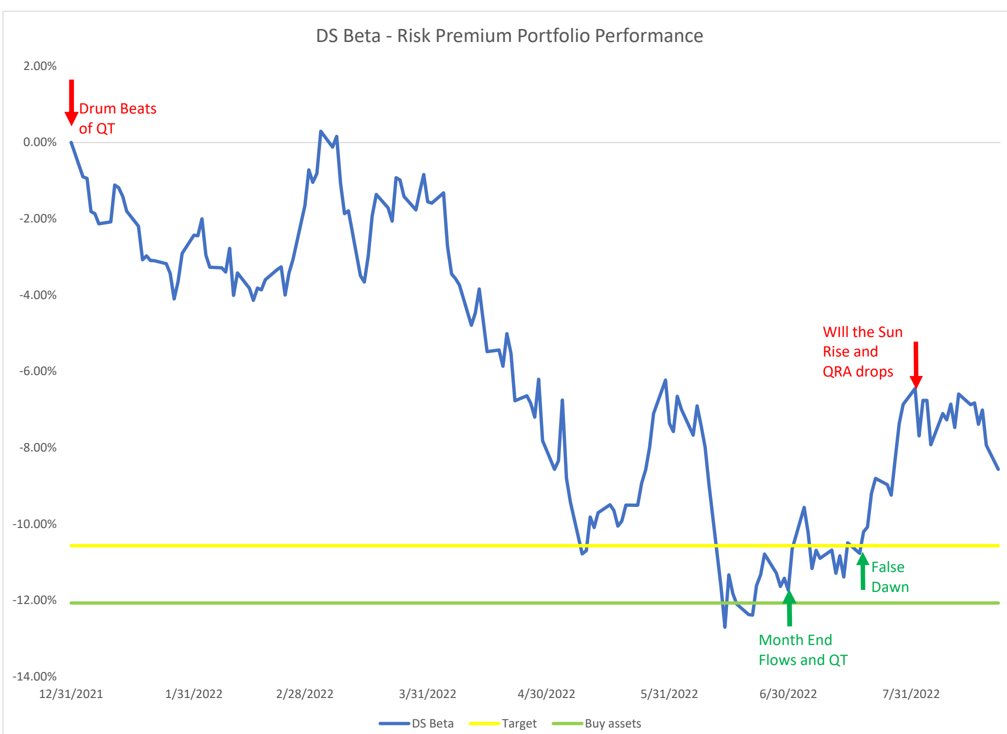
The Damped Spring Report

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

8/22/2022

At 10 AM EDT on Friday 8/26 Jay Powell will cement his legacy as a serious inflation fighter. But as everyone on the planet focuses on that event, we say today that Jackson Hole doesn't matter. What matters is not how convincingly hawkish Jay Powell's words are. What matters is the Fed's deeds and the US Treasury's financing plans. Who but STIR traders really care about the exact path of rate hikes. They will be what they will be. They will be higher for longer. While pricing that path into bond prices and then judging its effect on the real economy to aid in choosing assets to own is without a doubt important, by far more important is the imbalance between demand for assets and supply. The Fed and the Treasury have already shown us the path. Soon QT Impact is about to start roaring. The False Dawn was a rally on risk premium contraction. Since 8/1 when the QRA came out risk premiums are now on the rise. Assets suck. We expect significant pressure on assets to continue and generate 200-350 bps of negative return on diversified asset portfolios through the fall.



Jackson Hole

Plot twist amirite. All summer we have been pointing toward Jackson Hole with the story arc of our summer series. However, now that all investors, economists, and pundits are now laser focused on the speech, and that speech will get blanket coverage in the media, its time to gaze past the summer circus to the fall. But before we do let's review the message we would give if were in the shoes of the Fed Chair.

