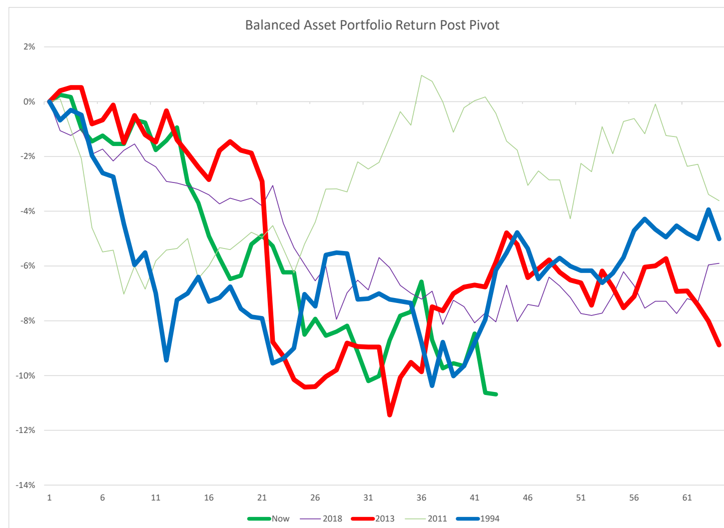
The Damped Spring Report

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

2/14/2022

Headline: Curve rallies on equity selloff and Ukraine fears. Real world uncertainty returns to markets which have been overly obsessed by Fed tightening. This move up in bonds is virtually the first counter trend move this year. It may be the signal that the month-long risk premium expansion driven by tightening fears has run its course. US Bonds may fall if real world uncertainty is relieved but falling based on hikes or QT alone is over and if they do back up it will likely be for the benefit of equities.

In December, in our outlook, we predicted a significant risk premium expansion once QT and hikes began. We had used four prior tightening cycles to estimate the expansion. In this chart we plot three months of returns for a balanced portfolio of assets after a pivot event. The green line is today since Dec 15th. The red line is the taper tantrum of 2013. The dark blue line is when Greenspan began a surprise hiking cycle. In the 1994 and 2013 cases the market was surprised by the pivot. The faint lines are 2011 and 2018 and were communicated upfront and resulted in much milder drawdowns. We believe that risk premium expansion has peaked. A new low in this portfolio will require more than frontrunning but Fed action that is not currently priced into markets



	Now	2018	2013	2011	1994
Max Drawdown	-10.7%	-8.1%	-11.4%	-7.0%	-10.4%
3 month return	TBD	-5.9%	-8.9%	-3.6%	-5.0%

Note: Somehow even the ECB has capitulated to the hawkish view and pivoted last week. If Europe continues down the path of policy that leads to flattening and risk premium expansion, assets in Europe are the best short vs any other world market though pricing has already moved a good amount. The chart above shows a timeline where European assets do poorly for another month. We shorted the EUR last week and will short Schatz and Sx5e on a bounce.

The high level for this DSR is that the real world and the real world of investing are not about the Fed alone. This past 5 weeks has been navel gazing by market participants. Things got so fierce that seven hikes were priced in to markets this year. CPI was hot yes. Bullard was foolish yes. But the Feds job is to operate in the real world where uncertainty is the only certainty. Where war, international trade, pandemics, economic decisions by policy makers, corporations, and individuals, are hard to predict. The Fed is not omniscient.

The Fed is a damper that leans against deflationary/recessionary or inflationary/expansionary, forces and attempts to soften the excesses. It does not try to cause reversals. Sometimes it does and sometimes it does not. The Fed has crude tools.

A mistake this time is particularly consequential as interest rates cannot be cut enough to offset the mistake and the balance sheet is already huge and distorting financial assets. The Fed must try to do no harm. The FOMC knows they do not the future and they will act with that level of humility.

They may need to hike as many times as seven this year. But they do not have that plan regardless of what March SEP may say. They are human beings doing a complex job.

