is of course not. QT is going to continue to compete for cash and further risk premium expansion is both inevitable and the stated desire of policy makers. We think the consensus has it wrong.

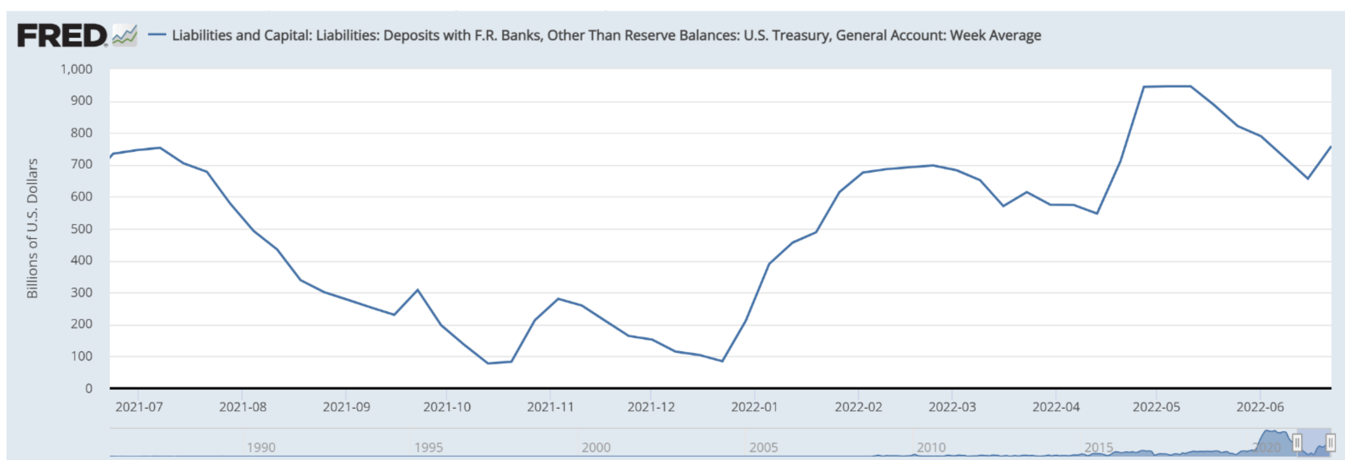
As a reminder, the Fed plans on most of its balance sheet reduction to be runoff. Runoff is choosing to not reinvest the proceeds from maturing assets they own. The maturity payment is paid by the US Treasury. They can pay it in three ways.

- Issuance of new Treasury obligations which now must be sold to the private sector, which is the actual transmission that impacts risk premiums
- Using their checking account
- Using budget surpluses

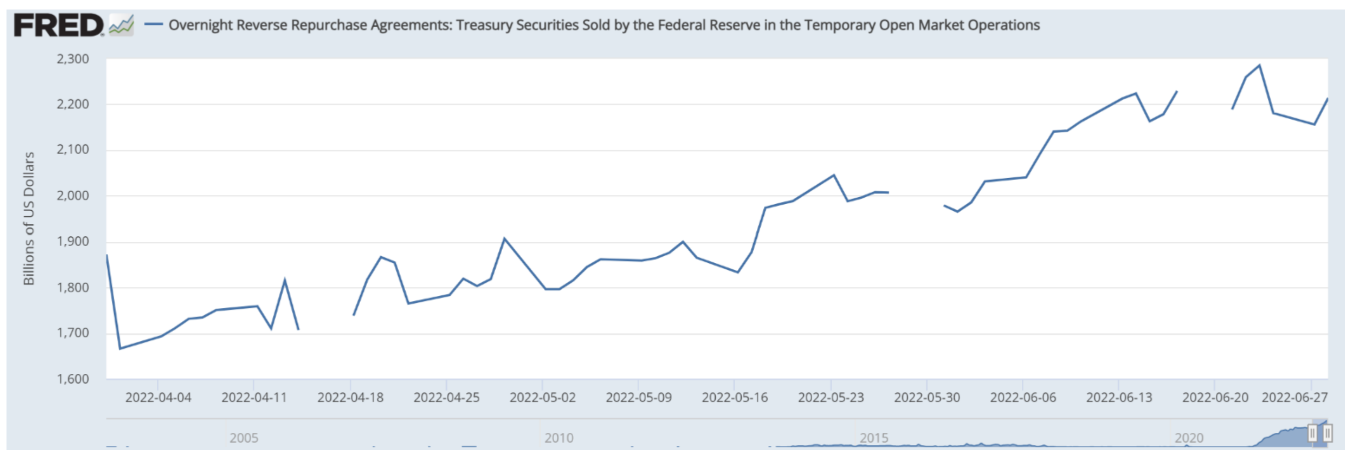
In the case of the Issuance the composition of the issuance matters as the more long-term bonds relative to short term bills issued has a greater impact on risk premiums.

