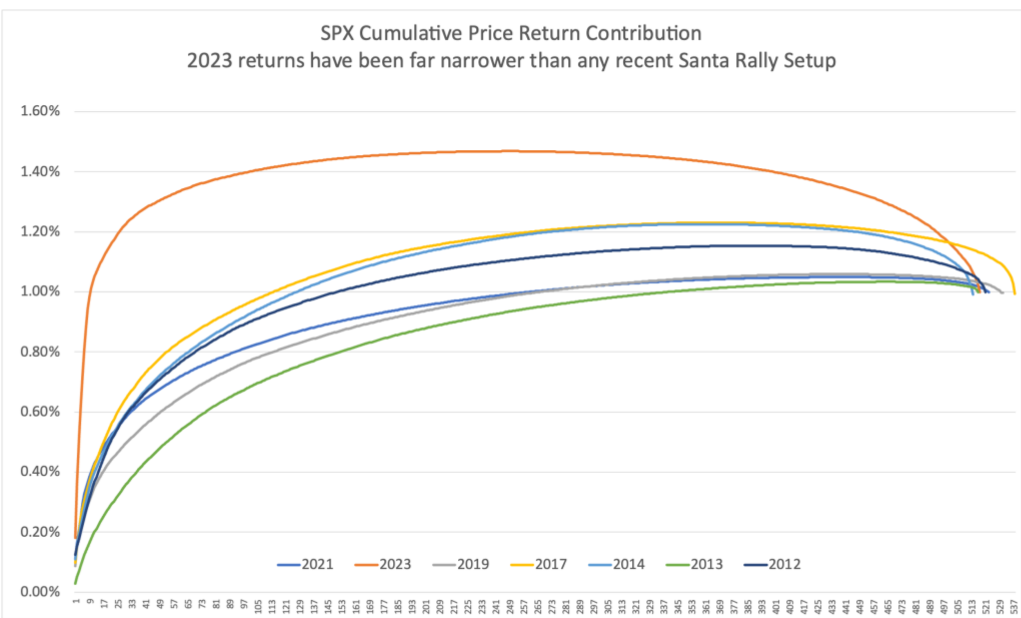
The Damped Spring Report

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

10/15/2023

As the year comes toward an end, investors are looking forward to a Santa Claus Rally in equities. This makes sense, as a hope, as often during the last two months of the year two reliable inelastic flows occur that drive markets higher and extend the rally for the year. Over the last 95 years when equity markets have rallied by 10% by Halloween buying stocks that day generates an average return of 4.68% with a maximum return of 14% and a positive return 83% of the time. The maximum loss is 2.01% and when a loss occurs the average loss is 0.60%. 36 observations exist. Santa is real! But this year is radically different.

Should we rely on back tested history and plow into the market? We prefer to understand the causalities at play and determine if these drivers of inelastic flow are present in today's market. Based on the drivers of the Santa effect we suspect those favoring a seasonal rally will be quite disappointed. A combination of factors including the extremely narrow sources of the equity market rally, and the large quantity of taxable losses available for investors to offset gains, makes this year quite different from years in the past. In addition, two FOMC meetings and an important quarterly refunding announcement may further dash Santa hopes. We are maximum bearish equities for other reasons but are examining the Santa effect in this report to better understand the possibility we are wrong.



Real world drivers of a Santa Clause Rally.

For any calendar-based market prediction it is critical to understand whether investors with these calendar-based motivators will act inelastically and generate alpha for those who can predict that flow. There are real world calendar-based motivations. Year-end motivations are principally.

- Tax Optimization
- Unaligned financial incentives for portfolio managers vs their investing clients
- Calendar based review of asset and manager allocations.

Tax Optimization

At the end of the year taxable investors are presented with a dilemma. They attempt to minimize their capital gain tax payments while also recognizing that efforts to minimize taxes exposes them to transaction costs and market risk vs their desired pretax portfolio. In years with broad gains which inevitably leads to realized taxable gains accumulating investors are stuck with a current year tax liability. That force has two real world consequences.

- It favors sorting one's portfolio and selling assets that have capital losses.
- It also discourages selling of winners until the following tax year.

Because the selling of losers and the delay of selling winners is not related to the forward return expectations of the assets the flow or delayed selling distorts the elasticity of supply and demand and results in price shifts. Losers get sold and supply of winners gets reduced for tax reasons. Because broad rallies of all assets provide very little taxable losses and significant taxable gains the elasticity shift highly favors less supply of assets and stokes a Santa Rally.

To predict the size of the impact one needs to consider.

- The balance of aggregate short-term gains and losses in the broad market
- Long term capital gain window for those who can realize a long-term capital gain vs a short-term gain.
- Any change in expected capital gain tax changes that would encourage a truly buy and hold investor to realize a long-term capital gain. (This is not a factor this year)

Investor and Manager incentives may not be aligned.

