The Damped Spring Report

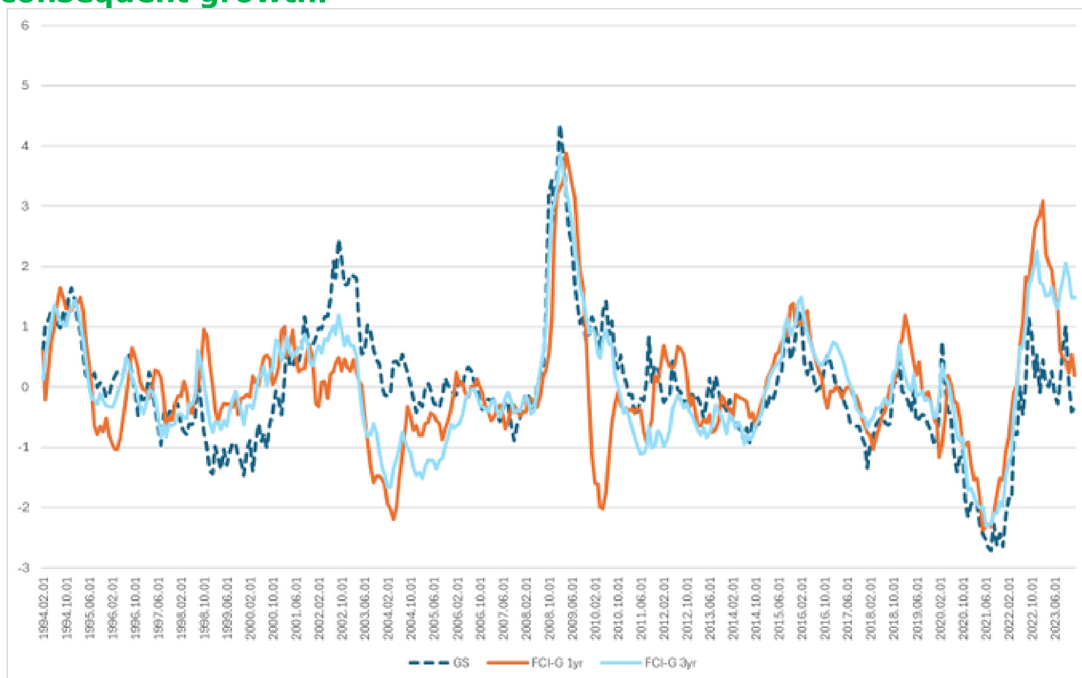
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

2/13/2024

This Damped Spring Report discusses a few issues driving markets:

- **Recent fiscal and monetary policy path developments.**
- **The macro implications of the US big cap tech ("Mag6)-led US equity market and deal with the question "Has NVDA killed macro?"**

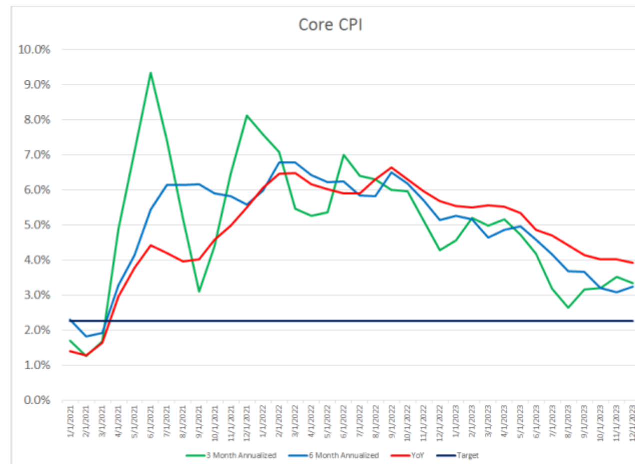
We continue to believe that asset markets are vulnerable to a meaningful correction led by higher bond yields across the curve. We expect bond yields to rise by 50 bp before the next Fed meeting in March. Given the economic climate, we expect no cuts at all in 2024, depending on the performance of equity markets and earnings. In our "Script" from last July (here), we stated that persistently higher long-term bond yields were necessary to cool demand adequately to well and truly kill inflation. Since then, inflation has continued to move toward the Fed's target, but GDP is running at least 3.5% and is highly unlikely to drop to the Fed's September 2024 target of 1.4% for the year without a significant tightening of financial conditions. Fed Governors Logan and Waller have notably mentioned the Fed's "new" FCI gauge, which shows increasingly easy FCI and consequent growth.

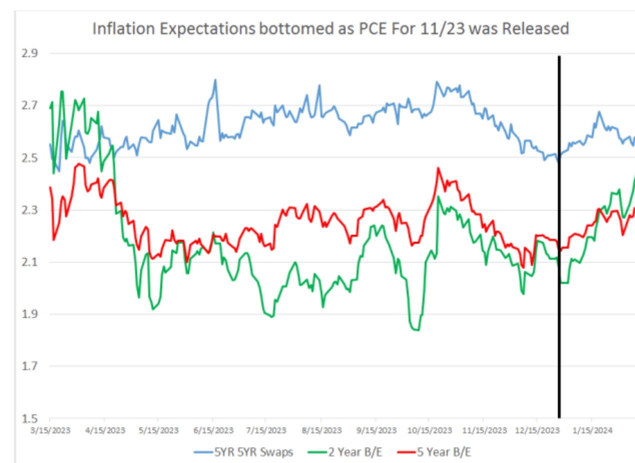


Review of recent fiscal and monetary policy path developments.

