The Damped Spring Report

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

09/11/2023

A year ago, at Jackson Hole Chair Powell said there would be pain. At the time Fed funds were 2.5%, 10-year bond yields were 3%, the S&P 500 was 4150, the unemployment rate was 3.7%, 5-year 5 year forward inflation expectations were 2.25% and Q3 GDP had just printed 2.5%.

Today after 300bp of hikes, 10-year yields are only up 125bp, the S&P 500 is up 7.5%, the unemployment rate, forward inflation expectations, and the GDP are all unchanged. Except for a few irresponsible banks there has been no macroeconomic pain at all. Hiking interest rates has done very little. We will see this week if short term inflation readings keep falling but it is very unlikely to us that the last year of Fed action has killed inflation.

Three things seem clear.

- **The economy is not responding to increased short term interest rates in the way it has in past cycles.**
- **The transmission mechanism that makes the Fed's short term interest rate work is broken and has implications for the future when easing may be required.**
- **The Fed's quantitative tightening lever has been disabled by the Treasury through July. But that has now changed.**

There will need to be some pain to kill inflation durably. We think that pain will follow the script we released in July and the script is in Act 2 now.

Asset valuations and inflation expectations remain far too optimistic. We also think that once the economic and market pain that kills inflation is felt, a completely new sort of persistent ache may replace the pain. The economy has failed to respond to hiking short term interest rates due to structural differences in the economy, that difference will cut both ways in a slowdown. After some sharp pain the economy may have chronic pain for a long time. We are not forecasting doom but are realistic.

In this DSR we will focus on

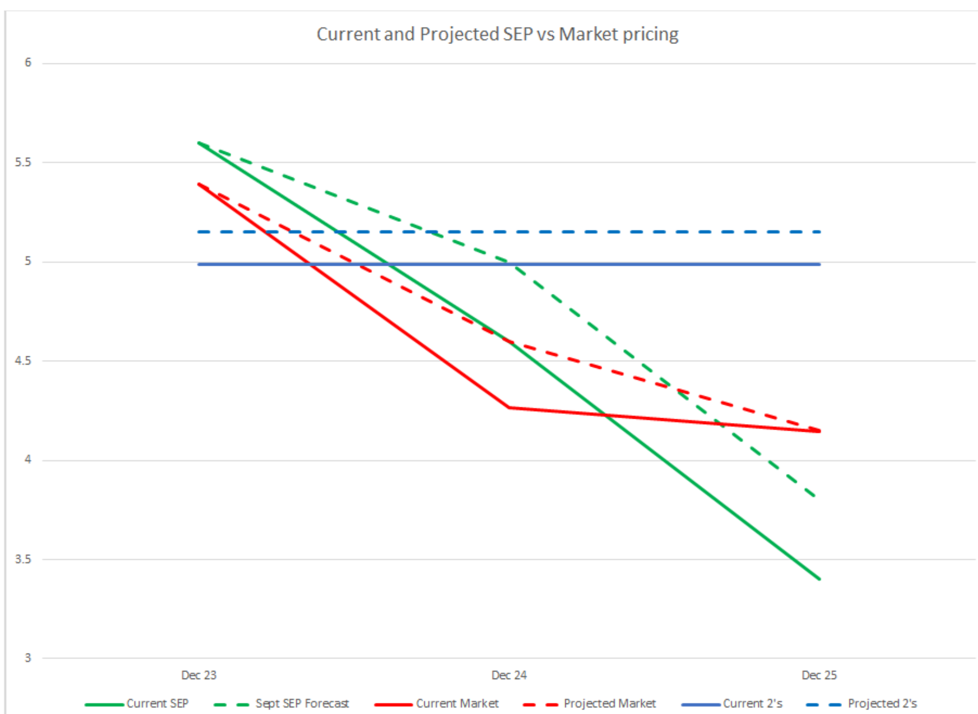
- **The potential for an asymmetric outcome of CPI "Two's Step"**
- **Where we are in "The Script"**
- **The next script. "Monetary ineffectiveness cuts both ways"**

"Two Steps"

In our most recent DSR we outlined the most likely lever that the Fed will pull at the FOMC meeting next week. Unless the inflation data later this week is well above consensus estimates the Fed will skip this meeting. However, we think they will target reducing cuts in 2024 regardless of the data.

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
- 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 unless the inflation data is extremely cold.**
- Not there. More hikes and longer pause. Extremely unlikely and no one is positioned for this outcome.

