The Damped Spring Report

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

03/17/2024

At this week's FOMC meeting, the Fed has an opportunity to deliver on its mandate and set the path to successfully kill inflation. If the Fed meets our expectations, we will leave our beloved Higherer for Longerer Island with our "Script" in hand and begin a long journey that unfortunately may still end at Recession Island. We hope the Fed will take this step to kill inflation and by doing so prevent a certain and much worse future recession. Nonetheless, consensus has ruled out a recession and has priced H4L forever. Although the H4L nightclub is raging, our bags are packed, and we are eyeing the exits as the time to leave approaches. We will see if the Fed gives us the signal.

FOMC Expectations.

SEP Dots Expectations

The uptick in inflation and a strong real economy put pressure on all of Dots. We review below the specifics of the Dots, but, as a headline, we expect:

- 2024 Fed Funds Dot will move up to 4.9.
- 2025 Fed Funds Dot will move up to 3.9.
- Longer-run Fed Funds Dot could move up to 2.6, which would be meaningful.

Press Conference

Expecting Chairman Powell to be hawkish is usually a bad bet. However, while a "Jackson Hole 22" mic drop at this press conference is unlikely, we do think Powell will lean hawkish, assuming the Dot Plot meets our expectations and may be hawkish even if the Dots are unchanged. We expect "What's the rush?" will be the dominant and appropriate theme.

In the press conference, QT will obviously be a topic. As the BTFP expiry has passed without incident and RRP remains above 400BN, we expect any QT Taper questions will be answered either vaguely (forecasting ongoing discussion) or perhaps more forcibly (QT is operating fine). We don't think any Taper will be announced. A wildcard would be any serious mention of a long-term SOMA Balance Sheet normalization, as previewed by Waller and detailed by us here.

Hawkish

We expect the Fed to be hawkish overall. To generate the highest odds of a soft landing with inflation returning to target and damage to the real economy minimized, we think this makes sense. However, as even the slightest weakness in the economy over the next 12 months is not discounted and we believe "The

[Script"](#) is the most likely path, we expect the market has moved too far. Higherer for Longerer Island is now over-crowded.

FOMC Cheat Sheet Market reactions.

Assuming markets have priced in the 2024 Dot going up by 25bp, we expect a knee jerk reaction and soon thereafter the implications would become clear of each of the various potential scenarios. The green box below reflects our central case:

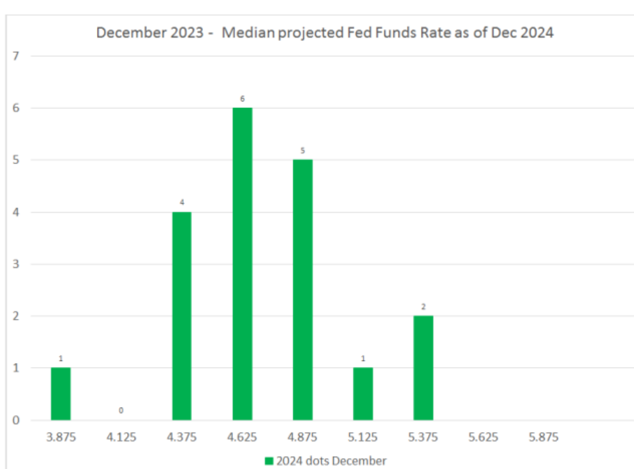
FOMC MARCH SEP	Dot			Initial move			Next day or two		
	2024	2025	Longer Run	Assets	Bonds	Stocks	Assets	Bonds	Stocks
Unchanged SEP from December	4.6	3.6	2.5	Buy	Buy	Buy	Buy	Sell	Buy
2024 Only	4.9	3.6	2.5	Neutral	Neutral	Neutral	Neutral	Sell	Neutral
2024 and 2025	4.9	3.9	2.5	Sell	Sell	Sell	Sell	Neutral	Sell
Max Hawkish	4.9	3.9	2.6	Aggressive Sell	Aggressive Sell	Aggressive Sell	Aggressive Sell	Neutral	Aggressive Sell

Essentially, long-term Bonds should struggle post the FOMC for reasons we outline below, but the best outcome for bonds would be a very hawkish Fed. A dovish Fed would result in a major steepening.

