The Damped Spring Report

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

12/31/2023

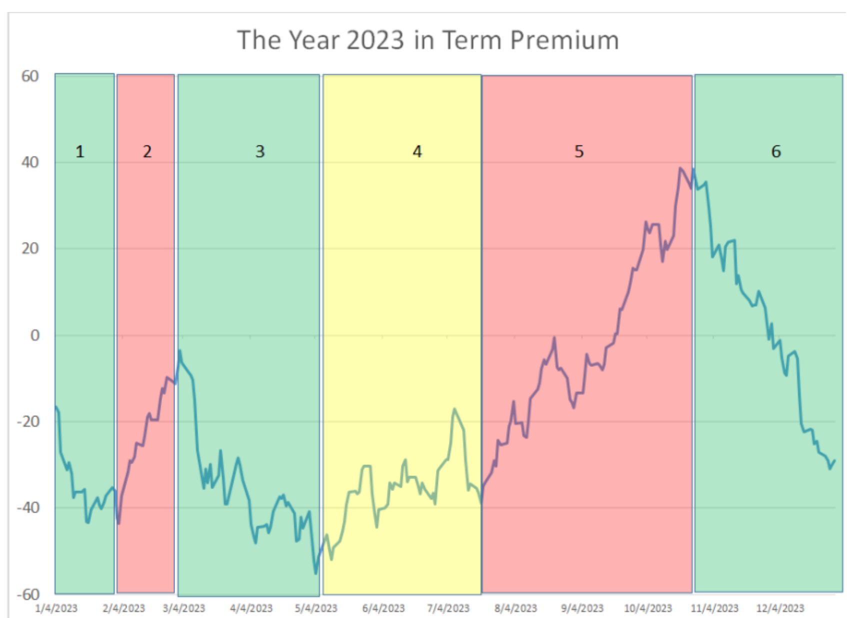
2023 was dominated by meaningful shifts in risk premiums, driven by Fed quantitative tightening, foreign central bank currency intervention, the debt ceiling, the policy response to four bank failures, and major shifts in US Treasury issuance. We expect more of the same next year. Perhaps 2024 may lead to some certainty regarding the economic outlook, but we continue to doubt that a soft landing will be achieved. We remain optimistic on real growth and pessimistic that inflation will get to, and remain at, target.

This DSR will review:

- **2023 for clues on future drivers to help us navigate 2024.**
- **The DS Alpha, DSBeta, and DSAlphaBeta performance.**
- **Our 1Q24 economic outlook.**
- **Our 1Q24 expectations for asset prices.**

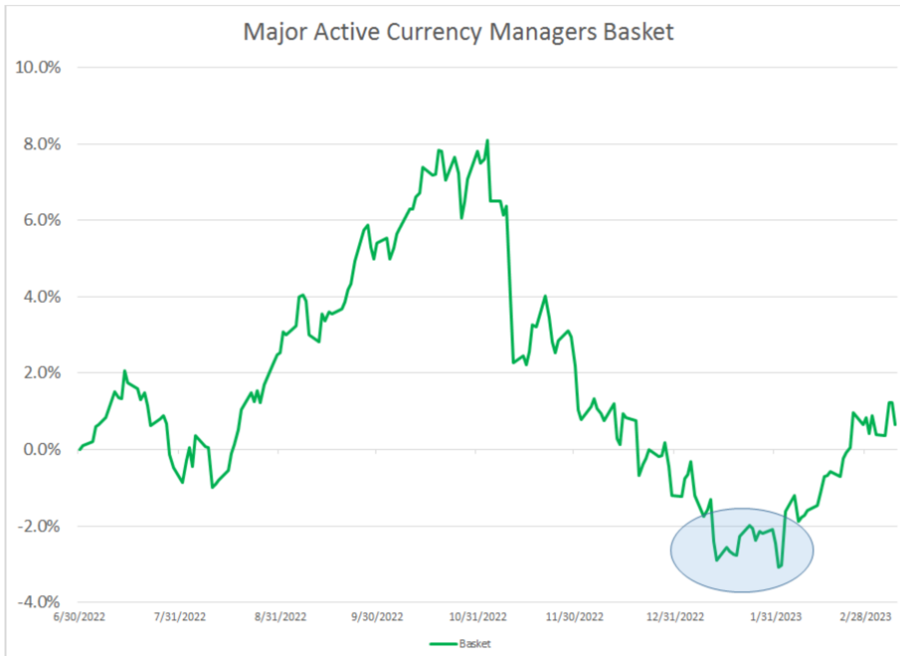
Breaking Down 2023's Big Risk Premium Drivers

Term premiums on 10Y bonds swung by 90 bp during 2024 and ended the year at a substantial negative level, collapsing 70bp in two months. Six specific time periods that stood out to us were important and bear keeping in mind during 2024.

