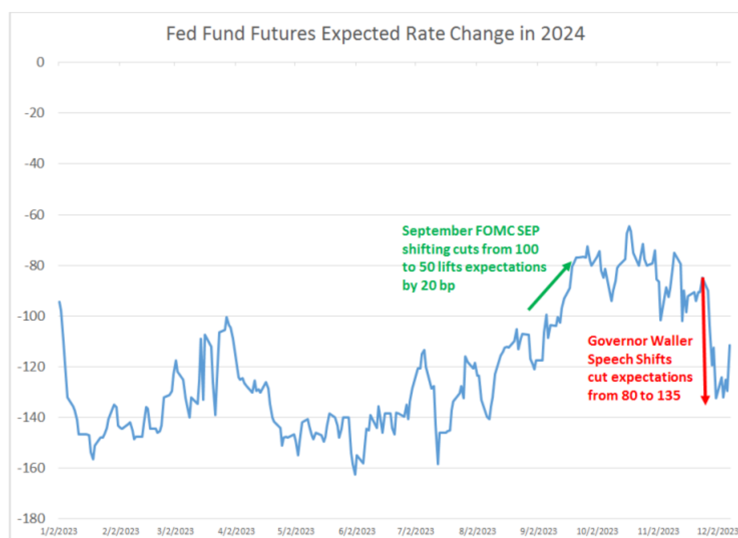
The Damped Spring Report

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

12/10/2023

The FOMC meeting this week deserves careful attention. Ahead of the meeting, short-term interest rate markets have swung wildly as market participants focus on the "Real" Fed Funds rate and whether falling inflation expectations necessitate cuts to Nominal Fed Funds to maintain a similar level of policy restriction. This myopic focus on a single measure of monetary policy is blind to many realities of actual monetary reaction functions, but nonetheless is the measure that fascinates market participants today. This is no accident, as the Fed has repeatedly validated this measure in penciling in cuts for 2024 and 2025 in past SEPs. Markets also reacted exuberantly to comments from previously hawkish Governor Waller that cuts to the Nominal Fed Funds rate in the context of falling inflation would be consistent with the Fed's restrictive policy goal.



Financial conditions have eased massively since the November FOMC and QRA announcement. While last Friday's stronger Non-Farm Payrolls report dashed some hopes of those betting on mechanical cuts, markets are still pricing in 110 bp of cuts in 2024. An SEP that comes close to validating those cuts would, if accompanied by dovish rhetoric, ignite the markets and the economy and represent a remarkable Burnsian moment. Remarkable because absolutely no pain is being felt by the economy. We understand the dual mandate can require a delicate hand on the levers when policy goals are in conflict. However, they are nowhere near conflict today. Take your foot away from the gas pedal!

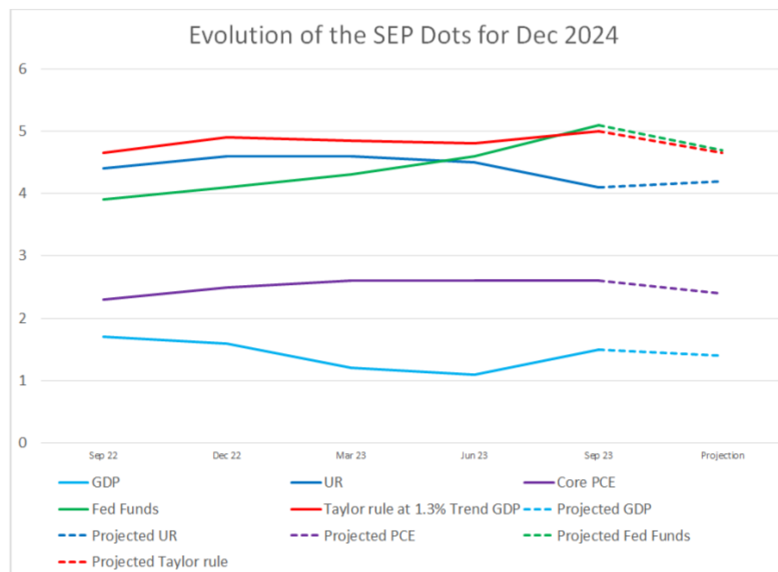
This Damped Spring Report covers:

- our expectations for the December SEP "Dot Plot";
- the implications of various SEP outcomes;
- a step back from the myopic to examine a wider range of monetary conditions;
- a broad review of what we think the Fed "should" do.