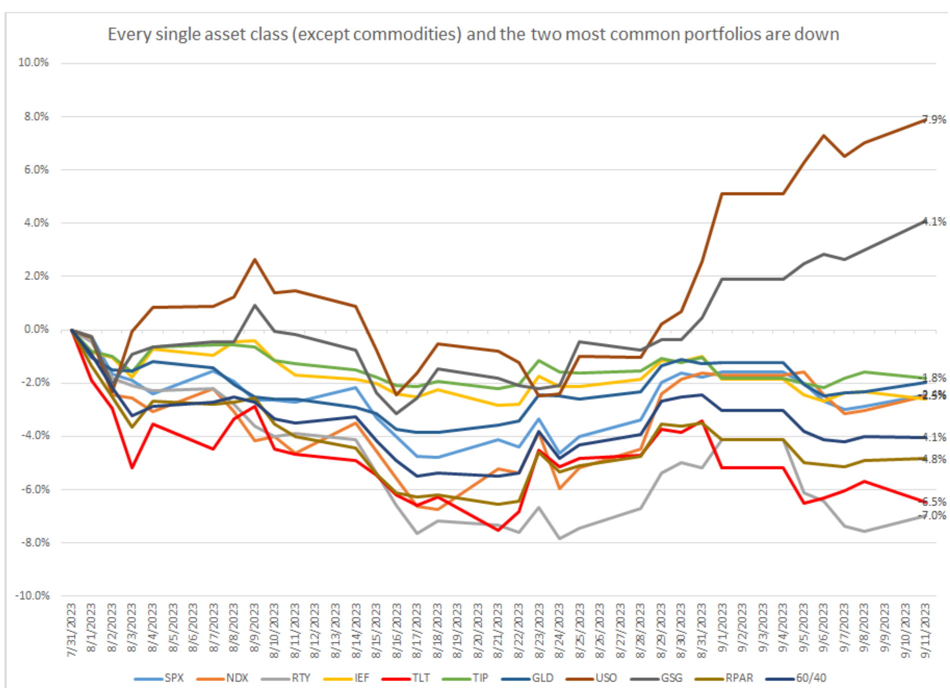


We expect the terminal rate for 2023 to remain at 5.6% with no risk to the downside and a few basis points of risk to the upside. More importantly we expect the Dec 2024 dot to rise close to 5.0 indicating only 60-70bp of cuts in 2024. The implication for markets is that 2-year yields will rise to over 5.15% and then be solidly pinned for months to come. SFRZ4 will drop to 95.20 and be buyable there.

Where we are in "The Script"

July 31st generated the Supply Catalyst that we had needed to begin Act 2 of our script. That Act has played out and is ongoing. We expect further poor performance of the long duration treasuries. This will trigger occasional glimpses of Act 3 as risk premiums on fixed income rise and arbitrage pressures begin.

Term premium has been the principal driver of bond yields. Since the QRA term premiums have risen to the high for the year but are still negative and we estimate at least 30bp more term premium expansion will occur as enormous issuance transmits QT.

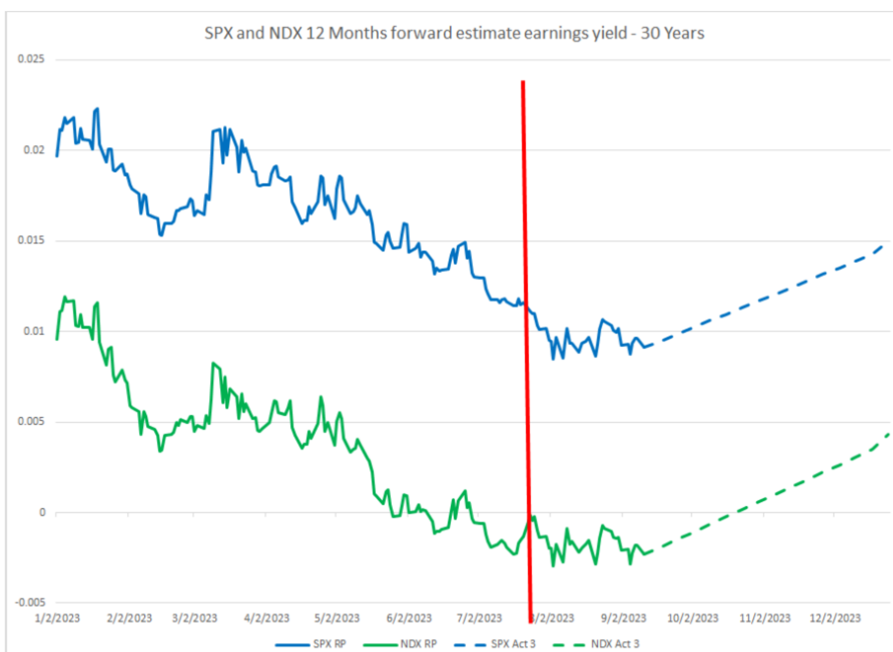


Since the supply catalyst occurred long term bonds have led assets markets lower. Equity markets have lagged bond markets and remain particularly vulnerable to a correction to catch down to the selloff in bonds. Noticeably economically sensitive stocks, albeit more leveraged, have also sold off. This is inconsistent with long term bond yields if driven by growth expectations. Perhaps there remains a sizable offsides positioning long value and short the Magnificent 7 tech stocks. That divergence is likely to correct as both NVDA and AAPL have already failed.

