The Damped Spring Report

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

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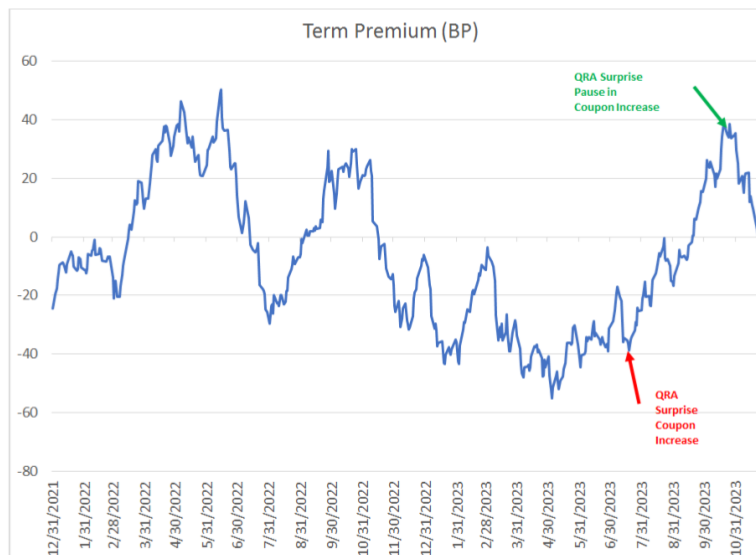
Since the Treasury decided to slow the increase in US Treasury issuance the global markets have staged an epic rally in all assets. US equity markets have rallied 10% and have recovered all their losses since July. US long term bond yields have fallen 50bp. Global asset markets have followed suit. The US dollar has weakened. While the Treasury will issue a huge amount of duration over the next 5 months and is likely to substantially increase coupon issuance in the second quarter. Investors have acted as if the all-clear sign has been flashed. This has all occurred in three weeks. Our framework for predicting broad asset market reactions depends on risk premium as the driver. While inflation and growth expectations matter, the only driver that generates rallies in all financial assets is a risk premium contraction. If the massive easing in financial conditions persists, we believe this will impact the real economy offsetting the recent trend of falling growth and inflation and demand central bank action. Growth and inflation expectations are heavily weighted to a recession or soft-landing outcome. A stabilization of the economy at above target growth and inflation is not discounted at all. We are now, short many points on the US yield curve, short gold, and building a short on equities. The reaction to the reduction in issuance has overshot and the still sizable issuance needs to be absorbed. Assets are vulnerable to a correction.



Risk Premium Framework

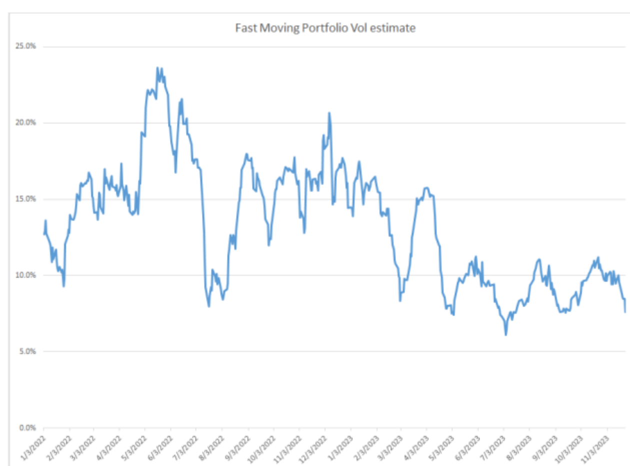
Clearly risk premiums have contracted since Halloween. The question is what are the drivers of that contraction? Our framework for the drivers of risk premium has two pillars.

- The amount of money and credit available to invest in financial assets vs the supply of financial assets.
- The risk of holding a portfolio of assets.

The big thing that happened on Halloween was a change in the expectations for future supply of financial assets. However, the amount of money and credit available to invest in financial assets given the ample reserve regime and good health of secured lenders can easily provide fuel to investors wanting to lever up and chase asset performance.

If financial markets have access to secured lending the moves from fear to greed and back have no real constraints. We will address the special case of the drawdown in the RRP later, but we do not think this is generating any meaningful influence on the willingness or more importantly the ability for investors or their leverage providers to buy assets.

At the same time the risk of holding a portfolio of assets is falling rapidly as fear evaporates. A marked decline in short term portfolio volatility expectations driven primarily by a collapse in equity volatility, if extrapolated, results in a need to lever up by investors. The volatility targeting funds who use a fast-moving unfiltered signal would want to lever up by roughly 30% since Halloween. Of course, that would be akin to selling equity vol at a new low. So, while it has almost certainly been a part of the rally in assets it seems unlikely that future levering up will be driven by falling volatility.



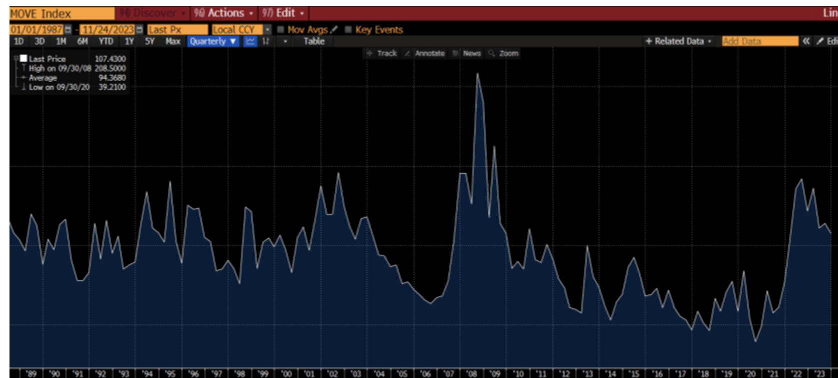
Our framework includes the fall in supply expectations, the fluid ability to lever up, the drop in realized portfolio volatility, momentum, fomo, and greed as drivers of the massive rally. Many of these factors have played out already. In particular,

the portfolio vol targeting buying seems unsustainable and the overhang of actual issuance will likely reverse the other factors in the weeks to come.

