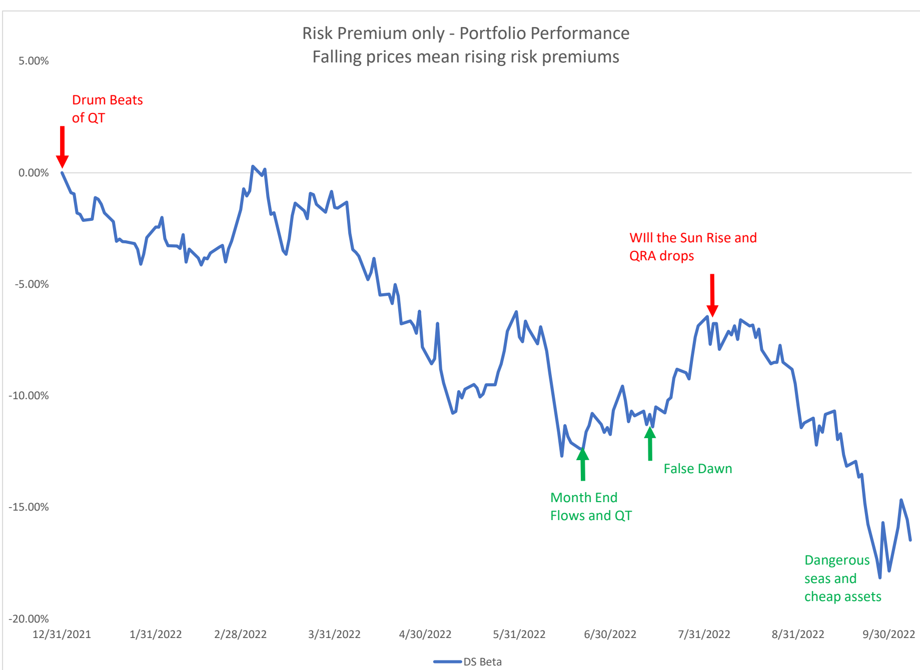
The Damped Spring Report

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

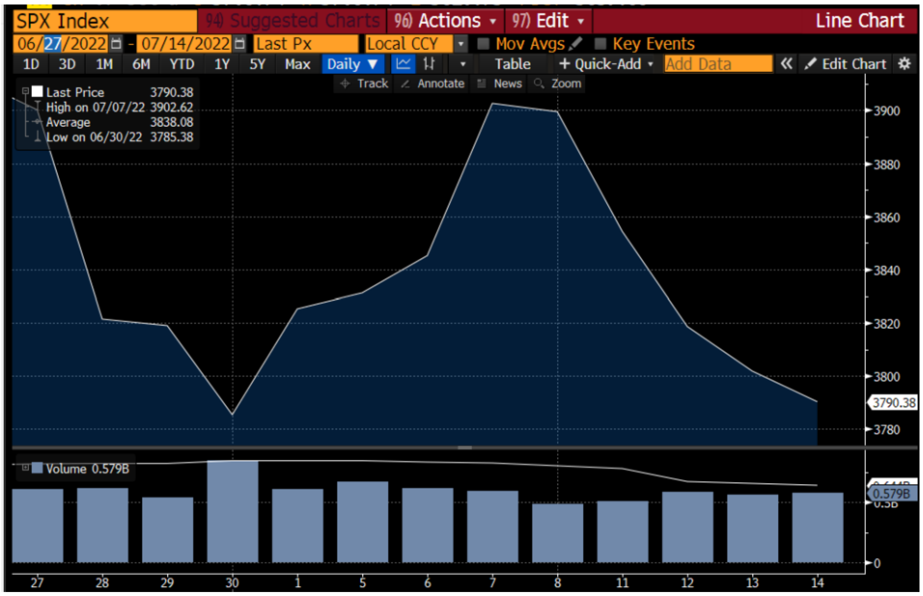
10/09/2022

After a dizzying rally, up 6.5%, on Monday and Tuesday and a subsequent violent selloff on Friday, the SPX ended the week up 1.5%. This reversal has led to increased bearishness over the weekend and prompted many to call for the next major leg down in equity markets and perhaps all financial asset markets. Is falling into the abyss next or is this action preceding another "False Dawn?" Humbly, we are not certain and significant data will arrive all month that may drive either outcome. However, we remain certain that any major asset rally will be capped by the continued headwind of quantitative tightening. Until expectations that quantitative tightening is nearing its end all rallies in asset markets will be "False Dawns." In this DSR we want to point out the similarities and differences between the circumstances that prompted us to correctly call the False Dawn in July and the current market and economic outlook. We fully expect a very weak market on Monday and yet we believe False Dawn 2 is more likely than descending into the abyss of another major leg down in asset markets.