We live in the real world, and it is sad to say that investment managers and their investors sometimes have different incentives. Investors want to maximize their risk adjusted return. Investment managers want to maximize their investor's risk adjusted return as well because it is good for client retention and gathering additional assets. However, the calendar can also add other incentives to the basic fiduciary incentive mentioned above that can temporarily misalign investor and managers incentives.

At year end the investment manager has three significant pressures that may misalign incentives.

- Underperforming funds may lose clients resulting in performance chasing of the winners.
- In strong years where performance-based incentive fees are large and "on the slope" Investment managers will receive certain compensation in the current year for additional gains and if those gains revert in January will have the entire year to recover those gains. Even if it results in a drag on future performance the drag happens when the Investment manager is "not on the slope" This incentive misalignment results in pumping the winners.

Year-end performance review – Asset and Manager shifts reallocation.

Investors spend the 4th quarter evaluating their asset and manager allocation choices for the following year. Manager subscription and redemption notices require varying lead time. Managers favored with subscriptions must wait till the new year begins and managers facing redemptions are incentivized to redeem the exiting investors at a bad mark at year end to favor the investors that remain in the fund. Investor transition agents often spread this out during the last few days of the year. Nonetheless that flow is almost all in the last few days of the year. It is typically procyclical based on the impact of the broader trend of the prior two months. Some people narrowly define the Santa Rally in this short window at year end. We think the bigger flows mentioned above drive the narrow the last few days.

Why is 2023 radically different?

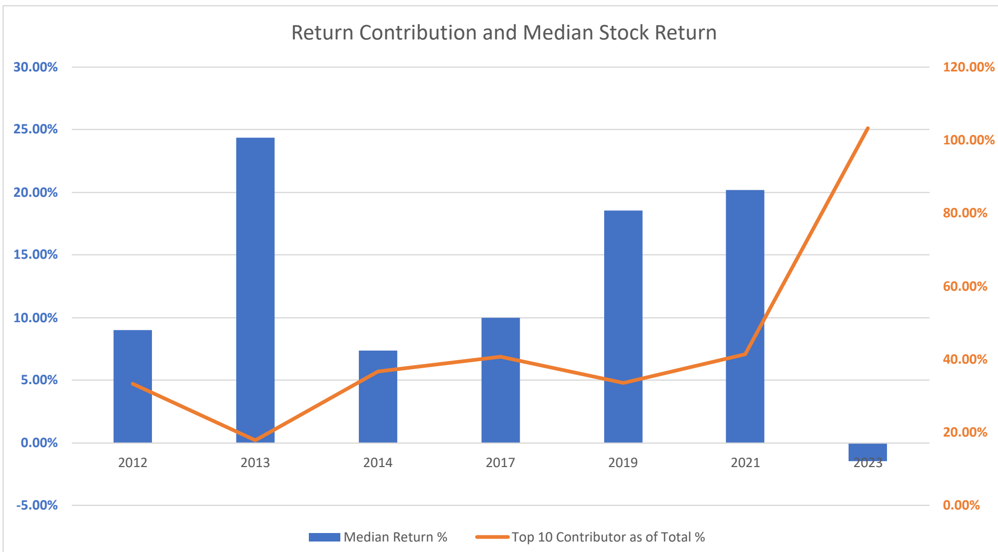
We outlined the drivers of a Santa Claus rally as tax optimization and performance chasing. When we dig into those factors it is quite clear that 2023 is very different than past years.

- Despite a strong equity market, the balance of assets are in drawdown vs assets with gains for the year providing an unusually large tax loss harvesting opportunity.
- The large tax loss harvesting opportunities allows investors to take both short- and long-term capital gains to offset losses which returns balance to the supply and demand of winners absent in most Santa Rally years.
- The gains are also extremely narrow.
- Performance chasing may still occur but given the performance has largely been driven by AI the willingness to chase AI is almost certainly controversial as the AI Reality/Hype is extremely polarizing for most investors and those that don't own AI may struggle to rent AI for performance chasing only to dump it in 2024.
- Wide dispersion in fund returns also takes many investment managers "Off the slope" which discourages them from pumping into year-end as they get no additional compensation for 2023.

