The Damped Spring Report

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

4/11/2022

Headline: The first round of aggressive tightening by the Fed has potentially concluded with release of the Fed minutes from the March meeting. Our view is that the Fed has achieved its short-term goal of, setting fed funds rate expectations, getting "serious" about inflation, and announcing the plan for QT. We expect the Fed to allow this goal to play out in the real economy and markets. There are many flavors of the future of inflation. Understanding the differences in these flavors, the fiscal and real economy drivers and the Fed's adjustments to their current monetary stance will be essential for market participants. In today's DSR we will review the menu. Choosing what to order is not obvious to us and we imagine data and in particular the fiscal response will be critical to making the right choice.

First, we will review our framework and our snapshot outlook for inflation, then we will discuss the flavors of outcomes that could happen, lastly, we will review market pricing and our positioning ideas.

Inflation drivers

Our framework for inflation considers major macro drivers of both demand and supply as well as the elasticity of each of those drivers. First let's review the framework.

Short term demand depends on the base spending needs of an overall society and the desire for discretionary consumption, constrained by savings, ability to borrow, and the cost of borrowing. Long term demand depends on the same things plus population growth.

Short term supply depends on the availability of raw commodities, food and crop/protein cycles, supply chains, labor availability, and substitution. Longer term supply depends on these things plus productivity.

Lastly, long term sustained inflation can also be caused by currency debasement which goes beyond simple central bank actions of interest rate settings or private sector credit creation availability.

To fully evaluate the outlook for inflation we have broken down these main drivers and estimated the current direction that they will likely travel over the next three months. We predict that inflation has peaked in the US. Other countries have had less direct wealth transfers to consumers and less stimulative direct government spending. However today is just a snapshot and any flavor of Inflation can follow. Government spending is a wild card.

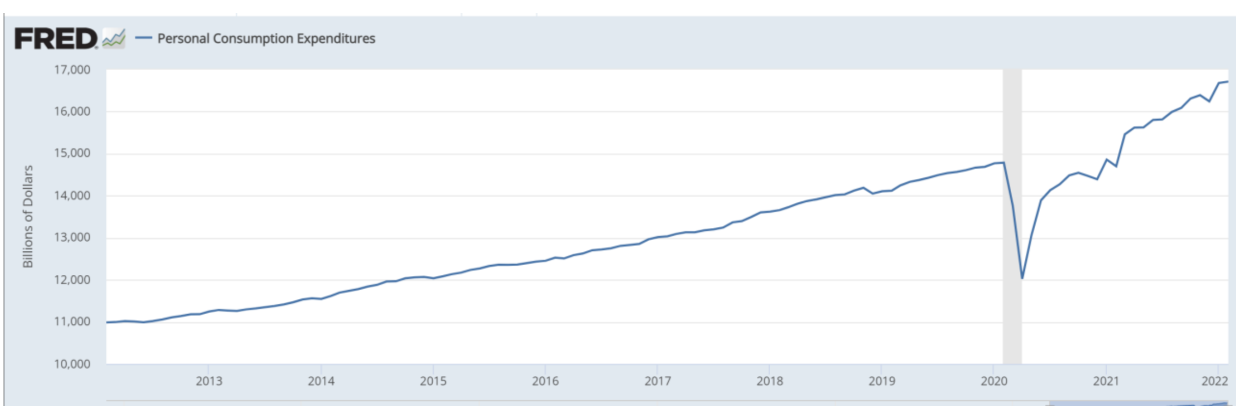
Direction of Short Term Inflation Drivers			
Driver	**Private sector**	**Public sector**	**Net**
Demand			
Base Spending			
Discretionary Consumption			
Savings			
Ability to borow			
Cost of Borrowing			
Supply			
Raw Commodities			
Food			
Supply Chains			
Labor			
Substitution			

Inflationary	
Neutral	
Deflationary	

Demand

Base Spending and Discretionary Consumption

Since the beginning of the Covid, the government has handed out significant stimulus to the private sector to bridge the loss of income during the pandemic. That money has been released into the economy rapidly as the pandemic lockdowns have ended. It has generated price increases throughout 2021 and into 2022. However, since September, the private sector has not received additional stimulus. This fact, as well as the increases in prices, particularly those impacted by the supply change, has slowed private sector consumption. The public sector continues to spend generating above desired inflation rates but well below the rate in 2021.



We find looking at the absolute price levels, and the observing the pre covid slopes, and the shape of post covid prices is useful holistically. Clearly the upward slope remains steeper than pre covid. Our expectation is it will remain steeper but nowhere near the level of the past year. The private sector continues to have demand but there are many signs that this will level off. However, there is a great deal of potential actions by governments across the world which could generate significant inflationary or deflationary pressures. This lever will be the most important aspect of demand for which to pay attention over the next year. **Military buildup, deglobalization, energy production, commodity production and secure supply chains may be national security priorities and those countries that spend on these priorities will generate sustained inflation and above expectation growth**

Savings

Private sector savings supplemented by massive government transfers has generated the wave that has powered prices higher. As we mentioned above there are signs that this wave is reaching its end. Savings rates have fallen below long term pre covid levels.

Which means to keep up with inflation consumers are now spending more of their paycheck. This obviously has limits. As prices increase if wages increase slower than prices dissaving or borrowing will be required to continue to spend.