CPI Revisions

Last Friday’s 2023 CPI revisions were dovish relative to expectations but left the inflation path unchanged. Peak disinflation pricing likely occurred as the PCE for November was released and now the reality of the necessary work required over the course of the year has become clearer.



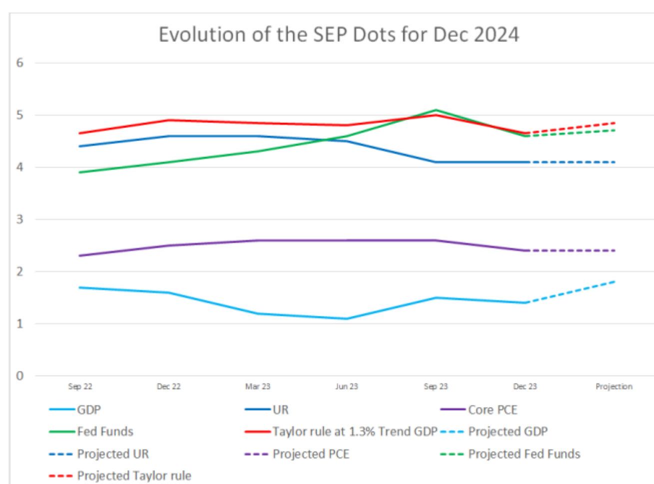


FOMC

The January 2024 FOMC meeting and press conference were notable as Chair Powell confirmed our view that a cut in March was “unlikely”. In addition, the tapering of QT (the “Taper”) was said to be a matter for discussion at the next meeting, but, given the results of the QRA and the likely path of RRP, we don’t expect any urgency to Taper. Lastly, the Fed’s statement removed references to financial conditions being tight. This change is notable when put in context with the FCI chart on page 1 above.

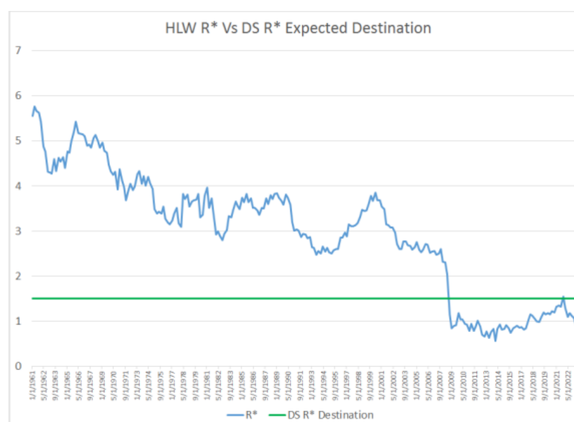
Unless data deteriorates rapidly, the Fed should leave rates unchanged at the next meeting and the Summary of Economic Projections, or SEP, should drive market

expectations. The Taylor Rule's myopic focus on real fed funds rate may have ironic consequences if GDP Growth remain highs and inflation doesn't fall rapidly.



Our expectation for the March SEP is a higher GDP estimate - perhaps as high as 1.8% vs Dec estimate of 1.4%, and no change in Core PCE at 2.4%. Based on the Taylor Rule, that would generate an increase in the Fed Funds for 2024 by 16bps. Again, assuming data continues to trend in line with recent history, we expect **Fed Funds for Dec 2024 will rise to 4.7% from 4.6%.**

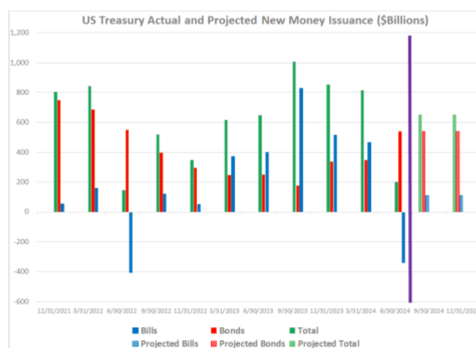
We have noticed some FOMC members speculating that it may be appropriate to consider a higher long-term nominal Fed Funds rate reflecting a post-Covid R* that more resembles the pre-GFC level. **If R* drifts higher from 2.5%, where it has been stuck throughout the post-Covid period, to something like 2.75% in the March SEP, a Dec 2024 dot as high as 4.8% may result**. We believe R* will settle well north of current estimates based on many factors that we have described in past work.



