The Damped Spring Report

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

4/27/2022

As the formal announcement of QT looms over markets at the FOMC meeting next week, the logical question markets have been focusing on is "Who's going to buy bonds to replace the Fed?" We agree that is a good question however, we have been focusing on a different question as well which will be addressed in the less followed announcement a day before the FOMC. On May 2nd, the quarterly refunding announcement (QRA) will provide concrete information regarding the Treasury departments issuance plans for the 3rd Quarter. The quarterly refunding announcement will address what we think is the question being ignored by the markets. "Who's going to sell bonds?"

Today's DSR will address both questions. Headline: We expect the amount of coupon debt sold by the treasury during Q3, will fall far more in quantity vs past quarters than the reduction in the Fed's balance sheet via QT. This lack of supply will be supportive for all assets through the summer.

Quarterly Refunding Announcement

On May 2nd we are going to get the release of the quarterly refunding announcement. This announcement will describe both the amount of new issuance that the Treasury will make and its composition. Given that we expect the FOMC to announce the start of balance sheet rundown it is critical to understand the supply of bonds given the drop in demand. Risk premiums on all assets will be impacted by this announcement. We expect that the amount of issuance and particularly the amount of coupon bonds will be far less than current market expectations. Here is a rough estimate of what we expect.

US Treasury Base Case Issuance

	Bills	Bond	New Money
Q1	221	508	729
Q2	(358)	424	66
Q3 EST	(50)	350	300
Q4 EST	25	275	300
Total	(162)	1,557	1,395

The important assumptions in our estimates assume are:

- The Federal deficit is projected to be roughly 1TN based on last year's CBO estimate. We think there is significant downside to this number, and we could imagine a number as little as 700BN which would reduce new money by a large factor
- We assume that the TGA which has peaked at 900BN as of tax season inflows will remain well funded and thus represents significant additional downside for the need for new money if Treasury decides to spend some of its saved funding. Our total funding estimate assumes fairly stable TGA.
- We assume that the Treasury is concerned about issuing adequate coupon bond supply to meet demand of long-term bond investors and as in the past three quarters will reduced coupon issuance by 75-80BN per quarter. However, as can be seen by Q2 data, the money market has been starved for new bills by a reduction of 358BN of bills and generated a sharp increase in the RRP. When new money needs fall sharply, as we expect, it is very difficult to only reduce coupons by a small amount as it results in tiny amounts of new bills money. Because of the enormous RRP and obvious demand for bills in the market the Treasury may be forced to issue even fewer bonds than our assumption

We could easily imagine that Treasury balances, new money needs, TGA size, and a conscious decision to avoid further starving the bills market, would generate the following issuance.

US Treasury Balanced Issuance			
	Bills	**Bond**	**New Money**
Q1	221	508	729
Q2	(358)	424	66
Q3 EST	75	175	250
Q4 EST	100	100	200
Total	38	1,207	1,245

So given all of the factors above that could put even more pressure downward on coupon issuance we have to ask, "Who's going to sell bonds?" We said in a prior DSR "Will she, or won't she?" that Janet had a lever to shift coupon issuance to bills to tap the RRP and offset some negative market consequence of QT as we approach the May QRA we have to rephrase our question to "Does she even have to?"

In other words, it seems clear to us that there will be very little coupon issuance during the remainder of 2022. Just looking at our conservative assumptions for 2022 the total coupon issuance above will be 1,557BN and over 42% of the coupon issuance has happened in the first four months of the year already.

When we add up the balances of fed purchase vs treasury sales of coupon debt on a quarterly basis the net amount of bonds that the market needs to absorb will be lower than virtually any quarter since Q2 2020.

Over the course of 2022 it is our expectations that US coupons will be in low supply, which is in stark contrast to what is broadly expected by the market where the question most asked has been "Who will buy the bonds that the Fed isn't buying." The answer: No one will have to.

We could not be more bullish assets based on contraction term premiums if our expectations play out. Significant risk premium contraction will fuel a sharp recovery in a risk balanced portfolio. We will wait to pull the trigger on positioning until we see the QRA but will pivot aggressively if we are right and obviously adjust our positioning if we are wrong.

