The Damped Spring Report

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

1/2/2022

The most overused meme we know is the Matrix Red Pill / Blue Pill choice. Despite its ubiquity and often poorly chosen application it seems appropriate to use as we say goodbye to 2022 and look forward to 2023. We believe that markets are priced for a soft landing. Forty years of deflationary headwind has trained people to expect inflation to moderate and the Fed and other central bankers to provide accommodation rapidly when economies weaken. Believing the central banks will be able to successfully achieve a soft landing because they have done so for most investors' entire lives is taking the Blue Pill. We believe a soft landing is extremely unlikely and the actual paths will be either a deep recession with central banks remaining restrictive for far longer than is expected or a period of potentially stronger nominal growth which will result in central banks ramping up additional tightening steps to deal with the lingering and lasting impact of the fiscal stimulus of the COVID period. Take the Red Pill which is positioning oneself for a much longer period of monetary tightening and wake up.

In the DSR of 12/16 we commented on the bond market. Our view was that due to massive momentum unwind flows, post October CPI, the bond market provided significant asymmetric risk favoring higher yields.   Since then, TLT has dropped 10% and yields are once again at 4% on 30-year bonds, up over 50bp from our report. In addition, our call on 12/1 to sell all assets has proven accurate as that portfolio has fallen 4%. Because many continue to swallow the Blue pill, we recognize that it's possible that assets of all sort could bounce after a December selloff. If so, we will continue to add positions favoring restrictive conditions as accommodative conditions are a long long way off.

Our thoughts on Q1 are quite simple

- **Short Assets across the board expecting tightening monetary conditions**
- **Opportunistically add two offsetting trades to diversify.**
  - **For a deep recession add Long bonds Short stocks**
  - **For a higher for longer environment add STIR trades which benefit from a reversal of the current expected rate cuts in 2023 and 2024**

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 four short weeks 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.

- 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 "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 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.

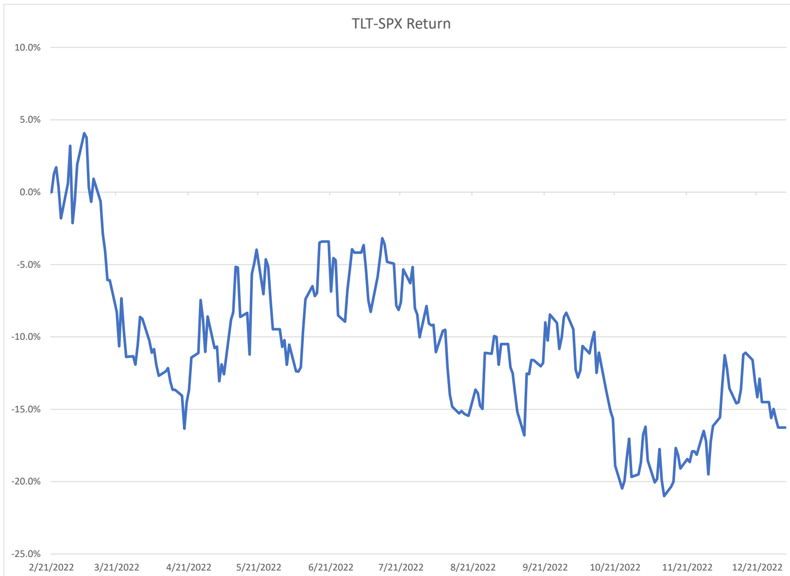
Bond Market corrected but still doesn't believe in Higherer for Longerer

The current pricing of bonds reflects less of what appeared in early December to be an imminent recession. Bond prices are close to equilibrium and more sense today given the uncertainty of the economic outlook. This equilibrium can shift rapidly over the course of the next six months depending on which glide path the economy takes. The STIR market continues to 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. Owning equities, counting on the Fed responding as priced, is truly nuts. However, we think in addition alpha can be made betting against current levels of priced in cuts. We will be adding this trade on any hot numbers.

The Great Convergence has plenty of time to get in shape

Our favorite trade to take advantage of a deep recession is to be long bonds and short stocks. As we wrote in the DSR "Great Convergence" 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.

It sure looked like the recession was upon us in mid-December but that has broadly retraced. We are looking to add US Great Convergence trades on dips. We still don't know if a recession is imminent but like the pricing near the lows of the year