We predict a significant sell off in Equities in the next 30 days driving the S&P 500 below 4200 and NDX below 14,000. At that stage Act 2 will be over. To be clear that selloff in equities would simply be the impact of the rise of bond yields. Equity risk premiums would remain compressed, and earnings expectations would still call for 12% earnings growth for 2024.

Act 3 ERP expansion

As the bond market leaves the stage as Act 2 concludes the equity market enters for Act 3. We expect that act will begin in Q4 and last the balance of the year. There will not be a Santa Rally. Act 3 is driven by equity risk premium expansion/multiple compression. Act 2 will drive equity valuations to lower levels simply due to risk free yields rising. Act 3 will cause equity risk premium itself to expand causing multiple to continue to contract despite bond market yields stabilizing at higher levels than today. Notice since the QRA equity risk premium has stayed compressed. Act 3 will be about long-term treasuries now offering both higher nominal yields and adequate term premiums placing pressure for equity risk premiums to normalize at levels still not particularly high vs recent history.



The combination of higher bond yields due to term premium expansion and equity risk premium expansion should have a meaningful impact on asset prices over the Act 2 and Act 3. **By the end of the year a 4.75% 30-year bond yield and a**

3800 level of the S&P 500 should begin to have a negative wealth effect and finally impact earnings estimates. Act 4 begins as earnings estimates start to be cut. Given the timing of corporate earnings reporting we expect Act 4 to commence in Q1 during earnings season.

Act 4

As demand weakens, earnings estimates are likely to be cut. In past recessions earnings estimates fell by 20-30% from the prior year. Currently earnings for 2024 are forecast to grow at 12%. The impact of an actual recession and a 40-50% drop in earnings cannot be overestimated. We are not calling for such a severe recession and its possible that inflation could still be running hot as Act 4 begins. We will have more on this as the year ends.

The next script "Monetary Ineffectiveness cuts both ways"

As noted, the economy and the markets have felt little pain over the past year. We have outlined various policymaker decisions and their impact on the asset markets and discussed the monetary and fiscal linkages but to recap.

Monetary policy

- Services economy is less sensitive to borrowing costs.
- Large cash holdings by economic participants from Covid stimulus payments generate increasing income as rates are increased.
- Low interest rate borrowing by corporates and homeowners over the past decade have locked in attractive long-term rates for many borrowers.
- Quantitative tightening has been conducted with runoff which has handed that lever to the Treasury which mean it gets muted during TGA drawdowns.

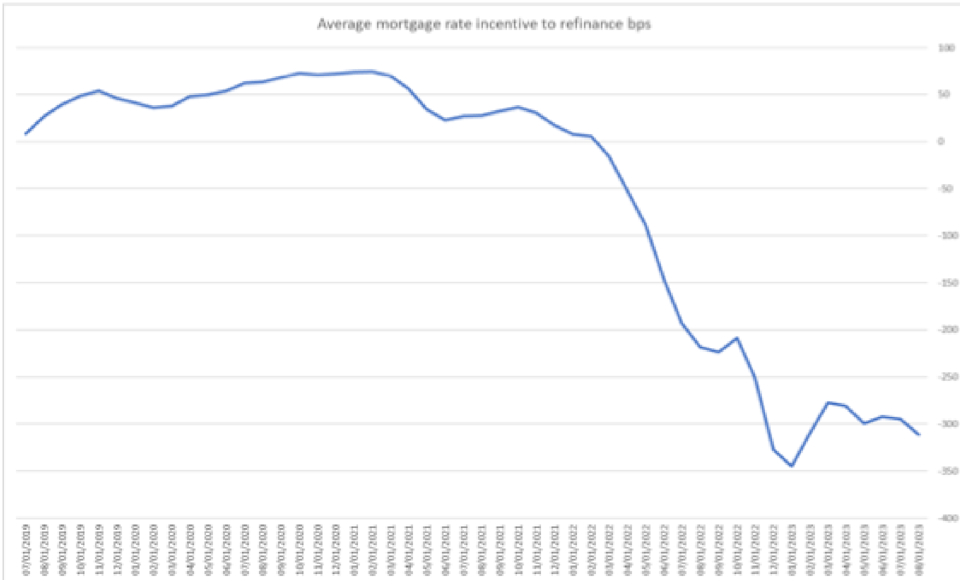
Fiscal Policy

- Unlike past cycles deficits have grown during expansion fueling further inflation and growth
- Counter cyclical deficit increases are likely to be unpalatable given the current deficit.
- Political gridlock exists for at least a year.