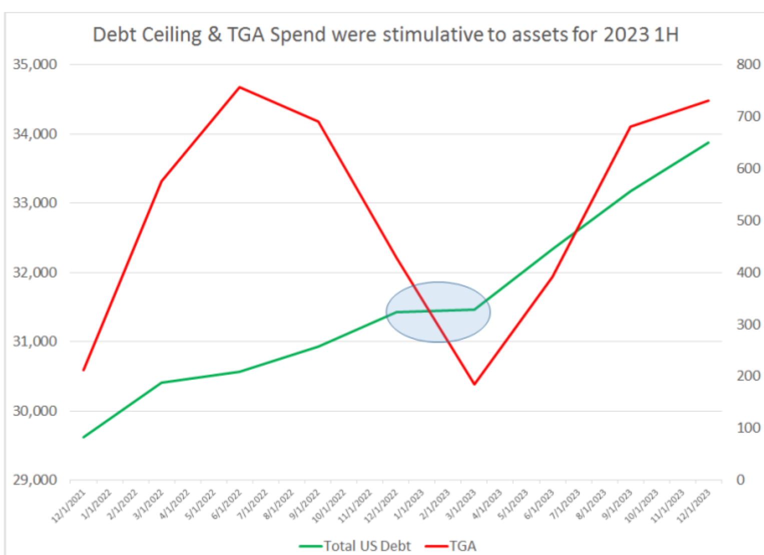


#1. Currency Intervention, Debt Ceiling, Oversold Equities, & AI Animal Spirits

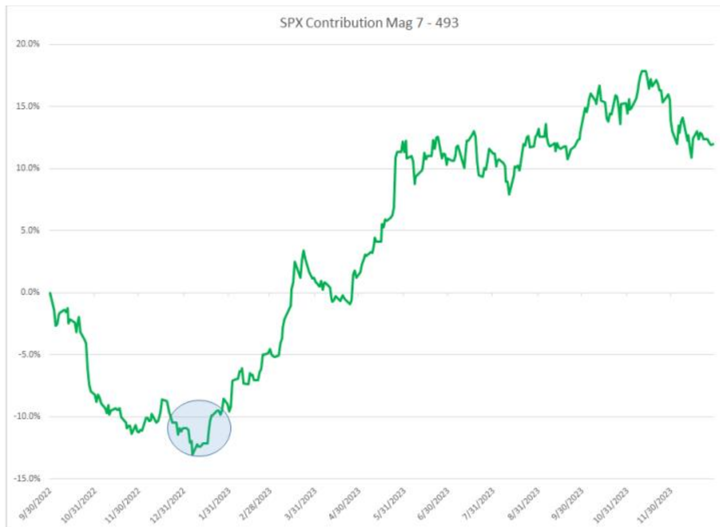
In January, term premiums fell 25 basis points as foreign central banks bought USD and USD assets and printed their own currencies to offset strength in their local currencies that threatened the reopening of their economies.



Foreign demand for USD assets provided an offset to QT runoff. At the same time, the US debt ceiling was reached, capping the issuance of Treasury Bills, Notes and Bonds. A combination of reduced issuance and continued fiscal spending using proceeds from prior issuances in the Treasury General Account (TGA) provided additional fuel for a January rally.

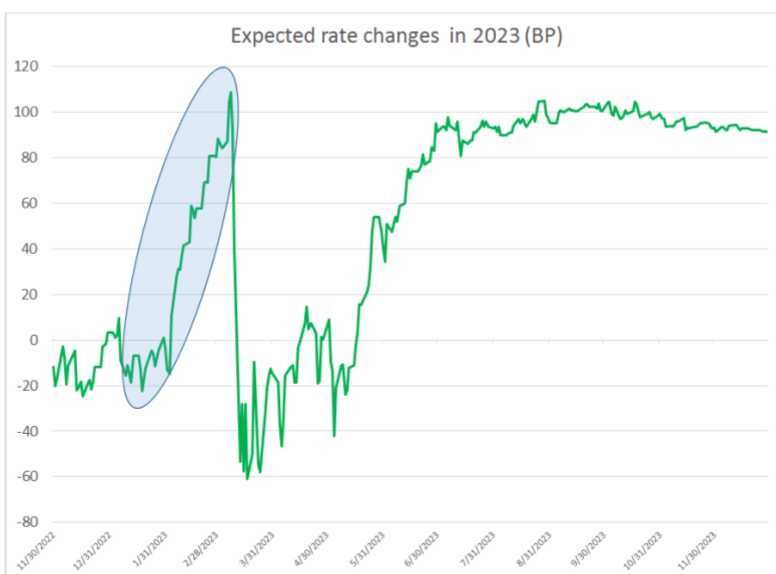


Equities, and particularly big cap tech (MAG7), had been sold viciously in Q4 2021. At the time we observed that some selling in MAG7 was due to tax-loss harvesting. By Jan 6, MAG7 had bottomed and began driving the overall index higher. On January 26, Microsoft invested $10BN in Open AI and the sleepy business of AI, ML, and LLMs like ChatGPT, became as well known to the general public as the internet in 1999. For the next 10 months (though not really that much in the past 5 months), there was a constant bid for MAG7 and AI equities.



