

The Damped Spring Report

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

6/19/2021

Summer waves. We changed our view on assets in an email to clients sent on Wednesday. While the bond market reaction to the Fed meeting has been noteworthy, our shift in view was due to a poor estimate of the timing of the massive issuance of UST need to finance the debt in Q2 and Q3 2021 and the faster speed of the spend down of the TGA which offset the issuance pressure. Specifically, the TGA is being spent faster than we expected in June. That is causing risk premium contraction on assets. We covered bonds and stocks shorts on Wednesday and kept our max gold short. We now believe that Janet Yellen will reach the Debt ceiling goal of 450BN of TGA by the end of July which will hold or further contract risk premiums. However, beginning in August the thesis that got us max short stocks and bonds will be back in play. Wave of liquidity in July, undertow in August.

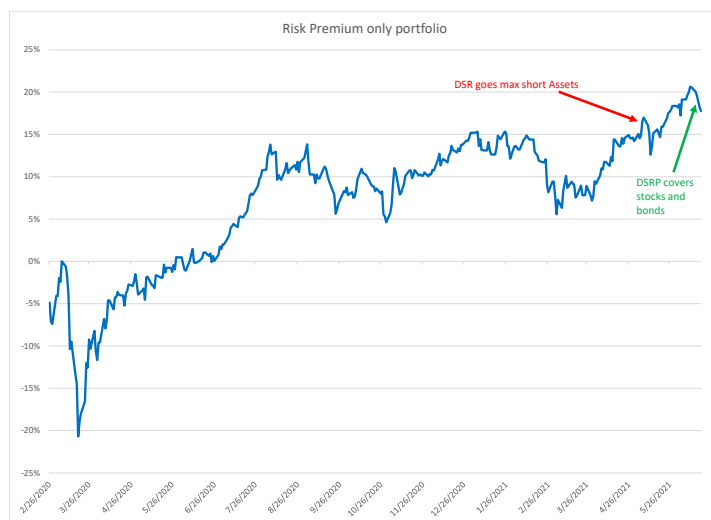
The market reaction to the Fed move was larger than we expected. Our initial thoughts are:

- 5YR 5YR inflation expectations as one measure of inflation which we know the Fed follows fell 20bp in two days and sits at 2.1%. This was a bad outcome for a Fed that wants inflation to run hot. While we believe strongly that short term inflation is transitory and understand that 2.1% averaged with above 3% for the next few years is precisely what the Fed wants 2.1% gives little wiggle room for the back years. We think, despite Bullard’s flip to hawkish, that the Fed will actively walk back hawkishness this week
- 30-year real rates fell 10bp. That makes sense to us. However, Gold fell. That is counter to its real rate driver. For that reason, we believe that the major takeaway to the Fed meeting reaction is that the Fed significantly strengthened its credibility. The fiat collapse call portion of the drivers for gold was marked down significantly. USD strengthened. Its not our lane in the Damped Spring Report but we will add that Crypto is very vulnerable.
- Since the Fed meeting, NDX100 is up slightly and SPX and RTY are down led by banks, economically sensitive sectors. This makes sense. However, significant intra index reweighting flows and quarterly options expirations were at play and likely will have impact on Monday. Two things occurred at the macro level possibly which net adds up to good support for equities
 - Risk free discount rates fell 25 bp pushing SPX valuation up 200 Pts.
 - Risk premiums may have expanded a bit due to higher vol and perceived tighter money hurting equity values by a 100 SPX Pts.

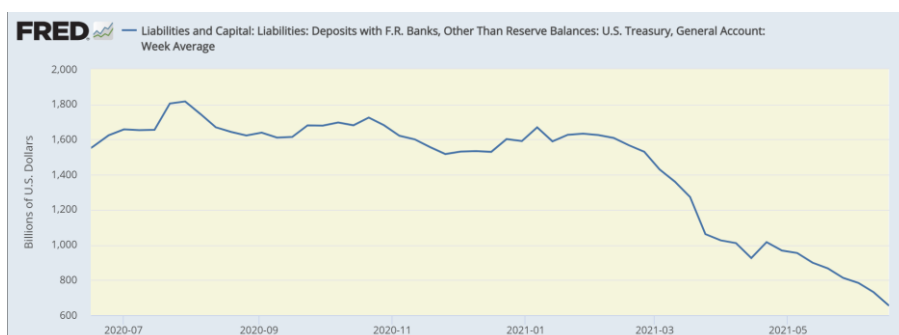
In synthesis the Fed re-established credibility, the bond market overreacted regarding back year growth and inflation expectations, Gold remains highly vulnerable as do potentially cryptos, and equities are well supported by lower discount rates. We are max short gold. Our tactical game plan for the coming week is to establish a long equities position and a short long term bonds position to fade what we think is a market overreaction. Strategically we see July as a good month to hold any asset and if given an opportunity at attractive levels we will buy/cover. However, as the TGA reaches its minimum level at the end of July and Janet has used all her liquidity bullets we will once again return to our Max bearish assets positions.