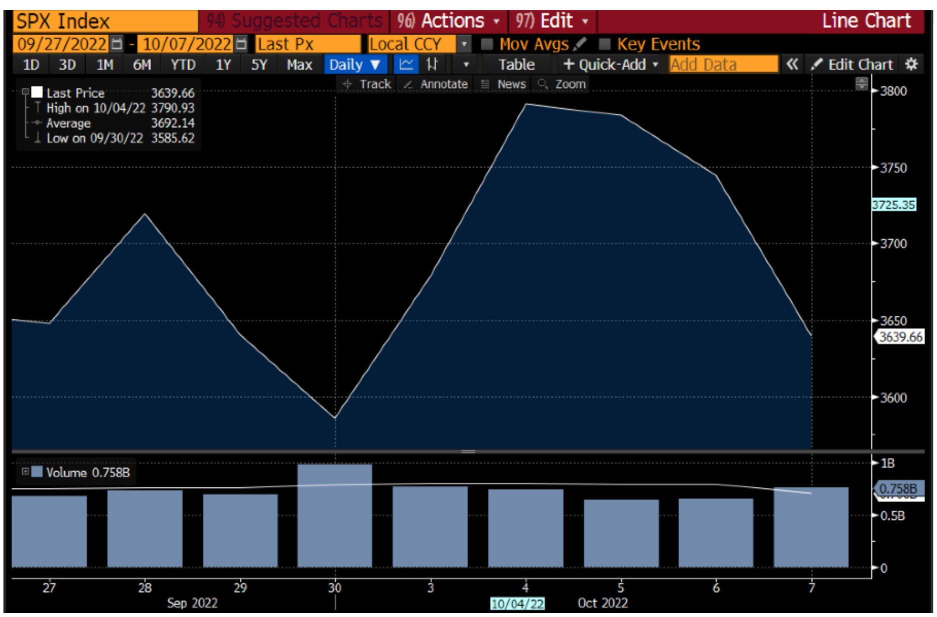


On Friday after a relatively benign NFP number which was nonetheless too hot given the Fed's clear focus on jobs, the equity market fell and closed a very weak session at only 1.5% higher than the prior week close. This sharp selloff right after a sharp rally reminded us of the price action at quarter end in June.

In June the JHEQX Collar did its magic, the market recovered and sold off hard

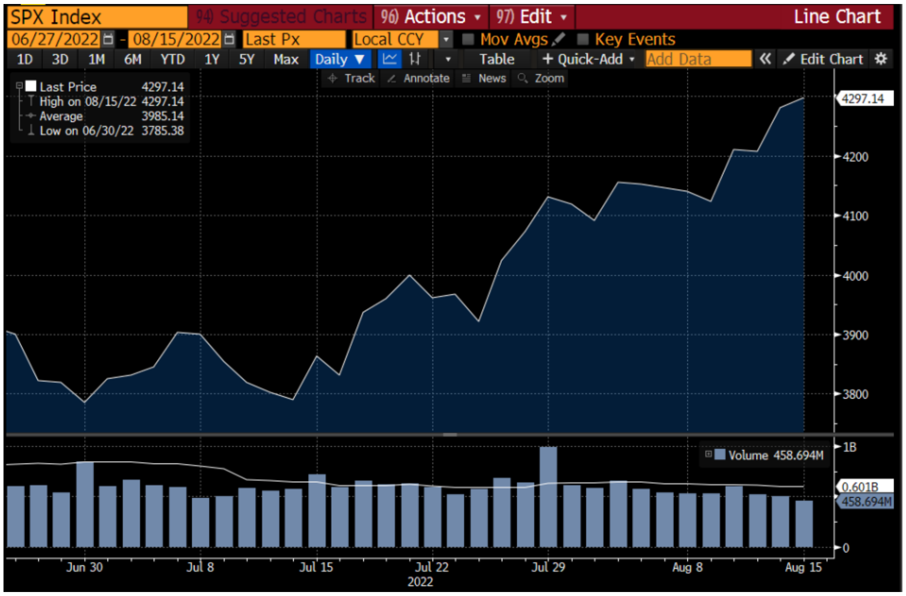


In September same thing albeit a bit faster.



At the end of June equities had made a 2022 low due to the hot CPI and Michigan survey numbers resulting in the Fed embarking on a rapid tightening. In early July calls for an imminent recession after two successive quarters of negative GDP plus the shift in Fed policy reversed the early July rally.

After the reversal, we called for a substantial rally which we named the False Dawn.



Overall asset markets began a meaningful rally with stocks peaking 17% by Jackson hole and overall asset markets peaking prior to that when the QRA described aggressive issuance in the second half of 2022 ending the false dawn rally.

Synthesis

At best we believe October can be another False Dawn and assets of all sorts can rally. Alternatively, given the move, on Friday the 6.5% rally may have just been a dead cat bounce. Will this be the abyss or a second false dawn? It pays to look at the conditions that led to a rally in July. Besides the last week's price action there are many similarities and some key differences between today and three months ago