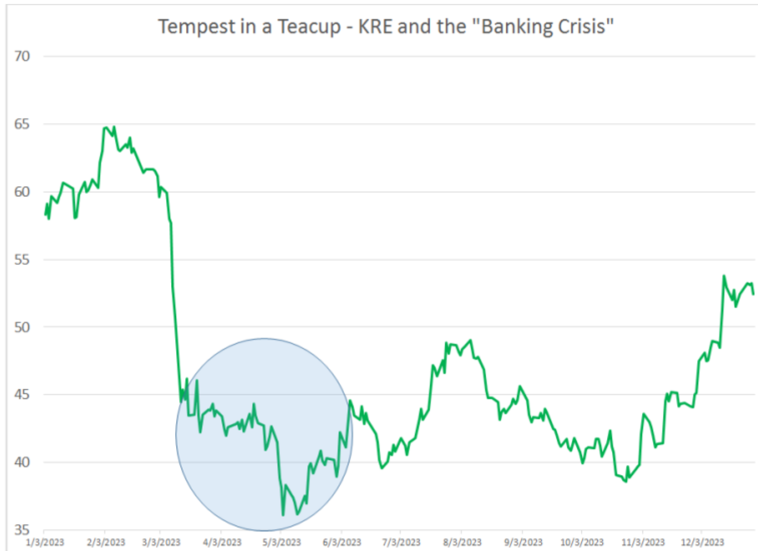
2. FOMC Hawkishness

By February 1, the second phase of term premium volatility had begun. The Fed was hawkish at the FOMC meeting and, perhaps surprising some, Treasury announced a full set of coupon issuance despite the debt ceiling restrictions in the February 1 QRA. The issuance was limited by extraordinary measures available to Treasury, but, perhaps due to Fed hawkishness, nonetheless led to significant term premium expansion. The Fed continued to be hawkish through Chairman Powell's March 9 Congressional testimony, in which Powell pushed back hard on the suggestion that the hiking cycle had ended.



#3 Tempest in a Teacup

The irony of the Fed's hawkishness was made immediately obvious the weekend following Powell's Congressional testimony as Silicon Valley Bank and Signature Bank were seized by the FDIC. Over the next two months First Republic Bank was sold to JP Morgan and UBS acquired Credit Suisse.



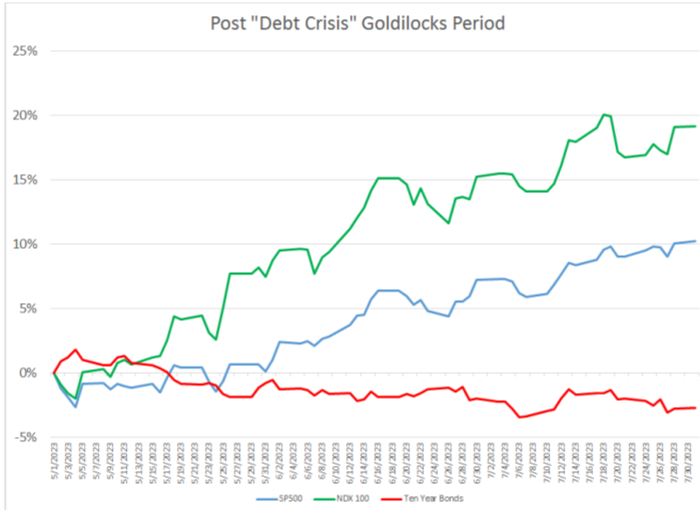
The most notable immediate policymaker action was the establishment of the Fed's BTFP facility. At the time, many market participants described BTFP as QE because it increased assets on the Fed's balance sheet and appeared to fuel animal spirits. We disagreed with this view then and disagree now. When following the money, it is clear to us that the BTFP prevented a fire sale of assets, which is supportive of assets but not stimulative in its own right.

Read our Damped Spring Report from the time for details on the BTFP transmission mechanism here or watch our video explainer here.

But the banking crisis did allow already strong pressure on risk premiums to re-exert themselves without any support from the now chastened Fed hawks. A combination of low issuance, TGA spending, AI excitement, and the market's perception of a "Financial Stability Put" created by a Federal Reserve and Administration willing to take immediate action to prevent financial instability contagion, all led to risk premium contraction.

