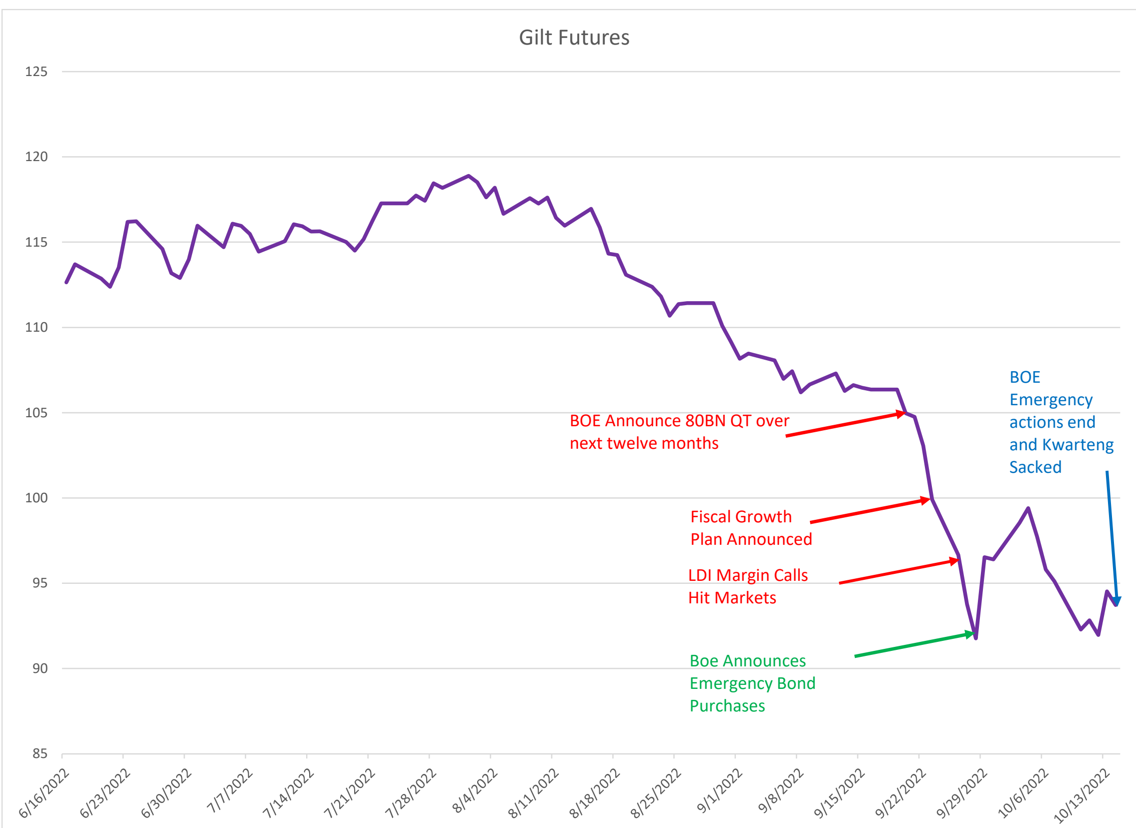
The Damped Spring Report

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

10/17/2022

Bond markets across the developed world are at an inflection point. Every point on the US yield curve is now the highest in a decade. There are very few positives to point to regarding the outlook for interest rates and there are many powerful negatives to indicate the further rate increases are going to bust yields higher across the curve. Lately we have had a good call on short rates and a bad call on long rates. We are modestly long bonds at this moment. In this DSR we will look at both the powerful pressures toward higher rates and highlight a few pressures which may offset these negatives. Our current outlook is that one way or another this current yield curve is going to shift meaningfully through year end and what it does will move all markets and possibly policymakers here and abroad. The Bond Market is Everything.

Let's start with the recent catalyst to market actions



On September 22nd, the Bank of England announced the start of a modest quantitative tightening of 6.6BN pounds per month over the next 12 months. Markets sold off as this was a surprise.

On September 23rd, the Truss Government announced a growth plan that was highly stimulative and required significant deficit spending. Markets began to crater.