December SEP

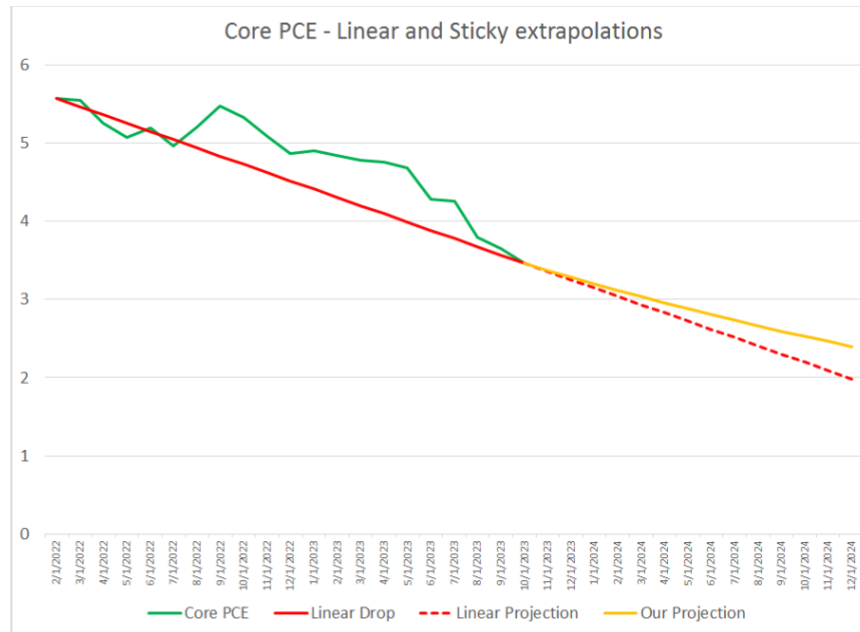
To understand the mechanical cut in nominal Fed Funds, it pays to look at the Taylor Rule. The choice of which version of the Taylor Rule should be used is not particularly important. What matters is the moving parts and the reasoning. The idea is that the desired interest rate is impacted by expected GDP and expected inflation. When GDP and/or inflation expectations are falling, the nominal interest rate should fall or else the nominal rate is more restrictive. We have many SEPs to compare the median projection of Fed governors. To be clear, they come to each dot with their own rationale, and it isn't certain whether the dots are in fact bound by a Taylor Rule sort of consistency. Nonetheless, in aggregate, the Taylor Rule looks to have been a rough estimate of the appropriate policy rate.

Our prediction for the new Dec 2024 dot is 4.7% This dot will be a 40bp decline since the last SEP, reflecting the facts that the Fed did not make the 25bp hike they forecast in September and will reduce the dot 15bps more to reflect the Taylor Rule outcome to which Waller notably referred. **4.7% is 2.5 cuts from the current rate and this will disappoint a short-term rate market that is currently priced for 4.5 cuts.**

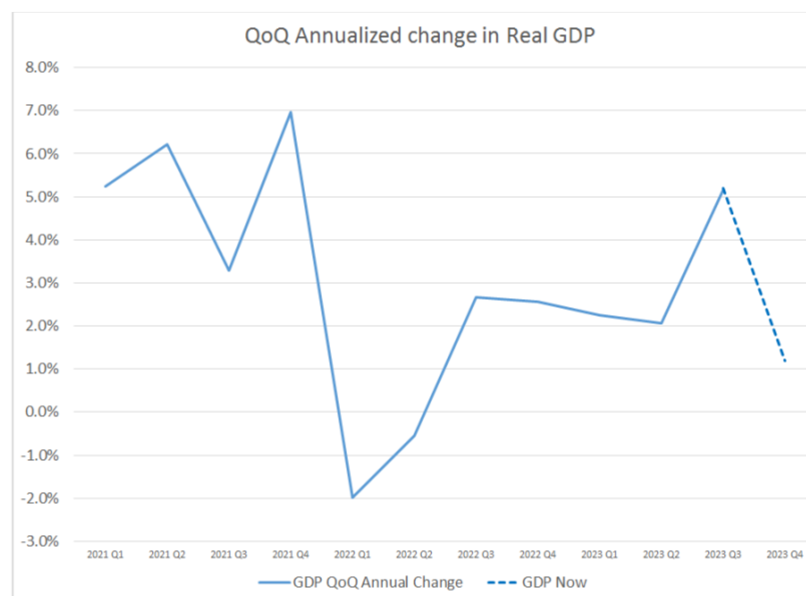


Notice the Taylor Rule (Red Line) has been above the median Fed Funds rate projection. This likely reflects the slow action by the Fed in hiking in 2022. But

