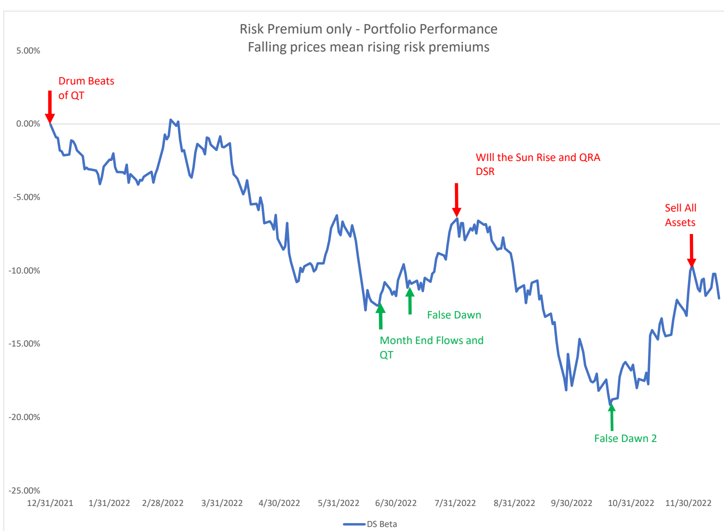
The Damped Spring Report

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

12/16/2022

In our note to you all Tuesday morning ahead of the CPI print we observed that Higher for Longer expectations had largely disappeared from market pricing leaving a deep recession or a soft landing as the two viable options for the US economy. A weak CPI number spiked assets by 2% across the board and we were able to make good sales in SPX and 30 Year bond futures call spreads before the rally collapsed. On Wednesday, higher for longer was reiterated by the Fed. The bond market did not believe the Fed. The equity market finally began to believe the bond market. Nothing was resolved.

Our view remains that asset prices in general are too high relative to the tightening needed to cool the labor market. We believe financial market tightening is inevitable due to either a recession occurring or higher for longer expectations rising from the ashes of disbelief as inflation stays elevated and labor stays tight. Only in the the unlikely soft landing scenario are assets in general a good value vs near term cash instruments like bills, and short term T-notes and Tips. Will higher for longer expectations return? If the bond market is right and a recession is going to happen soon probably not. But we don't think the bond market is priced well if it is wrong.



Economic Overview

In the last DSR we provided the various cases we see occurring in 2023. The Higherer for longerer case is still as valid as it was two short weeks ago and was reiterated by the Fed. Nonetheless the higherer for longerer scenario is no longer priced. As a reminder here is how we see the various paths for the economy.

