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The Damped Spring Report

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

1/22/2023

Markets have remained in a narrow range for many months now. The path to normalcy continues to be uncertain.

- **Has the Fed done too much and growth has turned over, labor conditions will weaken, inflation will continue to fall, and the Fed will need to aggressively cut to minimize the damage of a hard landing?**
- **Has the Fed succeeded in doing just enough tightening and a soft landing will occur in 2023?**
- **Lastly, has the Fed failed to do enough and inflation and perhaps real growth will remain higherer for longerer and a landing will need to wait, whether soft or hard?**

Our position in this period of uncertainty has been to be short of all assets. We believe the probability of a soft landing priced by markets is too high vs our view of the difficulty of achieving that outcome. We remain convinced that this is a solid bet. <u>However, we no longer can find attractive opportunities that benefit in an imminent recessionary environment.</u> There are many ways to profit in markets if the odds of a higher for longer environment returns.

We are shifting our portfolio to one that favors a shift away from the highly discounted recession case. This DSR is a tactical note reviews pricing each of the scenarios and why we believe the recession scenario is currently heavily expected and why the higher for longer is our base case.

This week's economic data is very light with PCE at the end of the week as the only highlight. Auctions are heavy in the front end of the yield curve. Earnings of big tech won't happen until the following week. The next DSR will focus on the Quarterly Refunding Announcement which may get more attention due to the Debt Ceiling. Oh, The Federal Reserve will also meet. **Full review in the Next DSR. Which will be called "There will be duration"**

Fading the Recession ideas (will notify clients if executing)

- Short Dec 2024 SOFR
- Long USD
- Short Long-term bonds (TLT, 10's 30's ultras)
- Long B/E

Economic Overview

Our economic overview remains the same as has been last month. The Higherer for Longerer case is still as valid as it was two months ago and was reiterated by the Fed. Nonetheless the higherer for longerer scenario is not currently priced. As a reminder here is how we see the various paths for the economy.

Red Pill cases.

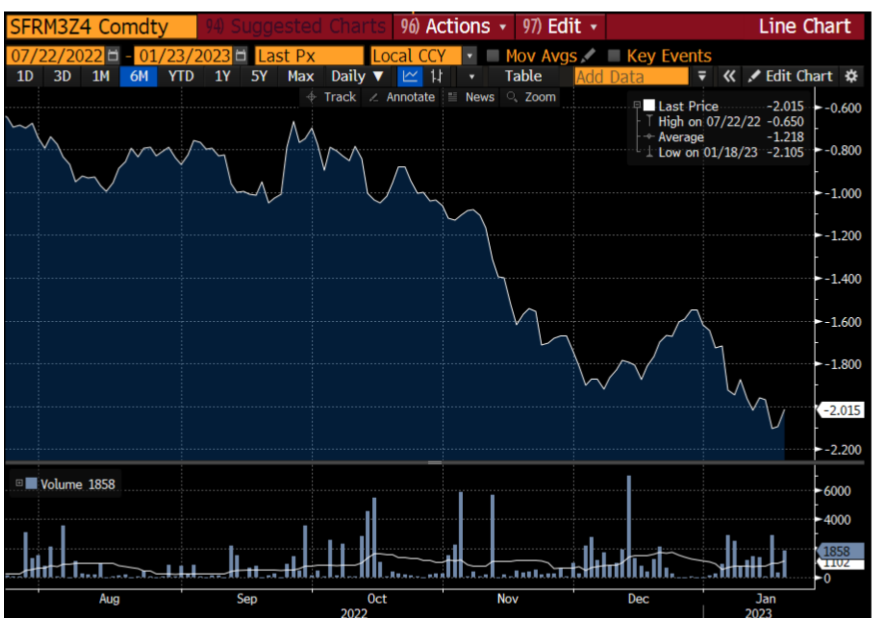
- The "over did it" case - The Fed will hit a terminal rate of 5% in 2023 and hold at that rate for an extended period which along with the hit to wealth of further asset price declines due to quantitative tightening will generate a meaningful recession, job losses, and demand destruction. Thus, well and truly killing inflation.
- The "higherer for longerer" case -Despite the tightening impacts mentioned above the economy does not 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 "Blue Pill paths"

