K

The Damped Spring Report

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

2/17/2023

Since December the global markets have been shifting between various paths to normalization. As these shifts have occurred, driven by strong views and levered positioning, we have notice various markets pricing in very different odds for each potential outcome. We think this will continue to be the shape of the investment landscape for the months to come. This provides significant alpha opportunity. In this DSR we will review our asset return framework and place that in context to the various likely paths to normalization of the economy and how those paths drive asset performance.

We have been quite lonely on what we have called Higherer for Longerer Island. We have positioned for tightening financial conditions and at the conclusion of the Fed Meeting strongly advocated a new expression of a trade benefitting from H4L which we called short Twos and Spoos. Over the past two weeks crowds from Recession Island have set flight to our lonely paradise. At the same time the dreamers on Soft Landing Island remain ever hopeful crowding their tiny atoll. We believe.

- **A Soft Landing is extremely unlikely to occur.**
- **Recession island is being quickly abandoned.**
- **Prices consistent with Higherer for Longerer have not fully adjusted.**

The Islands

Soft Landing Island

Those crowding on to this Island have been in control of assets though the end of January. A soft landing is a magical decline in inflation with minimal damage to the economy or and employment. Because the economy returns to trend growth and inflation, the Fed can remove restrictive monetary policy.

Recession Island

The inhabitants of Recession Island have been exclusively bond market investors whose dour nature results in an unbiased lens pointed at the world analytically. Recession Islanders see with certainty that a recession is the only way to fight inflation and that the Fed has already done too much. However, they are positioned expecting an imminent recession. Some Equity Permabears have homes here too.

Higherer for Longerer Island

We have been residing on H4L island since December. The island was an uninhabited paradise when we arrived. On this island the ample liquidity saved by the economy from the 2020 and 2021 stimulus checks cascades across the island via rivers and streams and down waterfalls filling natural lakes and the infinity swimming pools installed in the few villas that a few of us have built. This liquidity flowing through the economy and the tight labor market suggested to us that there was a reasonable probability that the Fed had not done enough, and that taming inflation would take more work by the Fed. We preferred the uninhabited H4L island to the crowded Recession Island but believe Soft Landing Island is built on unreasonable expectations and was extremely crowded.

Shifts

Over the last two weeks H4L Island has become the new hot destination for market participants with many Recession Islanders fleeing recessionary positions and heading to H4L. That said, while the spoken consensus seems to have moved to H4L the positioning remains offside. We aren't leaving the island. However, we do know that the path to normalcy must include a long stay at Recession Island. There will be no soft landing. Yesterday we bought a villa on Recession Island out of foreclosure from a bankrupt resident who was short NDX and Long 30-year Bonds and getting destroyed. Over the next quarter or so we will sell our Villa on H4L and buy up more fixer uppers on Recession Island.

Outlook

For months now we have been uncertain of how the economy would respond to the Fed hikes. We have leaned toward a higherer for longerer scenario playing out but also were open to a more immediate weakening of the economy. We remain uncertain about the economic outcome but clearly consensus and pricing are moving toward H4L. That said we felt strongly that market pricing was heavily weighted to an imminent recession and even more so a soft landing. Our strategy is to pay attention to the data and position ourselves for where the data is going not to where it was. However, we remain certain that a soft landing is unlikely.

Reminder of framework for the drivers of assets

The Damped Spring Framework has four pillars.

- Changes in growth and growth expectations
- Changes in inflation and inflation expectations
- Changes in risk premium
- Flow and Positioning and what is priced into markets.

Growth

- Equities benefit from rising growth.
- Nominal and Inflation Linked bonds benefit from falling growth.
- Commodities benefit from rising growth.

- Gold benefits from falling growth as real interest rates fall.

