The Damped Spring Report

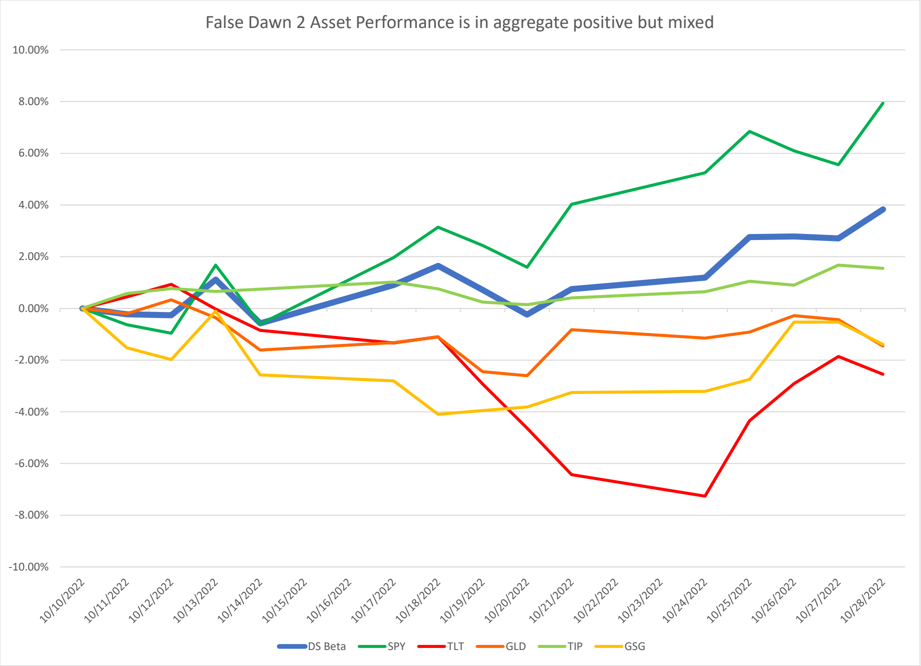
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

10/30/2022

The False Dawn 2 is coming to an end. It has been narrower than the false dawn of July. Equities have rallied 8.1% and real yields have fallen. Nominal bonds fell dramatically and recovered but remain down since the false dawn rally in equities began. Commodities and Gold are also down. Nonetheless assets portfolios have gotten bid up in aggregate as deleveraging flows flipped to releveraging and asset chasing. Our False Dawn thesis was built on:

- **Delevered positioning**
- **Cheap asset prices**
- **Overly hawkish sentiment for Fed path**
- **Extreme negative sentiment on earnings**
- **Ramp up of QT in September having an immediate impact**

All of those factors have shifted since we made this call. Asset prices particularly Equities have responded. Is False Dawn 2 over? We think not but it will depend entirely on the Quarterly Refunding announcement on 10/31 and TBAC recommended issuance schedule on 11/2.



Will False Dawn 2 end this week?

This question will depend primarily on the details of the Quarterly Refunding Announcement. Yes, you heard it here this data is more important than the Fed meeting. The False Dawn won't end:

- Due to the horrendous earnings and outlooks released last week by four of the five MAGMA Generals.
- Due to a 75bp hike at this weeks Fed meeting.
- When Powell remains as committed to fighting inflation as he was at Jackson Hole in this week's press conference
- When Treasury does not placate markets and announce a buyback program

It could end on Monday if the Treasury announces sizable budget deficit funding needs for Q4 2022 and/or increase borrowing for Q1 2023.

It will most certainly end the morning of the Fed Statement if increased borrowing is funded with increased Notes and Bond Issuance after many quarters of decreases.

Regardless it is nearing its end due to the peaking of releveraging flows which have brought equity valuations to above the top end of our range. But a catalyst may be necessary to flip sentiment.

All the other catalysts mentioned above are noise relative to the supply and demand of US treasuries. If our optimistic estimate for both quantity and composition of Treasury issuance is correct. The False Dawn 2 can continue despite the other negative headwinds. But False Dawn 2 will end. It's just a matter of timing. QRA can end The False Dawn 2 or extend it for a month or so. We will be reviewing this data real time and adjusting positioning accordingly as it is released.

