

The Damped Spring Report

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

10/20/2024

The Fed’s reaction function remains characterized by a myopic adherence to the Taylor Rule. Due to this over-focus, the Fed is experiencing the consequences. The Taylor Rule has three legs, GDP, UR, and Core PCE. Since the Fed cut 50bp (but, importantly, NOT because they cut 50bp), the final act of a long summer “Big Easy” resulted in a “Sweep the Leg” moment for each leg. Markets have completely pivoted, and the Fed is walking back dovishness. At the same time, the equity market has moved past macro, which is decidedly improving earnings outlooks, to actual earnings reports. We will review the “Sweep the Leg” moments and the substantial change in the nature of the underlying drivers of the equity market in this DSR. Next week, we will preview the last Quarterly Refunding Announcement by the Yellen team at Treasury, November’s FOMC, and the potential consequences of various election outcomes. Until the week of the election and FOMC, we expect choppy markets, and tactical positioning dominates our view.

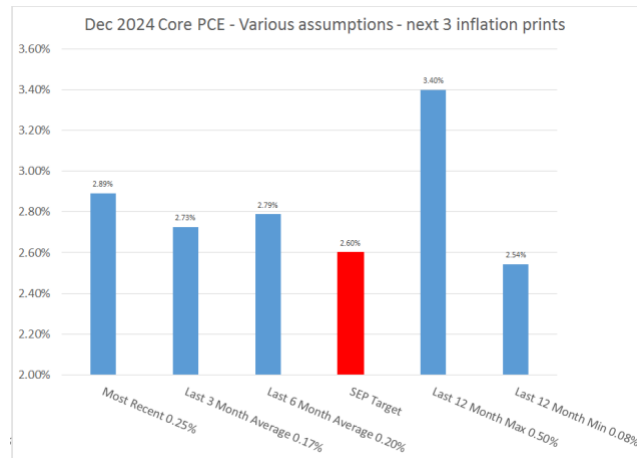
“Sweep the Leg” - A Miss for Every SEP Dot

Since the FOMC meeting, when the Fed cut 50bp and penciled in meaningful weakness in each leg of the Taylor Rule, data has swept each leg from the Taylor Rule’s 3-legged stool. There is little chance that the Fed will have data to support an additional 50bp of cuts. Nonetheless they may still soldier on.

The Three Legs of the Fed Reaction Function			
Leg	September SEP	Estimate based on the Leg Sweep of Dec Dots	Reasoning
GDP	2.0	2.7	GDP Now running at 3.2% for the last quarter available to the Fed through year end.
UR	4.4	4.1	No sign of weakness and a 4.05 last Print
Core PCE	2.6	2.7	Assumes the consensus forecast of 0.25% will be met for month end and then inflation needs to cool a lot in the next two months.
2024 Fed Funds dot	4.4	4.6	While the Fed will likely cut twice they have no obvious need
2025 Fed Funds dot	3.4	3.6	We expect a substantial pause but given the Fed will likely cut twice more this year this dot may not rise much
Long Run Dot	2.9	3	Continued trend higher for Neutral Rate

Inflation

September's Core PCE, released at month-end, will likely, given already announced CPI, PPI, and Import price components, print 0.25% or 3% annualized. In most scenarios, the Fed will not meet its SEP target at the December Meeting:

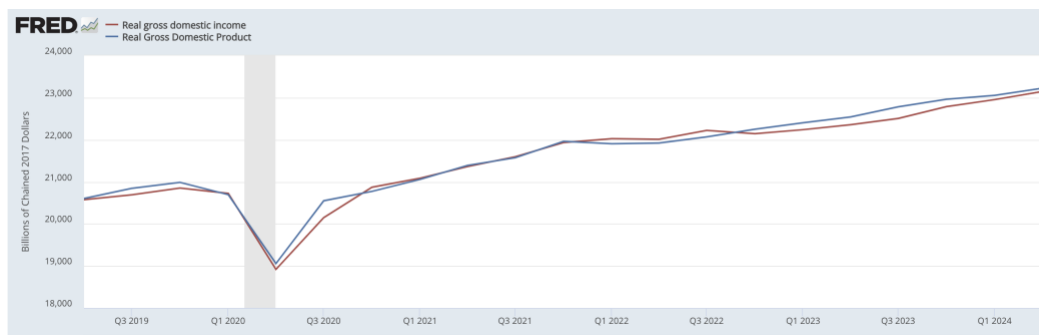


Employment

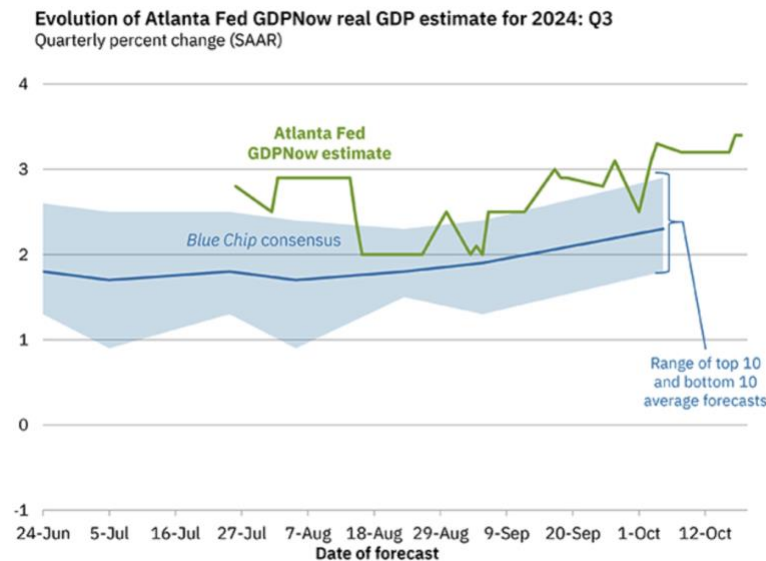
The 4.05% Unemployment rate was rounded up to 4.1% last month. With only two more reports to go it seems highly unlikely that the UR rate in the Dot plots will hit 4.4% by the December meeting. Given the overall strength of the economy, it could miss by a fair amount.

GDP

Perhaps the most important leg that had given the Fed concern about downside risk in the economy was the significant gap that had developed between GDP and GDI. GDI was unusually weak, indicating a tapped-out savings pool, amongst other things, and concerning many who thought a weak GDI print was a leading indicator for future GDP weakness. In late September, however, GDI was revised much higher and now is tracking tGDP. At the NABE Conference, Chair Powell began to walk back his Jackson Hole speech and the 50bp cuts by stating that the GDI revision removed one of the Fed's concerns. That began the big pivot in STIR markets.

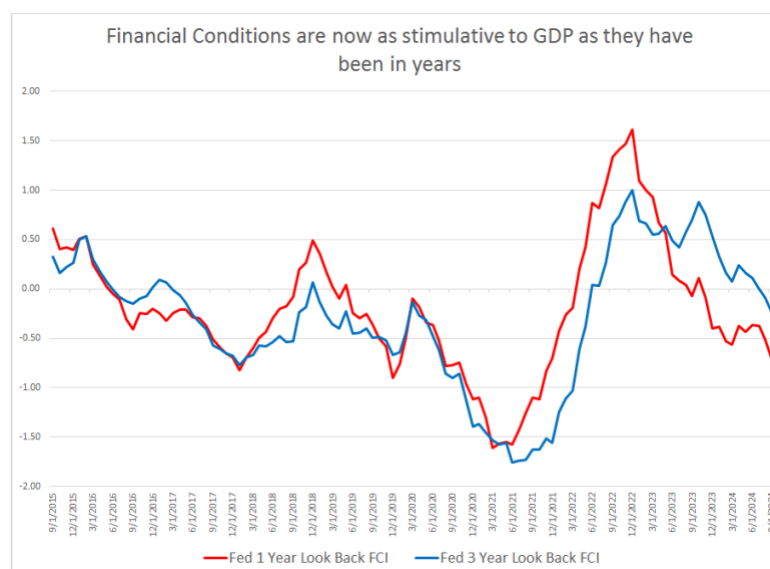


With most of the economic data already released for September and the third quarter GDP release on Oct 31, GDPNow has a low standard error and is currently at 3.4%. Analyst expectations have not yet been updated broadly, but those who have updated estimates are now averaging 3.0%. The economy remains quite strong, and the 2.0% SEP estimate seems highly unlikely to be met.



Financial conditions

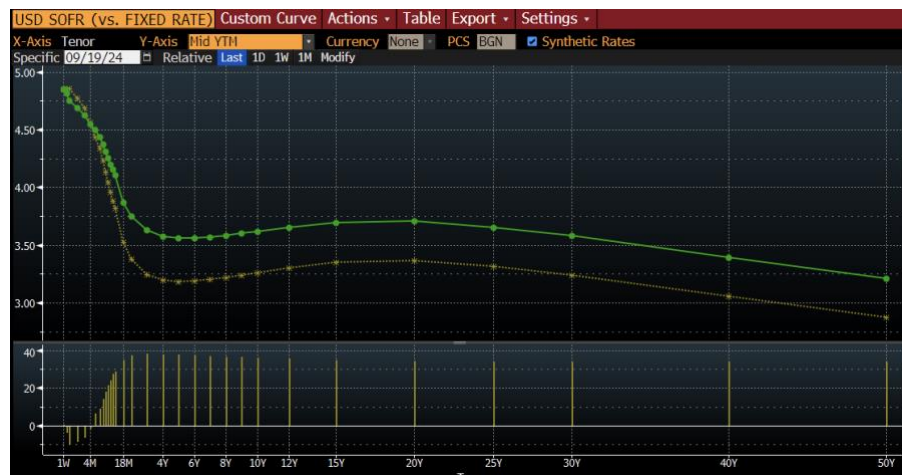
The Fed's own financial conditions indices are stimulative. We have been saying that in today's economy policy is determined not by the myopic real Fed Funds rate but by financial conditions, as the latter measure the ability of the private sector to raise capital to consume and invest, the health of the private sector balance sheet, and the wealth of its corporations and households that enables dissaving to consume and invest. Given this backdrop, it is impossible to believe the Fed's SEP forecast will be realized, which raises questions about the necessity of future rate cuts.