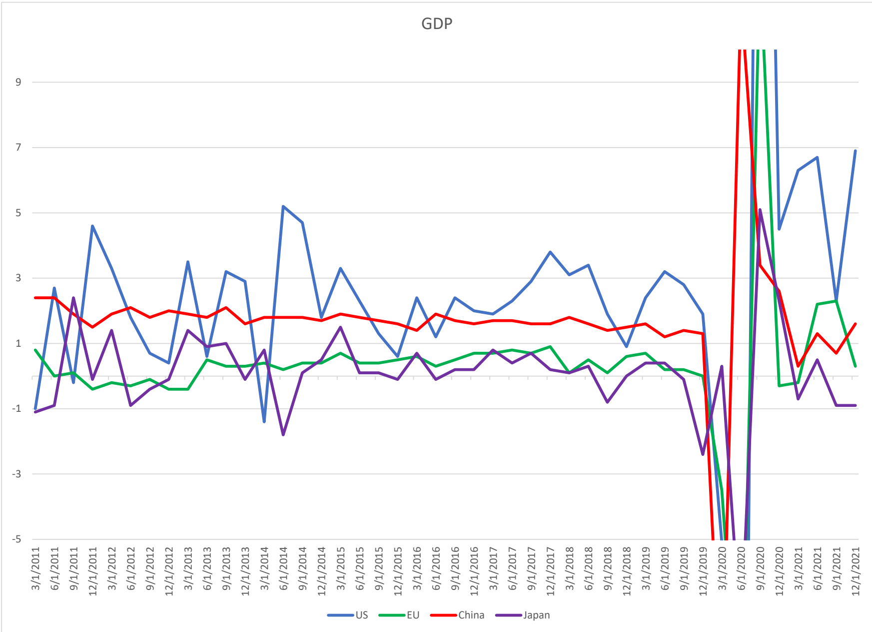
The lack of humility exhibited by the US Markets and European Markets regarding "absolutely knowing" what will happen in the next 9 months is the opportunity for those who can deal with ambiguity and uncertainty and be data dependent. **Market participants did not need to be data dependent when the QT drumbeats were heard first on Dec 15th by a few. Sell any asset was the appropriate trade. Since that got started in earnest, we have fought the tape as our estimate anticipated actual tightening would take the market to current levels not just frontrunning.** Now that the curve priced where it is, and consensus QT is near our QT tracker estimate. The markets have phenomenal opportunity as those with dogmatic arrogant approaches to how they would steer the Fed will get their comeuppance.

This DSR is about the repricing of global yield curves to extreme hawkishness on little evidence that extreme hawkishness is warranted. As mentioned above, the uncertainties facing the world prevents Fed officials to know the future which is always the case. But given the lack of meaningful historic cases they will have an even more complex challenge to estimate the impact of their actions.

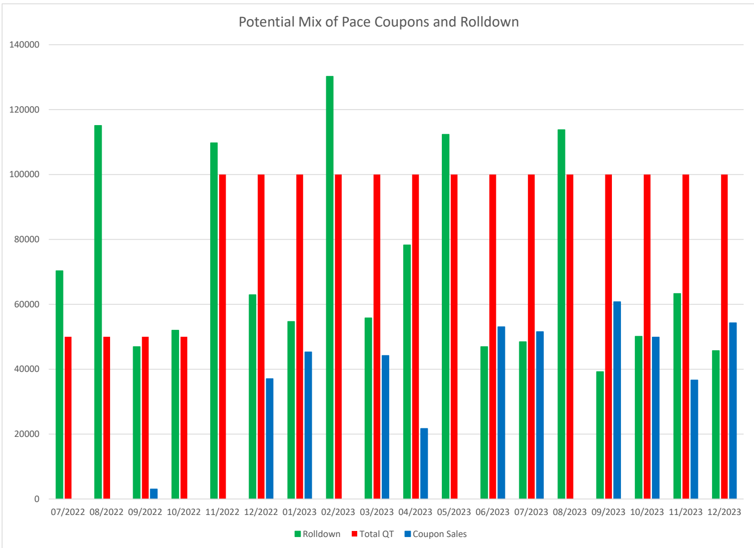
The yield curve is already at levels which may damper demand. People obsessed

with the Fed and short-term rates must predict the exact path the Fed takes to place their wagers. The macro economy does not give a damn about whether the Fed will or won't hike. They transact at the market interest rates and those are significantly higher across the globe over the past five weeks.

Market rates operate with a lag and the US and Chinese economy remains quite strong. Japan is in trouble, and we would expect continued dovishness for BOJ relative to all other central banks while a fiscal bazooka appears necessary again. Why Europe is pivoting is beyond us. But that inflation narrative is powerful.



In terms of QT our estimate for how QT will work remains exactly as stated



Interestingly, though we predicted this weeks ago, people are finally realizing that coupon sales are both necessary and likely to be with mortgages
This is not our game, but we believe that Mortgage spreads will expand all else being equal as the Fed does coupon sales in mortgages. If, however, the Treasury does not tap the RRP by overweighting bills the US Treasury issuance will compete with the mortgage sales and perhaps not do that much damage to spreads. We will simply report what we see.

Inflation narrative

We have been in the transitory inflation camp with a definition of transitory as through 2022 as we published in Feb 2021. Here is why. Taken from DSR "Inflation and why its likely transitory."