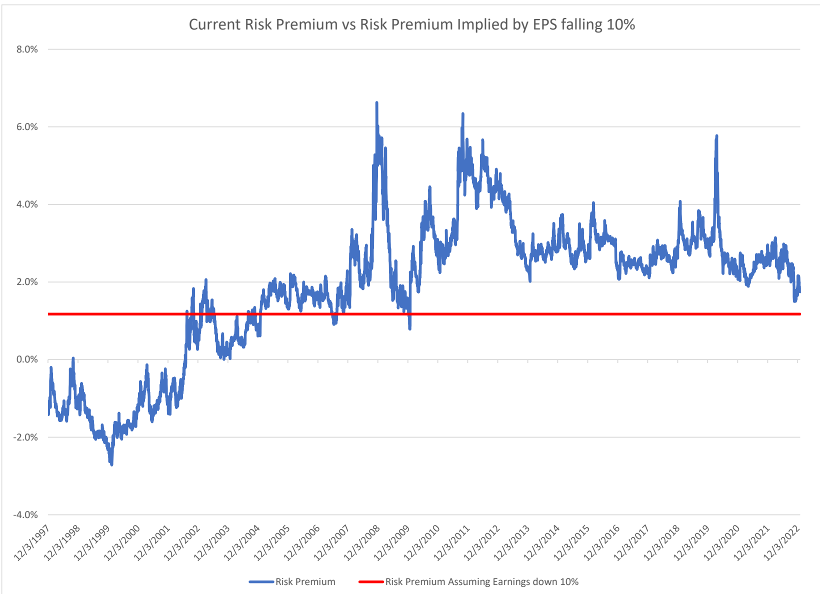


The events in German markets over the past two weeks raise a significant question about relative performance of bonds to stocks in Europe. We favor long stocks and short bonds or short assets overall as conditions tighten. As for Stocks vs Bonds we think bund underperformance has a long way to go

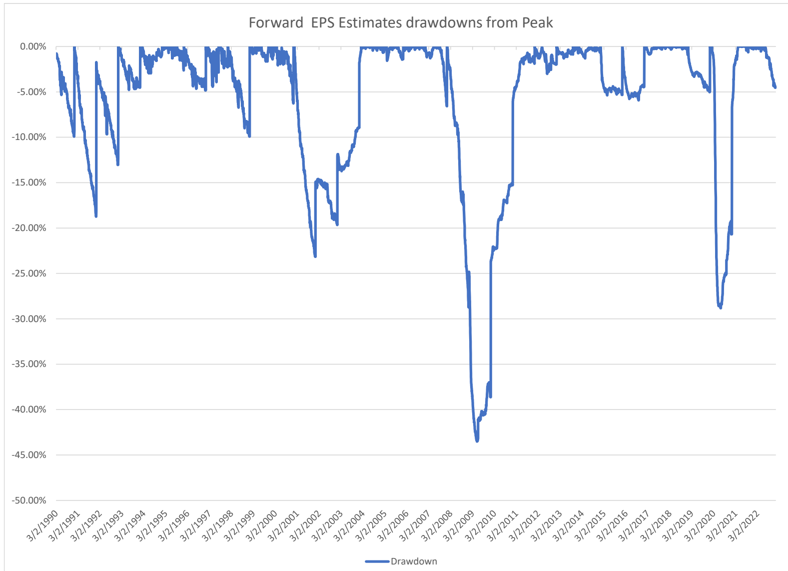
The US Equity market fair value is at best 200 points at worse 500 points lower.

The path of earnings estimated by analysts seems highly unlikely unless top line inflation stays high while wage and input cost inflation remains lower. Even in a higherer for longerer atmosphere we do not see how earnings can deliver 3-year growth anywhere near projections. As for the mechanics of inflation it is simply impossible given the current balance sheets of public and private sector entities for top line inflation to stay high without wage inflation catching up and surpassing top line resulting in margin compression. Anyway, these back year earnings estimates are fantasy.

Current 2023 earnings estimates are 229 per share which is a 5% growth rate over 2022. Only higherer for longerer gives this number a chance. If it occurs which is certainly possible the long bond will be much higher in yield than currently, Fed Funds will also be higher than priced. The equity DCF numerator may be higher but the denominator rising will kill multiples. Visually the implied risk premium of stocks is too low.



While its easy to say that earnings estimates lag. It isn't reflected in pricing. The Risk premium implied for say a 10% drop in earnings is near the lows pre financial crisis. The EPS estimate for 2023 has started to come down a little bit. It has a significant way to go if a deep recession happens.



Synthesis

As we enter 2023, the path of the economy remains uncertain. Fixed income markets had been as recently as 2 weeks discounting a significant downturn in both inflation and growth while equities seemed oblivious to the risk of such an event. Both markets have "corrected" closer to an appropriate level of uncertainty. Short term interest rates are still confidently pricing a significant shift in policy due to a weakening economy. Equity markets are counting on exactly the opposite outcome for earnings but also via the risk premium channel are confident in the blue pill of the Fed put. Long term bonds after dealing with an offside positioning are now more logically priced to uncertain outcomes. We are most confident that monetary conditions will tighten in the months to come and prefer short assets of all sorts. But in addition, both great convergence trades which occur during a recession and STIR trades which win in a higher for longer case are both attractively priced despite betting on differing outcomes. It's a nice pairs trade which can win along the way to whatever path the economy ultimately takes. Except for one. The blue pill of a soft landing.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 45,300,510					
	Total Return	45.30%		YTD Return		14.01%	
	Today's Date	1/2/2023		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	12	$ (1,680,000)	Open
11/3/2022	NDX Jan 10500/10000 Put Spread	158	127	$ 2,000,000	75	$ (1,050,633)	Open
12/23/2022	SPY 360/325 Dec 2023 Put Spread	10	250	$ 250,000	11	$ 25,000	Open
12/13/2022	TLT 100/90 Dec 2023 Put Spread	3.33	-375	$ 250,000	4	$ (25,112)	Open
12/1/2022	DS Beta Index set at 50 on initial execution	50	(1,000,000)	$ 5,000,000	48.02	$ 1,980,000	Open
				Risk		9.464%	