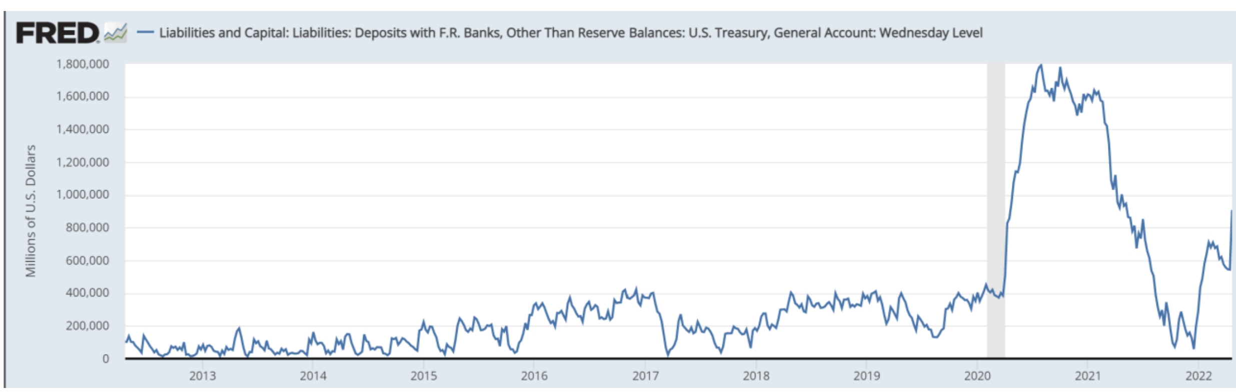
The two major pieces of information in the QRA are total new money needs and composition.

Total new money needs

Total new money is impacted by three factors

- Desired TGA Balance
- Tax Receipts
- Spending

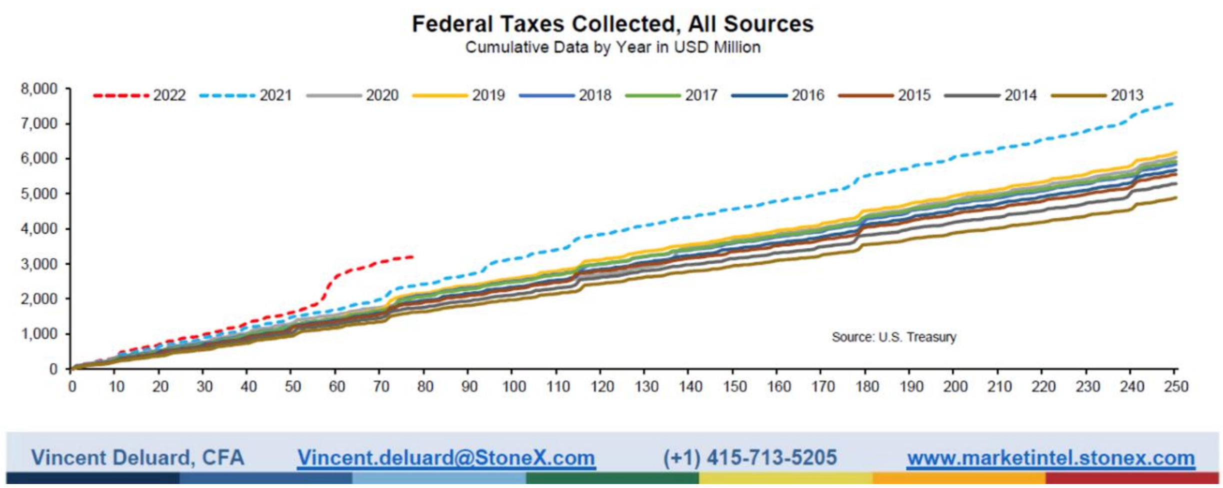
The TGA balance (The US Treasuries checking account) has been aggressively built in Q1 and is exploding higher partly in a seasonal way and partly through, higher than expected tax receipts.



Notice that in December 2021 the TGA was extremely low due to the debt ceiling remaining in place and the need for the Treasury to use its checking account accumulated in past years to pay its bills. In Q1 Treasury issuance was quite high and the TGA was built to 650BN which was the Treasury's target. Now it sits at 900BN. **It is highly unlikely that the Treasury will issue much new money when the TGA is at current levels however that is not part of our base case assumption.**

Tax Receipts

Tax receipts for 2022 are coming in extremely hot. As taxes receipts are tightly linked to NGDP and that is running at 8% or so for 2022, this should come as no surprise but at the same time it seems the market is ignoring the impact that will have on new money debt issuance. A Twitter analyst tracks daily tax receipts and has noticed that they are up 35% in the first third of the year over 2021's huge revenue.