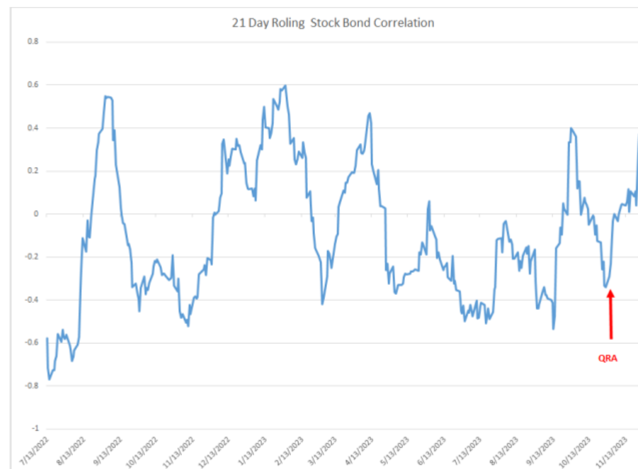
Portfolio Volatility Drivers of risk premium

Fixed income volatility has been stable and recently remains elevated. consistent with the period prior to the GFC, ZIRP, and QE.

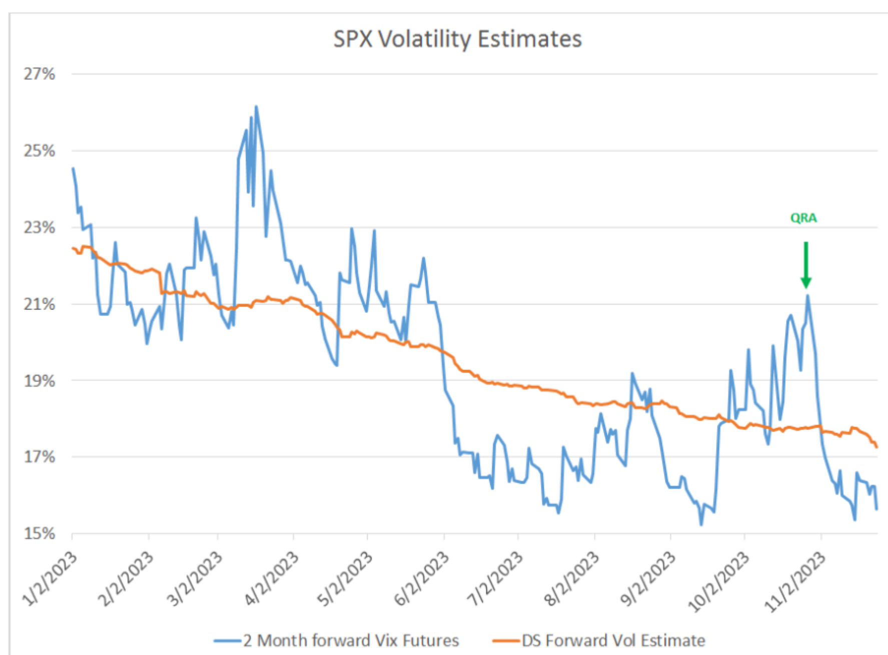
The MOVE Index range is consistent with the period prior to the GFC, ZIRP, and QE.



Bond stock correlations spiked as assets have all rallied and is quite elevated.



While these two components should drive delevering. The fall in equity vol has more than made up for that pressure.



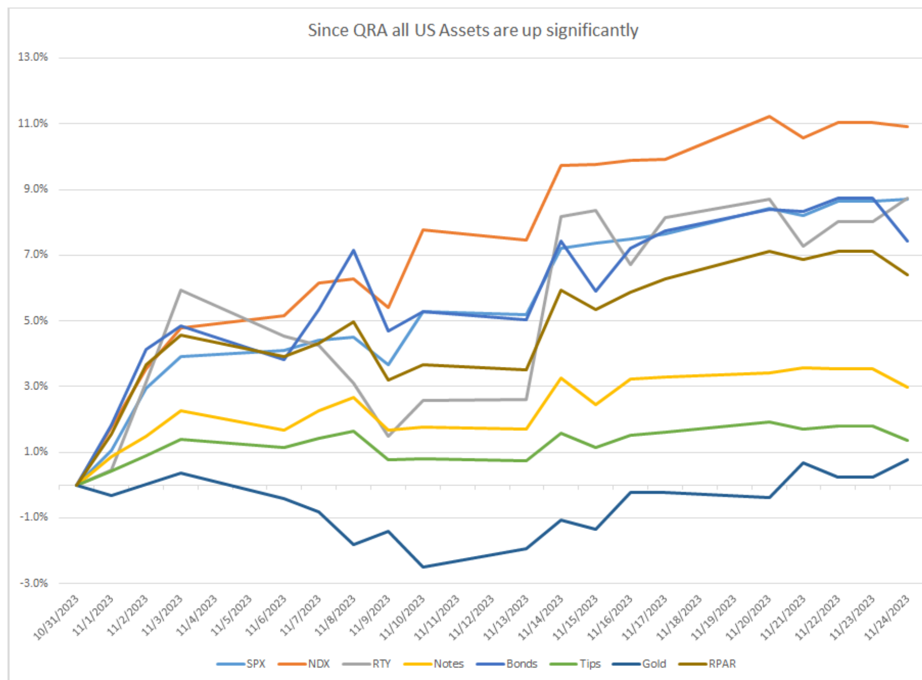
Further levering up will have to be driven by persistent lows in equity volatility which seems unsustainable. Correlations could fall but would have to be driven by growth expectations changing which would be disruptive to either bond or stock markets. Lastly fixed income vol could fall which is possible but given the large supply to absorb and pricing which favors a hard landing it seems unlikely. **Nonetheless part of the risk premium contraction since QRA has clearly been levering up due to lower expected portfolio vol.**

