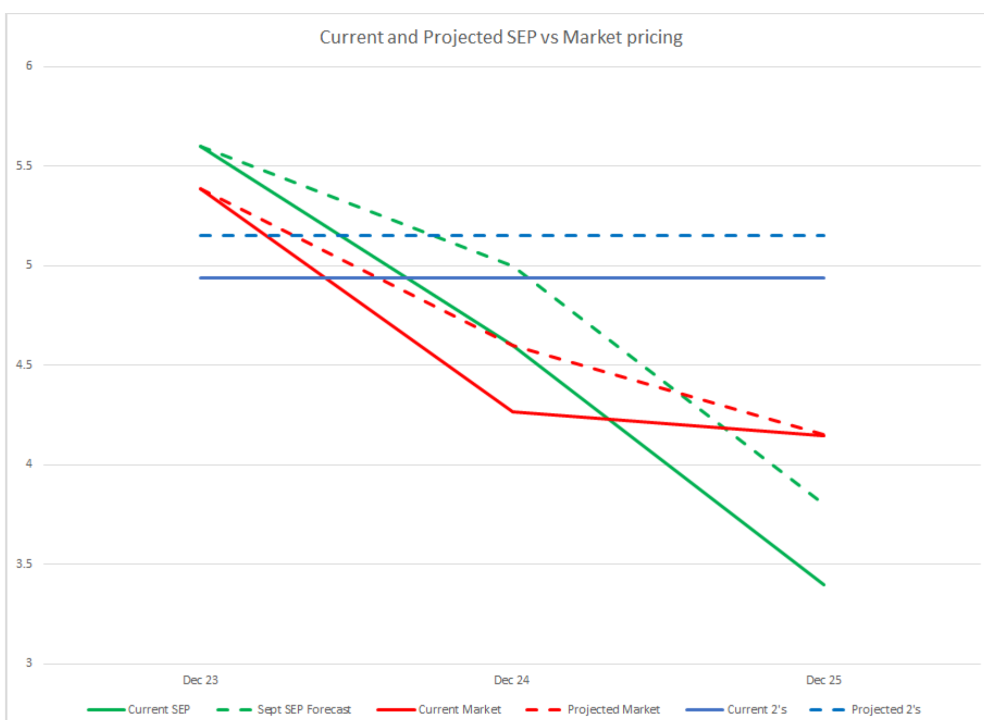
The Damped Spring Report

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

08/20/2023

As Powell's speech at the Jackson Hole Symposium approaches it makes sense to think about the levers that the Fed can pull and what direction the Fed will likely direct the market towards over the next four weeks. The Fed really has a single lever left. We call it "The two's step" The most likely outcome that combines the Symposiums agenda, the Powell Speech and the redrawing of the SEP dot plots announced on Sept 20th will be a step up in the pricing of two-year yields driven by a reduction in rate cuts priced into 2024.

Stepping back and examining the Fed's posture and its levers, it seems clear that unless inflation reaccelerates the fed funds is within 25bp of peak. The Fed has been unwilling to begin outright sales of its SOMA portfolio or increase runoff. The Treasury issuance may have put the teeth back into QT decreasing the need for Fed QT Tweak for now. The only nail left to hammer is rate cuts in the future. We expect two's to be the target of the next month of Fed guidance. The impact of this guidance will be a 20bp increase in two's yields.



Jackson Hole and the September FOMC Meeting

The Jackson Hole Symposium is titled “Structural Shifts in the Global Economy” The details of the agenda for the conference have not yet been released but it seems clear that the topics will likely be wonky and focused on r*/neutral rates of interest in the post Covid environment. Jay’s speech will be at 10:05 on Friday. We see a variety of possibilities for the speech which will be almost certainly carried through to the FOMC meeting in September and influence the new Summary of Economic Projections. Of course, data including PCE, NFP, Claims, and CPI/PPI could impact policymakers between Jackson Hole and FOMC, but our expectations is that data will not be conclusive for Fed officials.

Here are the possibilities we see from dovish to hawkish.