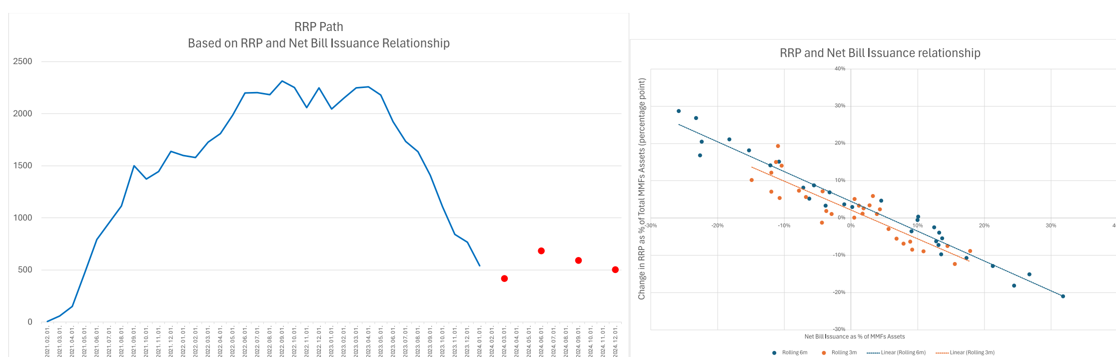
The irony of the myopic focus on the Taylor Rule and PCE Inflation falling and allowing the Fed to remain restrictive while cutting nominal Fed Funds is that it depends on the long-term neutral rate, which is certainly rising, not falling, and the GDP Gap, which is clearly not yet falling. The implication is higher than expected nominal interest rates this year and in the future.

QRA

The QRA was in line with our estimates of net Coupon Issuance. A total of $202BN of total issuance was needed, which was lower than our estimates due to strong tax revenues. Of that, $540BN of net Coupon Issuance will occur in 2Q24 vs $340BN in each of the prior two quarters. In addition, the step-up to this size of Coupon Issuances will likely remain going forward.



Notably, net Bills Issuance will be -$338BN, which means more Bills will mature than are issued. Indeed, projecting the net Bill Issuance for the next nine months will likely be -$115BN, which will dramatically slow the RRP runoff. We project the RRP will not drop below $350BN in 2024 and that the low will occur in 1Q24. That will enable a clear runway for QT to reach its target without Tapering.



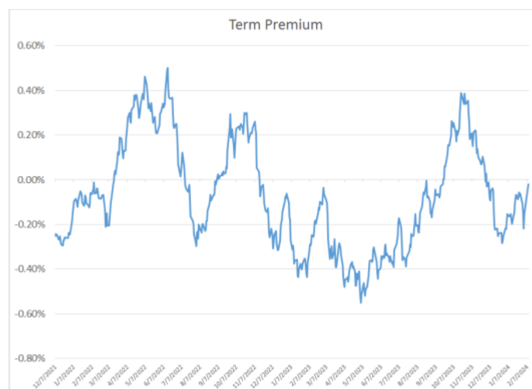
One wrinkle to the SOMA runoff is worth paying attention to at the March FOMC meeting. In June, September and December, the SOMA portfolio has low Coupon maturities that fall well below the $60BN QT Cap. Normally, adequate Bills mature for the QT Cap to be hit. These months would require a change in Bills reinvestment to purchase enough Bills that mature in each month to meet the QT Caps. The Fed may use this technical reason to:

- Do a mini-Taper and simply let runoff occur below the QT Cap for the affected months.
- Actually Taper to $45BN in June and $30BN by December.
- Tweak Bills reinvestment to maintain runoff at $60BN.

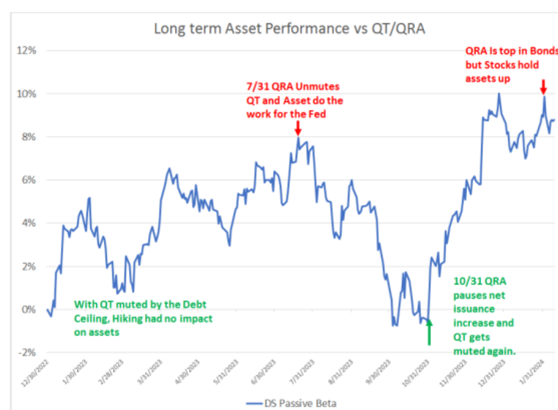
But the decision should be monetary policy-based and not RRP-level based.

Asset Pricing

Despite strong headwinds to assets from the Issuance plans and the likely ability of the Fed to maintain the QT pace if desired, the market has just begun to react and term premiums remain slightly below zero. Nonetheless, we are quite bearish bonds and expect term premiums to climb by 25-35bp through March 2024.



