The Damped Spring Report

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

12/15/2024

The Fed is on the verge of losing the long end of the bond market and risks sending the economy into a ditch. We wrote about the paths to normal here. Given the near certain market expectation of a 25 bp cut in the Fed Funds rate at this week's FOMC meeting, it is extremely difficult for the Fed to deliver an adequately hawkish dot plot and for Chair Powell to be anywhere near as hawkish as the bond market is currently priced. Because the FOMC is unlikely to be able to out hawk the bond market this week, we expect bond yields to continue to climb and equity markets to outperform bonds but not cash. To be clear, we do not know if the Fed wants to out hawk the bond market or has the slightest concern about the long end. The Fed has not cared all year. However, we think the long-term bond market is critical to the economic path and that a disruptive bear steepening could ensue if the Fed cuts again and stays dovish.

FOMC December SEP	Dot			Initial move			Next day or two		
	2024*	2025	Longer run	Assets	Bonds	Stocks	Assets	Bonds	Stocks
Prior	4.4	3.4	2.9						
Cut 25 Dovish Presser	4.4	3.4	2.9	Buy	Sell	Aggressive Buy	Aggressive Buy	Aggressive Sell	Aggressive Buy
Cut 25 "Truly" Hawkish Presser	4.4	3.6	3.1	Neutral	Buy	Sell	Neutral	Buy	Neutral
Dovish Pause	4.6	3.6	3.1	Sell	Sell	Sell	Buy	Buy	Neutral
Hawkish Pause	4.6	3.9	3.3	Aggressive Sell	Sell	Aggressive Sell	Aggressive Sell	Aggressive Buy	Aggressive Sell

* Not an actual dot

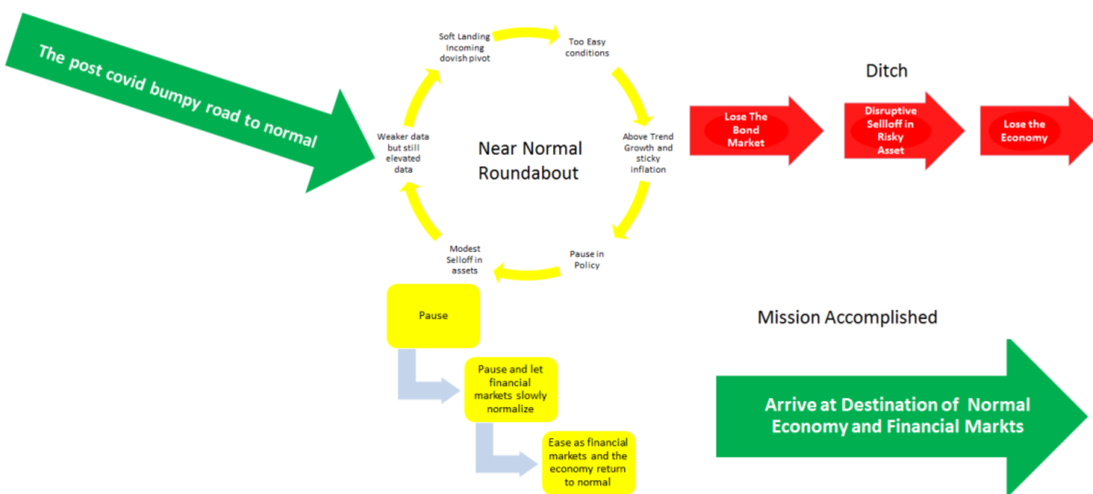
FOMC meeting preview

What matters for Wednesday

- The Fed is almost certain to cut 25bp, although we hope it does not.
- The SEP is likely to increase slightly the target fund rate for Dec 2025, reduce cuts from 4 to 3 and the longer run dot is likely to creep up to 3.1.
- The press conference rhetoric is once again likely to emphasize that the economy is strong, inflation is returning to target, rates are restrictive, and interest rates cuts will continue at a slower pace.
- In aggregate, the takeaway will be a less dovish or modestly hawkish outcome.

We think a mildly hawkish outcome will give no comfort to the bond market. STIR markets will not rally despite being quite cheap to the new dot plot and rhetoric. The long end will continue to sell off due to increasing term premiums and the equity market may begin to feel the pinch of tightening financial conditions. We would prefer the Fed at least try to match the bond market's hawkish pricing, but without pausing at this meeting Chair Powell will have to deliver a very hawkish press conference. We don't think Chair Powell will deliver such a hawkish outlook and probably does not believe one is necessary.

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.