Inflation

- Equities have a mixed response to rising inflation.
    - Rising inflation is a positive for revenue.
    - Rising inflation is a negative for expenses.
    - Depending on the mix of inflationary forces rising inflation can be either a negative or positive for earnings.
    - Rising inflation is a negative for equities due to rising bond yields used to discount equity cash flows.
- Nominal bonds benefit from falling inflation.
- Inflation linked bonds are over time neutral to changes in inflation.
- Commodities benefit from rising inflation.
- Gold has a mixed response to inflation. In cases where inflation is largely a monetary phenomenon gold benefits from rising inflation. In most other cases including supply channel disruption inflation and growth/demand driven inflation gold does not benefit from rising inflation

Risk Premium

- All assets benefit from easy money and credit conditions relative to supply of assets.
- All assets benefit from falling portfolio volatility.

Flow and Positioning

- Assets benefit from QE.
- QT is a headwind to assets.
- At any point in time certain cohorts can have inelastic needs to add or reduce risk. Momentum strategies are included in this inelastic flow.
- At any point in time certain cohorts can reach a maximum overweight exposure of minimum underweight resulting in a shift in a crowded position or a shift in flow favoring retracement

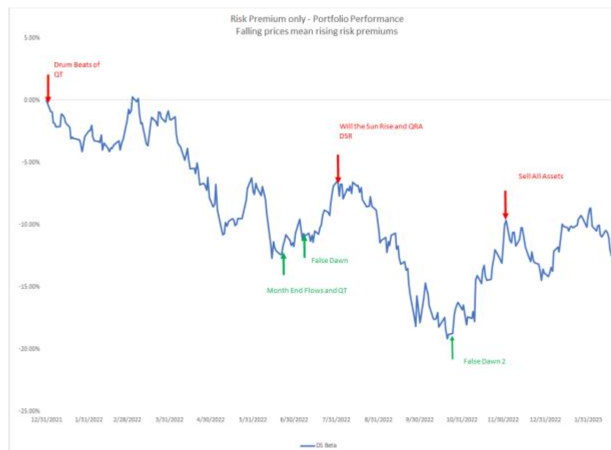
The Islands and what they mean for assets.

The various islands are metaphors for the most likely economic outcomes on the way to normality. As we look at each of the various outcomes through our framework and given current pricing and positioning, we can estimate the impact of shifts pointing toward one of the various outcomes.

Soft Landing Island

The most important feature of Soft Landing Island is the expectation of removal of restrictive monetary conditions. Inflation expectations and growth expectations move a little but that is more tweaking than shaping market pricing. Asset volatilities tend to fall, portfolio diversification benefit tends to rise, and the combination of lower portfolio risk and easier policy results in a levering up of asset portfolios and causing the highest risk assets to have high positive returns.

Our preferred trade for fading the probability of a soft landing has been to be short a risk parity portfolio. Its performance showed a big shift to Soft Landing Island in January that has largely corrected in February.



We continue to follow each of the major flows of Global CB's quantitative tightening, Fiscal issuance, and currency manager US Asset purchase and while the Treasury General Account will be paid down before the debt ceiling crisis is resolved we believe money will get tighter. As an aside we think the Fed should increase QT and may do so if asset markets remain elevated once the debt ceiling is resolved. We remain bearish assets and believe the extremely crowded Soft Landing Island will look like the Frey Festival by summertime.

Recession Island

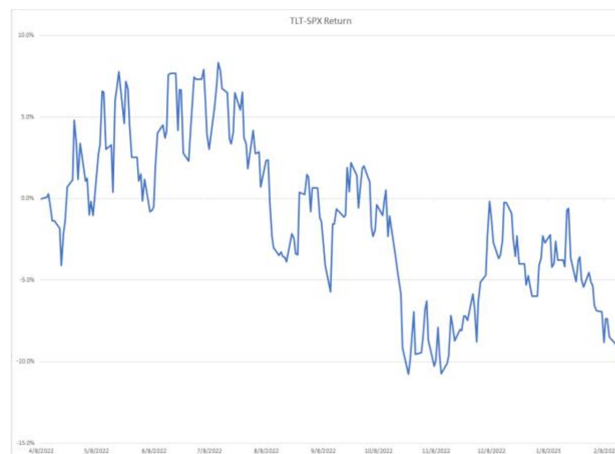
In January we wrote in that we no longer saw a single trade in the US bond market that paid off well in a recession. Of course, there is always shorting stocks which would obviously do well in a recession but given the other Islands and our view that the odds of a recession were about a coin flip to H4L we saw no edge in that trade. The bond market was discounting something completely different. It has moved dramatically since but still is holding out hope for a recession. Our bet of short Twos and Spoos is paying off handsomely and we maintain that view.

