The Damped Spring Report

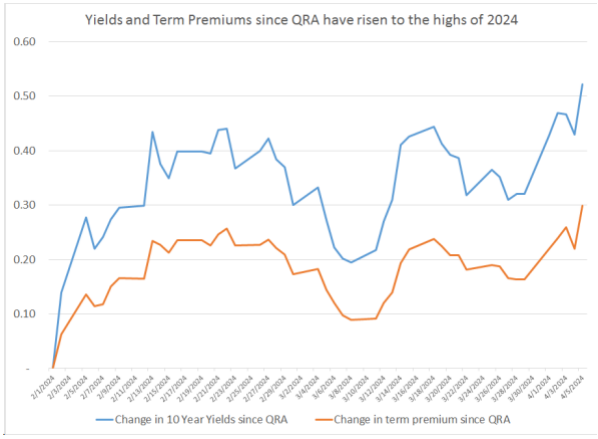
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

04/07/2024

The commencement of Act 3 of our script, "The Only Way to Kill Inflation," may have begun this week and looks likely to run over the next quarter. As a reminder, the play restarted in January when the Fed realized markets had misread Waller's dovish remarks prior to last December's FOMC remarks, which Powell reiterated in the subsequent press conference. The minutes released in January, and Logan's speech about a QT Taper, added to the enthusiasm for financial assets and continued the easing in financial conditions that began last Halloween. This extreme easing of financial conditions has acted on the economy and by January all data had perked up. This led to a walking back of Fed dovishness that continued through the March FOMC. The March SEP dot plot shifted to a higher Core PCE by year-end, a higher growth rate, a higher December 2025 interest rate, and a hint of a higher longer-term neutral rate. It was only due to the way medians are calculated that the December 2024 Dot remains at 3 cuts. Inexplicably, Powell was dovish in his last press conference. Since then, however, all FOMC members, including the Chair, have been walking that back since with speeches titled "What's the rush" and "Still no Rush."

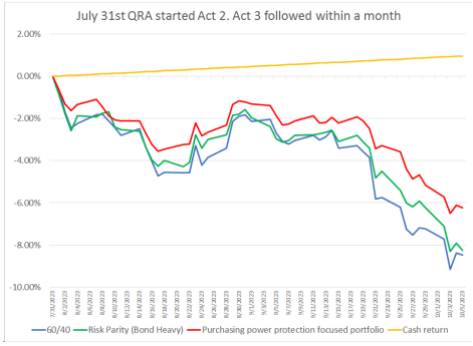
Act 1 is about higherer for longerer Fed Funds rates. STIR markets have finally adjusted and cuts now overlap precisely with the SEP for the first time in over a year. On February 1, Treasury announced its issuance plans for 2Q24. We think that is when Act 2 began.

Act 2 is about a supply catalyst causing a rise in bond yields. On February 1, Treasury increased gross Coupon issuance by $152BN to $1.1TN and net issuance by $190BN to $538 BN. Act 3 may begin soon.

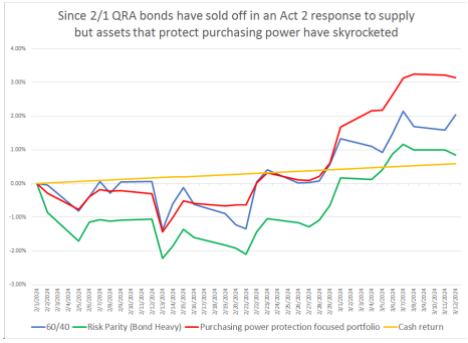


Post QRA returns.

On July 31, 2023, our play shifted from Act 1 to Act 2 when the QRA scheduled a significant increase in Coupon issuance. Bonds sold off first. Act 3 commenced in September and all assets fell:



Since the February 1, 2024 QRA, the response to the large supply catalyst was about the same for bonds as compared to QRA cycle that commenced July 31, 2023. However, portfolios broadly have outperformed cash. In particular, portfolios designed to protect purchasing power with heavy allocations to gold and commodities have performed best:



Despite rising bond yields and term premiums, Act 3 - where rising term premiums begin to spread to other assets, has been delayed. A few potential causes of this delay are worth considering:

- Rising growth expectations are supporting commodities and equities.
- Rising inflation expectations are supporting commodities, equities, and gold.
- Continued dovishness regarding rate path and QT taper are calling into question the Fed's commitment to get the job done.
- Currency concerns in the ROW are supporting commodities and gold.
- Until last week individual asset volatility has fallen rapidly, and portfolio volatility-targeting investors are willing to stay heavily leveraged.
- Twice before investors selling bonds have been penalized heavily by shifts in both Treasury and Fed policy and may not be quite so willing to sell ahead of supply flow that may be reversed.
- Concern about political actions that will support assets other than bonds.