Even though there are signs of term premium expansion driving real and nominal rates higher and gold lower, the SPX has rallied to all time highs. In aggregate, assets have fallen, but not as much as we have expected:

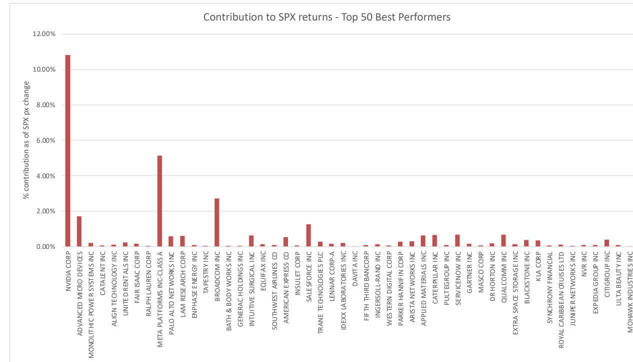


That brings us to equities. In the next section we will review equities through the lens of whether the Mag6 have made macro shorts in equities a fool's game. We will look under the surface to see what is happening to equity markets in the US and abroad based on the macro conditions ex Mag6. We think equity prices ex Mag6 are elevated but should be elevated relative to bonds given stronger real growth and still low long-term interest rates. We see cash outperforming equities ex Mag6 YTD and expect the same going forward. These equities are responding to macro conditions and are beginning to sell off alongside rising yields.

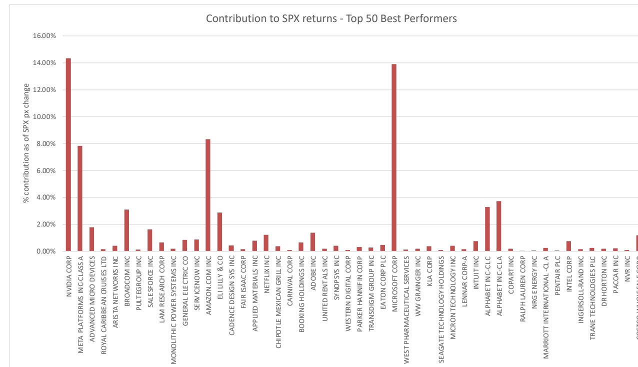
However, the big U.S. equity indexes are simply not responding due to increasing and outstanding performance of earnings and multiple expansion in the Mag6. Will this continue? That's not our game. The later section will describe the risks of using SPX and NDX for macro but requires some willingness to be exposed to a further rally in the Mag6.

Has NVDA killed macro?

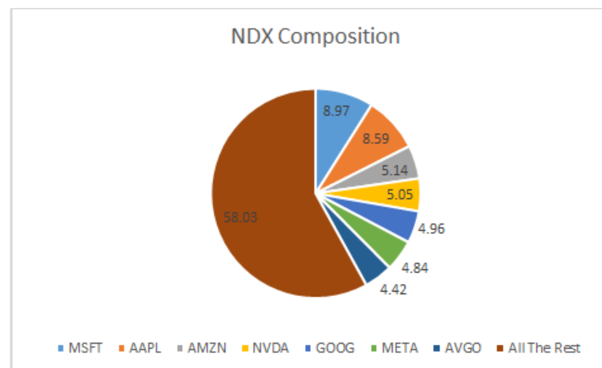
Since last Halloween's local low in equity markets, the rally in equities has been very narrow. Only 3 stocks that were in the top 50 performers mattered that much to the SPX. Notably, NVDA was responsible for over 10% of the total return of the index and no one else was really close:



Since AI took off a little over a year ago, the picture remains very narrow. Only 4 stocks that had Top 50 Performance made a significant contribution to SPX total returns:



This is not particularly insightful. We all have watched AI stocks rally, and the big ones get substantially bigger. NDX is particularly concentrated, and it is no longer possible to expect that it will behave as a macroeconomic asset:

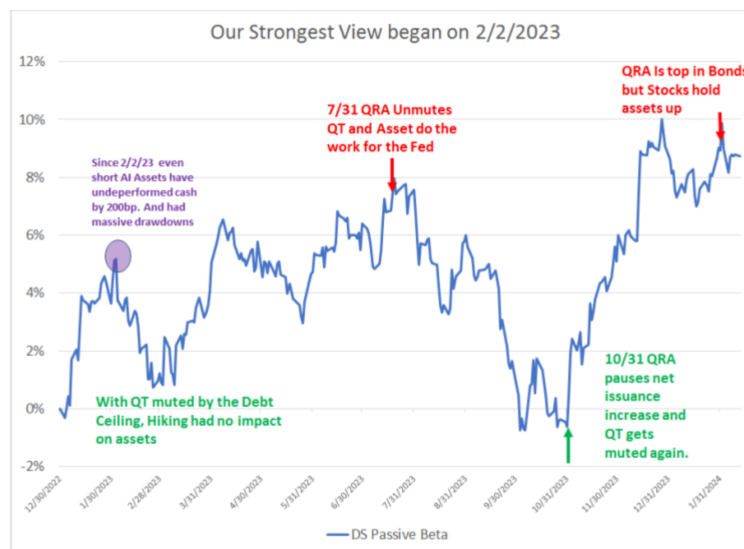


In order to retain a desired Sharpe ratio in macro trading, the underlying instrument must behave reliably with the macroeconomic signals that provide the edge. NDX has not responded to most macroeconomic drivers with any reliability for over a year. We have mistakenly thought it would. However, now that the index is so concentrated AND those large constituents are so volatile, trading NDX is like trading these stocks and these stocks are not being influenced by macro signals. The Sharpe ratio for NDX macro trading has fallen dramatically.