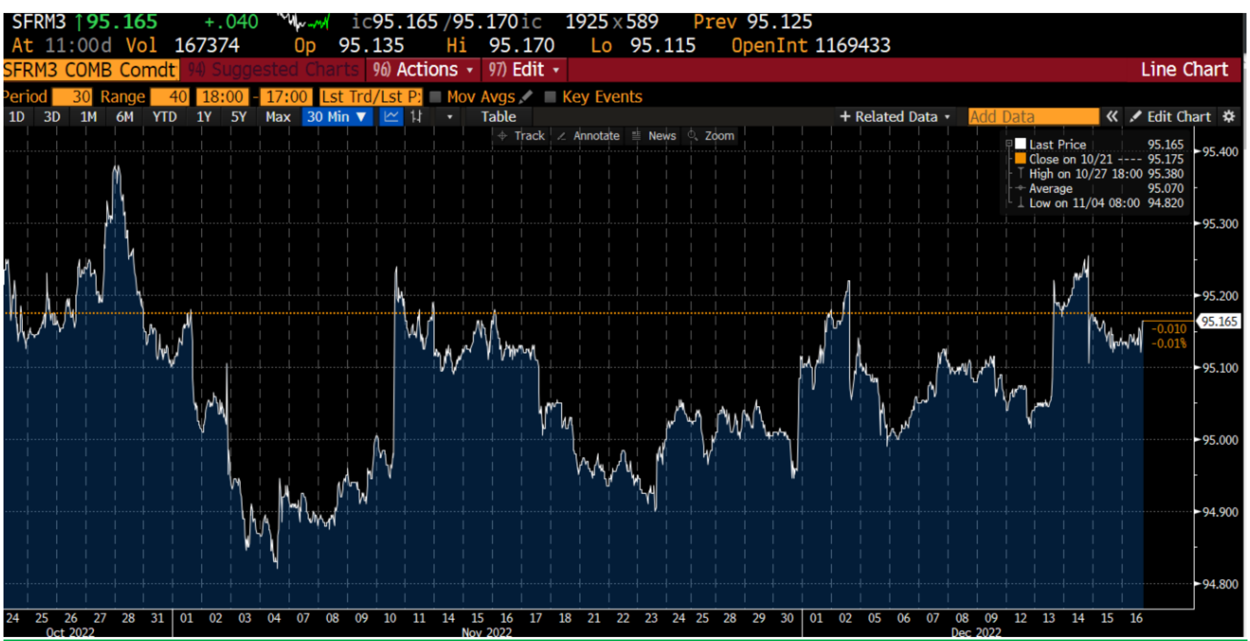
- The "over did it" case - The Fed will hit a terminal rate of 5% in 2023 and hold at that rate for an extended period which along with the hit to wealth of further asset price declines due to quantitative tightening will generate a meaningful recession, job losses, and demand destruction. Thus, well and truly killing inflation.
- The "higherer for longerer" case -Despite the tightening impacts mentioned above the economy doesn't respond. Fed doesn't pause for long if at all before hiking rates to a substantially higher terminal rate.

We think markets are currently priced for two "Magical paths"

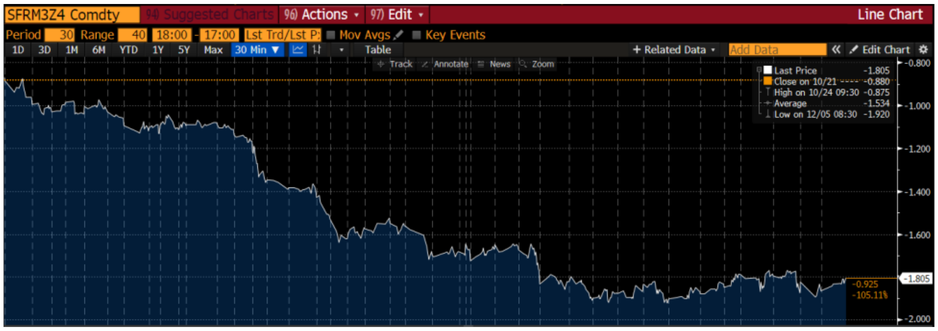
- Soft landing case - Inflation magically falls without a recession or at least without a meaningful loss in jobs, the impact of QT is mild, and the Fed can then tweak rates up and down when necessary.
- The Pivot Case - The Fed hikes a few more times and a mild recession with modest job losses magically kills inflation.

Bond Market doesn't believe in Higherer for Longerer

Since the November Fed meeting the terminal rate has fallen by 33bp and despite the surprisingly high median dot for 2023, the strong consensus of the dot plot, and Powell's hawkishness, the terminal rate continues to creep lower. (SOFR Futures higher).



By raising the 2023 terminal rate dot by such a large margin and only raising the longer term forecast by 20bp the Fed did suggest a 2023 peak and pause and then a 200bp rate cut cycle beginning in 2024. Perhaps this gave some fuel to the STIR traders, but they also front ran the cuts, ignoring the pause and pushing all the cuts into 2023 and 2024.



Currently SOFR Futures have pushed 80bp of additional cuts once the terminal rate is achieved from June 2023-Year end 2024. We think this is perhaps the greatest evidence of the bond market's doubt of higherer for longerer. For us we are looking to go long SFRM3 and short SFRZ4 at -2.0 if it gets there. This is perhaps the best way to play the H4L pricing to rise from the ashes. It will probably take only one not negative data point.