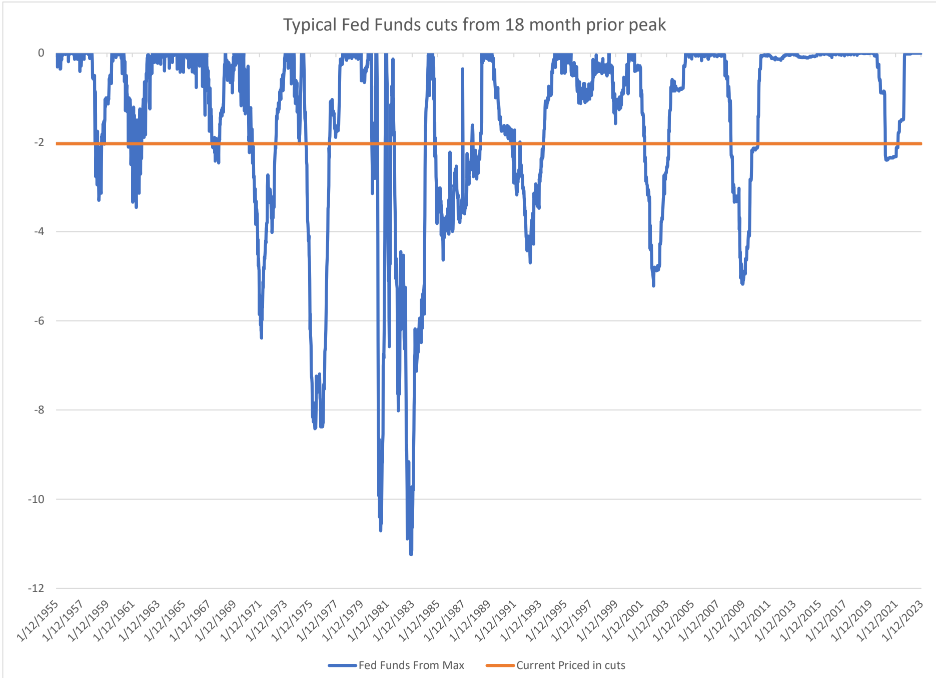
- Soft landing case - Inflation magically falls without a recession or at least without a meaningful loss in jobs, the impact of QT is mild, and the Fed can then tweak rates down when necessary.

Short term rates market is priced for an imminent recession

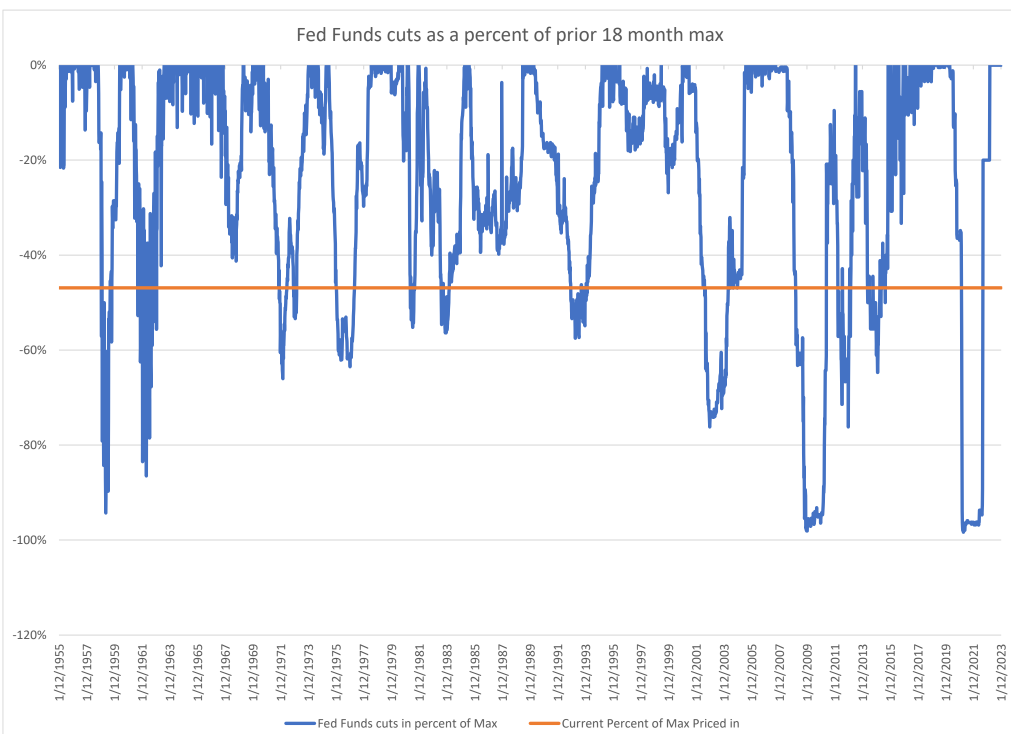
The STIR market now prices in a 65% of the typical amount of rate cuts in a typical expect blue pill outcomes of a Fed which will cut rapidly soon after reaching the terminal rate. The insight is that those with 40 years of training have always seen the Fed pivot rapidly. It is our view that if real economic weakness manifests the Fed will not rush to pivot without a meaningful asset selloff. We will be adding shorts in Dec 2024 SOFR.