Terminal rates have gone higher to north of 5% and been pushed out to September as economic data has been a catalyst for recession trade unwinds.

Cuts priced into 2023 have also radically evaporated.

Yet cuts post peak through 2024 remain quite significant and we believe have room to move to fewer cuts.

Our favorite trade for a recession remains the "Great Convergence" where the massive underperformance of long-term bonds vs equities retrace. In January that trade looked awful, reflecting crowded Recession Island Conditions. As of yesterday, we entered into this trade using QQQ as the short. We believe there is still a large amount of offside positioning short stocks and long bonds and believe a recession is not imminent. For those reasons we are going to grow this position slowly as investors flee Recession Island and head to Higherer for Longerer island.



Higherer for Longerer Island

Higherer for longerer Island is the most difficult to understand without consulting our framework. Soft Landing is simple. It favors all assets the riskier the better. Recession Island requires a little bit more work in that Nominal Bonds, TIPS do well, but Equities, and Commodities fall. Gold is a wild card but is generally fine to own. However, Higherer for Longerer is complicated. Some clear trades

- Short Term Interest rates rise as terminal rate gets pushed out and up and future cuts get pushed out.
- Bonds do poorly as the front end drags up already heavily inverted yields and growth and inflation expectations rise.
- Gold does poorly due to real rates rising.
- Commodities do well due to rising growth and inflation expectations.

Equities are more complicated as both headwinds and tailwinds blow.

Let's start with possible tailwinds.

- Growth above expectations is a clear positive to earnings.
- CPI inflation is a positive to nominal sales.
- The Fed may pause too long or not hike enough which will result in accommodative financial conditions and risk premium contraction.

Headwind

- Input cost inflation such as wages and commodities could rise faster than CPI cutting margins. Regardless higher nominal expenses are a headwind.
- Rising long term interest rates are a strong headwind as discount rates of equity cash flow results in lower equity valuations.
- The Fed may act quickly and aggressively which would cause risk premium expansion.

What are the deltas to these various forces?

For simplicities sake we can lump Growth and Inflation as Nominal GDP (nGDP). In addition, we can ignore the timing and scale of revenue inflation and expenses inflation. By making these simplifying assumptions we can expect 100bp of higher-than-expected nGDP would generate earnings growth of roughly 200bp. Because "Earnings" are in the numerator of most valuation models the impact of higher earnings is directly correlated to higher equity prices 1:1. 100bp of higher nominal growth leads to 200bp of higher earnings and 200bp of higher share prices. We suggest you play with the ideas and the sensitivities of equities to these factors and eliminate some or all of the simplifying assumptions. Getting the right answer isn't our goal. Our goal is to show that numerator growth is directly connected to price growth.

Which brings us to the denominator of valuation models. The denominator or discount rate is the long-term risk-free interest rate plus a risk premium for the lack of certainty of return when invested in equities.

Equity valuations are extremely sensitive to shifts in risk free rates and risk premiums. For instance, with a standard valuation model a 25bp change in the sum of the ERP and Rf rate at current levels of rates generates a 4% change in "fair value."

When you add the influences up it is clear that equities can improve by 2-4% if Nominal growth surprise to the upside, however, only a 25bp rise in risk free rates plus risk premium can wipe out that entire gains.

