The Damped Spring Report

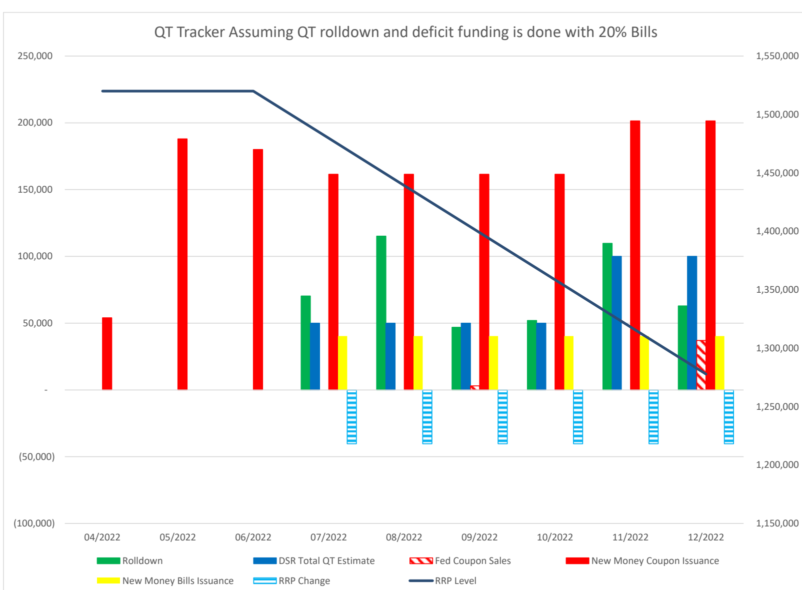
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

3/14/2022

Headline: Over the next seven weeks we will have a much clearer picture of the Fed's plans for Quantitative Tightening and the Treasury Department's plans to finance both the normal budget deficit and the Fed holdings that roll off during the 2nd half of 2022. The details of how these levers are pulled will have a significant impact on asset markets and risk premiums. Our QT Tracker has been enhanced and we will give two potential scenarios that likely bound the news. One which will reward asset holders and the other which may lead to further risk premium expansion and correlated selling of assets. Will she or wont she?

This coming week there will be more Ukraine/Russia headlines and a Fed meeting. We have no ability to predict the Ukraine headlines. We are highly confident that a 25bp rate hike will be announced. We expect a hawkish dot plot and presser. However, that is widely expected given Eurodollar pricing. The other news from the Fed will be progress on the QT Plan. We expect some details but do not expect start date or pace details to be released this meeting. Further, we expect a reiteration of prioritizing rate hikes over QT for inflation fighting.

This DSR will be devoted to what really matters. What matters is whether Secretary Yellen will use the lever she has in one way or another to either offset or enhance the impact of QT. Here is our base case updated QT Tracker.