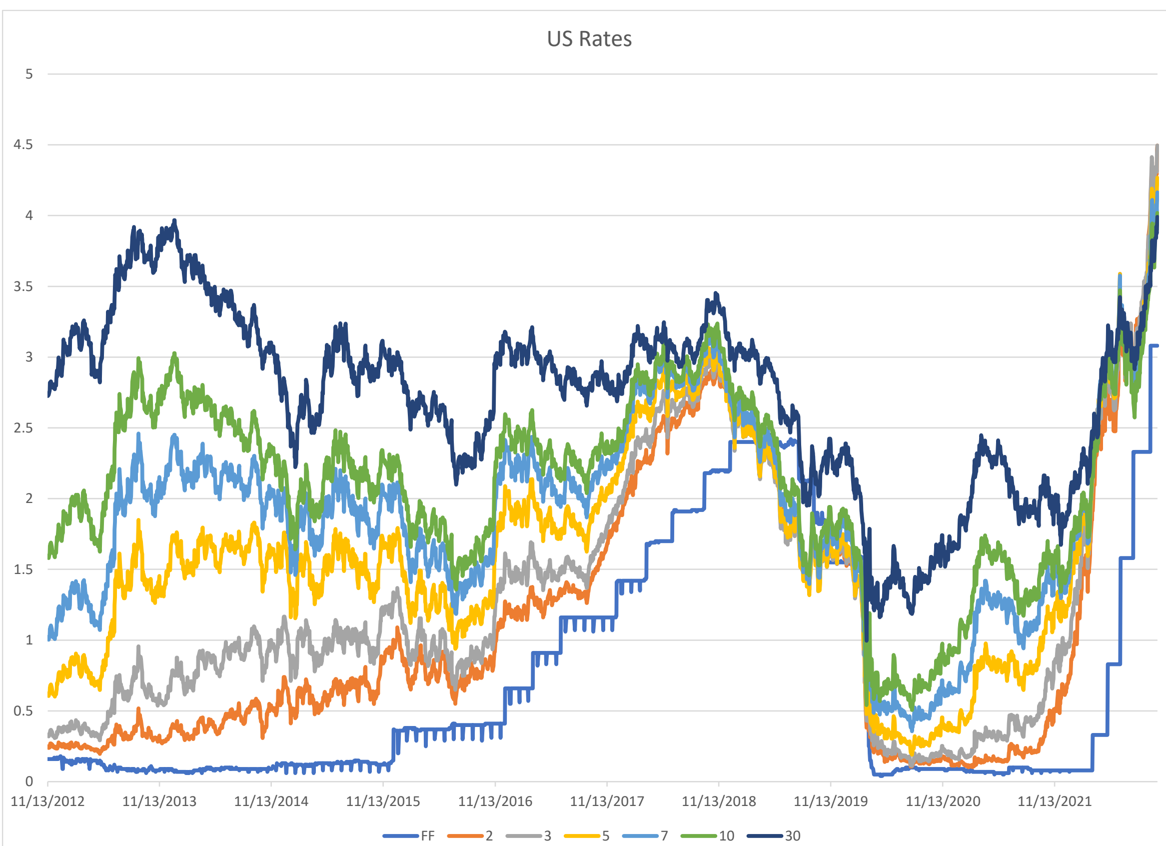
By Monday, the 26th a full-on crisis began to take shape as Pension Schemes with a portion of their assets invested in levered fixed income vehicles began to face margin calls and forced liquidations.

By the end of the week the BOE had announced an emergency program to buy bonds to add liquidity.

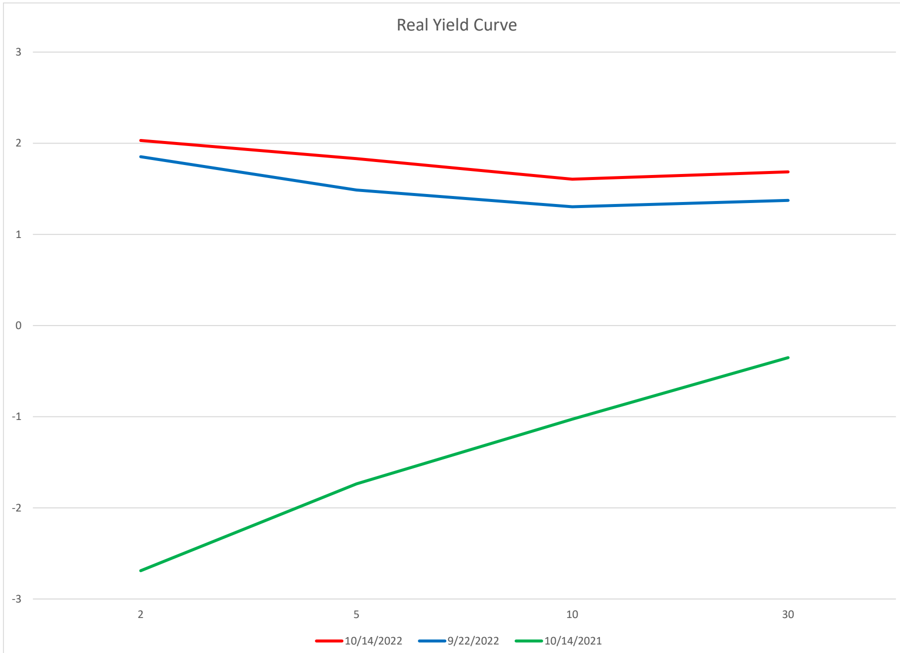
As of today, the emergency bond buying plan has expired, the Truss government has completely reversed course, the BOE seems resolute to continue to hike rates and reduce the balance sheet, and future impact of the LDI crisis remains hotly debated.

US Rates react to catalyst and strong data

Strong CPI and NFP data added to the already fragile market as the UK LDI crisis was extrapolated to all the possible unknown leverage in the global financial system. US Rates are now the highest they have been for a decade everywhere on the curve.



Real yields have gone from extremely negative to quite positive across the entire curve. Since the UK catalyst and economic data, the curve has jumped another 25bp