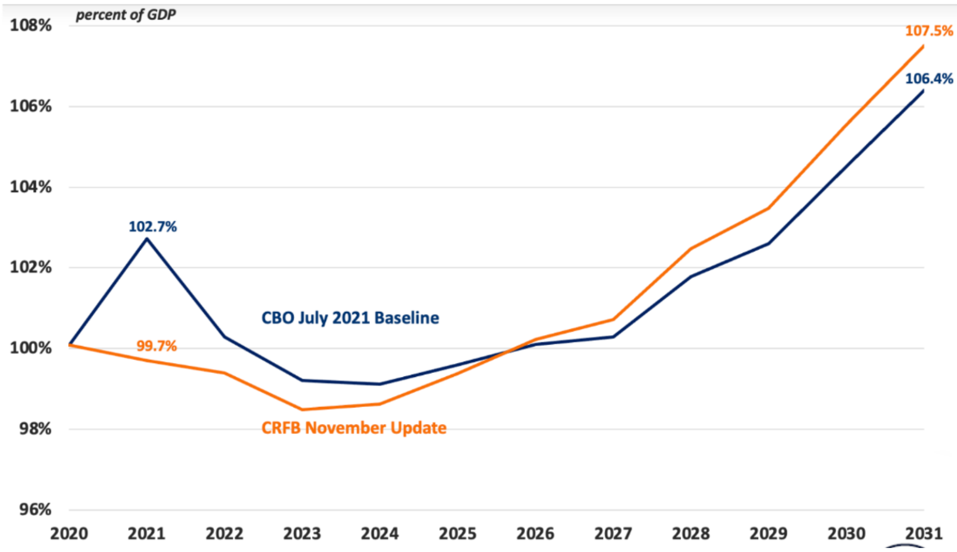
Sure, it may be a blip due to capital gain recognition, but the data says otherwise. The huge jump in tax receipts was in Withheld. That means people are getting more wages. Which makes sense because 8% nominal GDP results in one person's consumption being another person's income

US TREASURY - FEDERAL TAX RECEIPTS (in millions)

Month/Year	Withheld Income & Employment Taxes	Growth Rate vs '20-21	Withheld Individual Income Taxes	Growth Rate vs '20-21	Not Withheld Indiv. Income & Employment Taxes	Growth Rate vs '20-21	Corporation Income Taxes	Growth Rate vs '20-21	All Other	TOTAL	Growth Rate vs '20-21
December-21	$ 351,099	42.1%	$ 13,753	51.1%	$ 12,689	27.8%	$ 86,511	34.8%	$ 8,112	$ 472,164	39.7%
January-22	$ 273,162	21.2%	$ 64,296	45.1%	$ 85,062	5.6%	$ 13,058	-16.7%	$ 8,428	$ 444,006	19.3%
February-22	$ 258,172	11.6%	$ 8,507	73.8%	$ 10,635	46.9%	$ 6,282	34.1%	$ 6,123	$ 289,719	13.8%
March-22	$ 304,325	6.2%	$ 17,365	58.2%	$ 17,070	36.5%	$ 14,653	-17.3%	$ 8,043	$ 361,456	7.9%
April-22 mtd	$ 206,576	16.1%	$ 320,344	431.1%	$ 110,934	104.3%	$ 90,582	17.8%	$ 5,424	$ 733,860	95.7%
	$ 1,393,334	19.3%	$ 424,265	227.4%	$ 236,390	43.7%	$ 211,086	17.8%	$ 30,706	$ 2,301,205	37.4%
December-20	$ 247,043		$ 9,101		$ 9,927		$ 64,174		$ 7,646	$ 337,891	
January-21	$ 225,315		$ 44,308		$ 80,544		$ 15,678		$ 6,286	$ 372,131	
February-21	$ 231,378		$ 4,894		$ 7,242		$ 4,683		$ 6,434	$ 254,631	
March-21	$ 286,630		$ 10,978		$ 12,506		$ 17,708		$ 7,138	$ 334,960	
April-21 mtd	$ 177,881		$ 60,320		$ 54,301		$ 76,891		$ 5,669	$ 375,062	
	$ 1,168,247		$ 129,601		$ 164,520		$ 179,134		$ 27,504	$ 1,674,675	
December-19	$ 243,582		$ 5,970		$ 11,001		$ 60,106		$ 7,304	$ 327,963	
January-20	$ 232,446		$ 27,877		$ 78,629		$ 10,340		$ 8,277	$ 357,569	
February-20	$ 222,917		$ 3,840		$ 5,787		$ 4,249		$ 7,417	$ 244,210	
March-20	$ 255,582		$ 5,940		$ 11,459		$ 11,417		$ 7,309	$ 291,707	
April-20 mtd	$ 147,883		$ 10,738		$ 14,240		$ 6,232		$ 2,568	$ 181,661	
	$ 1,102,410		$ 54,365		$ 121,116		$ 92,344		$ 30,307	$ 1,403,110	
December-18	$ 234,044		$ 4,942		$ 10,829		$ 51,201		$ 7,342	$ 308,358	
January-19	$ 211,407		$ 22,111		$ 78,440		$ 8,124		$ 8,304	$ 328,386	
February-19	$ 209,781		$ 3,226		$ 5,454		$ 3,275		$ 6,478	$ 228,214	
March-19	$ 237,654		$ 6,714		$ 12,229		$ 12,577		$ 8,330	$ 277,504	
April-19 mtd	$ 175,053		$ 102,466		$ 128,394		$ 49,670		$ 4,608	$ 460,191	59.5%
	$ 1,067,939		$ 139,459		$ 235,346		$ 124,847		$ 30,454	$ 1,602,653	