Of course, it is also possible that inflation is already dead, and a soft landing is imminent. What will be interesting if, in fact, inflation is dead is if Act 2 (which is happening) leads to Act 3 regardless of Fed policy or the data. **Perhaps only a reduction in Coupon supply will prevent Act 3 and for that matter the rest of the script from playing out.** Our hope is the data does remain strong. The best hope for a soft-landing outcome (instead of a recession) starts with a very strong economy.

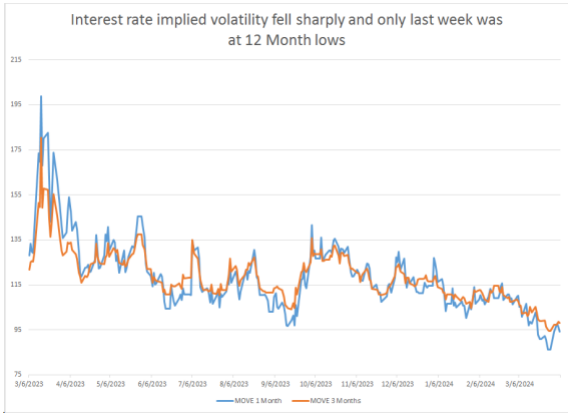
Nonetheless, $500BN+ of Coupon issuance per quarter for the next 3-6 quarters will cause yields to rise. Rising yields will cause multiples to contract. Falling equity and bond prices will increase borrowers' financing costs, tighten financial conditions, impact wealth, and hurt demand. Falling demand will hurt corporate earnings and, in turn, falling corporate earnings will increase unemployment.

The Fed can pull on the Fed Funds rates lever based on the Taylor rule or responding to data, but the economy is going to go through the various acts unless Coupon issuance is reduced. The game is afoot and only Treasury can cancel the show. They may well do that. On May 1, 2024, the QRA will tell us Treasury's plans. That same day, the Fed will likely announce a QT Taper. We will have a detailed preview ahead of the FOMC and QRA which will describe our thinking. For now, we expect QT Taper and continued Coupon issuance and the commencement of Act 3 ahead of the news.

Before we conclude this DSR, we will describe in more detail why we think certain assets continue to remain bid. We will also discuss a technical issue regarding the uneven distribution of bank reserves which will highlight why the Fed will QT Taper. We don't think the Fed should taper because a taper does reduce Treasury's financing needs and Yellen may react by reducing Coupons (instead of Bills) to further mute QT. Nonetheless, the Fed appears hellbent on a QT Taper and we can understand why.

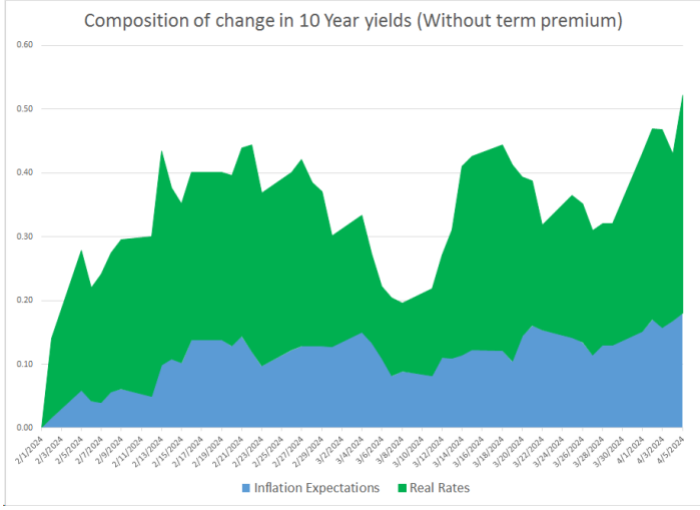
Act 2 is on stage, yet most assets don't care.