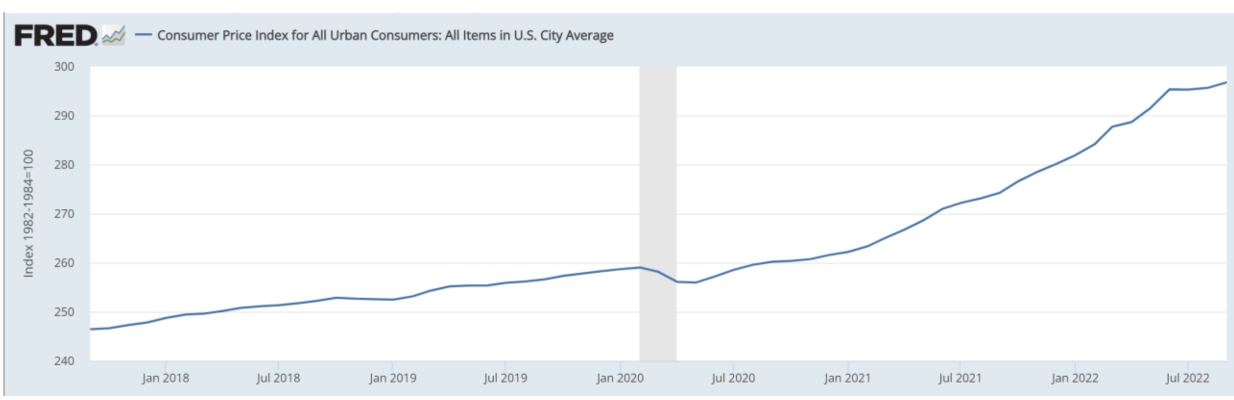


Negatives

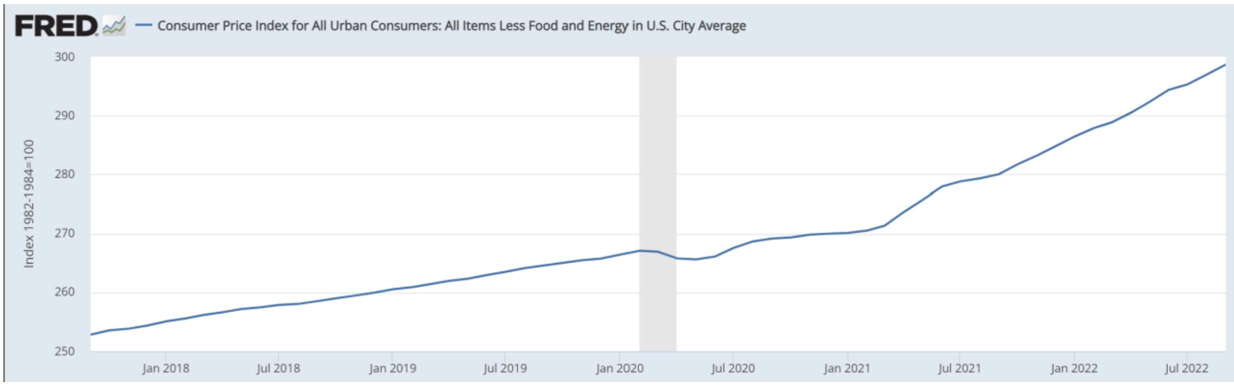
The current selloff in rates catalyzed by the UK fiasco and further driven by fundamentals and the constant and mounting pressure of global quantitative tightening seems like it has no chance of reversing. If the yield curve continues on its path any False Dawn rally from oversold conditions will struggle or fail. We are optimistic that this selloff is not going to head much farther down but we must be realistic about the negatives.

Inflation

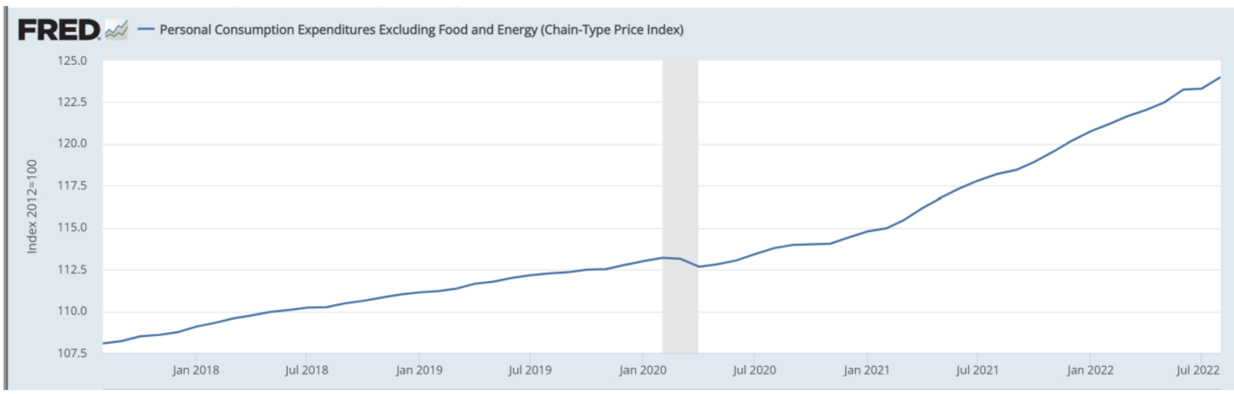
Headline Inflation announced last week was above expectations while CPI over the last quarter has been quite low as energy prices fell



Core Inflation was also substantially above expectation and is seeing no real flattening