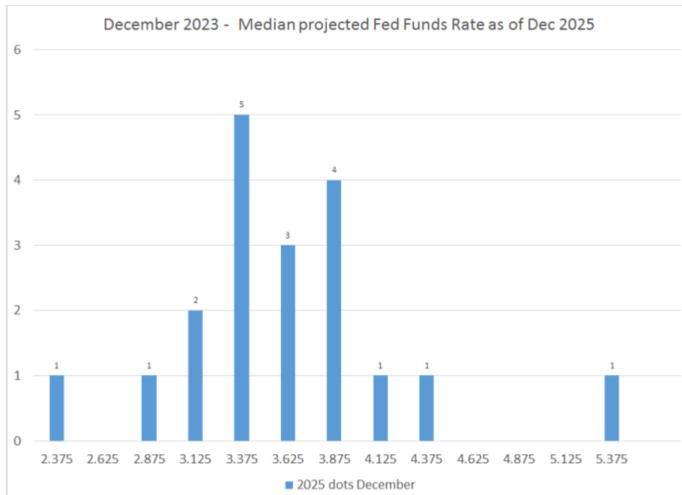
December 2023 Dots Distribution

Let's look at each of the Dots and what needs to happen to move a Dot. It is important to recognize that Dots represent the median of 19 FOMC members. That means Dots can shift when a few members move a Dot without a meaningful change in the FOMC's mean. Nonetheless, the median does a good job of minimizing the influence of outliers.

The Dec 23 SEP for Dec 2024 Fed Funds has a median of 4.625, rounded to 4.6. 11 FOMC participants have 4.625 or lower. It will take two members with a 4.625 Dot to move to 4.875 for the Dot Plot to shift. We think this is very likely. Movement by the hawks to more hawkish won't move the median.

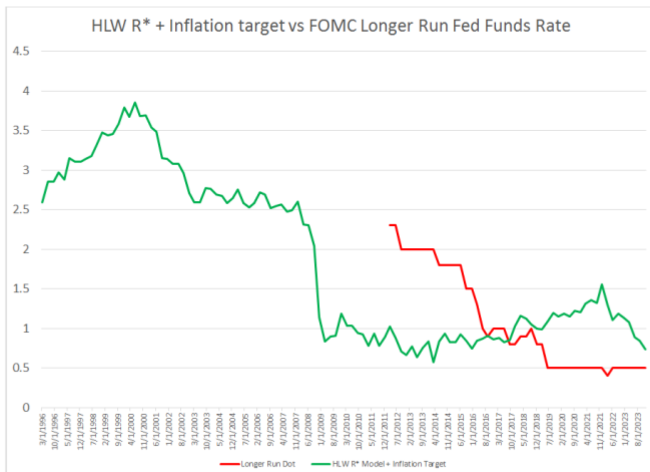


The Dec 2025 Projection is interesting. While each member independently adjusts their own Dots, the implication of a 2024 Dot going up by 25bp might result in the 2025 Dot staying the same (which would simply be a pushing of one cut from 2024 to 2025) or rising (which would be more hawkish and suggest lower total cuts over the next two years). In either likely scenario, the cuts projected by the SEP will either be 100bp or 125bp. An increase to 3.875 rounded to 3.9 will take some heavy lifting; all 3 of those at 3.625 will have to move. Our guess is that is likely, but not certain, and perhaps those at 3.375 will back fill the gap left at 3.625.

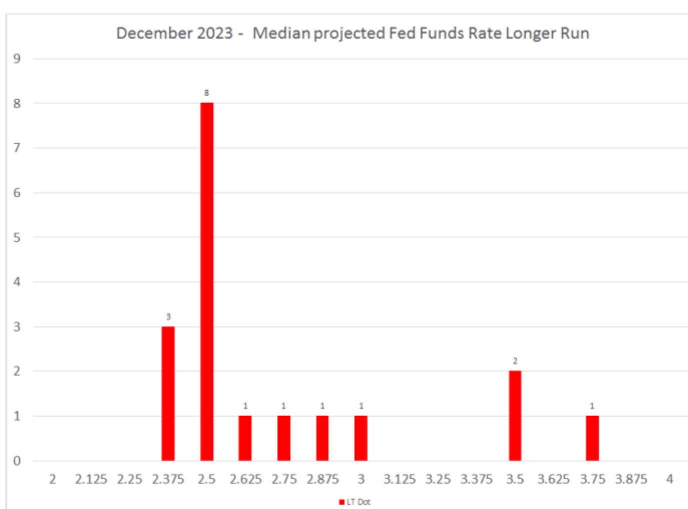


Dropping briefly into market pricing, given that the outcome is likely to be 100-125 bp of cuts projected in 2025, market actions have told a very different story. After drifting toward the projection of 100bp of cuts for the last few months, the cuts priced for 2025 reduced meaningfully and now are set at 72bp. This seems odd given the difficulty of moving the Dec 2025 Dot higher and the potential that the Dot Plot will project 125bp if left where it is. We think SFRZ5 may be getting to a buyable level.

The odd reaction in 2025 pricing may portend a higher longer-run Dot. The longer-run Dot is somewhat academic in nature. It is mechanically composed of the 2% Inflation target and r* (the unknowable neutral real rate). We do not think that a change in the Inflation target is being contemplated by the FOMC, which leaves r* as the variable in question. Since before Covid, the longer-run rate has not changed, flatlining at 50bps despite a tectonic shift in the way Americans work. New York Fed President Williams, whose name is literally on the r* model, has been steadfast in public comments that r* may have not changed and the secular decline in r* will return the rate to 50bp. His model's r* output has been falling throughout the Covid reopening. Perhaps his credibility on this topic has anchored most FOMC members and resulted in no change for 4 years. However, since the depths of the post-GFC economy, it has remained above current SEP estimates.