Let's look at the similarities

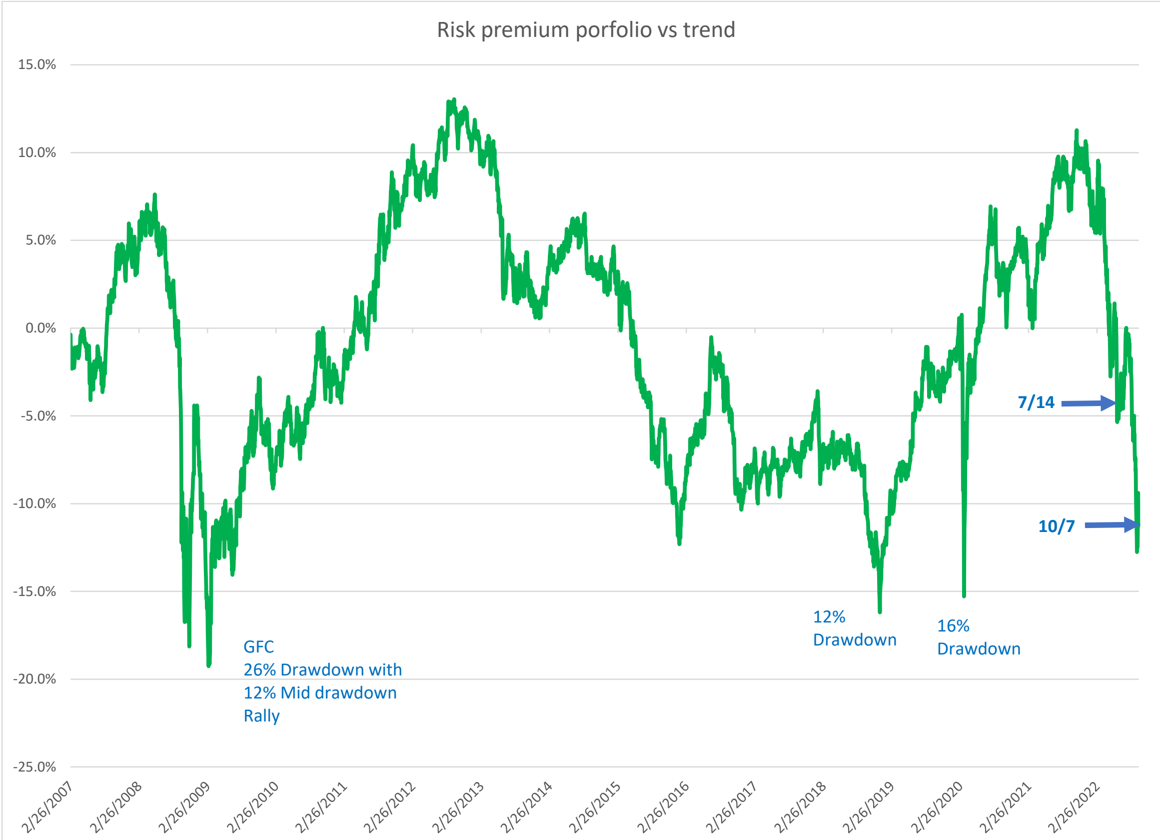
- Quarterly earnings announcements were/are about to be released. In both cases expectations were/are very weak and forward guidance was/is also expected to be weak. High nominal growth and the failure of wages to keep up to inflation kept earnings strong and though this is not long term sustainable it is likely that this imbalance will result in an upside surprise of both realized earnings and forward guidance relative to expectations
- The Fed had/has been ramping up hawkish talk and actions
- Positioning had/has grown quite bearish. Both volatility targeting deleveraging needs and institutional portfolio flows had/has gotten to unsustainable extremes.
- Quantitative tightening had/has leveled up by 47.5BN in the prior month, from zero to 47.5BN in June and from 47.5BN to 95BN in September
- As for markets

- Valuations of equites had/have reached new low levels
- Bonds had/have sold off significantly
- The USD had/has rallied
- Gold had/has fallen

But things are different.

- In June, The Fed had just gone full hawkish and while Jay Powell certainly blew the July meeting communications leading to an extension of the rally that wasn't until the presser at the end of July. Nonetheless many market participants believed that the Fed would quickly reverse its hawkish tone Today the Fed is at peak hawkishness which is ironically more likely to result in an actual easing or pause well sooner than July. However very few market participants now believe that the Fed will reverse course quickly. Today the Fed has been explicit with a terminal rate and the path with some wiggles is now clear through the next 3-4 meetings.
- In June market pricing favored cuts in 2023, today they favor pause, however there is now increasing demand for protection for a much higher terminal rate of 5.5% if that pricing becomes embedded in markets there will be only a brief False Dawn if any at all and perhaps the abyss looms more likely
- The early July correction started with a weekend of recession talk. Today the economic data is decidedly rosier regarding the strength of the economy. Imminent recession seems remote. This difference augers for strong earnings but also higher terminal rates
- Significantly, long-term interest rate levels are higher today versus three months ago. The 30-year treasury was only 3.3% vs current levels of 3.85%. This difference has an impact on equity valuations which should have impacted the SPX fair value by 300 SPX points. In July relative to bonds equities started the False Dawn 150 points cheaper. But at the same time instead of a recession weekend we have had robust economic news.
- A major difference is QT and its US Treasury Department issuance transmission mechanism. In early July the markets had been starved for assets for all of Q2 as new money issuance was actually negative in Q2 Q3 issuance has been heavy all summer and into September. In September, the market had twice as large a runoff to absorb and has been absorbing large deficit funding issuance poorly of late. Q4 is likely to keep pressure on assets given the issuance picture and full QT runoff

Today equity valuations relative to bonds appear to be 3% richer. However, broad asset portfolios are dramatically cheaper than in June driven by selloffs in bonds, commodities, and gold. Currently asset portfolio valuations are 700bp cheaper than 3 months ago