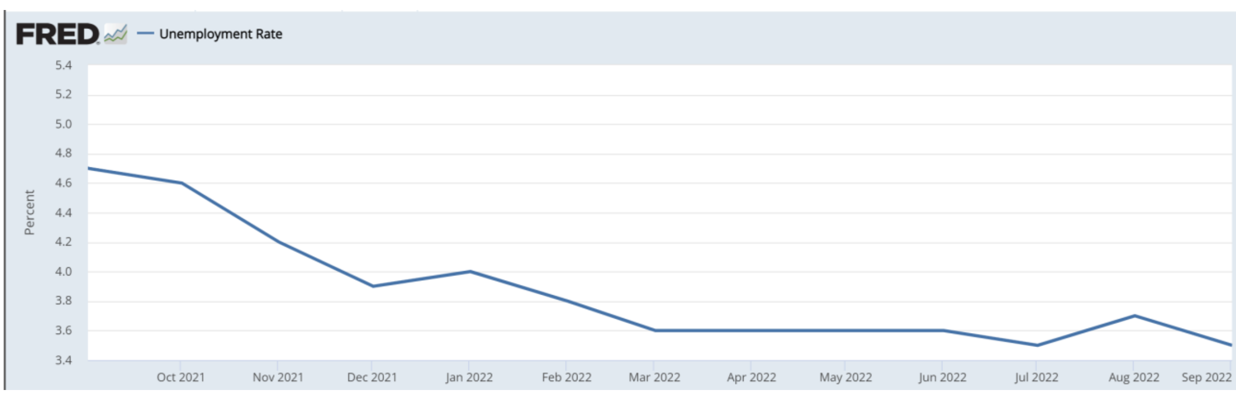


Nor does Core PCE



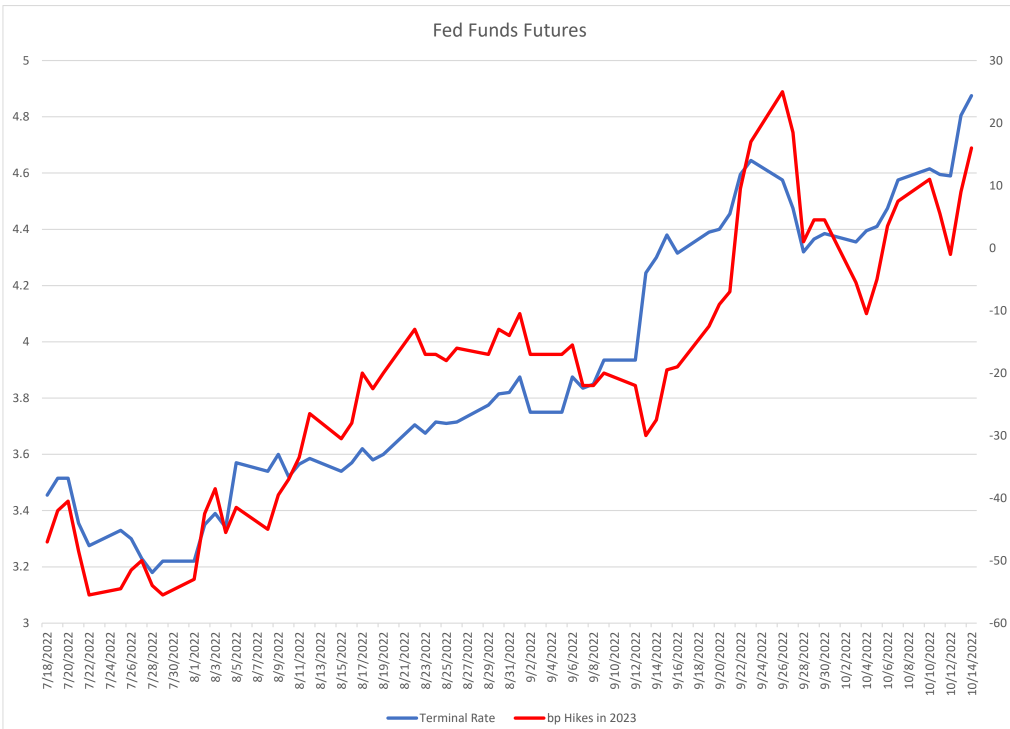
Jobs

The Fed absolutely hates this graph



Fed Path from pivot to not enough

As the data comes in and as future projections of inflation are sticky, and GDP and jobs appear robust the expectations for the path of Fed Hikes have shifted from a pivot in 2023 and rate cuts to a much higher terminal rate and hikes in 2023 in just 3 months. While we fully expected the priced in cuts to move to a pause as the Fed has made it clear that 2023 was at best going to pause at higher rates, the current terminal rate is now suggesting that the Fed is once again behind the curve and more hikes are necessary. Given the recent data the market action is not particularly surprising, but we believe that the Fed is going to be more patient before they validate current short rates. That said if the data once again gets ahead of the Fed and a 5% or more terminal rate begins seeming necessary the inflection point where we sit today will be another move down in all assets. It is necessary for any rally in the long end of the curve and thus other assets for the Fed to commit to 4.5-4.75% terminal in its rhetoric and for the data to validate that stance.



QT Headwinds

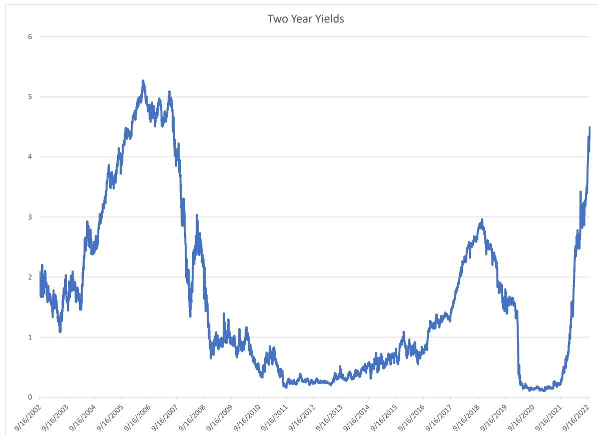
The Fed/Treasury Issuance headwinds of quantitative tightening remains at hurricane strength. We expect no change by the Fed given the lack of any financial instability in the US. We are also not fearful of either a contagion from outside of the US or some sort of domestic crisis. Perhaps that is naïve, but we don't see the leverage in the US system. Specifically, our Pension, and Life Insurance structures are not defined benefit except in certain circumstances. We also believe that any US Treasury buyback plans are not imminent and if they were to occur would not likely be financed with bills muting QT. A Treasury easing in the face of the current inflation outlook would be a bizarre lack of understanding of the Fed's mandate. Kwarteng and Yellen are quite different.