To successfully exit the Near Normal Roundabout without the market driving the economy into a ditch, the Fed should try to slow the selloff in the long bond before they lose it. A pause and a moderately hawkish press conference would likely do the job, but we don't expect the Fed agrees.

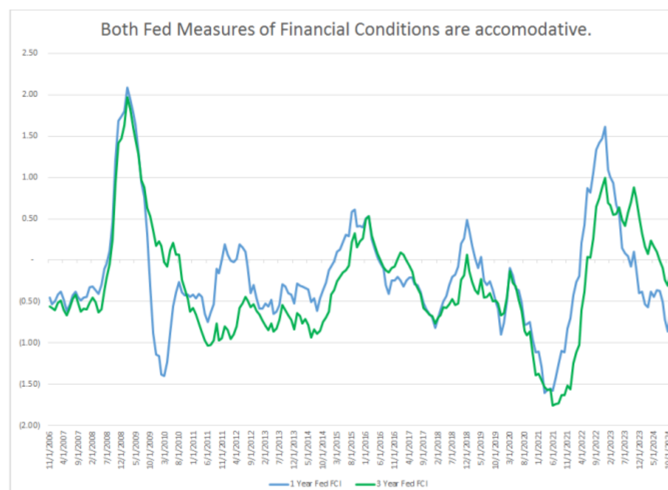
Monetary Policy framework

The Damped Spring Monetary Policy Framework considers all aspects of policy that impact the economy. We certainly acknowledge that real short-term rates were high and recognized the need to adjust that policy rate. Nonetheless, our framework weighs other aspects of policy more highly than the Fed.

Our review of Financial Stability suggests bank health is excellent. Despite weakness in some corners of the banking system where reserve balances held by some banks are too low and potential credit losses are rising, we judge these corners as non-systemic and overall, the banking system has tremendous capacity to provide credit in all likely economic climates.

Private sector balance sheets are in fantastic shape and asset holder wealth is at all-time highs. That combination of wealth, low-cost corporate and private sector funding, strong wages, near historic levels of employment, and public sector fiscal

spending, supports continued robust growth in the economy. Our view is that Fed Funds is less impactful on the economy than in past decades and that financial conditions are not restrictive and may in fact be accommodative.



The Fed disagrees

The Fed and many market participants have focused myopically on the Fed Funds Rate and the dots. The Taylor rule is doing all the heavy lifting. In fact, the Fed is expected to cut rates this week, despite:

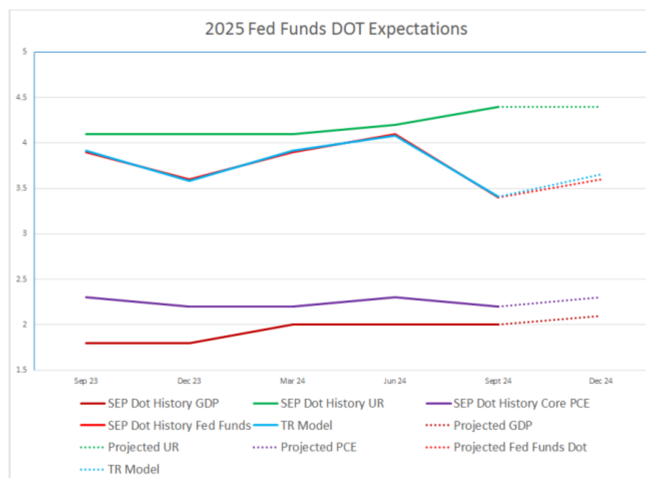
- Annual GDP running at 2.7% vs their prior assumption of 2.0%.
- GDI being revised higher and converging toward this elevated GDP, removing uncertainty about the validity of the GDP figures.
- Core PCE data (including the CPI, PPI, and Import Pricing reported last week) ending the year at 2.9% YoY versus Fed Projections of 2.6%.
- UR running 10-20bp lower than the Fed’s September Projection

The market expects the Fed to be dovish and cut. The Feb probably will cut but we see no reason it “should.”

