The Damped Spring Report

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

8/1/2022

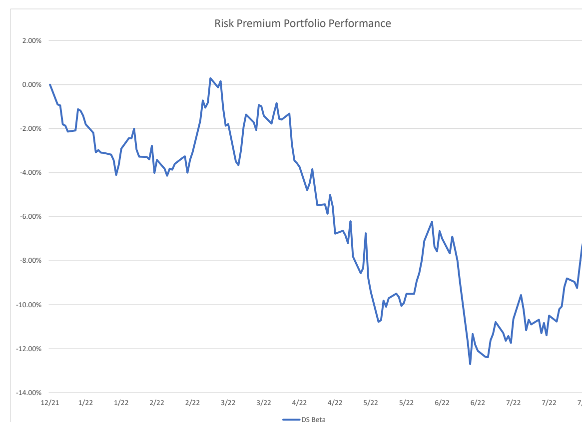
The "False Dawn" is playing out as assets have rallied on the back of a large re-leveraging flow. Today we release "Will the Sun Rise Over Jackson" Episode 2 Part 1. Chairman Powell, and he alone, will need to courageously affirm the Feds intention to kill inflation regardless of the consequences. We expect words to that effect at Jackson Hole and deeds throughout the fall into 2023.

Many markets participants believe the rally was caused by a Fed pivot. We disagree. We saw nothing in the statement on Wednesday nor Powell's press conference that would indicate that the Fed has pivoted at all. Our view remains that this is a simple re-leveraging which has some steam to continue but that window of strength will be shut soon if, and when, Powell drops the hammer.

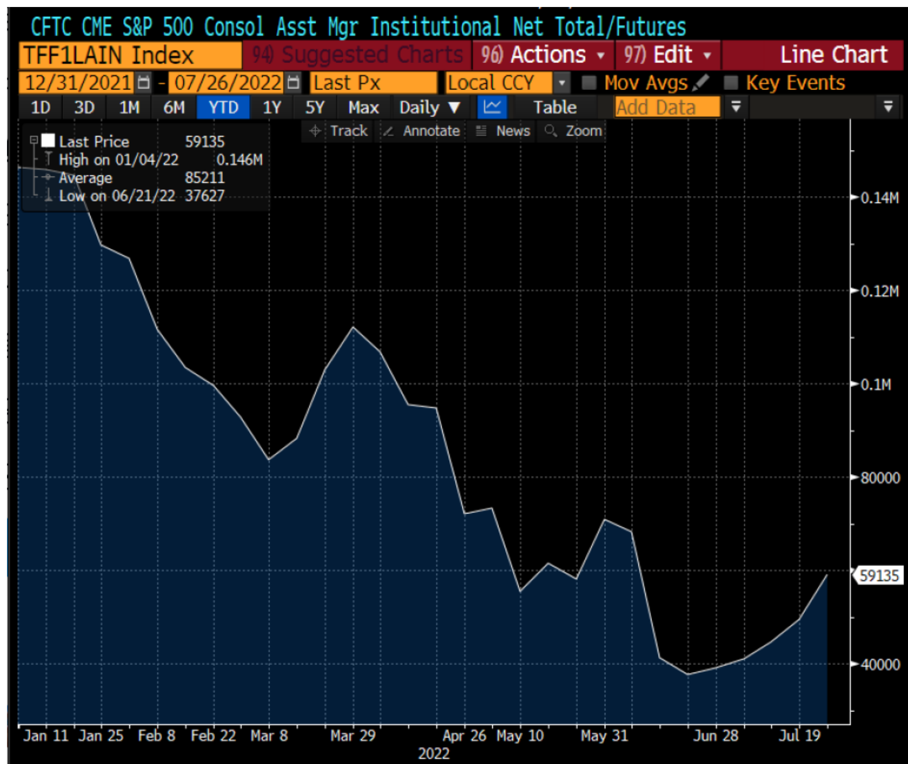
This coming week the QRA will provide some additional support for asset buyers. Into this rally we will be radically shifting our asset allocation during the week in preparation for the end of the "False Dawn." "Will the Sun Rise over Jackson?" We think not. Part 1 will set the stage; Part 2 will be released ahead of the event.

Assets have rallied broadly as the false dawn light spread

The SPX is up 12.5% from the lows, Nasdaq 100 16.3%, Nominal 10-year yields are down 82bp, and Real 10-year yields are down a whopping 72bp while inflation expectations anchored and stable. The DS Beta portfolio which is balanced to do well regardless of shifts in growth or inflation expectation has rallied almost 6%.



One measure of re-leveraging is institutional unlevered futures holdings. These investors sold 150BN of equity exposure over 2022 and have recently bought back 20%



While many are attributing the rally in long term assets to a pivot, The Eurodollar futures have priced in cuts in 2023 since the June Fed meeting and currently are within the range of trading for the entire month of July.