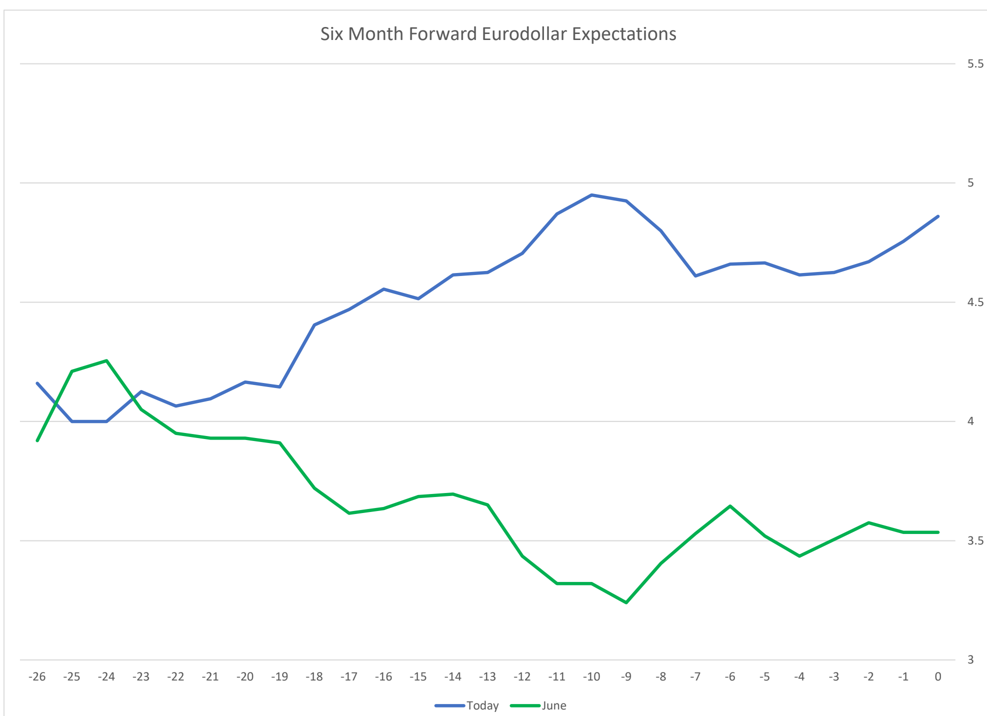


One other point is that every day we get closer to the end of of restrictive policy. We think it's too early to consider the end of the Fed's restrictive policy. We certainly would trade on it at this time. We do know the QT plan is likely to last at least two more years. But at the same time, we are 3 months farther across these dangerous investment seas than we were in July. Perhaps that means the abyss needs to be navigated through. Again, this is not a call for a new dawn. **This is a comparison of two bear market outcomes.**

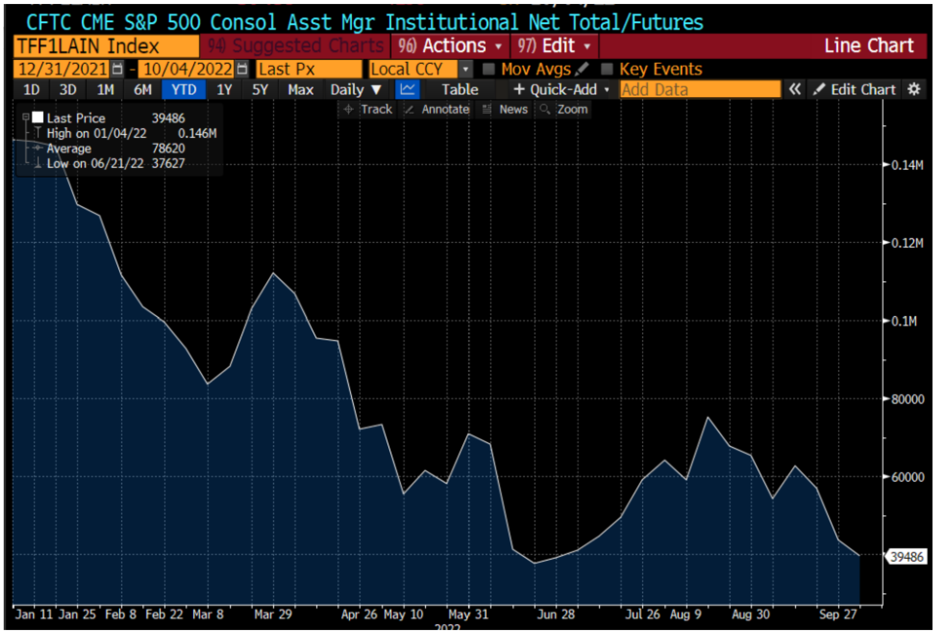
Details on similarities

During the lead up to earnings announcements in the second and third week of July consensus earnings fell by 2%. Yet by the actual release of earnings the market had begun to rally, and earnings estimates stabilized as actual earnings and guidance were above consensus. Over the past few weeks consensus earnings estimates have once again fallen. Perhaps they will continue to fall, and earnings will actually meet or fall below bearish consensus expectations. We are more optimistic due to high nominal growth, strong jobs market, with wages rising less than top line. We acknowledge the strong USD and later will mention the impact of the USD strength on earnings, but here will say that the USD strength in June was similar to strength in September