Source: US Treasury Daily Statements

Another cool graph we saw shows the next two years of “deleveraging” as the nominal GDP grows faster than the debt issuance. Meaning not enough bonds for the economy.



We are sticking with the CBO Deficit estimate of about 1TN for 2022 but if these tax receipts simply grow at the historic slope in the chart above the US Government deficit would fall dramatically from that estimate and issuance would fall as well

Spending

We expect gridlock through the midterms and beyond to limit any real possibility of additional spending in 2022 over current forecast. However, we recognize that a bipartisan priority for Military, Domestic production, Energy Production, and alternative supply chain infrastructure spending could be a stimulus for more deficit spending and issuance. But the details of each of these things are so partisan that any agreement would be hard to contemplate prior to the midterms. **Our assumption is that spending is fixed and has no net impact on issuance plans**

Composition

We at Damped Spring have had the opportunity over the years to speak to Treasury officials as part of their outreach program to discuss proper functioning of the markets for US Treasuries. The Treasury has a standing formal group called the Treasury Borrowing Advisory Committee (TBAC) which meets regularly with Treasury officials; however, they also reach out to a broader audience. By participating in these discussions and reading through the public notes of TBAC minutes and papers we have some understanding of the framework Treasury uses to decide the composition of issuance.

Our synthesis of Treasury issuance Framework

This framework balances each of these at times conflicting factors

- The highest-level goal by far is to optimize the US Government's long-term cost of borrowing
- Optimize the current cost of borrowing
- Provide adequate supply of US Bills, Notes, and Bonds to meet the needs of the broad range of investors in US government securities
- Promote liquidity in each of the sectors of composition
- Balance exposure to short term rate fluctuations which could lead to higher costs for the US Taxpayer in a rising interest rate environment with locking in longer term rates at a higher term premium incentive paid to investors

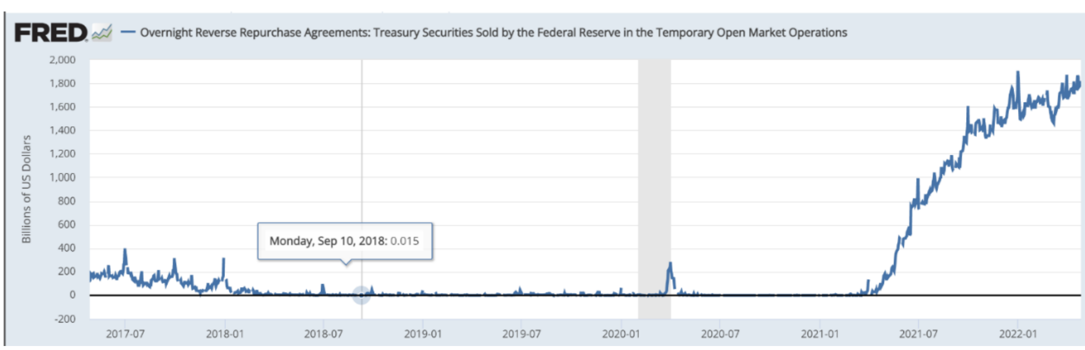
Outside of this framework there are two very relevant political considerations that have opposite actions depending on which is more important