here we are and the next step to projecting the Dec 2024 Fed Funds rate is to forecast the economic data.
The purple line is the Core PCE dot from the SEP through time. Over the last 5 quarters, the SEP forecast for inflation has risen slowly and is at the highest level since the hiking cycle began. It seems clear that the Fed is happy with the direction of Core PCE and is likely to lower the 2.6 Dot from September. How much lower? **Our prediction for Core PCE dot is 2.4% YoY for 2024.** This is a sizeable shift and partly extrapolates the pace of declines since the peak of Core PCE while recognizing that inflation could fall more rapidly but is also likely to be sticky and bumpy.

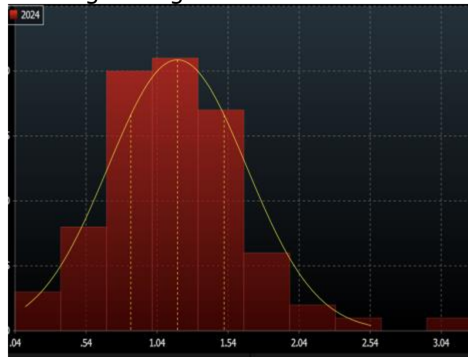


GDP Growth has been highly volatile over the past few quarters. Certainly, extrapolating GDP is not useful.



As future GDP predictions are uncertain, and the Fed believes it can execute a soft landing, **we predict that the GDP estimate on the dot plot will only fall from 1.5% to 1.4%.** Perhaps Wall Street analysts will guide the Fed or their own staff economists. Wall Street forecasts for GDP in 2024 have a median forecast of 1.2% But each Governor will use their own best forecast. We expect the data since the last SEP will not justify a major shift.

Bloomberg Histogram of 2024 GDP Forecasts



Consistent with a slight drop in GDP and informed by the most recent Unemployment Rate of 3.7%, **we predict the Fed will at most tweak the UR to 4.2% vs the Sept SEP of 4.1% and would not be surprised if they do not change that number at all.**

Notably, despite the market being offside vs the dot, a 4.7% 2024 Fed Funds Rate dot is simply the math that the Fed said they would follow combined with likely modest changes in economic forecasts. It sends no message other than to underscore the myopic mechanics of what has roiled markets recently and was likely misunderstood or caught participants short. We think the Fed has other reasons to be hawkish on Wednesday that have nothing to do with the "Real" Fed Funds rate. It is possible that they may express a hawkish view of the dots, but we like our projection and consider it as the Fed explicitly doing what they say they would.

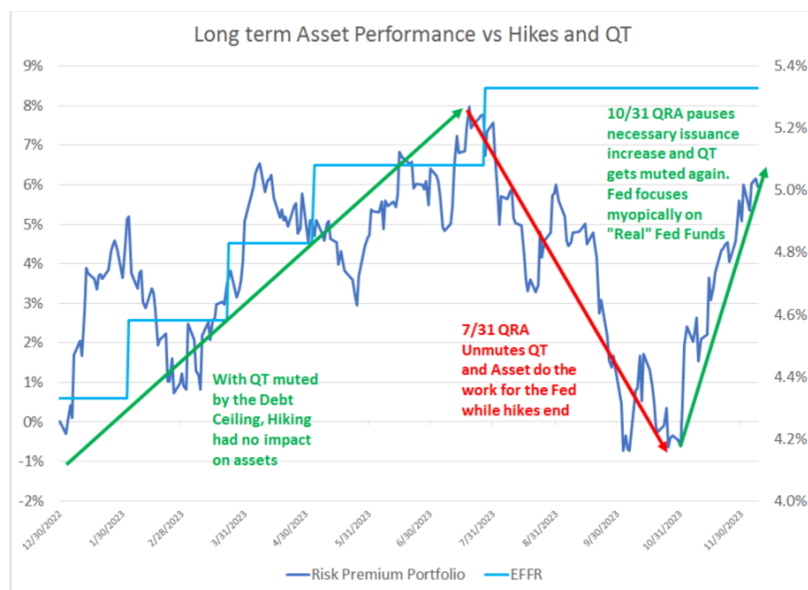
The dots won't go low, but more hawkishness is needed.