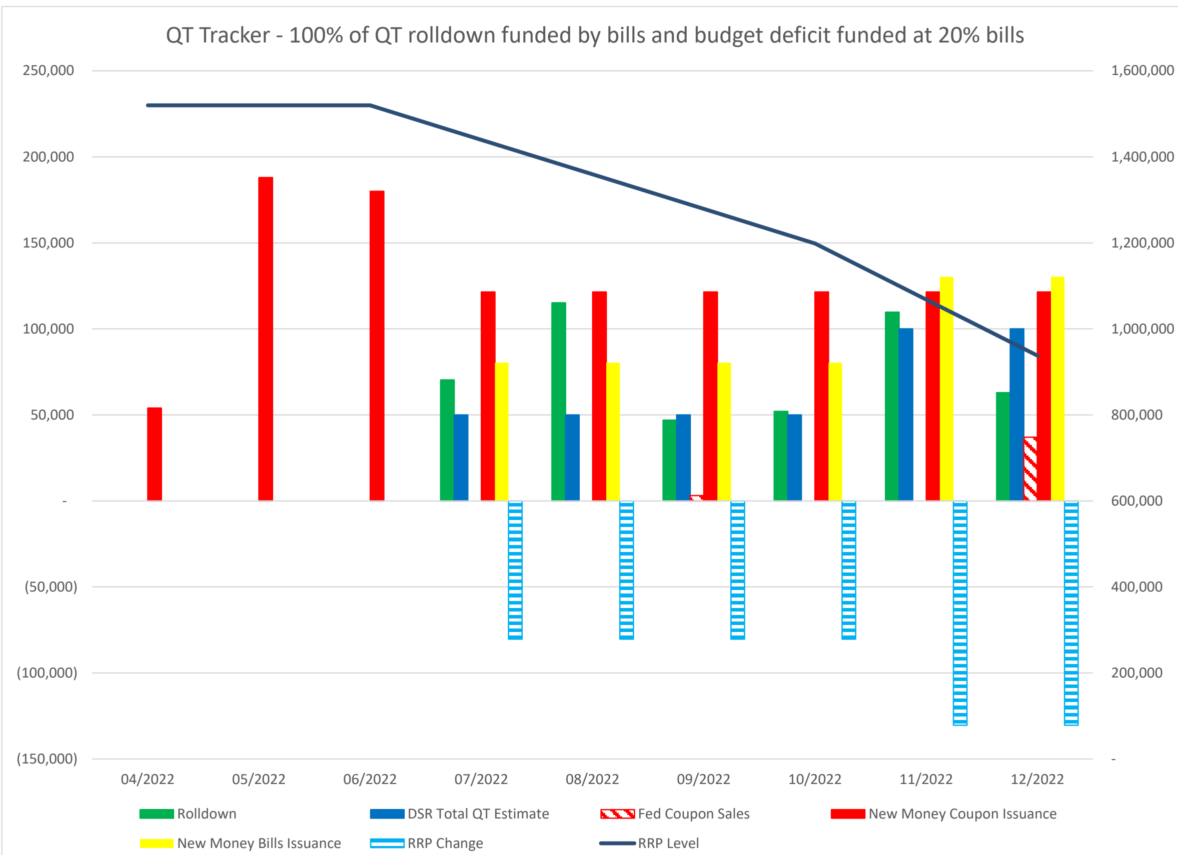
As you can see, we have added some additional data to our QT tracker.

- The dark blue columns represent our best estimate of the start date for QT (July) and the size (50BN for the first 4 months and 100BN for the foreseeable future
- The green columns represent the actual Fed maturities (ignoring the next three months as they are being fully reinvested
- When the green column is smaller than the desired balance sheet reduction the Fed will sell coupons or mortgages into the market to make up the difference. That column is rare and small in 2022 and is in red with cross hatches. Mortgages will be the open market sale of choice for the Fed
- The red columns are already announced coupon issuance from the QRA for Q2 and for 2H2022 a likely issuance schedule using CBO budget deficit estimates and a steady state TGA of 650MM
- The yellow columns are bills issuance using the TBAC guidelines and CBO estimate
- The blue cross hatched columns assume that excess bills are financed by RRP cash transitioning to bills
- The line is the balance of the RRP

One important thing to note is that the Treasury is issuing $424BN of coupons in Q2. That's a large amount of bonds and is concerning as QE has ended. It is particularly worth noting as at the same time the Treasury is reducing bills issuance by $358BN. Net of these plans is that new financing is quite low at $66BN vs the $729BN they sold in Q1 but still sizable in terms of coupons. We suspect upward pressure on the RRP given the scarcity of bills this quarter. The coupons sold may also put a floor on risk premium contraction and a cap on asset prices in Q2.

