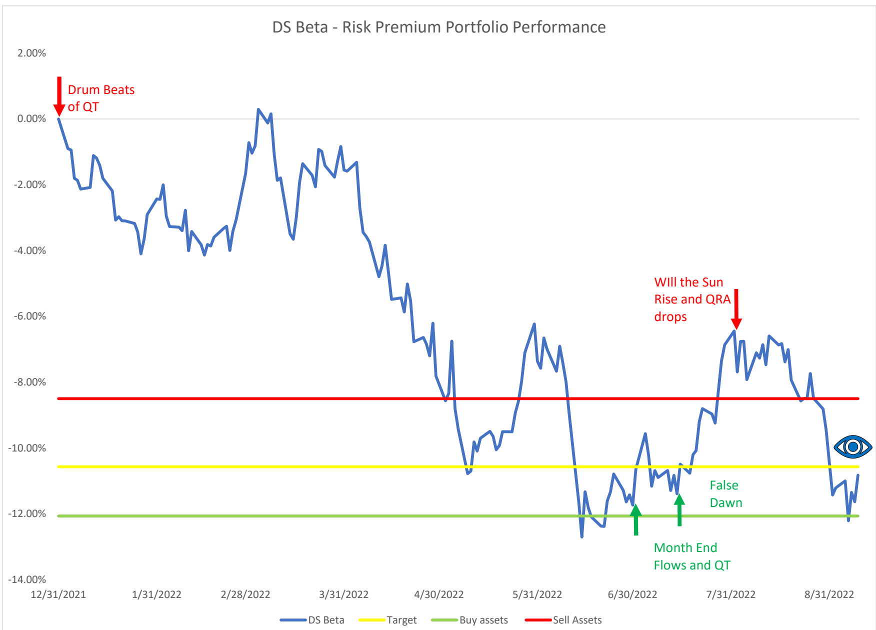
The Damped Spring Report

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

9/11/2022

Hurricane season officially opened at Jackson Hole. While that event was a catalyst for equity investors to unwind longs built during the "False Dawn" of July, asset markets overall have been falling since the winds changed on 8/1. Today we are in the eye of the hurricane and relative calm exists as headwinds from QT and issuance continue to constrain assets, but various crosswinds are creating some logical divergences across asset classes. The variable crosswinds are worth some focus, to navigate through the eye of the QT storm. But keep watch on the strong wind as leaving the eye and reentering the storm can happen at any time and is inevitable.



The crosswinds since early August have had varying impact across asset prices, in particular the long end of the treasury market has been much more impacted by risk premium expansion than other assets. This divergence is the first of many important asset price dislocations that we expect due to crosswinds this month. Once the relative calm of the eye of the storm passes these divergences will be blown away.

Monetary Policy

We believe the global central banks have all made clear that a premature pivot is not going to happen. That means QT is here for a year or more. While asset markets recovered well before the end of QT in 2018-2019 it is premature to even consider owning assets for a new bull run at current prices ahead of hopes of a pivot. Tactical owning of assets is possible but very price dependent. We think inflation is somewhere between Goldilocks where high inflation ends in 2023 and "Higherer for Longerers" where inflation lasts well into 2024 before returning to target.

September Crosswinds

The next few weeks have major crosswinds impacting asset prices

- Heavy auction schedule is the QT/Issuance Headwind
- Inflation data
- Equity Option Monthly Expiration
- FOMC Meeting
- Equity Earning Preannouncement window
- End of quarter rebalance and large at the money equity call

All Asset prices have corrected sharply since 8/1 and most are rebounding in the eye of the storm. The crosswinds during the calm will set prices for the return of the storm and result in massive opportunity for the balance of the year.

Auction Schedule

The US Treasury will issue 1/4 TN of bonds this month

Week of	Total Issuance (BN)	Composition
9/12/2022	91	3's 10's and 30's
9/19/2022	27	20's and 10's TIPS
9/26/2022	123	2's 5's and 7's
Total	241	

Currently the entire US Treasury curve is near or at the high yield for the year. This issuance supply has clearly dislocated the bond market from the rest of the asset markets. We don't think that is sustainable and convergence is likely. In addition, that divergence is likely to generate some rebalance flows at quarter and month end on 9/30.

Inflation data and FOMC Meeting

CPI on Tuesday, PPI on Wednesday, and U of Michigan new data for September on Friday, will all generate a lot of focus. We believe that the Fed is much more interested in jobs data but clearly, they will also pay attention to these data points. However, the inflation data needs to be placed in context given the Fed's stated reaction function.

For context we believe that the virtual monotone of “higher for longer” punctuated emphatically by Powell’s Jackson Hole Gettysburg address. (Short and sweet) will continue through this Fed meeting and frankly through at least the November meeting. No matter how cold inflation data gets and even if jobs and wages data slip the monotone will continue at least 3-4 monthly cycles.   We may be wrong, but we are highly confident that it will last through November's meeting at least.

Regardless of the prints this week we see no way that the Fed message will change. Given the pricing of 75 bp for Sept Fed meeting at 91% a hot set of number seems like a complete non-event for anything but STIR. A cold set of numbers are likely to have a knee jerk response across all asset markets given current pricing. We hope so. Our goal is to be short all assets at attractive levels by mid-October. Cold numbers are our friend

Equity Options Expiration on Friday 9/16

The extremely large number of puts owned by speculators is a strong driver for an equity rally this week. Last weeks equity rally was partly due to these flows, and they could end before expiration. For now, the bias is up.

Month end convergence?

By month absent a shift in asset pricing during the next two weeks, three factors are likely to impact markets. Month End Rebalances favor bonds over stocks. The large, structured product roll has a current strike of 4005 on SPX and expires on 9/30. It will act as a magnet due to pinning hedging activity by dealers. Lastly market participants will watch for preannouncements of poor corporate earnings to potentially indicate weakness in overall corporate earnings announced in the October.