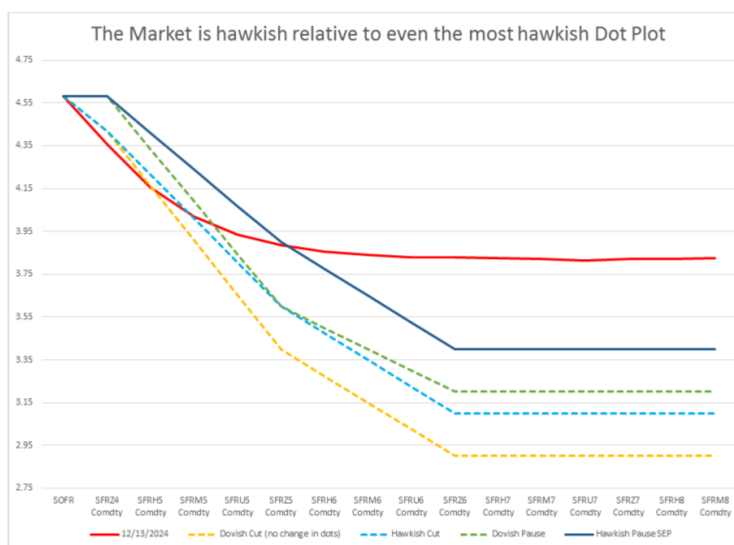
Economic Forecasts							
		2024				2025	
	GDP	UR	Core PCE		GDP	UR	Core PCE
Fed September Dots	2.0%	4.4%	2.6%	Fed September Dots	2.0%	4.4%	2.2%
Current Economist Consensus	2.7%	4.2%	2.9%	Current Economist Consensus	2.1%	4.3%	2.3%
Miss	0.7%	-0.2%	0.3%	Likely Fed Median Dots	2.1%	4.3%	2.3%
None of the Fed's September Dots come close to supporting the widely expected 25 bp Cut		All Hot		A raise of the Fed's 2025 Dot to 3.6% would require the Fed's dots to update to Economist Consensus	2.1%	4.3%	2.3%

We have built a fairly accurate “dot tracker” for Fed Funds that measures each component of the Taylor rule and uses published median economic consensus estimates of UR, Core PCE, and GDP 2025 and assumes no change in longer-term

neutral rate. It suggests a 3.6% Fed Funds target for Dec 2025 which is a slight increase from the September Dot. Assuming the Fed does cut this week, the new dot will project three cuts in 2025, which is still dovish:



Markets remain decidedly more hawkish than the Fed, even if the Fed were to deliver the most hawkish result. We have mentioned the Fed losing the bond market; the STIR market is already lost and the long end is likely next:



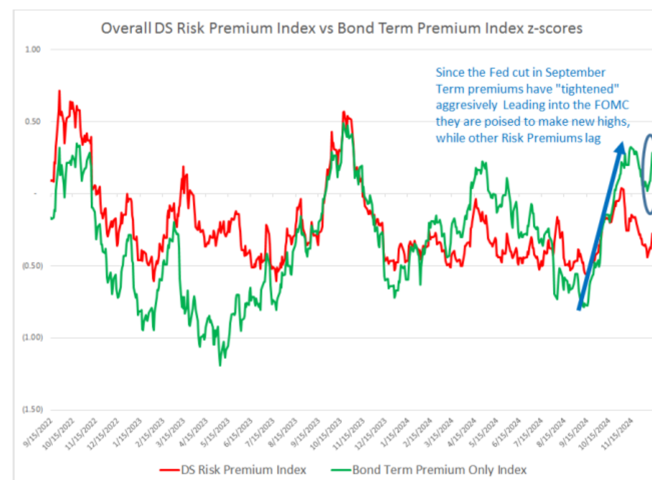
Why will hawkishness avoid a rapid disruptive tightening of financial conditions?

Whether the Fed cuts interest rates or not at this week's meeting is not going to make a difference to the economy or most asset prices except for the January Fed Funds Futures. What matters is the message the Fed gives about the future path of interest rates and their reaction function to changes in the economy. The market has voted, and it is clearly very hawkish. Of course, the market gets it wrong all the time. As recently as just before the September FOMC meeting, the market had priced a rapid decline in the trough interest rate from 5.3% to 2.8% in just 12 months. Multiple times over the course of the hiking cycle, the market priced rapid cuts. During the first stages of the hiking cycle that kicked off in May 2022,

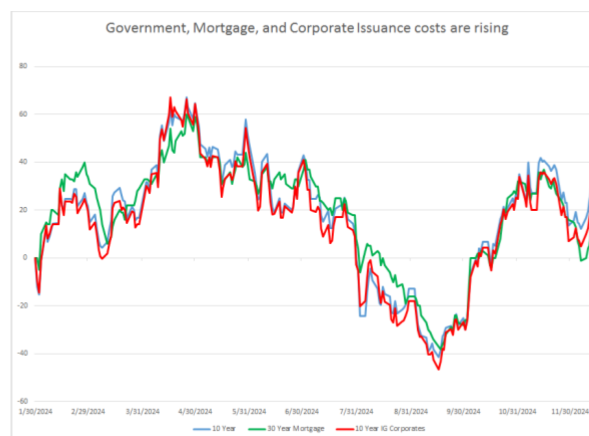
markets priced far more hikes than the Fed indicated. Over the course of history markets tend to price hikes AND cuts well before they happen and often wrongly or prematurely. This is normal. What is unusual in general and completely different in the last three years is that the market is "fighting the Fed" instead of frontrunning it. We have faded every frontrunning of the Fed over the past two years. When STIR has priced rapid cuts, we have said that is not going to happen. Today, we are saying fight the Fed. We agree with the market that the Fed is not adequately restrictive and needs to pause. We also have said many times that the Fed Funds rate is the wrong tool, and the Fed should reduce the duration of its balance sheet, but we will not repeat that here.