The long end of the bond markets is less clear. We sold bonds as part of the sell all assets trade of 12/1. We sold call spreads on bond futures on the CPI print. Clearly the long end of the curve has rallied a lot. We have mentioned in past work the short covering of the momentum strategy investors but if a recession becomes even more certain and inflation is clearly dead we expect to have losses in this exposure. There is room for a further bond market rally driven by falling growth expectations and further falling inflation expectations. But to us the long end of the curve has an asymmetric risk reward. It belongs in the short asset portfolio for both balance and limited additional losses

Real rates have actually gone up during the recent bond market rally. They have 15 bp of downside to us in the next month unless growth gets destroyed quickly.

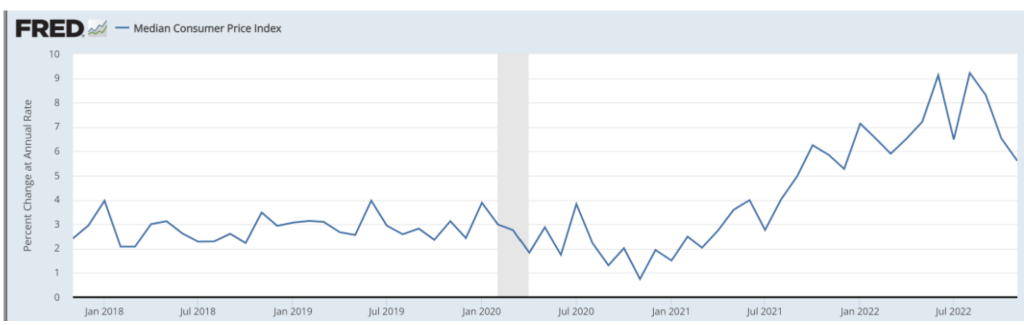
We simply wouldn't pin much hope on inflation expectations falling more than they already have.

Let's assume they could drop another 10bp in total that's 25bp and a yield of 3.3% Alternatively we think a higher probability outcome is a return to 3.8 or 4 on any positive prints. While a naked bond short might be a good trade in itself we think paired with a short equity and other assets trade is a low-risk high return alternative. This is how we are positioned.

Higherer for longerer?

We know the Fed is being clear about a higher terminal rate and a longer pause than the treasury market expects. Why? Two reasons. Inflation and Labor.

While many signs of economic weakness exist. Median inflation shows half of the inputs to inflation at high levels



In addition, labor and wages remain very tight. If we get evidence that either of these key elements of inflation is not responding to tightening the market will most certainly begin pricing a longer pause. Higherer for longerer will live again.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 44,143,511					
	Total Return	44.14%		YTD Return		12.85%	
	Today's Date	12/16/2022		Portfolio Created		4/15/2019	
Date	**Position**	**Entry Price**	**Amount**	**Worst case loss**	**MTM**	**P/L**	**Open/Closed**
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	1.5	$ (285,714)	Open
10/31/2022	SPX Jan 3600 Put	75	267	$ 2,000,000	28	$ (1,253,333)	Open
12/13/2022	SPX Jan 20 2023 Call Spread 4080/4180	57	-233	$ 1,000,000	10	$ 1,093,023	Open
11/3/2022	NDX Jan 10500/10000 Put Spread	158	127	$ 2,000,000	68	$ (1,139,241)	Open
11/16/2022	ZN Jan 112 Put	0.71875	28	$ 2,000,000	0.05	$ (1,860,870)	Open
12/13/2022	ZB Feb131/133 Call Spread	1.03	-10	$ 1,000,000	0.9	$ 134,021	Open
9/23/2022	DS Beta Index set at 50 on initial execution	50	(1,000,000)	$ 5,000,000	49.04	$ 960,000	Open