Term Premium contraction is spreading.

The contraction of term premium of long-term bonds has most certainly been driven by the unexpectedly low supply of Treasury issuance. Standalone measures of bond term premium drivers besides supply/demand such as bond volatility and bond ownership diversification benefit have been neutral or expansionary to term premium respectively. That leaves supply/demand as the driver. We expected substantial term premium contraction when we saw the QRA on Halloween. However, the ability for the market to absorb the actual supply has not yet been fully tested. We expect the term premium on bonds to either settle at around zero or begin to expand again.

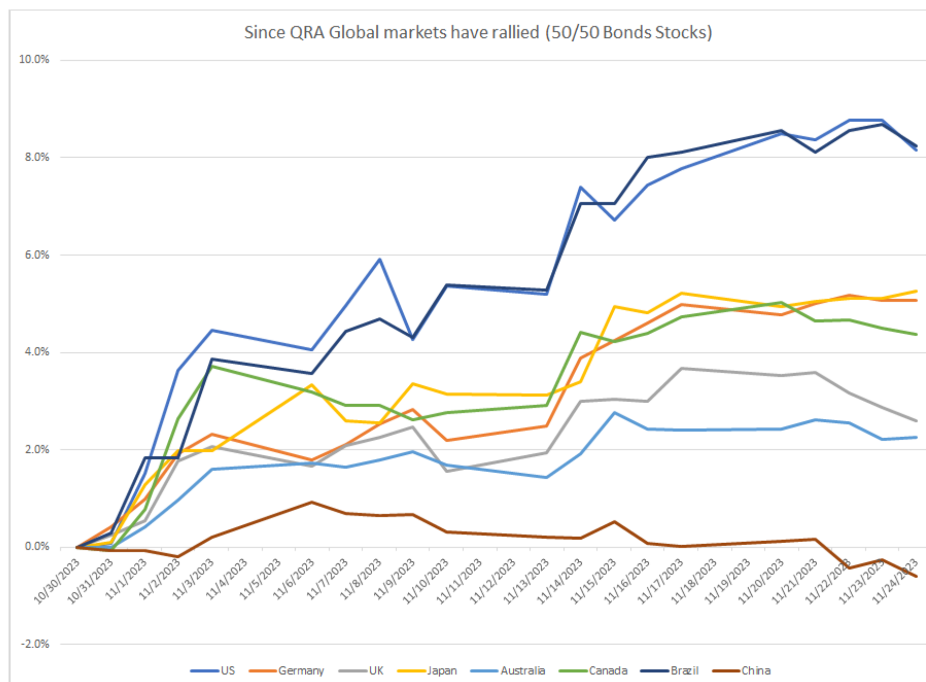
Other assets both domestically and foreign have responded to the contraction in US bond term premium. The process of global term premium arbitrage is as bond term premium contracts causing US bonds to be less attractive versus USD cash, other US assets get bid up as do Global Assets.

US Asset markets



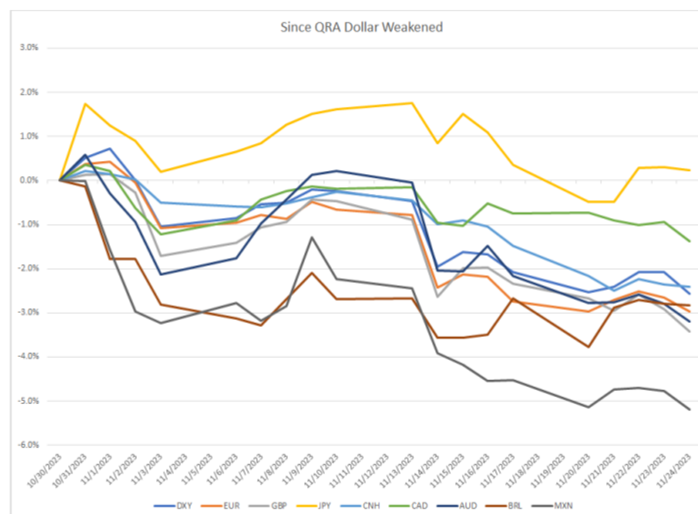
Foreign markets

All developed market bond and stock markets have rallied, and most emerging markets have as well. The less attractive term premium in US assets is resulting in capital seeking return outside the US despite the economic differences across the globe. Naturally, the move is less impressive than in the US as the driver of US Bond term premium weakens as idiosyncratic markets are arbitraged.



Currencies

A broadly weaker USD since QRA is also the likely result of term premium arbitrage as capital flows seek cheaper assets than US Bonds. We recognize currency markets are complex and certainly it's possible that relative dovishness of the Fed over other major CBs could be a driver, but we didn't see anything in the subsequent data or CB-Speak that would point to that shift.