More importantly, the market is not likely to respond to a dovish Fed. If the Fed were to cut and leave each dot exactly where it was in September AND Chair Powell delivered his typical soft-landing press conference, we expect that the STIR market would hardly budge. The long end likely would sell off hard as well. We see little downside to the Fed following the market at this meeting and being hawkish, but that would be a shift.

By shifting the Fed is more likely to dampen any additional uncontrolled steepening. Why? It comes down to credibility and its impact on term premium. By restoring credibility, the Fed would avoid further rapid term premium expansion. By avoiding rapid term premium expansion, the Fed would prevent uncontrolled tightening of financial conditions, allowing long term rates to rise slowly instead of rising rapidly and disruptively. By restoring credibility, the Fed would be able to release pressure from easy financial conditions and a hot economy with less damage. By waiting and remaining easy, the market will eventually tighten for the Fed with potentially more disruptive consequences as other forms of risk premium expand and cause asset price weakness:



In other words, by being hawkish the Fed can arrest some of the steepening that has occurred, which will "ease" increases in borrowing costs for the public and private sector at large. The recent increase in bond yields has impacted private sector borrowing cost already. Further term premium expansion will exacerbate the tightening. The Fed wants to ease financial conditions and the best way to do that is to slow the increase in term premium.

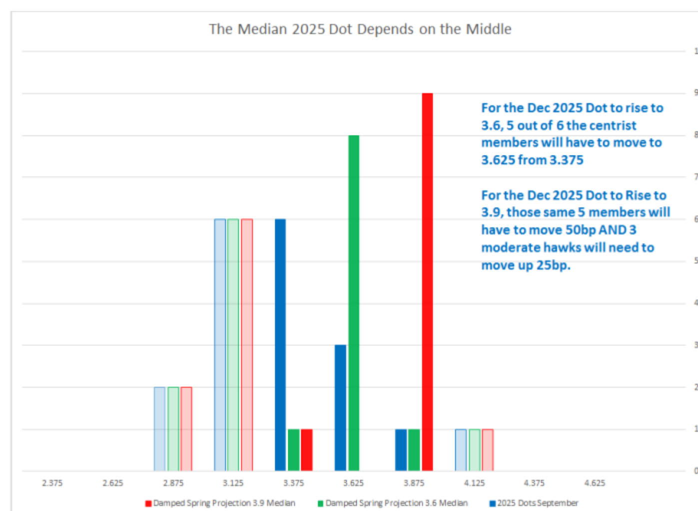


The rise in yields of all sorts is not due to rising inflation expectations or even meaningful rises in growth expectations. The rise has been largely caused by term premium expansion driven by the FOMC's oddly myopic dovishness and overconfidence in a soft landing. Further dovishness will make matters worse.

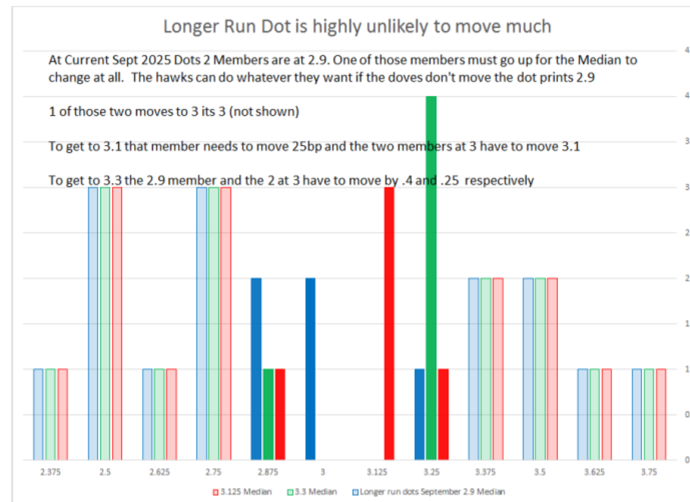
Details on the dots

Given the importance of the SEP in crafting the desired message, it pays to examine the dots carefully. It is possible that the members pencil in dots with a completely fresh and openminded outlook each time. However, it seems clear over the years that the members impose a framework that they believe anchors the various dots to each member. Williams, for instance, is notable as a real Fed Funds/Taylor Rule/Stable r* sort of guy. Various hawks appear anchored to the long-term interest rate, asset markets, and financial conditions. Regardless we think the prior dots are an anchor to changes from one quarter to the next, not due to closemindedness but due to the respective frameworks of the members.

