The Damped Spring Report

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

08/13/2023

On July 31st and August 2nd Treasury announced the new funding plans for Q3 and Q4 and opened the curtain for Act 2 of the play "The only way to kill inflation." As we have been saying the impact of QT has been muted over the last 7-8 months and asset prices have been bid up. We have been looking for a supply catalyst to turn asset markets and Janet delivered. Asset markets have begun to respond. Act 2 has started. This act will drag into year end.

Overwhelming supply of duration by the Treasury will cause risk premiums to expand. Treasury prices will lead other assets and cause portfolio losses. However, the real economy will keep slogging along.

- **Private sector debt burden will continue to be unaffected by both short-term maturity and now long-term maturity rate increases.**
- **Demand will remain driven by the employment cycle.**
- **Money market savings remain plentiful driving interest income gains.**
- **Corporations will continue to feel minimal pain in earnings despite a likely drop of 5-10% on their shares and will continue to hoard workers to meet nominal demand instead of doing preemptive job cutting.**
- **Financial institutions that matter will remain able to create credit.**

But wealth will suffer. Portfolios that have been aggressively levered up will be forced to delever and asset portfolios will no longer be a source of confidence or fuel consumption. That will eventually kick one leg out from under the two-legged beast called the American consumer.

"The only way to kill inflation" a play in five acts.

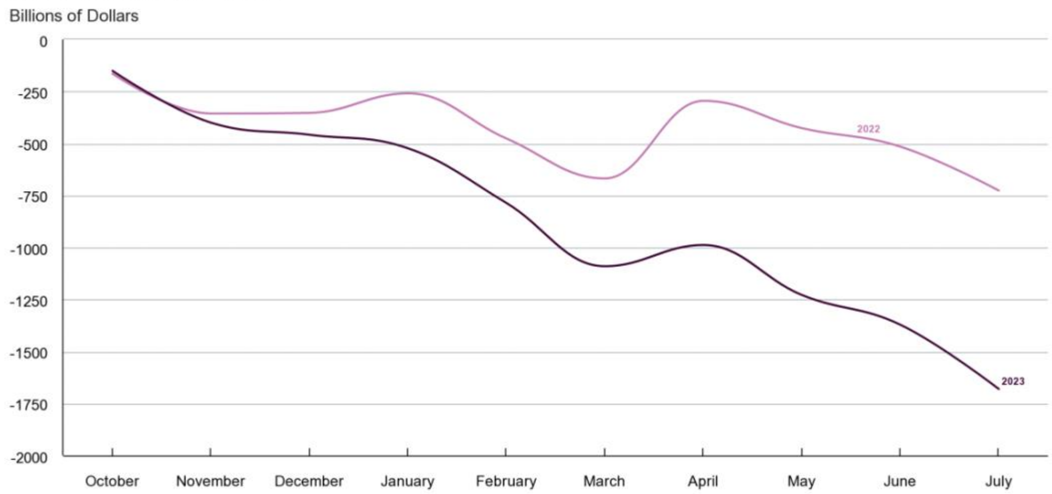
Act 1.	**Higherer for Longerer Island - Hikes continue and don't achieve goal.**
Act 2.	**Long end yields rise to new highs – supply catalyst has been delivered.**
Act 3.	**Multiple compression – Higher yields take the legs out of the equity market.**
Act 4.	**Earnings contraction – The tightening of Act 2 and Act 3 hit demand.**
Act 5.	**Recession Island – Finally. as equities sell off, companies fire workers.**

The Quarterly Refunding Announcement surprises the market.

