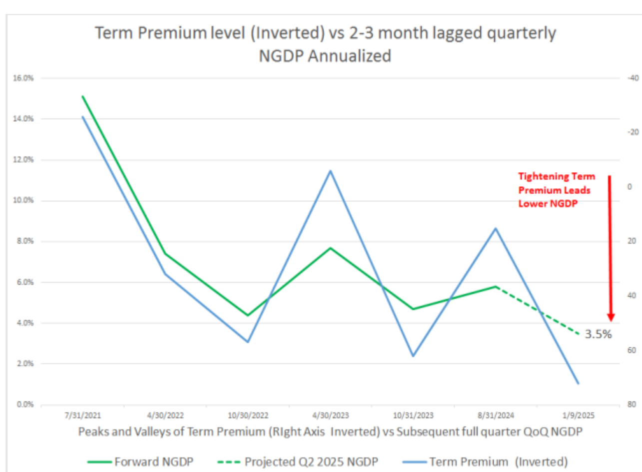
The Damped Spring Report

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

1/12/2025

After more than four years of holding an unwavering bullish stance on the US economy, we now believe that a slowdown will occur late in the first half of 2025. Since September, financial conditions have significantly tightened. In sharp contrast to the Fed's rhetoric, we have been certain that financial conditions were not restrictive but instead generally accommodative. Today, we are not sure if financial conditions are finally restrictive. Nonetheless, the tightening since September will have a sizable impact on the US economy.

Twice before we have warned that a slowdown could develop due to tightening financial conditions if policymakers did not prematurely react. But twice before policymakers did react and their reaction prolonged both desired economic strength and strong labor market conditions, and undesired above-target sticky inflation. We have twice before warned of a potential slowdown while also pointing to specific levers that would allow policymakers to postpone the slowdown. Each time we have been able to react when they overreacted and position ourselves based on their decisions. Today, policymakers have fewer levers as each lever available today to counter a slowdown will likely cause inflation to rise. This time we are not simply warning of a slowdown but instead hold a high confidence view that a slowdown is inevitable. Policymakers have no incentive and limited tools to react until the slowdown becomes deep. The impact of a significant tightening due to rising term premiums (which are unlikely to be easily reversed) will slow the economy from strong to somewhat less strong. The markets are not prepared for this outcome.



Act 3 in progress, Act 4 will likely follow

Our overarching view about the post-Covid US Economy has been that, unlike classic expansions driven by private sector credit growth (which is sensitive to increases in short-term interest rates), the post-Covid economy is supported by income growth and private sector wealth. To slow demand in such circumstances, job growth must slow to reduce income growth. To slow job growth, equity prices need to fall. In addition, a selloff in equities reduces wealth and increases financing costs, which, in turn, reduces private sector demand.

We were optimistic that the Fed's QT program would result in demand destruction and slay inflation. The front running of QT in 1-3Q22 was a meaningful tightening that saw the first phase of the killing of inflation. Since then, we have written much about how the QT impulse was muted or offset by actions of both the Fed and Treasury. It is still clear to us that there is only one way to bring inflation back to target. We wrote a script here. The play goes like this and today we are mid Act 3:

The Script "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.

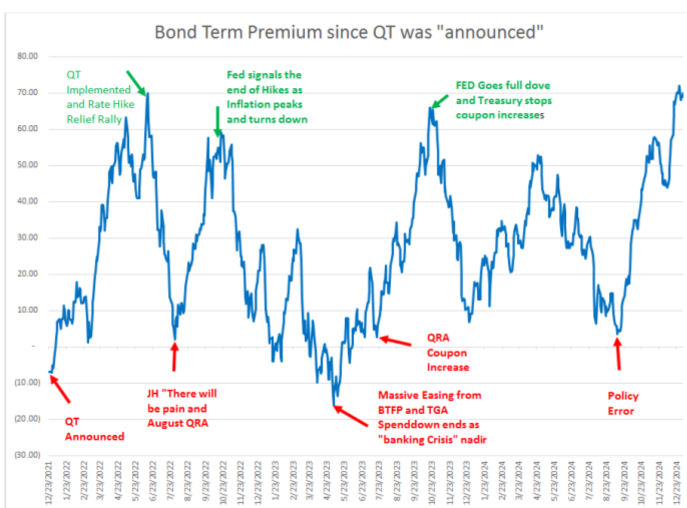
Term premium

An essential pillar of the Damped Spring Macro Framework is the concept of risk premium. High risk premiums reward investors at the expense of the real economy and low risk premiums stimulate the economy as investors (for whatever reason) are willing to lend their cash for low expected returns over cash. We do not believe that the level of interest rates by itself determines whether monetary conditions are tight or loose. It is the risk premium that sets the level of tightness as the level of rates is driven by growth and inflation expectations while the risk premium allocates the benefit of the exchange of assets for cash between investors and real economy consumers and businesses. When the Fed tightens via rate hikes or QT, the goal is not to set the rate at a level but to adjust the risk premium at a particular rate to encourage less speculation in assets, less consumption, less private sector activity in general and more holding cash.

