# The Damped Spring Report

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

5/15/2023

**Asset markets continue to stay resilient. We are short all assets and believe cash provides a better return than owning assets. However, we are surprised that asset markets have not fallen much in 2023. In our DSR King Cash we discussed may of the drivers of risk premium. We concluded that risk premiums are extremely tight across all assets. Yet, we worry about missing a major factor in risk premium contraction. In this DSR we will explore the possibility that a delayed QE effect is operating in the markets that is providing a bid for assets of all sorts.**

The Big 4 of Tech companies who buy back shares, have massively outperformed.

Quantitative easing by the Fed works to contract risk premiums as the Fed purchases bonds and removes risk held by the private sector. As risk premiums contract on Treasury bonds other assets become more attractive and the sellers of Treasury bonds purchase those assets, and the sellers of those assets eventually are forced out of asset markets entirely and consume. Tech Stock buybacks are not QE. The reason buybacks are not QE is that when a company buys back its shares it must use another asset it has or must issue to pay for the shares. That

other asset is injected into the financial system and that results in no net change in assets held by the private sector. However, these large companies have been the end saver of a major portion of the Covid Stimulus. The buybacks have been financed by this stimulus not new issuance. For this reason, the buyback flow may be a "Delayed QE" which is also squeezing on fewer and fewer marginal sellers who may be demanding a greater risk premium concession. Obviously, there are many potential causes for Big Cap Tech to outperform. Nonetheless we are open to the idea that a "Delayed QE" is impacting these stocks. The risk premium squeeze on these stocks is also likely supportive of assets in general. We will add this flow to the many others we discussed in our "King Cash" Damped Spring Report as a possible tailwind for assets. The share repurchase tailwind has also likely peaked.

## Review of risk premium headwinds and tailwinds

### Demand for assets

Demand for assets starts with the availability of money and credit. It takes money either borrowed or swapped from cash to buy assets. Money and credit demand is generated from three basic sources.

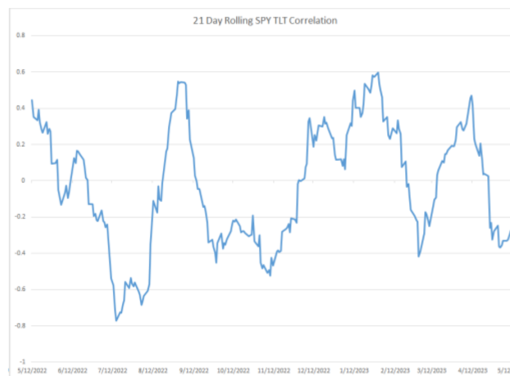
- A private sector investor who is in cash or outright short assets can have animal spirits which are relatively inelastic and force asset owners into cash. Asset owners of this sort tend to be elastic, and a price concession is required to force them into cash. Prices rise.
- A bank either foreign or domestic can create money out of thin air to buy assets.
- A central bank either foreign or domestic can pursue stimulative asset buying policies which forces the private sector into cash (QE). In addition, Central Banks that need to counteract their currency appreciation can sell their local currency and now have USD which needs to buy USD assets.
- **Adding – Corporations who are flush with cash and cash flow from prior wave of Fiscal Spending can buy assets.**

### Supply of Assets

The Treasury continued to fund the government and issue sizable duration during the last two quarters. However other new asset creation including private sector loans fell. Private sector corporate bond issuance was mixed, and Equity issuance was almost non-existent particularly in December and January. Other public issuance was also light this whole period. Treasury General Account fell as the debt ceiling was reached, extraordinary measures were used, and tax refunds were sent, it's possible that this flow which is usually slow moving did ignite some animal spirits. It is clear that the TGA drawdown and debt ceiling resulted in less bills issuance. The outlook for supply was clarified by the most recent QRA and is enormous with $1.2TN of issuance by Sept 30th, but none of that supply will come before the debt ceiling is resolved. Any modest demand, like share repurchase, that is funded with cash has had a significant impact.