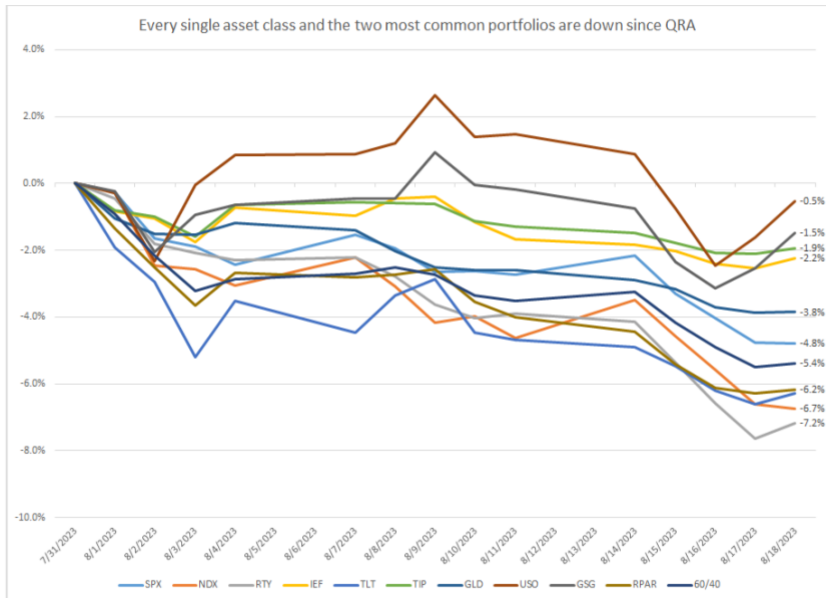
- Victory over inflation, Terminal rate reached. No change to cuts in SEP in 2024 and 2025 – Very unlikely but possible and priced by markets somewhat.
- Almost there and data dependent and no change in cuts in SEP in 2024 and 2025 – Possible, heavily priced by markets and reflects the views of the most dovish on the committee.
- **Almost there and data dependent BUT significant reduction in cuts in SEP for 2024 – This our expectation for the 4-week period starting with the speech and ending with the SEP.**
- Not there. More hikes and longer pause. Extremely unlikely and no one is positioned for this outcome.

We expect a hawkish Jackson Hole speech as described above but do not expect the speech to be anything like last year’s speech and will respect the wonky agenda and be more theoretical. Perhaps he will be short and sweet but given the uncertainty that seems unlikely. The message will be the pause will be very long due to the potential for a higher r* and for good risk management principals. The FOMC and the SEP will follow that guidance. If the SEP delivers as such it’s hard to think that two’s will be able to trade with yields below 5%. Downward pressure on the SFRM4 through SFRH5 will be strong. We will be looking for appropriate ways to express our view as the week progresses.

Where we are in “The Script”

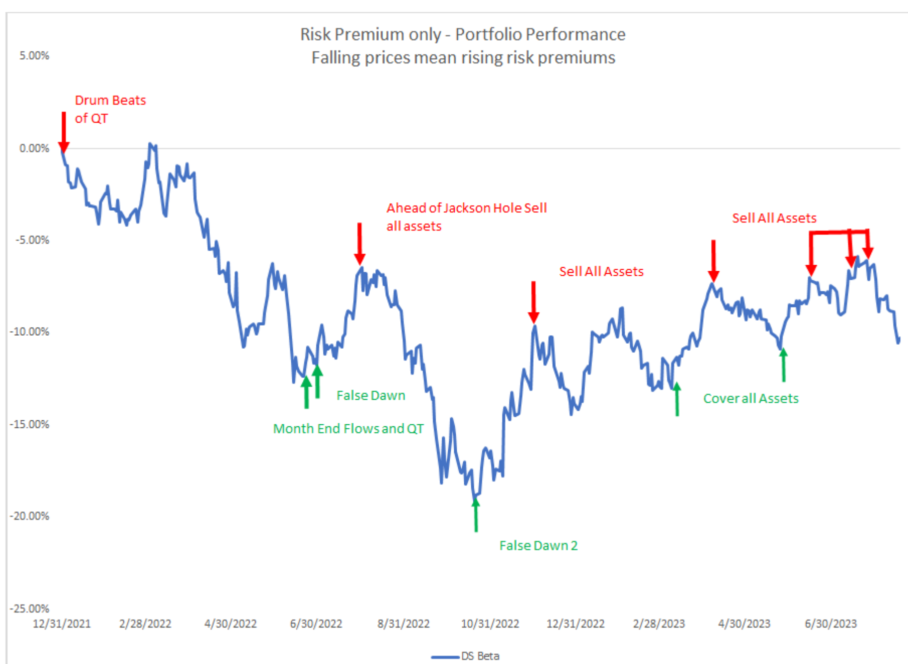
The Jackson Hole Speech and the September FOMC will be the shiny objects that garner the news media’s attention but Act 2 and Act 3 of the script should continue to be the dominant force on asset markets. Act 2 which is Fixed income supply driven expansion of risk premiums and Act 3 which is broader catch up of risk premium expansion on assets of all sorts particularly equities should drive all assets lower over the rest of the year. Since the quarterly refunding announcement,