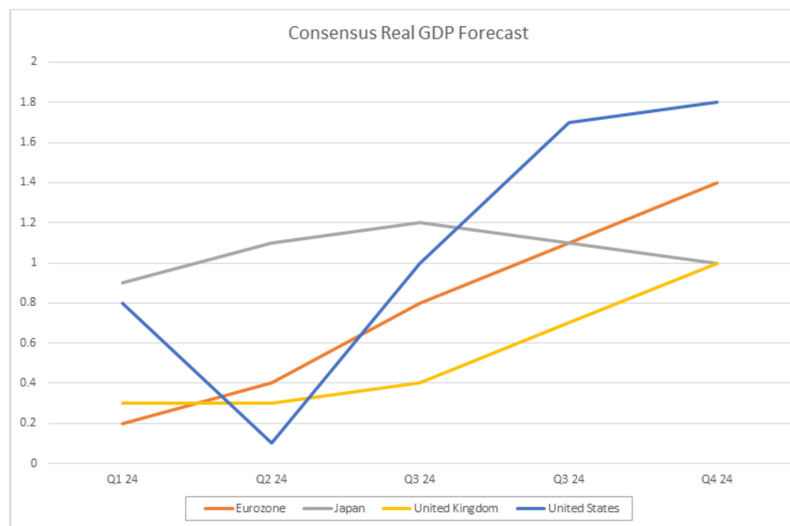


Leading up to the QRA USD had been at a YTD high overweight in the custody portfolios of the largest global institutions serviced by State Street. Since then, the overweights have been sold aggressively. This overweight was the third highest over the last decade. We do not have strong views on currencies now but are not buying the dip on USD pairs until this overweight comes into balance.

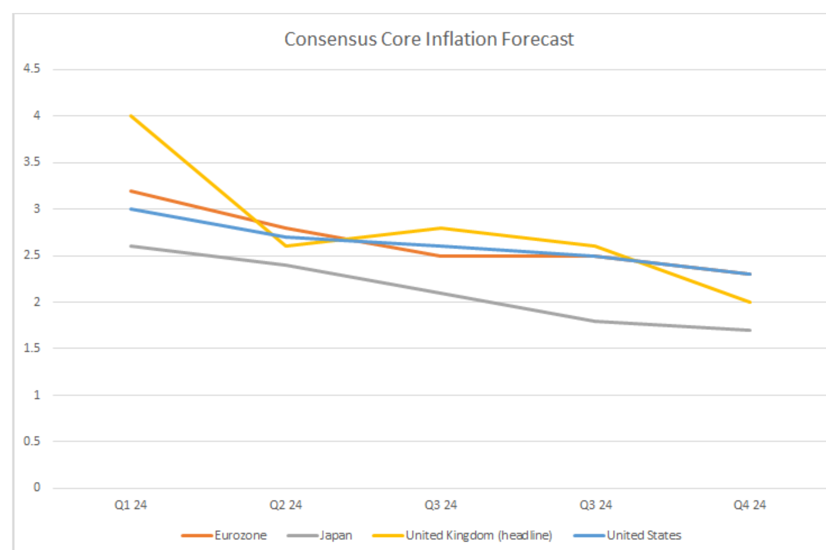
Economic outlook

Our view on the US and Global economies remains more optimistic on real growth and more pessimistic on inflation than consensus. We expect nGDP to be higher for longer over the next two years unless the impact of quantitative tightening removes the extremely easy financial conditions that have developed in the last few weeks. We described our "Script" to kill inflation and slow the economy and it has been rewound to the beginning where H4L short term rate policies by central banks are inadequate to get the job done.

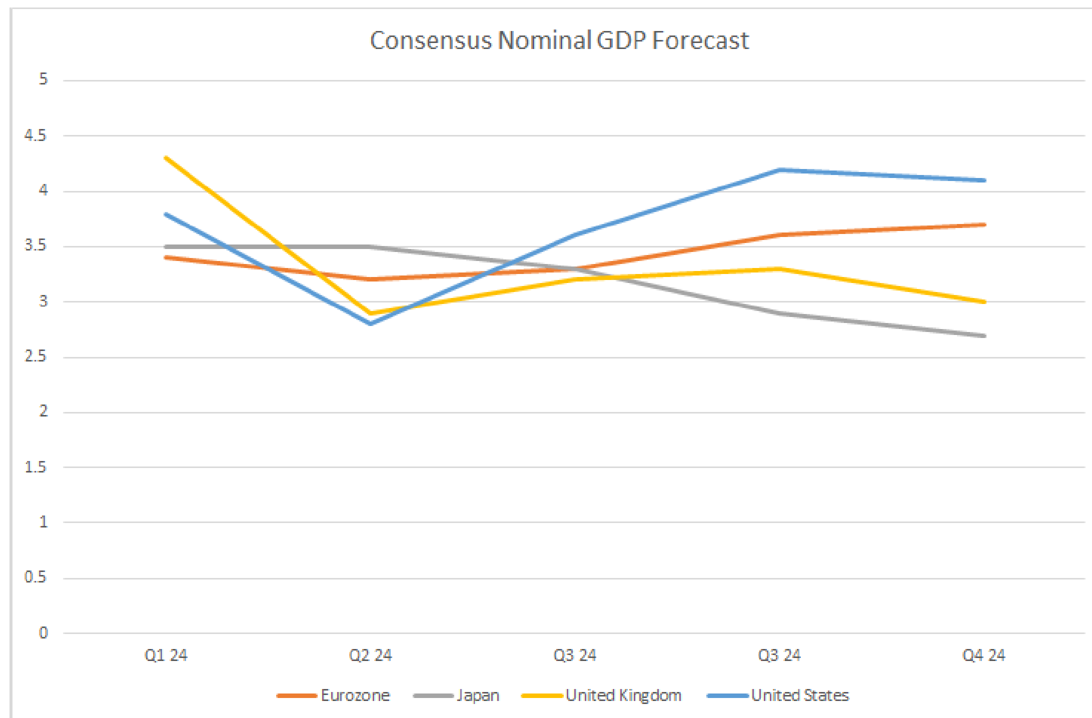
Current consensus real GDP growth forecasts suggest a near miss of a recession and then an increase to below trend in the 2H of 2024. Japan Consensus is to never really ignite.