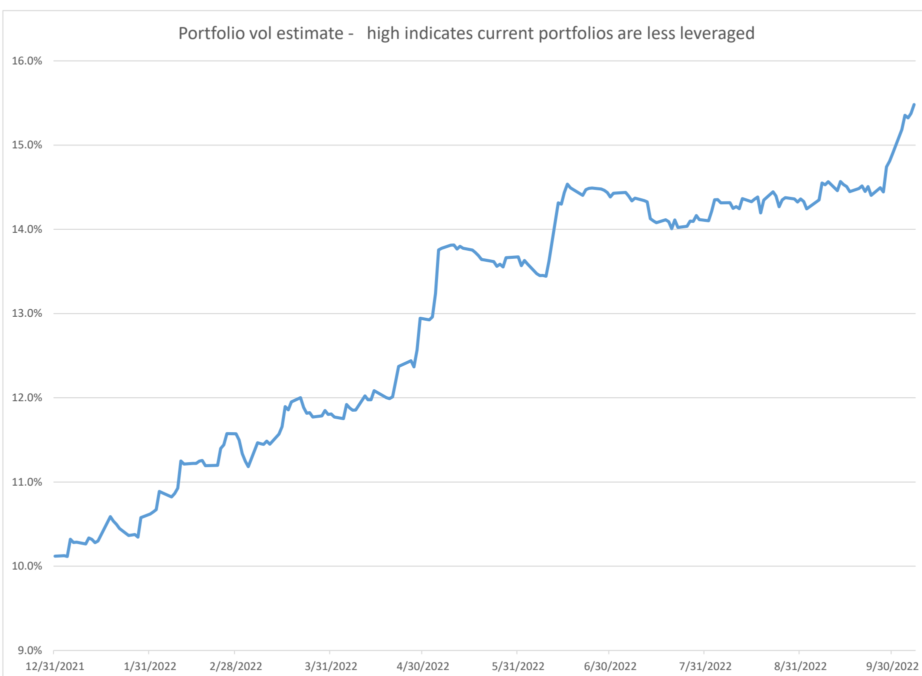
In June the Fed surprised the markets and hike and indicated substantial further hikes would be necessary. But the market did not believe the Fed. Now the Fed is being taken seriously. No change in Fed messaging, just markets pricing in reality vs hope.



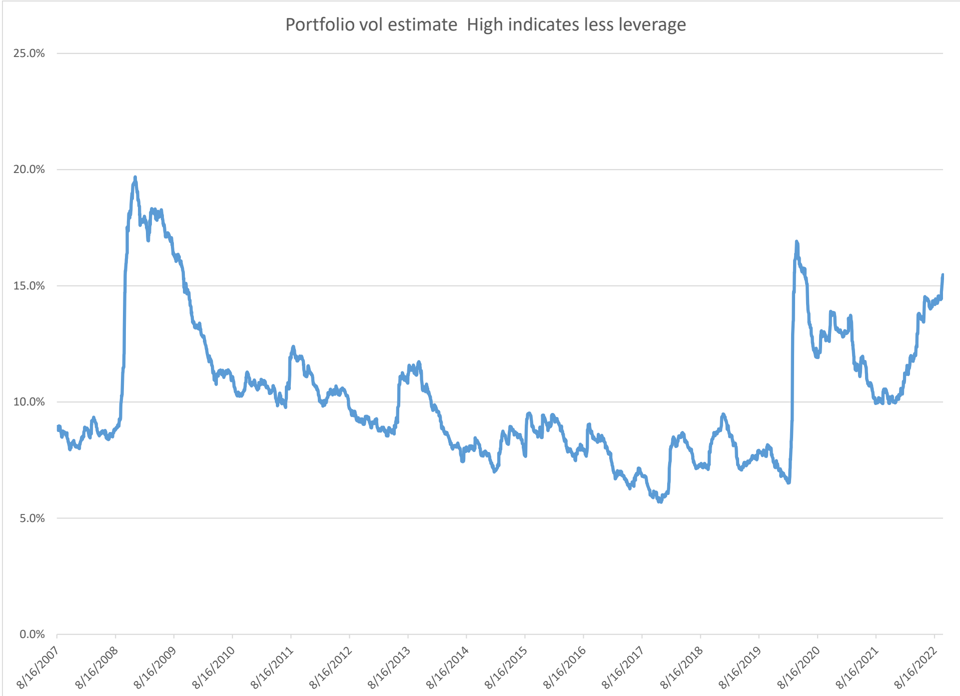
Positioning has once again got decidedly bearish. We follow long only asset managers, as they tend to both use portfolio insurance techniques and volatility targeting. They derisked to a historic low in June, after rerisking during the first false dawn they once again derisked to new low levels. The last point on this chart is through Tuesday. We are confident that aggressive portfolio insurance selling was a factor in Fridays 3% sell off and though things can change before Tuesday the next Friday report will see another new low in risk



Our gauge for vol targeting derisk level has spiked to the most delevered reading we have seen this year and like June spike substantially from lower levels