What happened in June. – How we were wrong.

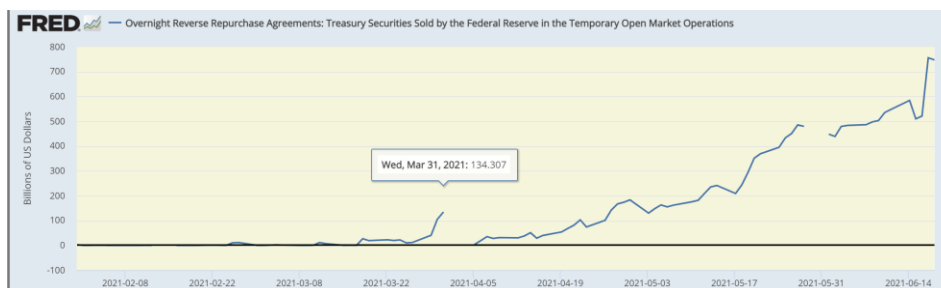
The portfolio that we use to track risk premiums rallied 130bp since we went max short.



We believe that a combination of the two principal drivers of risk premiums resulted in strong asset performance. Realized volatility was low and that drove some portfolio leveraging. But more importantly the pace of Treasury General Account usage vs funding via issuance was at a much faster pace than what was announced. On May 3rd, the Treasury announced a target for the TGA account for June 30th of \$800BN. Today the account is at \$653BN.



The impact of 150BN less issuance than announced has been felt across all assets by the typical QE risk premium mechanism. Since late January over 1TN of Federal deficit has been funded from the TGA instead of bills and bonds issuance. The lack of bills has led to the incredible demand for the RRP



The balance of the spending (lack of issuance) is likely to have found its way into the real economy and long-term assets. Regardless the quantity of the liquidity injection (really the lack of issuance) has been much larger than we expected.

By July 31st as mandated by the Debt Limit suspension and the Bipartisan Budget act of 2019 the TGA will need to be below \$450BN. Because the actual number is unknown and due to the additional minimum of \$200BN that must be spent down we are watching this extremely closely. Eventually the use of this account will slow bottom and reverse. We expect further support of asset prices until the pace slows and will be back to max short before the bottom. The Treasury has announced its intent to rebuild (tap debt markets) the TGA by end of September. The issuance wall is quickly approaching but for now still off on the horizon.

Current Model Portfolio Performance and Recommendations

Assumed Portfolio size	\$	100,000,000						
LTD P/L	\$	21,540,089						
Total Return		21.54%						
Today's Date		6/19/2021	Portfolio Created				4/15/2019	
Date	Position	Entry Price	Amount	Worst case lc	MTM	P/L	Open/Closed	
4/29/2021	QQQ July 320/300 Put Spread	3.5	2857	\$1,000,000	1.4	\$ (600,000)	Closed	
4/29/2021	USA August 151/148 Put Spread	0.625	1600	\$1,000,000	0.125	\$ (800,000)	Closed	
5/3/2021	QQQ July 320/300 Put Spread	4.5	2222	\$1,000,000	1.4	\$ (688,889)	Closed	
5/3/2021	USA August 151/148 Put Spread	0.5	2000	\$1,000,000	0.125	\$ (750,000)	Closed	
5/25/2021	TY August 132/134 Call Spread	0.625	-1455	\$2,000,000	0.578125	\$ 68,182	Closed	
5/25/2021	SPX July 4200/4300 Call Spread	50	-400	\$2,000,000	35	\$ 600,000	Closed	
5/25/2021	GC August 1900/1950 Call Spread	16	-588	\$2,000,000	1.8	\$ 835,294	Open	
4/29/2021	GCA August 1750/1700 Put Spread	17.5	571	\$1,000,000	13.5	\$ (228,571)	Open	
5/3/2021	GCA August 1750/1700 Put Spread	10	1000	\$1,000,000	13.5	\$ 350,000	Open	