The Damped Spring Report

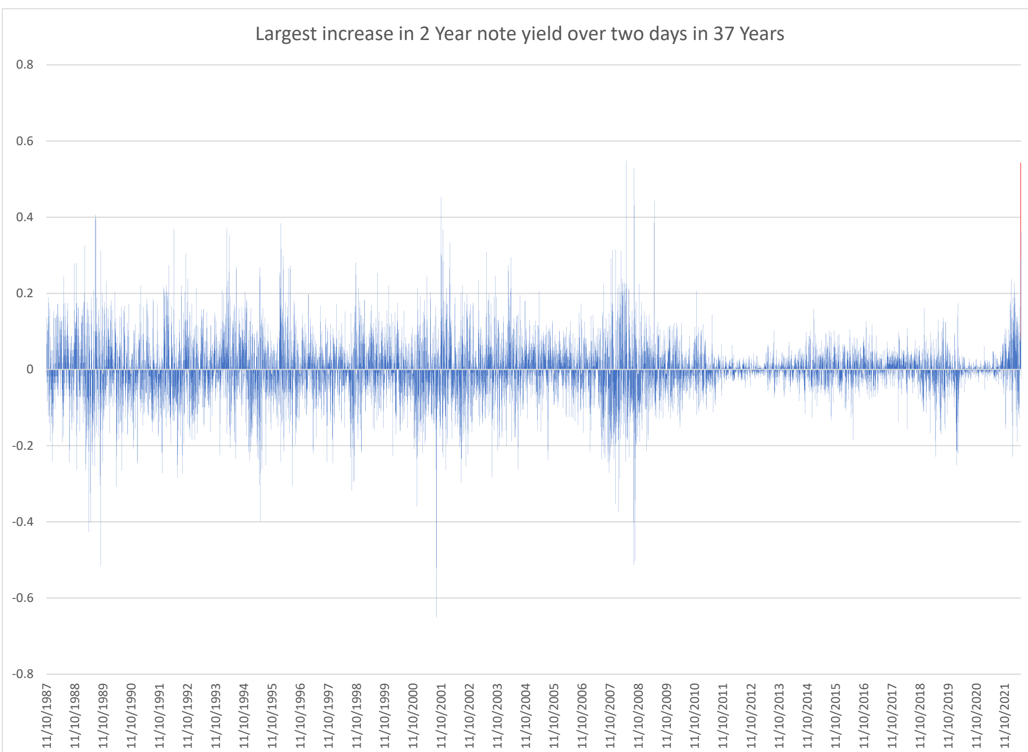
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

6/15/2022

Since Thursday afternoon ahead of the CPI release global markets have priced in major tightening by the Fed. We wrote in "The many flavors of Inflation" that the Fed may sometime in the future reach the conclusion that they have not done enough to tame inflation. We described that as the "Oh shit" moment. It describes a tipping point where another round of tightening is "announced" through aggressive forward guidance. The market had its tipping point over the last three days. Will the Fed meet expectations? Odds are strong that they will. They may have leaked their intentions. They may just want to take advantage of the repricing and simply meet expectations. They will probably hike 75 but our question is simply "What's the rush?"