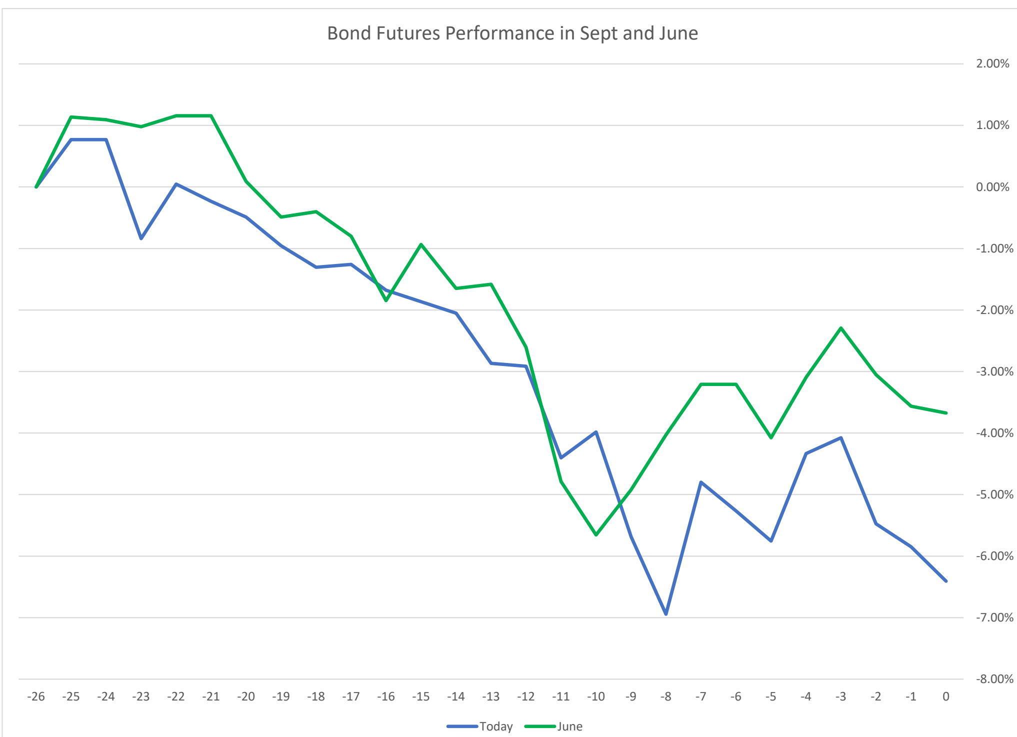


Notably this level of delevered portfolios is now near the Covid high and within sight of the GFC peak. Portfolios have massively derisked.

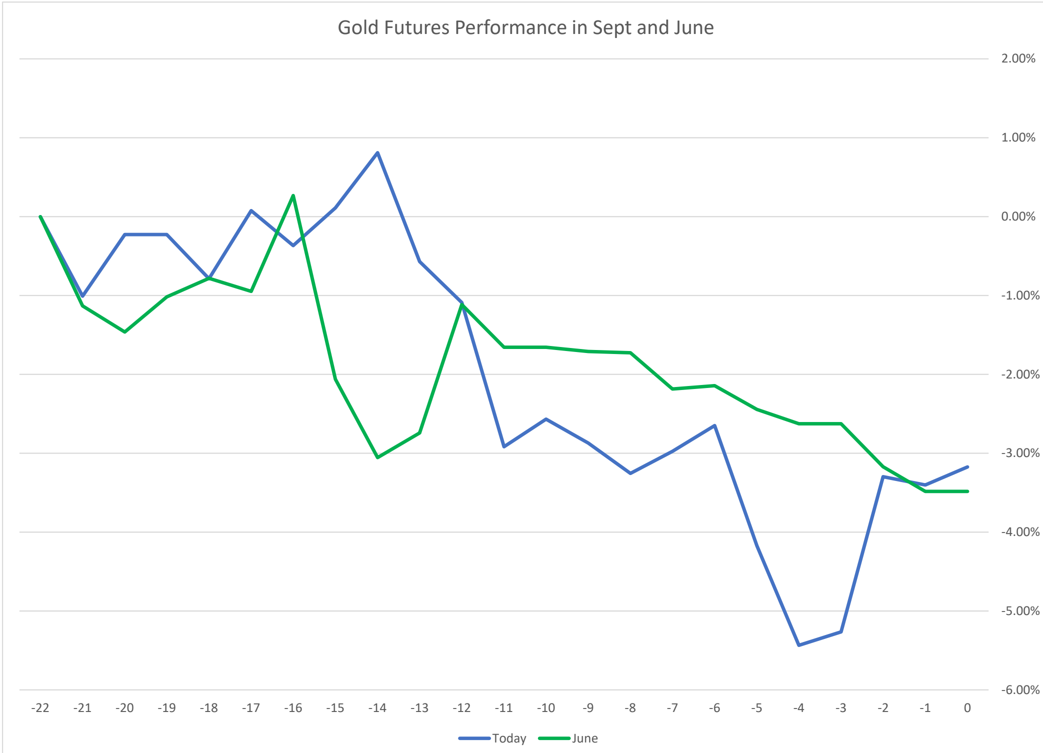


Besides equities the June and September moves were similar in other markets as well