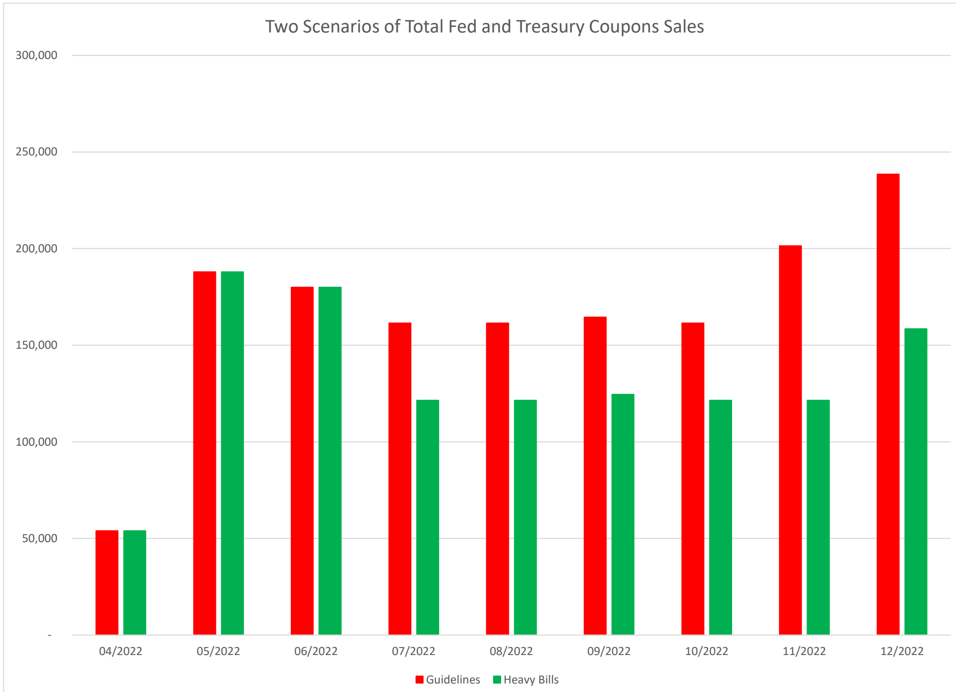
This is a good time to remind ourselves of the mechanisms of QE and QT. QT results in market participants needing to fund the maturities that are payable to the Fed. The Treasury chooses what new bills, notes, or bonds to sell, and the market absorbs those excess assets. The demand for short maturity assets like bills is very deep and investors need only a small concession (higher yield) to buy bills. Long term Treasury bonds require a larger incentive to attract the same dollars of investment. This incentive is called risk premium. The longer the term the bond, the bigger impact on risk premiums. That risk premium expansion from long term bond issuance gets spread to other assets as the buyer of the long-term bond must sell something else such as a stock. The buyer of the stock then must delay consumption. In that weak way, often described as the wealth effect, demand is cut which eases inflation pressure. QE which decreased risk premiums and increased wealth was inflationary to assets but ineffective in generating inflation of goods and services. QT will be ineffective in fighting inflation as the transmission mechanism is weak. Raising rates is the strong tool to fight inflation for the Fed and decreasing the budget deficit growth is the tool for Fiscal policy makers. The Fed has unequivocally said the same. They will do both QT to reduce the balance sheet and hike rates to fight inflation. The hope is that if they can reduce the balance sheet without creating serious damage for financial markets, and, fight inflation with rate hikes, the Fed will have ammunition to fight a slowdown in the future.

Janet Yellen understands QT's heavy impact on asset prices and weak impact on inflation. She also understands the effect of short rates on inflation and assets. She holds a lever that can mute QT's impact on assets which unfortunately costs her the weak impact QT has on inflation if she pulls the lever. Will she be willing to sacrifice a weak inflation fighting tool for the gain of stabilizing markets? Clearly inflation is the priority not the market. However, she and Jay know hikes do the job and are going to happen. Plus, in their hearts both know that they can't do anything about supply shocks and those will ease. She may be able to live with muting QT. We are not sure what she will do. We do know how she will use the lever if she chooses. Let's go to an alternative QT Tracker estimate

