The Damped Spring Report

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

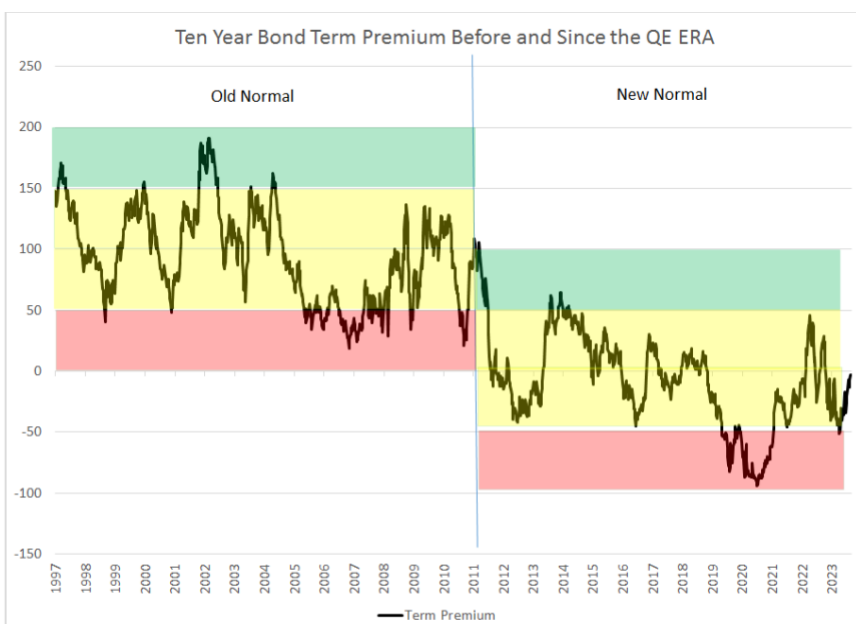
09/24/2023

"The Script", "Issuance – The Path to Normal" & "The Two's Step" were the summer trilogy of Damped Spring Reports which forecasted.

- **The mechanical steps necessary to bring inflation back to target.**
- **The supply catalyst that would start the second act of the script.**
- **The need for the Fed to do its part by pricing out the cuts in 2024.**

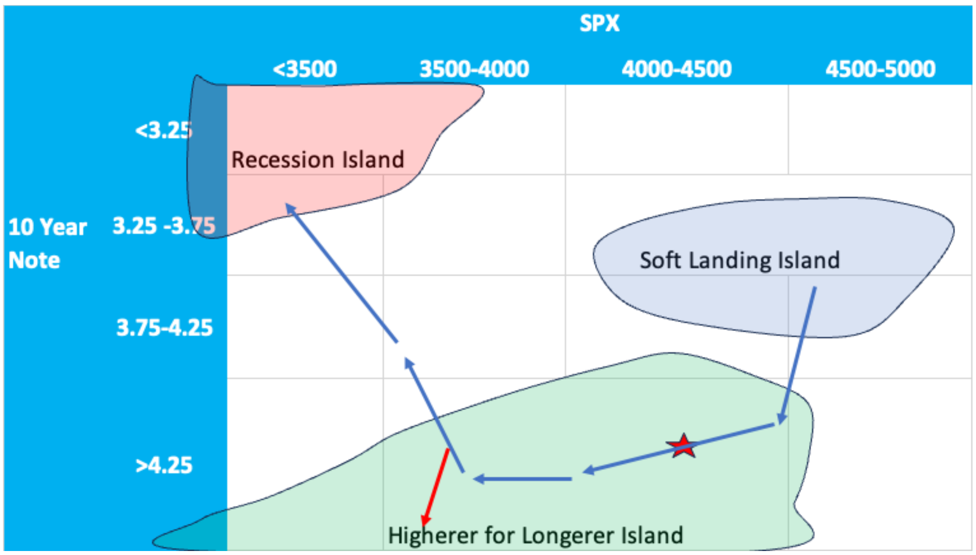
There has now been "Some Pain" as our most recent DSR predicted which we believe has just started for equities and is half complete for bonds. We remain confident in our short-term outlook for Act 2 of the script where higher bond yields due to supply driven risk premium expansion puts pressure on equities. Eventually bond risk premiums will normalize and at that time we expect equity risk premiums to follow causing equities to fall in Act 3.

While market forces will dominate "The Script" through Acts 2-4, when pain is felt in the real economy the response of policymakers will determine whether the economy remains in the New Normal Sea or returns to The Old Normal of higher forever interest rates and lower equity multiples. Basically, a place wherein risk premiums reward investment.



The Islands of New Normal Sea.

In February we described "The Islands" These islands are in the New Normal Sea. In the New Normal Sea, severe economic downturn results in rapid cuts in short term interest rates to zero but more importantly once at zero uses asset purchases to stimulate the market and to a lesser extent the economy. The use of QE is a powerful force to reduce asset risk premiums and since QE2 has kept risk premiums well below the pre GFC "Old Normal".



