The Damped Spring Report

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

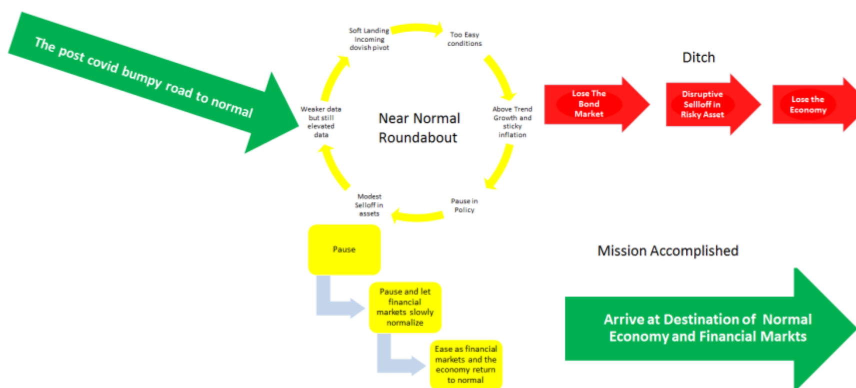
11/19/2024

The Covid Era was a historically unusual time in which policymakers chose to shut down the global economy. While the response to the shutdown varied across the globe, the largest economy chose to avoid a massive loss of wages and a severe tightening of financial conditions with massive government fiscal transfers and an equally large monetary easing.

Early in the pandemic, financial markets began to travel a path back to normal while the real economy lagged. The path for the economy and markets has been extremely bumpy over the last four years. At times, markets and the economy have appeared completely out of sync. However, "normal" is still the likely destination for both the economy and markets. As of today, the real economy is much closer to destination "normal" while financial markets remain far from normal.

Over the last year, the economic path has avoided any major bumps and the destination now appears within sight. The real economy's path has been exceptionally smooth because financial market conditions have dampened downside risk. Financial market conditions provide cheap and easy financing for anyone who can borrow in public markets or access private credit or equity markets. Additionally, historic household and corporate wealth have supported consumption and employment. Downside risk is and has been quite low. Markets remain volatile - their path has had its share of bumps and normal is nowhere in sight. The US economy is in the Near Normal Roundabout:

The Economy is stuck in the Near Normal Roundabout where Nowhere Near Normal Financial Markets prevent a fully normal healthy economy. There are three paths. Keep spinning in circles, Lose the bond market and drive into a ditch, or policymakers choose to act to normalize financial markets and accomplish the mission.

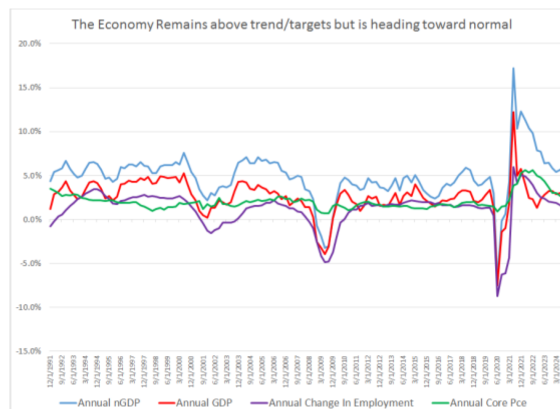


We don't think global asset markets are in a speculative bubble, but by any measure they are far away from normal. While the economy and markets do not have to be perfectly in sync for the economy to return to normal, financial markets need to make considerable progress to return to normal for the economy to truly normalize without financial markets providing cushioning. Current financial market conditions, where wealth is high, and investors are willing to finance the real economy with very low expected returns for the risks they assume, put the odds quite low that the economy will reach its destination. For now, the economy is in a roundabout where supportive financial conditions generate above-trend real growth, strong labor markets and above-target inflation. The economic destination is close, but the roundabout will remain endless until an exit ramp is taken. Stay in this endless loop and too high inflation, tight labor markets and strong real growth will delay arrival at the destination. An exit ramp exists in the form of a long road to normal characterized by a slow normalization in financial markets over months and years. Unfortunately, future policymaker mistakes or impatient financial markets could send the path into a ditch if a rapid uncontrolled normalization of financial markets disrupts the journey.