Tight monetary policy slows the economy in these ways:

- Raising short-term interest rates increases the cost of borrowing for financial institutions, which may slow their desire to offer loans.
- Raising short-term interest rates makes holding cash more attractive vs consumption.
- Existing floating rate interest increases, which makes it more difficult for borrowers to carry their debt burden and reduces demand.
- Raising short-term interest rates may also cause longer-term interest rates to rise. As most households and enterprises borrow long-term, it is essential for monetary policy to cause long-term rates to rise.
- Finally, increases in risk premium due to QT cause assets to fall and that impacts wealth and thus demand.

It is clear to us that in the current economy the short-term interest rate hikes have done very little to tighten financial conditions. Only the front running of QT in the first three quarters of 2022 and the unmuting of QT by increased coupon issuance announced in July have had any meaningful impact on financial conditions that impact demand in the current US economy.

Yes, inflation has fallen, but labor and real GDP continue to be resilient. The spike in inflation was in fact a serious supply story and, as much as transitory was mocked, supply disruption-driven inflation did prove transitory. That's over and now the real work begins. The short rate isn't doing its job. Now that asset prices are back near peak, it is clear that long-term bond yields are no longer doing the work of the Fed, term premiums are negative again, and even mortgage spreads are collapsing. The Treasury controls QT and has eased significantly. In our view, the Fed can't abandon the job.



Term Premium has been the root cause of the easing. QT has been muted and then unmuted and is now muted again. Hikes are having no obvious impact.

What can the Fed do?

The Fed has created a myopic focus on Real Fed Funds while remaining quiet on QT since its inception. Not once have the minutes suggested any reflection by the committee on the effectiveness of the QT program designed over 18 months ago. No review at all; no public comment at all. Comments have been limited to infrequent observations that the program is operating in the background and some mention of the target destination when Reserves plus RRP = 11% of GDP. Indeed, when the program was announced the idea of having a mortgage-free balance sheet was widely discussed as desirable and yet the mortgage runoff has been well below cap. What major Fed initiative is done without periodic review? In October, many Fed members stated that increases in term premium (the result of QT) have done some of the Fed's work for them:

Lorie Logan: "… if term premiums rise, they could do some of the work of cooling the economy for us, leaving less need for additional monetary policy tightening to achieve the FOMC's objectives."

Christopher Waller: "The financial markets are tightening up and they are going to do some of the work for us...We are just keeping a very close eye on that. We will see how those higher rates feed into what we do on policy in the coming months."

Philip Jefferson: "I will remain cognizant of the tightening in financial conditions through higher bond yields and will keep that in mind as I assess the future path of policy,"

Neel Kashkari: "It's certainly possible that higher long-term yields may do some of the work for us in terms of bringing inflation back down," and added "But if those higher long-term yields are higher because their expectations about what we're going to do has changed, then we might actually need to follow through on their expectations in order to maintain those yields,"

Jerome Powell: "Financial conditions have tightened significantly in recent months, and longer-term bond yields have been an important driving factor in this tightening. We remain attentive to these developments because persistent changes in financial conditions can have implications for the path of monetary policy."

The combination of Treasury's choices on issuance and the Fed's short rate myopia have completely reversed the "work."

What can the Fed do?

In the statement, the SEP and the press conference and in on-going Fed Speak, Fed governors can be hawkish.

- Dots – They can be more hawkish than the Taylor Rule suggests.
- They can walk back the rhetoric on longer-term rates and recognize conditions have eased.
- They can balance the myopia they have created on Real Fed Funds with their actual framework.
- They can reiterate the obvious Risk Management benefit of cutting only when there is actual pain and not before because they can always end QT and cut if needed.

What may the Fed do?

We believe the December meeting is crucial to determine if the Fed will endorse the easing obvious to anyone with eyes or push back. One is the path of hoping and praying the plane lands softly. The other path is being a policymaker willing to do the job. It's a moment for sure. We expect:

- An SEP plot that hews closely to the rule they keep discussing and increase cuts from 2 to 2.5-3 in the 2024. We don't think they will endorse the current 4.5 cuts.
- We assume they will be silent on everything else. They have shown no willingness to do what it takes of late.