In our last report we focused on the quarterly refunding announcement as a possible catalyst for Act 2 to begin. We suspected that due to the large future funding needs of the Treasury and the already high amount of bills outstanding that the issuance would be both large and would significantly increase the duration issuance. Our estimate for Q4 was a financing need of 600BN and duration increase from 178BN in Q3 to 275BN in Q4. We were, by far, higher than any other sell side or buy side published figures. Turned out we were way low. Not only was the total issuance 852BN, but duration issuance for Q4 was increased to 338BN. That is 160BN more coupon treasury issuance than this quarter. That increase is essentially the size of a whole quarter of QT. In addition, the financing needs for Q3 2023 jumped by 234BN to 1TN in one quarter, which highlighted the bigger issue going forward, the deficit is rising. Expenditures have risen mostly due to higher debt service costs and higher inflation indexed expenditures and the tax receipts estimates have not kept up and have begun falling.

The Congressional Budget Office followed up with a report increasing the projected fiscal deficit to 1.6TN. 2024 deficits will not show much improvement despite the debt ceiling resolution spending constraints.

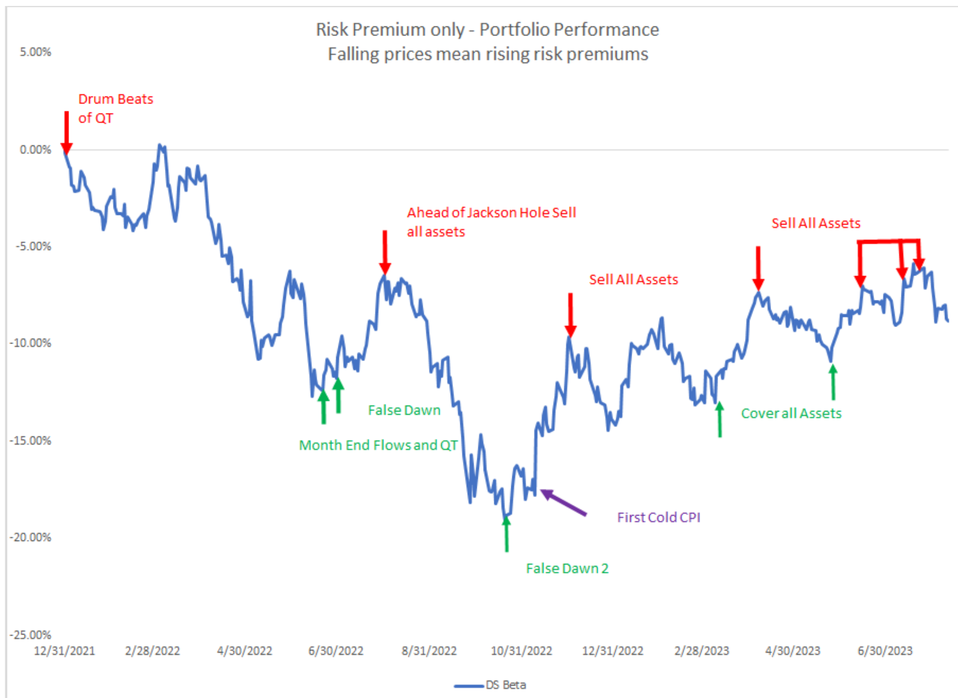
Figure 1.
Cumulative Monthly Deficits
Fiscal Years 2022 and 2023



Data Sources: Congressional Budget Office; Department of the Treasury.
The value shown for July 2023 is CBO's estimate.
Values for all months have been adjusted to exclude the effects of timing shifts.

The picture for 2024 private sector issuance will likely require 400BN of deficit funding and 180BN of QT making for a run rate supply of US Bills and Bonds of close to 580BN. At the end of 2023 the Treasury will have over 22% of its outstanding obligations in bills which is well over its guidelines. Just to keep that fraction steady at the lofty 22% level, coupon issuance will need to run at 450BN per quarter up an additional 120BN vs Q4's sizable issuance. **Negative risk premiums will simply not survive this onslaught of issuance. Assets will underperform cash.**