Rates pricing

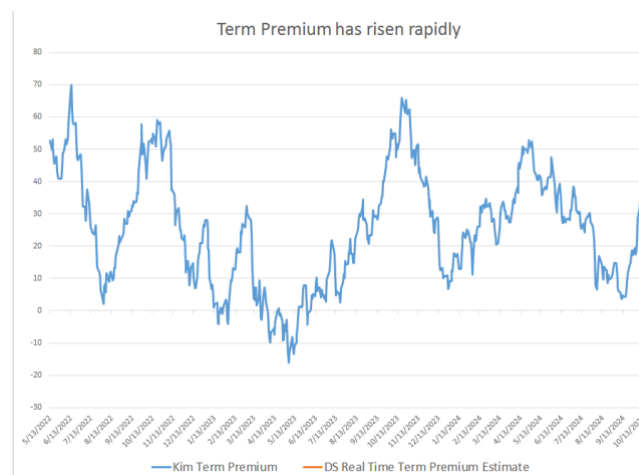
Yield Curve

After the 50bp cut and subsequent dovish comments by almost all Fed officials, the “Sweep the Legs” data trilogy has led to markets expecting a slower path of cuts and a higher trough rate happening later. Beyond STIR markets, bond yields have risen in a parallel shift. At this stage, markets are priced bang on the SEP dots. The market expects the 2025 dot and each of the longer-term dots to rise and is now pricing some small possibility that the Fed pauses at one of the next two meetings.



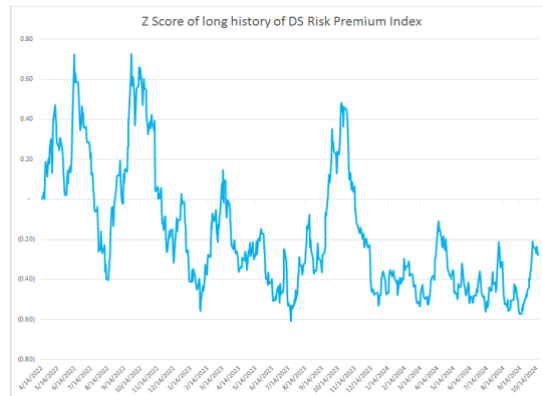
Risk Premiums

Perhaps unintentionally, the Fed’s dovishness in the face of strong data has actually begun to tighten financial conditions modestly. The most notable is the increase in term premium in the bond market. While nowhere near as high as last October, bond market term premiums are expanding:



However, a broader measure of term premium (which includes other asset markets and volatility markets) has risen along with bond term premium due to bond

premiums being part of the index, but equity levels and volatility and credit spreads are moving in the opposite direction, suggesting the expansion of term premium has yet to be arbitrated by global asset allocators.



The Market is doing what the Fed refuses to do.

Has the Fed gone too far and lost the bond market? So far, the answer is yes. Can the Fed get things back on track and achieve its mandate? We continue to believe (and see obvious evidence) that the myopic Fed Funds rate is not the lever that the Fed thinks it is. To achieve its goal, the Fed has to reduce its balance sheet duration. We have outlined an extensive plan for a QT2.0 [here](#). We think the Fed should immediately change their reinvestment of runoff proceeds in excess of the QT Cap into only bills and short-term coupon Treasuries. More generally, we think the 5-year review should deal with the question of the impact of the balance sheet on monetary policy. Our view is:

We think the long-term goals for the Balance Sheet should be:

- **A Balance Sheet which supports Ample Reserves to allow banks to operate smoothly.**
- **No MBS to avoid distorting the private mortgage/housing market.**
- **Shorter duration to avoid distorting the yield curve and to clean up the Balance Sheet for future crises.**
- **Consistent with monetary policy goals.**
- **Transparent.**

We go back to our Script on how to kill inflation. We are once again on Higherer for Longer Island

The Script "The only way to kill inflation."