## Risk

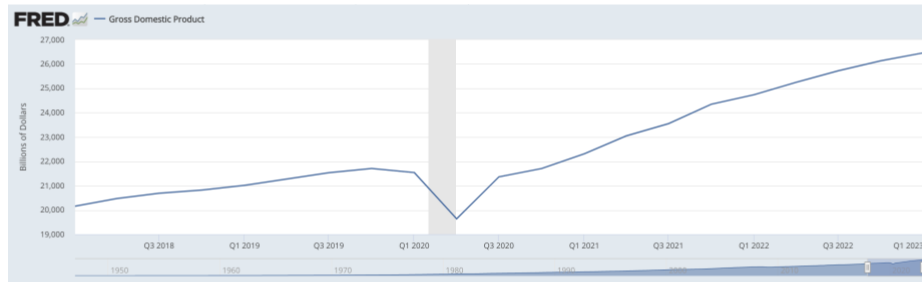
Implied asset portfolio risk has also been a tailwind for assets as implied rates and equity volatility has fallen and rolling asset correlation has moved sharply negative.



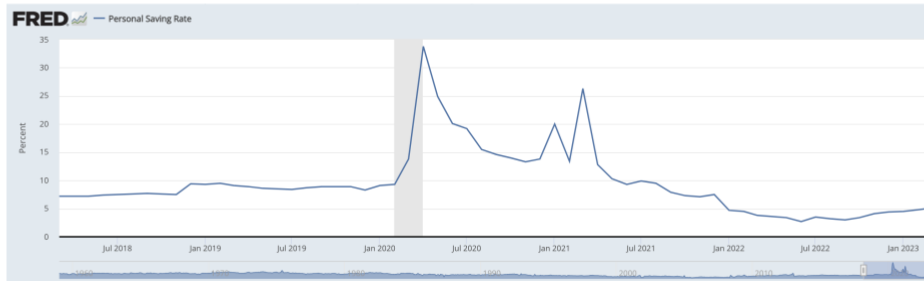

Adding the "Delayed QE" buyback tailwind to other tailwinds net of headwinds the past few months have been generally supportive of asset prices. However, assets are already extremely overpriced and would require ongoing tailwinds to sustain these levels. Headwinds have been broadly absent and are building offshore.

## Fiscal spending generated growth and savings.

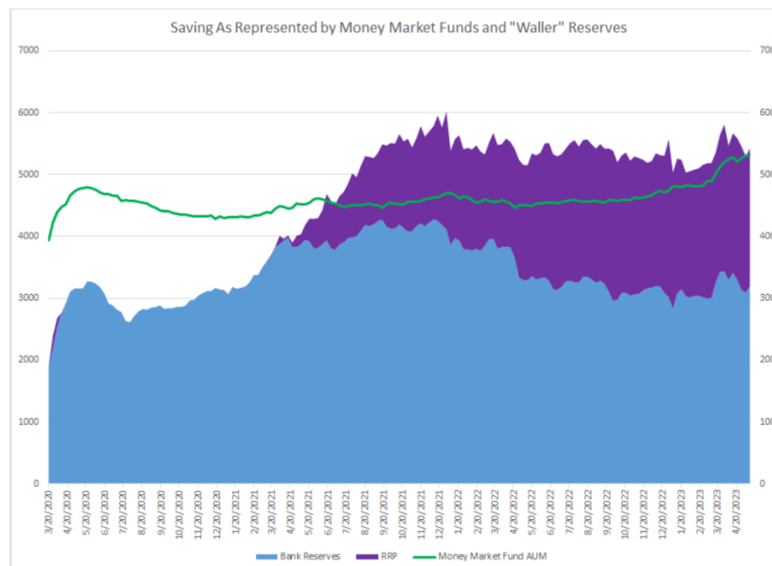
$6TN of Fiscal spending handed the real economy a huge burst of income to offset the GDP loss of the shutdown. While supply shocks and the shutdown resulted in less consumption and production and a $2TN annual GDP hit the economy was back to "normal" output and consumptions after 2 quarters.