The BOE has announced QT and we expect them to execute on that plan. The ECB is tilting at QT. We expect they will announce plans on October 27th. Clearly the headwind on assets is only getting stronger.

Technicals

We don't do Technical Analysis. But we read about it and can appreciate the dire situation across the curve.

No resistance on twos until 4.95

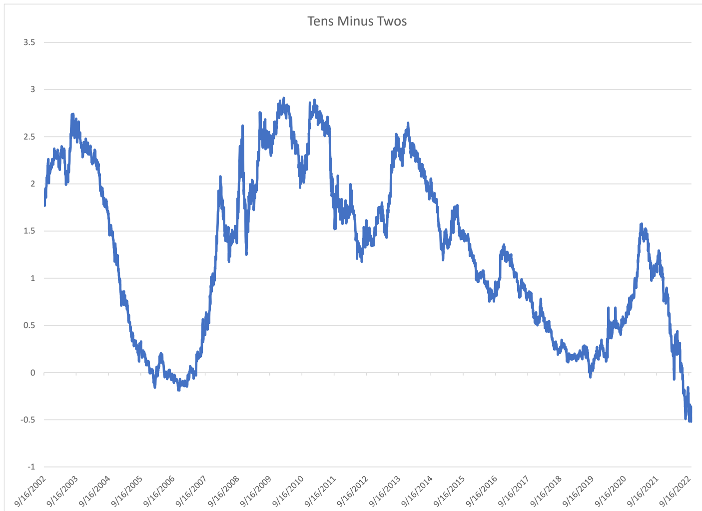


Five's look free and clear to 4.5

And Thirty's to 4.2

Carry

Clearly the Two's -Tens's inversion leaves levered investors like banks and hedge funds cold due to negative carry of long end bond positions. Animal spirits to capture capital gains riding the curve will need quite a bit more evidence that this blazing hot economy is cooling.



The negatives are quite overwhelming. The combination of QT, Fundamentals, Technicals, possibly Fed behind the curve, and the unsettled LDI situation represent a toxic environment for bonds. At the same time as we read through all of this bearishness, we believe that a selloff will need a meaningful catalyst as our synthesis of the environment is shared by most strategist, economists, and investors to whom we speak.

Positives

Without a catalyst for a new low we see a variety of positives which are worth reviewing. The great insight for the year has been who will buy all the bonds that are sloshing around the system. The usual suspects that have bought bonds have been the Fed, Banks, and foreign governments to help cap appreciation of their domestic currency. All of those entities have stopped their buying and begun selling. At some price those seeking capital gains when conditions shift to disinflation and or recession will once again return to bond buying. The question isn't who will buy bonds? It's at what price?

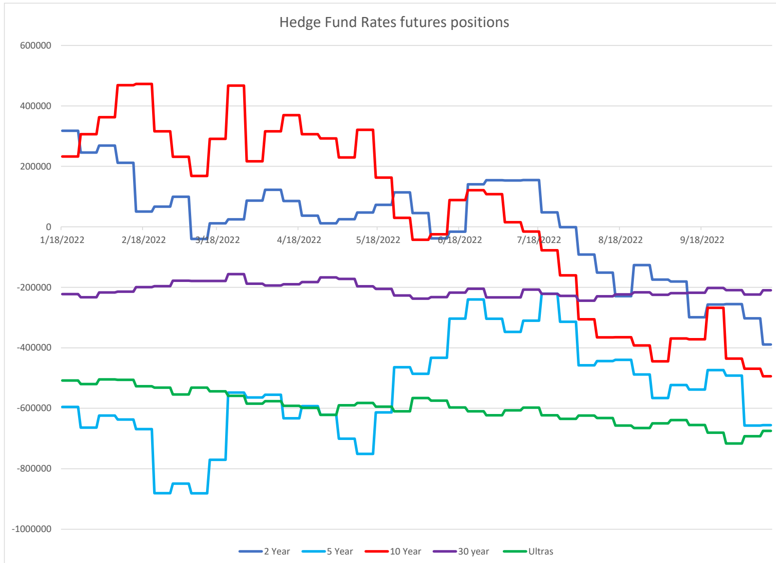
Flow and positioning

For many reasons ROW holdings of US Treasuries has dropped since February through July by $200BN USD much of that has been Japan and China. Both of those countries have been defending the currency. This week we expect further declines in Treasury holdings for August and again for September when that data is released. Until those countries currency holds up on its own or is allowed to fall further the selling will likely continue. Yet the positive spin is that the market has absorbed this large selling without breaking