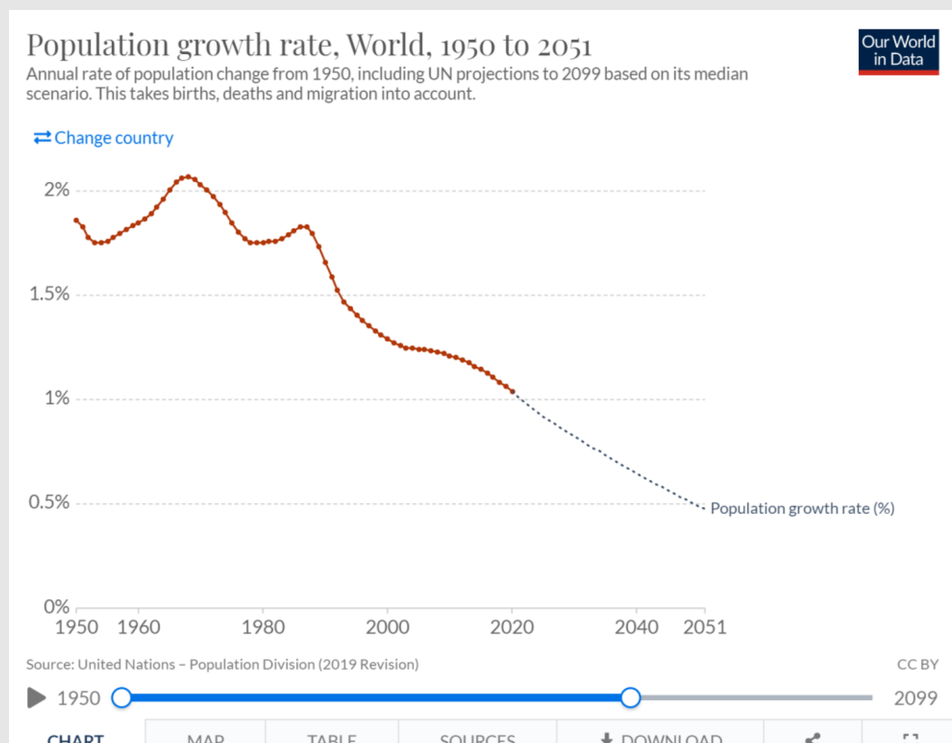
Demand driven inflation

It is certainly likely that, as the global economy reopens, demand for all goods and services will spike ahead of the ability for suppliers of these goods and services to deliver. I think of it as a reverse toilet paper spike. It makes sense that prices would have a onetime adjustment against this demand. However, long term inflation means not just a onetime spike, but repeated price rises through time. The major drivers for sustainable long-term inflation are:

- Population growth
- Willingness and ability to [EARN], leverage, and dissave, for extended time
- Expectations of long-term currency devaluation

Population growth

The world population growth rate is low and projected by the UN to continue to fall.



This decline in population is a significant deflationary force

Willingness and ability to spend for an extended time

As we have mentioned in past reports,

- Consumers have saved significantly during the pandemic as fiscal transfers have offset declines in income. They will dis-save near term, but savings have a limit thus dis-savings is not sustainable. For consumers to drive prices sustainably higher after an initial pop they will have to layer on more and more debt until the labor market becomes tight and workers have leverage to demand higher wages. [THIS IS BEGINNING]
- Governments are unlikely to continue their spending trends after the pandemic relief bills end. Both political realities and debt capacity will pinch back government spending
- Corporations that were most impacted by the virus are much more in debt and less able to spend. We have mentioned the impact of these zombies in past reports

We believe that 2021-2022 will certainly see increased real consumption. But we do not believe this is sustainable after the initial dis-savings as debt loads are already high.

Currency devaluation

Clearly there have been currency crises where fiat money becomes worthless. The rally in crypto is more likely a speculative flow than driven by true concern in fiat. Gold has performed poorly which rejects this fear. Real estate seems to be rallying or falling based on idiosyncratic post pandemic preferences. Fiat currency pairs have been stable. We do respect that significant purchases of assets by the global central banks are perceived as printing and recognize the risk that if those central banks cancelled the debt that true printing would occur. However, recognizing that the balance sheets will be worked down rapidly in the face of above desired inflation means this printing will be reversed. One caveat of grave concern, but, not in the cards for the moment, is the possibility that central bank independence is further compromised, and they become unwilling to slow economic growth to fight rising inflation if it were to occur.

One important point to note is that all currency crises in the past have occurred when a countries liabilities are mostly foreign currency denominated. This happened in the Weimar Republic and all EM currency devaluations occurred when foreign currency obligations weighed heavily on the domestic economy.

In updating this work based on what we know today, we are convinced that both Fed action to cut demand and broad relief of overall supply chain constraints will drive inflation back toward target. We are worried about three inflationary tailwinds.