What if the Fed overtightens?

When there is pain, the Fed can cancel QT and/or cut. What's so hard about this? There is no pain. The Fed must look beyond the myopic Taylor Rule and backward data and examine what real impactful financial conditions will lead to.

The Fed has fostered market myopia on the definition of restrictive.

What are tight financial conditions? This is a question with no clear answer. We believe that any correct answer requires a multifaceted view. We'll mention a few common ones and our thoughts but not be anything like exhaustive. What is clear is what it means to be tight. Tight financial conditions mean that the availability of money and credit makes it difficult/expensive for someone who needs spendable cash to consume, invest in the real economy, pay back debt, or buy financial assets. In other words, people compare the utility of cash vs these uses of cash and prefer cash.

The implication of tight financial conditions is that economic activity slows. Consumption slows and real investments of all sorts slow. When these things slow without a change in supply of goods and services, prices drop or increase more slowly. That change in prices is either deflation or, more commonly, disinflation. As demand for goods and services drops at a fixed price, real consumption also drops and people consume fewer units of those things. So, both inflation and real growth fall as tight financial conditions persist.

Let's get into some key elements of the multifaceted thing called financial conditions. Let's start by saying again that it is multifaceted, and any single element is simply not enough to determine if financial conditions are tight or loose. Various single elements of financial conditions can become the myopic focus of market participants and the Central Banks can add to the myopia by pointing to a particular element in their communications and actions. Indeed, during certain

cycles over history various single elements were emphasized and then discarded. In addition, even if one accepts the idea of a multifaceted financial condition analysis, each economy may respond differently to each element and the weightings of each element may be quite different depending on the economy and the structure of its institutions.

Let's deal with a few elements that are common today. Perhaps the most common element today is the level of Fed Funds. This is the literal lever that is the primary tool for the Fed to tighten/ease financial conditions. It works by setting the rate (net of bank profit margins) that a participant in the economy can receive holding cash vs consuming or investing. That's an important basic rate and raising that rate has an impact on people's break-even expectations of utility for cash vs consumption or investment on an overnight basis. However, the next step is to think about the future path of short-term interest rates. Because it impacts future breakeven decisions and because it impacts future decisions, expectations of the future path of short-term rates may have an impact on today’s decision.

Now it gets even more complicated, and the current discussion often highlighted by the Fed includes inflation expectations. For instance, at a fixed nominal Fed Funds rate, if you expected your cash to buy less tomorrow than today because of inflation (even if the nominal Fed Funds rate was attractive), you may still decide to consume or invest today. That inflation expectations-adjusted nominal rate is referred to as the "real" Fed Funds rate and modern theory weights this element of financial conditions perhaps more heavily than others.

The Feds dot plot and the Fedspeak you hear has emphasized this real rate time and again the last two years or so. We may be wrong, but this mythical element may well be weighted as high as the money supply was weighted in the Volcker era. Is it myopia to think that this element describes the multifaceted concept of financial conditions adequately? We are sure of it. But let's describe the huge problem with its common usage. We know the nominal level of Fed Funds. We don't know the inflation expectations of the economy. Those are only an estimate. Lots of estimates are used and none of them are certain to be correct. One simple method is to estimate inflation expectations based on prior realized inflation. But monthly numbers are very noisy and longer-term estimates like YoY are lousy estimates for future inflation particularly if inflation has been trending in one direction or the other. Analyst consensus, Fed Dot plots, or market-based estimates of future inflation are themselves prone to both extrapolating recent trends and anchored by the Fed's target inflation level. The bottom line is inflation expectations are uncertain, which means the Real Fed Funds rate is only a guess.

If one uses that rate, however, one chooses to estimate inflation expectations and myopically use the output to determine if financial conditions are tight or loose. In

my view, it is almost certain that this path leads one to be wrong about the future of the economy, the path of interest rates, and the future of financial market pricing.

The lesson here: Don't be myopic! What else is important? This diatribe is getting long, so I'll give you my framework. The concept is that financial conditions depend on the supply of money and credit vs the supply of financial assets. While consumption always causes the shifting of money from one saver to another, the supply of money and credit balances the amount of assets one can purchase for savings. When financial assets offer a poor risk-adjusted return, those with access to cash and credit prefer to hold cash. When assets offer a high risk-adjusted return, people spend cash and borrow cash to invest. The interplay of money and credit and financial asset is something we weigh heavily in our assessment of financial conditions. This should be simple to understand but then humans desire to simplify the concept into something they can then myopically stare at. Money Supply in the Volcker era was one of these simplifications. We prefer to measure and track other things.