Country	Jul 2022	Jun 2022	May 2022	Apr 2022	Mar 2022	Feb 2022	Jan 2022	Dec 2021	Nov 2021	Oct 2021	Sep 2021	Aug 2021	Jul 2021
Japan	1234.3	1236.3	1223.7	1218.5	1232.4	1306.3	1303.1	1304.0	1328.6	1320.4	1299.6	1319.7	1310.2
China, Mainland	970.0	967.8	980.8	1003.4	1039.6	1054.8	1060.1	1068.7	1080.8	1065.4	1047.5	1047.0	1068.3
United Kingdom	634.6	615.4	630.4	612.7	634.9	625.2	608.8	647.4	621.9	580.2	566.4	568.9	541.6
Luxembourg	304.2	306.8	294.3	294.0	300.8	314.0	310.8	325.6	333.3	314.3	312.0	294.2	291.7
Cayman Islands	291.9	300.4	294.2	291.4	292.7	274.7	271.0	261.8	262.1	271.9	266.8	263.5	263.8
Switzerland	287.3	295.3	291.1	271.6	274.1	281.7	299.0	288.0	292.1	289.9	294.4	292.6	296.2
Belgium	285.5	273.6	268.4	255.7	264.6	258.4	243.0	271.7	224.9	225.8	220.9	227.7	220.5
Ireland	277.2	285.1	288.7	309.6	315.9	314.8	308.3	334.3	330.0	324.1	309.6	326.4	319.8
Taiwan	239.9	233.9	230.7	228.4	238.4	248.5	248.6	251.0	248.6	242.4	239.4	237.2	242.2
Brazil	237.6	230.5	232.7	233.3	237.2	241.2	239.7	244.5	248.8	247.7	249.0	248.9	248.5
France	232.8	236.9	243.6	243.8	247.0	239.6	233.9	224.9	228.2	239.7	242.0	238.1	235.9
Canada	214.1	193.6	210.6	220.4	221.8	208.1	200.7	202.0	195.1	200.3	167.1	169.2	167.0
India	212.0	208.8	203.7	199.0	199.8	199.8	198.6	198.9	205.2	210.7	218.4	217.0	219.2
Hong Kong	193.2	187.7	186.1	195.4	208.2	205.9	226.1	225.7	234.9	233.4	229.5	219.5	227.1
Singapore	188.2	181.8	178.5	183.1	191.8	192.8	192.5	194.5	190.2	188.5	189.3	191.5	192.6
Saudi Arabia	121.6	119.2	114.7	115.7	115.5	116.7	119.4	119.0	116.5	116.5	123.8	124.1	128.1
Korea	112.3	112.3	115.7	117.8	119.3	122.4	124.4	131.2	132.7	125.4	130.1	129.0	126.1
Norway	111.8	112.4	108.4	115.1	116.0	119.4	115.1	97.6	100.2	105.0	120.8	119.9	119.1
Germany	87.5	94.9	90.8	92.8	93.8	90.5	84.3	83.4	82.3	83.8	83.6	82.4	80.5
Bermuda	81.7	78.9	76.9	74.7	72.4	70.7	69.3	71.9	73.2	70.9	72.3	70.2	68.1
Netherlands	65.5	63.6	63.5	61.9	63.8	64.5	59.7	68.1	68.3	67.6	67.1	65.3	68.7
Australia	54.1	52.0	54.6	57.4	56.3	57.8	57.0	53.5	54.6	53.8	47.8	47.1	46.3
Israel	53.1	51.5	50.9	52.0	59.5	66.0	63.8	69.1	64.3	65.8	64.0	63.9	65.5
Philippines	51.2	49.7	50.6	50.9	52.5	53.9	52.5	48.6	50.3	49.8	50.5	49.8	50.5
Mexico	49.5	48.8	48.0	47.3	47.7	47.1	44.4	46.2	47.4	50.0	48.4	50.7	50.1
Kuwait	49.4	46.0	46.3	46.1	46.8	50.6	50.6	46.4	46.3	46.0	46.3	46.8	46.5
Thailand	48.7	49.6	50.0	57.8	64.3	62.1	62.6	62.2	62.9	59.2	61.0	57.3	57.3
Sweden	43.9	42.2	41.9	46.6	46.7	48.5	47.3	40.5	40.2	40.0	43.3	43.2	43.7
United Arab Emirates	41.3	39.9	38.3	41.7	45.6	46.3	44.8	44.8	48.6	53.0	58.1	58.7	58.0
Italy	40.3	40.5	42.0	42.7	44.3	45.5	42.2	42.4	44.1	43.6	41.8	41.0	41.8
Vietnam	39.9	39.2	39.1	40.1	40.7	41.4	42.3	43.0	43.8	45.0	45.2	44.8	42.9
Chile	38.7	41.0	40.0	37.0	37.9	37.2	35.3	35.8	36.4	37.8	38.8	38.3	40.9
Poland	36.2	35.3	36.0	37.0	39.2	45.5	44.9	42.2	55.1	54.6	54.3	55.2	56.1
Bahamas	35.7	30.3	30.0	39.5	36.1	33.5	35.9	34.9	28.3	23.9	18.4	21.6	16.7
Colombia	35.1	34.9	34.9	35.4	34.5	34.0	33.3	33.1	33.7	34.2	33.3	33.1	36.2
Iraq	34.6	32.0	32.9	28.3	26.2	24.1	23.4	22.5	21.2	20.4	18.0	18.9	19.0
Peru	32.0	30.8	29.9	30.3	29.9	29.5	29.0	28.0	27.4	27.5	28.1	28.0	28.8
All Other	434.1	432.3	427.4	426.8	425.2	437.4	435.9	440.1	429.8	432.3	424.0	428.0	431.3
Grand Total	7501.2	7430.8	7420.4	7455.1	7613.3	7710.6	7661.6	7747.6	7732.1	7660.7	7570.9	7578.8	7567.3
Of which:													
For. Official	3942.7	3902.6	3912.3	3950.5	4066.7	4165.1	4170.2	4160.5	4204.8	4179.4	4207.9	4216.3	4254.1
Treasury Bills	234.0	238.3	248.6	256.6	259.7	278.3	266.7	247.6	239.5	247.7	255.4	258.0	276.4
T-Bonds & Notes	3708.7	3664.3	3663.7	3693.9	3807.0	3886.8	3903.5	3912.8	3965.3	3931.7	3952.5	3958.3	3977.7