- Act 1. Higherer for Longer Island – Cuts are not realized
- Act 2. Long-end yields rise to new highs
- 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.

Is the Equity market rich?

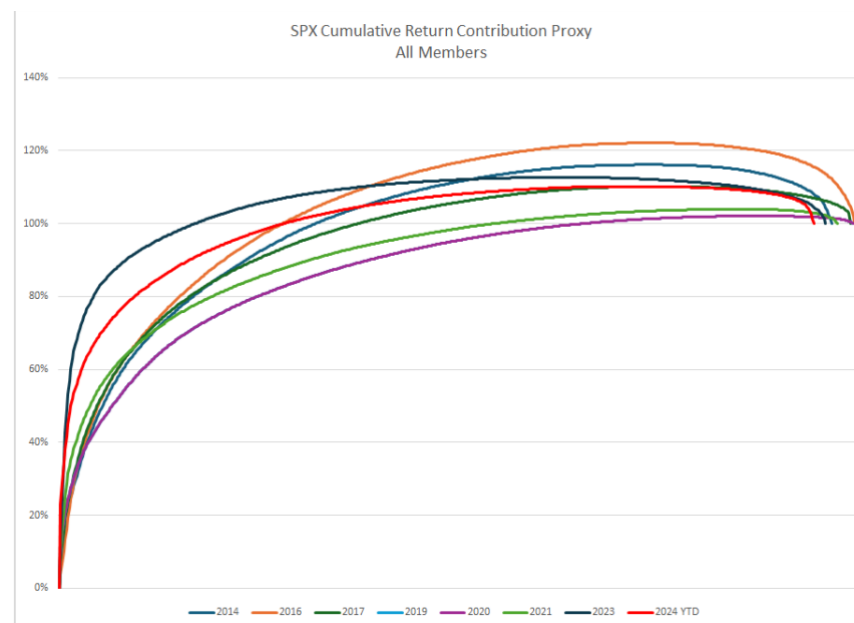
We have been dead on correct about the economy being much stronger than market participants expected for over four years now and remain of that view. A H4L viewpoint has dominated our positioning and risks. However, at the same time we have been short equities, which has reduced our sizeable profits on bonds. We continue to believe that an equity short position when paired with an aggressive bond market short position provides us both the flexibility to buy major dips like in April and August and hedges us in case, we overstay our welcome on Higherer for Longerer Island and miss the early signs of a significant slowdown.

As we head into the election, we recognize that equities could rally on a Trump victory and rally even further on a Red Sweep. We also note, and will discuss in our next DSR in a week, the betting markets, polls, and in fact financial markets pricing in increased odds of both. We expect choppy equity markets for the rest of October and are trading equities tactically until then.

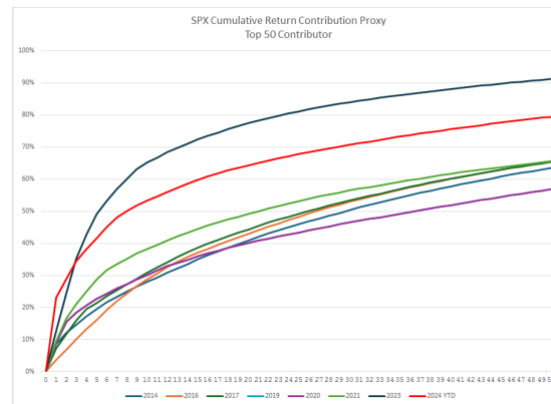
Nonetheless, equity markets have begun to shift. The Mag7 is no longer the only driver of equity markets like they were in 2023. To better understand the dynamics of a changing equity market, we look more deeply into sectors to see if the recent shifts are likely to cause a meaningful rally in equities over time. Our conclusion is that the broadening of markets is mostly valuation increases in non-Mag7 stocks, which now need to deliver on rising earnings expectations. Mag7 is no longer seeing P/E expansion and it is all about delivering on lofty earnings expectations.

Breadth

2023 was a year in which a few stocks dominated the total return of the broad equity market. Notice the steepness of the 2023 line. 2024 followed suit until recently, but is now broader than 2023 while still narrower than prior years:



Showing the top 50 winners by each year further illustrates the anomaly of 2023 and the convergence going on in 2024:



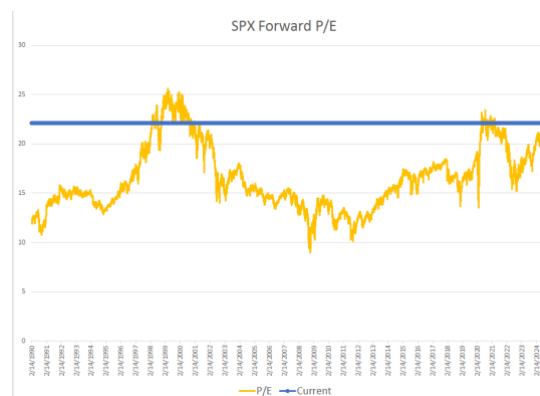
Index returns related to composition framework

We all understand that, at a macro level, overall changes in valuation and earning expectations drive equity returns. When digging one level down, composition changes become a major driver of index performance. We want to know whether the broadening of the equity market that has been underway lately can generate an overall increase in equity prices. We already know that the Tech Sector and Mag7 stocks have been growing into elevated P/E's and see little reason for that to change. We will attempt to answer these questions.