As shown above, term premiums have been responsible for only about half the increase in bond yields. We believe future supply is weighing on the bond market, although, until recently, rapidly falling expectations of future bond volatility has constrained risk premium expansion:

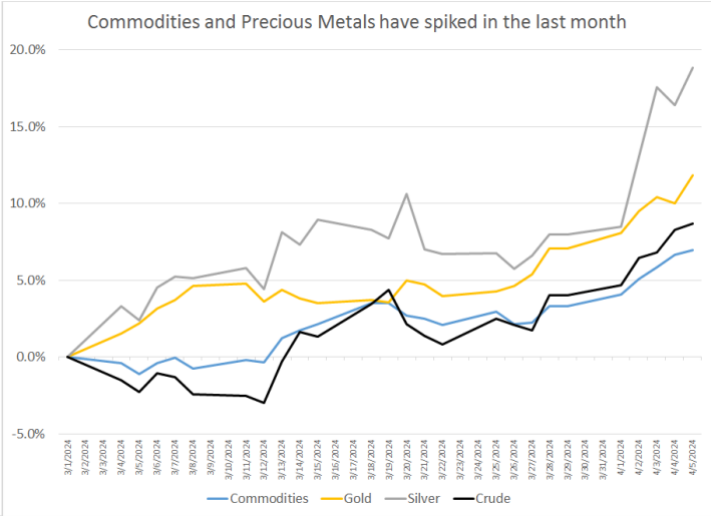


This week's inflation data and sizeable auctions may cause market fluctuations. We expect the inflation prints to be on the cold side of consensus, which will support STIR by keeping a June cut on the table. Regardless of the data, the front of the yield curve is pinned to a narrow range, which could also keep volatility low. At current levels of implied volatility, we do think the upside to bond volatility is higher than the downside and we expect upward pressure on term premiums.

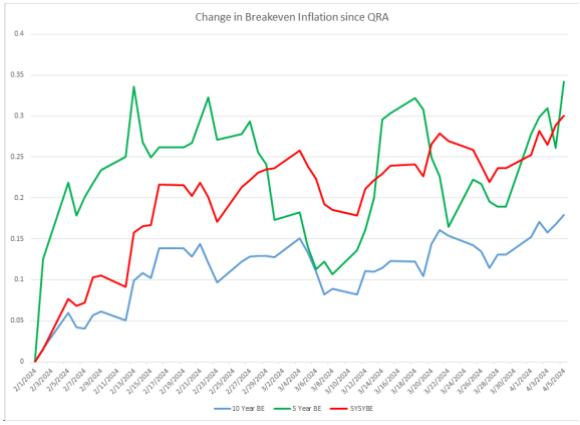
As inflation has risen over the first quarter of 2024 and growth expectations have been robust, it is possible that either the Fed jumped the gun with its dovish rhetoric in December or the market perceived them as being more dovish. Inflation expectations have risen. Indeed, the Dot Plot has upgraded its growth and inflation dots for year end. The combination of stronger growth and rising inflation expectations has been responsible for the rest of the increase in bond yields.



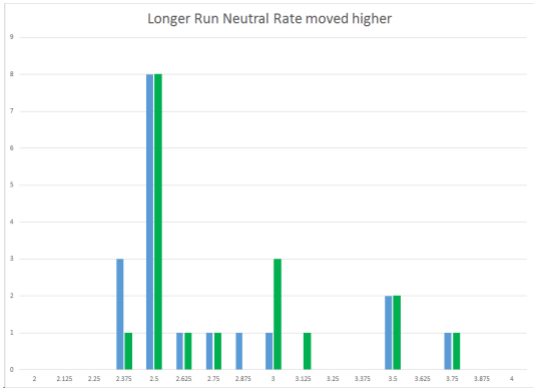
Notably, all things that do well in rising inflation have spiked over the past month. Market participants may be getting spooked by the Fed's willingness to allow financial conditions (other than Real Fed Funds) to ease considerably while still providing guidance that 3 cuts are expected:



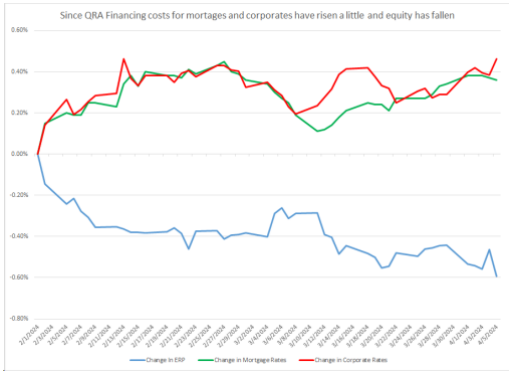
This is igniting inflation expectations. Each measure is at 2024 highs:



Additionally, the Fed has begun shifting its r* higher, albeit grudgingly:



These factors have impacted long-term bond prices, but, due to easing financial conditions, credit spreads, mortgages and equity financing of all sorts have gotten only modestly more expensive or even cheaper, although equities may also be discounting stronger growth.