"The Script" first three acts operate assumes the Fed will continue to behave in the way that they have behaved since 2008. We believe that markets are now running along the second blue arrow above in Act 2. Equities down yields up. But somewhere along act 4 we expect a crossroads event for markets. Faced with signs of imminent weakening employment and real GDP the market will begin to front run the Fed's rate cutting aggressively. **What the Fed and Fiscal policymakers do will potentially cause a radical detour from the playbook.** We are exploring the possibility that the age of ZIRP and QE to offset economic weakness is over. In our diagram above perhaps Higherer for Longerer Island isn't an island at all but is just the coastline of the "Old Normal" Continent where QE doesn't exist, and term premiums return to normal resulting in higher forever interest rates and lower equity valuations. We assume markets will respond to weakening economic results according to the blue pathway. Old habits will be extremely hard to break. However, other possibilities also exist.

- Despite the mechanics of the script playing out the economy remains strong
- The economy weakens but the Fed turns it back on ZIRP and QE and keeps rates elevated and continues to reduce its balance sheet.
- Fiscal policymakers act in a variety of ways to deal with increasing deficits and weakening economy.

If the economy remains strong that will result in further Fed action on both the rates lever and potentially QT. Both of those will look like Higher Forever rates and an Old Normal level of Term Premium

If the economy weakens as expected the Fed will either endorse the New Normal Policies of ZIRP and QE or reject them. We expect the Fed to reject them, but markets have and will fight that idea aggressively. Turbulence in Act 4 will be huge. Clearly the fiscal response is unpredictable. Rising deficits on weakening revenues could result in

- Austerity with higher taxes or spending cuts.
- The opposite, expanding the deficit even more and resulting in inflation and risk premium expansion.
- A year ago, we discussed the 3D's of Deglobalization. We think economic weakness will almost certainly result in the cyclical force of the 3D's to turn secular.

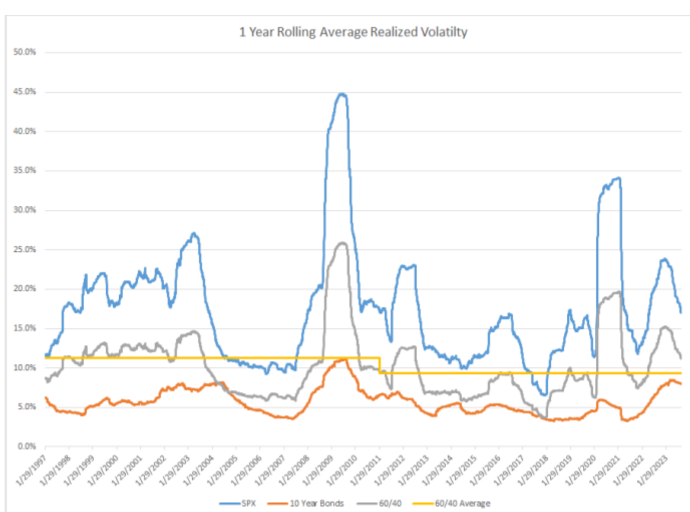
So what? We are committed to our script until economic pain is felt. If pain is somehow never felt, higher bond yields and lower stock prices will occur anyway as the Fed is forced to act even more strongly. If pain is felt, we expect the market to assume that the New Normal playbook will occur. For many reasons this assumption may be a poor one. As we see pain occur, we will be focusing on the policymaker's signals and actions to understand whether we remain in the New Normal where long term bonds are buyable, or we return to the Old Normal where they are not.

What is the difference between the New Normal and Old?

We delineate the New and Old Normal in a narrow and specific way. The Old normal has risk premiums that are driven by purely market forces. The New Normal has distorted risk premiums that are driven by QE and now slowly moving QT.

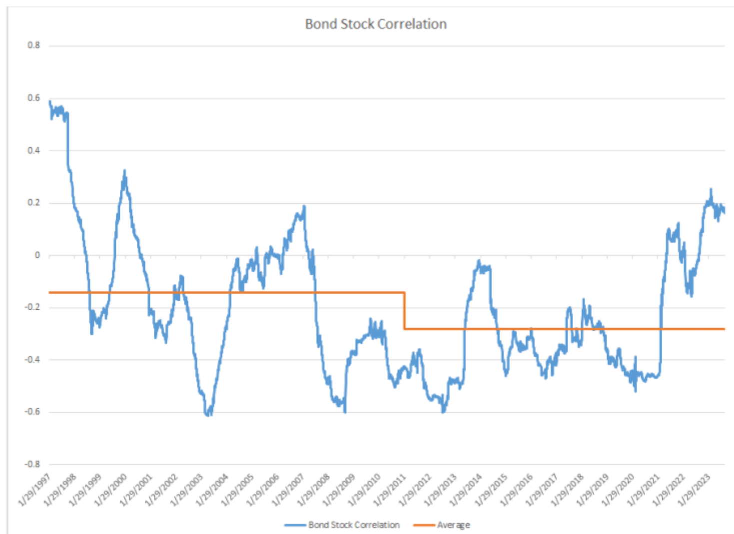
Risk Premium is the excess return long term asset buyers expect over holding cash for assuming risk. Our framework breaks that return into two principal drivers

- Portfolio Risk
- Money and Credit available to purchase assets vs supply of assets.