- 10-year bond yields have risen 30bp.
- 30-year bond yields have risen 40bp.
- SPX has fallen close to 5%.
- NDX has fallen over 6%.
- Notably all forms of assets have fallen.



The Damped Spring Risk Premium driver has clearly been the only thing that could have hit all assets in such a way. Our DS Beta portfolio which we shorted a few weeks ago has collapsed. It is designed to have no exposure to changes in inflation or growth expectations and thus is a pure measure of risk premium changes. Those changes are driven by two factors which are and will continue to be in play for the balance of the year.

- The amount of money and credit available to own financial assets vs the supply of financial assets (this has been the immediate driver since the QRA)
- The expected portfolio risk of holding assets vs cash. As asset markets become more volatile and correlations across assets increase and become positive this will exacerbate asset weakness as deleveraging pressures grow.

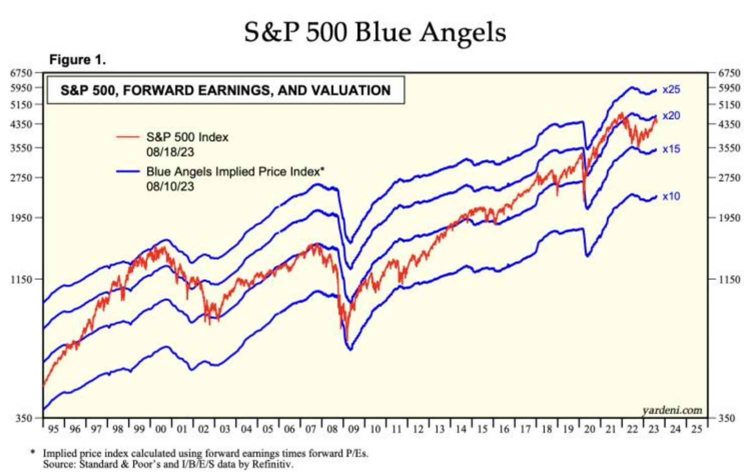


[What does the end of Act's 2 and 3 look like for assets.]()

Our thoughts on the impact of the two risk premium expansion Acts are for risk premiums to expand by 40-60 bp. Some has already occurred. Another 25-45 is likely.

That would take yields to **4.5-4.7** and perhaps run in to some technical resistance.

The expansion of bond term premium and the Act 3 catchup on equity risk premiums would most likely support a multiple of about 16. Given earnings expectations don't change until Act 4 that implies an **SPX level of 3800.**



Supply Catalysts loom

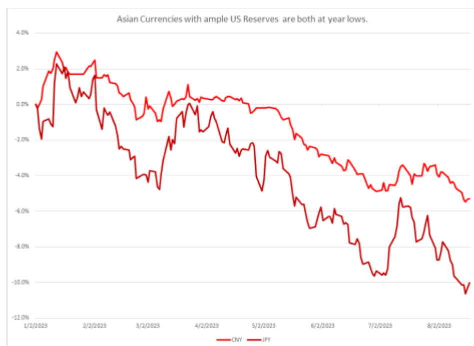
In our script we mentioned catalysts for a supply driven selloff.

The potential supply catalysts that will generate a more permanent expansion of term premium and transmit to other asset risk premiums will have to come from major non investor flows.

- More quantitative tightening including outright sales by the Fed.
- Defensive moves by China and Japan to stem currency weakness.
- Regulatory requirements on banks forcing a deleveraging of duration exposures.
- **A shift from bills to bond issuance by the Treasury**

Clearly our highlighted catalyst occurred. More QT is unlikely for now, but the other two potential catalyst are developing stories.