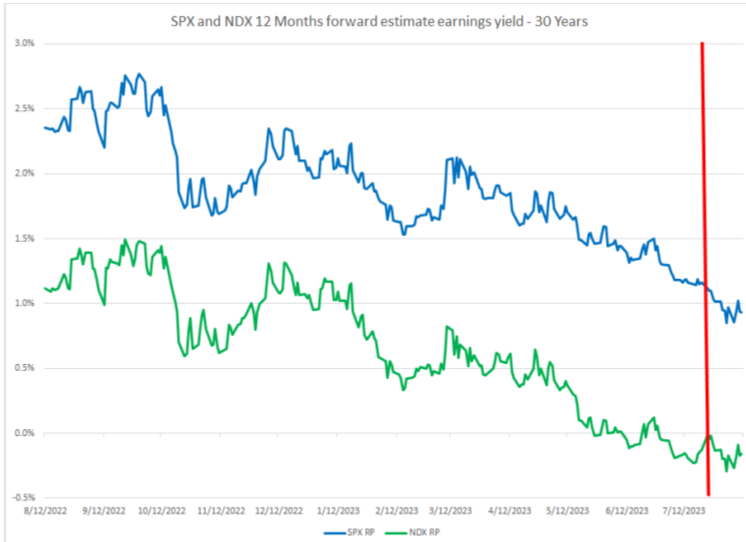
Because of negative risk premiums in bonds and tight risk premiums in all other assets we have been aggressively shorting all assets. The catalyst of the QRA began to generate a modest deleveraging out of assets led primarily by a selloff in long term bonds. This is simply frontrunning of the supply to come as over levered long only portfolios begin to accept the fact that expected returns over cash are slim. As supply comes to market the selloff may intensify. Frontrunning is Scene 1 of Act 2. Throughout Acts 2 and 3 risk premiums will expand in general, first in act 2 in the long-term bond market, and then in Act 3 in equities. While the play metaphor is useful to understand the sequencing it should be noted that Act 2 and Act 3 will overlap in timing performing on side-by-side stages. Action in bonds will lead and then action on the equity stage will dominate the performance and that will swing back and forth through time driven by the other winds of growth expectations and inflation expectations. But the strongest headwind will remain supply, driving risk premiums wider.



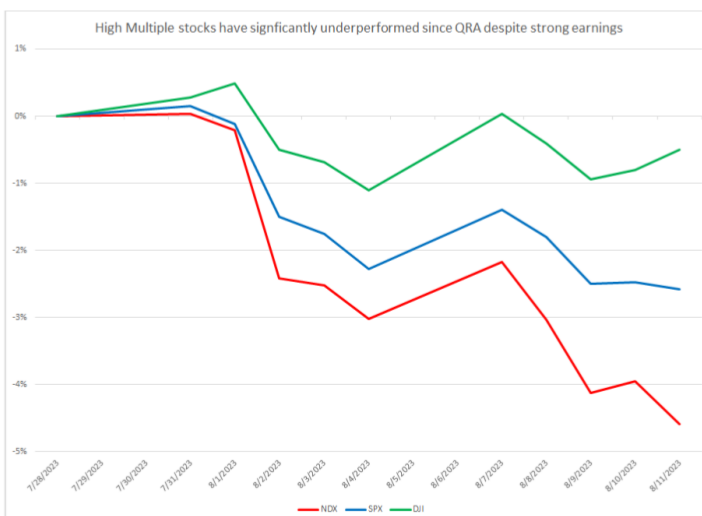
The bond market leads Act 2

The big catalyst for Scene 1 of Act 2 to begin was issuance of US Treasuries. The obvious response was for US Treasury yields to rise. Term premiums have trended higher but remain deeply negative since the QRA.

The less obvious response is for other assets to fall. Scene 1 is about Treasuries. The rise in Treasury yields without a significant fall in equity earnings or prices has ironically caused equity risk premiums to contract modestly and make new lows.



Equity markets are still quite exuberant for good reason. The Q2 earnings were strong as was forward guidance for SPX in aggregate. GDP remains strong, margin pressures have yet to hit as passing through wage costs has been possible in many industries. It is difficult for the equity market to respond quickly to events in the bond market while the earnings picture remains solid. However, the strength in the equity market can be broken down by sensitivity to risk premiums. Those equities with the highest multiples are the most exposed to risk premiums and they have significantly underperformed since QRA despite simultaneously announcing earnings and earnings guidance beats. QRA is modestly impacting stocks. But as mentioned Act 3 where equity risk premiums expand is likely to begin at any time.