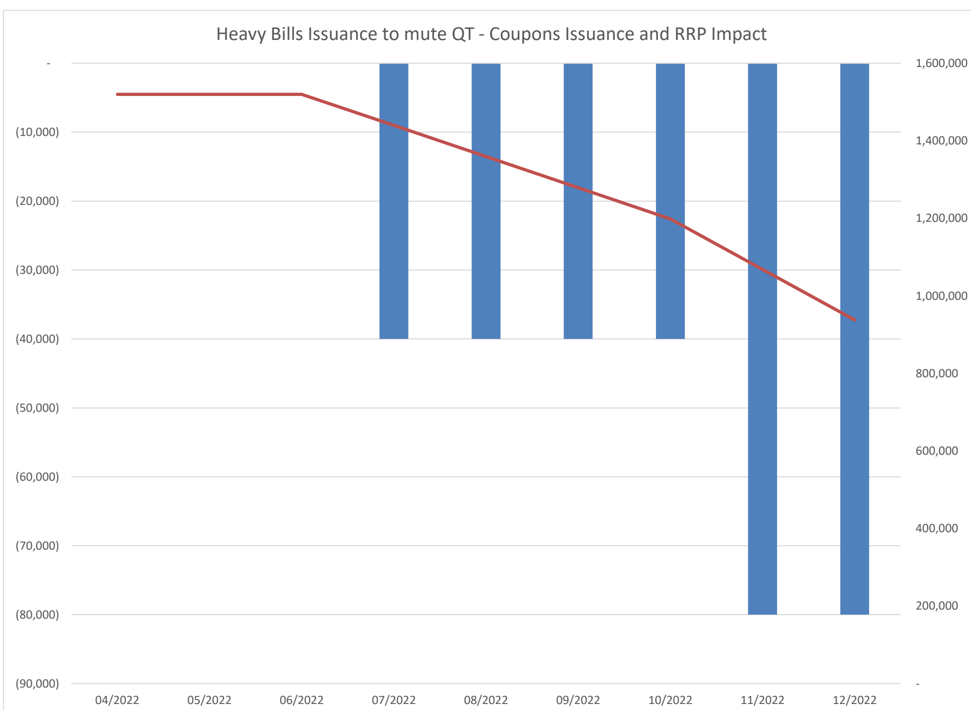


In this chart the assumption is that all the roll off of the Fed's holding will be funded in the bills market likely tapping the RRP for liquidity. Additionally, the 2022 budget deficit would be funded with 20% bills consistent with the prior chart and with TBAC guidelines.

Zooming in and comparing all the coupons for sale in the two scenarios



And then looking at the difference in coupons for sale and the impact on RRP if a heavy bills lever is pulled



The supply of bonds and its impact on all asset risk premiums can be significantly adjusted with the lever Janet holds. We don't want to minimize the complexity of the choice to pull the bills lever. We also are open to the remote possibility that she taps the RRP for even more liquidity if needed to support markets.

There are many issues.

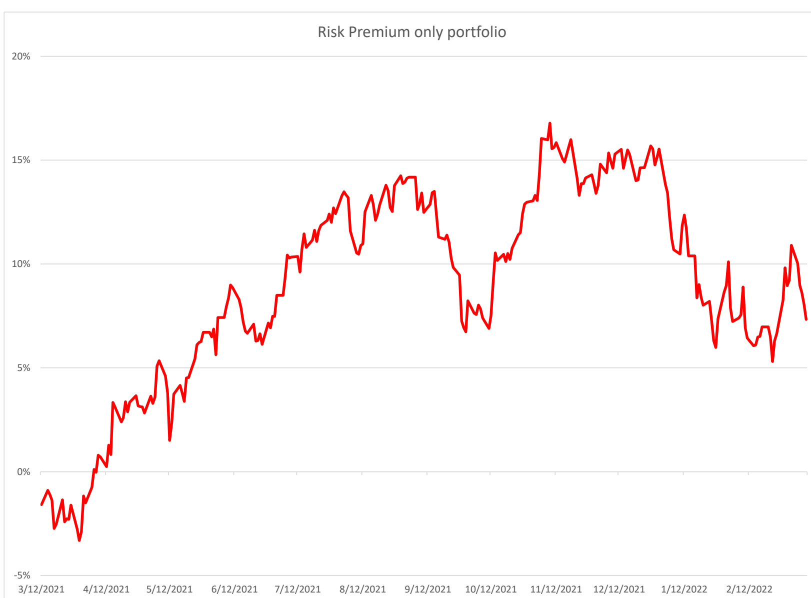
- TBAC guidelines, which in normal times recommends that bill issuance be limited to provide investors with a broad set of maturities and protecting taxpayers from having to pay higher interest costs as short-term rates are hiked and T-bills need to be rolled.
- Political criticism, Though the RRP is widely misunderstood and in the weeds politically if the bills lever is pulled it may result in political criticism that the administration is not fighting inflation.
- On the other hand, RRP isn't particularly attractive politically and is a clear pent-up demand for bills.