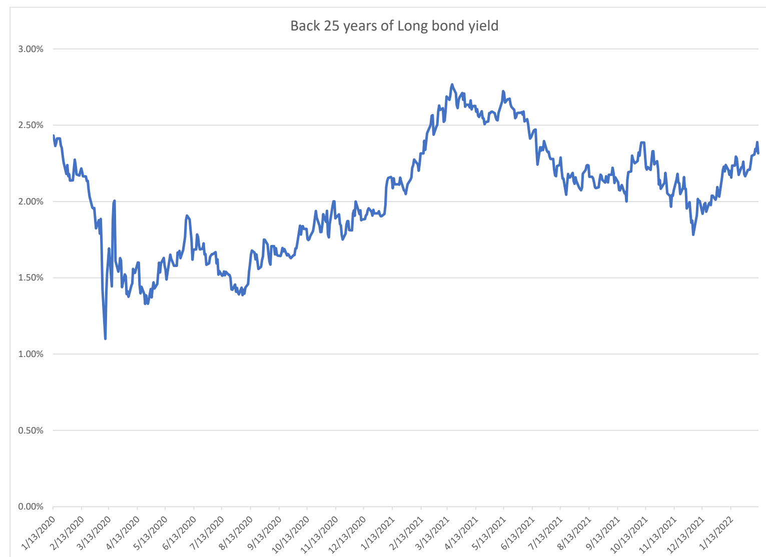
- Oil is semi-permanently supply chain constrained as ESG has made financing for energy infrastructure scarce and at high prices. We think backwardation of the oil futures curve seems a great opportunity. Stocks are extremely crowded but three-year futures look very attractive
- Copper and Aluminum supply chain does not have ESG headwinds but was not built for the demand that sustainable energy projects require. ESG is a demand tailwind for commodities that conduct electricity

- Labor supply constraint may be more permanent than expected but signs are improving that the great resignation is "transitory" wages are a concern worth watching.

The Fed cannot engineer the ESG winds with its tools. But they can decrease demand. The Fed can engineer less labor tightness and slow wage inflation with its tools. The Fed will use them.

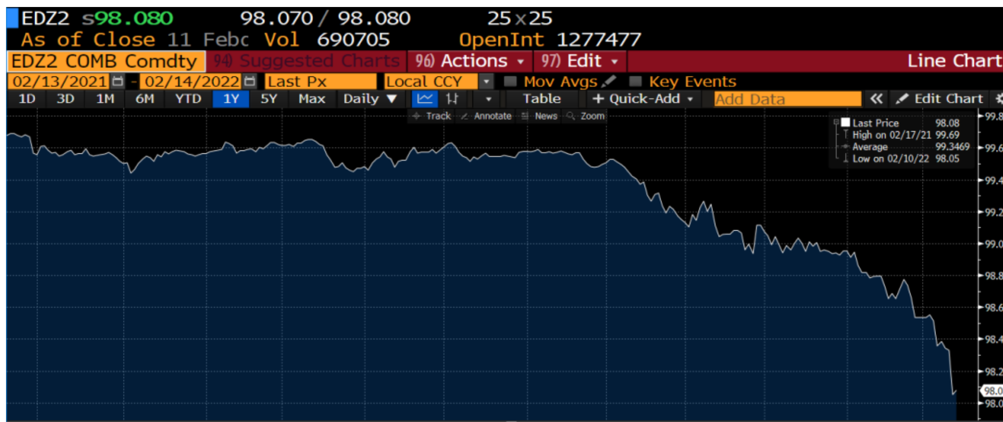
So, what about rates?

Quite simply, the long end of the curve has peaked for the next few months. Most of the move has been risk premium expansion. I think we can all agree that the next five years may be an interesting tightening cycle. But the 25 years left in the long bond is up 40bp since the QT drumbeat started



This has happened while inflation expectations have collapsed. Meaning term premium expansion has been even larger

And then there is this



Yes, the Fed may hike 175bp over the next seven meetings. But seems asymmetric as hell given our views above. We are a buyer of Dec Eurodollars below 98 all day long.

Equities

We have been much more aggressive trading our equity position in February. We are long here. As we have shown above, we think the risk premium portfolio is near its absolute bottom. For that reason, we expect that as risk premiums settle the equity market sentiment which is extremely bearish will abate and we will get out of our equity longs perhaps not at all time highs but within the range of the strikes we are long.

Current positions

- Short EURUSD with 1.14/1.10 Put Spread
- Long USM2 by shorting 154/151 Put Spread.
- Long SPX March 4600/5000 call spread
- Long NDX 15000/15750 call Spread

Targets for new positions

- Long Dec 22 Eurodollar contracts 1% AUM position. Target is 97.95 with a 97.50 stop
- Short Schatz March futures at 111.75 with a 112.5 stop
- Short Sx5e on any bounce will update with options spread live
- Looking to add USM2 April 156/158 call spread on dip will update live
- Looking to add short 3-month CL futures vs long 3-year futures at 20 30 stop loss