Adding all this up, most markets are reflecting greater concern about rising inflation and easy financial conditions, while growth assets are enjoying the strong real economy.

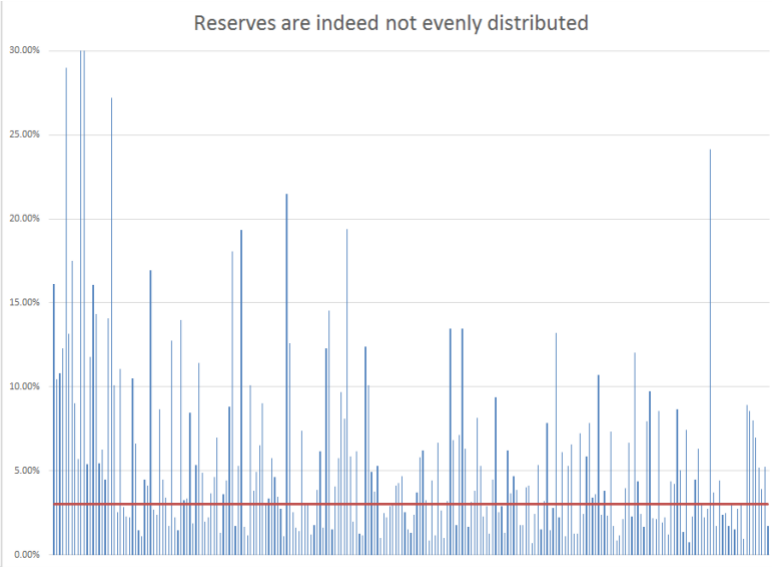
Uneven distributions of reserves is a real concern

The Fed has also contributed to the easing of financial conditions by discussing a QT Taper. While informed bond investors understand the idea of slowing down to ensure arrival at the destination, those investors who don't invest based on Fed policy suspect (potentially with good reason) that taper is the first step to ending QT and hence a buy signal. The broad market just isn't buying the story. We think the Fed is communicating the story well, but markets hear only talk and don't yet believe it.

We have written many DSRs on the mechanics of QT. By choosing runoff instead of outright sales from its SOMA portfolio, the Fed handed the monetary lever to Treasury (which controls the composition of Bill and Coupon issuance) vis. the SOMA runoff. For good reasons, Treasury has muted QT and its impact to achieve other financing goals and due to debt ceiling restrictions. We have modeled the RRP decline and wonder why the Fed feels rushed to taper. We continue to believe that RRP will not draw close to zero by year-end, unless Treasury radically increases Bills issuance. We have also looked at the Standing Repo facility and are confident that it will prevent any 2019 repo availability problems if and when the RRP does in fact go to zero.

Recently, we have heard from Powell and other Fed members a new "reason" for concern, namely, the uneven distribution of reserves across the US banking system. We dug into the 235 largest banks in the US, which hold 93% of total bank assets and 83% of total reserves and see some reasons for the Fed's concern.

Many banks in this top tier of banks have reserves below 3% of total assets:



This may seem like a huge problem. But here is some background which you may find helpful in assessing its importance. Since 2020, the banking system has no longer operated as a fractional reserve system. However, reserves are still the lubricant for our financial system.

Reserves 101

A bank reserve is an asset of a private sector bank, essentially a deposit in it's name at one of the Federal Reserve regional banks. It is instantaneous liquidity just like physical Bills or coins in the vault of the private sector bank. Why does a bank need bank reserves to do business? Until 2020 (i.e., pre-Basel 3), a bank had reserve requirements to make loans or buy assets for their own account. That was called fractional reserve banking and that's what caused problems for George Bailey in "It's A Wonderful Life."

When you write a check on your JPM checking account and hand it to someone for a good or service, the recipient may deposit it in his Citi checking account. JPM and Citi settle the transaction by JPM transferring a bank reserve to Citi. This happens all the time. Any time a transaction is settled, a bank deposit transfers from one bank to another and with it bank reserves. Any time a depositor moves money to another bank reserves move. In other words, a bank MUST have reserves to exchange for deposit shifts. In addition, a bank that buys Treasuries settles the transaction by giving up its reserve to the Fed.