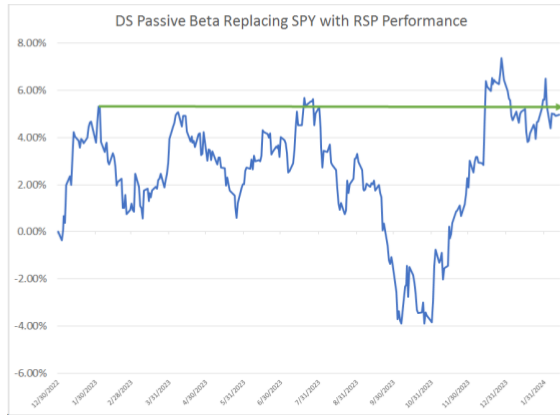
Do we have a view on AI? Sure. It’s an important influence on current inflation as AI investment spending is sizable. To the extent that it one day influences productivity, it will be an important driver of the economy. However, we have no edge in picking stocks over the short term. Nor do we know when the AI bubble will stop inflating. We pass. Does that mean we won’t trade equities? No, but NDX is no longer an option. We do think the SPX still responds to macroeconomic signals in an adequate way to take on positions and we will accept the volatility of the SPX tech components in our process. Do we think tech is in a bubble? Yes. Do we think it will pop? Yes. Do we have any insight about when? Absolutely not.

Non-NDX equity markets have behaved in line with macro signals.

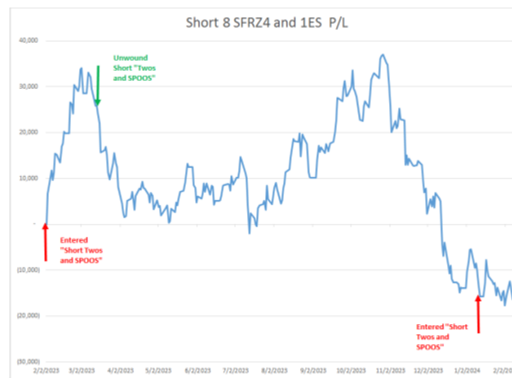
Our strongest forecast for most of the last year has been that assets will underperform cash due to narrow or negative term premiums and a need to tighten financial conditions to bring inflation to target. Twice we covered - once during the “Tempest in a Teapot” banking crisis, and once when Janet decided to pause Coupon increases. Those were lows:



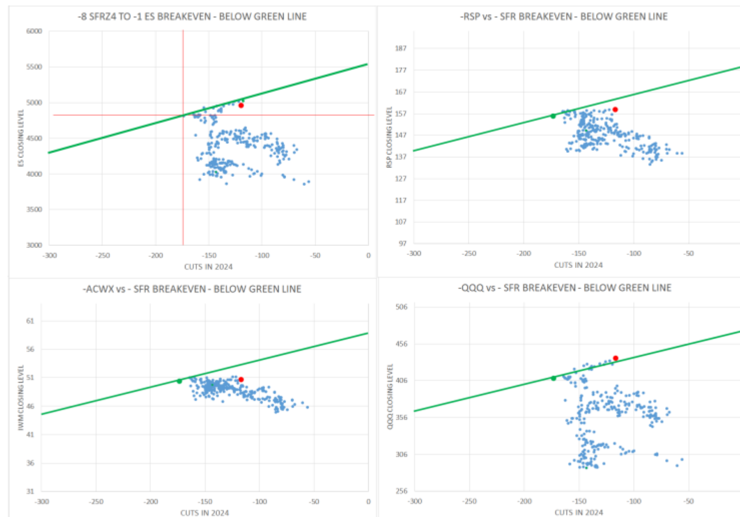
And yet, despite assets underperforming cash, the AI stocks lifted all assets. Simply adjusting the portfolio to equal weight would have resulted in substantial underperformance and, in fact, a negative absolute return. Our strongest view remains in place and while the difference in outcomes is AI, it doesn’t dissuade us from maintaining SPX shorts.



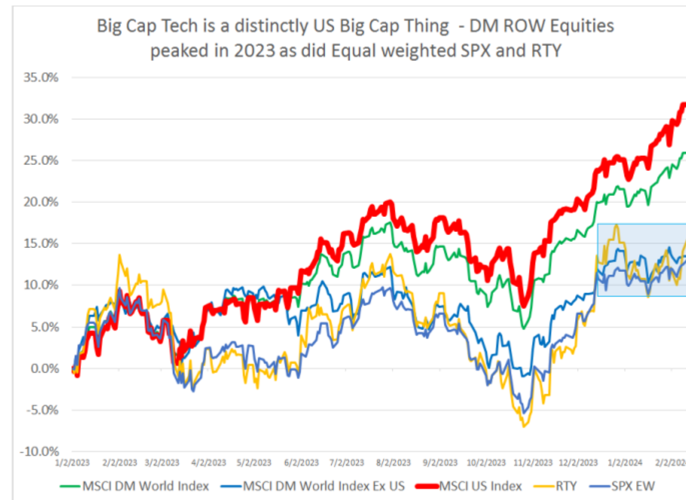
Our next strongest forecast is that bond markets are pricing marked slowing in the economy while equity markets are pricing high earnings growth and easy financial conditions. Our two strongest opinions have led us to be short bonds (including the short end) and short stocks as both priced-in outcomes cannot happen. Twice we have shorted ES and SFRZ4 in the so called “Short Twos and SPOOs” Trade. Our entry and exits on the first trade were fine. Our most recent entry is at breakeven, primarily because of the strong contribution of a few stocks:



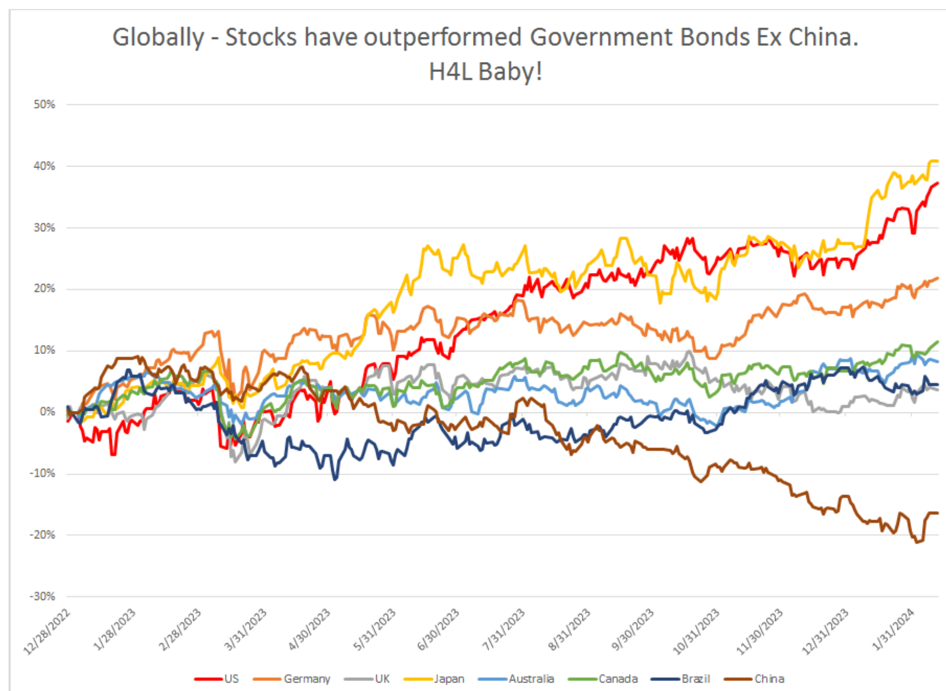
Another way to visualize the impact of AI on our second strongest view is to replace ES with other equity market exposure with more/less Mag6/AI exposure.



Hammering home this point: Mag6 is eating the world this year and has been doing so for over a year:



Our last forecast, which is more loosely held, has been our best performer. We have been bullish growth relative to expectations for over 20 months. We have been dead right and will continue to hold that view until long-term interest rates are high enough to slow the economy. They are not close to such levels. We have not bet on our most successful forecast as we viewed its uncertainty to be too high. The trade for a "higher for longer", or H4L, outlook would have been long stocks/short bonds. We continue to believe in H4L and at this level of pricing favor short bonds and are neutral stocks based on this single opinion. Global growth expectations have clearly risen for over a year and no recession is in sight. We are not chasing growth at current levels, but bond markets remain exposed to our triple whammy of strongest signals.



What do we really think of AI stocks and AI as a macro force?

We have no business predicting the path of stocks in general and AI stocks in particular. Move on to the next section is our best advice. Nonetheless, we do have some thoughts that are low confidence and provide little actionable information. Like anyone, if you ask for our opinion, we will give it. Mostly we don't know. We will address AI from this perspective.

- What are the implications on the macroeconomic environment of AI?
- As all corporations eat from the same macroeconomic pie, what constraints are in place to limit growth of a particular sector?
- Is the current environment a bubble similar to the internet bubble?

The macroeconomic relationships of AI are straightforward. In order to implement an AI strategy for improving a business that currently uses less evolved forms of manufacturing, client acquisition, client retention, employee productivity, etc, a company needs to invest in building AI capabilities either directly or purchasing business specific AI software services. Build or Subscribe are the two options, but they devolve into a single idea: someone must buy hardware, cloud, software, data, and hire those who can put it all together and make it work. The buildout of AI requires capital investment on hardware that depreciates rapidly and ongoing payments for each of the other items. Spending on each of these items results in dissaving and that spending is the sellers' income. Implications include lower earnings for those who "need" AI to compete, higher earnings for those who sell AI and higher wages for those who move from a current job to another AI-related one.