Current Consensus Inflation forecasts are optimistic. All countries are expected to achieve their inflation target more or less in one year.



The real GDP and inflation forecasts add up to a goldilocks environment of 3.0-4.0% nGDP. A global perfect soft landing is consensus. It's not surprising that such a goldilocks environment is reflected in global asset prices.

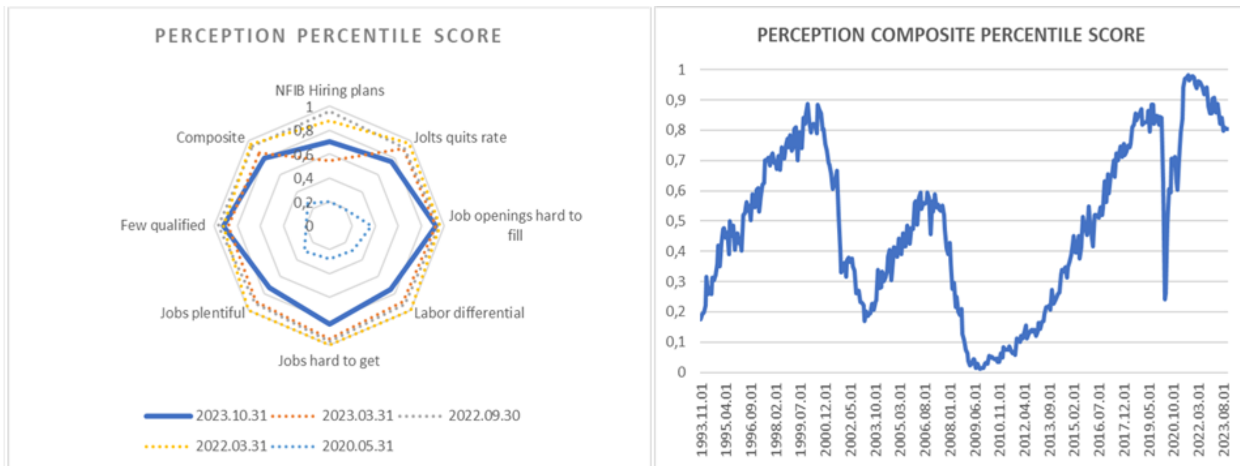


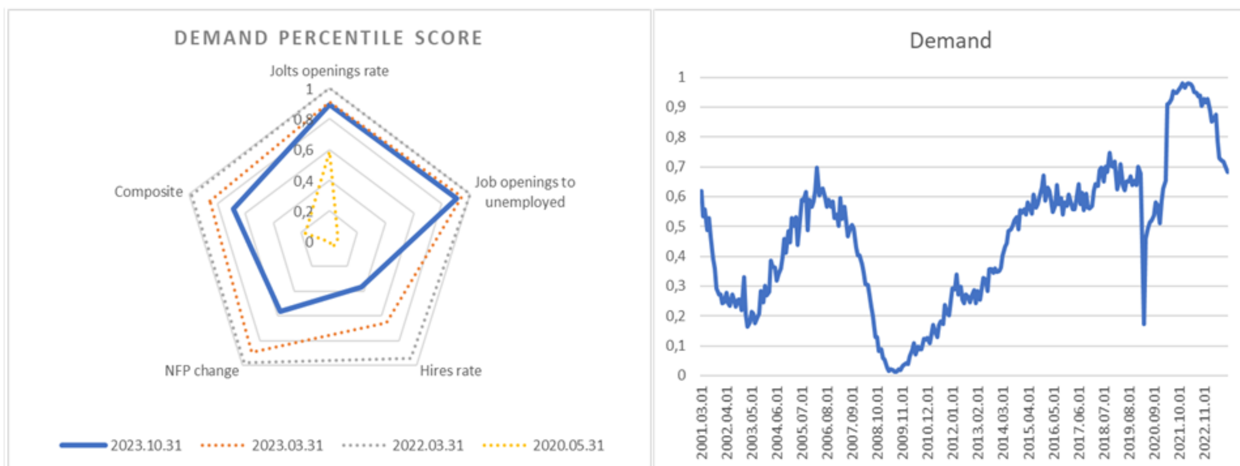
Our estimates for nGDP are well above consensus. Labor tightness, easy financial conditions, ample reserves, healthy lenders, healthy balance sheets of both the majority of private sector household wealth and corporate wealth, significant on-going fiscal deficits, and a priority by global fiscal policymakers for inflationary deglobalization adds up to significant inflationary pressure. We see the trends in growth and inflation. We simply suggest that consensus and markets have already extrapolated those trends to an unrealistic soft landing. Obviously, we are not seeing the hard landing either but at least that potential likely outcome is not priced in many assets particularly corporate obligations of all sorts.