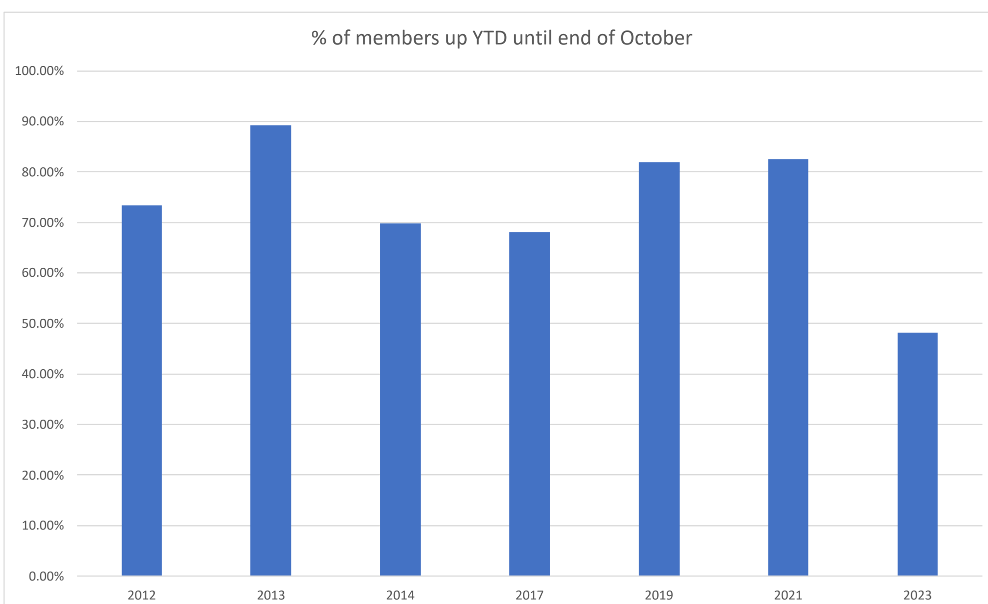
When we add all this up, we see the next two months as dominated by macro and not by seasonals. The seasonals are likely neutral which given market positioning and investor expectations means any seasonal premium in the market will evaporate quickly. We are max short equities.

Plenty of Taxable Losses and Narrow Capital Gains

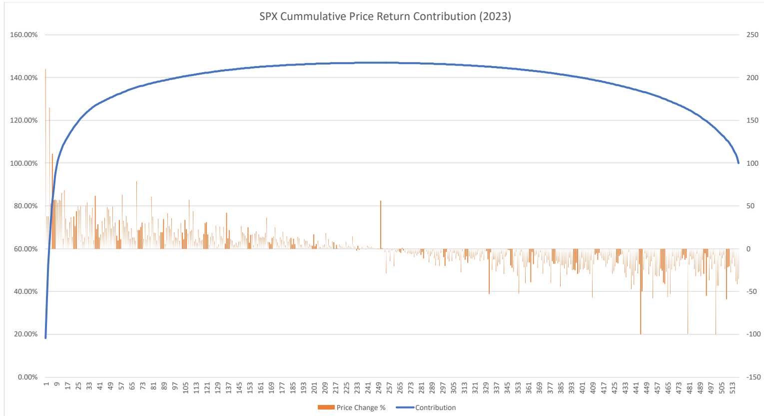
We all know about the Magnificent Seven has been leading the stock market returns but is worth reviewing the implications. In 2023 the median stock out of the S&P 500 is down. The top 10 market cap stocks have generated more than 100% of the return of the index. There are both plenty of capital losses available to harvest and a very narrow set of stocks to performance chase.



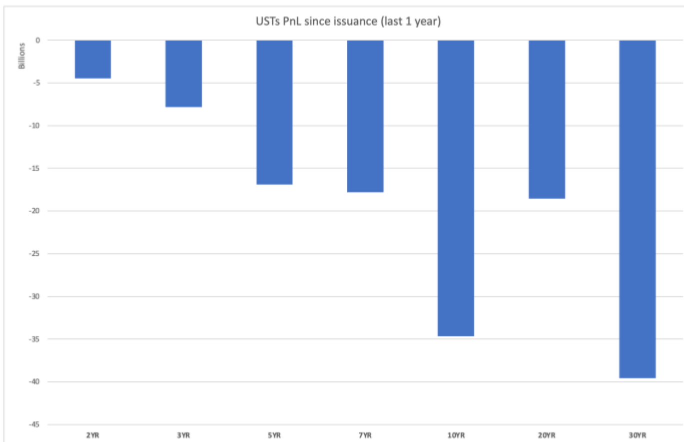
Not only are the 10 stocks dominant but the next set of stocks to chase are mostly underperformers.



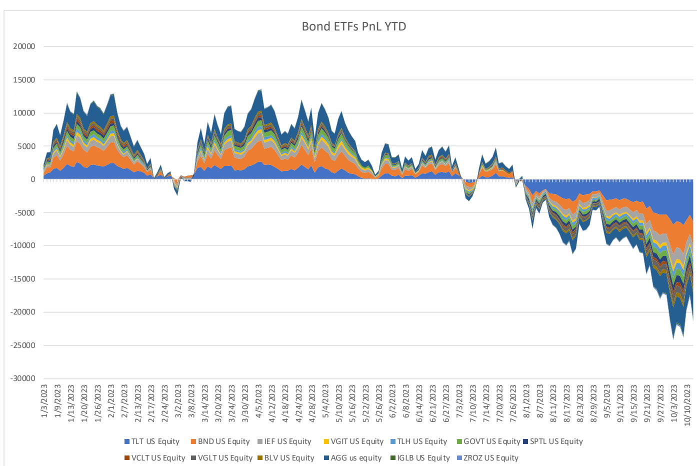
Pictured another way one can see the sizable capital loss potential and the very slight positive returns of the non-Mag 7 middle.



Not only do stocks have sizable tax loss harvesting opportunity but US Treasuries purchased over the last year are also generating over 100BN in short term taxable capital losses.