Each burst of stimulus was saved, and then normal savings rates persisted. Lately savings rates have begun increasing again.



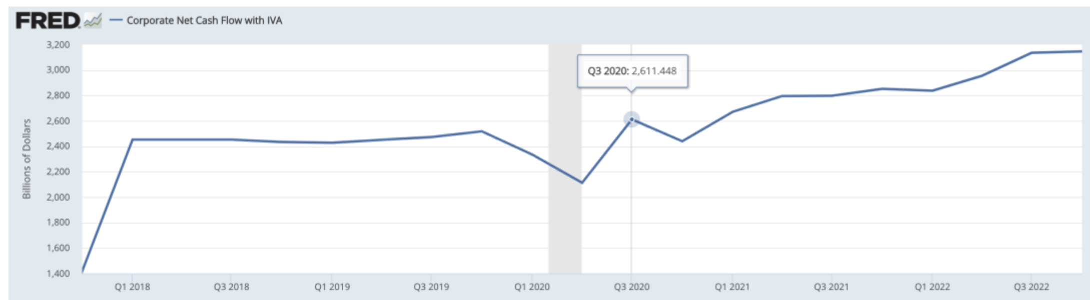

That savings has accumulated over the past 3 years mostly in Bank reserves and RRP, the so called "Waller Reserves." Money Market Fund AUM has been steadily growing and recently both high short term interest rates and modest bank deposit flight has added AUM to Money Market Funds. MMF's also are almost all of the RRP Balance. In addition, the total amount of cash like savings has been very stable for over a year.



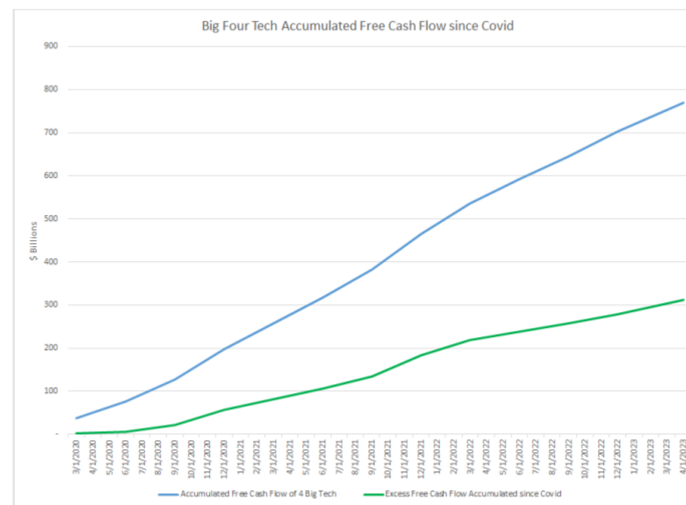
## How has the nature of who is saving changed?

Let's follow the fiscal spending that was done. 6TN of spending accumulated in individual recipient's bank deposits. Stimmy checks and wages and other corporate expenses were the form of this spending. The spending was initially spent, saved, or invested. Over time the non-corporate recipients spent these deposits via consumption. Inflation of goods and services ensued. Each dollar spent was someone else's income. Corporations accumulated profits, owners of commodities used for goods manufacturing swapped their commodities for cash, and individuals received wages. Those individuals then repeated that cycle. Each cycle corporations accumulated more profits and individuals has less savings. Essentially the final destination of the Fiscal spending in 2020 and 2021 will one day land in corporate coffers, commodity suppliers and with long term individual savers.

When looking at the stability of the RRP and Bank Reserves over the past two years it appears that not much has changed since the fiscal spending impulse ended. This hides the flow mentioned above. All those bank deposits and money market fund accounts have changed in character in a meaningful way. From individuals to corporations and long-term savers. Currently Corporate Annualized Cash Flow accumulation is at 3.2TN per year. That's up $750BN per year prior to COVID. When people talk about deposit flight it makes us laugh. This is the real deposit flight.