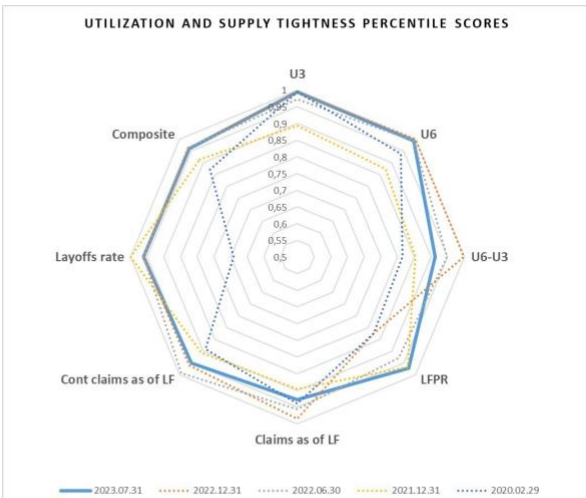


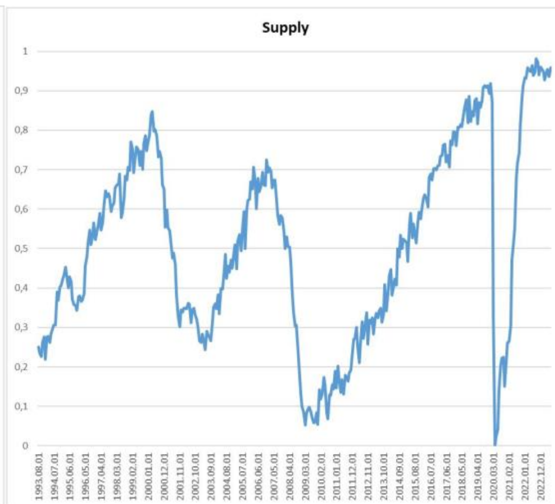
Bonds underperformed cash and stocks in Scene 1. They will likely continue to underperform cash for the entire Act but every once in a while, equities will take the stage.

The labor market is tight.

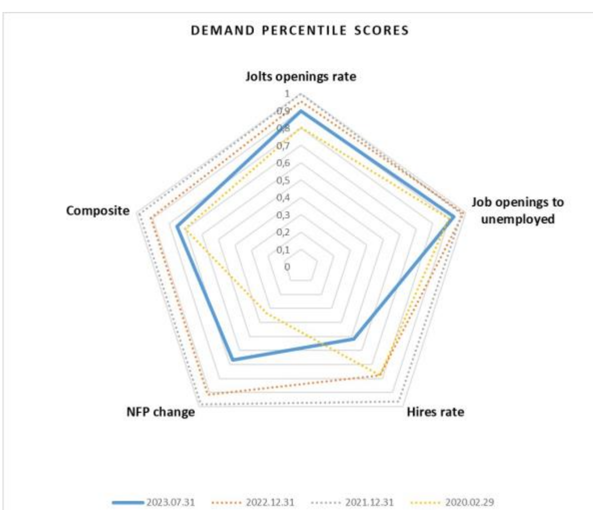
Equities will continue to be supported by the strong economy. In this section guest writer @danielsimonyi (follow him on twitter) puts together some interesting charts on the labor market today and how the script results in a lag of employment losses. The value in observing the strong labor market supports the sequencing of "The Script" and suggests a recession remains far off. Bonds won't like this section.