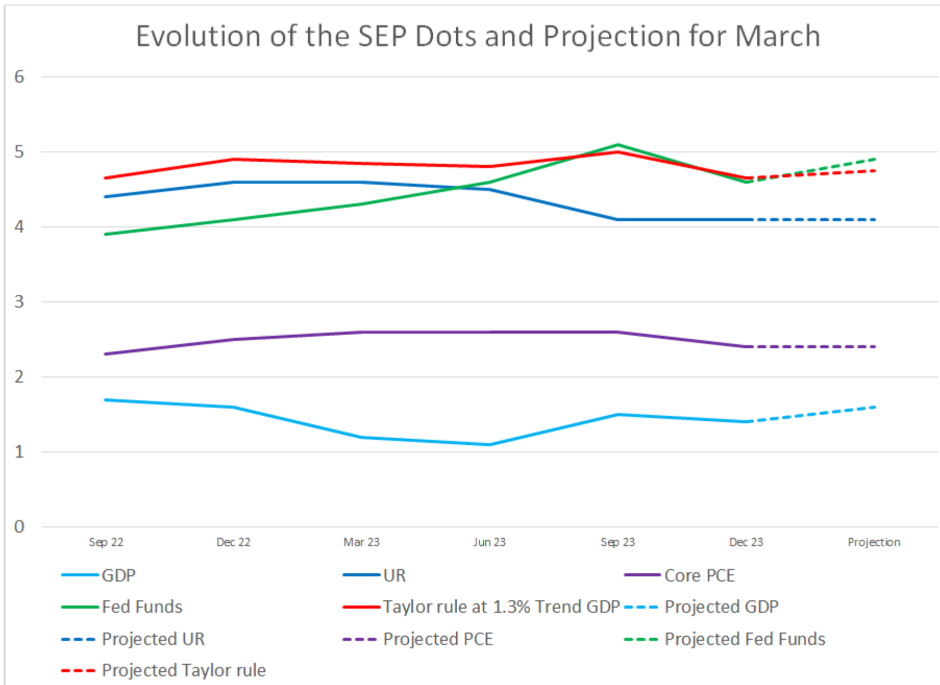


The Dots from last December reflect some dissent on the topic, which has been echoed by recent public comments from some of the more hawkish FOMC members. Oddly, only 18 members made a projection. If two of eight members move to 2.625, the median will rise to 2.5625 rounded to 2.6. If three move, it will also round to 2.6. In this case, if indeed the dot rises it will be important to see how many moved up from 2.5.



Economic Dots and Taylor Rule

Since last December, the US economy has remained strong. GDP continues to surprise to the upside, labor remains tight, and inflation is well above target. We expect some modest upside in the GDP Dot for 2024 and do not think Fed members will change the more important Core PCE Dot, although it now has more upside risk. Our projections suggest a Taylor rule Fed Funds rate of 4.9.



Before leaving the Dot Plot – Median vs Mean

As shown above, as the SEP uses FOMC members' median forecast, it pivots on the actions of the middle of the distribution and just two or three neutral/dovish members moving to neutral/hawkish will cause the Dot Plot to shift. However, to get a fuller picture of the sentiment the mean is useful as well. Last December, the mean was slightly more hawkish than the median. We will observe the full set of ots to gauge the overall movement as the data is dropped.

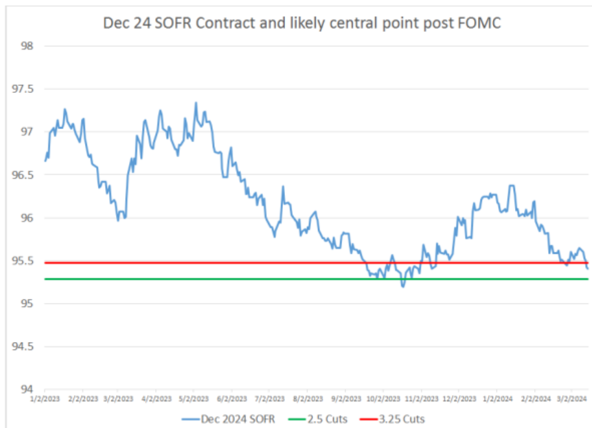
Fed Funds projections in December 2023

	Median	Mean
2024 Dot	4.6	4.7
2025 Dot	3.6	3.6
Longer Run	2.5	2.7

What will be priced-in after the FOMC?