Typical Rate cuts over 18 months that exceed what is currently priced in happen in a deep recession or financial crisis in the last two decades rate regime.



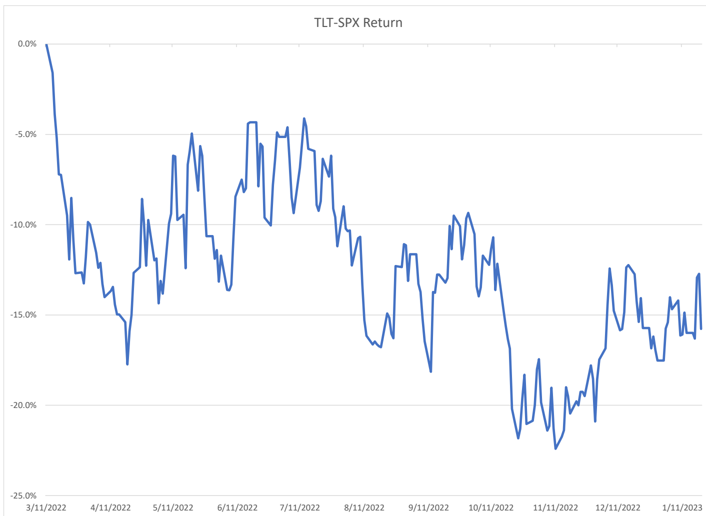
Correcting the above levels chart with % cuts of peak fed funds to adjust for levels of rates, some noise is introduced during the post GFC/Pre covid period as rates were close to zero but the point is clear. Current priced in cuts are only realized if a recession or financial crisis occurs. Furthermore, in many recessions fewer cuts are made.



The Great Convergence trade is no longer attractively priced.

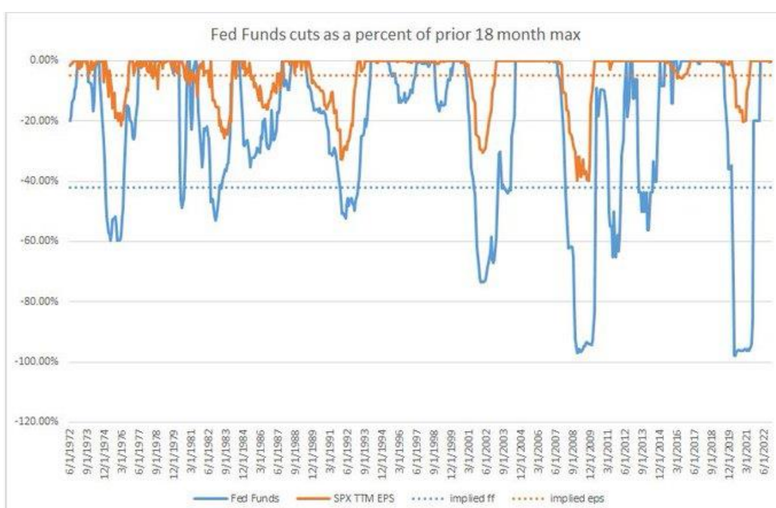
Our favorite trade to take advantage of a deep recession had been long bonds and short stocks. As we wrote in the DSR "Great Convergence" In November we expect the US to be the earliest place where that trade makes sense and the opposite trade to make more sense the farther you travel east around the globe.