The Bond ETF picture is not pretty at all. Current capital losses of 20BN.

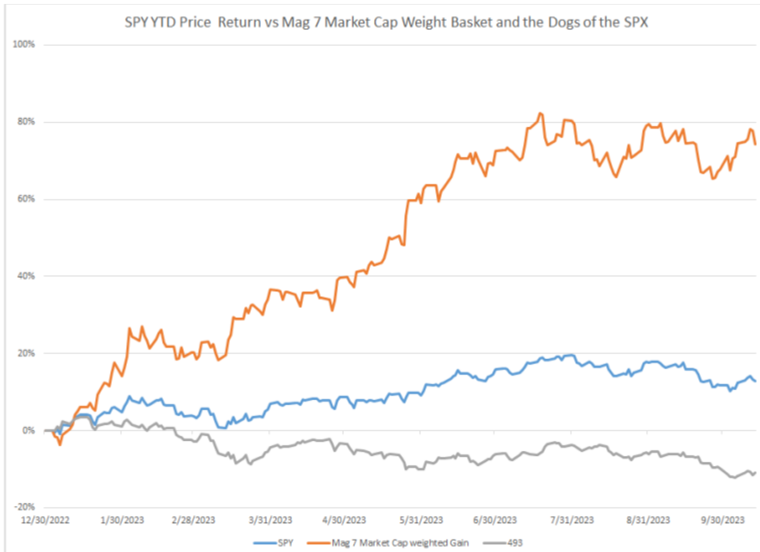


Due to sizable tax losses harvesting opportunity in both bonds and most stocks, which is highly unusual in an up year, it’s clear that there is little or no need to defer capital gains in Mag 7 or any other stock for that matter.

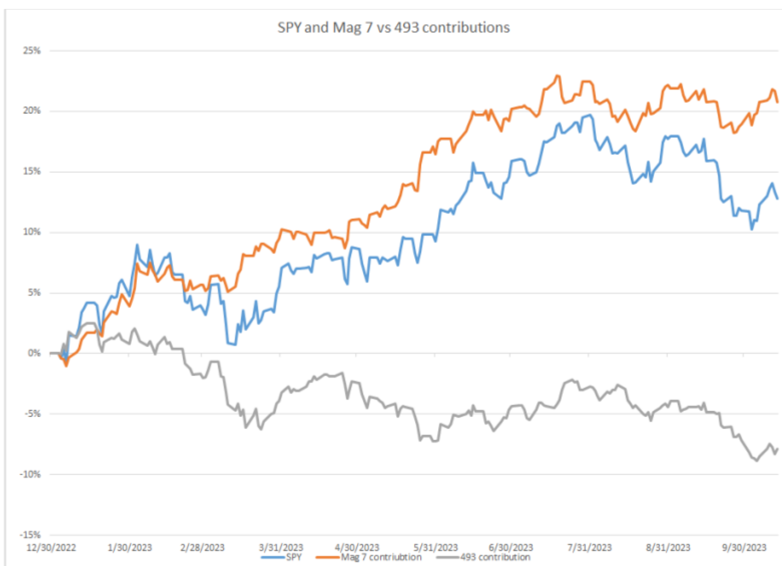
The Magnificent Seven- a diversion for a rant on how rich they are.

The future of AI and the valuations of the Magnificent Seven are not our lanes. We will see what the earnings reports and guidance will be in the next two weeks. Nonetheless we are suspicious of the ability for the Mag 7 stocks to grow at the necessary rate to sustain current multiples and are extremely pessimistic on multiples broadly as described in "The Script" Act 3. In terms of earnings growth our view is that the customers of the Mag 7 including the 493 other equities in the S&P and you and me will be impacted by "The Script" and demand for the Mag 7 products will likely slow. These companies have become the economy and though we have been very optimistic about nominal GDP given what's priced in, Nominal GDP must continue to grow at very hot rates to deliver on earnings.

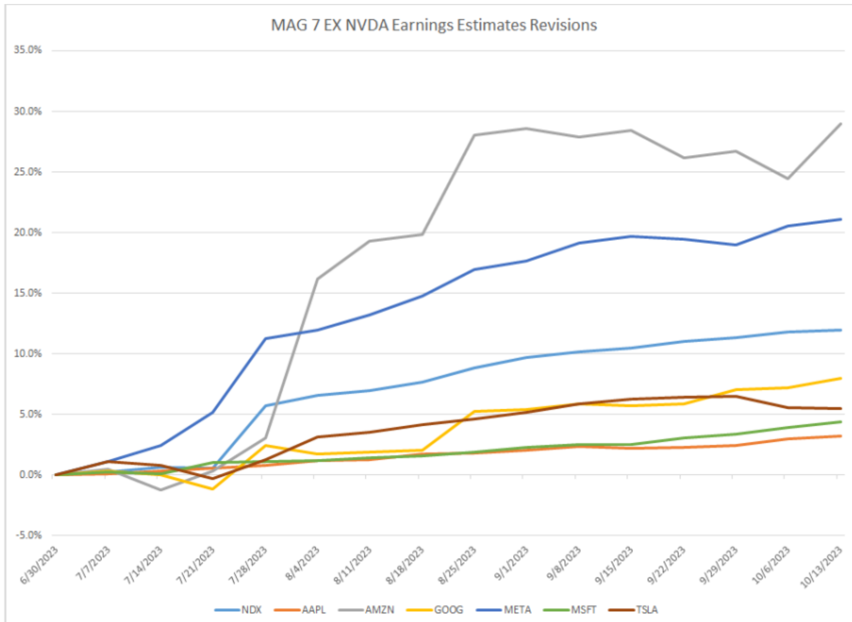
Absolute returns of the Mag 7 are close to the highs leading into earnings.