We expect that as we enter Act 5, and a recession kicks the Fed will respond to weakening growth predictably by cutting interest rates. However, it is also likely that they will be concerned about cuts rekindling inflation and will be behind the curve. But it is also true that the cuts will have less impact than in the past contractions for the same reason that they have been less effective to date.

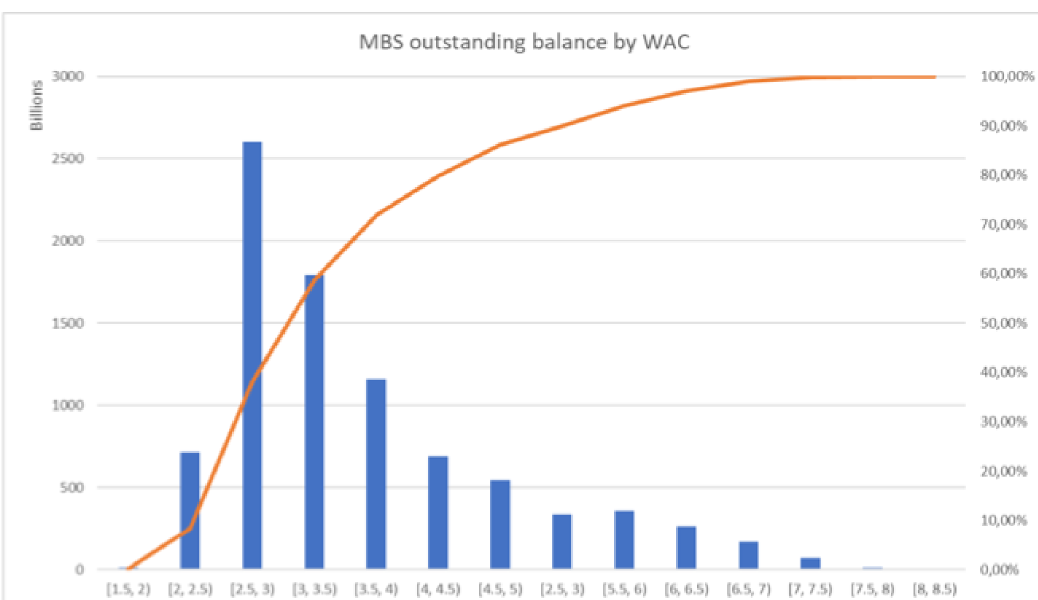
The classic linkage for rate cuts is the refinancing channel, given the current private sector balance sheet the upcoming rate cut cycle may be less stimulative in boosting the economy. What is the refinance channel? If you have a mortgage and mortgage rates decline, then you have an opportunity to refinance your current loan into a cheaper one.

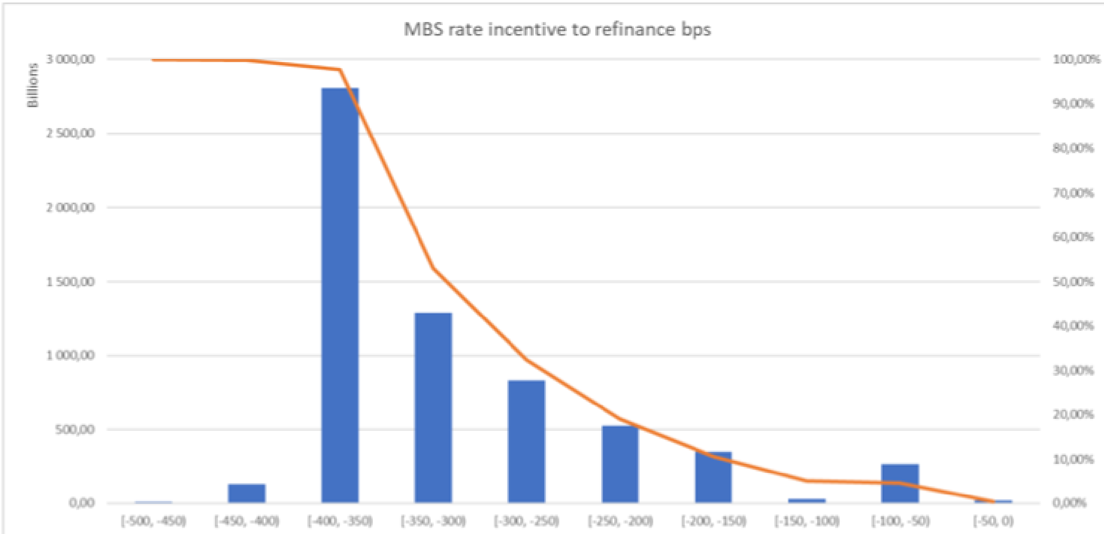
On a broader aggregate macroeconomic level, the refinance channel could have a substantial influence as a driving force. Rate cuts decrease mortgage rates, enabling households to refinance their loans and this in turn, releases additional disposable income, which can could be spent and boost overall demand. What's the situation today?