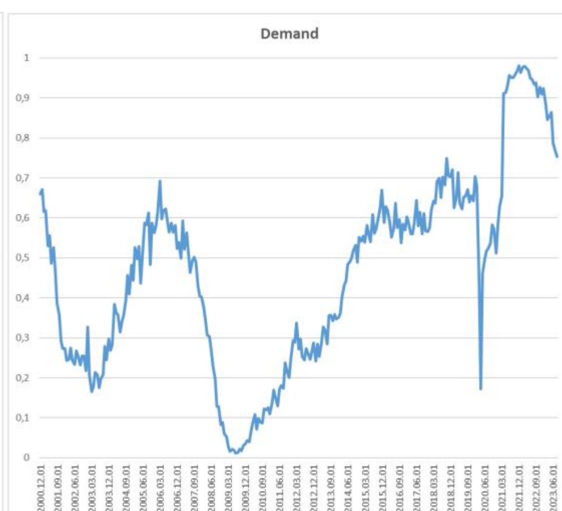
Labor market supply characteristics reveal significant limitations compared to historical patterns. The U3 unemployment rate is very tight, indicating a scarcity of available labor. Additionally, the U6-U3 spread, which measures labor market slack, reinforces this trend. Add to this the elevated prime age LFPR and the longer-term labor force growth reveals natural constraints going forward. In summary, these supply factors collectively suggest that the labor market is naturally constrained in its potential for growth.



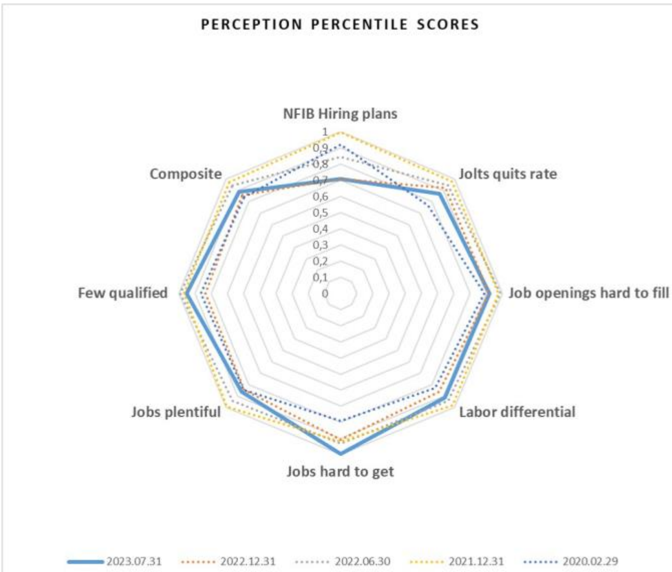


The demand side appears slightly weaker compared to post covid but still pretty strong compared to prior cycles, yet the robust nominal growth and continued strong demand are poised to support NFP, primarily driven by the expansion of lower and mid-wage service sector employment.