Over the last month we see significant developments that will impact the supply of new bonds that the US Treasury will need to issue. We expect once again that the Quarterly Refunding announcement on August 1st for size and August 3rd for composition will provide additional support to the idea that the impact of QT over the next 6 months has been over discounted.

The Treasury General Account remains well funded providing enough money if desired to completely pay off the balance of the year of runoff

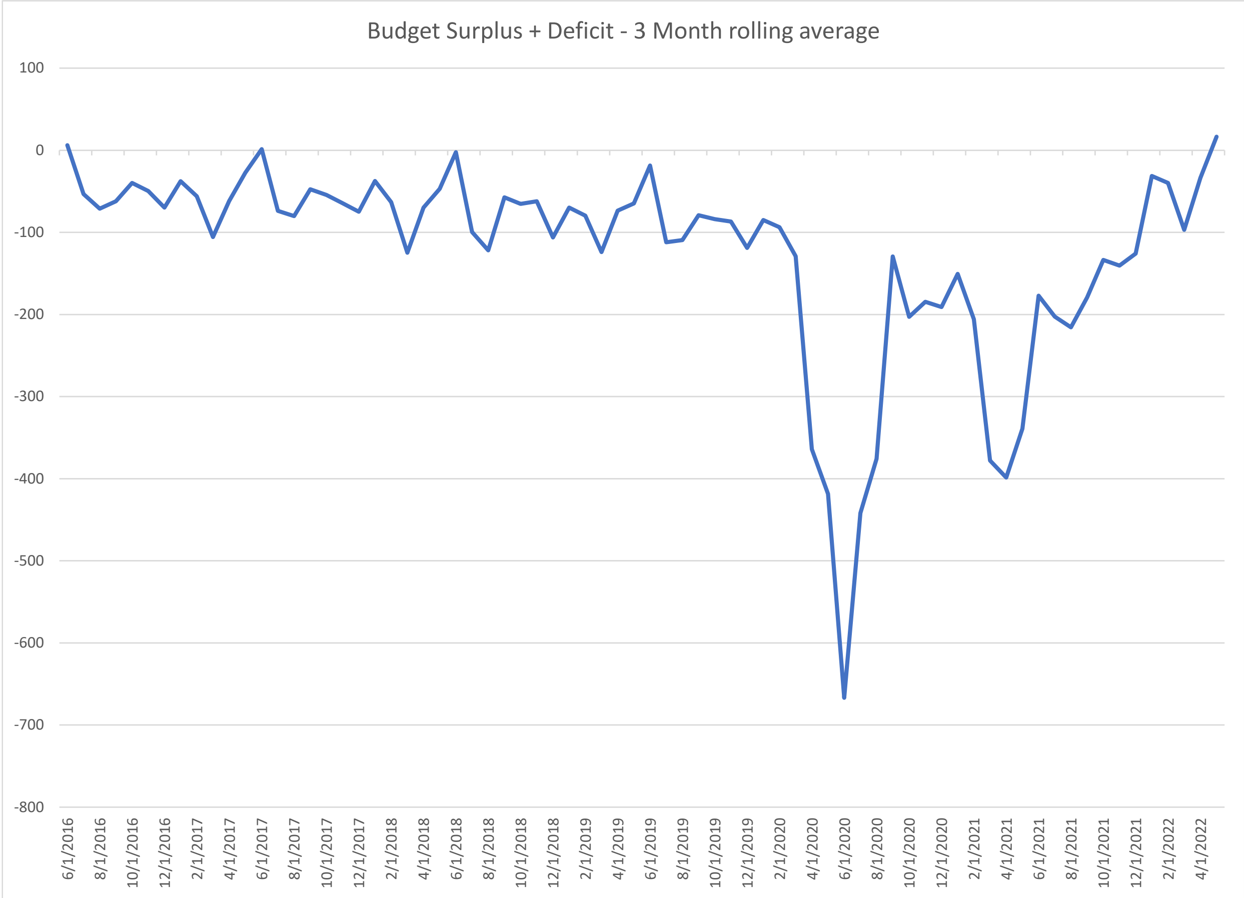


The RRP has exploded as the Treasury has not had enough borrowing needs to modestly reduce coupon supply without massively reducing bills supply. In the last quarter the RRP has grown by over 600BN and represents significant demand for US Treasury bills.