In the post-Covid economy, the Fed Funds rate impacts a much smaller slice of the economy than ever before. The risk premium on long-term assets has a much larger impact. QT was designed to increase risk premiums on long-term assets where it matters. For several reasons, the impact of QT was prematurely muted each time risk premiums expanded, delaying the soft landing and frustrating the Fed's mission. Today, term premium, an equivalent concept specific to the fixed income market, is expanding again. We are optimistic that this will help the Fed achieve its mandate if policymakers do not overreact to a slowdown. Act 3 of the script has been underway since September and equities are beginning to catch down to bonds via multiple contraction. If this is not offset prematurely, actual demand destruction can occur and the economy can finally land softly, and the Fed can accomplish its mission.

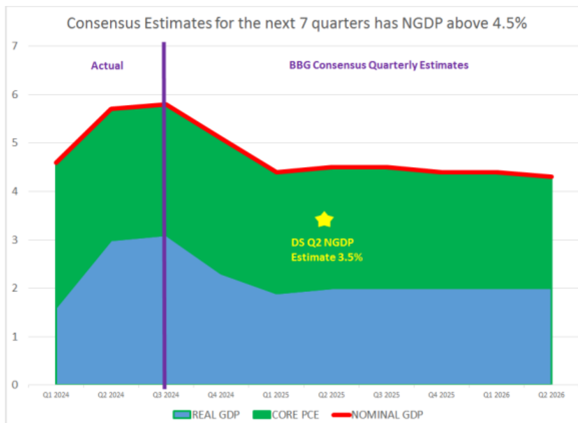
Since QT was announced, term premiums spiked to current levels twice and reversed. In 2022, the announcement on QT got heavily front run and term premiums spiked. Soon after, the Fed began hiking, which was welcomed by asset markets By October 2022, asset markets made their post-QT low. At the same time, the inflation data reported that month allowed the Fed to ease back meaningfully on their hawkish outlook. Fed funds rates were at 4.25% and the Fed indicated that most of the hikes were behind us. Risk premiums collapsed on that dovish pivot and bottomed at the nadir of the “Banking Crisis” that followed as significant easing took place during the crisis. Once again, term premiums climbed rapidly in 3Q23 as a supply catalyst of increased Treasury coupon issuance and torrid GDP readings pushed assets down aggressively. Once again, the Fed and, this time, Treasury reacted aggressively as asset markets sold off. The Fed eased by forecasting rate hikes were over and incorporating the nonsense rhetoric that to maintain the “equally tight” policy Nominal Fed Funds had to be lowered mechanically to realize a fixed real Fed’s Fund Rate. Treasury delayed increasing coupon issuance. Term premiums collapsed again. As of today, term premiums are at a new high. However, unlike the prior term premium expansions, equities are within a whisper of all time highs.

We will address in later sections the levers and incentives that could be used to counter the term premium expansion but strongly believe that no “bailout” is forthcoming unless equities fall. Unlike the past two term premium expansions, which did not result in equities falling, the “tightening of financial conditions” is half-baked. We expect some policymaker response after an equity selloff but do not expect one before a selloff occurs. If we are correct and the term premium expansion slows the economy, equities will be sure to follow and, if they do as we expect, the economy will slow enough to achieve the Fed’s Mandate. However, if at any time the policymakers do prematurely react, the script will reset to Act 1 and higherer for longerer conditions will continue and the economy will continue to stay turbocharged:



The US Economy remains strong

Last week, the trend of surprisingly strong economic numbers and higher than desired inflation continued. The Non-Farm Payroll and U3 Rates were far stronger than consensus and the unreliable (but occasionally mentioned by the Fed) Michigan Survey had a big uptick in inflation expectations. But it was just part of the ongoing trend of warm data. Based on the Damped Spring Risk Premium index model, the extremely easy conditions in the late summer are partly responsible for the 4Q24 rebound in growth and inflation. Unfortunately, the model now forecasts a 100bp miss in nGDP relative to consensus in 2Q25. **We expect a slowdown to 3.5% for nGDP in Q2 vs 4.5% consensus:**