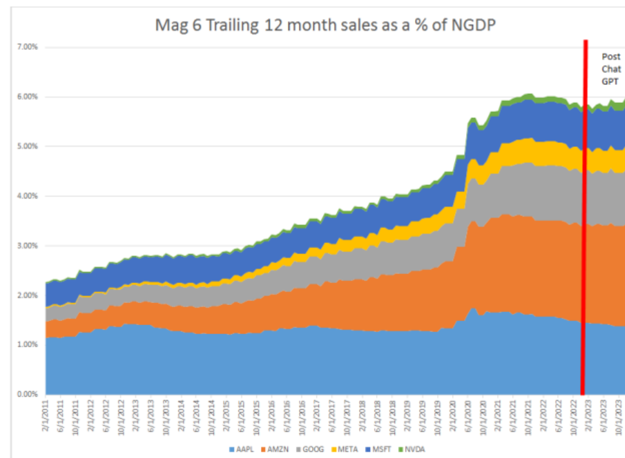
As the economy is currently doing well broadly, it is likely that companies will continue to not cut other expenses that are generating strong returns in order to pay for AI spending. A tightening of software developer jobs and perhaps a loss in productivity, both real and nominal, will occur as there become more developer jobs than there are developers. However, it is possible that companies scale back expenses. In order to fund the AI spend (assuming other expenses are not cut), leveraging up may occur, putting upward pressure on borrowing costs. When we add up the pressures, we believe a levering up/dissaving will increase demand across the economy and result in inflationary growth impulses.

Leveraged inflationary growth impulses will increase both prices and rGDP, which, in turn, will increase the potential pie. However, the GDP Pie is constrained by trend growth factors of productivity and population. Essentially, all companies and other businesses have a single pie to take a slice of their revenues from. Much of the $25TN US GDP is not going to change much. The portion of the pie available to AI can only grow so much. Our view is that the markets have decided that a few companies are likely to get all the incremental GDP available in this space. The question is how much pie has already been "claimed". We think current AI equities are priced based on all the available slices allocated 500%. We see investors plowing into AI future revenue streams as if it was the acclaimed musical

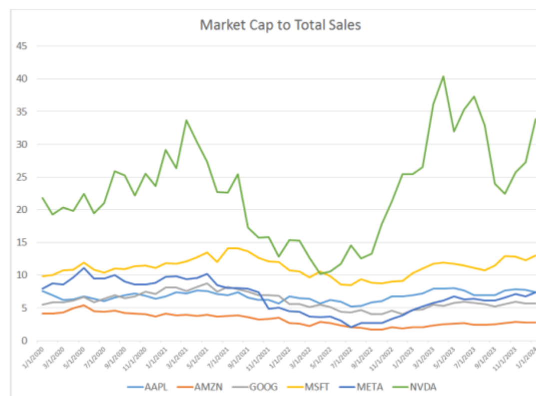
"Springtime for Hitler" made famous by "The Producers" film. In this case, the AI revenue share is probably going to be Standing Room Only, but stocks are already multiple times oversubscribed.

<u>How do the numbers look?</u>

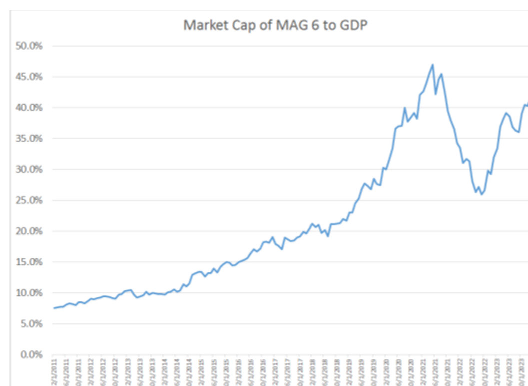
Total Mag6 revenue as a percentage of GDP has more than doubled over the past 12 years and now rests at 6% of GDP. This is obviously a large number. GDP Growth of 5% would create an overall pie increase of $1.25TN.



At current levels of GDP share, that would be a $75BN y-o-y increase in sales. Under no circumstances would that generate the sort of sales and earnings growth necessary to support current AI stock multiples. It must come from increasing the size of the pie. Note since MSFT invested in Open AI, sales of many of these companies have fallen and, in aggregate, their % of GDP remains flat. Perhaps over the next 3 years, the Mag6 take another 1% share of GDP. That would generate $250BN in sales increase per year, which is not insignificant. However, it would amount to y-o-y increases of about 16% in total sales. MSFT and NVDA are already valued at lofty multiples to sales. Will sales multiples expand as well? Perhaps, but, using conservative assumptions, it will surprise us if AI takes 3% of GDP without some other portion of these companies' revenue being lost. Regardless, from a top-down basis, valuations suggest that all of these companies will have a full piece of the expanding pie. We think not.



One final "Valuation" Chart shows that these companies have in the past been worth a higher percentage of total nGDP. Part of the decline was inflation. Perhaps this is sustainable, and the stocks can, as a group, rally back to their prior peak % of GDP. However, that's only 5% + GDP growth in terms of the stock prices. Obviously, there is no limit to the % of GDP, but it does show how huge these companies are. They must each eat a bigger slice of a pie that just doesn't grow that much and not eat each other's share to sustain valuations.



We think that these stocks, in aggregate, are in a bubble and will be lower two years from now that they are today. One or two may win, but not all. We have low confidence in our view, but we have seen this before.