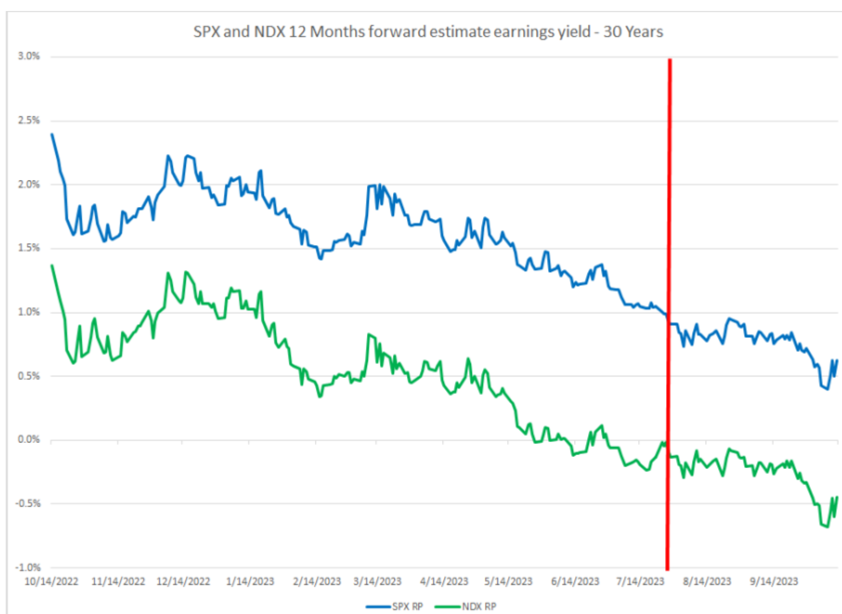
Outperformance is as large as ever.



Earnings estimate revisions are higher across the board. We couldn't even put NVDA on the chart as it blows away these numbers. Of course, with a GDP which may be north of 4% for this quarter the earnings for equities including MAG 7 will be very strong.



Nonetheless with both earnings expectations rising for the group and overall Earnings yield – 30-year bond rate falling clearly growth expectations for equities in general and the largest components are quite optimistic.



This rant on rich Mag 7 is only meant to show the polarity about AI and drive home the point that these are the stocks that performance chasers "need" to chase. We don't think those who missed them will chase them and those who own them won't have to defer taxable gains unless that's all they own.

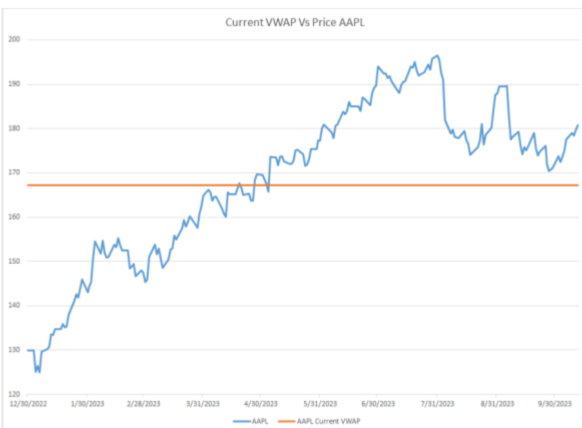
Capital gains on Mag 7

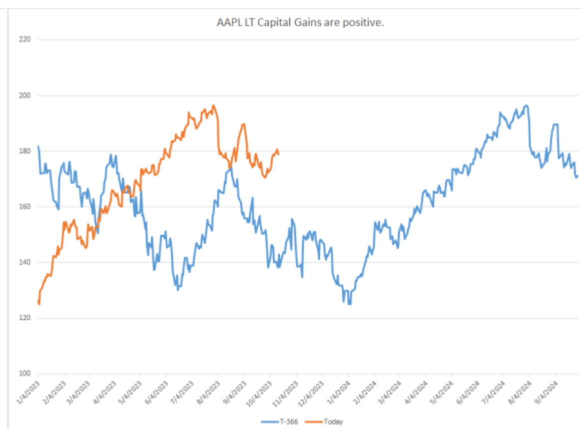
Capital gains fall into three categories.