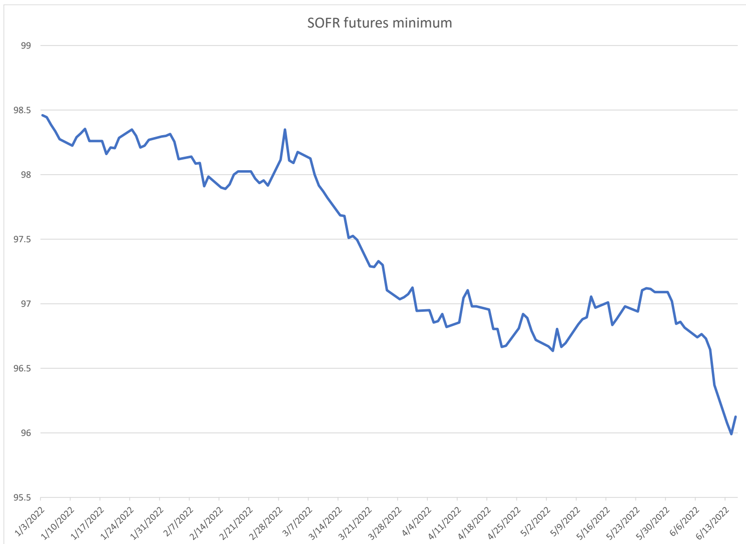
What happened

Over the last three days markets made historic moves

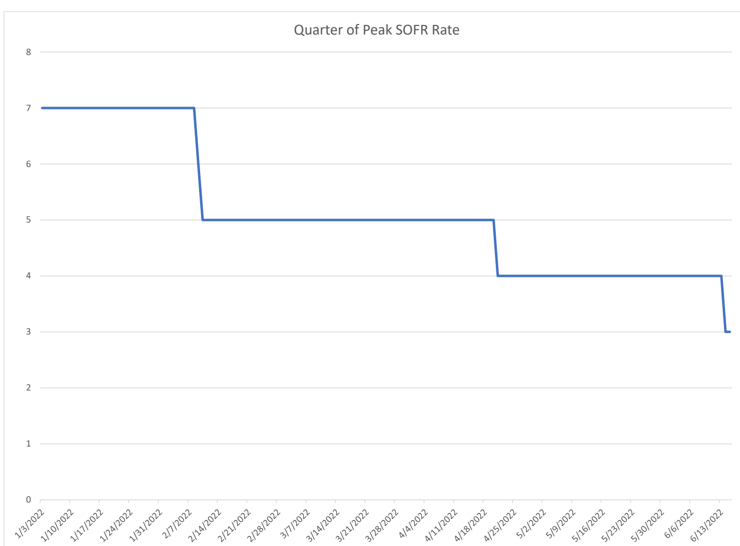


Prior to this week, the only time 2-year notes had a bigger move was during the Volcker tightening cycle of 80-82. During the Volcker cycle fed fund rates were simply announced by a phone call to the Primary Dealers. No meeting, no official announcement, no press conference, just a complete surprise.

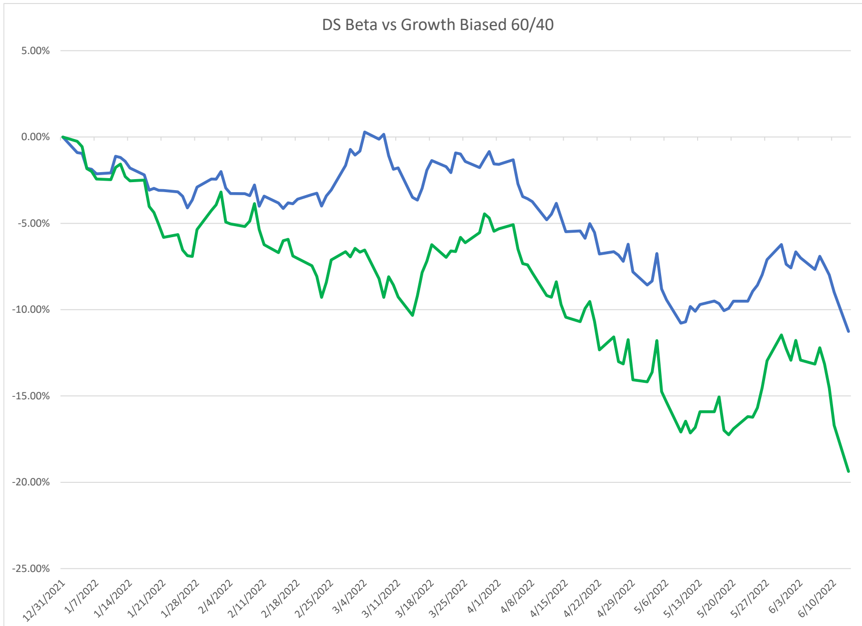
Unlike the old days, today we have forward guidance, speeches and testimony by the Fed chairman, and public consensus building via voting governors' speeches and televised interviews. This transparency, and of course the zero lower bound, has kept STIR volatility extremely low. The market had a tipping point for SOFR rate peak level and timing of peak. SOFR fell 75 basis points.