- Inflation fighting is a clear political issue for the Biden Administration. US Treasury can overweight coupons vs bills in order to place pressure on all asset markets via the risk premium expansion channel which would affect wealth and curb consumption amongst asset holders
- Trying to get elected when the stock market crashes during your administration is a tough job. In order to support markets, the US treasury can issue more bills and less long-term assets. This would relieve pressure on assets with the unwanted consequence of perhaps extending inflationary pressures

We think that Janet has the lever we have described and can essentially affect asset prices through her choices. However, we don't think she needs to make a decision in this QRA. Here's why.

The RRP and Bills market problem

The Reverse Repo Program at the Fed is a program that offers a home for assets that want short-term interest-bearing cash. Money market funds are by and large those who "deposit" cash in the RRP. It has grown massively due to the savings that have resulted from the fiscal spending done during the pandemic.



While the totals have been volatile it is also interesting to note that since the Treasury reduced bills by 358BN in Q2 the RRP has been climbing each and every report and now sits 300BN higher than at the end of Q1. It is clear to us that a decision to reduce or increase bills issuance has an impact on RRP. In other words, if the Treasury wanted or needed to raise money, they could issue a ton of bills and get liquidity that is currently sitting on the balance sheet of the Fed and paying investors interest from taxpayers. It is an odd dynamic to essentially pay interest while not getting the money to spend. At the same time unless tax receipts fall, or spending rises or for some odd reason the desired TGA is increase the RRP money looks pretty much stuck. But it does represent untapped demand for bills if anything goes haywire with the economy.

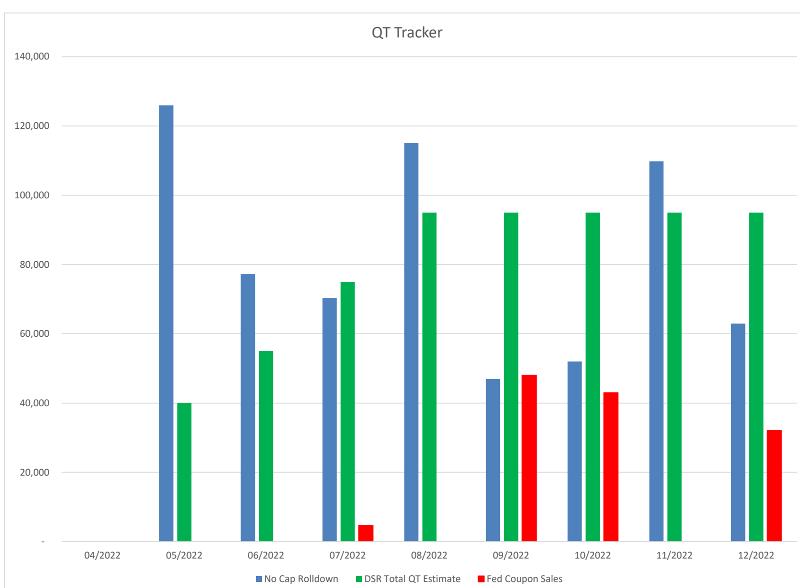
Starve the market for bills or bonds?

The reduced need for new issuance due to a narrowing budget deficit and an overfunded TGA places the Treasury in a sticky situation. They just don't have much of either to sell. They have made it clear to us in conversations that they are nervous about significantly reducing coupons. We assume they will reduce at 75-100BN. But that means that once again they need to reduce bills issuance. That has undesirable impacts including the odd RRP growth and the continued discount of bills to other money market rates. Perhaps they have learned the lesson of the 358BN reduction this quarter. If so the only way to increase bills is to reduce coupons even further. This is dynamic we are watching. But the big takeaway is Coupons are dropping without Janet's hand on the lever. "Will she, or won't she?" She can't. The natural flow of the economy is reduced issuance. **QT isn't going to be sterilized actively by Janet but will be sterilized none the less.**