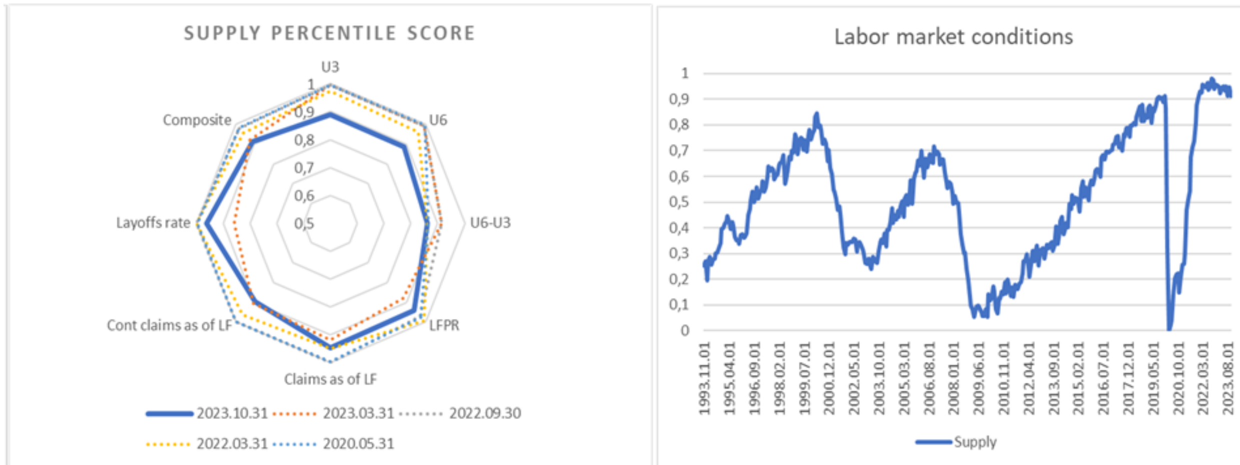
Labor conditions

In this report we focus on labor conditions. Labor market supply characteristics still reveal significant limitations compared to historical patterns. In the following charts we plot the various factors of supply, demand, and perception of the labor market and compare each factor too history. Then we add those factors. It's clear that the labor market tightness has eased somewhat over the last year but is far from adequately easy to extrapolate a soft landing.

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. Over the recent weeks, investors have closely watched initial jobless claims and continuous jobless claims data, drawing conclusions about potential weaknesses in the foreseeable future.

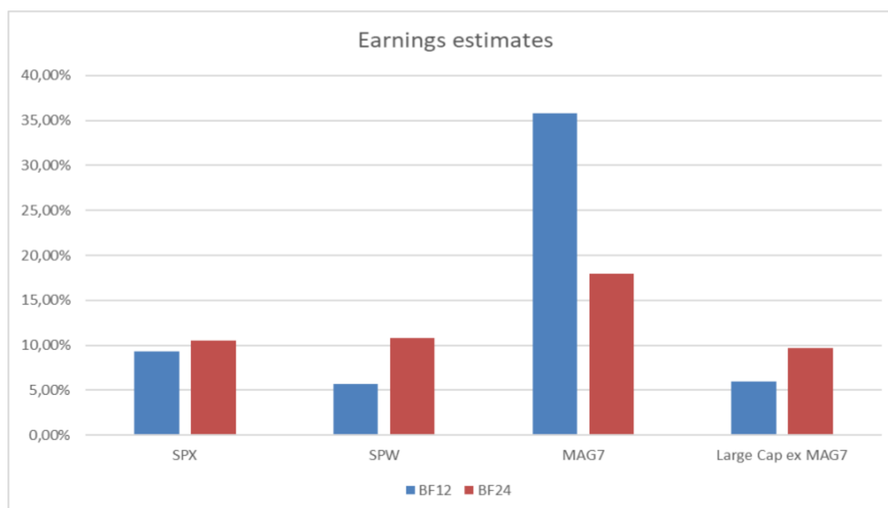
However, it is crucial to emphasize that a more insightful metric for monitoring jobless claims data involves evaluating developments relative to the total labor

force and using this metric gives a clearer signal relatively to the raw numbers. The demand side weakened slightly in the recent months but is still strong compared to prior cycles. Yet the robust nominal growth and corporate balance sheets and continued strong demand are poised to support NFP, primarily driven by the expansion of lower and mid-wage service sector employment.

The perception and sentiment data indicates a robust positive outlook among workers and employees which leads us to anticipate a sustained quits rate and significant bargaining power. Consequently, the labor supply conditions led us to 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.

We can get further confirmation when examining corporate earnings and unemployment trends. 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. Firms tend to refrain from employee layoffs until a substantial decline in corporate earnings and profits becomes evident. This, dynamic, underscores the interplay between economic sentiment, corporate decision-making, and the evolving labor landscape during times of economic turbulence. The recent easing of financial conditions will stimulate the economy and we expect a bounce in economic activity in the coming months and we think the recent weakness in economic data should not be extrapolated.