<u>Compare the current bubble to the internet boom in the late 90's.</u>

We lived through the internet bubble and saw how it went from elite seats on Wall Street. We had access to all the best research and worked closely with investors, hedge funds, sponsors, high net worth entrepreneurs looking to hedge, newly formed corporations and the old-time corporations they were disrupting. We saw the rise of electronic trading and our own businesses being disrupted as well. There are many similarities to today.

- The internet was going to change our lives.
- Investors of all sorts – bulls and bears alike, knew it was a bubble.
- Valuations were high for companies with brand new and almost always unprofitable businesses.
- Fixed income was largely not involved and stood by watching.

There are some key differences.

- There are very few meaningful new companies.
- There is no IPO market.
- The companies that dominate the current bubble seem to be much more conservatively valued. However, this is because all of the Mag6 have legacy business with substantial earnings power. The increase in multiples for future AI revenues is almost certainly as elevated as it was in 2000 but appears less extreme due to the ballast of great businesses.

- The potential for legacy businesses to be disrupted may not be fully factored in.
- The disrupted companies are not yet obvious. In 2000, we knew Barnes & Noble, and telcos were under threat. Today's disrupted companies are less obvious.

Take these comments on the Mag6 for what they are: low confidence views. Over the next few years, we may bet on this sector despite our low confidence. However, we are confident that this is indeed a bubble and that, like all bubbles, it will pop.

So What? – steps to trade equities with macro signals

- We are going to reduce our weightings of our traditional macro economic signals that drive our trading of NDX. We are bearish Mag6 but have low confidence on that view. In essence, we expect NDX positioning to be low Sharpe ratio and will size accordingly.
- SPX continues to behave reasonably relative to macroeconomic factors and we will not change our process in terms of trade direction or sizing. However, we are also concerned that, for short positions, a rapidly inflating bubble will force us to close positions prematurely and, if long, the downside of a bubble pop may trigger the same action. For that reason, high delta shorts and longs will have protection for tail risk.
- NDX trading will focus on high confidence signals that continue to operate well, like positioning-related indicators and will be done in smaller size.

Synthesis

Asset markets are quite elevated and risk premiums are thin at best. All of our major forecasts are set to deliver alpha in the next few months. We remain short bond and stock markets (while also hedging an extreme upside tail event). Over the next few weeks, we expect to cover twos and roll down and out our bond shorts. In addition, after NVDA earnings we are likely to reset and increase shorts in equities.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 57,216,136		
Total Return	57.22%	YTD Return in excess of cash	-1.66%
Today's Date	2/12/2024	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
2/8/2024	CLK4 Long 80 Call	2.13	469	$ 1,000,000	2.38	$ 117,371	Open
12/13/2023	ESH4 Two's and SPOOS (doubled on 1/12/24)	4,764.00	-200		5034	$ (2,700,000)	Open
12/28/2023	NDX 2/16/2024 16500 Put	205.00	49	$ 1,000,000	1.23	$ (994,000)	Open
1/19/2024	NDX 2/16/2024 17000/16600 Put Spread	90.00	111	$ 1,000,000	2.9	$ (967,778)	Open
1/19/2024	NDX 3/15/2024 17000/16300 Put Spread	89.00	112	$ 1,000,000	49	$ (449,438)	Open
12/22/2023	SPX 3/15/2024 4600 Put	54.40	184	$ 1,000,000	6.36	$ (883,088)	Open
2/2/2024	SPX 3/15/2024 4600 Put	14.00	714	$ 1,000,000	6.36	$ (545,714)	Open
1/19/2024	SPX 2/16/2024 4750/4650 Put Spread	15.00	667	$ 1,000,000	0.25	$ (983,333)	Open
2/7/2024	"David Hunter" +7/24 5400 C - 12/24 5400/5600 CS	(22.00)	500		-18.18	$ 191,000	Open
1/23/2024	FXI	22.80	438596	$ 500,000	22.8	$ -	Open
2/1/2024	ZBH4 2/23/24 119 (P/L ROLLED FROM 119/117)	0.3125	3200	$ 1,000,000	0.59	$ 900,000	Open
2/5/2024	ZBH4 2/23/24 117 Put	0.34375	-3200	$ (1,100,000)	0.14	$ 650,000	Open
2/1/2024	ZNH4 2/23/24 110 (P/L ROLLED FROM 110/108)	0.078125	1255	$ 98,047	0.21875	$ 176,484	Open
2/1/2024	ZBM4 3/24/24 122/118 Put Spread	0.90625	1103	$ 1,000,000	2.00	$ 1,206,897	Open
2/1/2024	ZNM4 3/24/24 112/110 Put Spread	0.390625	2560	$ 1,000,000	0.953125	$ 1,440,000	Open
11/28/2023	ZTH4 Two's and Spoo's (doubled on 1/12/24)	102.578125	-450		102.28	$ 267,188	Open
12/27/2023	"Sell All Assets Basket" SPY	475.80	-15763		500.98	$ (396,910)	Open
			Risk	9.498%		6.5%	