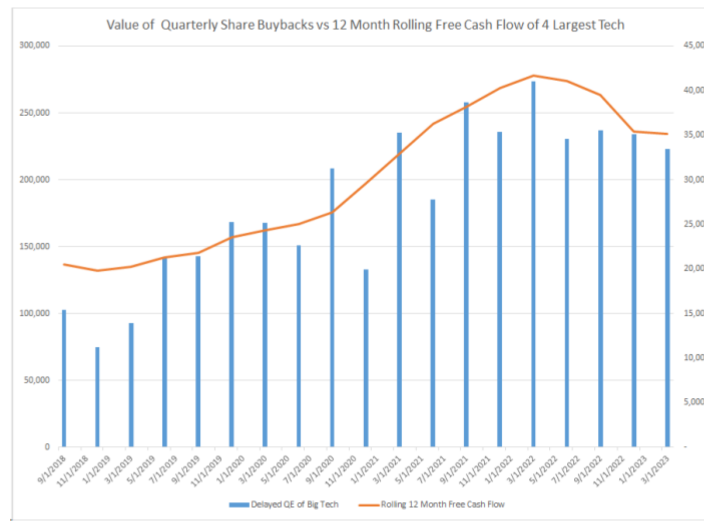

The Big Four Tech Buy Back Companies of course have seen a disproportionate increase of this shift of deposits.



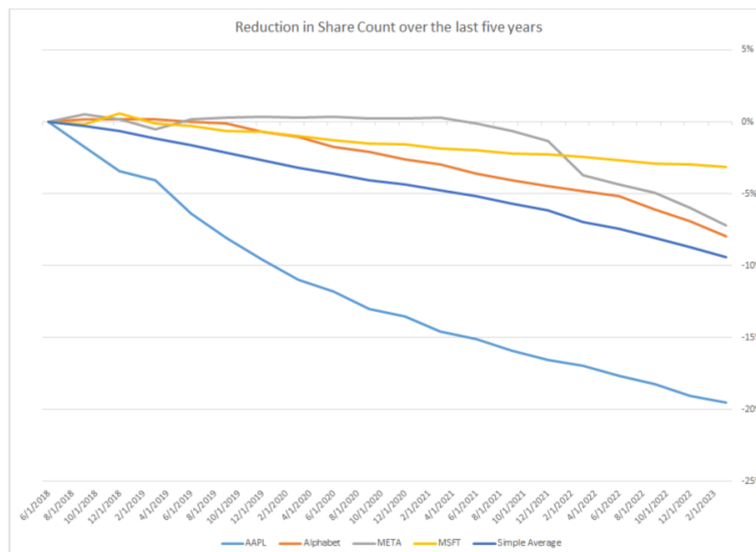
Over the past three years accumulated cash flow has grown by $750BN at these four companies, of which $300BN has been excess of pre covid levels of accumulation. We are not judging corporations or these four companies. We are simply tracking the flow of the stimulus spending in order to determine how the flow impacts financial markets.

What have companies done as the cash accrued on their balance sheet?

As mentioned above the shift of bank deposits from recipients to corporations via consumption has left bank reserves plus RRP stable. However, Corporations, and these four in particular have also repurchased shares. They use a bank deposit to repurchase the share and hand the owner that bank deposit. Notice that the amount spent on repurchases roughly tracks the prior year's free cash flow accumulation. Also note that free cash flow has fallen over the past 4 quarters due to lower profits.




These buybacks have also reduced share count outstanding by on average 10% and for the largest company AAPL by almost 20% over the last five years.



## Why do companies buy back their stock?

There are a few reasons for why a corporation buys back its own stock. Three dominate and a fourth reason is rare. Companies buy back stock to

- Offset shares issued to employees for compensation.
- Offset shares issued as compensation for merger transactions.
- To return capital to investors in a company that has either limited options to invest in their own business OR expectation of winding down operations over a 10–20-year horizon.
- Rarely, management will repurchase stock because it is cheap, and they have the best position to know.