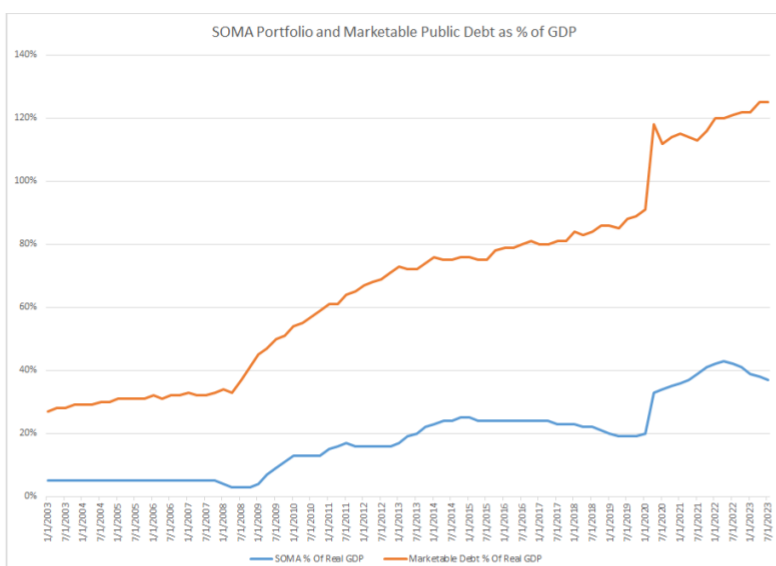


Our framework for Portfolio risk does not see much difference between the New and Old Normal. Individual asset volatility is similar in both regimes, portfolio risk is 20% lower. If this lower risk was sustained that would support a 20% lower excess return for assets to generate the same risk adjusted return which would still drive a risk premium much higher than current levels.

The driver of the lower portfolio risk has been better portfolio diversification when holding a bond stock portfolio. But that diversification benefit has failed miserably over the past two years and may drive expectations of portfolio risk back to Old Normal levels and require Old Normal levels of risk premium.



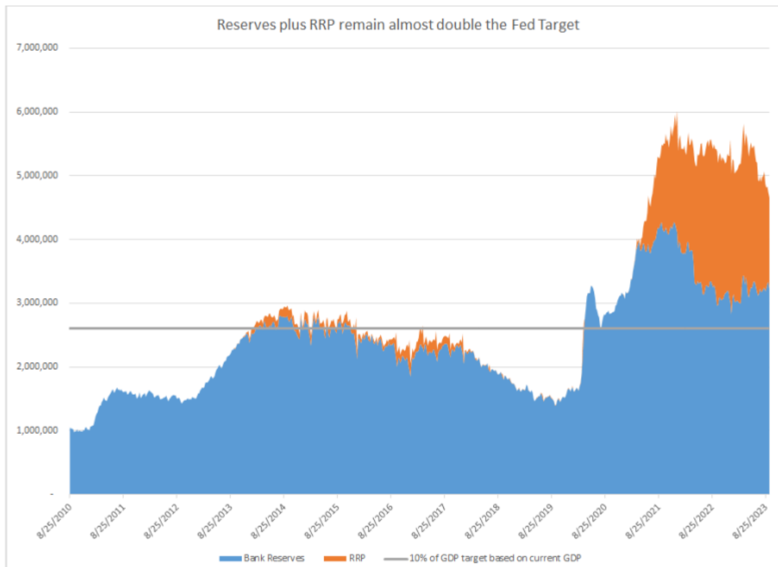
The elephant in the room that has caused the New Normal is QE and a massive increase in fiscal deficit. We believe that the step function for risk premiums came with the implementation of QE2 and the step function for inflation came during covid from fiscal spending.



The combination of QE since 2010 and the Post Covid QE financed fiscal deficit have had two principal financial impacts.

- Asset prices have remained buoyant from Fed buying.
- Reserves have skyrocketed creating an ample reserve regime.

QT is progressing slowly and is working on both asset prices, when and if the Treasury finances the QT with duration issuance, and reducing reserve balances. But as can be seen by the first chart in the report term premiums have only expanded back to zero and in the chart below Reserves plus RRP have only fallen modestly and remain well above target.