We aren't making a prediction if this lever will be pulled. We would only observe that Treasury did build the TGA back up aggressively in Q1 when Fed bond purchase were still occurring, further they significantly reduced bills supply in Q2 which may increase RRP balances. They are also planning a large bond issuance this quarter before they compete with QT in Q3. It points to good preparation for QT by the Treasury. Fund the TGA, fund more RRP, issue coupons in size before QT. The lever is quite strong. Will she, or won't she?

Absent a public statement, the Quarterly Funding Announcement on May 2nd will give the green or red light for investments of all sorts. This lever is not well understood and barely reported or research, but fear of QT is justifiable and something we wrote about in December. We believe that market expects the worst outcome from QT and will be surprised if the lever is pulled. Asymmetric outcomes would occur.

Comments on Markets

The performance of the risk premium portfolio after bottoming on 2/14, as we predicted in our last DSR, and spiking post Ukraine invasion has stalled last week.



Additional risk premium expansion pressures from these levels is not likely from news emanating from the Fed meeting. However, if, in the unlikely event, details of QT do emerge suggesting a start of QT before June and at a greater size than expected we would no longer be willing to hold assets as that would cause an end to any risk premium contraction possibilities.

Holding assets is a difficult endeavor given the various winds, but we do know for sure that QT will be a serious headwind for assets. Any potential tailwind for assets due to overly hawkish positioning has a narrow timeframe to work out. The window for any further risk premium contraction is closing and will only be reopened if Janet pulls the bills lever on May 2nd. The QT tracker and paying attention to the related levers, are essential for timing RP action. Given the current state we have a low confidence buy the dip on a diversified portfolio of assets through May 2nd. But we are very light risk and will continue to be quite aggressive shifting our positions in March and April.

Bonds

We have no positions in bonds now but are leaning to buying many places on both the US and European curves. The bull case for tens and thirties is inflation expectations fading, overly hawkish front-end pricing, and Janet's lever.

Inflation expectations have certainly spiked

Dec Eurodollars are making a new low

We have mentioned the levers Janet can adjust to manage issuance impact

But we are looking to buy when mortgage convexity players sell and a yield spike to 2.15 or so provides us a good entry on tens. We sent emails to clients when we were max bullish bonds a month ago that 1.70 was going to happen when the mortgage guys got offside and had to receive (buy bonds). We sold and went modestly short tens and thirties. Now just 7 days later all these guys are going to have to pay (sell bonds). We are waiting for that flow Otherwise between 1.90 and 2 tens are in no man's land. Our trade will come via a DSR Position Update by email to our clients