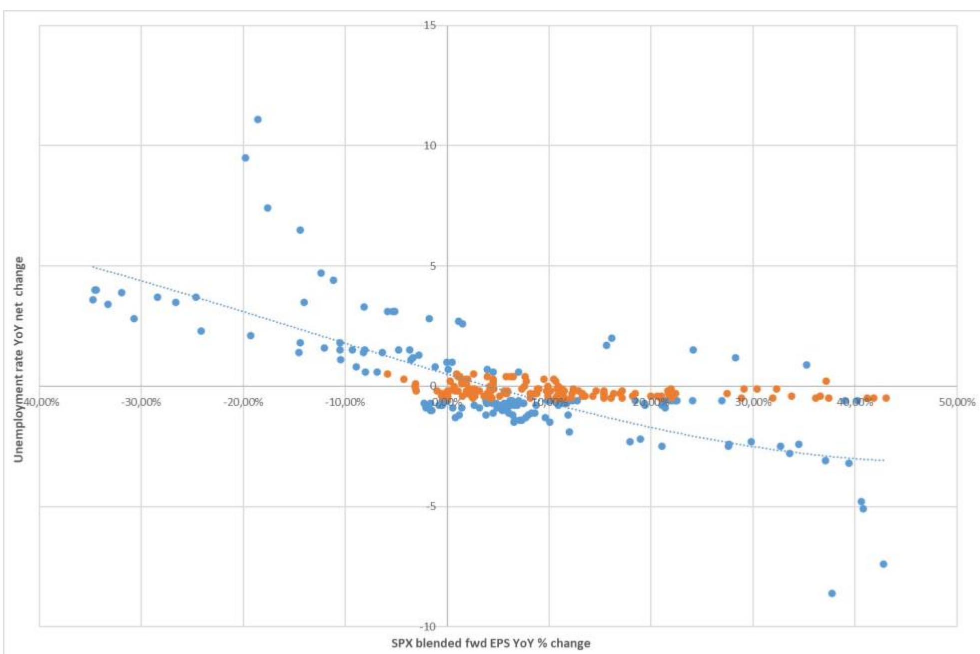




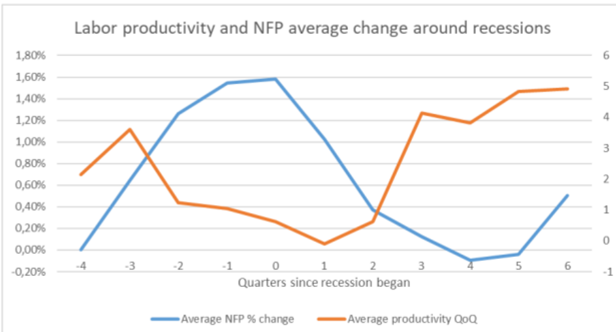
The available perception and sentiment data indicates a robust positive outlook among workers and employees which leads us to anticipate a sustained elevated quits rate and significant bargaining power. Consequently, we expect upward pressure on wages on a composition adjusted basis. The concept of composition adjusted AHE is important, as it helps mitigate potential distortions within the overall AHE calculation, such as those stemming from overtime and variations in hours worked across industries with differing wage levels. This consideration gains particular significance in the present context, where prevailing conditions align with a notable increase in the presence of relatively lower-wage employees.

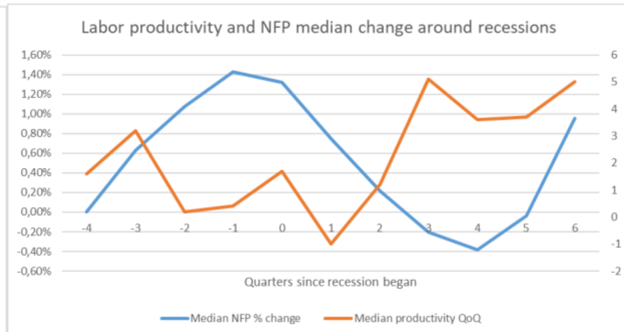


This chart below holds significant importance, revealing a noteworthy pattern: firms tend to refrain from employee layoffs until a substantial decline in corporate earnings and profits becomes evident. This is the point of the sequencing described in the script. Blue dots are when UR changes by more than 50bp YoY.



We can get further confirmation when examining labor productivity and NFP trends during periods of recessions. There is a pattern that firms retain excess workers in the early phase of a recessions. This could be explained by the anticipation of fast and mild recessions. However, as the recession deepens and the reality of declining earnings materializes, businesses tend to adjust their workforce by firing. This, dynamic, underscores the interplay between economic sentiment, corporate decision-making, and the evolving labor landscape during times of economic turbulence.





Potential further supply catalysts

In our script, we focused on the QRA as the most likely supply catalyst for risk premium expansion and Janet delivered. However, we are still watching for.

- Currency weakness and fiscal and monetary stimulus in China and Japan which will unleash additional UST supply.
- Regulatory or market pressures on US Banks burdened with duration exposures.
- Any shift in Fed QT Plans

We are adding the deleveraging/portfolio insurance flows, that we have discussed in past DSR’s, as long only and vol targeting funds have significantly levered up over the past 6 months.

Synthesis

As interest rates rise due to overwhelming supply and yet the economy stays warm, we expect a bear steepening with

- 2023 SOFR in a tight range
- Cuts in 2024 taken out.
- Substantial pressure on the rest of the curve.