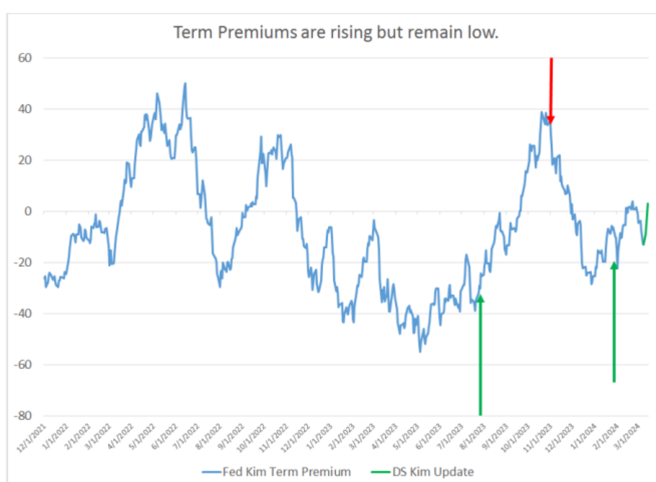
Short rates

Dec 2024 SOFR contracts are likely to trade in a tighter range regardless of the FOMC. The two cuts Dot will center around 2.5 cuts or 95.28 level. The three cuts Dot will center around 3.25 cuts or about 95.48, unless Powell is extremely dovish:



Asset Markets

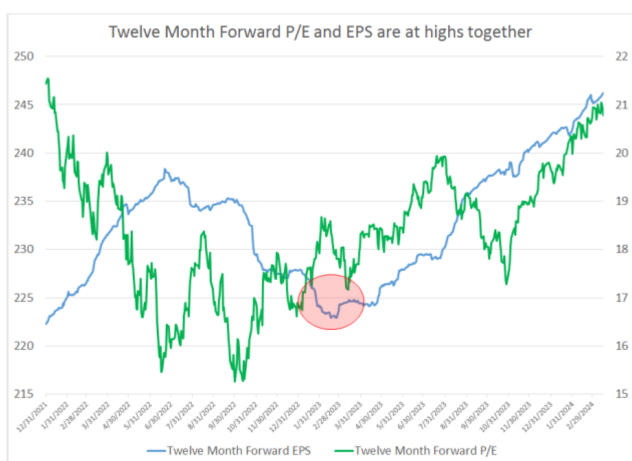
The short-term rate market will be most impacted by the FOMC, and asset markets will be less predictable, although elevated asset prices continue to depend on a soft-landing mix of robust NGDP, falling inflation, low asset volatility, and easy financial conditions. Since the last QRA, Bond term premiums have steadily risen and we believe we are now once again in Act 2 of our script. Last July, the supply shock of jumping from 178BN of net coupon issuance to 338BN created a panic move in term premium. Treasury reacted to the 80bp expansion in term premium by sensibly keeping net issuance at 348BN. Markets rallied strongly on this "lack of supply." However, on January 31, Treasury announced 538BN of net coupons. The likely net supply for the next two years will be 500BN+ per quarter. The market initially shrugged off the January 2024 QRA, but has since begun to struggle. We expect term premiums to continue to have substantial upward pressure.



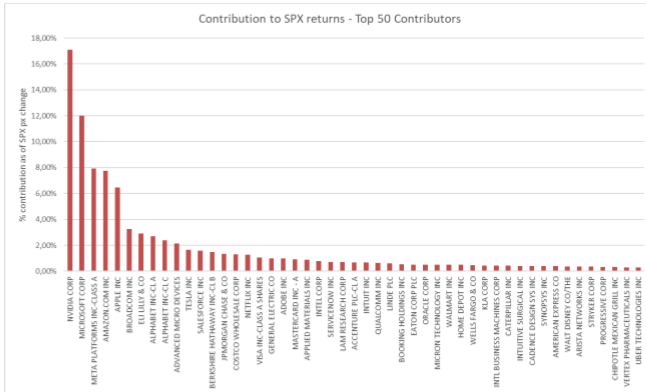
Broad asset market returns have been mostly driven by term premium contraction and expansion as well, although strong NGDP has highly favored pro-growth assets. Notably since the "Drumbeats of QT" in December 2021, asset markets have almost fully recovered:

Equities have benefited from low bond term premium, strong NGDP, strong earnings growth expectations and have massively outperformed Bonds. It is notable that the outperformance occurred only since the MSFT Open AI investment, with a brief reversal during the "Tempest in a Teacup" banking crisis:

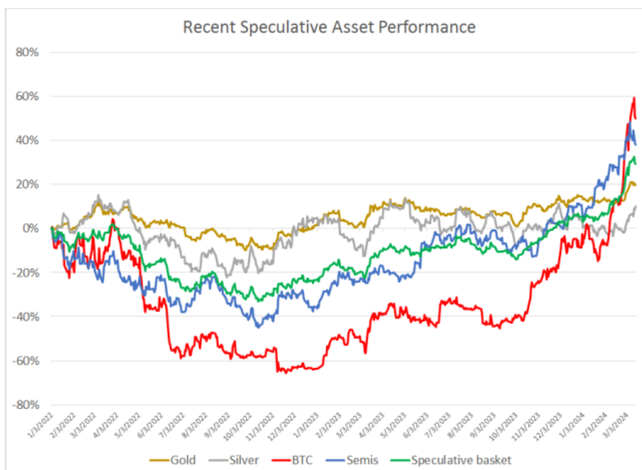
Nonetheless, broad earnings expectations and P/E ratios are elevated:



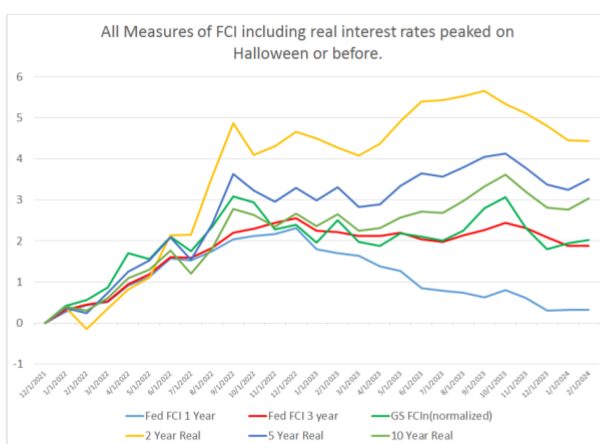
Equity performance since the MSFT Open AI Investment has been extremely narrow: two stocks have accounted for 30% of the 15 month return and five stocks have accounted for over 50% of the total price return:



Other speculative assets returns have been phenomenal. Specifically, Semis (driven by AI) and Fiat currency alternatives have exploded higher in 2024:



FCI is as easy as it has been since the hiking cycle began. Any tightness visible before Halloween has reversed, including real interest rates:

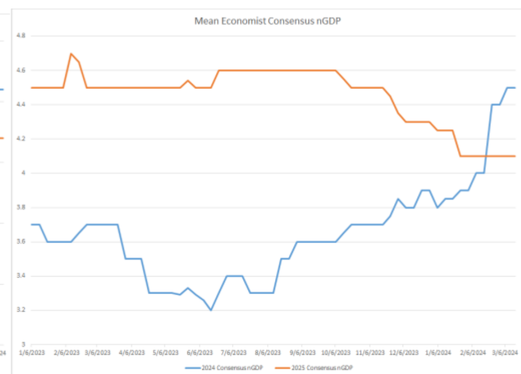


The Economy remains strong.

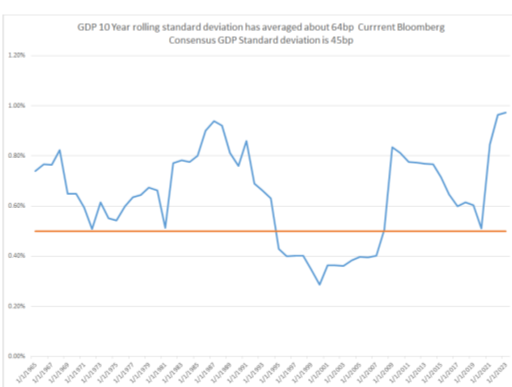
Last October, FCI and real rates were tightening rapidly and many Fed members remarked that the rise in long-term Bond yields was now doing some of the Fed's work. We agreed and looked to the Halloween QRA first to see if term premium expansionary pressure would continue to cause tightening. When we saw the pause in Bond supply increases, we pivoted on our market and economic outlook on the expectation that markets would rally in response. Of course, markets rallied more than we expected. In addition, we expected that the tightening that occurred from August through October would cause a softening in the economic data during the following few months. It is our view that rate hikes have long and variable lags, but long-term bond yield changes have much shorter and not variable lags. We may be wrong on this view, which we describe in more detail below. Regardless, economic data did soften through year-end. Since then, FCI and real rates have eased substantially and, not surprising to us, economic data has reheated.

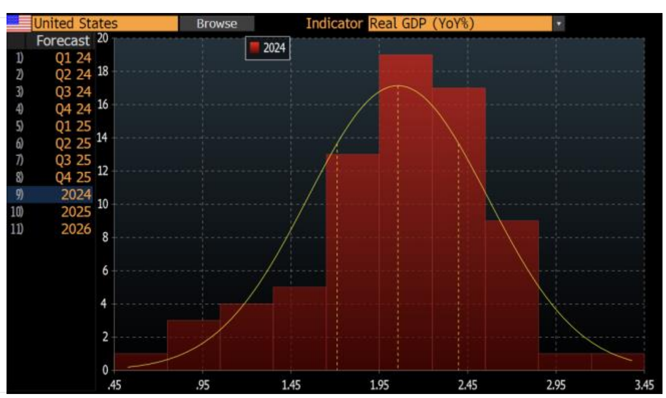
Economist Consensus

Real and nominal GDP forecasts for 2024 forecast no recession at all:



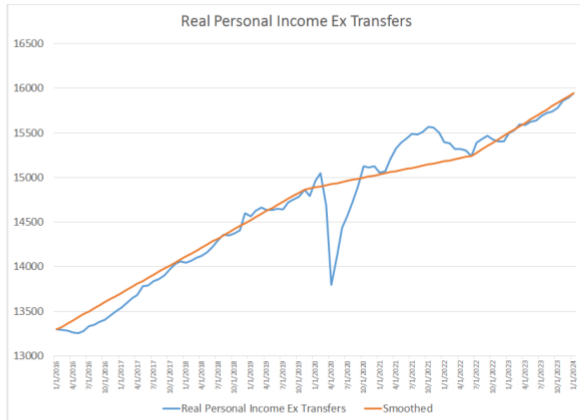
While we are done with the Dots for today, as a reminder the Fed Median GDP Dot is currently 1.4 vs economist consensus of 2.1. Fed Core PCE and Economist Consensus is the same at 2.4. What is particularly notable about the consensus real GDP estimates is its narrowness, which reflects "confidence" that the economy will continue to deliver.



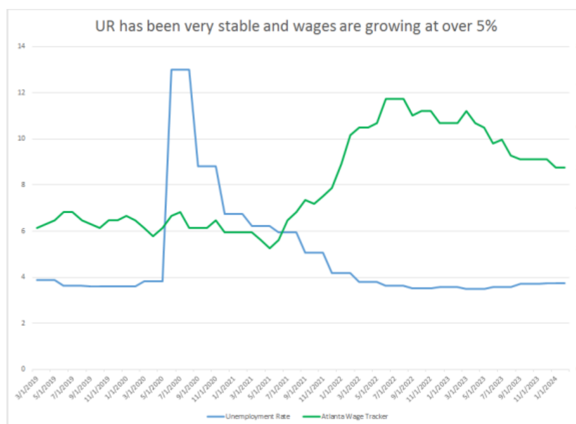


Incomes are strong.

Real personal income growth is back on the pre-Covid trend of roughly 3%.



A combination of stable employment and rising wages has supported spending and asset prices:



Wages, income, and wealth are the dominant drivers of spending in this cycle.

Back to the Script.

To remind everyone of "The Script". This was written last July. The script got started soon after and rapidly progressed to Act 3 until Janet blinked on Halloween.

"The only way to 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 equity rally.
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.

The play to kill inflation was sent off stage. The slightly lagged response to the Act 3 tightening resulted in weaker economic numbers into year-end. The Fed practically pivoted with Wallers myopic comments on the real Fed Funds Rate, which was reiterated in the December FOMC press conference, and resulted in the pricing in of as many as 7 cuts in 2024. Ten-year Bond yields and Mortgage rates cratered by 120bp. Not surprisingly, the massive resultant easing has come through without much lag and with renewed economic strength. This past January, it became clear that we had restarted Act 1 and Higherer for Longerer slowly became discounted again. At the end of January, Treasury once again surprised the market with $538BN of net duration issuance, but this time market shrugged it off as nothing. However, the supply glut looms, and bond term premiums are now slowly rising. Those who front ran increased supply expectations in October are burned and unwilling to risk another Crazy Ivan from Treasury. We expect the supply to be a serious headwind that will not be front run and that will impact the market over time. The catalyst for Act 2 and the rest of The Script is no longer supply. Supply is immense. In this version of The Script, time is the new "supply" catalyst.

Framework detour

Fed rate vs market rate

It's time to review why we think long-term rates are what tightens financial conditions and slow the economy in general and in particular given the current structure of the US economy. When the short-term interest rate changes without any Federal reserve action, it means the yield which borrowers and lenders of cash agree to meet has changed. This is the same for every market price. What matters in conducting monetary policy is whether the Central Bank influences the rate to a rate that, but for their action, would be different. Why is this important? In our view, when the fair market rate rises absent Fed action, that means borrowers really want money and lenders don't want to lend. That could be a fundamental shift in growth outlook as a driver or other drivers. However, the rate goes to a new equilibrium reflecting a fair deal for both borrowers and lenders. It becomes the literal neutral rate. What the Fed does is make an artificial rate that is different than the equilibrium rate. Why? If the economy is too hot, the Fed doesn't want it to overheat and so they set the short-term rate higher than the "equilibrium rate. If you are a borrower, you need to pay up. If you are a lender, you are incentivized to keep your cash and lend it to the Fed. That "restrictive" rate set by the Fed impacts those who borrow and lend overnight. Until QE in 2008 the Fed only pulled on the overnight Fed funds lever. QE attempted to shift long-term borrowing rates down. By doing that, the Fed encouraged borrowing from those who borrowed long term and discouraged lending by pushing down lending rates. The big takeaway, in our view, is that the Fed controls the attractiveness of borrowing and lending not with the level of rates they set but with the difference between the rate in markets without the Fed compared to the rate they set.