The average mortgage today is more than 300 bps out of the money from a refinancing perspective before costs therefore a refinance wave of the past cycles won't happen in the next cutting cycle with the current borrowing distribution because refinancing incentives are very far away.

Looking more granularly using MBS outstanding





The distribution of outstanding mortgage suggests that the "ATM effect" will be absent and the Fed will have more challenges to stimulate than in prior cycles.

Another headwind is the change in the pricing matrix. Last year the FHFA outlined intentions to decrease expenses for specific first-time and lower-income buyers while raising fees for the majority in cash-out refinancing and in January this fee framework was extended to nearly all forms of refinancing. The data illustrates that only a small fraction of the overall borrowing is associated with higher mortgage rates as of now.

A cynic would say that it is essential that more people borrow at higher rates in order for the Fed to have teeth in its rate cutting actions. It's clear that only a very long pause would shift borrowing distribution meaningfully to higher rates in the mortgage market. Such a pause would only be possible if inflation was allowed to stay well above target for years to come. Our bet is that the Fed will have a weak lever to pull in 2024 and will be behind the curve for fear of igniting inflation. If we have a recession in 2024, we expect a chronic aching recession. We will address other forms of borrowing particularly corporates and municipalities to further demonstrate the low impact of rate cuts in future DSR's. Thanks @danielsimonyi for help in researching this section of today's DSR.

Synthesis

There needs to be some pain for inflation to be well and truly killed. We have seen very little pain so far and the next year will be more difficult for markets and the economy. In the very short term, the inflation data and the FOMC will set the yield for two-year notes. We expect two's to settle around 5.25% and the long end to continue to sell off. We also are beginning to consider what happens next. Our view is that a recession will be deeper and longer than most expect.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000						
	LTD P/L	$ 59,138,512						
	Total Return	59.14%		YTD Return in excess of cash		13.84%		
	Today's Date	9/11/2023		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	0.75	$ (642,857)	Open	
9/7/2023	NDX 10/20/23 Expiry 13900 Put	82.00	-84	$ (2,000,000)	56	$ 218,400	Open	
8/2/2023	NDX 10/20/23 Expiry 14500 Put	245.00	40	$ 1,000,000	140	$ (420,000)	Open	
8/4/2023	NDX 10/20/23 Expiry 14500 Put	228.00	44	$ 1,000,000	140	$ (385,965)	Open	
8/24/2023	NDX 10/20/23 Expiry 14500/13900 Put Spread	95.00	53	$ 500,000	84	$ (57,895)	Open	
8/29/2023	SPX 9/29/2023 4075 Put Unwind	6.00	188	$ 500,000	3	$ (56,400)	Open	
7/31/2023	SPX 9/29/2023 4300 Put	24.00	417	$ 1,000,000	12	$ (500,000)	Open	
8/4/2023	SPX 9/29/2023 4300 Put	35.00	286	$ 1,000,000	12	$ (657,143)	Open	
8/23/2023	SPX 9/29/2023 4300/4075 Put Spread	26.60	188	$ 500,000	9	$ (330,827)	Open	
9/8/2023	DAX 11/17/23 15500/16000 Call Spread	301.00	-503	$ 500,000	301	$ -	Open	
9/7/2023	ZBZ 10/27/2023 118 Put	1.58	2363	$ 3,729,109	1.75	$ 406,141	Open	
9/7/2023	ZNZ 10/27/2023 109 Put	0.77	3009	$ 2,303,766	0.80	$ 103,434	Open	
9/8/2023	RXZ3 11/17/2023 132 137 Call Spread	1.17	427	$ 500,000	1.17	$ -	Open	