Equity

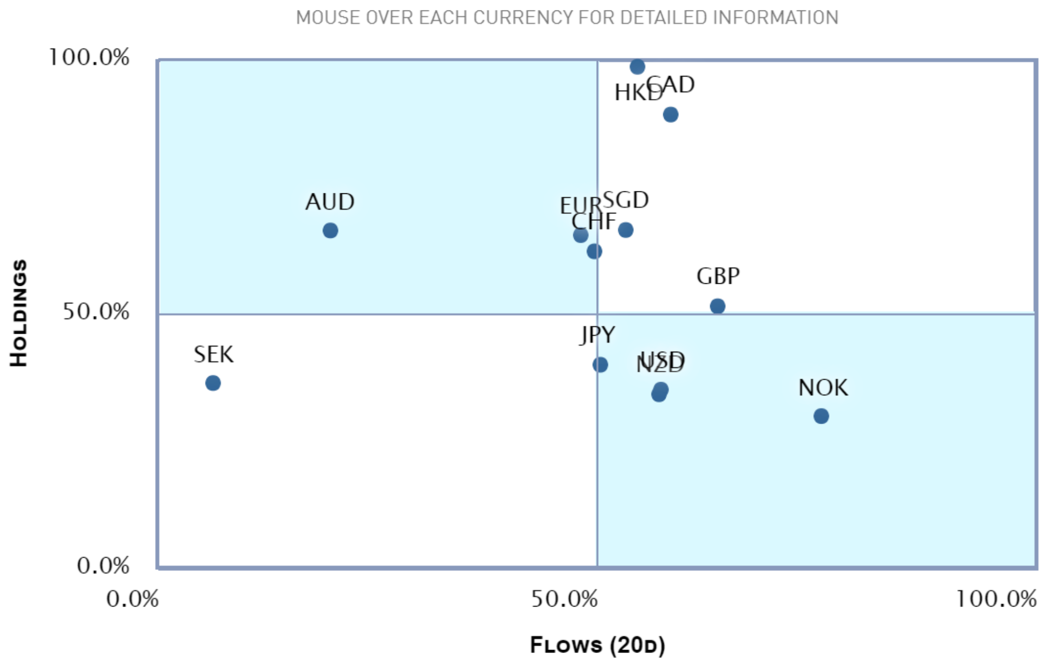
Short term bullish set up we are long SPX, NDX and as of this morning NKY Upside calls through early April.

- Bullish Month end and quarter end flows
- Hawkish fed pricing
- JHEQX negative gamma (We will write on this during the next week)
- Valuation, growth bounce and earnings

Currencies

Our view on USD has been our most consistent call of the year. However, it was based on investor flows into the relatively strong US asset market from Japan and Europe. Recently we have been bearish the EUR and bet against it via USD. Last week at 116.90 we email that we were once again going short the Yen. This was not due to dollar strength but due to a BOJ/MOF need to continue to be relatively accommodative vs the rest of the world. We also are aware of 120 digitals in autocallable and OTC markets that may be a technical magnet. Dollar strength was our last six-month call. Today we have the same position, but Yen and EUR weakness will be the driver. Positioning is not crowded despite the weakness.

Developed Markets - Flows and Holdings



Blue quadrants indicate potential unwinds of overweights (upper-left) or underweights (bottom-right).

Current positions and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 35,851,738					
	Total Return	35.85%		YTD Return		4.56%	
	Today's Date	3/14/2022		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case l	MTM	P/L	Open/Closed
2/24/2022	CLH5 20 pt stop	73.5	100	$1,000,000	73.43	$ (7,000)	Open
2/24/2022	CLM2 20 pt stop	100	-100	$1,000,000	99.25	$ 75,000	Open
2/24/2022	EURUSD 5/13/2022 Put Spread 1.11/1.07	0.86	232,558,140	$2,000,000	1.41	$ 1,279,070	Open
3/4/2022	EURUSD 5/13/2022 Put Spread 1.11/1.07	1.48	(116,279,070)	$ -	1.41	$ 81,395	Unwind
2/24/2022	NDX April 14500/15000 Call Spread	144	69	$1,000,000	66	$ (541,667)	Open
3/14/2022	NKY April 26250 Call	275	36	$1,000,000	275	$ -	Open
2/24/2022	SPX April 4400 Call	45	222	$1,000,000	43	$ (44,444)	Open
3/11/2022	USDJPY 120 6/13/2022 Call	0.44	227,272,727	$1,000,000	0.7	$ 590,909	Open