Besides the various options the Treasury has to tap its checking account or shift back toward bills to fund Fed maturity runoff the bigger point is that the US budget deficit is rapidly shrinking. This is due to gridlock in new spending and more importantly inflation driven tax receipts.

While the recent path of decreasing budget deficits is unlikely to result in any form of sustained surplus, the forces of NGDP levels higher than the average nominal cost of interest results in less debt burden and financing needs for the US government.



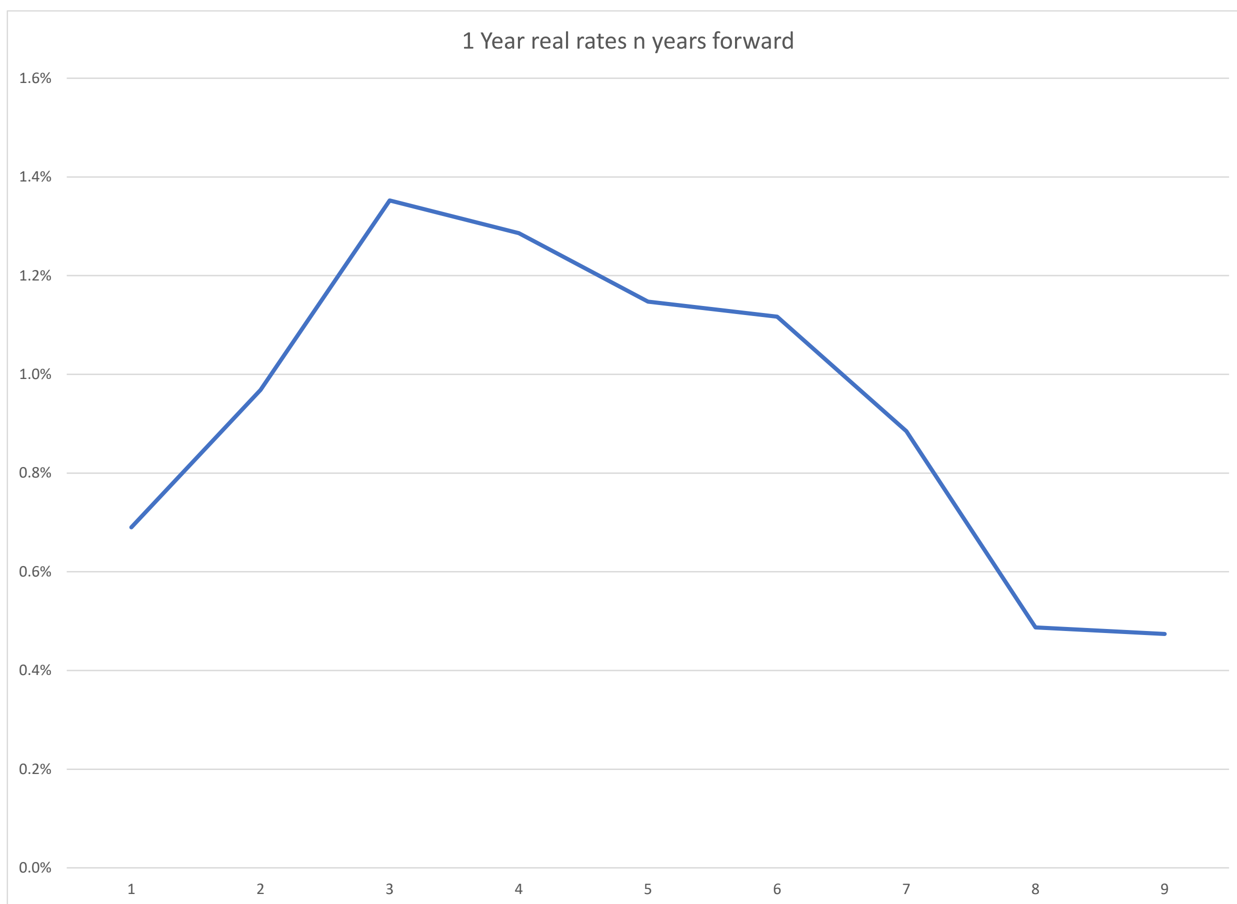
In the May QRA due to a massive spike in wage withholdings due to wage inflation the Treasury announced that it would actual redeem some of its debt. We expect some new money issuance in Q4 and a continued reduction of issuance of at about the last three quarter average pace with a resultant further bills reduction. This assumes that the Treasury will NOT tap any of the liquidity in the RRP and will in fact exacerbate the problem. If they choose to tap the RRP the Coupon number would have to fall.