How can a bank raise reserves?

- It can sell assets (loans or securities)
- It can increase its deposit rate and attract deposits from other banks.
- It can issue securities like bonds and stocks or even CD's The buyer pays with a deposit from another bank and owns the securities sold.

This is all normal banking business. However, the bank may still need reserves very fast. None of those ways delivers reserves quickly. A bank can also borrow reserves from other private sector banks or the Fed itself. A private sector bank will lend reserves if the reserve borrower has assets that are suitable collateral for the reserve loan. The Fed can also lend reserves through the Discount window. Prior to March 11, 2024, the Fed also lent reserves via the BTFP. Lastly, the Fed can create reserves via the Standing Repo facility, whereby the Fed lends cash in the form of reserves by buying bonds and agreeing to sell them back to the private sector bank overnight at a fixed interest rate. Each of these Fed actions has different collateral terms.

So that's why a private sector bank needs bank reserves and how they can raise reserves.

Stepping back to the banking system as a whole, the existing reserves in the system were created long ago and then supercharged in quantity by the mechanism of Fed asset purchases. During QE, by buying Treasury obligations and mortgages, the Fed paid reserves to the private sector bank for one of the bank's assets or paid a private sector non-bank for its Bonds by transferring a reserve to the person's bank who created a deposit in that client's name.

QT has the opposite impact. If Treasury issues a Bond, only a bank or private

sector non-bank can buy that security to pay back the Fed's runoff. The bank loses a deposit, and a reserve is transferred back to the Fed. For now, reserves have remained sizeable as Treasury has issued Bills that the MMF funds like, and QT has hit RRP balances. However, the composition of issuance and the RRP balance approaching zero can cause systemwide reserves to fall.

Today, regardless of RRP balances, QT can hit a specific bank's reserve amount. That happens when a banking client depositor decides to buy a bond. The bank still has to pay with a reserve. That's the problem. They may have limited reserves and have to use one of the emergency liquidity programs to get needed reserves to settle client transactions.

One last thing: Prior to embarking on QE/QT, the Fed could always adjust reserves by either offering reserves at a low interest rate to encourage repo (which increases systemwide reserves) or bidding high interest for repo in which they borrow reserves from the private sector borrowing cash and pledge collateral in a reverse repo with banks. Back in ancient times (pre-2008), the Fed repo and reverse repo markets were the principal mechanic to adjust M1/M2 and set interest rates.

More Details on Uneven Distribution of Reserves.

You may be asking a couple of questions about these banks.

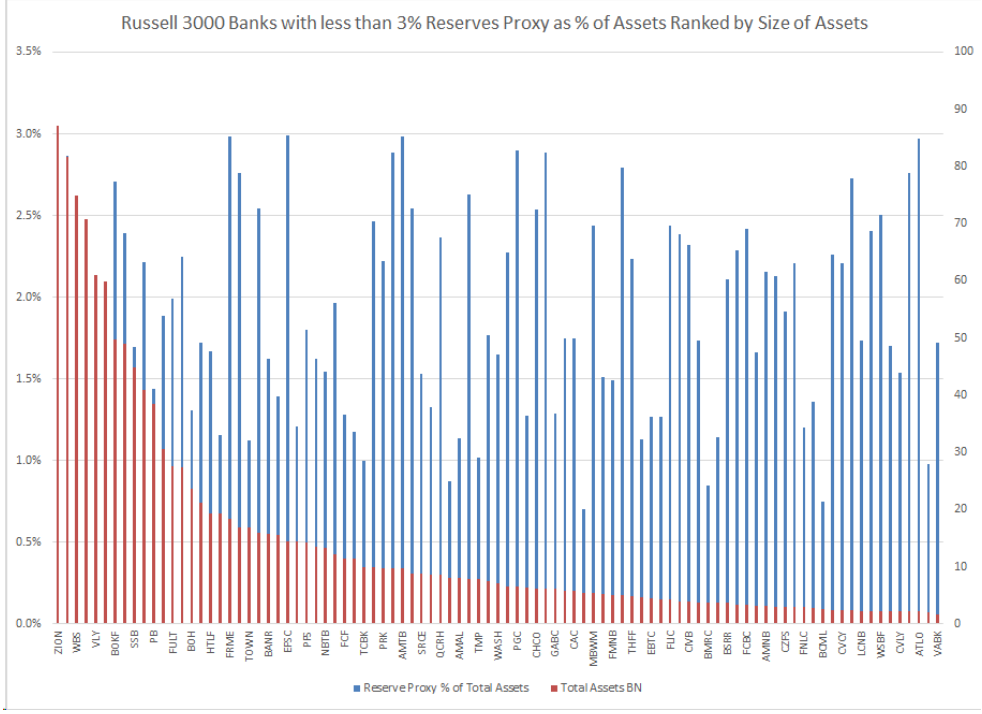
- How does a bank decide on how much reserves to hold?
- If uneven reserves and low levels at certain banks are a big enough problem for the Fed to taper QT, why isn't the Fed doing anything to get these banks to raise reserves?