Since our observation of that trade as a cheap way to play an imminent recession it has gotten 700bp richer at current levels. We unwound some of our position last week. We will unwind the rest this week. Going long bonds and short stocks is simply not price attractively anymore. A recession would need to be much more certain to make any money at all in this trade.



While the long-term bond market vs equities is less attractive, the STIR market is priced for a recession but not equities.

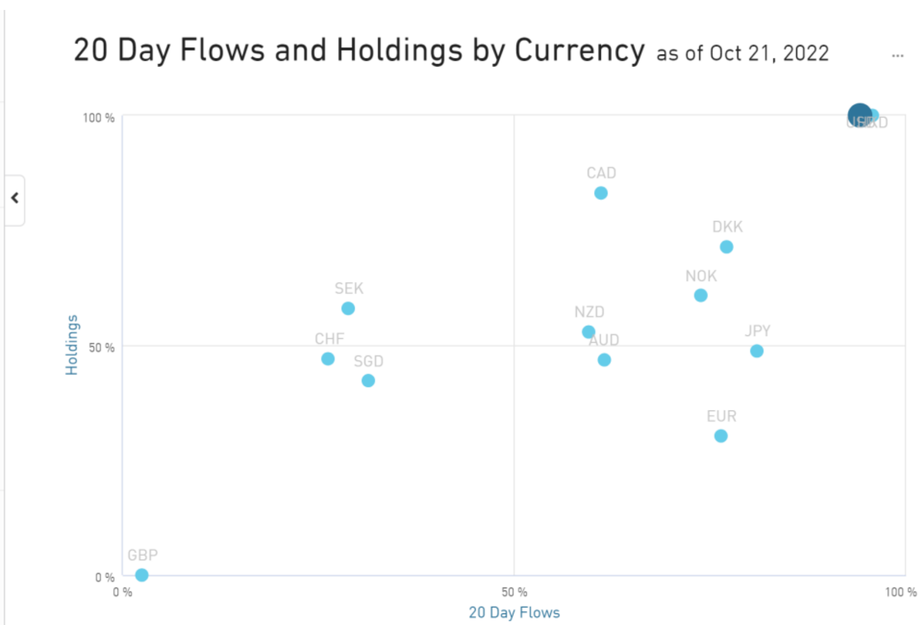
The path of earnings estimated by analysts seems highly unlikely unless top line inflation stays high while wage and input cost inflation remains lower. But in a recession the earnings estimates are pure fantasy. Note the EPS Estimate drawdown vs the Fed Funds estimate and drawdown.