#4. Post "Banking Crisis" Goldilocks

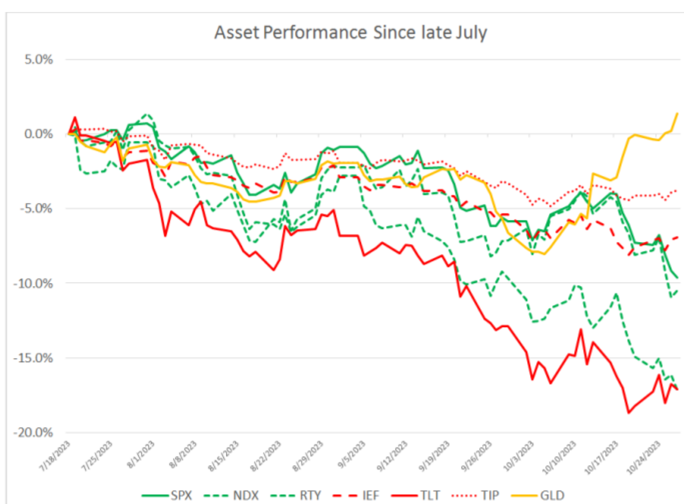
By early May, First Republic Bank was acquired by JP Morgan. Risk premiums were pressured lower with limited coupon issuance and a less hawkish Fed, but supported by some uncertainty due to the approaching D-Day of the government shutdown. Largely unnoticed was the May Q3 QRA issuance schedule, which proposed a large bills issuance and the smallest coupon issuance since the GFC. But for the D-Day uncertainty, this was a perfect Goldilocks environment. By July 31, equities led by MAG7 and AI-names had rallied substantially while bonds had only fallen a few percent.



To summarize, between the banking crisis and July 31, the world changed. Very limited new issuance and TGA spend contributed to strong real GDP that, against a backdrop of falling inflation, a less hawkish Fed and the Financial Stability Put, favored equities, particularly MAG7 and AI names, while not being horribly bearish bonds. Markets responded accordingly through July 31.

#5. Significant Coupon Issuance Increase Blows Out Risk Premiums.

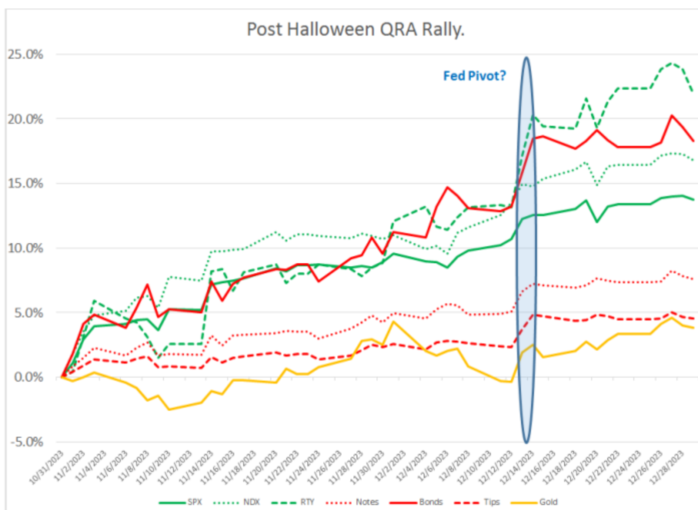
On July 31, Treasury announced a large issuance schedule for the remainder of Q3 and Q4. A large TGA increase financed by bills was widely expected and, given the size of the RRP as a source of bills demand, the bills issuance was not particularly important. However, coupon issuance grew by 150BN. That issuance meant that QT was no longer muted by other factors. The impact was immediate and powerful. Risk premiums went up 80bp in 3 months. Long-term bond yields rose by 100bp, driven mostly by risk premium but perhaps also by strong real 3Q23 GDP. All assets fell sharply, with only gold generating a positive return due, in part, to the October 7 Hamas attacks. This was a classic risk premium expansion driven by investors over-levered long and being required to absorb an extra 150BN of risky Treasury notes and bonds.



#6. Janet Flinches! The Fed Pivots?

On Halloween, the QRA once again became big news in 2023. On Feb 1, the QRA surprised investors who thought the debt ceiling might prevent coupon issuance. The May 2 QRA telegraphed the lowest issuance of duration in the post-Covid era. The July 3 QRA shot a bazooka at asset markets vulnerable to a reversal of Goldilocks expectations. On Halloween, Janet flinched. The significant selloff in the long-term bond market caused Treasury, with the advice of TBAC, to pause duration issuance growth for at least one quarter. We saw that action real time and immediately covered all shorts and went long all assets. Treasury announced an issuance schedule of roughly 60% T-bills. While Treasury had already relaxed the historic range of 15-20% T-bills as a percent of total debt, in the Halloween QRA Janet kicked the can of refinancing Federal Debt with notes and bonds instead of bills down the road for at least one quarter (if not more) and perhaps permanently.