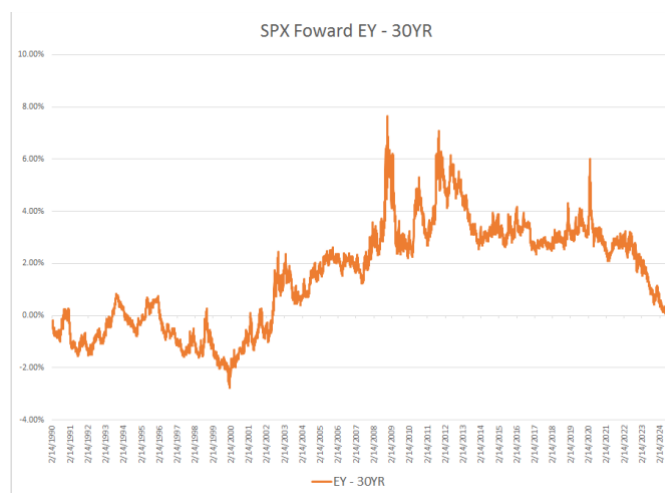
- Is the rest of the market cheap?
- Are earnings expectations for these companies elevated or conservative?
- Will Mag7 be a drag or contributor to equity returns given their sizeable current market cap, which seems to matter still?

Absolute levels

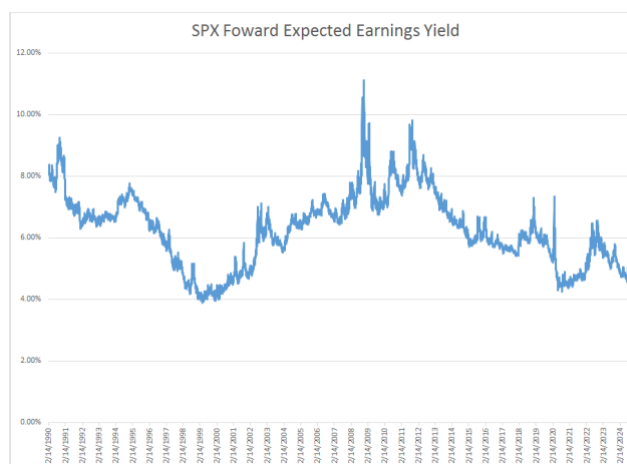
We start with the overall market. Notice that P/E's (which are one amongst many flawed valuation models) are elevated relative to history, but, at the same time, are elevated in part due to the significant increase in weighting of the high-growth tech companies:



(Earnings yield – long term bond yields) is another flawed but useful method that, compared to P/E, at least does recognize the importance of the discount rate. While we certainly don't love the idea that the SPX forward earnings yield is equal to the return on 30-year bonds, throughout the 1990s this was not unusual.



Rounding out the picture: Part of the significant earnings yield discount was much higher long-term interest rates. When we think about the absolute return of an asset, its "yield" is helpful. The current long bond yield is 4.38%. Buy it and you will get that return to maturity. The earnings yield is just another way to roughly estimate the expected future return of an equity investment. Low is less attractive than high relative to equities' absolute return potential. In 1990, the wind was at the back of markets. As the internet boom began, high interest rates were falling and earnings yields were high. Today, forward return expectations are mediocre at best:



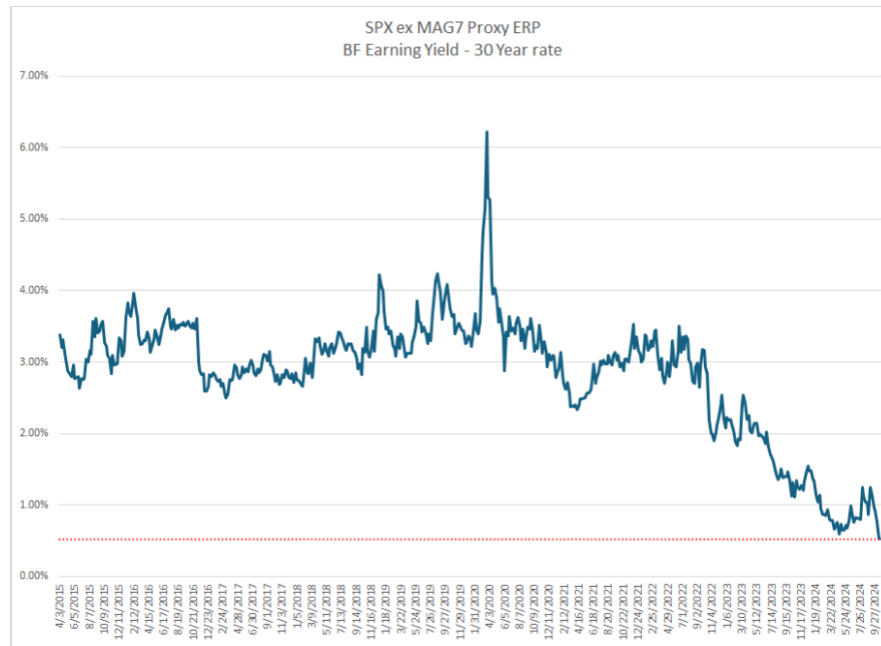
Composition

The overall stock market may be relatively rich to bonds and to itself, but composition can provide magic if Mag7 can remain at current multiples on hopes of delivering earnings growth AND deliver the earnings growth that they have in

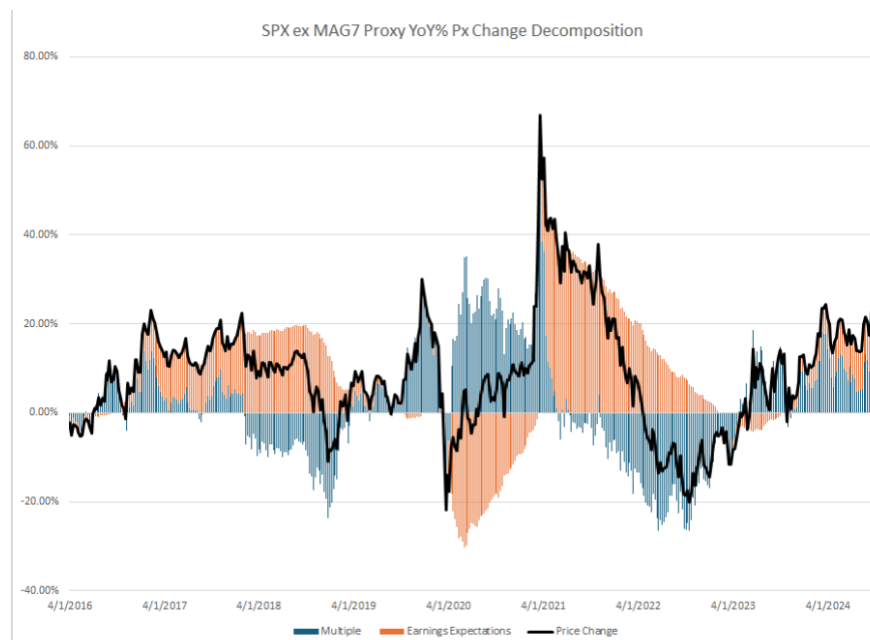
recent past while the rest of the market experiences multiple expansion and higher than expected growth.

Are other sectors cheap?

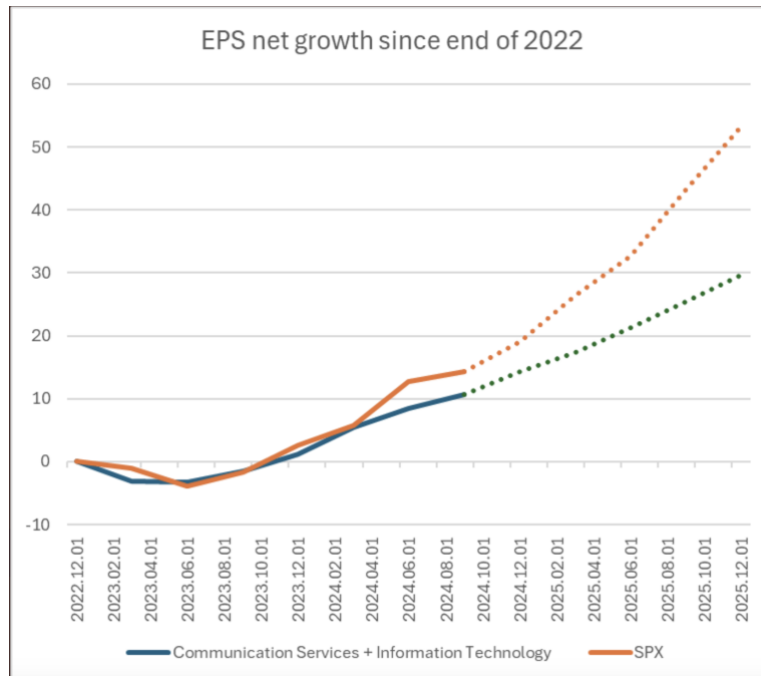
Let's look first at the 493 stocks, SPX ex Mag7. Earnings yield – 30-year rates are higher but at a post-Covid low:



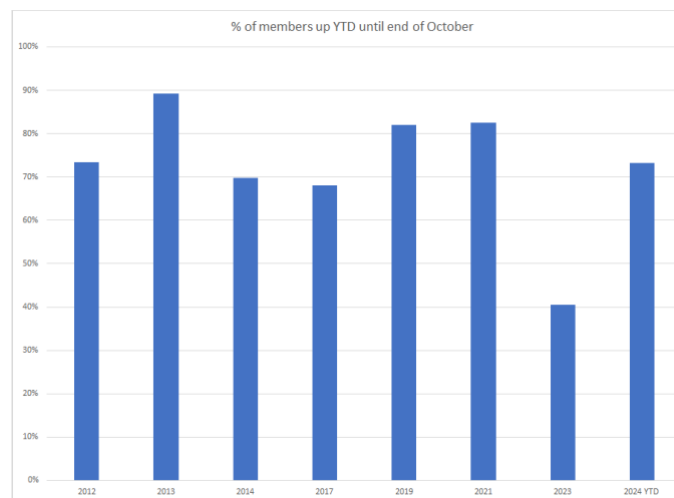
By decomposing the price into valuation changes and earnings expectation changes, one can see that most of the recent broadening has been valuation driven:



Looking at tech more broadly than Mag7, one can see that all the SPX earnings growth over the past few years was the Tech Sector broadly while the future expectations depend significantly on the other sectors. SPX EPS growth in points far exceeds the Tech Sector's contribution:



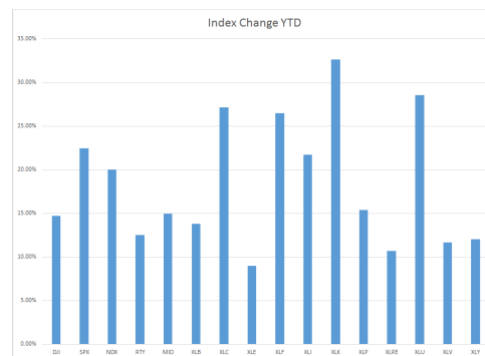
The broadening continues to demonstrate the anomaly of 2023:



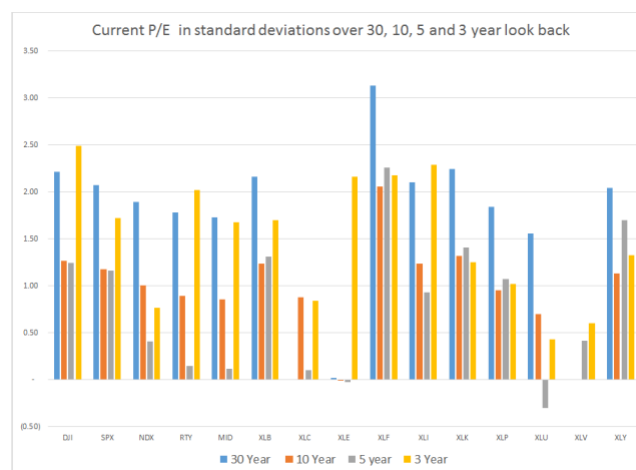
We know that the Tech Sector and Mag7, in particular, are high multiple stocks and see earnings growth consistent with that high multiple. The rest of the sectors are lower multiple sectors experience lower or no growth.

Sectors do not seem particularly cheap in aggregate as we have demonstrated above but down a level almost all sectors do not seem particularly cheap relative to themselves. In fact, all are bid up quite a bit except the beaten down energy sector.

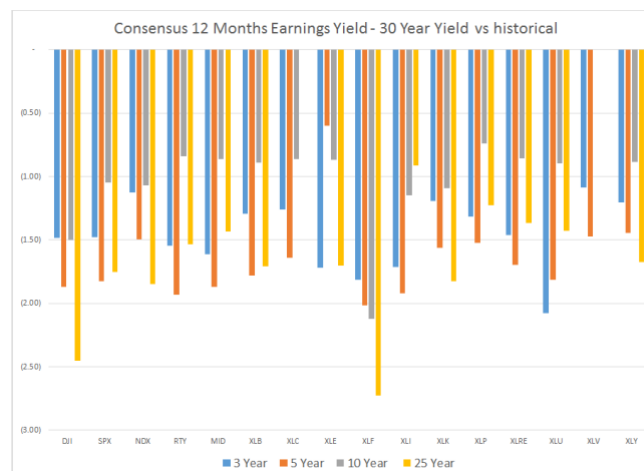
All sectors are strongly positive YTD:



All P/E's are high relative to each sectors average P/E through almost all windows:

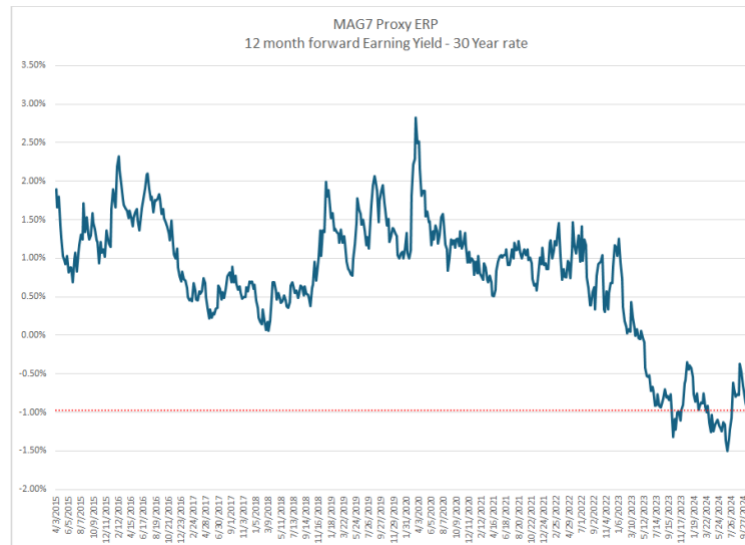


And Earnings Yields minus 30 yr bond yields are all very low. We see no bargains.



Well, maybe Mag7 can save the day.

Earnings Yield – 30 yr Yields are quite low, as are absolute yields. Also, the valuation pump has subsided as this measure bottomed soon after NVDA's last earning report.



But Mag7 continues to perform and has performed recently not due to multiple expansion, but by delivering and exceeding high earnings expectations.

Coming back up to the overall market.

The continued strength in equity markets has been driven by valuation increases in the broad market and Mag7 and the Tech Sector more broadly, delivering exceptional earnings which have beaten elevated expectations. This trend could certainly continue. Of course, Mag7 could also deliver such advances over the year to come that multiple expansion occurs, and the broader market could deliver on now highly elevated earnings expectations. We see a market that is broadly and by sector priced rich. Valuations are high and will depend on more easing of financial conditions. Earnings expectations are quite elevated and increasingly dependent on otherwise low growth sectors.

Synthesis

The economy is booming, and financial conditions are extremely easy. Over the next few weeks, Treasury will disclose its plans on coupon issuance, another read of the jobs market will be released, a consequential election will occur and then the Fed will meet. We see no value in any circumstances in long-term bonds and are aggressively short. We see the equity market as being broadly and narrowly rich and at the same time recognize that a Trump Presidency will be bullish equities and bearish bonds. We remain tactical on equities and are short today. While we don't expect an increase in bond coupon issuance during the QRA, it is possible they guide future auctions higher. On a dip we will cover equities and regardless have small equity exposure going into election week.

Current Portfolio and Performance

Assumed Portfolio size		\$	100,000,000				
LTD P/L		\$	67,142,399				
Total Return			67.14%	YTD Return in excess of cash			8.26%
Today's Date			10/19/2024	Portfolio Created			4/15/2019
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
10/9/2024	CLZ4 72/77 Call Spread	1.58	633	\$ 1,000,000	0.94	\$ (405,063)	Open
9/30/2024	SPX 11/15/2024 5700/5500 Put Spread	44.44	250	\$ 2,000,000	22.00	\$ (561,000)	Open
9/30/2024	NDX 11/15/2024 19900/18900 Put Spread	219.85	91	\$ 2,000,000	160.00	\$ (544,635)	Open
9/24/2024	ZBZ4 11/22/24 124/119 Put Spread	1.45	1376	\$ 2,000,000	3.06	\$ 2,215,054	Open
10/1/2024	ZNZ4 11/22/24 114.5/112.5 Put Spread	0.66	1524	\$ 1,000,000	1.47	\$ 1,238,095	Open
10/4/2024	SFRZ5	96.70	2400	\$ 1,000,000	96.63	\$ (420,000)	Open
8/19/2024	"Sell All Assets" Short SPY	558.07	-22399		582.65	\$ (550,558)	Open
8/19/2024	"Sell All Assets" Short TIP	108.46	-115255	\$ 1,000,000	109.20	\$ (85,865)	Open
8/19/2024	"Sell All Assets" Short GLD	238.87	-43198		244.41	\$ (239,321)	Open
8/19/2024	"Sell All Assets" Short GSG	20.97	-238436		21.74	\$ (183,596)	Open
			Risk	10.000%		11.1%	