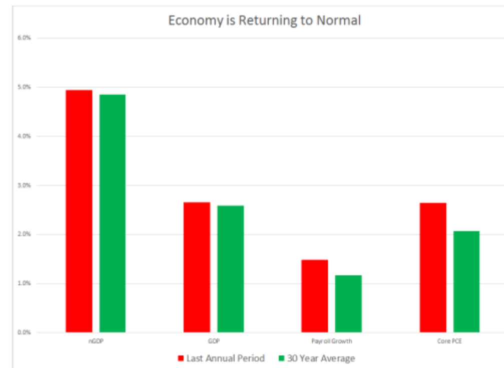
Damped Spring "warned" FOMC policymakers ahead of the election about the risk of an undesired path. Since then, financial markets have come closer to the ditch. The easy path for policymakers is to continue the endless circle of easy financial conditions and never get the economy to its destination. However, markets may have other plans if policymakers make that choice. While a controlled normalization of the financial markets by courageous policymakers may be a long and slow journey, the outcome will be a stable and healthy real economy and financial markets. Continuing to support abnormal financial conditions heightens the risk that financial markets eventually unwind and send the economy on an undesired path.

The economy is not yet normal, but normal is in sight

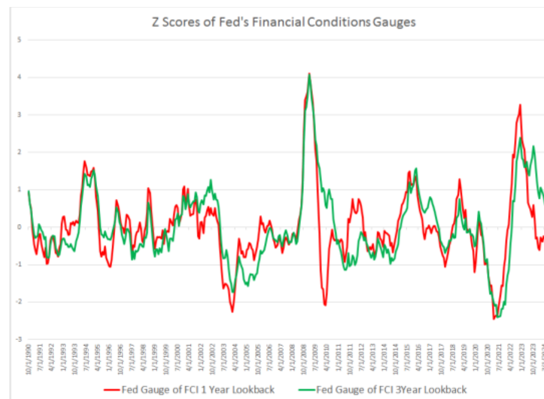
If one looks at the economy with any sort of perspective, it is hard to not be impressed with its recovery from high inflation and overheated labor market to near normal:



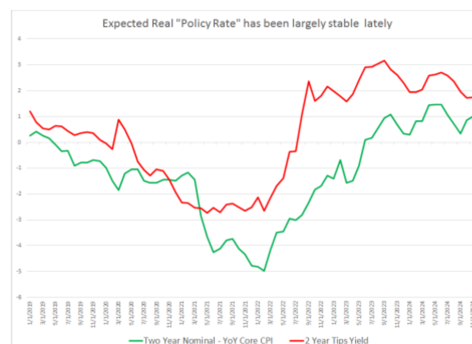
Looking at long-term average "normal" economic data, which of relate to population growth, productivity improvements and an administered inflation target, some indicators appear normal while others are near normal:



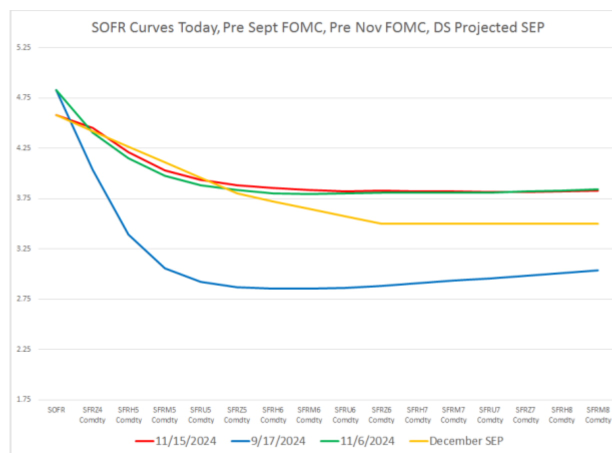
However, progress toward normal has stalled because of easy (and easing) financial conditions. Since the Covid lows, Damped Spring has consistently stated that a return to normal will require a normalization of financial conditions as the post-Covid economy is not as sensitive to Fed Funds and is much more sensitive to long-term asset prices and, in particular, risk premiums paid by those who want money to those who have money. Today the Fed's own gauges of financial conditions are expansionary:



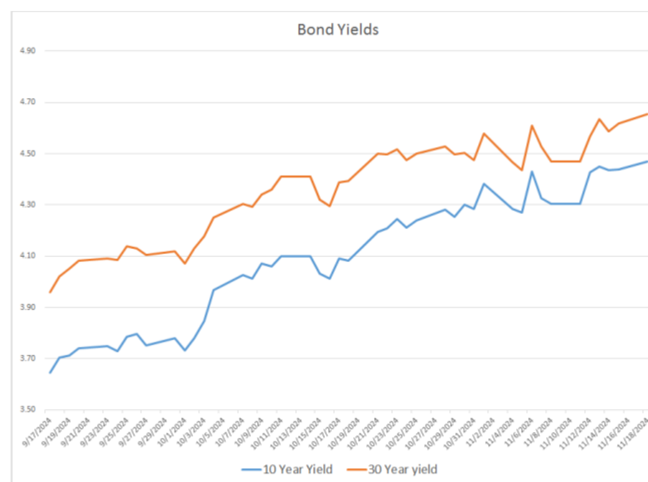
Despite a full year of constant rhetoric that financial conditions are restrictive and that rate cuts are necessary to avoid adding restriction as disinflation occurs, even short-term real rates have remained stable and have eased lately:



During the summer, a modest slowdown (likely generated by a brief rise in bond yields and April's equities selloff) resulted in aggressive Fed Speak in August about the need to ease. In September, the Fed cut 50bp, which appeared reasonable to those looking in the rearview mirror. The September SEP and press conference, and later comments by all members, told the tale that a cutting cycle was underway and that there was "likely … many more rate cuts over the next year." "The point is, we do have room to move, and that is what the committee is signaling." Just two weeks later, the GDI revision resulted in major walk backs from this guidance. Markets did not wait: Expected trough interest rates ahead of the 50bp cut in September have gone from 2.8% happening rapidly to 3.75% later in the cutting cycle:



Long-term bond markets have moved in one direction since the 50bp rate cut, and yields rose further after the election and the additional Fed rate cut:



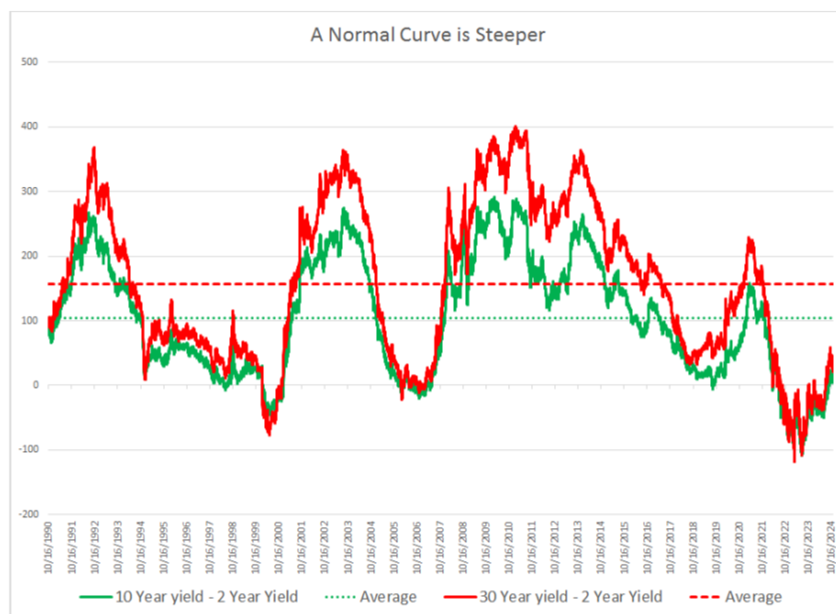
The increase in bond yields has led economists and Fed officials to disaggregate the increase in yields to drivers. We will address this disaggregation below, but while it appears to be a healthy increase in real yields and anchored inflation expectations, we believe it is all term premium, which is a great concern to us. Term premium

expansion IS the driver of financial conditions, and a rapid further term premium expansion is the factor that risks driving the economy into a ditch.

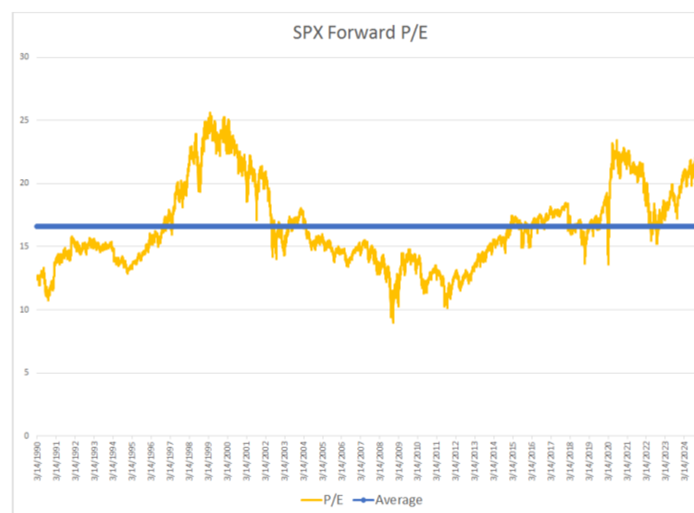
The financial markets are nowhere near normal

Before we dive into rates disaggregation and term premium, it pays to simply step back and look at current pricing. Current pricing is nowhere near normal across almost all asset markets. We don't think any broad market is in a classic bubble nor do we think that, if policymakers make smart choices, a disruptive "crash" toward normal is necessary. However, a return to normal IS necessary for the economy to return to normal and escape the Near Normal Roundabout.