China and Japan may need to sell long term US Treasuries to fund purchases of their local currencies. The maturities held by these reserve managers are by and large medium term in nature and would put pressure on 5-year yields. Potential currency support may generate 50-250BN in duration sales.



US Banks may be forced to deleverage their liability structure by replacing short term borrowings with long term debt which would force the private sector into more long-term assets.

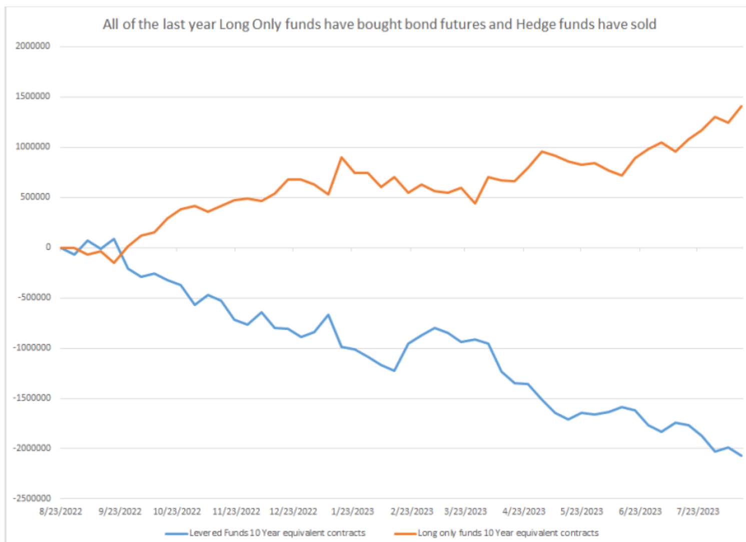
> The Federal Deposit Insurance Corp., the Federal Reserve and the Office of the Comptroller of the Currency are preparing a proposal that would require banks with at least $100 billion in assets to issue enough long-term debt to absorb losses if regulators were forced to seize the institution. 4 days ago

This recent regulatory proposal if enacted could generate a 10% shift of non-deposit liabilities from short term to long term or roughly 340BN of 10 year or longer supply.

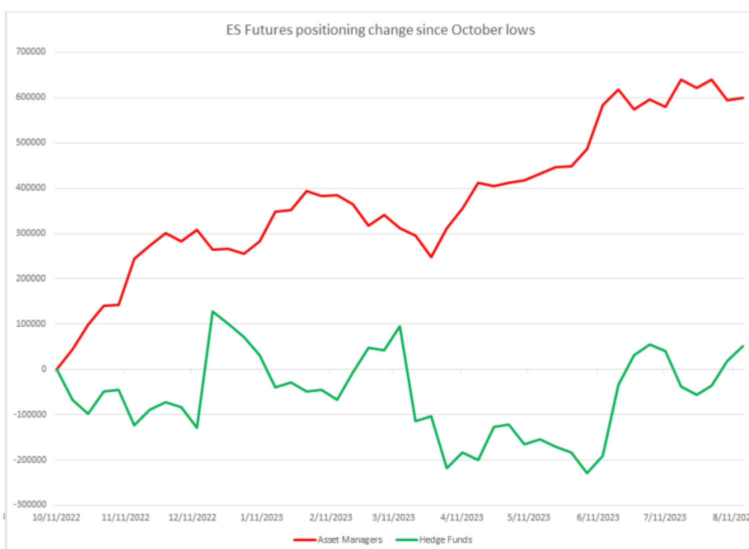
Deleveraging of long only and vol targeting funds has yet to begin.

A combination of low asset volatility, high diversification benefit and benevolent asset supply dynamics since the lows for assets in early October, has led to an extended "False Dawn" for assets. This dynamic has caused long only asset managers to chase returns and leverage up. Extremely low levels of portfolio risk were forecasted for most of the last quarter and asset returns had been strong. We believe that long only asset managers are now significantly over leveraged and have not yet begun to unwind this exposure.