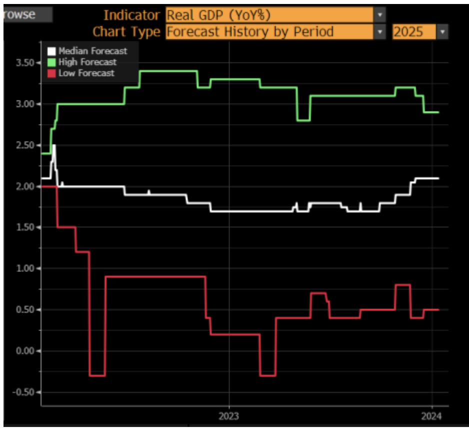


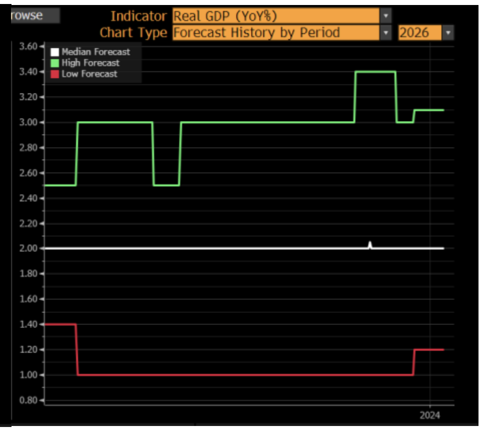
Economic consensus

Like many guesses about the future, economic consensus tends to be most correlated to recent conditions and the trend of those conditions. Guesses about the economy's future is also anchored by slow-moving trends like population growth, low volatility factors like productivity, and policymaker actions which attempt to target economic variables. For many of those reasons, these guesses are not likely to be predictive and are rarely accurate. Nonetheless, they are used by investors and policymakers who make decisions based on economic outlook. The decisions made then impact asset prices and the real economy. Market timing depends on one having an out of consensus view, having the market priced for consensus, and having one's own view turn out to be correct. Today, the market is priced for an ongoing strong economy and a Fed that has paused its rate hiking cycle. However, we have an out of consensus view that the increase in term premium and the tightening of financial conditions it creates will cause nGDP to miss by a wide margin. Let's review consensus. Of note is that the Fed's SEP Dot plot perfectly matches private sector consensus. This is not uncommon; everyone has the same data.

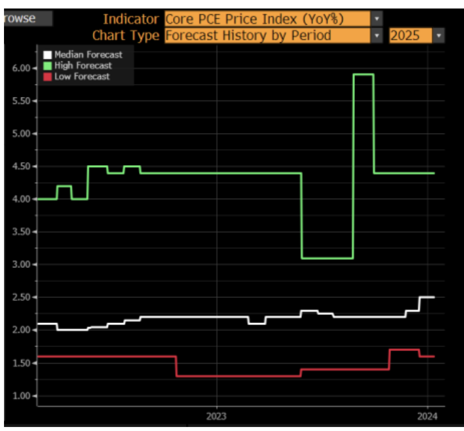
	Fed December SEP	Current Economic Consensus
2025 GDP	2.10	2.10
2026 GDP	2.00	2.00
2025 Core PCE	2.50	2.50
2026 Core PCE	2.20	2.30

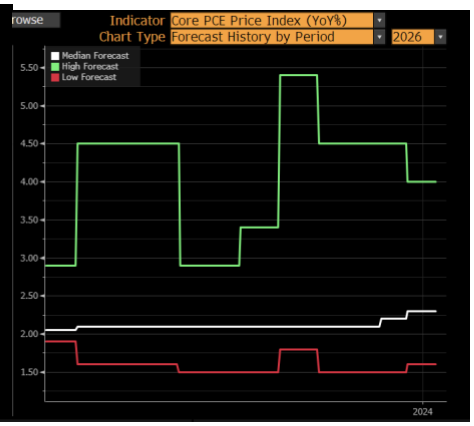
Digging into private sector forecasts, it is notable that not a single economist projects a recession. Less than two years ago, many economists projected a recession and some called for a severe one:



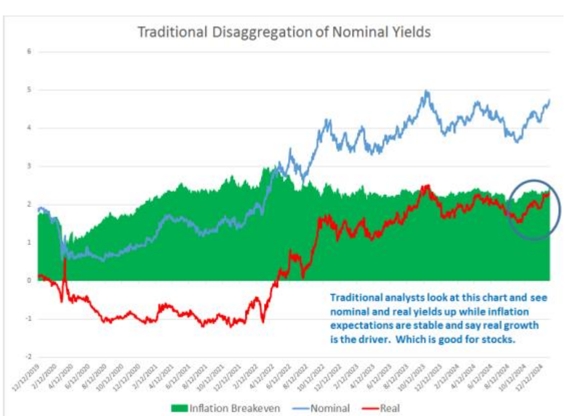


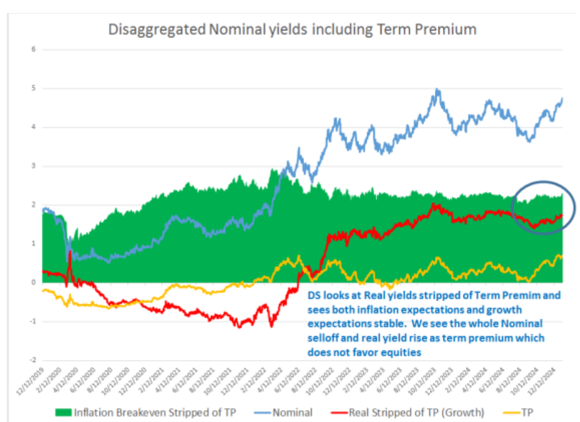
Inflation outlooks are slightly rising:





Market-based growth and inflation expectations sourced from disaggregating nominal yields, when done the traditional way, suggest rising growth expectations and modestly rising inflation expectations, neither of which has come through in economist forecasts. Using our own disaggregation method, we see flat growth and inflation expectations and term premium expansion:





Risk Premium forecast

Term premiums are rising and are both tightening financial conditions and clouding market-based forecasts of the economy. Our framework for risk premiums has two explanatory pillars:

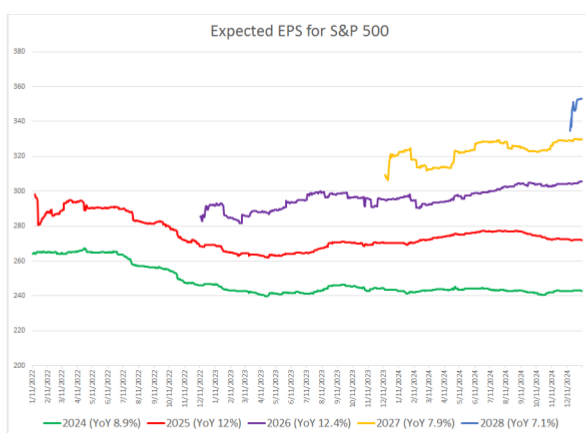
- Expected future portfolio volatility, which is composed of individual asset class expected volatility and cross-asset correlations.
- Demand for financial assets from savers versus supply of financial assets from the private sector and government issuance.

We forecast continued upward pressure on risk premiums and downward pressure on asset prices as:

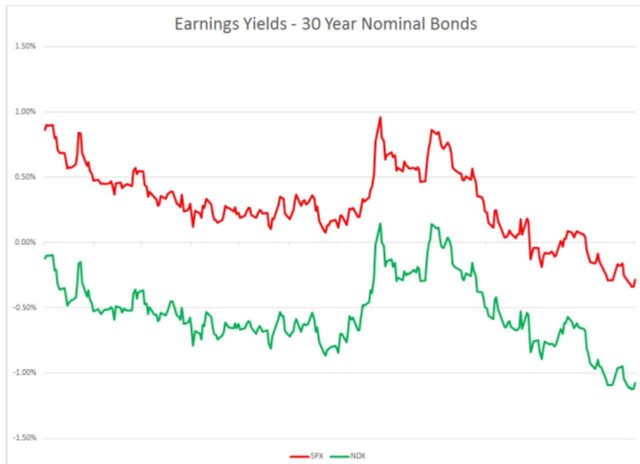
- Treasury will likely increase coupon issuance.
- The Fed will not likely ease policy until the economy slows.
- Private sector balance sheets are full of assets and the cost of leverage (as measured by swap spreads, and private sector repo volumes) is high and constrained.
- Real long only private sector asset managers are already fully allocated to assets.
- Economic uncertainty regarding both monetary and fiscal policy will likely increase individual asset volatilities while policies that impact growth will take a back seat to inflation and financial conditions drivers, both of which decrease portfolio diversification benefits. This combination should increase portfolio risk and reduce demand for assets.