- Those that bought this year and have short term capital gain.
- Those who bought the lows in Q4 2022 who's basis is just crystalizing into a long-term capital gain.
- Long term owners. They don't matter seasonally.

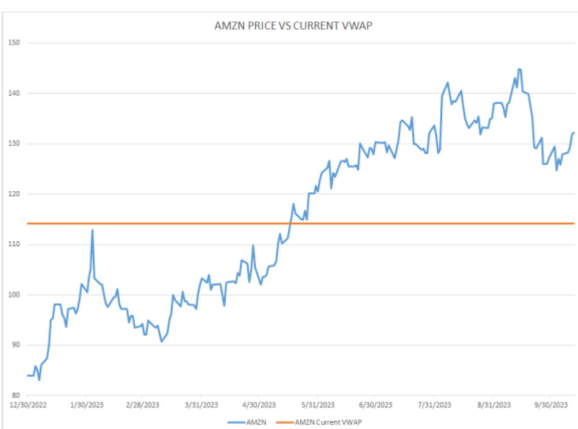
All of the MAG 7 spot prices are well above the volume weighted average price which indicates the average buyer during the year has capital gains. Offsetting that is the big selloff in tech in Q4 2022 gave many cheap entries relative to today and their holding period is soon to be 366 days or more. That reduces the capital gain tax by half. Stocks particularly vulnerable to the 366-day window are AMZN, GOOG, and TSLA. The balance of the stocks will have less pressure as they have been at long term capital gains for months.

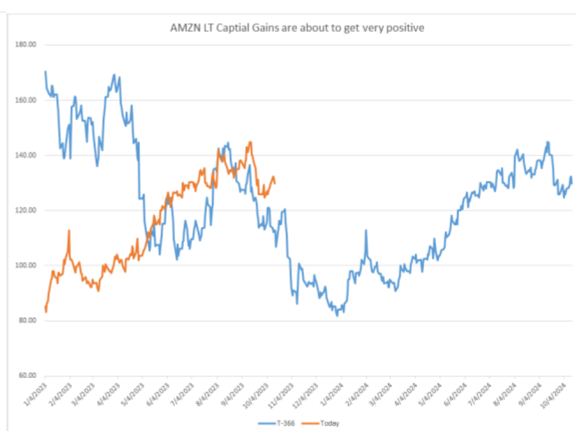
AAPL is modestly above its VWAP and will likely see limited new LT capital gain harvesting.



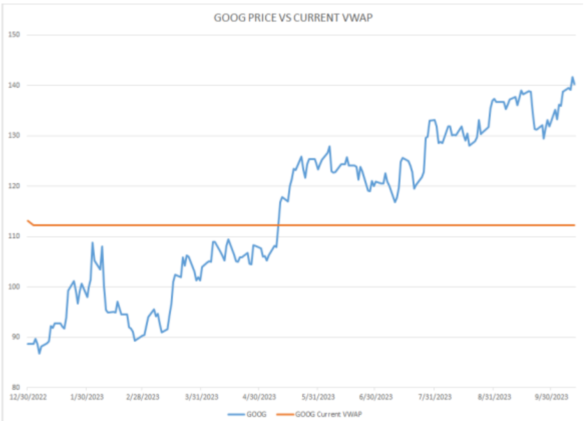


AMZN is well above its VWAP suggesting significant short term capital gain deferral needs. However, AMZN is just coming into a period where stock bought in Q4 now has a long-term capital gain.

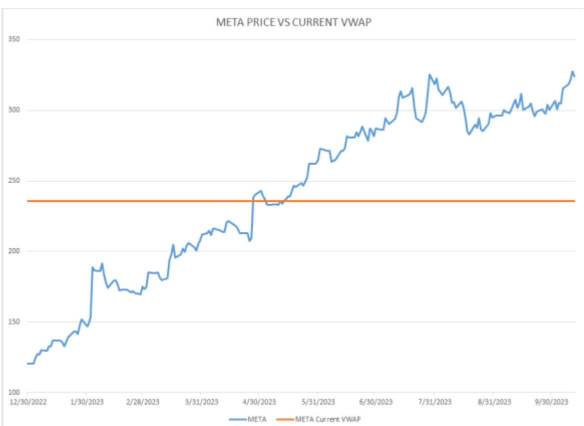


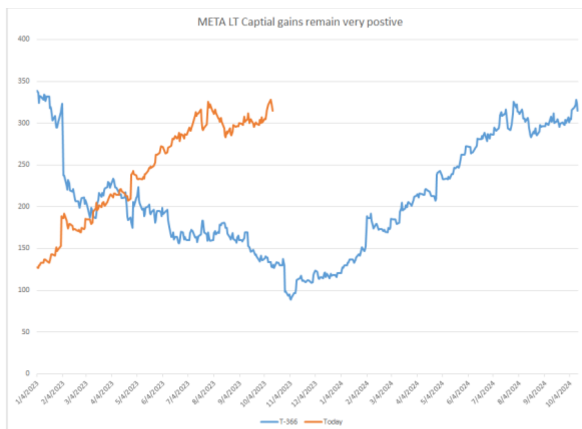


GOOG has substantial built in ST capital gains suggesting ST tax gain deferral to 2024. However, GOOG is just coming into a period where stock bought in Q4 now has a long-term capital gain.