Who cares about overnight rates?

Participants in the overnight rate markets include real savers, floating rate borrowers, secured asset backed borrowers, and banks. Real savers – those with their cash in a bank or brokerage account or a money market fund, compare the return they get on that cash to their desire to consume or invest in financial markets. Certain US corporates borrow short-term or in floating rate loans. Everywhere else on the planet (except the Netherlands and the US), mortgage borrowers have exposure to floating rates. Levered investors in futures, or securities bought on margin, are also exposed to short-term interest rates, but by far the banking system is the most exposed to short-term interest rates. The Fed Funds rate has been the Fed's preferred tool for decades because of the sensitivity of the banking system to short-term interest rates.

Banks have primarily floating rate liabilities. By far their biggest liability is deposits held by private sector households and business. When the Fed increases short-term interest rates, it conceptually increases the rates that depositors demand from their banks. Has your savings account interest rate risen as much as Fed Funds? How about your brokerage account interest on cash? Do you see why the phrase "long and variable lag" is used? In real life, the immediate impact of a rise in interest rates is a passing through of that rise to the banks' floating rates assets with virtually no pass through to depositors. The increase in loan interest does make the prior borrower struggle more with paying back the Bank, which is a tightening. But depositors move slowly and walk toward bills and money market funds that have market-based rates only over time. Consequently, there is initially little tightening impact on the consumer. If Bank assets are fixed rate loans (e.g., Mortgages) the rise in short-term interest rates has very little impact at all. Over time, new fixed rate loans will have higher interest rates and make borrowers less willing to lever. Over time, marginal savers of cash like the high interest income and perhaps reduce consumption or investment.

Inverting the curve

As short-term interest rate yields rise, the yield curve inverts. Investors in long-term Bonds (Lenders) and Borrowers of long-term fixed rate loans are not directly impacted by the change in the short-term interest rate. Indeed, they may expect the rate to fall again. If so, the long-term equilibrium yield may not change much at all. That results in short-term rates being set at a higher level than long-term Bond yields. Once again, the lag is long and variable. As the yield curve gets more inverted and stays inverted for longer, Borrowers look to borrow long at attractive rates and Lenders look to lend in shorter maturities to capture a higher yield. This flow results in a rise in longer-term bond yields over time.

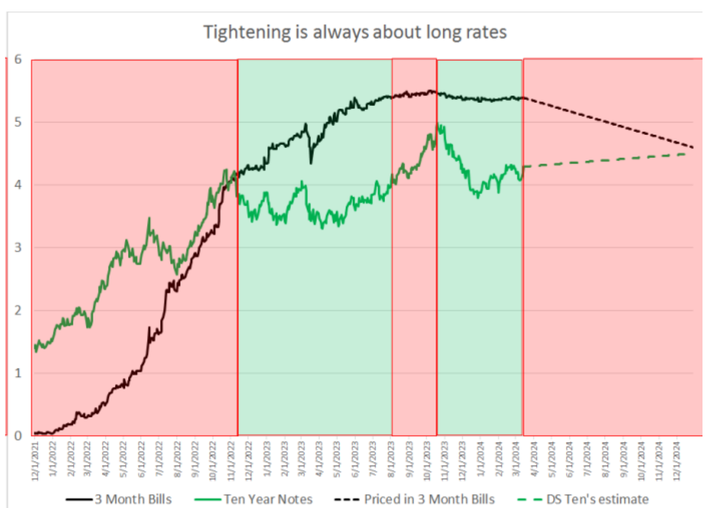
Who cares about long-term interest rates?

Risk-free long-term interest rates are the discount rate for all long-term investments. Assets markets really care about long-term interest rates. Both real investments like homes, machinery, factories, and office buildings, and financial assets are priced relative to long-term risk-free interest rates. Additionally, most borrowing in the United States is in the fixed rate long-term corporate and mortgage markets. A homeowner determines housing affordability based on the mortgage rate. A corporation determines the viability of its growth plans based on where the long-term corporate bond market is offering financing. While the Fed can adjust the short-term interest rate (and with long and variable lags it adjusts the long-term interest rate and asset markets), the Fed is unable to impact the long-term rate without pursuing QE asset purchases or outright sales of Bonds. QT Runoff hands the monetary policy on long-term interest rates to Treasury. So far, for many valid reasons Treasury has muted the impact of QT Runoff.