Financing Trends			
	Issuance quantiites		
	Bills	**Bonds**	**Net New**
Q1	220	508	728
Q2	-433	407	-26
Q3	-153	335	182
DS Q4 Estimate	-149	249	100

The point of this analysis is that the Treasury has halved the amount of coupon issuance that the market must absorb over the last year. This must be considered when judging the impact of QT. The transmission mechanism IS coupon supply. Its falling as fast as the Fed is running off its balance sheet. Yet is discounted to have a continued impact on risk premiums.

The Fed is done for the summer.

They will do what they say and not get any more hawkish based on a single number. The aggressive shift which was cutely connected to the since revised long term Michigan Inflation Survey data has played through markets. We look at June meeting and subsequent shift as the Fed just buying itself some insurance when the market was offering. Now they can actually observe the data. Of course, 25 bp here or there could shift, and we aren't making a case for a particular meeting outcome. But in aggregate the Fed has done its job for now. Our reasoning is that forward real rates are now positive across the entire curve



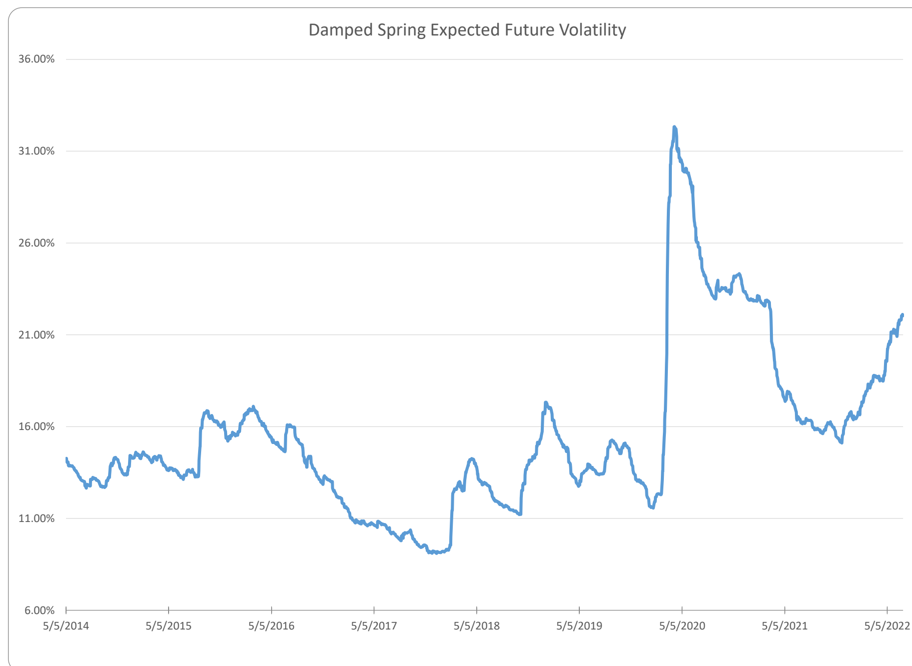
This represents a fair picture of a restrictive financial conditions playing out and an eventual easing. Market based Inflation expectations have also crumbled across all windows of observation.