Consensus earnings estimates for Mag 7 are obviously very high but even the rest of the S&P 500 has optimistic earnings growth. It seems unlikely for this sort of

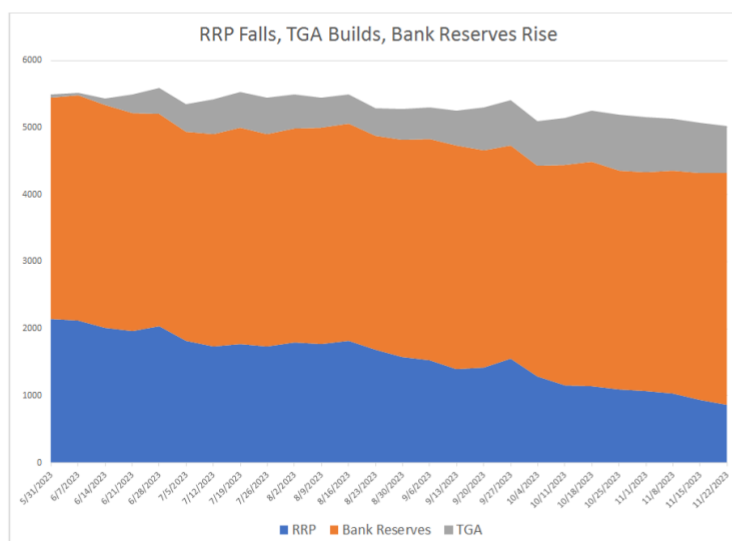
growth to be achieved without inflation staying high and higher than expected inflation would not be coincident with less rate cuts than currently priced.

Our view is that the FED will not cut as fast as priced in without a meaningful equity market selloff based on the historical patterns. Since QRA equities have rallied on term premium contraction which led to multiple expansion. Almost all the rally has been multiple expansion. The cross-asset movements support our view that the key driver was risk premium contraction across all asset classes because all asset classes rallied hard and commodities the least sensitive to risk premiums lagged and that could be explained by the supply and positioning in the oil.

When we add up the labor situation and the need for equities to sell off before significant easing in the labor market can occur, we suspect that for the equity market to be correct nGDP will have to remain above consensus AND policymakers will have to tolerate higher inflation.

What about the RRP and net liquidity measures?

One of the notable trends in the past few months has been the drop in investments by Money Market Mutual funds in the Fed O/N RRP. Of course, QT results in the assets of the Fed balance sheet falling and so it's not surprising that the liabilities fall. But great focus is being placed on the changes of each balance sheet liability.



The idea is that the RRP is falling much more rapidly than QT. That means the TGA and Bank Reserves are rising. In this section of the DSR we weigh the impact of the shift in the Fed's liabilities and whether the nature of the liability means it is more or less likely to impact the economy or the financial markets.

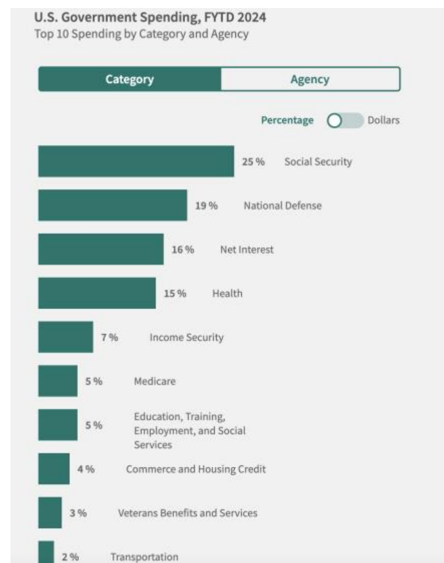
Dealing first with the TGA. It represents future spending that has already been financed. However, that would depend on the Treasury choosing to spend down that account. It is currently at the Treasuries mandated minimum and any spending done below the minimum in the recent past has only been done when there was a debt ceiling in place. We don't expect the TGA to be used to stimulate the economy but will obviously pay attention if it is. The big deal is whether the RRP drop which has modestly raised bank reserves is an important driver for financial assets.

What happens when the RRP goes down substantially? There are two important paths, and those paths are essential to understand what could happen to long term assets. Let's start with what is actually happening. I'll also ignore QT for now. QT makes things worse for assets in both paths.

When the government issues bill to finance spending two things happen

- People get spending in their bank accounts.
- Bills get sold to investors.

That is literally all that happens. Let's break those two things down. People have deposits. What do they do with deposits from the government? Let's be clear this is the money they expected and the fact that bills were issued has no bearing on what they do with the deposit at all. Here's where the deposits go.



Look at the chart and imagine what happens to most of the money. It gets spent immediately! Even a bunch of the interest gets spent by people living on fixed income. BUT some doesn't get spent. Interest being the biggest category. Those

deposits accumulate in, brokerage accounts, treasury direct accounts, mutual funds, pension funds and MMFs as interest on T-bills, T-notes and T-bonds. That money could be used to buy financial assets. But let's follow the rest of the money first. 90% of the deposits get spent. That spending is someone else's income, and they save some and spend some. That spending then is someone else's income who saves and spends and so on until all the original deposits end up in savings. This is important. All that savings ends up as either corporate profit, in the hands of people who can save and not spend long term (wealthy people), and some of it in the hands of people who swapped their holdings in commodities (oil, industrial metals, soft commodities) for deposits. This process of government spending coursing through the economy and ending in savings is constant and is blind to how the money is financed. When it's deficit funding it's stimulative to demand and impacts growth and inflation. But that's another topic.

Let's move to the savings that are constantly increasing due to this spending Adding the unspent interest on debt that I mentioned immediately accumulated in savings, we now have savings increasing at exactly the rate of the increase in government obligations. This savings is just the fiscal deficit handed to savers and those savers buy the government obligations with the savings.

A lot of people lose the mechanism at this point because they say, "wait these savings can buy stonks." That is true. However, at the macro level individual decisions to buy stonks just shift the hot potato. The seller of the stonk, has a deposit now and ultimately someone ends up buying government obligations.

Okay. Here's where the RRP comes into the picture. The RRP is one of many government obligations that investors can choose for their cash. Where do private sector investors hold Cash? Really one of three places.