Equity earnings

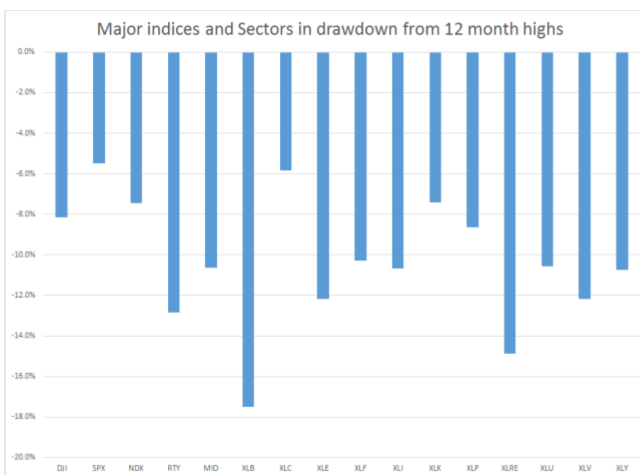
Actual earnings growth for the S&P500 for 2023 was 0.0% versus 2022. Over the last three years, earnings expectations for 2024 (green line below) started at $265 per share and will deliver only $242. Earnings growth for 2024 is expected to end with growth of 8.9%. For the last three years, earnings expectations for 2025 (red line below) peaked at $300 per year and have drifted lower and now are expected to grow by a robust 12%. For the last two years, earnings expectations for 2026 continue to climb, delivering 12.4% growth before leveling off in out years:



Equity markets are counting on (and likely priced for) robust earnings growth and cannot sustain themselves at current levels if the economy does start to weaken. We do not think P/E (earnings yields) and bond yields should be compared naively over the long history of markets. However, given the above picture of generally stable expectations of EPS growth for the next 3-4 years, using a short history of this valuation metric can be useful. Over the last year, equities have been at the richest level for this metric. A 50bp back up in this metric would result in a meaningful drop in equities. That simply assumes that equities Ketchdown to the bond selloff and robust earnings expectations stay the same:

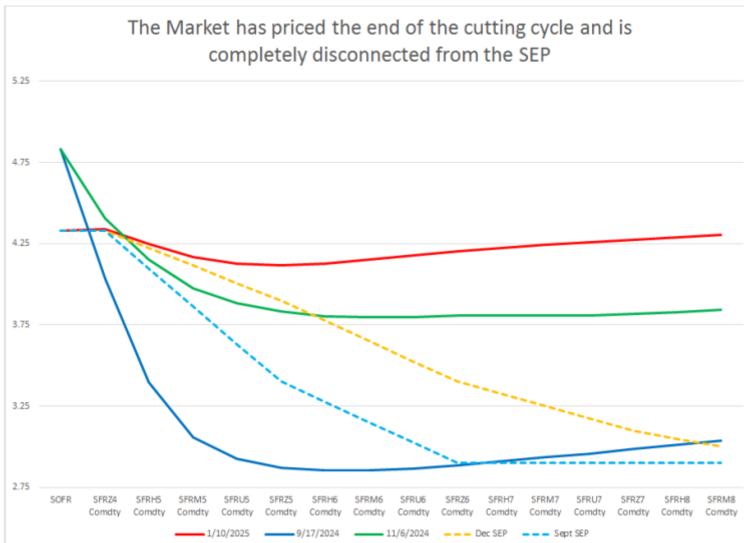


No major index or subsector is near all-time highs, which, along with momentum signals, suggests some of the FOMO is abating.



Monetary Policy Stance

Essentially, the FOMC has lost the bond market. Both the FOMC and the private sector look at the exact same data. As shown above, the FOMC outlook for the economy is identical to the outlook of the private sector consensus. The only additional information from the FOMC is what they intend to do with the Federal Funds rate if economic consensus is correct. This path is the "reaction function" of the Fed. The market provides the path of interest rates that it expects. The market-based reaction function is supported by the same economic consensus. Clearly the market is more hysterical than the Fed. Clearly both the Fed and the market adjust their projections based on data. What is unusual today is that markets are priced for the end of the Fed cutting cycle. Usually when the economy is in a weakening trend, markets price in a more dovish path than the Fed is predicting. Since the hiking cycle began, STIR markets have consistently and wrongly anticipated a deeper and faster cutting cycle than the Fed projected.



Even as recently as September, the market was projecting far more cuts far faster than the Fed delivered in its September Dot plot. Yet as the Fed delivered its 50bp cut and cut twice more, the market has seen the data heating up and has jumped to the end of the cutting cycle. It is a radical tightening. The long-end of the bond curve has incorporated the market-based path and on top of that impact has increased the term premium it demands. The entire yield curve is at least 100 bp higher in four months. The Fed's SEP are just numbers on paper. Actual economic participants of all sorts are affected by the market-based tightening immediately. Can the Fed slow the market-based tightening? Given the reaction to rate cuts that the market has deemed premature, the lever of guiding for additional rate cuts seems broken as compared to October '22 and '23. In a report before the November FOMC, we warned that the Fed needed to adopt a more hawkish stance or risk the bond market doing the Fed's work for them. Since then, the FOMC chose to cut 25bp twice more. The only lever they have is to be hawkish. The market will punish further dovishness. We hope they are hawkish over the coming months and accept the likely outcome of an economic slowdown.