FOMC Meeting

Our expectations for the FOMC are largely at consensus as priced in regarding near term hikes and forward guidance on hikes. As for QT we expect that to begin immediately. Perhaps they will delay a month, but we doubt it. All other FOMC related news will remain hawkish

Our QT Tracker adjusted a bit for the specific in the minutes now looks like this:

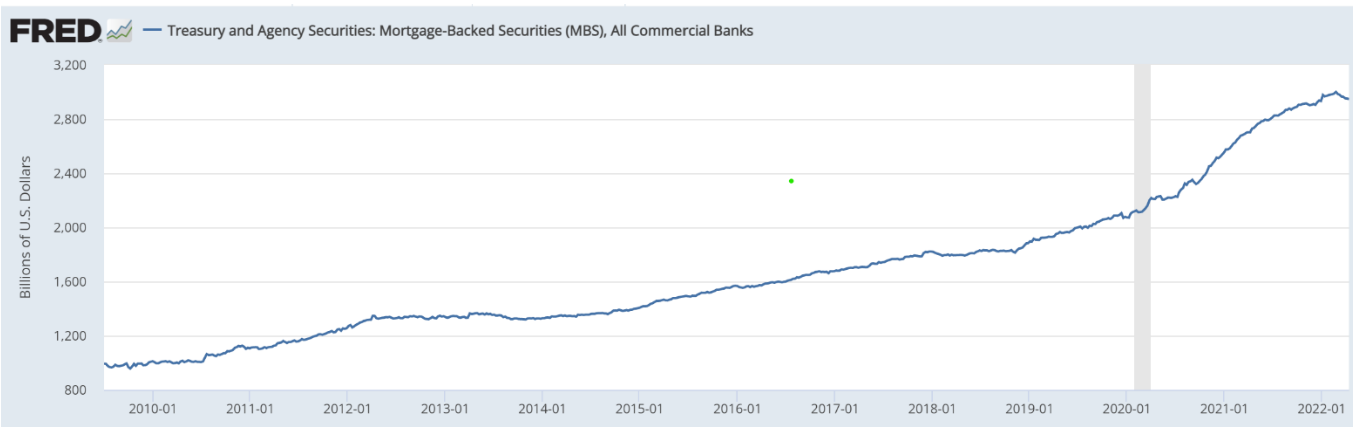


"Who is going to buy?"

This question is still relevant. Let's look at important holders of bonds. We agree broadly that demand for bonds particularly at prices in January has ebbed. In addition, the idea that the US will use its currency and assets as a weapon is quite popular and we are sure certain global risk managers are taking steps to protect themselves. However, the major pools of holders are unlikely to make any real move.

Banks

Banks bought a huge amount of UST over the past year continuing a trend to buy bonds that started during the financial crisis. The dip is a concern obviously, the flat curve is a concern. However, loan growth is not likely to be any better with mortgage refi flow going toward zero and yet the nominal economy continues to grow rapidly. Banks seem neutral to us for demand.



Sovereign reserve managers

The strength in the USD is likely to generate higher local economy exports which will once again challenge the Sovereign reserve manager to invest all of these USD Balance of Payments capital account inflows. For China who until very recently saw its currency even stronger than the USD wants to control its appreciation or even devalue for its stimulative effect locally it will need to print Yuan sell it for USD and buy UST. We think that dollar strength and CNY outperformance will result in increased demand for UST.

Investors

Pension funds have aggressively sold bonds over the past 4 months. They represent significant demand at higher yields, but they are not levered and so can only absorb so much flow. Net positive for sure.

Hedge fund

Positioning is mixed

What's priced

The "Drumbeats of QT" were first heard on Dec 15th and became obvious to all on Jan 4th in the minutes. Next week the drumbeats are actually going silent, and QT is upon us. Our conclusion is that QT has been sterilized not by Janet pulling some lever (though she was a sly fox to fund the TGA during QE and starve bills to build more ammo for a rainy day in RRP) but by the simple mechanism of an economy that is generating higher nominal growth vs its nominal interest costs, and some spending restraint.

Despite what we think is fantastic conditions for assets of all sorts what's priced in is exactly the opposite. 60/40 portfolios have fallen 12% and the DSR Balance Beta portfolio has fallen 6%. If the QRA and Fed meeting are as we expect we will go max levered long the DSR Beta portfolio.