- Bank deposits
- Money Market Fund (MMF)
- T-bills

Let's deal with MMF's for now. A MMF is a portfolio of short-term obligations that are essentially government backed The MMF looks for the most attractive pool of investments Currently their choices are.

- RRP
- T-bills
- Private sector government collateral repo

Now remember MMF's are just pools of savings. Investors in MMF's don't care at all what the MMF manager is doing with the money amongst those options. The end investor just sees his cash balance grow with interest and deposits more as he gets savings from income. And grow it has.

People unfamiliar with actual investment plumbing call this "Cash on the Sidelines" it isn't. The reason why this MMF money isn't cash on the sidelines is that currently every investor is invested exactly as they are. If tomorrow someone in an MMF wanted to buy equities she could do that. BUT the seller would now have cash and be "on the sidelines". That trade is and has always happened. What matters isn't the quantity of cash it's the animal spirits of fear and greed and the balance of whether being on the field is attractive or being on the sidelines is attractive. What can be said, is that the quantity is quite large and that may impact the market moves as greed kicks in but also speaks to the market move if fear returns.

Anyway, let's go back to the MMF PM who is deciding to invest. As of today, bills have been a better deal than RRP and so MMF's have increased their bills holdings and decreased their exposure to RRP. They have also modestly increased their allocation to private sector repo which we will come back to in future reports. It's important to remind you that the end saver is not impacted by the PM's choices they have no clue, and it doesn't directly change their view on stonks Now what happens when the MMF chooses bills instead of RRP. The answer is that the banks that got the original deposit from the spending paid for with an increase in bank reserves from the Fed get to keep that reserve. That's it. MMF chooses bills RRP down, bank reserves up.

So, the MMF and the MMF end saver drops out of the picture now. Now it's all about the bank and it's depositors. Starting with the deposits. Just like MMF

balances that money is not "cash on the sidelines". Any choice by a deposit to buy results in someone else getting a deposit.

But banks themselves can choose to lever up their assets because they have a new reserve and deposit. In decades past, when fractional reserves regime held, and when reserves paid no interest banks did this. They either printed money and bought assets for their own account, or they lent to people with money created out of thin air and those people bought assets.

In a world of ample reserves an increase or decrease in reserves has close to zero impact on banks decisions to buy assets or provide leverage to those who want to buy assets. **Banks can lever up with no real constraint at this point and the increase in reserves that has occurred lately has no impact on their ability. It's their willingness that matters. In addition, given banks' ability to lever up their clients are able to lever up as well. But it's their client's willingness that matters in today's world**. Reserve increases used to impact ability to lever. The don't anymore. It's all about willingness. It's all about animal spirits.

We have high asset markets, we have high cash balances, we have banks and bank clients able to lever up. It is a volatile environment, but the mechanics of RRP dropping are not impacting the story at all. It was like this when RRP was higher, and it will be when RRP is lower. It's all about willingness. In closing, the second path is when MMF end investors choose to spend or invest and MMF balances fall resulting in MMF fund managers reducing asset holdings and RRP as one of those. This isn't happening in reality and as you can see above any choice like that will simply increases reserve balances at banks equal to the drop in RRP and the same dynamics of willingness and animal spirits apply.

Synthesis

Our synthesis of what has happened since the QRA hasn't changed. Treasury pulled a Crazy Ivan and caught the market short. The easing of financial conditions removes the cover that the Fed had to stop hiking. We will see if the rally in all assets persists, and we wouldn't be surprised at all if it does. However, this will almost certainly be a "False Dawn" for assets, and we expect the market to be less blind this time and aware that in one of the next two QRA's "The Script" will return to Act 3. Perhaps this time the catalyst will not be a slap in the face. At the moment, we think assets are at the top end of their range and we will be adding shorts opportunistically.

Current Portfolio and Performance

The DS Alpha Portfolio is now up 25.03% YTD in excess of cash.

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Close
	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 70,331,320					
	Total Return	70.33%		YTD Return in excess of cash		25.03%	
	Today's Date	11/27/2023		Portfolio Created		4/15/2019	
11/7/2023	CLG4 85/88 Call Spread	0.61	1639	$ 1,000,000	0.45	$ (262,295)	Open
11/7/2023	NDX 12/15/2023 Put Spread 15000/14500	99.75	201	$ 2,000,000	12.6	$ (1,747,368)	Open
11/14/2023	SPX 12/29/23 4465/4515/4565 Call Butterfly	6.50	1538	$ 1,000,000	6.5	$ -	Open
11/14/2023	ESZ3 Two's and SPOOS	4,497.00	-45	$ 1,000,000	4568.75	$ (161,438)	Open
11/1/2023	SFRZ3SFRZ4 Spread	-0.95	1000	$ 1,000,000	-0.91	100,000	Open
11/3/2023	ZBH4 12/22 114/116 Call Spread	0.875	-1125	$ 1,000,000	1.00	$ (140,625)	Open
11/14/2023	ZTZ3 Two's and Spoo's	101.625	-113		101.41	$ 49,219	Open
11/17/2023	ZNH4 1/26/24 109/106 Put Spread	0.859375	1164	$ 1,000,000	0.98	$ 145,455	Open
10/18/2023	GCZ3 Dec 1925/1875 Put Spread	12.41	806	$ 1,000,000	0	$ (1,000,000)	Open
11/16/2023	GCG Dec 12/26 1990/1940 Put Spread	13.79	725	$ 1,000,000	9.03	$ (345,178)	Open
			Risk	10.000%		6.6%	