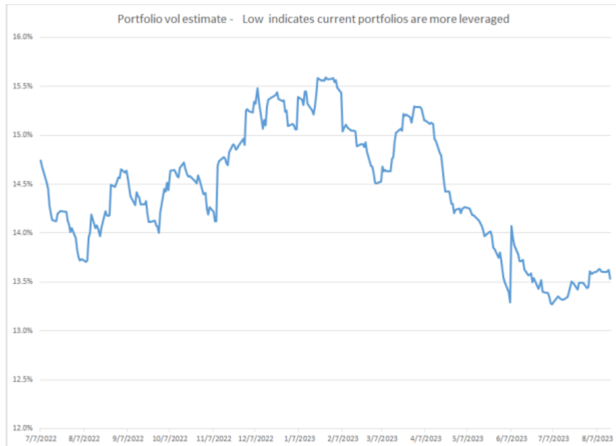
Fixed income exposures have dramatically increased while hedge fund shorts are most likely hedging long positions in cash bonds, mortgages, corporates and other assets. This selloff in Fixed income has generated significant drawdown and pain for the overleveraged long and they have not yet begun to sell.



The picture for equities is perhaps even more dire as exposures have grown rapidly on the long side while hedge fund exposures have not changed.



Systematic volatility targeting funds and virtually any discretionary fund with a shadow volatility target has responded to the collapse in portfolio volatility and leveraged up. If portfolio volatility has bottomed further asset buying from leveraging up is unlikely and any rise in volatility will generate significant deleveraging flows.



Synthesis

This Damped Spring Report is about the shiny objects of Jackson Hole and the next FOMC meeting will transpire. We expect modestly hawkish events with pressure on the two-year sector of the yield curve. But in the background act 2 and act 3 supply generated risk premium expansion will drive all assets lower. Potential piling on to the duration supply problem could emerge from Asian reserve managers and US Banks. Perhaps more importantly portfolio deleveraging has yet to begin. We remain short bonds, stocks and all assets.

Current Portfolio and Performance

DS Alpha returns are now at YTD highs up 15.85%. We are looking to cover our short position in DS Beta. Based on this DSR we are also considering adding a short bet on two-year notes for the next 4 weeks expecting to unwind after the FOMC meeting.

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 61,147,575		
Total Return	61.15%	YTD Return in excess of cash	15.85%
Today's Date	8/19/2023	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	0.3	$ (857,143)	Open
8/18/2023	NDX 10/20/23 Expiry 13900 Put	249.20	-84	$ (2,000,000)	219	$ 253,680	Open
8/2/2023	NDX 10/20/23 Expiry 14500 Put	245.00	40	$ 1,000,000	370.6	$ 502,400	Open
8/4/2023	NDX 10/20/23 Expiry 14500 Put	228.00	44	$ 1,000,000	370.6	$ 625,439	Open
8/18/2023	SPX 9/29/2023 4075 Put	27.50	-703	$ (2,000,000)	23.1	$ 309,320	Open
7/31/2023	SPX 9/29/2023 4300 Put	24.00	417	$ 1,000,000	60.5	$ 1,520,833	Open
8/4/2023	SPX 9/29/2023 4300 Put	35.00	286	$ 1,000,000	60.5	$ 728,571	Open
8/2/2023	ZBZ 9/22/2023 116 Put	0.984375	-2363	$ (2,326,471)	0.86	$ 295,425	Open
7/31/2023	ZBZ 9/22/2023 120 Put	0.703125	1422	$ 1,000,000	2.31	$ 2,288,889	Open
8/2/2023	ZBZ 9/22/2023 120 Put	1.0625	941	$ 1,000,000	2.31	$ 1,176,471	Open
8/2/2023	ZNZ 9/22/2023 110/107 Put Spread	0.587301587	1703	$ 1,000,000	0.80	$ 356,841	Open
6/15/2023	DS Beta Short Component GLD	182.52	-16495		175.33	$ 118,656	Open
6/15/2023	DS Beta Short Component GSG	20.26	-151863		21.28	$ (154,156)	Open
6/15/2023	DS Beta Short Component SPY	449.01	-16925	$ 1,200,000	436.5	$ 211,732	Open
6/15/2023	DS Beta Short Component TIP	107.68	-69506		105.08	$ 180,830	Open
6/15/2023	DS Beta Short Component TLT	102.38	-87527		93.77	$ 753,173	Open
			Risk	3.474%		8.8%	