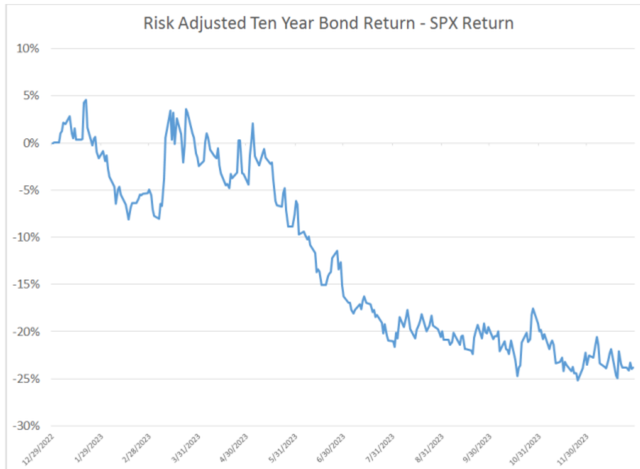
In December, Fed Governor Waller described the Fed's forward rate path more explicitly, but not in any way new, as focused on "Real" Fed Funds. The SEP during the FOMC meeting modestly confirmed that Taylor Rule/R* view by adding a rate cut to the 50bp already in the SEP from the September FOMC. Importantly, Powell did not distance himself from the perceived pivot. The asset rally driven entirely by a 70bp decline in term premium ignited further and markets ended the year pricing 162bp of cuts in 2024.



The relative lack of duration supply has caused term premiums to now rest at negative 30bp, making issuance of Notes and Bonds very attractive again. Will Janet be emboldened by the rally to extend duration? We will find out on 1/31. Will she risk inflation reigniting to keep unemployment rates low and real GDP growth high? While political calculation is not our lane, we are sure that a soft landing without a reignition of inflation is the best outcome for Janet and the Biden administration. Will she or won't she? As been seen this entire year, Janet holds the primary monetary policy lever. We will not predict how she pulls the lever, but will watch what she does. However, at this stage risk premiums are severely depressed and upside for owning all assets depends on her favoring bills and risking inflation.

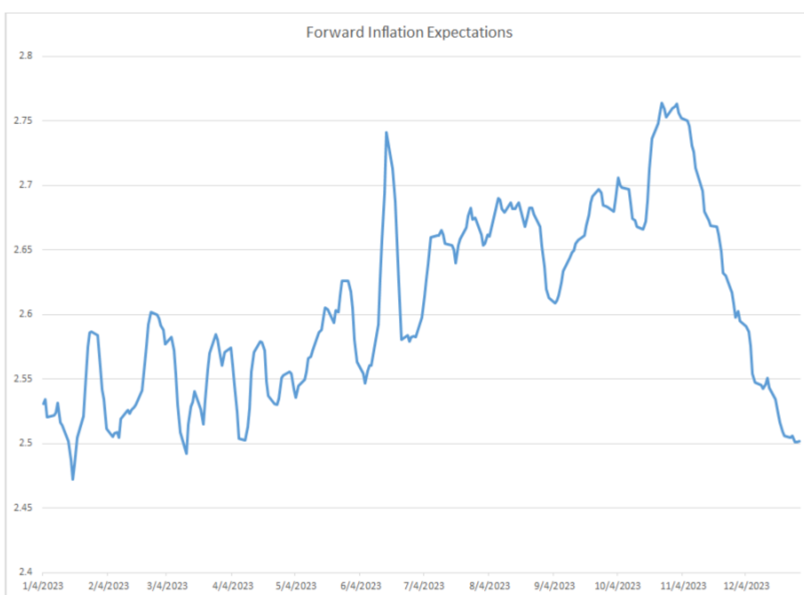
What of Inflation, Growth, and Fed's Path?

All that really mattered for macro in 2023 was trading the QT transmission flow. However, within asset markets shifts in growth and inflation expectations had short term impacts on assets' relative performance. In particular, much stronger than expected real growth drove the biggest divergence in asset pairs.

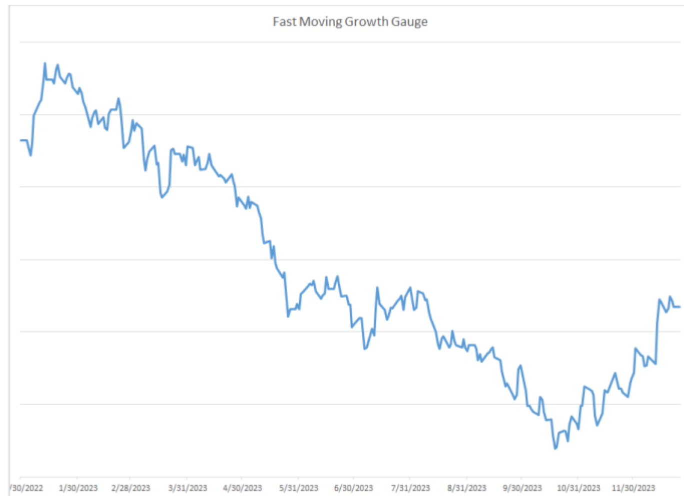


The equal risk pair of 10Y Bonds and SPX diverged by 25% as growth was strong and positioning massively offside in long bonds, which resulted in huge underperformance in the first seven months of the year. Notably, since the 7/31 QRA, bonds and stocks have fallen and risen in price in virtual lock step. This pair is driven in opposite directions by growth expectations, while inflation is strongly correlated with bond yields but loosely correlated to equity prices. Consequently, we are convinced that the driver of this pair since July was entirely risk premium expansion followed by contraction.