Both of these questions have the same answer. The Fed eliminated Reserve Requirements in 2020. No regulation means no teeth for enforcement. Banks see the ebb and flow of their reserve balances and probably give themselves a decent buffer to the amount in case they get tight and set the reserve amount based on that. Banks with a ton of small insured personal bank accounts or modest business account with low transactions sizes can be more confident keeping low reserves. Others with sizable daily transactions need more.

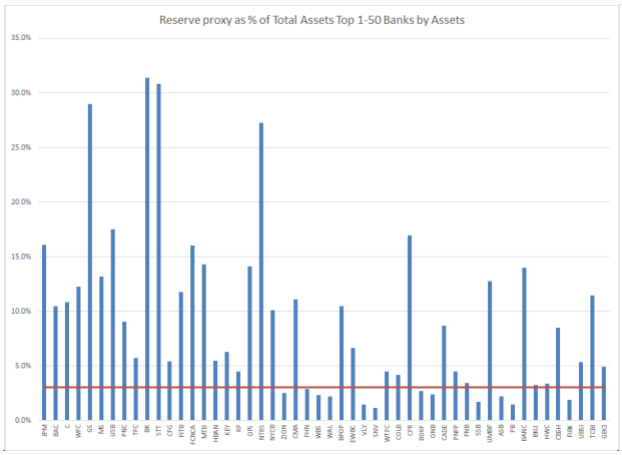
To be honest, we think reserve requirements were pretty silly anyway and, given the ample reserve regime post-Covid, it is not a big deal for the banking system. Nonetheless, as the Fed heads towards an ample reserve regime from an abundant reserve regime, an individual bank may get squeezed into a tight situation. Is that a reason to taper given the various belts and suspenders in place? We don't think so. However, the Fed may be smarting from the supervision lapses during last year's bank failures and we think the Fed is being prudent, which makes sense to us. **We think they will taper. However, Treasury still holds the QT lever. If QT Taper results in a concurrent reduction in Coupon issuance, QT's impact will be attenuated. If QT Taper results in a concurrent reduction in Bills issuance, QT will remain just as active and impact financial conditions as it did before QT Taper.**

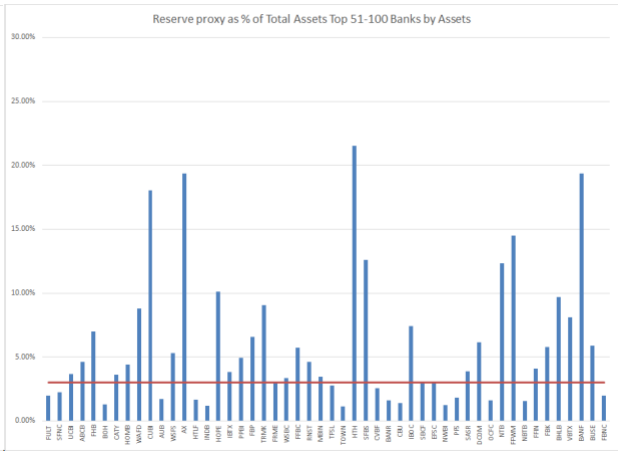
Drilling down to individual banks that some may find interesting, we ranked the banks by asset size and provide the level of bank reserves for each. We think 3% is a pretty good flag for banks with reserves that may be too thin, although, as we said, each bank is different.