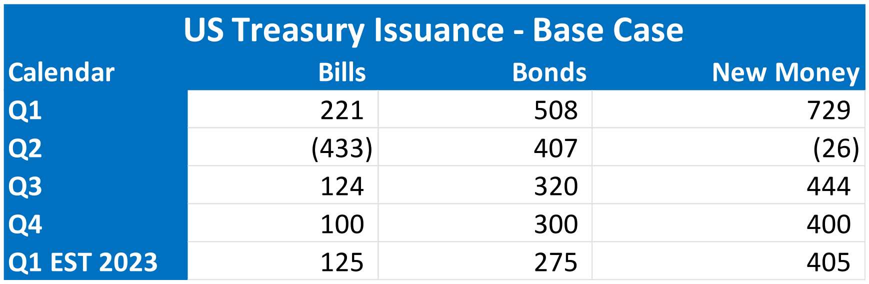
Our tactical outlook must be considered in the context of our high-level outlook for the economy and the financial asset markets. This outlook remains the same as it has been since last December and throughout the year

- QT is a major headwind for asset appreciation
- Demand side inflation will last longer than expected
- Demand side inflation has upside as governments spend on the 3D's of Deglobalization, Domestic Energy Build, Duplicate Supply Chain Creation
- Real Growth will be stronger than expected
- Due to strong growth and inflation pressures the Fed will need to be not only higher for longer but higherer for longerer
- Thus, US asset prices have limited upside.

Tactical Headline: We expect the amount of coupon debt sold by the Treasury during Q4 and Q1, will surprise to the downside supporting assets through November. But the Treasury has a lot of levers and estimating the QRA release is fraught with difficulty. We will hold our asset positions and shift rapidly if we are wrong on our estimates.

Quarterly Refunding Announcement and TBAC Statement

On October 31st we are going to get the release of the quarterly refunding announcement. This announcement will describe the amount of Treasury new issuance. On Fed Wednesday the TBAC recommended financing schedule will describe its composition. Given that in September the FOMC increased QT to $95BN per month it is critical to understand the supply of bonds given the drop in Fed Reinvestment. 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 less than current market expectations. Here is a rough estimate of what is expected by most market participants.



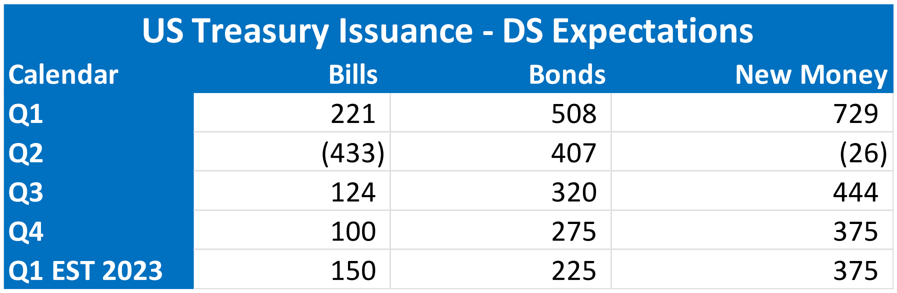
US Treasury Issuance - Base Case

Calendar	Bills	Bonds	New Money
Q1	221	508	729
Q2	(433)	407	(26)
Q3	124	320	444
Q4	100	300	400
Q1 EST 2023	125	275	405

The important assumptions for our own estimates assume are:

- The Federal deficit is projected to be roughly $903BN based on September's CBO estimate. We think there is some downside to this number, and we could imagine a number as little as $800BN which would reduce new money by a large factor
- We assume that the TGA which has peaked at $700BN and will remain at that level 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 slightly lower but stable TGA.
- We assume that the Treasury is concerned about issuing adequate coupon bond supply to meet demand of long-term bond investors but will as in the past four quarters reduce coupon issuance by $50BN per quarter.
- 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

Our estimate assumes Treasury balances the new money needs, TGA size, desire to continue to reduce coupon issuance, and add bills to avoid further starving the bills market, generating the following issuance.



US Treasury Issuance - DS Expectations

Calendar	Bills	Bonds	New Money
Q1	221	508	729
Q2	(433)	407	(26)
Q3	124	320	444
Q4	100	275	375
Q1 EST 2023	150	225	375

Composition of Issuance and Treasury Buyback Plan

The UK fiasco which exposed a technical weakness in the pension fund investment scheme and margin calls to LDI portfolios has increased the noise in markets about government bond market liquidity. While the UK situation was in our opinion a tempest in a teacup, the market continues to trade in a volatile fashion and market participants are looking for policymaker intervention. The Fed is going to keep pressure on assets with continued QT. The Fed would like asset prices lower. The UK gilt market broke for a few weeks for many idiosyncratic reasons and the BOE had to intervene. During a tightening cycle that sort of flip is undesirable. Ideally the Fed would engineer a soft landing for the economy AND a soft landing for the markets. It's quite tricky for them given their levers.