As the Fed has been unable to get long-term rates to rise and become restrictive, asset markets are elevated. This provides attractive financing for corporates and has supported a wealth boom for asset holders able to access cash to continue to spend by selling or borrowing short-term against appreciated assets. What is clear is that higher long-term interest rates almost immediately bite if restrictive. The slowing in the last quarter when 10-year bonds peaked over 5% and mortgages peaked above 8% is clear evidence of long-term rates not having a long and variable lag.

The ongoing supply catalyst + time = Act 2 slowly turning to act 3

Time is the catalyst. Eventually high long-term interest rates will slow the economy. However, it will also take supply. The good news for the Fed is that Treasury is now supplying duration to the market and will for many quarters.



Since the Fed announced its balance sheet unwind and began raising rates, it has always been the long rate that did the heavy lifting. First, it was dragged up by the short rate, but the economy and the asset markets fell in the first red box time frame, as indicated above. Then QT was muted by the Debt Ceiling and the banking crisis and markets spiked in the first green box. Then briefly "The Script" played out for three months until Treasury blinked on issuance and the Fed perhaps misread the impact of the brief tightening. *The second green box may end this week.* The combination of over 25 Months of rising long-term interest rates and years of future significant supply may send equities to Act 3, and, if so, will portend what is completely outside of the current consensus: an actual 4Q2024 beginning of a shallow recession. We hope a soft landing can be achieved and we truly would prefer that a deeper recession is avoided, but we are confident that in order for the inflation fight to be well and truly won The Script must play out.

Synthesis

We have been amongst the most optimistic about the strength of the US economy. We find that position overcrowded as of today. We have expected Fed policy to remain higher than priced for longer for years. We think the market now agrees it will remain higher than priced. Ironically the market has moved to where it is no longer clear that H4L is priced. The Fed may surprise us and not change the SEP at all, they may taper QT, the press conference may be dovish. If so, we will dutifully cover our equity shorts, go long gold and maybe even crypto, go huge on long-term US Bonds shorts, and cancel our chopper off H4L island. However, we have confidence the Fed will do what it takes to kill inflation. There will be some pain but, in the end, it will be the healthiest path for the world. We are told that the tourist cruise ship is leaving all its guest on H4L Island and heading back out to sea empty. We have also heard that the evening entertainment on the ship is a play called "The Script". Perhaps we will grab a ride, although we its destination is not Recession Island. Wednesday at 3:30 is our boarding time. Our bags are packed.

Current Portfolio and Performance

We have a lot of risk and will be resetting our portfolio after the FOMC.

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 57,676,762		
Total Return	57.68%	YTD Return in excess of cash	-1.20%
Today's Date	3/17/2024	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
3/12/2024	ESM4 FUTURES 5400 Stop Loss	5,241.00	-200	$ 1,590,000	5,183	$ 580,000	Open
2/22/2024	NDX 3/28/2024 17500/17000 Put Spread	96.00	104	$ 1,000,000	81	$ (156,250)	Open
3/1/2024	NDX 3/28/2024 17500/17000 Put Spread	55.00	182	$ 1,000,000	81	$ 472,727	Open
2/22/2024	SPX 3/28/2024 5000/4700 Put Spread	38.00	526	$ 2,000,000	13	$ (1,315,789)	Open
2/7/2024	"ADJUSTED DH 12/24 5400/5600 CS (STOP AT 106.55)	106.55	-500	$ 977,500	79.38	$ 1,358,500	Open
1/23/2024	FXI STOP Loss	22.80	219298	$ 500,000	24.1	$ 285,088	Open
2/13/2024	ZBM4 3/22/24 117/115 Put Spread	0.5625	6400	$ 3,600,000	0.19	$ (2,400,000)	Open
3/1/2024	ZBM4 3/22/24 120/121 Call Spread	0.40625	-1684	$ 1,000,000	0.14	$ 447,368	Open
3/1/2024	ZBM4 3/22/24 120/121 Call Spread	0.65625	-2909	$ 1,000,000	0.14	$ 1,500,000	Open
3/14/2024	ZBM4 4/27/24 119/116 Put Spread	1.09375	0		1.09	$ -	Likely Roll
3/14/2024	ZNM4 4/27/24 110/108 Put Spread	0.5625	0		0.56	$ -	Likely Roll
2/13/2024	ZNM4 3/22/2024 108 Put	0.2582	5070	$ 1,309,074	0.02	$ (1,229,855)	Open
12/27/2023	"Sell All Assets Basket" SPY Stop at 540	475.80	-15763	$ 378,310	509.67	$ (533,890)	Open
			Risk	14.355%		13.4%	

P.S. How do each of the Acts impact assets?

- Act 2 Bond Term Premium Expands
    - Press Bond shorts
    - Remain short equities
- Act 3 Risk premium expansion
    - Press Equity shorts
    - Favor short all assets
    - Buy 2Ys

- Act 4 Earnings contraction
    - Cover Bond shorts
- Act 5 Recession Island
    - Buy 10Y Bonds
    - Cover all assets
    - Cover equity shorts