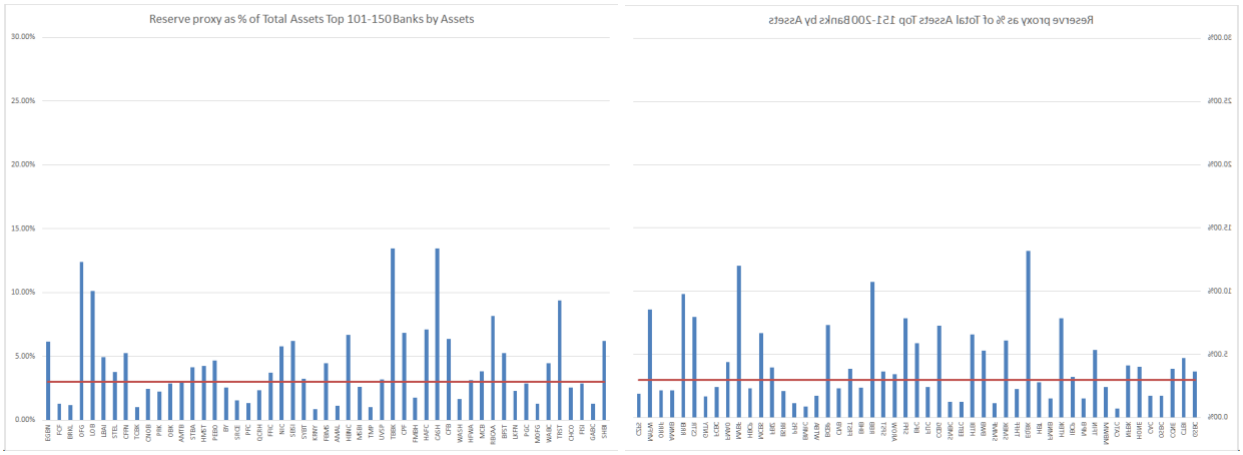
Here's the money shot. These are all banks with less than 3% reserves by size:

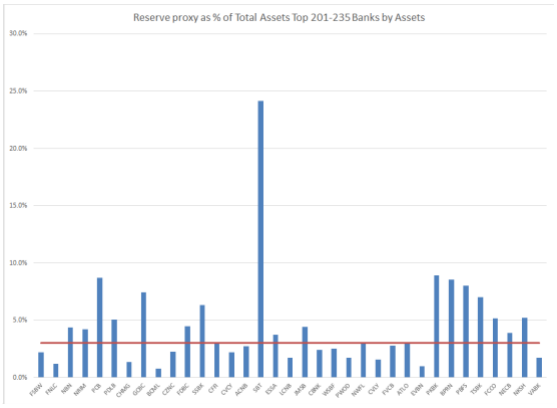


Full review of all 235 banks:









Synthesis

Act 3 should follow Act 2 if Treasury maintains Coupon issuance. We will know that decision on May 1. The priced-in path of Fed Funds will have little or no impact on the economy or markets as long as Act 3 plays out. We are bearish long-term bonds as our biggest risk position. We are tactically short equities and would add shorts in all assets if the bond market continues to steepen the curve. Gold and Commodities are not worth shorting, however, until momentum turns. We also believe that STIR is fairly priced and provides a decent hedge to short equities and bonds and we are accumulating a long position.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000			
	LTD P/L	$ 57,415,152			
	Total Return	57.42%	YTD Return in excess of cash	-1.46%	
	Today's Date	4/7/2024	Portfolio Created	4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
2/7/2024	"ADJUSTED DH 12/24 5400/5600 CS (STOP AT 106.55)	106.55	-500	$ 977,500	93	$ 677,500	Open
1/23/2024	FXI STOP Loss	22.80	219298	$ 500,000	24.2	$ 307,018	Open
3/28/2028	SPX 5250 May 17th Put average of 3/28 and 4/4 4/5	80.88	245	$ 1,981,560	102	$ 517,440	Open
3/28/2028	NDX May 17 18250 Put average of 3/28 and 4/4	356.00	45	$ 1,602,000	450	$ 423,000	Open
4/4/2024	SFRZ5 Consolidated Positions	96.19	3000		96.03	$ (1,200,000)	Open
4/4/2024	ZBM4 4/27/24 119 (reflects close out of 116)	1.04	2639	$ 2,744,560	2.25	$ 3,193,190	Open
4/4/2024	ZNM4 4/27/24 110 P/L reflects close out of 108	0.48	5030	$ 2,414,400	0.89	$ 2,065,444	Open
			Risk	10.220%		16.2%	