In this environment of ample reserves and slow runoff it seems unlikely that term premiums will rapidly return to the Old Normal. Turbulence in the later part of the script is likely.

What is a fair risk premium?

Let's get into the math of risk premiums to better understand the radical difference between the New Normal and the Old. When looking at choosing between assets and cash we need to start with the idea that any asset prices the expected outcome of growth and inflation properly. Meaning that whether we buy bonds which respond to falling growth or stocks which respond to rising growth we must expect that both investments price the same probability of outcomes. Clearly, they may not but that's a different topic. Assuming the future economic outcome is the same then any asset can be judged based on its expected excess return over cash. Over the past 100 years the expected excess return of an asset has been a Sharpe ratio of 0.25. How does that translate into risk premium. If the asset has a 6% expected volatility the expected excess return would be 150bp. If it has a 12% volatility the excess return is 300bp. When looking at the average 10-year term premium in the past this 25bp Sharpe Ratio was about right. Today, the expected risk adjusted return in excess of cash is **negative**.

Destination for asset prices

"The Script" is still in Act 2. Even if we never return to the Old Normal where the level of risk premiums compensate investors adequately, risk premiums are going to rise. QT will pull reserves and RRP from the system. **Treasury has shifted it issuance to notes and bonds from bills. Over time they will continue to issue more duration, even if deficits stabilize and QT runs its course, as the Treasury has already used up its bills issuance quotas. The pressure is on for them to refinance some of this bills issuance. Duration is for sale.**

But risk premiums are unlikely to go back to Old Normal levels once this correction occurs. Markets adjust to supply. We expect bond term premium to stall at positive 50bps. That is the low level of the Old Normal and the High level of the New Normal. We will then be at the crossroads and policymakers will determine which reality we will operate in going forward.

Synthesis

2024 will be a year of turbulence. QT and duration issuance will be a strong headwind for all assets. Fiscal deficits and the ample reserves regime will provide ongoing support to the economy. Cyclical spending for Deglobalization may become secular. Eventually "The Script" will play out hitting demand and increasing the unemployment rate. At that point the crossroads will be upon us. Policy makers choices will determine which path we take. Bond prices will depend on those choices.

Current Portfolio and Performance

DS Alpha had its best week in its five-year history and is on track for its best year. This week the portfolio made 8.84% and is up 22.04% YTD.

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 67,335,587		
Total Return	67.34%	YTD Return in excess of cash	22.04%
Today's Date	9/24/2023	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	1.22	$ (419,048)	Open
9/8/2023	DAX 11/17/23 15500/16000 Call Spread	301.00	-503	$ 500,000	265	$ 90,452	Open
9/7/2023	NDX 10/20/23 Expiry 13900 Put	82.00	-84	$ (2,000,000)	91	$ (75,600)	Open
8/2/2023	NDX 10/20/23 Expiry 14500 Put	245.00	40	$ 1,000,000	221	$ (96,000)	Open
8/4/2023	NDX 10/20/23 Expiry 14500 Put	228.00	44	$ 1,000,000	221	$ (30,702)	Open
8/24/2023	NDX 10/20/23 Expiry 14500/13900 Put Spread	95.00	53	$ 500,000	130	$ 184,211	Open
9/22/2023	SPX 10/20/23 4200 Put	28.58	700	$ 2,000,000	30.5	$ 134,360	Open
8/29/2023	SPX 9/29/2023 4075 Put Unwind	6.00	188	$ 500,000	2.75	$ (61,100)	Open
7/31/2023	SPX 9/29/2023 4300 Put	24.00	417	$ 1,000,000	27	$ 125,000	Open
8/4/2023	SPX 9/29/2023 4300 Put	35.00	286	$ 1,000,000	27	$ (228,571)	Open
8/23/2023	SPX 9/29/2023 4300/4075 Put Spread	26.60	188	$ 500,000	24.25	$ (44,173)	Open
9/8/2023	RXZ3 11/17/2023 132 137 Call Spread	1.17	427	$ 500,000	0.53	$ (273,504)	Open
9/15/2023	ZBZ 10/27/2023 115Put	0.63	-2363	$ (1,476,875)	0.98	$ (849,203)	Open
9/7/2023	ZBZ 10/27/2023 118 Put	1.58	2363	$ 3,729,109	2.22	$ 1,513,797	Open
9/15/2023	ZNZ 10/27/2023 107 Put	0.20	-3009	$ (611,203)	0.31	$ (329,109)	Open
9/7/2023	ZNZ 10/27/2023 109 Put	0.77	3009	$ 2,303,766	1.00	$ 705,234	Open
9/21/2023	UNWIND Of ZVZ 10/27/2023 118/115 Put Spread	1.41	-591	$ (831,094)	1.24	$ 98,254	
			Risk	10.614%		11.1%	