Looking specifically at various market-based expectations of growth and inflation we can't help but notice the volatility of these measures. Inflation expectations ended where they started, but the reversal was extremely sudden and inconsistent with the rate of change of the persistent disinflation in the economy.



Our growth gauge did show persistent slowing the first 10 months of the year, but the easing in financial conditions and the perception of a pivot has reversed some of that slowdown.



Fed policy actions slowing the size and frequency of rates hikes, pausing to reflect on incoming data, and forward guidance around cuts have been measured and incremental. However, the markets expectations of cuts in 2024 have varied wildly.

Despite the easing of financial conditions post 10/31 QRA and the ramp up in growth expectations, the market has fully priced a pivot. The market's extrapolation of further disinflation, when paired with the Fed's bizarre myopic focus on Real Fed Funds, has caused cuts priced into 2024 to increase substantially in December. We believe the market is far ahead of the data. We also believe that the Fed is not myopic and recognizes that the easing may make them have to work harder. Only persistent and continued disinflation and an overshoot below the Fed's inflation target could possibly result in rate cuts priced in to occur. Without rising unemployment, we would be surprised if the Fed cuts anywhere near what is priced-in, even if disinflation continues.

2023: Lessons Learned.

By far the most important takeaways from 2023 was the significant market reactions to timing of fiscal spending vs fiscal financing and the composition of issuance changes. Most of the alpha delivered this year in the DS Alpha portfolio came from understanding the impact of these flows. Ironically, our biggest mistakes were fading too early our own view of these impacts. This was something that occurred in 2022 as well. We had high confidence that the drumbeat of QT in 2021 would have a major impact on asset prices and we bought dips too early. This has been corrected in our signals going forward.

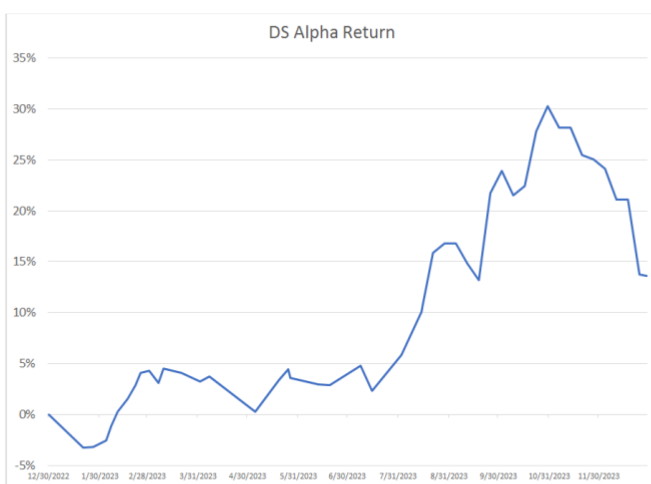
We have remained confident in the economic resilience of the US economy and yet chose to only make bets that were anti-soft landing. Despite confidence in our H4L call, we weigh a recession and a higher for longer environment equally. This weighting led to a balance in weight of bond market and equity market shorts when term premiums were extremely tight. A pure bond market expression would have been more sensible given our own expectations that growth would be resilient and favor equities.

During the "Tempest in a Teacup" we covered most of our equity shorts. But given our understanding of the situation, we once again didn't bet on long equities in case we were wrong. Most of the time we prefer to be humble vs cavalier. We failed to separate the big deal from the doom.

AI hype is not our lane, and we rarely chase greater fool-dependent trades. Nonetheless, from a risk management standpoint, it was obvious something was happening, and we will consider steps to limit fading bubbles. Better to sell on the other side of the hype.

Lastly, the economy has been mostly chugging along in the right direction with very little volatility. We avoided big calls on growth and inflation. We think that was where many other investors failed, and we think that will likely be where investors fail again in 2024. If we see reasons for a big call, we won't hesitate. In fact, today we differ markedly from consensus, confident that the easing in financial conditions will result in both inflation and growth delivering results above expectations unless both the Treasury and Fed act to offset strength.