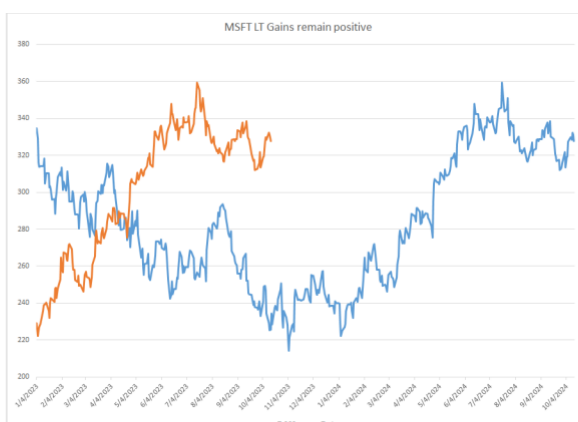


META has substantial built in ST capital gains suggesting ST tax gain deferral to 2024. The long-term capital gain picture is also not likely to generate long term capital gains selling.

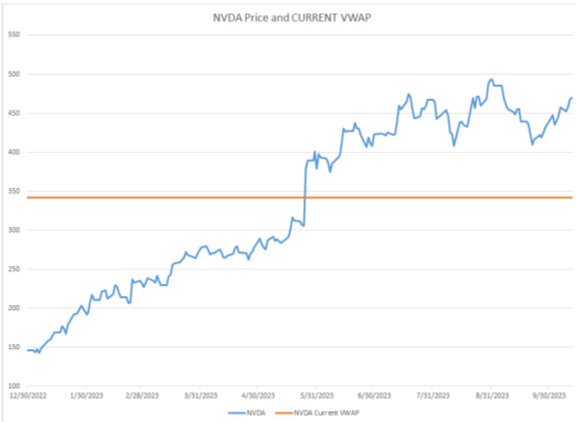


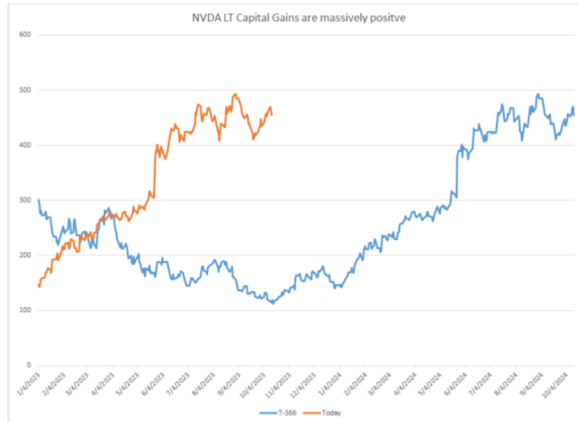


MSFT is modestly above its VWAP and will likely see limited new LT capital gain harvesting.

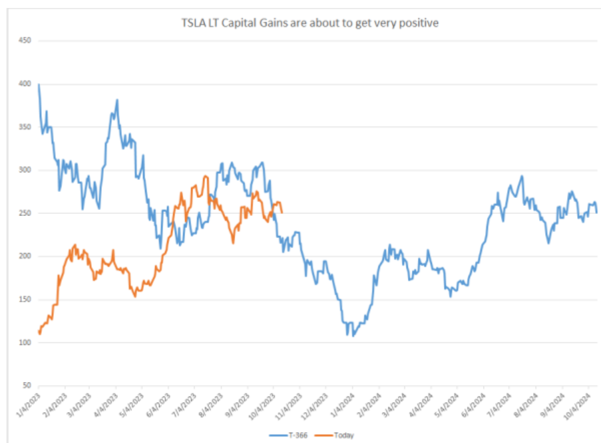


NVDA is the big move and is well above its VWAP though clearly the VWAP jumped a lot after that massive earnings beat its still near all time highs. Tax gain deferral pressure is sizeable.





TSLA is well above its VWAP suggesting significant short term capital gain deferral needs. However, TSLA is just coming into a period where stock bought in Q4 now has a long-term capital gain.

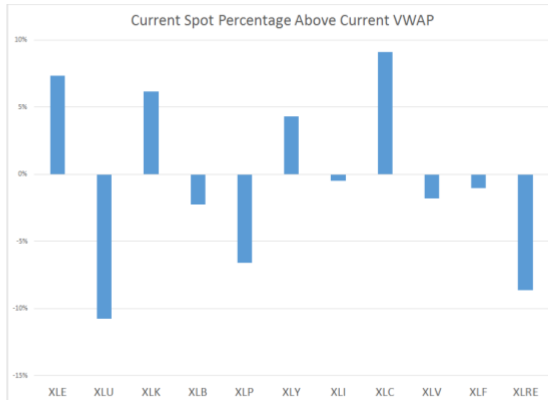


All of the Mag 7 has large short term capital gains built into there price history and volumes during 2023. Without a doubt in environments where offsetting short term capital losses were not available these stocks would be the last stocks an investor would sell for tax reasons and investors who did want to sell would sell in 2024. We believe there are enormous tax losses to be harvested and for that reason expect taxable gains to be taken in these names. In particular, AMZN, GOOG, and TSLA are entering a period where capital gains held for 1 year or more allow selling for long term capital gains. This flip to LT from ST is a solid reason for investors to sell these names.