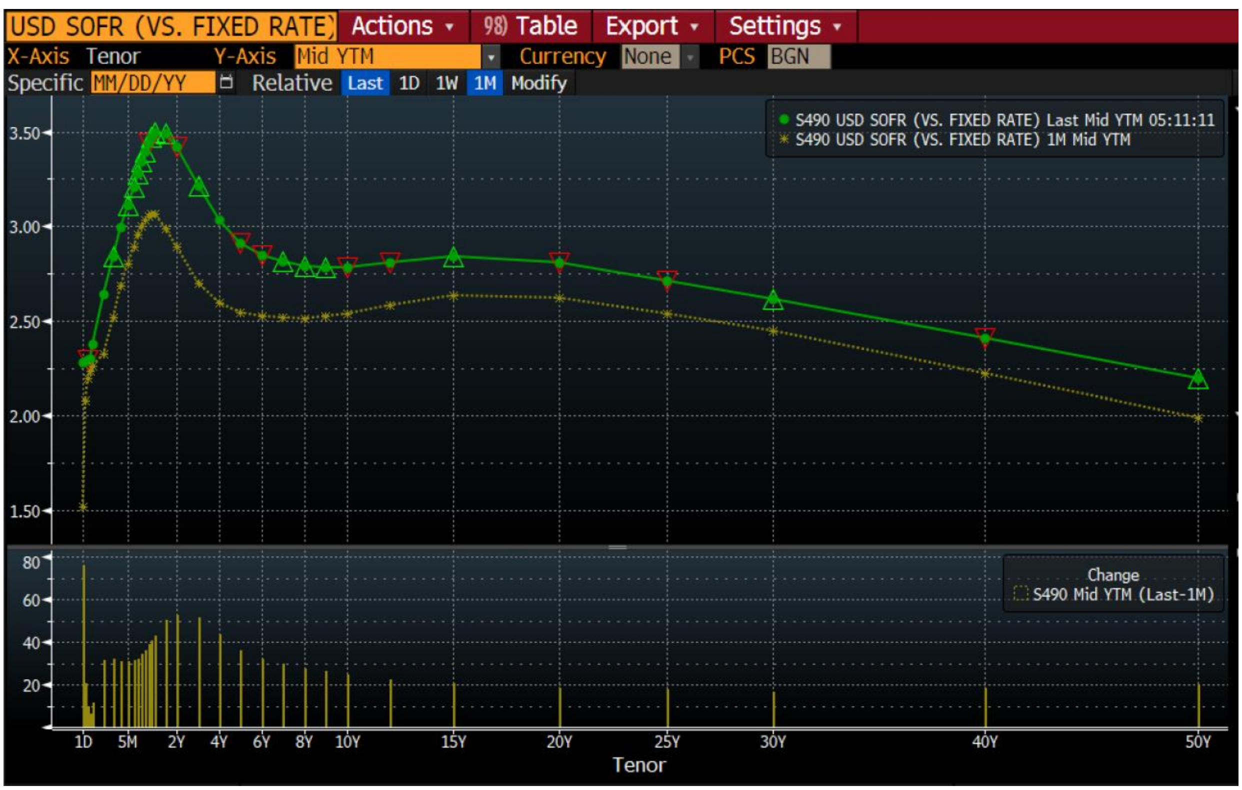
- The labor market is tight resulting in wage and employment growth.
- The private sector (including corporations) has accumulated wealth, above trend savings rates, and access to accommodative credit conditions resulting in continued high demand.
- While interest rates have moved up substantially conditions indicate that current rates are well below restrictive.
- The Fed recognizes certain weaknesses in the economy, our actions are partly responsible for that weakness, and yet the risks remain quite unbalanced regarding inflation and full employment. Fighting inflation is clearly our priority.
- While rate hikes are our preferred tool for slowing demand, quantitative tightening will ramp up in September and aid in tightening financial conditions also cutting demand for certain capital-intensive expenditures
- Lastly, Additional government spending may result in short term demand creation. (We don't actually think he will say this because politics), but he should.

The high-level point is that the speech will be higher for longer. Unequivocally hawkish. We fully expect debate at a myopic level of each word for signs of a pause or pivot. But that will be noise and consistent with the uncertainty of outlooks that any humble market participant must acknowledge.

But we also believe that a lot of progress has been made debunking the pivot narrative and subsequent market pricing. So perhaps JH will be a relief for markets. We placed a bet in early July that cuts priced for 2023 would evaporate.

Markets now price less than 25bp cuts in 2023 which is evidence that the good cops (the cast of post FOMC fed speakers) have been convincing. **We have as of today also taken half of our trade long EDZ2 short EDZ3 off at a healthy profit.** We don't think that there will be any net hikes in 2023 and our central case remains hikes in the first half but the easy money on this bet has been made.

The longer part of the hiking cycle is getting priced in. The higher part has also shifted by 50bp. We think both have room to move but ahead of JH and with the focus the event is going to generate we suspect that the path of rates trade is trending higher for longer but with a coin flip bet in the short term.



While there appears to be less actionable opportunity in STIR for the meeting it does make sense to examine longer term assets for what's priced in. In our first chart we showed significant risk premium expansion since the FOMC press conference and short-lived bounce through QRA on 8/1. The risk premium expansion to date is partly rate hikes higher for longer exerting a tightening impulse.