Fiscal policy stance

Broadly speaking, the policy actions and the sequencing of policy actions is not something we can guess. Nonetheless we are paying attention and have expectations of the impact of each item the Trump Administration has called out as their agenda. However, until the Debt Ceiling is lifted, none of the Trump agenda that requires congressional votes can be implemented.

Debt Ceiling

We suspect the Debt Ceiling will be lifted rapidly. While the Debt Ceiling is a convenient political forcing mechanism for deficit cuts, the Trump Administration is not fighting with the opposite party to reduce the deficit, but is fighting with itself on how much the deficit is reduced. The dozen or so Republican Deficit Hawks in the House are the obstacle. We suspect they will cave quickly. If we are wrong, we have outlined the timeline and impact of that path on issuance and the spend down of the TGA in our last DSR.

Deregulation

Deregulation is short-term pro-growth and disinflationary. We expect aggressive steps to deregulate, which is a strong short-term positive for asset markets and the economy in our view. Some deregulation can be implemented without Congress, and we expect it will be.

Tariffs

The ultimate destination of the Trump Agenda seems to be the complete rewriting of global trade. This will take a bumpy path. In the short term, we expect tariffs to be threatened and implemented and their impact to be inflationary to either prices or the USD or both, and anti-growth.

Deficit

Reducing the deficit is the agenda of the Trump Administration and no administration since Bill Clinton has had a surplus. Any deficit reduction plan requires Congress and that requires resolving the Debt Ceiling. Reducing the deficit is anti-growth and disinflationary. We will not predict the actual policies and certainly will wait until the Debt Ceiling is resolved but remain highly skeptical that a meaningful deficit reduction will emerge.

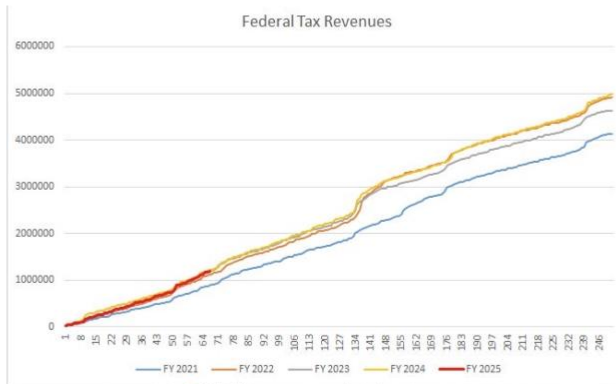
Immigration

We expect some deportation and broadly lower legal and illegal immigration. Given the sharp reduction in labor supply, we expect U3 to remain low and labor conditions to tighten. Commensurate with lower legal and illegal immigration, we expect demand to also drop but at a slower rate than supply. The immigration agenda item can be implemented by the executive branch alone and the impact is anti-growth and inflationary.

Natural path of the deficit.

Without any changes in spending or tax policy, it is notable that the 2025 fiscal year deficit is likely to fall without any policy action. The refinancing of bills 100bp lower than last fiscal year will save interest payments of $60BN per year netted against the modestly higher interest rates paid on coupon bond refinancing that occurs over the next year.

Tax revenue in 2025 is running the hottest in the last 5 years. In addition, as always, April will see a ramp up of revenue. That ramp could be surprisingly higher given that almost all assets were up over the course of the 2024 tax year which will likely mean large capital gains tax payments. That large tax payment, which of course is a one off for this year, could lower the deficit by another $75BN.



Once again, the private sector paying taxes reduces the deficit and, unless the money is recycled to spending, deficit reductions are disinflationary and anti-growth. To the extent it reduces bills issuance it is largely irrelevant to markets.

QRA

That brings us to the next QRA, which will be announced in early February. We expect no change in coupon issuance and will detail our thoughts ahead of that announcement in our next DSR. Perhaps a language shift that indicates the desire to term out the debt is about as much as the market could get.