Notice that real wages continue to drop

We have mentioned how consumption fueled by the stimulus payments works in past reports but as a reminder, spending ultimately lands in corporate savings. They then use that cash for investment in plant and equipment which is stimulative for growth and deflationary long term, in share repurchase which is stimulative for assets, or hold in cash. As of now corporations are favoring the latter two over the former. That could change particularly with the direction of government spending. **Overall, we think the savings based inflationary indicator has reversed and consumer savings are now pointing toward disinflation.**

Ability to borrow and cost of borrowing

Private sector balance sheets are healthy, and banks have a ton of capacity to lend. If the private sector uses its debt capacity and the banks are willing that could generate further inflation. However, borrowing costs are rising which will slow borrowing. **Our view is that the balance of ample loan availability at albeit higher costs is currently inflationary.**

Supply

Raw commodities and food

Commodities have rallied all year Since the spike after the Ukraine invasion commodities have reversed fairly dramatically. The GSCI index is down 10%

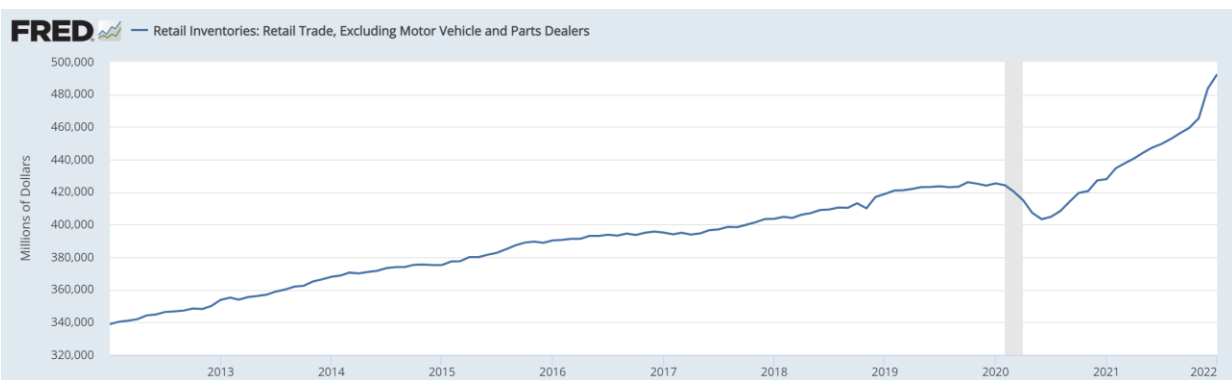
While those particular commodities that are most impacted by the war and other supply chain disruptions have fallen even more sharply. Oil is down 30%

Wheat

While it is very difficult to determine whether supply chain problems have peaked this selloff in commodities to admittedly still high levels will take some of the heat off the inflation prints in the months to come

Supply changes are clearly improving

Retail inventories have spiked



Dry bulk has turned

Labor

Clearly labor markets are tight. **Wages remain weak on a real basis as noted above; however, we expect some catch up between CPI and wages which is clearly inflationary**

Substitution

This simply does not exist now for most supply chain constrained goods, Autos, Oil, Copper, Aluminum, are not going to be substituted soon or even the next decade. ESG compounds this problem as it constrains fossil fuel investment and spurs copper and aluminum demand. **While food may see some substitution effects, the key commodities and labor have no such flexibility, so we expect continued inflationary conditions**

The Flavors of inflation

As can be seen in our chart there are and will remain many conflicting factors that will impact supply and demand and prices. We thought it would be useful to lay out some of the potential outcomes and what would have to happen for them to occur using the above framework

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.

It is important to note that all policy makers from all world economies must be considering this deglobalization issue and how their own status impacts their decision making.

Current markets

We have taken a 5% drawdown from peak of 16.13% YTD. We are looking to get long all assets again after the CPI print later this week. We think that the selloff in the long end is massively overdone. It seems to us that market expectations are moving toward case 4 rapidly. We also believe that despite likely bipartisan political pressure to begin deglobalization in response to all of the supply chain disruptions any effort to write a plan will fail when the details are negotiated unless an actual crisis occurs in this country.

We continue to focus on the here and now and our understanding of the levers that drive inflation expectations which we believe are likely to fall, while the Fed is likely to remain vigilant but on the sidelines until more data comes through. But most importantly we expect the understanding of the QT mechanism and the Treasuries role in its transmission to evolve through the first week in May and the risk premium expansion that is currently happening to reverse.

Current positions and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 42,813,351					
	Total Return	42.81%		YTD Return		11.52%	
	Today's Date	4/11/2022		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case l(	MTM	P/L	Open/Closed
2/24/2022	CLH5 20 pt stop	73.5	100	$1,000,000	77.5	$ 400,000	Open
2/24/2022	Fxi June 35 calls	1.6	6250	$1,000,000	0.7	$ (562,500)	Open
3/31/2022	NDX April 15500 Call	58	172	$1,000,000	2	$ (965,517)	Open
3/31/2022	SPX April 4625 Call	23.75	421	$1,000,000	2	$ (915,789)	Open
4/5/2022	SPX May 4600/4700 Call Spread	40	250	$1,000,000	25	$ (375,000)	Open
4/5/2022	NDX May 15250/16000 Call Spread	230	43	$1,000,000	131	$ (430,435)	Open
4/4/2022	NDX April 15750 Call	22	-172	$ (378,400)	1	$ 361,200	Open
2/15/2022	TY May 126 Call	0.703125	1422	$1,000,000	0.02	$ (971,556)	Open
3/25/2022	EDZ3 50bp stop loss	96.93	2000	$1,000,000	96.58	$ (700,000)	Open
3/25/2022	USA June 146/144 Put Spread	0.734375	-790	$1,000,000	1.203125	$ (370,370)	Open
4/5/2022	US/ZB June 150/153 Call Spread	0.640625	1561	$1,000,000	0.25	$ (609,756)	Open
4/1/2022	TY May 123 calls	0.515625	1939	$1,000,000	1/32	$ (939,394)	Open
			Inception Risk	10.6%	Total Risk	4.5%	