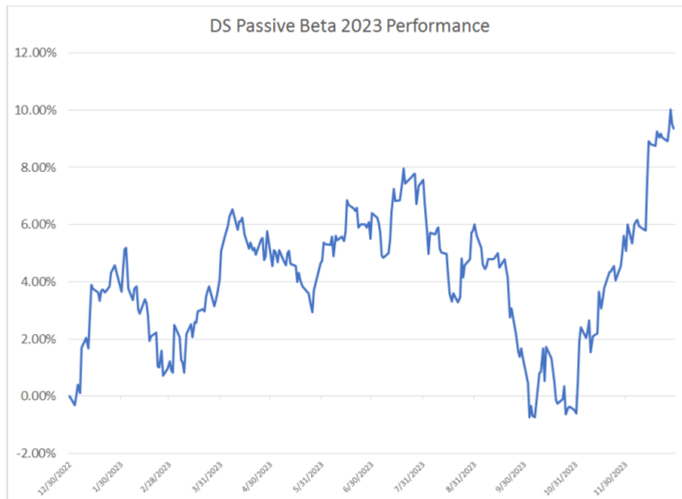
Review of DS Alpha Performance



In 2023, DS Alpha generated returns that were above our expectations, but below our expected Sharpe Ratio. DS Alpha also experienced a greater than expected drawdown over the last two months. We caught the bottom of both equity and bond markets on Halloween, but have added shorts to all assets as the market has far exceeded our expectations of term premium contraction and our view of the whether the Fed has indeed pivoted.

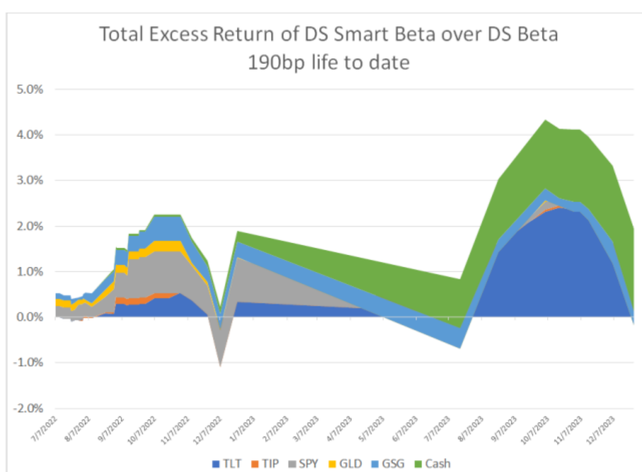
Review of DS Beta Performance.

DS Beta delivered its expected return in excess of cash, but also had a Sharpe Ration that was below expectations.



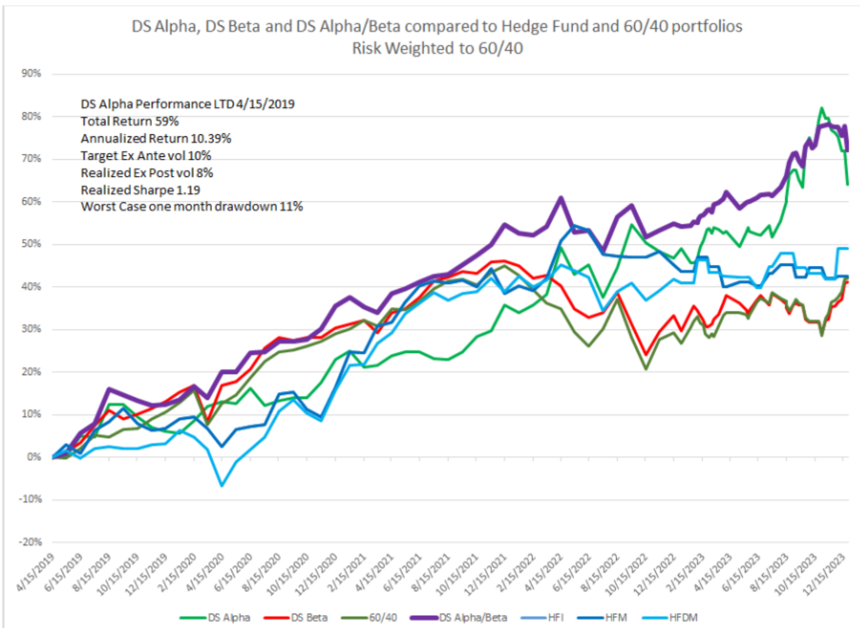
Review of DS Smart beta performance

DS Smart Beta, which adjusts weightings of assets within the portfolio and between cash and assets, contributed 110 bp of performance in excess of DS Passive Beta returns. Since inception in June 2022, DS Smart Beta has added 190 bp.



Review of DSAlphaBeta vs Comps

DSAlphaBeta which is the combination of DS Alpha and DS Beta has delivered superior returns since inception as DS Alpha is uncorrelated to Stocks, Bonds, and other hedge fund strategies. That proved fortunate during the last two months as DS Alpha's drawdown happened to be short assets which DS Beta was of course long.



DS Alpha Correlation to	DS Beta	60/40	HFI	HFM	HFDM
	-19%	-24%	18%	18%	19%

1Q24 Synthesis and Outlook.