The current market prices the Dec 2025 dot at 3.4%. To move the dot to 3.6% will take 5 out of the 6 centrist doves to move up 25 bps. This is our central case. If the Fed cuts, we see no possibility that the 2025 dot rises to 3.9.



After five years of a 2.5% longer run dot, the longer run dot has modestly drifted up to 2.9. Members are dug in on their views. Eight hawks are much higher and many of the eight doves have moved very little. It comes down to three members setting the median. Our view is the median dot will rise to 3 or 3.1 without much difficulty based on one member moving. However, to get to 3.3 requires that a member change his or her outlook by a significant amount. The STIR market trough interest rate for this cutting cycle is 3.75. The dots will end the week far away from the market.



Asset valuation

Economic consensus is for a slowing economy with disinflation heading toward target. In this section we will plot some scenarios for individual assets and portfolios over the course of the next twelve months. We use extremely conservative estimates for asset returns:

- Multiples left mostly in line despite the recent bond sell off.
- Not particularly weak equity earnings in the economic slowdown case.
- A modest selloff in bonds in the strong economy case with aggressive multiples and earnings for equities.

Asset portfolios beat 1-year bill returns only in the combination of the most optimistic outcomes:

50% Equities 50% Bonds		1 Year Scenarios					
Asset	Current Pricing	Economic Slowdown	IRR	Soft Landing	IRR	Economic Bounce	IRR
1 YEAR BILL	4.22%	2.50%	4.2%	3.50%	4.2%	4.40%	4.2%
2 YEAR NOTE	4.23%	2.50%	6.0%	4.00%	5.0%	4.60%	4.1%
10 YEAR NOTE	4.40%	3.25%	12.5%	4.50%	3.7%	5.20%	-1.2%
EQUITIES	6,051	4,974	-15.8%	6,142	3.5%	7,087	19.1%
NTM Expected EPS	267	240	-10%	283	6%	299	12%
MULTIPLE	22.7	20.7		21.7		23.7	
50/50			-1.7%		3.6%		9.0%
Relative Performance vs bills			-5.9%		-0.6%		4.7%

One must expect a near-perfect outcome to prefer assets over cash. We suspect there will be better environments over the next few months to invest.

Synthesis

The economy is in fantastic shape, outperforming the Fed's expectations. Inexplicably, the market is pricing near certainty of a cut this week. At the same time, every other point on the yield curve suggests the Fed has made a mistake in cutting and is likely to compound the problem with further rate cuts and dovish guidance. Risky assets, on the other hand, are at extreme valuations knowing that an easy Fed is supportive of risky assets. We expect the Fed to be business as usual this week and that posture will lead to further bear steepening and relatively soon - perhaps before the end of the year or early next year, the equity market will join the bond market selloff. The combination of those reactions to an unnecessarily dovish Fed will send the economy into a ditch. It can be easily avoided.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 63,370,307					
	Total Return	63.37%		YTD Return in excess of cash		4.49%	
	Today's Date	12/15/2024		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	38.00	$ 2,166,667	Open
11/7/2024	SPX Dec 31St 5560/5460/5360 Put Butterfly	1.65	1515	$ 250,000	0.20	$ (219,697)	Open
11/7/2024	DEC VIX Futures 13.85 Stop	15.85	500	$ 1,000,000	14.55	$ (650,000)	Open
11/13/2024	SPX 5900/5500 12/31/2024 Put Spread	45.65	438	$ 1,999,470	10.00	$ (1,561,470)	Open
11/13/2024	NDX 20000/19000 Put Spread	100.21	200	$ 2,004,200	10.00	$ (1,804,200)	Open
12/4/2024	SPX Dec 31St 5955/6055 Call Spread	77.55	-833	$ 1,450,251	73.00	$ 379,015	Open
11/7/2024	ZBH4 1/24/25 113/108 Put Spread	0.70	2844	$ 2,000,000	0.47	$ (666,667)	Open
11/25/2024	ZNH5 1/24/25 110 Puts	0.59	3353	$ 1,990,844	0.88	$ 943,031	Open
8/19/2024	"Sell All Assets" Short SPY	558.07	-22399		604.21	$ (1,033,473)	Open
			Risk	11.695%		10.3%	