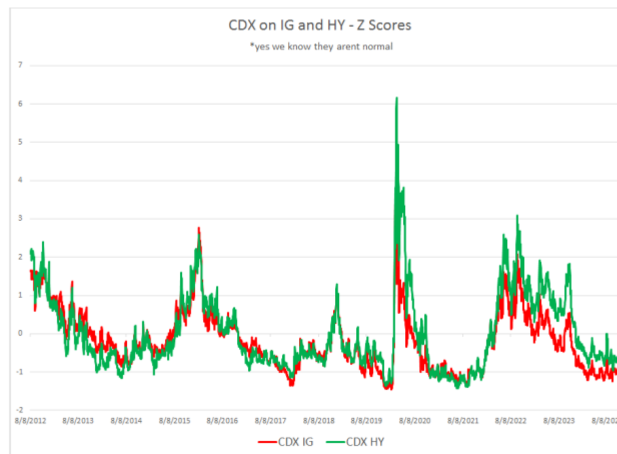
Normal yield curves are positively sloped by 100-175 bps, not 20:



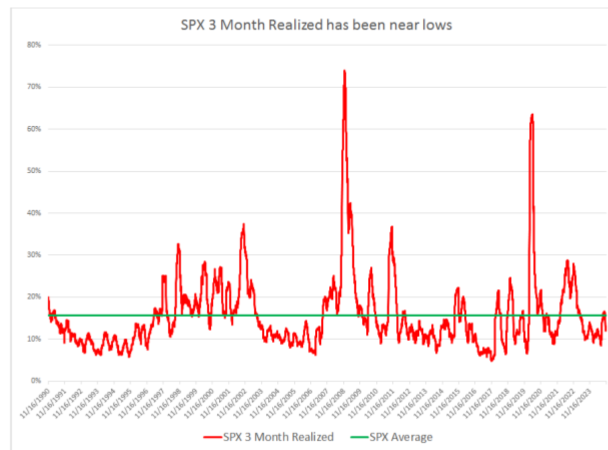
Normal P/E multiples are 16 not 22:



Credit spreads, measured with CDX, are much tighter than normal:

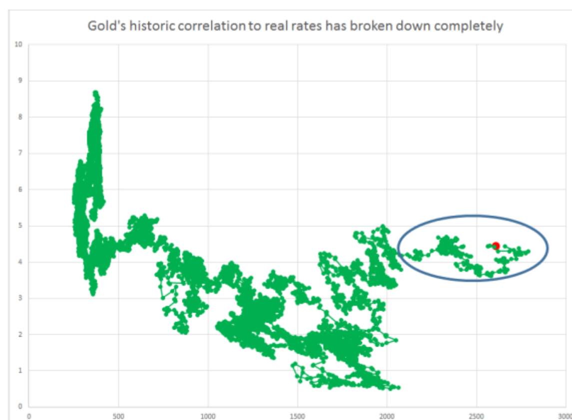


Realized equity volatility is near lows, consistent with a Near Normal Roundabout:



Inflation expectations are above target, having moved sharply down in the summer and sharply up recently. Inflation expectations are quite close to normal [Note: using inflation swaps reduces noise from physical bond financing and maturity and strips some term premium problems out of the indicator]:

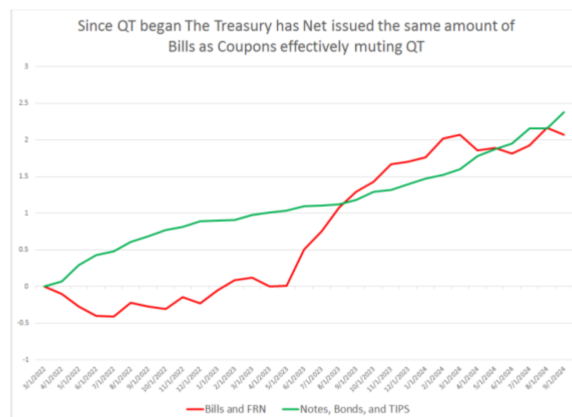
Gold is no longer connected to its principal driver of real rates and is Not Normal:



Normal financial markets

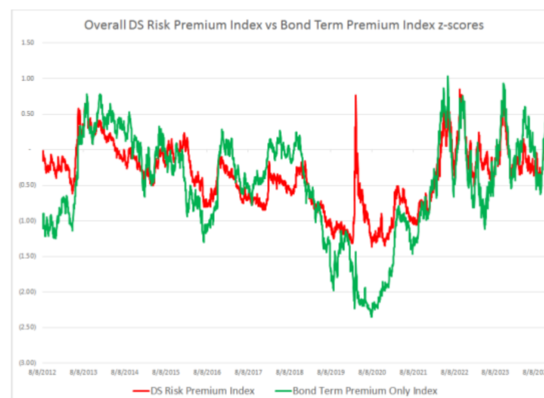
What are normal financial markets? **The literal purpose of financial markets is to provide a means whereby one who needs cash today for consumption or investment in the real economy can tap other peoples need for savings. Those with savings enter financial markets to generate superior risk-adjusted returns on their savings versus holding cash in money market funds, interest-bearing savings accounts, or other cash-like liquid investments like T-bills**.

Today, as discussed in the prior section, the cost of financing consumption or investing in the real economy is abnormally low. Everyone should be borrowing money, selling shares, selling Treasuries (the government sure is) and issuing corporate, municipal and mortgage bonds. Savers are willing to accept an abnormally low risk-adjusted return on broad asset portfolios. We have written hundreds of pages on why this imbalance exists and believe the original sin was the choice to do QT with runoff and allow Treasury to manage monetary policy by choosing what liabilities – bills, notes and bonds, to issue. Treasury chose bills and starved savers who wanted assets and didn't need more cash. Of course, the savers bid up assets:

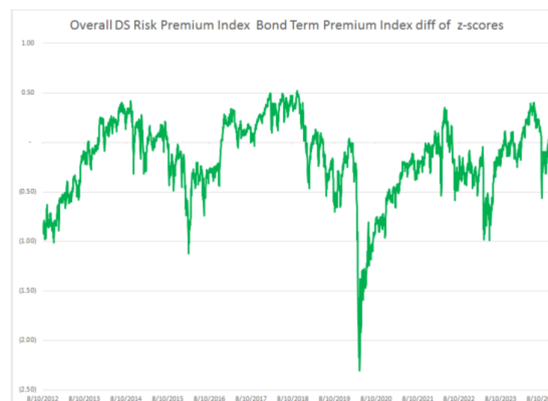


How does one measure the expected risk-adjusted return on an asset or an asset portfolio? Damped Spring's approach is based on our risk premium framework. We published a [Twitter 101](#) that explains what we believe risk premium is and what drives changes in risk premium. However, risk premium is not directly observable and requires a model to estimate its level and change. We have built an index that includes market prices and fundamental conditions in the plumbing of the money creation system to create a broad index of risk premium. We also use single asset market risk premium models to assess the process of risk premium arbitrage across markets. Our view is that over the medium term all assets carry the same risk-adjusted return, but that over the short-term asset markets can be cheap or rich relative to each other. **What is critical to understand is that the level of risk premiums across and among assets assumes nothing about future economic conditions.** Equities are likely to go up and Treasury bonds down when growth exceeds expectations, but expectations are already priced in both markets.

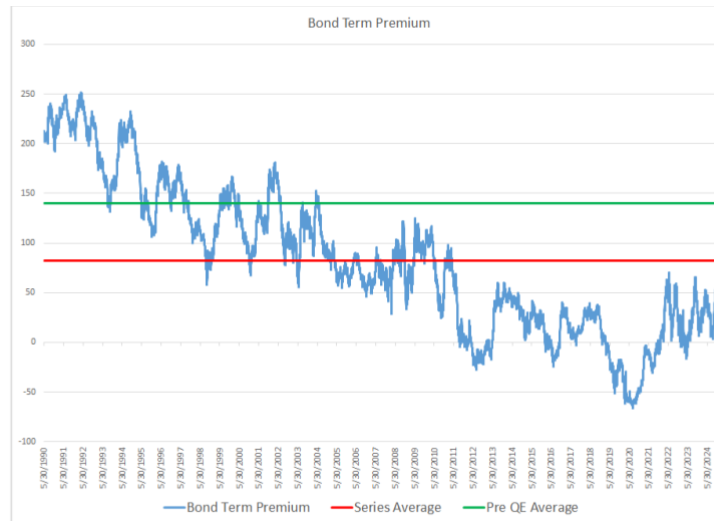
Since the Fed's September rate cut, bond markets have sold off significantly. As we will show in the next section, that has been due largely to term premium expansion, but most other assets remain near highs. Both our DS risk Premium Index (red) and single asset bond term premium model (green) suggest risk premium expansion has occurred. Notably, bond term premium is near the highs of many recent overall market lows, including June and Oct of 2022 and Halloween 2023:



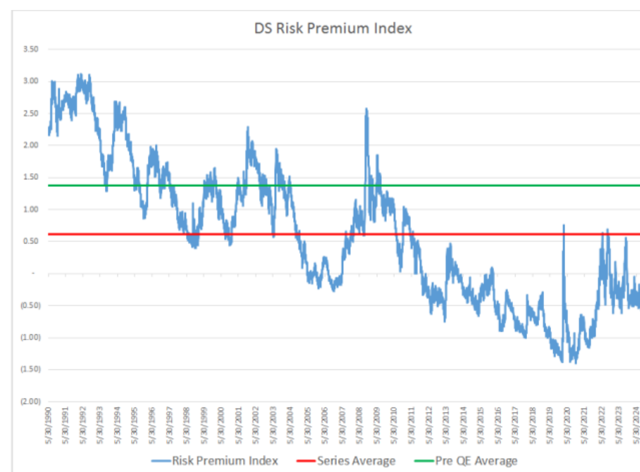
However, unlike other bottoms in bonds, bond term premium has diverged substantially from our broader measure risk premium index:



This divergence in risk premium expansion (which is largely only occurring in bonds) will almost certainly converge in the near term. That can happen by bonds outperforming equities with no change in expectations or equites can ketchdown to bonds and cheapen. Given the abnormal level of broad asset pricing and our continued expectations that the bond market has further downside, we expect equities to ketchdown. Bond term premiums are not normal today. They are abnormally low:



Overall term premiums are more abnormal:

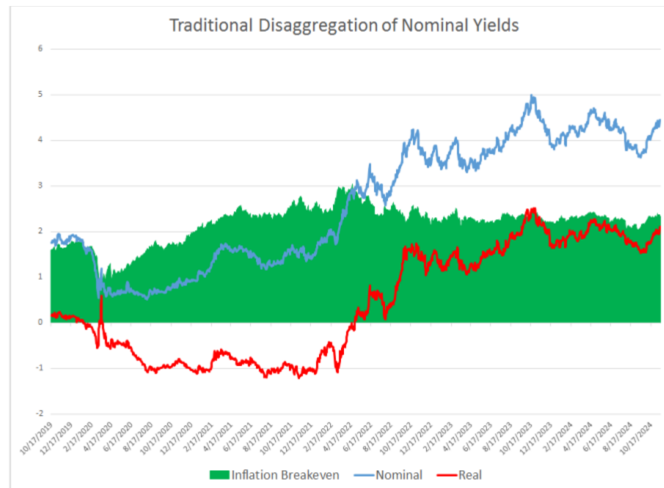


Today’s saver is getting a bad deal and will likely receive poor risk-adjusted returns holding assets. The reasons are many but Treasury issuance favoring bills for almost two years is certainly amongst the main culprits.

Damped Spring Framework for disaggregating nominal bond yields

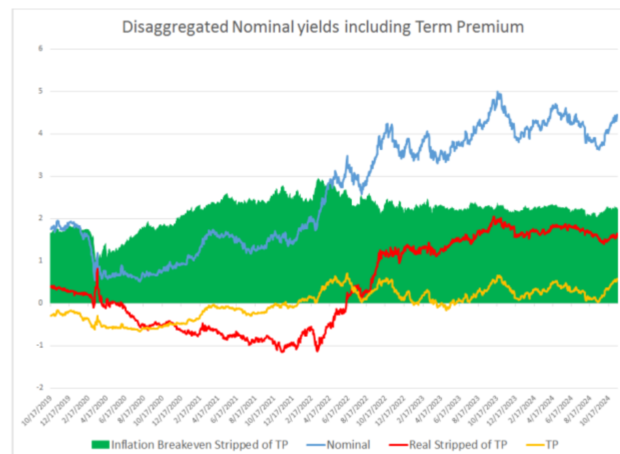
We believe that risk premiums are expanding, led primarily by bond term premiums. Many who attempt to disaggregate changes in bond yields seem to

ignore term premium in their analysis. The traditional disaggregation is: Nominal yields = real yields + inflation b/e. When looked at without considering term premium, the traditional disaggregation looks healthy. Nominal yields are up quite a bit, but that is mostly due to real rates rising and anchored inflation expectations. Rising real rates can simply be the result of increases in real growth expectations. In other words, the selloff in long-term bonds could simply be investors shifting from discounting the summer slowdown to a recovery with stronger than expected data or it could be enthusiasm for the new administration. We think it is neither:



We believe TIPS and Nominal bonds both have a term premium. As both types of bonds have price risk versus cash, they deserve some sort of term premium to convince an investor to part with cash. Our basic disaggregation is Nominal Yield = Real yield + TIPS term premium + B/E inflation Expectations + Inflation expectations term premium.