What’s priced

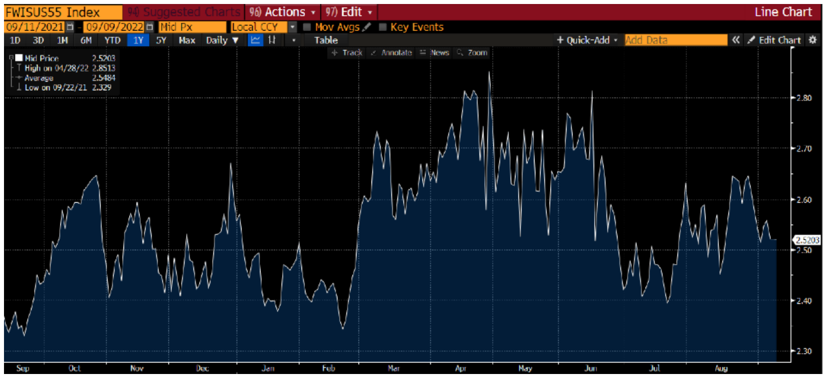
The page 1 chart shows the overall pricing of assets since QT was announced. Digging into the total returns using simple metrics of common ETF’s

Asset	YTD Total Return
DS Beta	-10.83%
SPY	-13.70%
TLT	-26.90%
TIP	-8.80%
GLD	-6.51%
GSG	27.82%

Clearly the selloff in long term bonds has been the principal driver of asset performance. Equities have fallen primarily due to the rise in long term discount rates as forward earnings estimates have stayed elevated due to high nominal growth. Gold has suffered in line with rising real rates.

The very front end of the curve remains exactly where it was pre-Jackson hole regarding the end of the hiking cycle albeit shifted up due to an expectation of 75 bp in September.

Since 8/1, The bear steepener in the bond market is consistent with expanding risk premiums front running supply. It has not been driven by inflation expectations which have broadly softened.



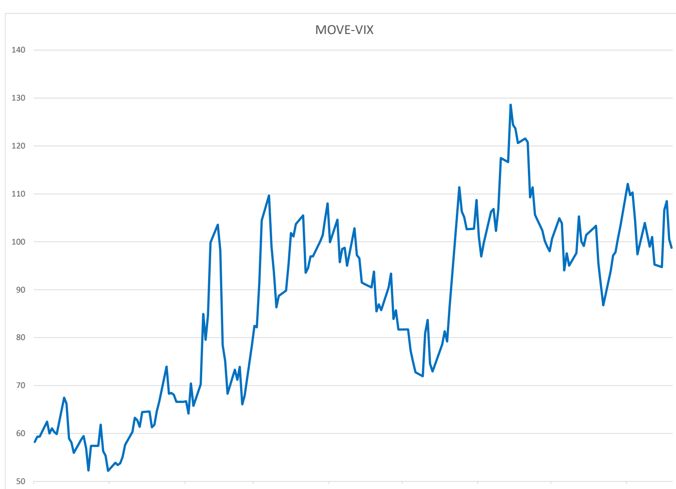
Perhaps the equity rally and the bond selloff is due to a recovery in growth expectations. Bond prices across the curve are at or near lows. Equities have bounced significantly which means it is possible that growth expectations have risen. Gold has also bounced despite real yields increasing which is more a sign of risk premium contraction than growth. At the same time commodities are weak which means growth expectations are probably a small driver for assets is at all.

This leaves risk premiums. As we have shown assets in general have corrected a lot and bounced last week in the eye of the hurricane. But it appears individual asset risk premiums have diverged with bond wider and stocks and gold tighter.

Risk premiums for assets can diverge for two reasons.

- Temporary flow and positions resulting in opportunity
- Persistent shifts in expected volatility/risk of each asset class.

Implied volatility certainly has diverged over the course of 2022. But its hard to conclude that the recent divergence is related to increased risk expectations for bonds



Synthesis on market pricing

Assets in general are in a "no touch zone" in which overall risk premiums are priced about fairly. The bond market has aggressively cheapened while other assets have bounced. A divergence in risk premiums like this is not likely to persist. However, adding up the various headwinds it is our expectations that bonds will likely stay under pressure relative to data. Meaning good data for bonds will not result in a meaningful rally. Equities will likely drift higher all week and eventually give way to the QT headwinds and end of month flows getting sucked into the 4005 gamma hole by month end. Of course, more disruptive moves are possible. We have virtually no risk at the moment. We will buy all assets across the board if they fall 3-4% and Sell equities aggressively above 4125 on a rally. If we are correct and the bond market is cheap and rallies into the auctions, inflation data, and the FOMC we will also unwind our small bond long and go short long-term bonds. However, we don't think we will get that lucky.

Because we are in the Eye of the Hurricane expect multiple Trade Updates as the month plays out.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 48,749,806					
	Total Return	48.75%		YTD Return		17.46%	
	Today's Date	9/11/2022		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
8/30/2022	SPX Call Spread 3950/4000 9/30/2022	28	357	$ 1,000,000	36	$ 285,714	Open
9/2/2022	SPX Call Spread 3950/4000 9/30/2022	28	357	$ 1,000,000	36	$ 285,714	Open
9/9/2022	SPX Call Spread 4050/4100 9/30/2022	27	-714	HEDGE	26	$ 71,400	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	2.95	$ (972,222)	Open
8/11/2022	TLT Short 113/116 Sept Put Spread	1.3	-5882	$ 1,000,000	2.95	$ (970,588)	Open
9/2/2022	TLT October 109/114 Call Spread	2.15	4651	$ 1,000,000	1.68	$ (218,605)	Open