Capital gains by sector.

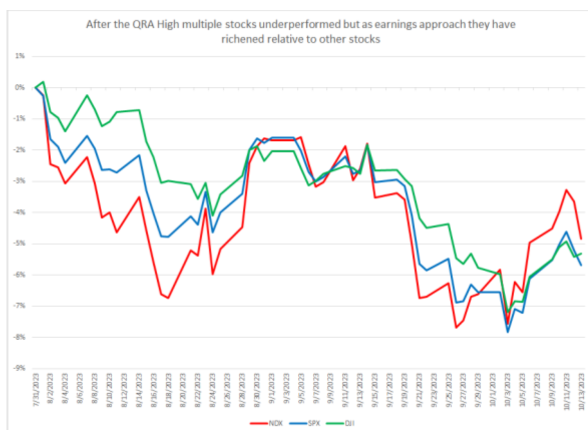
Mag 7 capital gains and the offsetting large stock and bond capital losses is the big story of this tax season; however, we have looked at various sectors which of course are infected with MAG 7 in some cases but seems useful to see where the tax harvesting is likely to occur and where it is unlikely in the stock market.

Taxable losses are heavy in utilities, banks (KRE as well), consumer staples and Real Estate sectors. Notably the one sector that does not have a Mag 7 constituent is energy. Given the geopolitical environment if any sector is likely to see taxable gain deferral and possibility even performance chasing it is the Energy sector.



Is there a Santa premium developing?

When the bond market started selling off post August QRA we expected high multiple stocks to be most affected. This proved accurate. But since the end of the quarter these stocks led by the MAG 7 have outperformed. Perhaps its earnings expectations rising, perhaps it's the seasonal narrative the has been reliable in most years. Nonetheless there seems to be a developing premium in Mag 7.



Synthesis

Santa rallies are real and driven by predictable flows. When looking at the Mag 7 and the gains accrued by investors in 2023 it would be fair to expect that any investor in these stocks who wanted to sell would defer until they own them for more than 366 days or wait till next year. However substantial tax loss harvesting opportunities in most stocks and all bonds allows investors to more than offset taxable gains on Mag 7. In addition, performance chasing of a narrow set of polarizing AI stocks seems unlikely but admittedly possible. This DSR reviewed the Santa Effect and its unusual difference in 2023. "The Script", data, policymakers' actions, and

indeed earnings are more powerful forces vs seasonals and anything can happen, but we feel burying Santa for 2023 is worth it to avoid distraction.

Thanks @DanielSimonyi for help preparing this report.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 67,771,096		
Total Return	67.77%	YTD Return in excess of cash	22.47%
Today's Date	10/15/2023	Portfolio Created	4/15/2019

Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Close
CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	0.25	$ (880,952)	Open
CLZ3 83/81 Put Spread	0.99	-495	$ 500,000	0.73	$ 128,713	Open
DAX 11/17/23 15500/16000 Call Spread	301.00	-503	$ 500,000	139	$ 407,035	Open
NDX 10/20/23 Expiry 14500 Put	245.00	40	$ 1,000,000	33	$ (848,000)	Open
NDX 10/20/23 Expiry 14500 Put	228.00	44	$ 1,000,000	33	$ (855,263)	Open
NDX 10/20/23 Expiry 14500/13900 Put Spread	95.00	53	$ 500,000	24	$ (373,684)	Open
NDX 10/20/23 Expiry 13900 Put	82.00	-84	$ (2,000,000)	9	$ 613,200	Open
NDX 11/17/23 14700 Put	360.00	28	$ 1,000,000	249	$ (308,333)	Open
NDX 11/17/23 14700 Put	300.00	33	$ 1,000,000	249	$ (170,000)	Open
SPX 10/20/23 4200 Put	28.58	700	$ 2,000,000	7	$ (1,510,147)	Open
SPX 11/17/23 4275	77.00	130	$ 1,000,000	62	$ (194,805)	Open
SPX 11/17/23 4275	69.00	145	$ 1,000,000	62	$ (101,449)	Open
SPX 11/17/23 4275/4125 Put Spread	24.00	833	$ 2,000,000	31	$ 583,333	Open
RXZ3 11/17/2023 132 137 Call Spread	1.17	427	$ 500,000	0.50	$ (286,325)	Open
EURUSD PUT SPREAD 1/4/2024 1.05/1.02	0.77	(44,843,049)	$ 1,000,000	0.79	$ (8,969)	Open
		Risk	12.000%		8.2%	