### Employee Compensation

Stock option and regular share awards are a popular form of compensation for startups. These companies may be cash strapped and "save" on compensation and cash burn. Over the last two decades the accounting for this compensation has improved in a way that it hits current income and B/S by valuing the options on award date. But companies don't lock in the compensation expense via purchasing the options in the market which would defeat the purpose of saving cash. Management lets the options run, either saving a little cash if the company fails, or diluting the company as the stock rallies. The first is bittersweet. They deal with the second by covering stock as the options are exercised or outright stock vests. They also benefit from vesting policies by retaining employees who want to be around to collect the proceeds after vesting and exercise. Because startups offer option and stock compensation, and employees are also considering big cap companies for careers the big cap companies use this form of comp as well. The result is that many companies mechanically buy stock to reduce dilution. **It is important to note that this type of buyback is procyclical. When stocks are higher more options are exercised, and more buybacks are necessary. When stocks are lower no options are exercised and no buyback are necessary.**

### Merger Compensation

Companies acquire or merge with other companies for many different reasons.  In certain deals, the compensation for the target company is paid in shares. This is done for accounting reasons and for the target company shareholders to avoid an immediate capital gain. The result of these transactions is that the post-merger company may be less leveraged than it desires.  By mechanically repurchasing the shares they are able to achieve their desired capital structure.  This type of buyback is episodic and in the last few years has been smaller than other forms.

### Return of Capital

Returning capital to shareholders through dividends or share repurchases is both a way to generate returns for shareholders beyond appreciation AND an acknowledgment by management that the cash generated by the business cannot

be invested in the business at a risk adjusted return that surpasses the return of the shares themselves.

Certain companies with a great short term cash flow generating business may see their business winding down over the next decade. This happens all the time. A good example is Eastman Kodak. They made photography film. They owned the category. Unfortunately, they were slow to adapt their business model to digital. Once they were too far behind to pivot, they knew that film would continue to generate cash flow until everyone had transitioned to digital. They began aggressive share repurchases shrunk the company to its tiny size today. One may also consider the oil industry and the high cost of new projects and the potential for a long-term decline in petroleum earnings as a driver for many share repurchase programs in that industry. Long term winddown share repurchase are important but differ from the bigger cases like AAPL and Berkshire and other mega cap stocks which seem to growing fine but have no other use of cash. These will be discussed below.

## Alpha repurchases

Before dealing with large cap return of capital programs it is worth mentioning the rare case of repurchases done by management opportunistically. I think of John Malone, Larry Tisch, Ron Perlman and especially Barry Diller who combine great operating skills with great investment acumen. A typical operating management team is simply unequipped to sort their individual companies' future path from sector and macro drivers. For these reasons opportunistic share repurchases are rare. A better signal for management teams willing to place skin in the game on their shares is tracking insider buying.