Given the focus on JH and pricing on the short end, it's certainly possible that the hikes driven risk premium expansion is now priced in and long-term assets are now priced for a coin flip. But that is the point of our DSR today. Look past the coin flip to QT and Issuance and the coin is clearly tilted to Assets Suck.

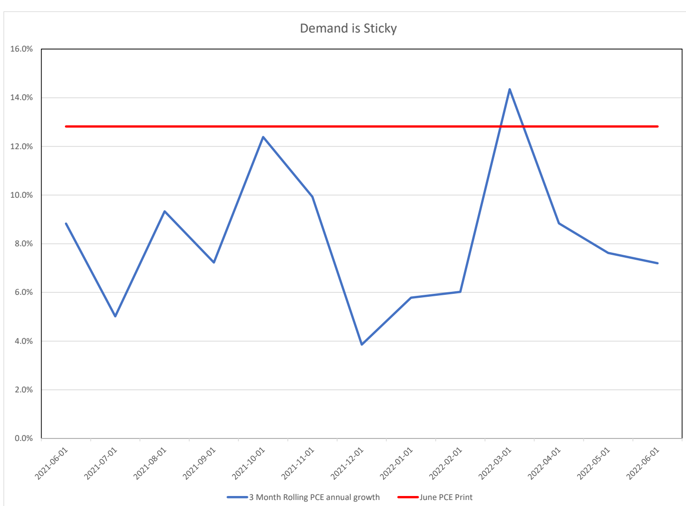
Inflation

Based on how we would write the Jackson Hole Speech it is obvious that our view on inflation outcomes has shifted. In our DSR, The Many flavors of Inflation from 4/11/2022 we outlined a Goldilocks Case 3, which was our central assumption at the time, and a Case 4 which we described in this way.

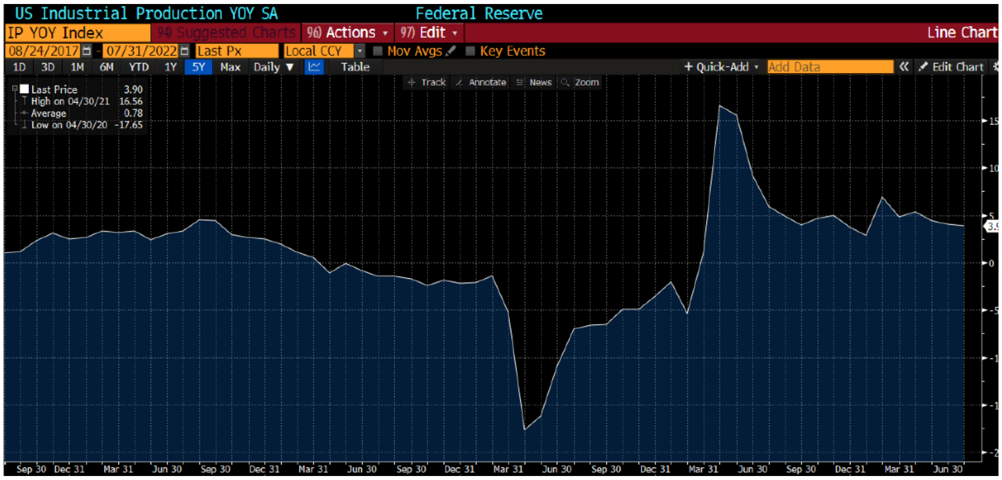
> **Case 4. More persistent above trend inflation and growth as government spends deglobalization, energy production, military protection, and domestic supply chains, with deficit spending**

Since our report we have seen growth fall, but without any impact on labor tightness. We have also recently seen two government policy spending initiatives that address the exact issues mentioned in Case 4. Because of the persistent private sector demand driven by labor, wealth and money and credit conditions and this wave of spending we believe we are much closer to Case 4 than Goldilocks and that informs our outlook on the Jackson Hole Speech for hawkish further words and deeds by the Fed.