Lately we have been all over the amount of duration supply provided by Treasury issuance. We think that's a factor. In addition, we have been loud about the limited or no impact that a change in bank reserves in an ample reserve regime has on the concept we are describing so we don't weight "Net Liquidity" anywhere close as much as certain single element thinkers.

Perhaps the most intriguing source of impact in financial conditions is the fiscal side. When fiscal policy injects stimmies via deficit spending that money is both designed to be spent or invested and at a minimum increases the supply of money and credit and perhaps it's elasticity and is an easing. Government austerity is a tightening.

One last element that is heavily weighted in our framework is the willingness and ability for private sector commercial banks to lever up. Willingness is a business decision and subject to greed and fear. Ability is impacted by internal risk management and external regulatory constraints. The regulatory framework imposed after the GFC limited the ability for banks to lever up and banks are in a much better place today and so are likely to remain able to provide stimulative money and credit.

When looking at the current policy stance the Real Fed Funds rate may be adequately tight. But the overall multifaceted policy stance is too easy. The Fed has handed the QT lever to Treasury and the Fed Funds rate is just not doing much. We will see if the easing since Halloween lasts. If it does, we expect the economy will stay higher for longer.

Synthesis

We expect the Fed will execute on its Taylor Rule-oriented mechanics on the SEP and pencil in a dot of 4.7 for year-end 2024. We think the short-term interest rate market will be disappointed and the curve will bear flatten. Equities will likely remain bid unless the Fed is somehow more hawkish. We think the Fed should be more hawkish but most likely won't be until data begins to warm more. Our view remains anti-soft landing and short both long-term bonds and equities, confident that one or the other will pay handsomely and possibly both if the Fed takes its job seriously.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 66,368,567		
Total Return	66.37%	YTD Return in excess of cash	21.07%
Today's Date	12/10/2023	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
11/7/2023	NDX 12/15/2023 Put Spread 15000/14500	99.75	201	$ 2,000,000	2	$ (1,959,900)	Not in Risk #
11/7/2023	CLG4 85/88 Call Spread	0.61	1639	$ 1,000,000	0.08	$ (868,852)	Open
11/14/2023	ESZ3 Two's and SPOOS	4,497.00	-45	$ 1,000,000	4609	$ (252,000)	Open
11/28/2023	ESZ3 Two's and SPOOS	4,561.00	-55		4609	$ (132,000)	Open
11/29/2023	NDX 2/16/2024 15500/15000 Put Spread	85.00	118	$ 1,000,000	85	$ -	Open
12/1/2023	NDX 2/16/2024 15500/15000 Put Spread	101.00	99	$ 1,000,000	85	$ (158,416)	Open
11/14/2023	SPX 12/29/23 4465/4515/4565 Call Butterfly	6.50	1538	$ 1,000,000	5.8	$ (107,692)	Open
11/29/2023	SPX 2/16/2024 4400/4300 Put Spread	12.20	820	$ 1,000,000	11.3	$ (73,770)	Open
12/1/2023	SPX 2/16/2024 4400/4300 Put Spread	12.40	806	$ 1,000,000	11.3	$ (88,710)	Open
12/1/2023	ZBH4 2/26/2024 114/110 Put Spread	0.90625	1103	$ 1,000,000	0.67	$ (258,621)	Open
12/8/2023	ZBH4 2/26/2024 114/110 Put Spread	0.67	1493	$ 1,000,000	0.67	$ 2,799	Open
11/29/2023	ZNH4 2/29/24 108/106 Put Spread	0.375	2667	$ 1,000,000	0.38	$ -	Open
12/8/2023	ZNH4 2/29/24 108/106 Put Spread	0.375	2667	$ 1,000,000	0.38	$ -	Open
11/28/2023	ZTH4 Two's and Spoo's	102.09375	-225		102.16	$ (28,125)	Open
11/16/2023	GCG Dec 12/26 1990/1940 Put Spread	13.79	725	$ 1,000,000	8	$ (419,869)	Open
			Risk	12.000%		9.6%	