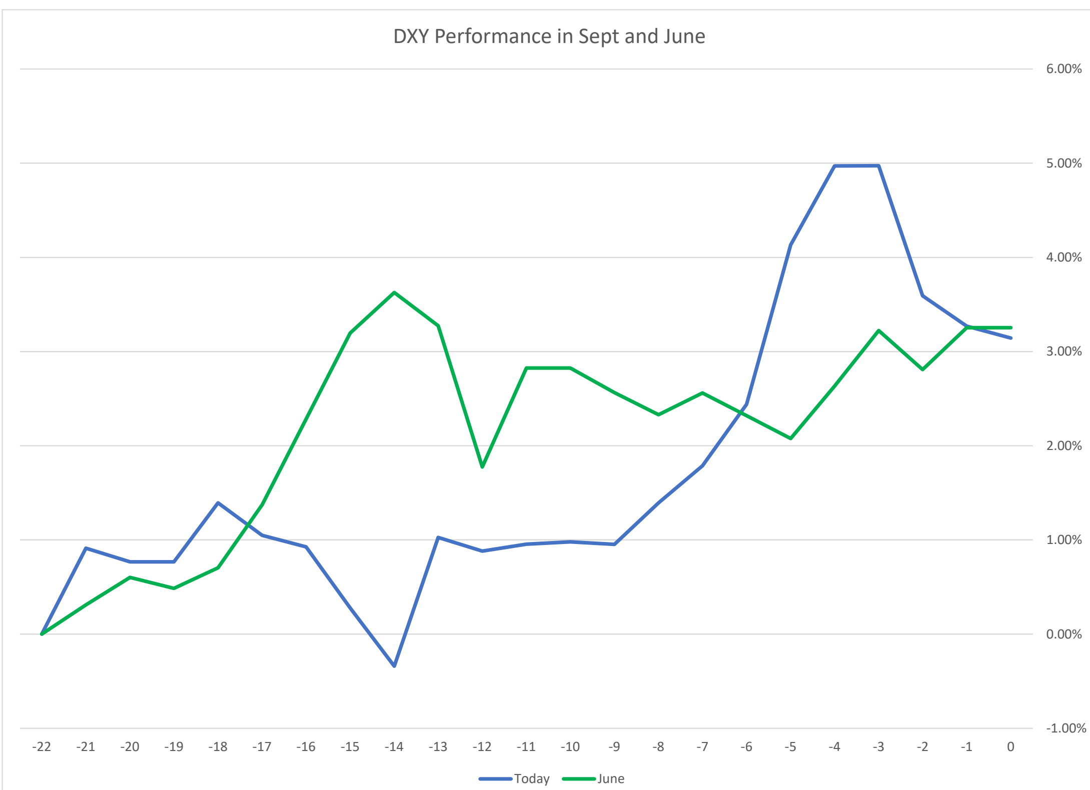
Long Bond futures sold off



Gold sold off



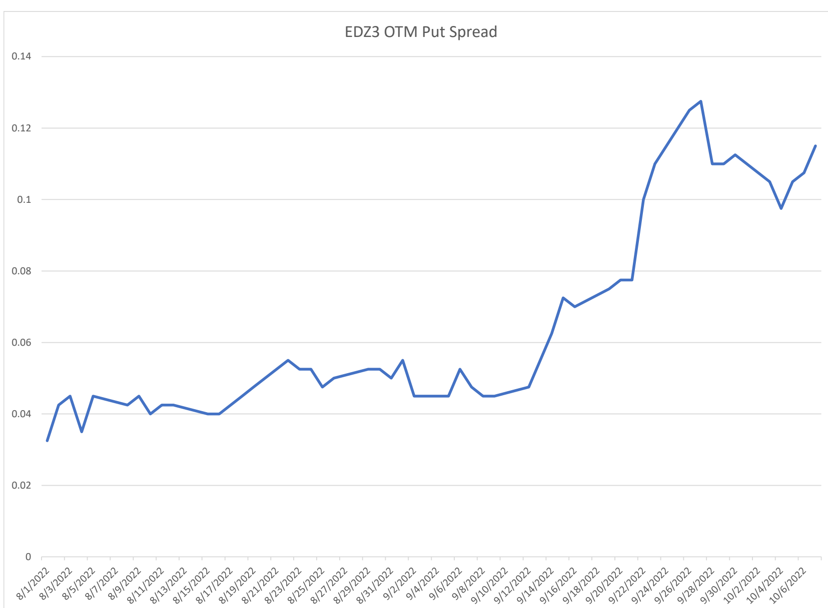
The USD rallied indicating a global deleveraging and impacting actual US company earnings and expectations which were already low



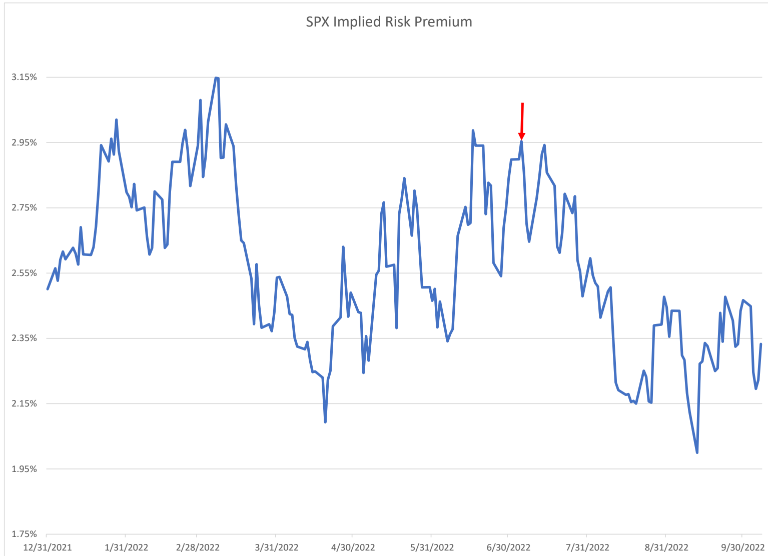
Details on differences

In June, the market did not believe The Fed and expected cuts in 2023, At this stage a pause is fully priced. Back in June we went long EDZ2 and short EDZ3 precisely because we believe the Fed. We got this right. In the first False Dawn Rally market participants may have hoped that a dovish pivot would make them right. Today there is no such hope. Would you rather bet on a rally when a pivot is already expected of when all have lost hope?