The Script revisited. We believe the easing of financial conditions across mortgages, floating rate liabilities, and corporate spreads, as well as the significant recovery of bank balance sheets, will result in increased economic activity. Adding continued large fiscal deficits and wealthier corporations and asset-holding consumers will also offset the disinflation of oil prices and other supply chain goods. Any bounce of growth and inflation should be dealt with by firm Fed action but also with the duration supply catalyst to cause bond yields to rise. Janet returned the script to Act 1, and we believe it will take all 5 acts to well and truly kill inflation.

Act 1. **Higherer for Longerer Island - Hikes continue and don't achieve goal.**

Act 2. **Long end yields rise to new highs – Requires a supply catalyst.**

Act 3. **Multiple compression – Higher yields take the legs out of the equity market.**

Act 4. **Earnings contraction – The tightening of Act 2 and Act 3 hit demand.**

Act 5. **Recession Island – Finally. as equities sell off, companies fire workers.**

Risk Premiums

Risk premiums once again do not offer a positive expected value for assets over cash. That situation has been the norm post-Covid. We expect that either the Fed and Treasury will need to act in order to generate a normal reward for holding assets in order to cool the economy or a recession will cause a widening of term premiums as cash needs for debtors and consumers increase. However, as long as the recession is delayed and policymakers tolerate asset inflation, term premiums are not likely to return to attractive levels. We will be looking to the 1/31 QRA for direction but in the short term are comfortable short assets in our alpha portfolios and overweigh cash in our beta portfolios.

Portfolio volatility also plays a part in asset valuation. Owning assets is always short volatility. Current levels of implied volatility are quite low. We are not interested in being short volatility at current levels. In addition, owning asset portfolio is more attractive when assets are uncorrelated across the portfolio. We expect a rise in correlation.

Growth

We see very little chance of a recession in the near-term. We believe a recession will follow persistently high long-term interest rates. Until that happens, we expect a strong real growth environment.

One would have to be blind to miss the disinflationary environment we have been living through. However, one would also have to be suffering from myopia to extrapolate the improvement in supply chains to a reduction in demand. Demand is fueled by wealth, wages, fiscal spending, and the ability to borrow at attractive rates. All factors of demand are now positive and supportive.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 58,879,822		
Total Return	58.88%	YTD Return in excess of cash	0.00%
Today's Date	12/30/2023	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
11/7/2023	CLG4 85/88 Call Spread 1/17/2024	0.61	1639	$ 1,000,000	0.02	$ (967,213)	Open
12/13/2023	ESH3 Two's and SPOOS	4,708.00	-100		4813	$ (525,000)	Open
11/29/2023	NDX 2/16/2024 15500/15000 Put Spread	85.00	118	$ 1,000,000	29	$ (658,824)	Open
12/1/2023	NDX 2/16/2024 15500/15000 Put Spread	101.00	99	$ 1,000,000	29	$ (712,871)	Open
11/29/2023	SPX 2/16/2024 4400/4300 Put Spread	12.20	820	$ 1,000,000	4	$ (672,131)	Open
12/1/2023	SPX 2/16/2024 4400/4300 Put Spread	12.40	806	$ 1,000,000	4	$ (677,419)	Open
12/22/2023	SPX 3/15/2024 4600 Put	54.40	184	$ 1,000,000	48	$ (117,647)	Open
12/28/2023	NDX 2/16/2024 16500 Put	205.00	49	$ 1,000,000	229	$ 117,073	Open
12/1/2023	ZBH4 2/23/24 114/110 Put Spread	0.90625	1103	$ 1,000,000	0.13	$ (862,069)	Open
12/8/2023	ZBH4 2/23/24 114/110 Put Spread	0.67	1493	$ 1,000,000	0.13	$ (813,433)	Open
11/29/2023	ZNH4 2/23/24 108/106 Put Spread	0.375	2667	$ 1,000,000	0.09	$ (750,000)	Open
12/8/2023	ZNH4 2/23/24 108/106 Put Spread	0.375	2667	$ 1,000,000	0.09	$ (750,000)	Open
12/27/2023	ZNH4 2/23/24 112 Put	0.796875	1255	$ 1,000,000	0.97	$ 215,686	Open
11/28/2023	ZTH4 Two's and Spoo's	102.09375	-225		102.88	$ (351,563)	Open
12/27/2023	"Sell All Assets Basket" SPY	475.80	-15763		475.31	$ 7,724	Open
12/27/2023	"Sell All Assets Basket" TLT	99.57	-90389		98.88	$ 62,368	Open
12/27/2023	"Sell All Assets Basket" TIP	107.67	-69661	$ 1,000,000	107.49	$ 12,191	Open
12/27/2023	"Sell All Assets Basket" GLD	191.88	-15635		191.17	$ 11,101	Open
12/27/2023	"Sell All Assets Basket" GSG	20.66	-145208		20.06	$ 87,125	Open
			Risk	13.000%		5.7%	