In addition, rate hikes got more front loaded moving another quarter earlier to March of 2023. That is a fairly aggressive tightening in both timing and level with a peak rate of 4% which assuming that is 50bp restrictive leads to a terminal rate (neither restrictive nor expansionary) 3.5% that rate is 75-100bp above the terminal rate of most of the Fed officials as of two weeks ago. Quite a tipping point by markets. The dot plot confirmation will be important.



The sharp increase in STIR resulted in an actual tightening of financial conditions and all assets fell sharply. Asset markets made new lows for the year in both the DS Beta balanced portfolio and the 60/40 benchmark portfolio. The DS Beta portfolio 4.3% in four days.

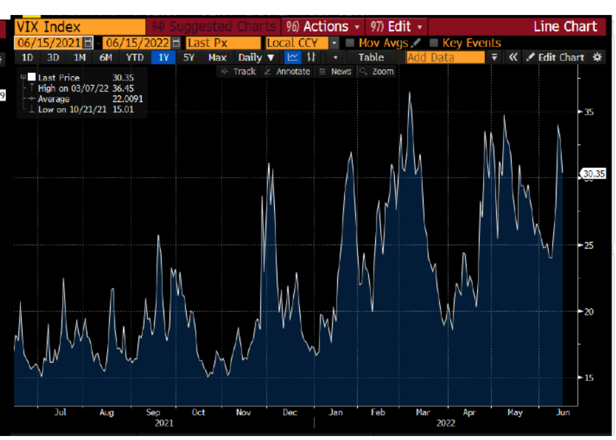


The DS Beta portfolio is balanced to growth and inflation expectations and thus the sell off is pure risk premium expansion. The two drivers for risk premiums are

- The availability of Money and Credit vs the need for Money and Credit to support asset prices
- Portfolio volatility which itself is driven by
    - Individual asset class volatility
    - Diversification benefits

The shift in STIR impacted the Money and Credit channel and the tipping point nature of the move impacted individual asset class volatility which led to deleveraging and exacerbated loss of diversification benefit.

The Move and The VIX Both spiked with FI Vol now 2.5x higher than a year ago



However, this tipping point seems to have left a mark on inflation expectations. It is too early to tell if this new level of interest rates will actually kill inflation, more on that later, but expectations of even short-term inflation fell after spiking on Friday.

The move in 5-year expectations was even more notable.

Has the inflation beast been tamed with this sort of tightening? This question can only be answered by time and data. Which once again makes us ask the question, "What's the hurry?"

In our report of April 11th "The many flavors of Inflation" we described 4 cases that we believe are plausible for the path of the economy. Here is a reprint:

Case 1. Fed kills inflation, Fiscal does not stimulate

In this case, we expect the demand side to be hurt by borrowing cost drivers across the economy, and government spending to be deflationary. Labor supply would also become deflationary. The effect on financial asset drivers would be:

- Risk premium expansion due to over tight policy
- Inflation expectations fall
- Growth expectations fall

And asset price response

- Stocks down
- Bonds up
- Gold down
- Commodities down

Case 2. Fed fails to control inflation

In this case, we expect the demand side to be unharmed by borrowing cost drivers as by definition fed policy would remain stimulative, savings from wages would generate inflationary demand. Labor supply would become inflationary. The effect on financial asset drivers would be:

- Risk premium contraction due accommodative policy
- Inflation expectations rise
- Growth expectations rise

And asset price response

- Stocks up
- Bonds down
- Gold up
- Commodities up

Case 3. Goldilocks

In this case, the fed roughly has it correct and the inflation ebbs fairly rapidly in line with currently priced inflation expectations, trend growth and trend inflation prevail. The effect on financial asset drivers would be:

- Risk premium collection and modest vol related contraction
- Inflation expectations neutral
- Growth expectations neutral

And asset price response

- Stocks up
- Bonds up

- Gold up
- Commodities up

Case 4. More persistent above trend inflation and growth as government spends deglobalization, energy production, military protection, and domestic supply chains, with deficit spending

In this case, additional demand for all goods due to government spending results in more persistent inflation across all aspects of the economy and requires and oh shit moment for the Fed and they engage on another round of aggressive tightening. The effect on financial asset drivers would be:

- Risk premium volatility as the Fed recalibrates its policy
- Inflation expectations rise rapidly
- Growth expectations rise rapidly

And asset price response

- Stocks up initially
- Bonds down
- Gold up
- Commodities up

As the Fed recalibrates to the new growth impulse it then recycles up to the first three cases.

Given the new level of rates and the Fed's focus, Case 2 remains highly unlikely. We also respect the idea that the Goldilocks case 3 is a narrow landing strip for the economy. However, that landing strip widens if the economy can tolerate a fast pace as is currently priced. In April with the fed path far less steep and front loaded we were leaning toward a case 4. Strong economy and persistent inflation.

In terms of a timeline for an evolving Case 4 we expected that if inflation was persistent that the Fed after seeing some data would have an "Oh Shit" moment. We expected that would be at Jackson Hole in August. Despite all of the markets tipping point action we still believe in that timeline and though we understand that the odds favor 75bp today, we don't think they should raise 75 and wouldn't be surprised if they have not had the tipping point that the market predicts. We don't know how the economy will play out; we don't think the Fed knows either.

Markets and the weeds of the Fed meeting

The Fed meeting is packed with data and optionality. The potential outcomes of todays Fed meeting will be hawkish regardless of what they actually announce. They would have been hawkish if the CPI was weak. They are single tone until inflation turns over.

In terms of policy levers and other data

- They could hike 50 or 75, odds are 75 we think they should do 50 but would be surprised if they did
- They could shift to a more aggressive QT with outright sales or hitting the cap sooner or increasing the cap. We completely disagree with the minority opinion that they should pause QT. However, we think they will make no changes.
- RRP rates they could adjust them to release some supply into the economy. This would be counter to their mandate, and we expect no change to the RRP/FFR relationship. One day this could change but not today.
- We are due for some SLR reform. Perhaps we could see some details which could address some stress in the cash markets of short-term UST's
- We expect the dot plot to reflect speed, size, and peak FFR somewhere near current pricing. We expect higher and more persistent inflation and perhaps optimistic growth relative to consensus.

Why rush? The fact that the market would now be surprised if they go 50 is a reason to take the opportunity to meet the expectations of the market and go 75. But it does go against the sober data dependent fed and looks panicky on one number. It also was not forward guidance and choosing to "surprise the market" and do 75 after they were clear about 50 looks sort of stupid and poorly communicated but they will likely go forward with 75 anyway. We respect the argument that they lose credibility, that was hard fought, regarding forward guidance, but at the same time we think they can spin that with the classic quote. "When the facts change, I change my mind"

So what?

The markets have clearly priced in a new path for interest rates, Risk premiums blew out. Discount rates blew out. Assets fell. We were wrong on our positions but now have been offered these same positions at a substantially cheaper price. It's our intent to opportunistically add assets across the board. We thought we had time to hold assets as the Fed observed incoming data and either shifted to a more aggressive path or declared a humble and still vigilant victory at Jackson hole. Today killing inflation seems much more likely than it did two months ago. The impact on the economy of this second phase of tightening will take time but the market has already adjusted. This gives us much greater confidence in our view than when we were betting on a lull before a storm. Of course, case 4 may need a third wave of tightening and a 5% Fed funds. With that sort of Funds rate, we are quite certain the economy would collapse into a long recession   But there is plenty of time before that "Oh Shit" moment.

We have added one new trade before we restructure our long asset positions. We have sold Dec Puts Spreads on Dec 2022 Eurodollars at 96/95.5 for 0.35