Policy maker reactions

If we are correct and the tightening of financial conditions since the September FOMC meeting slows the economy with a two-to-three-month lag, data should begin disappointing in March or April. If that plays out, the question for markets is what will policymakers do? Will this be a premature pivot 3.0 or will policymakers show the patience they have not shown twice before? What is the incentive for the fiscal policymakers? Is it the same as in 2022 and 2023? Our view is the Fed has made a meaningful pivot to an extended pause and will be more patient than in the last fourteen months. We have no idea what President Trump will do in the face of a slowdown but hold a loose view that a slowdown soon after inauguration would be ideal compared to one that happens before the Midterms. Obviously, a strong economy and markets for the full term of his Presidency would be his preference. We cannot predict what will happen.

We can evaluate the levers that could be pulled and the likely impact that those levers, if pulled, would have on the economy and markets.

Monetary levers

We see little incentive for the Fed to ease into a modest slowdown given the recent economic data and given that risk assets have yet to follow bond prices lower. However, it’s worth considering what levers they could pull

- The Fed could lower Fed Funds or indicate a steeper path and lower terminal rate in forward guidance. Given the reaction to the recent rate cuts, we suspect that will be ineffective.
- The Fed could stop QT. QT is currently small and already muted. Ending QT will have no impact on the market and more likely will backfire, particularly if the slowdown is real economy and jobs-related while inflation stays sticky.
- We see zero chance the Fed will institute QE or any other version of large asset purchases until they have cut rates to zero. Even if cutting rates to zero occurred, the bar for more QE will be high. That said they will throw all sorts of liquidity and possible asset purchases at a financial stability crisis. However, a financial stability crisis during a slowdown which puts downward pressure on long-term bond yields is highly unlikely.

Fiscal Levers

The Trump Administration has many levers to pull that could offset slowdown pressures. Although we think the Trump Administration would pull those levers when they need to, we see little incentive to for them to pull those levers prematurely.

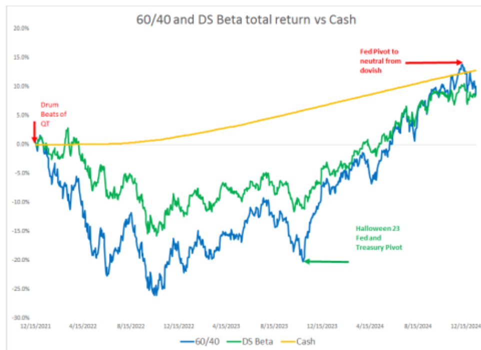
- The primary lever is increasing the deficit to offset private sector slowdown. It is possible a modest slowdown in 2Q25 could motivate a complete reversal in the entire budget deficit reduction agenda of the administration, as has happened in a bipartisan way for two decades. However, we think that a reversal is highly unlikely so soon.
- Tweaks to tariffs, immigration policy and ramping up of deregulation could have marginal impact.
- Lastly, and probably the most unlikely move, the new Treasury Secretary could use Activist Treasury Issuance Policy and reduce coupon issuance and rely more on bills issuance. The Hypocrisy Meter would explode on this particular outcome.

Extraordinary levers

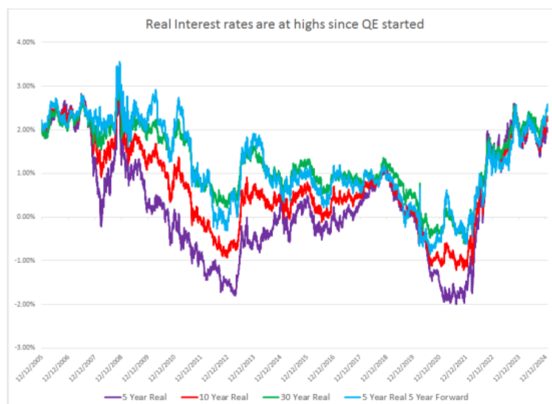
We accept the possibility that other levers exist that we have not considered. They include geopolitical non-economic strategies and tactics, direct intervention in the currency markets, and the cajoling of our allies and enemies to influence our economy and markets. We will pay attention to the levers we know about and to new levers if any are unveiled. For now, we simply do not see much incentive to respond at all to a modest slowdown.