Since April we have been describing the levers that Janet Yellen can pull to dampen some of the undesired effects of QT and lower the likelihood of something breaking in markets. Today many market participants are looking for the Treasury to announce a Buyback program. The smoke that leads to this idea was visible in the TBAC minutes of August 2nd where the committee recommended staff research the implementation of such a buy back. In addition, the standard questionnaire sent to TBAC members both past and present in mid-October in preparation for the November 1st TBAC meeting included a question about Buybacks. This smoke has generated some expectations of an imminent buyback program. **We think that there is no need for a buyback plan as one of the most important benefits of a buyback plan can be achieved simply with a composition change of next quarters issuance.**

Is there a problem that needs to be addressed in the treasury market? Let's break that question down. Bonds are having their worst year in history. That's not a problem per se. The front end of the Treasury curve is by and large being impacted by the Fed path. Long duration treasuries are under pressure due to risk premium expansion and supply from:

- The Treasury itself to pay back the Fed for runoff
- The Banks and Levered Funds who have been frontrunning QT all year
- Foreign Holders engaging in reserve management and currency intervention

It's possible that a bear market in bonds needs intervention but that seems to be a bad reason. When looking more granularly to futures vs cash, swap spreads, repo, and, off the run on the run relative value positions it does not seem that there is meaningful systemic risk from those who arbitrage those relationships. Obviously, that can change but that's the principal problem that a buyback plan is designed to address. Treasury can take illiquid off the run govies out of the market and replace with on the run. We just don't think that it's necessary or has any meaningful political or economic benefit.

So we come back to the reason for a buyback program is to take duration out of the market. That can only be done by the US Treasury if the funding of the buyback comes from already saved cash (TGA), surplus revenue, or by funding with T-bills. The problem with funding a buyback with T-bills is it directly offsets the goals of the Fed to fight inflation through the wealth effect channel of QT. It's also a risk to the US Treasury as it is funding floating and has increased rate hike risk. But stepping back from the noise of the Buyback Program**. If the US Treasury wanted to reduce duration issued into the market, they already have that lever. The first move before a buyback funded with bills would be an issuance shift from coupons to bills. That tactic would precede any buyback plan funded with bills and evidence of such a move will be in the TBAC announcement on November 2nd. Again we aren't sure that is necessary or desired but know how to react if coupon issuance reduction and bills issuance increase occurs.**

One additional point on composition shift. The US Taxpayer currently has 2.1TN Tbills like notional on which to pay interest in the RRP. Yet the taxpayer gets no money to spend from the RRP. We think that the RRP should be tapped via significant bills issuance and related SLR reform. That issuance would not change the countries interest rate risk but would fund the budget and reduce treasury bond issuance. Janet Yellen holds this lever to offset the entire impact of QT. Will she? Well, she has been reducing coupon issuance all year. That has already offset some QT pressure. If the Fed wants asset prices to fall and yet not break anything Janet can lend a hand. The lever of issuance composition held by the Treasury and the levers that the Fed has are a powerful combination if used in a coordinated way. We will see how they work together. This week will be a tell. Don't miss it.

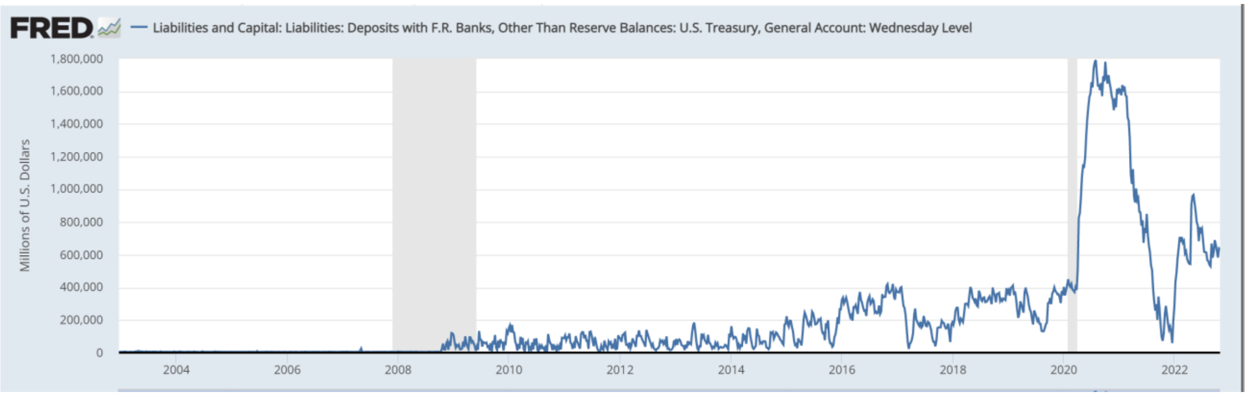
Digging into the various factors impacting Treasury Issuance