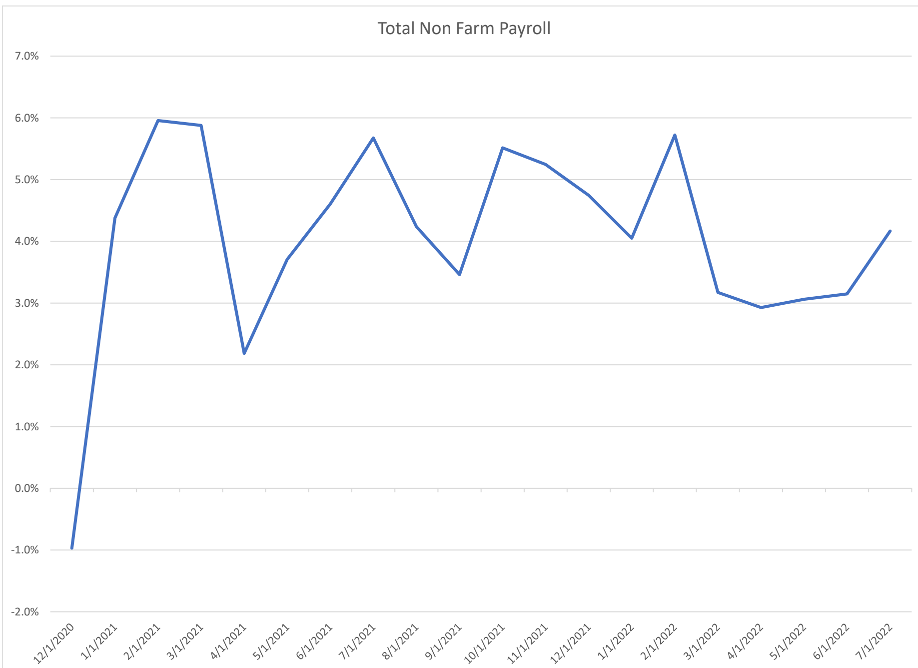
Demand remains sticky and MoM in June printed north of 12%



While simple measures of supply are only growing less than 5% suggesting a significant gap. Industrial Production is running around 4%



As are employment gains.



For the gap between demand and supply to close and reduce inflationary pressure jobs and productivity would need to grow rapidly or demand will have to come down. Labor force participation could grow but shows little signs of such flexibility at the moment.

We think that the Fed has clearly stated its framework for inflation and that is entirely dependent on demand destruction primarily through attacking labor. The Headline CPI is not the signal. Core is sticky and more relevant. But at the end of the day Consumption, production, employment are the data points that will drive the Fed.

QT/QRA/TGA

On 8/1/2022 after examining the Quarterly Refunding Announcement (which we got badly wrong) we noticed a couple of key points

- The intention of maintaining a large TGA of greater than 650BN
- Net new money issuance of 844BN in 2H 2022 surpassing our own estimate by 444BN
- A plan to finance both new spending initiatives while maintaining ammo in the TGA for a potential debt ceiling battle after the midterms

These announcements coupled with the step up to 95BN of QT runoff in September will result in an imbalance of supply of assets vs demand for assets. Jackson Holes doesn't matter anymore. This is the signal risk premium expansion is inevitable. Risk premiums expanded a ton over 1H2022 as the drumbeats of QT were front run. Then contracted as that front running was met with limited QT impact due to TGA spend down. Today TGA wont bail out assets and issuance are once again climbing while risk premiums have contracted.

In our next episode -The Finale – The zombies

The plight of over levered countries and companies in a higher for longer restrictive world with weaker growth will be described. Spoiler: The Zombies are on the run.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000				
LTD P/L	$ 44,515,295				
Total Return	44.52%	YTD Return	13.23%		
Today's Date	8/23/2022	Portfolio Created	4/15/2019		

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
8/2/2022	NDX Sept 12000/11000 Put Spread	133	75	$ 1,000,000	73	$ (451,128)	Open
8/2/2022	SPX Sept 4050/3850 Put Spread	47	213	$ 1,000,000	35	$ (255,319)	Open
8/5/2022	NDX Sept 12500/11500 Put Spread	138	72	$ 1,000,000	175	$ 268,116	Open
8/10/2022	SPX Sept 4050/3850 Put Spread	32	313	$ 1,000,000	35	$ 93,750	Open
8/15/2022	Sx5e Oct 3700/3600 Put Spread	27	370	$ 1,000,000	40	$ 481,481	Open
8/16/2022	Sx5e Oct 3700/3600 Put Spread	23	435	$ 1,000,000	40	$ 739,130	Open
7/7/2022	EDZ2EDZ3 50bp stop loss	-0.65	1000	$ 500,000	-0.37	$ 280,000	Open
8/5/2022	TLT Short 113/116 Sept Put Spread	1.2	-5556	$ 1,000,000	2	$ (444,444)	Open
8/11/2022	TLT Short 113/116 Sept Put Spread	1.3	-5882	$ 1,000,000	2	$ (411,765)	Open
8/9/2022	GLD October 167/162 Put Spread	1.5	6667	$ 1,000,000	3.1	$ 1,066,667	Open