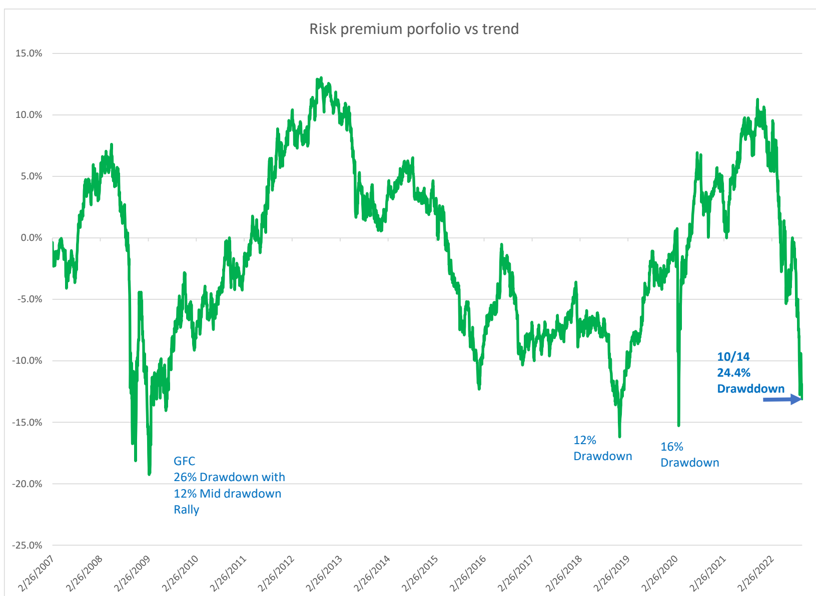
Banks are also major buyers of treasuries. During the first QT Banks actually bought as the economy weakened rapidly. So far this year the US Banking system has sold 250BN of US Treasuries and Agency securities. A sizable shift. In addition, JPM reported a DVO1 of short 40MM ten-year equivalents. Banks have sold a ton, and some are short.

Lastly it is important to track levered funds as they control a tremendous number of treasuries for their size. They are now short at every point on the curve and on ten-year futures alone have sold 100BN notional in the last year



Asset valuation

Assets of all sorts are as cheap as they were at the pandemic lows and rivaling the GFC lows



Fed stance

The Fed has made it clear that it intends to raise rates to a terminal rate and then pause to assess the impact. We believe that. Based on our reading of the Fed it would prefer to have assets stay down but not break. Causing a stock or bond market crash like what has happened in the UK would not help the Fed's inflation fighting mandate. They want steady pressure not a clown show we saw last week. Our view is that the Fed is targeting 4.5 – 4.75 and if they reiterate that convincingly the market can rally. If they start favoring 5 plus handles this inflection point will dip dangerously downward

UK LDI resolution

Our reading of the LDI situation is that all interested parties have been all over the exposures of the LDI's including Sponsors, End Pension Funds, Regulators, and Central Bankers. Bailey's decision to end the buyback program is either evidence that the storm has mostly passed or a colossal career mistake. Though UK hasn't been doing well in the competence derby lately we don't think betting on Central Banker stupidity will pay in this case.

Gridlock and Cyclical Government Austerity

Based on polling data and the composition of the Senate even if Dem's hold we expect gridlock post mid-terms. The three Ds of fiscal spending in response to the Covid Supply Chain break and increased nationalism remain

- (D)eglobalization
- (D)uplicate supply chains
- (D)omestic energy production

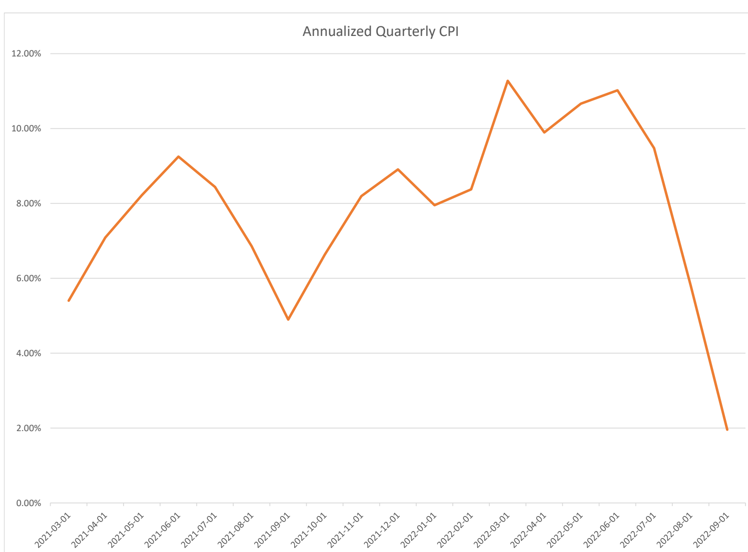
Both parties are predisposed to spending on projects that achieve "3D" goals. But the agenda of each party radically differs on how to achieve the goal that we do not believe meaningful spending will occur post-election day.