In summary, Equities will struggle to rally in an H4L world unless long-term risk-free rates remain stable and/or risk premiums contract. This seems to provide very little incentive to own equities if residing on Higherer for Longerer Island. In addition, H4L will almost certainly result in a recession and equities are particularly vulnerable to that outcome.

What's priced in?

Stepping back from the various shifts from one island to another it's important to think about current pricing. With QT still operating and European Central Banks just beginning to tighten it is quite clear that assets have a meaningful headwind for appreciation. But each asset is on its own path. We think.

- Equities are rich and have been bid up by both Soft Landing Islanders and Recession traders squeezed out of shorts.
- The front end of the US yield curve has moved a lot but is likely to move further toward higherer for longerer
- The long end of the yield curve is likely to be dragged higher in yields even without a large shift in inflation expectations.
- The USD has likely bottomed for the year. Particularly against EM, China and Japan.
- Gold is in a no man's zone.
- Commodities, particularly industrial metals and energy seem cheap.

However, equities stand out to us as extremely miss price at this point. Here's why. A recession will almost certainly occur. If so, we would expect long term bond yields to fall which is supportive to equities and risk premiums to stay at current levels or expand which is a headwind to equities. But earnings should fall meaningfully. We think fair value of equities in a recession is below 3400 on SPX.

In a higherer for longerer scenario we think long term yields will rise by 40bp, earnings will rise by 5%, and risk premiums will expand. In aggregate that places fair value at 3700 a 10% sell off from here.

Only in a soft-landing scenario do we see any value in equities. In such a scenario yield will fall by 50bp, earnings will rise by 4%, and risk premiums will contract. Those combinations of inputs generate a fair value of 4350 or a 7% rally by year end. Add that up and we can't get to current pricing of 4065. Assuming the odds of a recession in 2023 or higherer for longerer followed by a recession have equal odds that would mean a soft landing is 55% likely to occur. Seems crazy to us.

We are short QQQ and SPX and pounding the table that equities are rich. Our current fair value is 3700.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000					
LTD P/L	$ 46,785,677					
Total Return	46.79%		YTD Return		1.49%	
Today's Date	2/17/2023		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case los	MTM	P/L	Open/Close
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	1.2	$ (428,571)	Open
1/4/2023	FXI ETF	30.28	115,000	$ 500,000	29.5	$ (89,700)	Open
1/26/2023	SPX 3900/3500 March Put Spread Two's and SPOOS	36	139	$ 500,000	26.5	$ (131,944)	Open
2/1/2023	SPX 3900/3500 March Put Spread Two's and SPOOS	28.67	523	$ 1,500,000	26.5	$ (113,372)	Open
2/16/2023	QQQ 298/318 March 17 Call Spread RI	11.15	-550	$ 500,000	8.27	$ 158,400	Open
2/1/2023	Short SFRZ4 Twos and Spoos	97.085	-1600	$ 2,000,000	96.4	$ 2,740,000	Open
2/14/2023	long SFRU3 Twos and Spoos	94.75	1600	$ (2,000,000)	94.74	$ (40,000)	Open
2/16/2023	TLT 104/100 March 17 Put Spread	1.95	-2500	$ 500,000	1.92	$ 7,500	Open
2/6/2023	USDJPY 131/136 Call Spread	1.18	84,745,763	$ 1,000,000	1.8	$ 525,424	Open
12/1/2022	DS Beta Short Component SPY	407.38	-30680	$ 500,000	405.69	$ 51,849	Open
12/1/2022	DS Beta Short Component TLT	105.76	-141831		102.73	$ 429,748	Closed
12/1/2022	DS Beta Short Component TIP	109.37	-114290		107.4246	$ 222,340	Open
12/1/2022	DS Beta Short Component GLD	167.84	-29790		171.42	$ (106,648)	Open
12/1/2022	DS Beta Short Component GSG	21.47	-232880		20.15	$ 307,402	Closed
12/1/2022	Net Positive carry	2.00%				$ 213,699	Open