Perhaps the Fed will cut rates in 2023. They clearly could if inflation is dead. But there is no obvious pivot to different levels of cuts based on the Feds actions or statements last week. In fact, any careful reading of the press conference indicated that the Fed has a bunch more work to do and is planning on killing inflation

"So there's probably some additional tightening – significant additional tightening in the pipeline" Powell

Yeah, he's bad at press conferences and we get how this may sound wishy washy, but he got the ball to the endzone.

Then he spiked it.

"People wrote down 50 basis points higher than that for 2023. So that's even though that's now six weeks old, that's the most recent reading."

This statement was a good cop sort of statement. Prior to the press conference the weak economic data and commodity sell off, did not give Powell cover to push out the 2023 cuts. It would have taken a special sort of courage to do that then. But at the same time, he did state facts and reference the SEP for "forward guidance." They are going to kill inflation. He knows it's like the 70's and pays to go too far with tightening vs the last 35 years where easing too early never created a problem.

Story Arc

The story arc for the first part of "Will the sun rise over Jackson" happens in this chronological order

- QRA announcement supports asset prices – will she? No.
- Good cops – will come out of the woodwork saying "we haven't pivoted"
- Jobs date and CPI could provide political cover for the bad cop
- If data doesn't provide cover market pricing will further ease and that alone may be enough

Depending on the way the first part of this episode plays, either with obvious political cover by data, or further market moves, we believe Jackson Hole will be when Powell goes full Volcker and then follows up in September with actions and guidance consistent with his words.

Quarterly Refunding Announcement

Today we are going to get the release of the quarterly refunding announcement. This announcement will describe the amount of new issuance that the Treasury will make. On Wednesday the composition is released. In September, the size of the monthly FED balance sheet reduction will double to 60BN of UST and 35BN of MBS, so 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 Issuance - Base Case			
	Bills	Bonds	New Money
Q1	221	508	729
Q2	(433)	407	(26)
Q3	(153)	335	182
Q4 EST	(70)	270	200
Total	(435)	1,520	1,085

The important assumptions in our estimates are:

- The Federal deficit for the first 9 months of the fiscal year is $514BN while the CBO projected the annual deficit be roughly 1TN as recently as May. 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. The CBO agrees.

The federal budget deficit was $514 billion in the first nine months of fiscal year 2022 (that is, from October 2021 through June 2022), the Congressional Budget Office estimates. That amount is less than one-quarter of the $2.2 trillion shortfall recorded during the same period in 2021. Revenues were $779 billion (or 25 percent) higher and outlays were $945 billion (or 18 percent) lower than during the same period a year ago.

The deficit at this point last year was much larger because of spending in response to the coronavirus pandemic—mostly for the recovery rebates (also known as economic impact payments), unemployment compensation, pandemic relief through the Small Business Administration (SBA), and the Coronavirus Relief Fund—and because revenues were lower.

In its May report on the budget outlook, CBO projected a deficit of $1.0 trillion for 2022. Given the results through June, however, CBO expects that the deficit this year will be smaller than that.

- We assume that the TGA which is now down to 600BN 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. That said the reason for a large TGA is to protect the administration in the event of a debt ceiling stalemate like was experienced in Q4 2021. The current debt ceiling is 800BN above debt currently subject to the ceiling allowing the administration a great deal of room to draw down the TGA instead of tapping the market
- 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 reduced coupon issuance by 75-100BN per quarter. However, the money markets havebeen starved for new bills by a reduction of 433BN in Q2 and an additional reduction of 153BN in Q3 totaling 686BN of fewer since April 1st This bills desert generated a sharp increase in the RRP. In fact, not surprisingly the RRP now stands at a record 2.3BN up 633BN over the same time period. This is no coincidence. **Cut bills supply and RRP grows**

- 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 cutting existing bills and having that demand move to the RRP. 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. Which would keep bills outstanding flat and not exacerbate the problem. However, it would result in a very large reduction in coupon issuance

US Treasury Issuance - Bills Flat Case			
	Bills	Bonds	New Money
Q1	221	508	729
Q2	(433)	407	(26)
Q3	(153)	335	182
Q4 EST	-	200	200
Total	(365)	1,450	1,085

In other words, it seems clear to us that there will be falling coupon issuance during the remainder of 2022. Just looking at our conservative assumptions for 2022 the total coupon issuance above will be 1,520BN and over 72% of the coupon issuance has happened in the first 7 months of the year already.