We must admit we are fairly concerned that inflation will remain sticky and the priced in terminal rate of 4.5 will jump to 5.5. That is a very different concern than we had three months ago when we looked at priced in cuts and made a bet on both the cuts directly and asset prices. Markets have begun pricing this tail. We ourselves are considering buying this put spread and will be watching if markets continue to swing from cuts in 2023 to hikes. That shift would kill a false dawn and lead to the abyss for asset prices

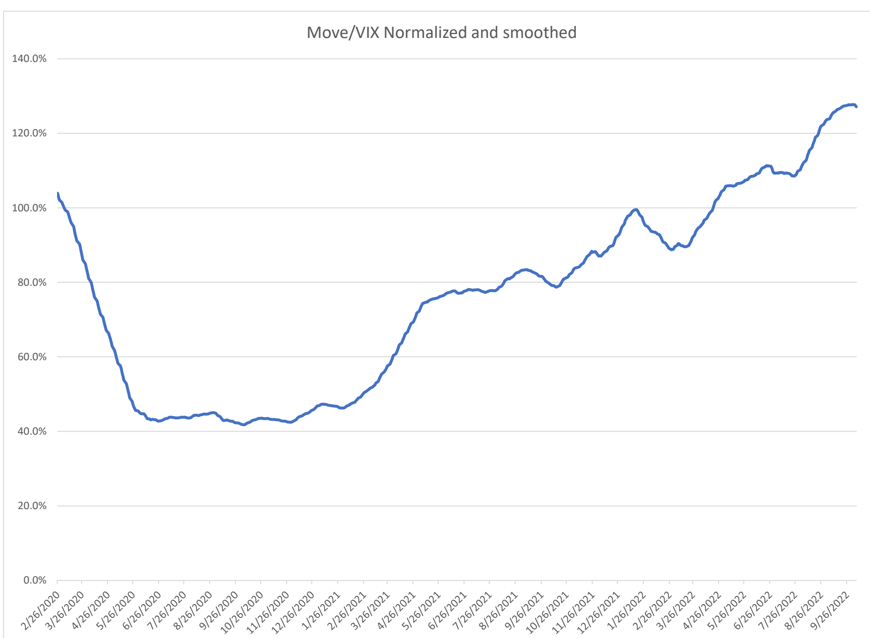


While assets are very cheap relative to June and versus history, Equities are not a bargain relative to bonds.



It’s possible that earnings expectations are more optimistic this quarter than last, that would make sense for many reasons, however we think a significant reason why equities have essential outperformed bonds is the increase volatility of bond prices driving idiosyncratic risk premium expansion in bonds versus all other assets. Many have said that equities have just been impacted by a change in the discount rate. If, however, part of that discount rate has been idiosyncratic risk premium expansion in long-term risk-free rates then equities don’t seem so rich.

If this ratio of FI volatility to Equity volatility reverts Equity will not look as rich to bonds as they have of late



So here we are once again staring over the abyss, We fully expect a continuation of Friday's selloff ahead of supply of 10's and 30's and inflation data. Later in the week earnings start flooding in through month end. The US Treasury is deficit spending, and the Fed is buying fewer bonds. On top of all this the market has completely switched from pivot in 2023 to 4.5% may not be enough. Thankfully the Fed is just doing what it says it will do. We can not predict the data and of course things change, however, there is enough similarity between today and the end of Q2 that we believe a "False Dawn 2" will take all assets higher by the end of October. Then, on Halloween, we see how much and what the composition of Q1's debt issuance will be in the Quarterly Refunding Announcement. It's our favorite report and its contents will either kill the false dawn or spur an unlikely Santa Claus Rally.

We are long equities from 9/30/2022 lows and hedge aggressively into the rally. We bought gold and bonds on 10/7. At this stage we are sitting on our risk and are looking to buy cheap 5.5% terminal rate protection just in case.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000						
LTD P/L	$ 46,491,505						
Total Return	46.49%		YTD Return		15.20%		
Today's Date	10/9/2022		Portfolio Created		4/15/2019		

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed	Type
9/15/2022	CLX 10/17/2022 82/80 Put Spread	0.7	-385	$ 500,000	0.1	$ 230,769	Open	1
9/30/2022	NDX 11500 Call 10/21/2022 (bked at avg cost)	161	124	$ 2,000,000	107	$ (670,807)	Open	2
10/3/2022	NDX 11900 Call 10/21/2022	93.1	-104	Hedge	52	$ 427,440	Closed	2
9/16/2022	NDX 12000 11/18/2022	490	20	$ 1,000,000	145	$ (704,082)	Open	2
10/3/2022	NDX 12500 Call 11/18/2022	157	-20	Hedge	51	$ 212,000	Open	2
9/23/2022	SPX 3670/2620 10/21/2022 Put Spread	20	-333	$ 1,000,000	23	$ (100,000)	Open	2
9/30/2022	SPX 3700 Call 10/21/2022 (bked at avg cost)	60.2	332	$ 2,000,000	53	$ (239,203)	Open	2
10/3/2022	SPX 3850 Call 10/21/2022	25.5	-332	Hedge	10.2	$ 507,960	Open	2
9/16/2022	SPX 4000 Call 11/18/2022	91.5	109	$ 1,000,000	17	$ (814,208)	Open	2
10/3/2022	SPX 4100 Call 11/18/2922	27.5	-109	Hedge	8	$ 212,550	Open	2
10/7/2022	ZBZ2 126/129 November Call Spread	1.09375	9	$ 1,000,000	1.171875	$ 71,429	Open	3
9/2/2022	TLT October 109 Call Spread	2.15	4651	$ 1,000,000	0.01	$ (995,349)	Open	3
10/7/2022	GLD Nov 159/163 Call Spread	1.58	6,329	$ 1,000,000	1.55	$ (18,987)	Open	4
9/16/2022	GLD OCT 155/153 Put Spread	0.82	-4237	$ 500,000	0.29	$ 224,576	Open	4