The Fed has room to see if actual inflation will begin to weaken. This may not happen quickly, but the Fed can be more patient given market pricing. Our expectation is that the Fed will continue to validate the current path. That will result in less surprise and falling asset volatility

We have developed a method of estimating what global portfolio managers use to determine the riskiness of their portfolio. The concept at play is to use a predictor of individual asset volatility and portfolio pair wise correlation expectations to measure expected future portfolio risk.

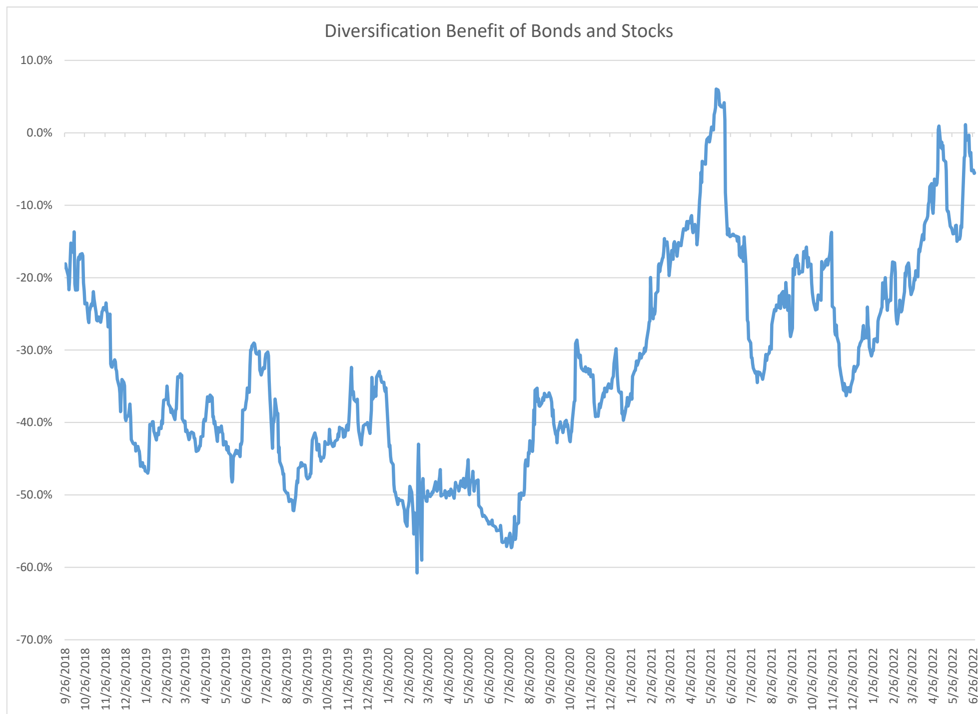
Our view is that PM's have an elevated risk estimation for each asset class that is unsustainable, and they expect portfolio diversification to be weak. The result is that portfolios have been degrossed due to a prediction of high portfolio volatility

Our SPX gauge is very high



As is the Bond Gauge

Bonds and Stocks have opposite responses too changes in growth expectations and that provides a diversification benefit when holding both assets. That benefit is seen in the expected negative correlation. That benefit is currently estimated by portfolio managers at very small



The combination of these portfolio risk drivers has been a global deleveraging of portfolios that target a certain level of Risk. Those who have bought what was sold needed a concession and that has come in high risk premiums. Our view is that along with the QT driver mentioned above that portfolios will see they are now under risked driving risk premium contraction over the near term.