When examining the relative price risk of TIPS versus Nominal Bonds, a majority share of the Nominal Bond term premium is disaggregated to TIPS term premium. This disaggregation suggests that most of the increase in yields is term premium expansion and real growth expectations and that inflation expectations are a small factor:



Paths and market implications

Policymakers largely wasted their time last year. They approached the destination and eased too early by guidance or actions and the Near Normal Roundabout has taken them farther from their goal. Policymaker attempts to arrive at their destination while financial markets are nowhere near normal is frustrating markets and consumers who continue to despise inflation and price levels. Those who benefit (including corporations and the wealthy), on the other hand, are happy to travel the loop again and again. However, market participants may have grown tired of this behavior and a disruptive long-term bond-led selloff in assets could drive the economy into a ditch. A path exists to slowly return assets to normal without major disruption that bleeds into the economy. Hopefully, policymakers make the best choice. Regardless Damped Spring takes market positions cognizant of the macro-economic conditions, what the policymakers do (not what they should do), and what is priced into markets. Here is our view on how the paths will play out in markets.

Near Normal Roundabout

Markets are broadly priced for ongoing loops around the Near Normal Roundabout. Equities should outperform bonds, and the bond market should remain relatively flat. When navigating markets on the roundabout, given current pricing, we have a bias to be short assets relative to cash and short long-end bonds. But asset normalization won't happen because easy financial conditions will prevent asset normalization. Consequently, we ignore "value" and will cover shorts in all assets on dips. However, we also believe that the time spent on the roundabout is ending.

Alternative Destinations

Once leaving the Near Normal Roundabout, the path is to normal financial markets. We expect that destination will look like:

- Fed Funds between 3.5% and 4%.
- 10Y yields between 4.75% and 5%.
- 30Y yields between 5% and 5.25%.
- Equity multiples between 17 and 19.
- Gold returning toward its relationship with real rates and between 2200-2400.

But the destination could arrive quickly or slowly. If we arrive quickly at the destination, significantly worse overshoots of any or all these levels could occur.

Slow path to normal

A slow path to normal will take a year or longer. It will take discipline by policymakers not to overreact (as they have reliably done over the past year) to strong but weakening data or markets that make occasional downward moves. In this scenario, bond markets stay steady but also underperform cash as they drift steeper toward normal. Equities, on the other hand, do not necessarily have to sell

off much. The slow path to normal can be a 20% correction in multiples while earnings continue to grow, resulting in potentially small upside in equities over the next few years. A slow return to normal in which bonds are stable and equities grow into their multiples is a wonderful Goldilocks path. The Goldilocks path is available for the courageous. Cash may outperform assets during this journey, but asset markets are okay. The path to normal is slow. Volatility will be low, and Alpha will be even harder to find. But that path is the best for the economy and households.

Ditch

If policymakers remain in the Near Normal Roundabout, they run the risk that a period of stronger than expected growth and/or inflation will lead to a rapid bear steepening due to term premium expansion driven by lack of confidence in policymakers. A disruptive steepening may even cause policymakers to react via rate cuts or market intervention, which would only compound the problem. It would not surprise us if the Ditch Path resulted in financial markets overshooting normal steepening more and causing a greater equity multiple contraction. Indeed, this sort of disruptive move would impact the real economy and equity multiples could contract, presaging a decline in earnings growth relative to expectations. Of course, this path also has financial stability potholes. Those potholes would likely elicit a policy response and, once again, compound the problem. The Fed has two mandates, and, while full employment is clearly a risk to exiting the Near Normal Roundabout, labor markets remain historically strong. The Fed needs to choose an exit or one will be chosen for them. Our current portfolio reflects high odds that we are going into a ditch. Once that ditch becomes evident, asset markets will have no place to hide. If bond yields rise and equity prices fall, precious metals and other assets will be sold by investors to offset margin calls and reduce risk.