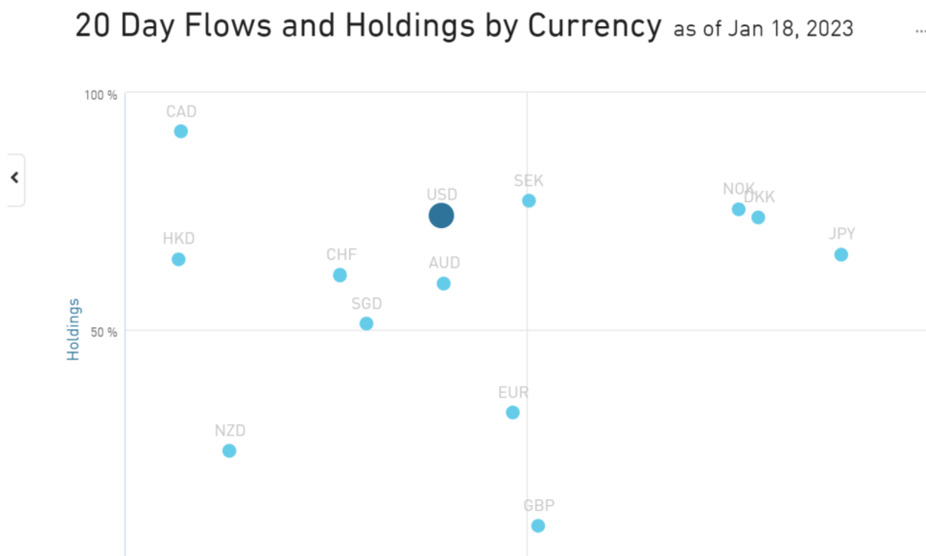
USD

The USD has been weak as expectations of Fed pause and subsequent cuts indicate relative dovishness vs the rest of the globe In addition the USD long was an extremely overcrowded trade. We believe that the USD is priced for a recession and are looking to go long USD (probably vs a basket of DM) in the weeks to come as the overbought overweight conditions resolve. One quarter ago DXY peaked.

At the same time the USD was max overbought and overweight according to the holdings of State Streets institutional custodial accounts (A dominant sample size). Far upper right is a reliable signal. Also notice the GBP at the time underweight and being sold to an extreme



Contrast that with the picture today. Which shows USD being sold but still overweight. We look at this and the recent price concession and our view that the Fixed income market overstates the potential for the FED to cut rates and are interested in adding USD exposure on a dip



Break Evens and Bonds

Our view on break evens and long-term nominal bonds is that inflation expectations are now below target when adjusted for PCE and commodity prices are likely to have bottomed. We like break evens here and are also looking to buy on a dip.

Similarly we are bearish Nominal bonds and would short on any meaningful rally

Synthesis

We believe that pricing of all assets taken as a whole indicates overcrowded positioning in a recession case in the fixed income and currency markets and a soft landing case in equities. We think the positioning that would win if the Fed simply sticks to its SEP or must pause longer or raise rates higher is close to zero. We like those odds and our positioning reflects that view at the moment and will continue to be increased by diversifying into other markets and adding to our favorite trades.

In the lead up to the Fed Meeting and the Quarterly Refunding Announcement we expect little change in markets. As a preview to the next DSR we think

- The Fed will hike 25 and be hawkish in the press conference
- The debt ceiling is broadly misunderstood by markets and issuance will be heavy in Q2
- The QRA will clarify this misunderstanding on Feb 1 and issuance will be sizable and dominated by coupons

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 42,006,175		
Total Return	42.01%	YTD Return	-3.29%
Today's Date	1/22/2023	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	1.6	$ (238,095)
12/23/2022	SPY 360/325 Dec 2023 Put Spread (GC)	10	250	$ 250,000	7	$ (75,000)
1/10/2023	SPX 3750/3550 March Put Spread (GC)	43	116	$ 500,000	28	$ (174,419)
1/4/2023	FXI ETF	30.28	115,000	$ 500,000	32.31	$ 233,450
12/23/2022	TLT 100/90 Dec 2023 Put Spread (GC)	3.33	-375	$ 250,000	2.4	$ 34,858
1/5/2023	Long SFRM3 Short SFRZ4 (H4L)	-1.7	909	$ 500,000	-2.03	$ (300,000)
1/12/2023	Long SFRM3 Short SFRZ4 (H4L)	-2	909	$ 500,000	-2.03	$ (27,273)
1/13/2023	GLD Feb 17 2023 178/181 Call Spread	1.3	-1471	$ 250,000	1.6	$ (44,118)
12/1/2022	DS Beta Short Component SPY	407.38	-30680	$ 2,500,000	391.96	$ 473,086
12/1/2022	DS Beta Short Component TLT	105.76	-141831		106.28	$ (73,752)
12/1/2022	DS Beta Short Component TIP	109.37	-114290		108.7101	$ 75,420
12/1/2022	DS Beta Short Component GLD	167.84	-29790		178.88	$ (328,882)
12/1/2022	DS Beta Short Component GSG	21.47	-232880		21.445	$ 5,822
				Risk		5.811%