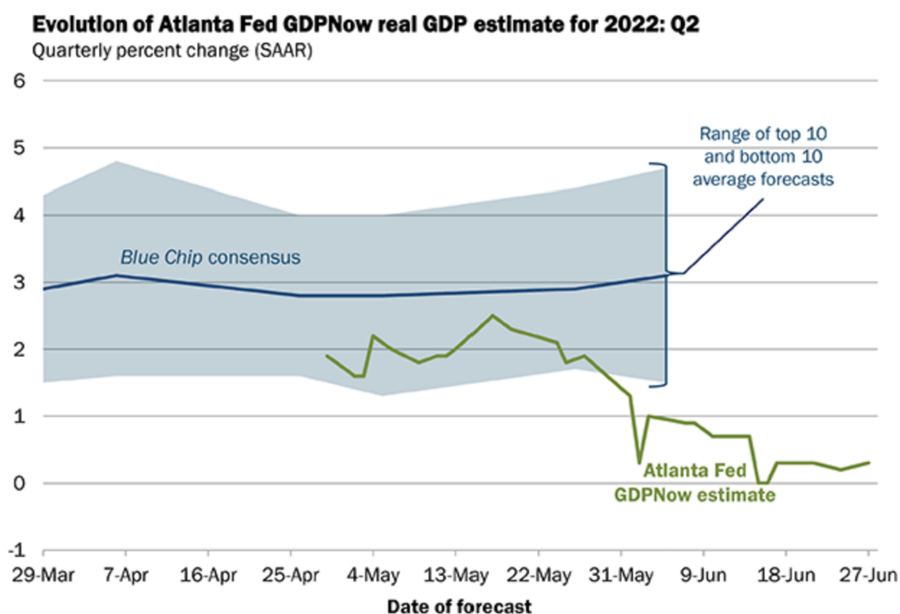
Speaking of Growth - The Recession began months ago!

We don't care about the technical naming of a recession by the NBER. We think after today's final Q1 GDP print of -1.6% and the current GDP Now estimate for Q2. That its possible that this period will be labeled a recession.

Latest estimate: 0.3 percent — June 27, 2022

The GDPNow model estimate for real GDP growth (seasonally adjusted annual rate) in the second quarter of 2022 is **0.3 percent** on June 27, up from 0.0 percent on June 16. After recent releases from the Federal Reserve Board of Governors, the National Association of Realtors, and the US Census Bureau, the nowcast of second-quarter real gross private domestic investment growth increased from -9.0 percent to -8.1 percent.

The next GDPNow update is ***is Thursday, June 30****. Please see the "Release Dates" tab below for a list of upcoming releases.*



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

But we just don't care much about the label. It is clear to market participants and priced into asset markets that we are amid a period of well below trend growth throughout the world. We don't expect that path to change radically but are paying attention to the wiggles to weight our beta portfolio. The alpha from betting on growth fluctuations is not particularly strong at the moment but expectations and positioning seem to be on the weak side. Notably the divergence between GDPNow and Analysts estimates will likely converge as analysts cut numbers.

Speaking of cutting numbers – Equity earnings estimates seem high

Current analyst consensus SPX EPS is 229 for 2022. That's a whopping 10% earnings growth over last year. We at Damped Spring have never used that number for any equity valuation work we do. Furthermore, given the real GDP slowdown it seems particularly foolish to expect this sort of earnings growth. Our view is that no investor believes the current forecast Our pricing models imply an EPS between flat and up 4% is discounted in current SPX levels.

However, we want to point out something that is getting lost in the analysis by many bears and stagflationistas.

Equities are a nominal asset. The earnings are received by the owners in nominal dollars. When determining 2022 earnings one needs to dig a little deeper in environments like today.

Our framework considers the following.

- Nominal GDP is Corporate Revenue
- Corporate Expenses are subject to inflation just as the revenue side but may have lags
- Corporations have fixed costs that do not rise with inflation.

Given those three things we can consider the Case 1 when input cost inflation equals revenue. In this case the operating leverage generate surprising earnings growth.

Case 1	2021	NGDP	2022	
Revenue	100.0	5%	105.0	
Variable Cost	67.0	5%	70.4	
Fixed Cost	20.0	0%	20.0	
Profit	13.0		14.7	13%
Profit Margin	13%		14%	

Of course, if input cost (like wage) inflation is much higher that results in negative earnings growth and margin compression

Case 2	2021	NGDP	2022	
Revenue	100.0	5%	105.0	
Variable Cost	67.0	10%	73.7	
Fixed Cost	20.0	0%	20.0	
Profit	13.0		11.3	-13%
Profit Margin	13%		11%	

But the operating leverage does provide some buffer for input costs to inflate more than revenue without hitting margin growth

Case 3	2021	NGDP	2022	
Revenue	100.0	5%	105.0	
Variable Cost	67.0	7%	71.4	
Fixed Cost	20.0	0%	20.0	
Profit	13.0		13.6	5%
Profit Margin	13%		13%	

We will be digging into the earnings reports over the early weeks of July to see how inflation and real growth slowdown and which of the income statement line items are impacted but we are more optimistic about earnings than most.