## Many reasons at once

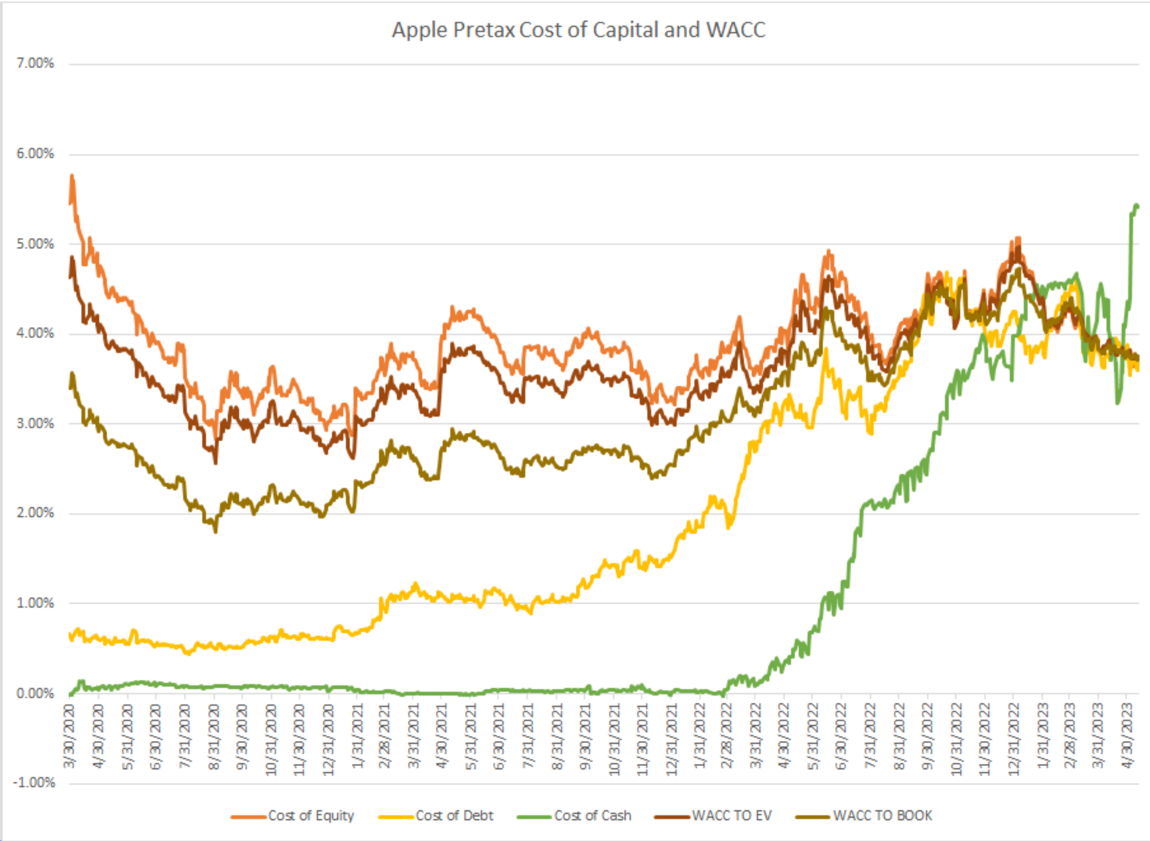
Returning to the big cap tech stocks. These companies use employee stock and options awards for compensation and the dilution does generate a good reason for share repurchases. But that is not sufficient to explain the 20% drop in share count of Apple. Below we will describe managements thought process for strategically weighing the use of cash to fund share repurchase.

## What is WACC?

A corporation must consider its investments based on a framework. At any time, the corporation can make an investment in an asset based on its ability to raise capital from the private sector. Big investment grade companies have many potential ways to raise capital. They can issue corporate bonds, equity, preferred shares, or borrow from banks. The cost of those forms of financing varies through time. Overall market conditions impact the company as does its idiosyncratic performance. Credit spreads can widen or tighten. Benchmark risk free interest rates fluctuate. Stock prices change. In order to assess the cost of financing a new investment a company determines its Weighted Average Cost of Capital. The

WACC calculation assumes a desired distribution of the company's choices for financing across its balance sheet mixing liabilities and shareholder equity. The lower the WACC the more attractive an investment may seem. If a company has a lot of cash on its balance sheet that cash impacts its WACC as it generates a return which is sacrificed if used. Currently corporate cash is likely to earn 5% if deposited in wholesale money markets.

Apple has had the good fortune of very low WACC for many years. They have funded all growth with minimal debt issuance and zero equity issuance. This WACC allows them to buy any company in the world. Nonetheless they have reached a point where they are unwilling to make a meaningful acquisition. Perhaps they simply don't believe that a meaningful acquisition would be approved. Regardless they have also benefitted from low cost of debt to purchase relatively high-cost equity. Interest rates have shifted over the last 12 months and have impacted both the cost of debt and the cost of cash. The multiple of the stock has also jumped which can be seen as reducing the cost of equity. As the cost of debt and cash increase and the cost of equity decreases the value in cash/debt financed equity share repurchases as a return of capital may no longer be attractive. The convergence of the earth tone colors with the yellow and green has eliminated the attractiveness of share repurchase to reduce share count.