What’s priced in

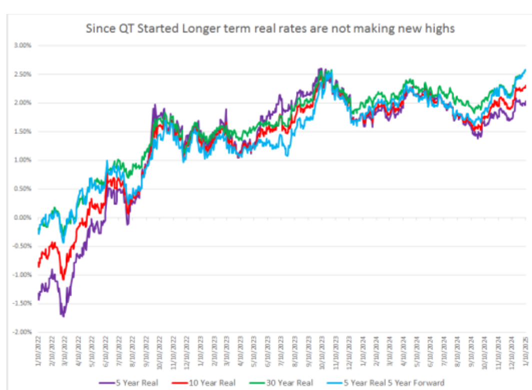
Since QT, balanced portfolios have only recently outperformed cash. Equities have massively outperformed, and bonds have underperformed. In aggregate, assets may have peaked for the short term as risk premium arbitrage causes a portfolio rebalance while continued supply of Treasuries keeps the bond market from rallying:



Real interest rates are becoming attractive, but we are yet to begin buying for our alpha portfolio and prefer STIR:



This is due to our view that over the short-term, real yields still have some upside before they become buyable for a trade:



The next few months

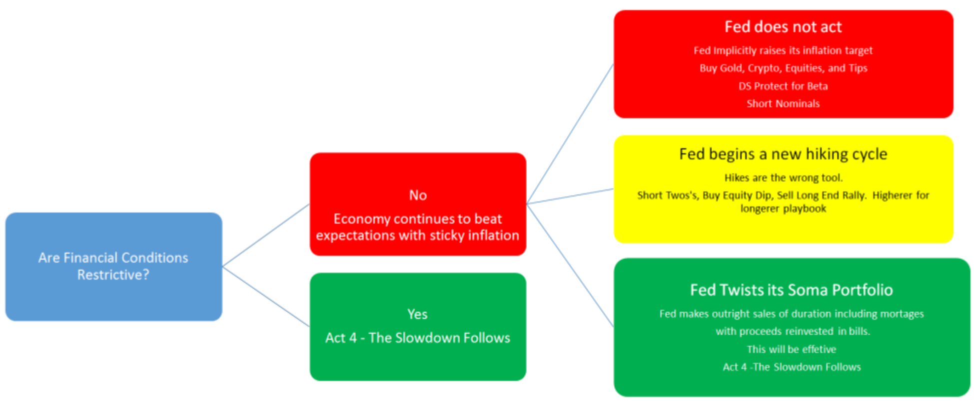
The tightening of financial conditions operates with a lag but much less of a lag than Fed Funds tweaks. We expect a slowdown to develop, but in the next month we expect economic data to remain hot. By mid-February we expect policymaker clarity.

- Debt ceiling will be lifted.
- FOMC will remain hawkish.
- The actual Trump Agenda will begin to be implemented.
- Treasury will provide information about coupon issuance at the Feb 4th QRA.
- Corporate earnings will be released.

At that point we expect the data to begin disappointing.

What if conditions are still accommodative?

A major premise of our shift from strong bull on the economy to expecting a modest slowdown is based on financial conditions becoming restrictive. We could be wrong, even if policymakers do nothing to change conditions. Financial conditions may still be accommodative. We decided to game out that possibility:



Synthesis

Markets have largely ignored the Fed and have meaningfully tightened financial conditions. If policymakers can be patient and not intervene, the economy has a decent chance of cooling off relative to expectations and stands a chance of achieving the desired soft landing. However, asset markets are not priced for a slowdown. STIR has priced the end of the cutting cycle and a terminal rate far in excess of the Fed's estimate of neutral. Long-term Treasuries now offer more attractive term premium and real rates but given the economic strength and the possibility that the Fed will not be patient and ease prematurely again the long-term Treasury market remains unattractive. Equities are expecting years of strong earnings and have not yet adjusted their valuations for higher real and nominal interest rates and higher risk premiums. Equity investors remain convinced that the Fed is already restrictive, and an easing of policy will follow. We are short equities and long STIR and are looking for a final leg down in long term yields to buy tactically.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 71,038,540					
	Total Return	71.04%		YTD Return in excess of cash		0.98%	
	Today's Date	1/12/2025		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
12/30/2024	SPX February 2/21/25 Put Spread 5700/5200	30.45	492	$ 1,498,140	58.00	$ 1,355,460	Open
1/2/2025	NDX February 2/21/25 Put Spread 20500/18500	245.47	41	$ 1,000,000	350.00	$ 425,836	Open
1/2/2025	SPX Call Butterfly for 3/31/24 Strikes 6065/6165/6265	13.00	769	$ 1,000,000	12.00	$ (76,923)	Open
12/17/2024	SFRM6	96.025	2668	$ 2,000,000	95.870	$ (1,033,850)	Open
Order	FXI Equity Long stopped at 26.02	28.02	250000	$ 500,000	28.02	$ -	Order
Order	ZB 111/107 Put Spread Expiry 2/21/225	1.69	-865	$ 2,000,000	1.69	$ -	Order
Order	SPX Put Butterfly for 3/31/24 5665/5565/5465	2.00	2500	$ 500,000	2.00	$ -	Order
			Risk	5.498%		6.2%	