Other assets will follow.

- As bonds cheapen other assets will be dragged down as well. We expect that path to be a bumpy but in a clear direction.
- Equities have richened since the bond selloff and are due for some catch up.
- Gold is vulnerable.
- However, commodities which have the least exposure to risk premiums and are sensitive to growth should continue to do well.

Current Portfolio and Performance

Performance has been very strong since the last Damped Spring Report which predicted a severe response to the QRA. The portfolio gained 7.33% in three weeks. Risk has been reduced as profits have been taken.

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 54,845,523		
Total Return	54.85%	YTD Return in excess of cash	9.55%
Today's Date	8/13/2023	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	0.5	$ (761,905)	Open
5/25/2023	NDX August 13000 Put	250.00	60	$ 1,500,000	1	$ (1,494,000)	Open
6/9/2023	SPX August 4185 Put	48.00	250	$ -	1	$ (1,175,000)	Open
6/9/2023	SPX Call Spread August 4320/4400	48.00	-250	$ 2,000,000	74	$ (650,000)	Open
7/31/2023	SPX 9/29/2023 4300 Put	24.00	417	$ 1,000,000	45	$ 875,000	Open
8/2/2023	NDX 10/20/23 Expiry 14500 Put	245.00	40	$ 1,000,000	276	$ 124,000	Open
8/4/2023	NDX 10/20/23 Expiry 14500 Put	228.00	44	$ 1,000,000	276	$ 210,526	Open
8/4/2023	SPX 9/29/2023 4300 Put	35.00	286	$ 1,000,000	45	$ 285,714	Open
7/5/2023	ZFU 106.5/105.5	0.359375	2783	$ 1,000,141	0.50	$ 391,359	Open
2/1/2023	SFRZ4 ShortTwos and Spoos	97.085	-1600	$ 600,000	95.85	$ 4,940,000	Open
7/26/2023	SFRZ4 ShortTwos and Spoos (partial unwind)	95.855	1000	$ (4,340,000)	95.85	$ (12,500)	Open
7/31/2023	ZBZ 9/22/2023 120 Put	0.703125	1422	$ 1,000,000	1.63	$ 1,311,111	Open
8/2/2023	ZBZ 9/22/2023 120 Put	1.0625	941	$ 1,000,000	1.63	$ 529,412	Open
8/2/2023	ZBZ 9/22/2023 116 Put	0.984375	-2363	$ (2,326,471)	0.63	$ 849,346	Open
8/2/2023	ZNZ 9/22/2023 110/107 Put Spread	0.587301587	1703	$ 1,000,000	0.58	$ (15,625)	Open
5/17/2023	AAPL 160/175 Call Spread	9.8	-192	$ 100,000	14.2	$ (84,615)	Open
5/17/2023	AMZN 105/115 Call Spread	6.42	-279	$ 100,000	10.28	$ (107,821)	Open
5/17/2023	GOOG 110/120 Call Spread	6.57	-292	$ 100,000	10	$ (100,000)	Open
5/17/2023	META 230/245 Call Spread	8.4	-152	$ 100,000	13.49	$ (77,121)	Open
5/17/2023	MSFT 300/315 Call Spread	9.47	-181	$ 100,000	14.06	$ (83,002)	Open
5/17/2023	NVDA 280/300 Call Spread	11	-111	$ 100,000	19	$ (88,889)	Open
6/15/2023	DS Beta Short Component GLD	182.52	-16495		177.6	$ 81,212	Open
6/15/2023	DS Beta Short Component GSG	20.26	-151863		21.56	$ (196,677)	Open
6/15/2023	DS Beta Short Component SPY	449.01	-16925	$ 1,200,000	445.65	$ 56,868	Open
6/15/2023	DS Beta Short Component TIP	107.68	-69506		105.79	$ 131,481	Open
6/15/2023	DS Beta Short Component TLT	102.38	-87527		95.37	$ 613,129	Open