Catalyst

A likely catalyst is the December FOMC meeting. If the Fed cuts and the SEP is only modestly hawkish, we expect bond markets to drive us into a ditch. If the Fed pauses and provides a hawkish dot plot, the market may be on its way to a slow normalization.

Policymaker actions and the impact on the paths

We think the best way for the Fed to achieve its goals is to slow the bond selloff by humbly pivoting back toward hawkishness. By slowing (but not stopping) the bond market's return to normal, the risk of a disruptive move is lowered. A disruptive increase in risk premiums would undoubtedly drive equities toward normal more rapidly than the alternative. Rapid selloffs would also mark down the wealth of both corporates and households and increase the cost of capital for consumption and investment in the real economy. Driving into a ditch is not required to return to normal. Policymakers can take actions to head toward normal in a way that would avoid the ditch. Specifically:

- Pause in November or give clear guidance that December is off the table.

- Reiterate the Fed's commitment to reducing the balance sheet regardless of the RRP level.
- Give clear guidance that the terminal rate is probably much higher than previously thought.
- Give clear guidance that, although the Fed prefers to avoid job losses, it is willing to accept some losses to ensure inflation well and truly returns to target.
- Indicate that part of the 5-year review will focus on bringing the balance sheet to a more sustainable composition consistent with the Fed's long-run goals.
- We also strongly suggest changing reinvestment of maturities above the QT cap in only 5Y and under notes and bills.

All these suggestions are hawkish. There is little downside to hawkishness. The market has already moved from a terminal rate of 2.8% reached in 12 months to a 3.75% terminal rate in 18 months. However, by being clearly hawkish, the Fed will, for the time being, make the long-end of the yield curve happy. A happy long-end prevents a rapid and uncontrolled de-risking and its negative consequence for the economy. Slow and steady back to normal in both the economy and markets is the soft landing we all hope for.

Synthesis

The economy is near normal but won't be normal until financial markets move from nowhere near normal to normal. In a normal financial market and economy, private sector capital is priced in a balance where choosing to tap savers' cash has a cost and savers have a reasonable expected return for risk. Today, primarily due to Treasury favoring bills issuance for two years (but also the Fed myopically focusing on the short-term real Fed Funds rate in setting policy), markets are nowhere near normal and government involvement is preventing the private sector from finding a balanced price for financing and investing. The intervention may continue but the consequence will be an increasingly fragile financial market. We are hardly doomers and think there is a viable path to normalization. We hope policymakers lead us down that path.

A slow normalization is not awesome for assets but is also no reason to dump them, particularly if a slow normalization occurs and assets converge to modest returns in excess of cash. Selling vol comes to mind as the best strategy. Unfortunately, a slow normalization means the policymakers need to step back and stop fiddling. Will they? Probably. Once the policymakers adjust their thinking, a slow path to normal can be achieved.

Current Positions and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 68,450,829		
Total Return	68.45%	YTD Return in excess of cash	9.57%
Today's Date	11/19/2024	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
10/31/2024	SPX Dec 31St 5955/6055/6155 Call Butterfly	12.00	833	$ 1,000,000	19.50	$ 625,000	Open
11/7/2024	SPX Dec 31St 5560/5460/5360 Put Butterfly	1.65	1515	$ 250,000	1.90	$ 37,879	Open
11/7/2024	DEC VIX Futures 13.85 Stop	15.85	500	$ 1,000,000	16.30	$ 225,000	Open
11/13/2024	SPX 5900/5500 12/31/2024 Put Spread	42.00	238	$ 1,000,000	73.50	$ 750,000	Open
11/13/2024	NDX 20000/19000 Put Spread	86.00	116	$ 1,000,000	182.00	$ 1,116,279	Open
11/7/2024	ZBH4 1/24/25 113/108 Put Spread	0.70	2844	$ 2,000,000	0.89	$ 533,333	Open
11/15/2024	SFRM6 Starter Positon	96.105	560	$ 500,000	96.16	$ 77,000	Open
8/19/2024	"Sell All Assets" Short SPY	558.07	-22399		585.07	$ (604,763)	Open
Pending	CLG5 Mid January Expiry 71 Call	2	500	$ 1,000,000	2	$ -	Pending
Pending	ZNH5 1/24/25 110 Puts TARGET ENTRY	1.00	1000	$ 1,000,000	1.00	$ -	Pending
Pending	GCG 1/28/2025 2700 Call TARGET Entry	20	500	$ 1,000,000	20	$ -	Pending
			Risk	6.750%		9.5%	