**In synthesis asset risk premiums have remained extremely tight since collapsing in November on the weak CPI print. Most recently big cap tech have outperformed the broader market. A tailwind from stock buybacks is always present in markets when share count is reduced and saved cash funds the share repurchase. The combination of a war chest of cash built from covid fiscal stimulus, other tailwinds of animal spirits for under owned assets that benefit from a recession, falling portfolio vol, and TGA drawdown all have generated elevated asset prices in absence of debt duration issuance due to the debt ceiling. As we mentioned in past DSR's the tailwinds are decreasing, the valuations are extreme. Share repurchase tailwinds have already begun weakening and higher debt cost, cash returns, and equity values make repurchases increasingly unattractive.**

## Current Portfolio and Performance

| | | | |
|---|---|---|---|
| Assumed Portfolio size | $ 100,000,000 | | |
| LTD P/L | $ 45,245,305 | | |
| Total Return | 45.25% | YTD Return | -0.05% |
| Today's Date | 5/15/2023 | Portfolio Created | 4/15/2019 |

| Date | Position | Entry Price | Amount | Worst case loss | MTM | P/L | Open/Close |
|---|---|---|---|---|---|---|---|
| 10/20/2022 | CLZ23 95/105 Call Spread | 2.1 | 476 | $ 1,000,000 | 0.2 | $ (904,762) | Open |
| 1/4/2023 | FXI ETF | 30.28 | 115,000 | $ 500,000 | 27.5 | $ (319,700) | Open |
| 3/16/2023 | NDX 12500/11750 6/16/23 Put Spread | 230.00 | 43 | $ 1,000,000 | 65 | $ (717,391) | Open |
| 3/28/2023 | NDX 12500/11750 6/16/23 Put Spread | 170.00 | 59 | $ 1,000,000 | 65 | $ (617,647) | Open |
| 3/28/2023 | SPX JUNE 3900/3500 Put Spread | 60.00 | 333 | $ 2,000,000 | 16 | $ (1,466,667) | Open |
| 5/11/2023 | NDX 13370/13470 5/18/23 Call Spread | 48.00 | -96 | $ 500,000 | 36 | $ 115,385 | Closed |
| 2/1/2023 | SFRZ4 ShortTwos and Spoos | 97.085 | -1600 | $ 2,000,000 | 97.08 | $ 20,000 | Open |
| 3/15/2023 | ZN 117/113 Call Spread | 1.8125 | -914 | $ 2,000,000 | 2.21875 | $ (371,429) | Open |
| 4/25/2023 | ZF 110.5/109.5 July Put spread | 0.421875 | 4741 | $ 2,000,000 | 0.375 | $ (222,222) | Open |
| 5/5/2023 | EURJPY 148/152 Call Spread OTC 8/7/2023 expiry | 1 | 50,000,000 | $ 500,000 | 1 | $ - | Open |
| 5/5/2023 | USDJPY 135/140 Call Spread OTC 8/7/2023 expiry | 1.2 | 41,666,667 | $ 500,000 | 1.3 | $ 41,667 | Open |
| 4/13/2023 | DS Beta Short Component GLD | 189.805 | (5,269) | | 186.81 | $ 15,779 | Open |
| 4/13/2023 | DS Beta Short Component SPY | 410.5 | (6,090) | $ 500,000 | 411.59 | $ (6,638) | Open |
| 4/13/2023 | DS Beta Short Component TIP | 110.805 | (22,562) | | 109.42 | $ 31,249 | Open |
| 5/3/2023 | DS Beta Short Component TLT | 106.9 | (28,064) | | 104.27 | $ 73,807 | Open |
| 4/13/2023 | Net Positive carry | 2.00% | | | | $ - | Open |