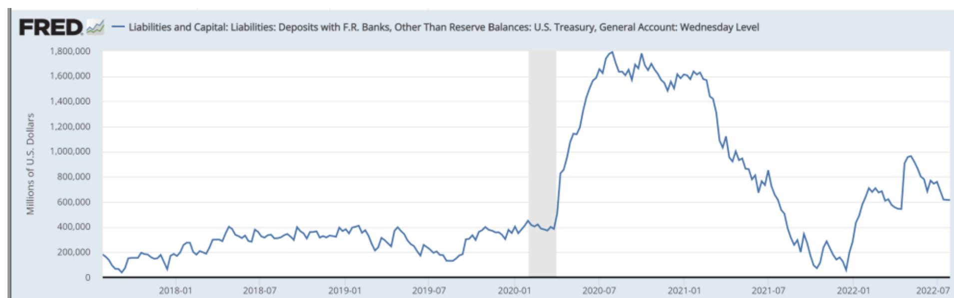
When we add up the balances of fed purchase vs treasury sales of coupon debt on a quarterly basis the net amount of bonds that the market needs to absorb will be very low through August supporting asset prices. **As QT ramps up in September and if Powell is courageous and announces mortgage outright sales the balance begins to shift and headwinds for asset prices gather.**

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) had been aggressively built in Q1, exploded higher in Q2, and is being drawn down in Q3, but rests well above historic levels.



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 600BN. In addition, the Debt ceiling is 800BN higher than current levels leaving the Administration plenty of room to issue if desired. **It is 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. Despite the real GDP contracting 0.9% in Q2 Nominal GDP is well north of 6%. As taxes receipts are tightly linked to NGDP, 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.

We are now projecting a fiscals year deficit estimate of about 800BN 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

The Chips bill will increase longer term spending, and the reconciliation gambit going on with Manchin may result in some end of year increase, but that impact will likely be in 2023. **Our assumption is that spending is fixed and has no net impact on issuance plans for Q4.**

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 686BN in Q2/Q3 the RRP has been climbing each and every report and now sits 633BN 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 65BN. 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 686BN reduction over the last two quarters. 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. **QT isn't going to be sterilized actively by Janet but will be sterilized none the less.**

Good cops will come out of the woodwork through Jackson Hole

Over the next two weeks Fed Governors will be all over the tape reiterating their commitment to fight inflation until its dead. Kaskari already spoke over the weekend. Brainard and Bullard are on the schedule already this week. It's going to be nonstop "We didn't pivot." Nonetheless without hot jobs, CPI, Michigan expectations or significant repricing toward more dovish expectations the market will largely ignore the rhetoric. The reason why markets have moved higher is flow not pivot.

Jobs date and CPI could provide political cover for the bad cop

Of course, if the data does in fact turn out to be hot Powell is set up perfectly for a Volcker moment at Jackson Hole

If data doesn't provide cover market pricing will further ease and that alone may be enough

We will monitor the priced in cuts and if that continues to move toward a clear pivot in 2023, we think that alone will be sufficient for Powell to bring down the hammer at Jackson. We will also add to our position in EDZ2EDZ3 if that pricing materializes.

Episode 2 Part 2 will be released ahead of the Jackson Hole speech and will evaluate the economic reports, the market pricing, and the opportunity for Powell to seize firmly the Volcker torch. If he does, we think that is in the long run much better for markets than the alternative, but we also believe Equities, Gold, Oil will suffer in the short term.

We will be unwinding our long equity position and going short over the next two weeks and potentially shorting gold and oil and buying the USD against JPY and EUR. Keep an eye out for DSR Portfolio Shift emails.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000						
	LTD P/L	$ 42,081,813						
	Total Return	42.08%		YTD Return			10.79%	
	Today's Date	8/1/2022		Portfolio Created			4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM		P/L	Open/Closed
6/28/2022	NDX August 12500/13500 Call Spread	175	114	$ 2,000,000	530	$	4,057,143	Open
7/26/2022	NDX August 13500 Call	18	114	Hedge	42	$	273,600	Closed
7/26/2022	SPX August 4000 Call	24	-320	Hedge	40	$	(512,000)	Open
6/28/2022	SPX August 4000 Call	62.5	320	$ 2,000,000	158	$	3,056,000	Open
7/7/2022	EDZ2EDZ3 50bp stop loss	-0.65	1000	$ 500,000	-0.75	$	(100,000)	Open
7/20/2022	TLT Short 113/116 Sept Put Spread	1.5	-6667	$ 1,000,000	0.9	$	400,000	Open
7/20/2022	TLT 120 Sept Call	1.5	6667	$ 1,000,000	2.5	$	666,667	Open
7/26/2022	TLT 125 Sept Call	1.4	-13333	Hedge	1.1	$	399,990	Open
			Inception Risk	6.5%			14.741%	