The UK Fiscal fiasco may set a durable pivot toward austerity in future government messaging. Thermostat settings during the winter, vehicle usage, lentil eating, and other forms of more subtle expectations management are also accelerating which may lead to acceptance of austerity to fight inflation. That never really lasts but for now a cyclical move toward austerity would be supportive of bond prices.

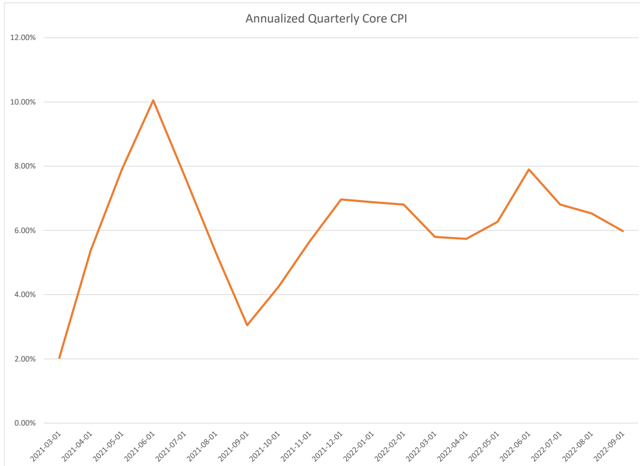
Contrary to popular belief the economy is actually slowing

Inflation

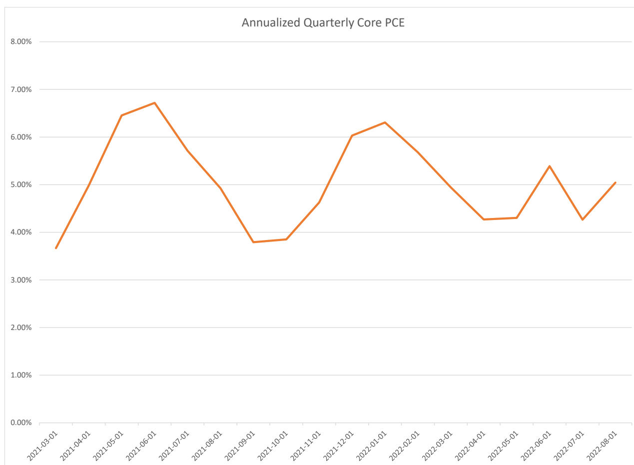
Quarterly CPI is cratering



Core CPI is also slowing but sticky for now



Core PCE is both the most important for the Fed and remains stubborn



Employment growth is slowing but needs to go negative

Synthesis

The Bond Market is Everything. Friday's close set up a potential inflection point resolving with either significant new lows for bond prices and other assets or a False Dawn Rally. We expect the latter for all the reasons we have written in last week's report and a balanced assessment of the negatives and positives facing the bond market. However, if LDI is not resolved or if some other black swan is exposed that would catalyze the negative outcome.

Our view is that the Fed is going to kill inflation by remaining hawkish, but they will hike to a terminal rate of 4.5-4.75% and then pause for many months. The economy is beginning to show signs that the hikes are taking effect and weaker CPI and Jobs data is ahead of us. While equity earnings are expected to be weak the third quarter Nominal growth will likely surprise, and equities can rally with bonds.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 44,897,914					
	Total Return	44.90%		YTD Return		13.61%	
	Today's Date	10/17/2022		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
9/15/2022	CLX 10/17/2022 82/80 Put Spread	0.7	-385	$ 500,000	0.01	$ 265,385	Open
9/30/2022	NDX 11500 Call 10/21/2022 (bked at avg cost)	161	124	$ 2,000,000	25	$ (1,689,441)	Open
9/16/2022	NDX 12000 11/18/2022	490	20	$ 1,000,000	110	$ (775,510)	Open
10/3/2022	NDX 12500 Call 11/18/2022	157	-20	Hedge	45	$ 224,000	Open
9/23/2022	SPX 3670/2620 10/21/2022 Put Spread	20	-333	$ 1,000,000	20	$ -	Open
9/30/2022	SPX 3700 Call 10/21/2022 (bked at avg cost)	60.2	332	$ 2,000,000	34	$ (870,432)	Open
10/3/2022	SPX 3850 Call 10/21/2022	25.5	-332	Hedge	2	$ 780,200	Open
9/16/2022	SPX 4000 Call 11/18/2022	91.5	109	$ 1,000,000	19	$ (792,350)	Open
10/3/2022	SPX 4100 Call 11/18/2922	27.5	-109	Hedge	9	$ 201,650	Open
10/7/2022	ZBZ2 126/129 November Call Spread	1.09375	9	$ 1,000,000	1	$ (85,714)	Open
10/14/2022	ZB Dec 124/122 Put Spread	0.875	-889	$ 1,000,000	0.75	$ 111,111	Open
9/16/2022	GLD OCT 155/153 Put Spread	0.82	-4237	$ 500,000	0.7	$ 50,847	Open
10/7/2022	GLD Nov 159/163 Call Spread	1.58	6,329	$ 1,000,000	1	$ (367,089)	Open