Total new money needs

Total new money is impacted by three factors

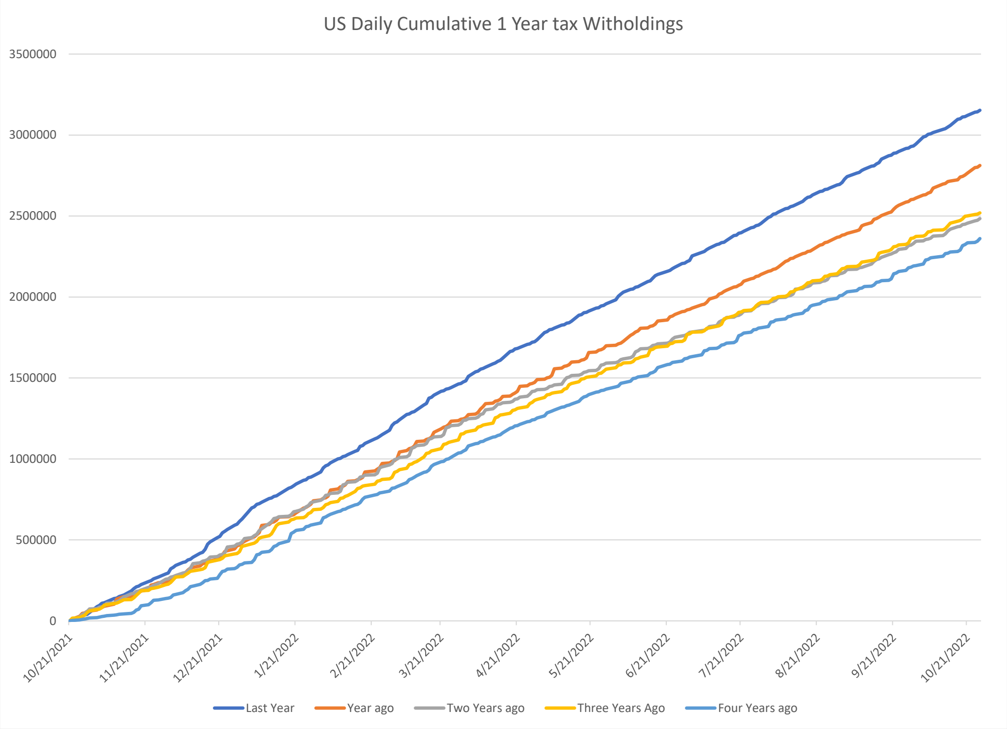
- Desired TGA Balance
- Tax Receipts
- Spending

The TGA balance has now stabilized at around 650BN. It remains quite large vs pre covid levels. We think that the level has room to fall but will be carefully managed as it is insurance for Debt Ceiling Politics

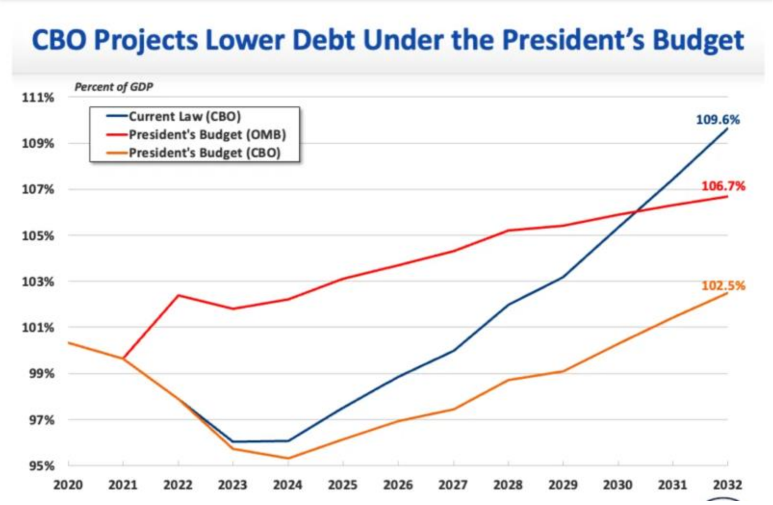


Tax Receipts

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. Specifically, revenue is 341BN above this time a year ago. We see this as being a significant tailwind for assets due to reducing the pressure for issuance.



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. The Red line seems like an error based on the CBO's notes and is not their projections



We are using a slightly more aggressive deficit than the CBO consistent with higher wage inflation for longer and accounting for higher interest costs, COLA, and Inflation link bond maturity top offs of about 800BN for 2023 but if these tax receipts simply grow at the historic slope in the chart above the US Government deficit would fall below our estimate and issuance would fall as well

Spending

We expect gridlock after 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 with the current political alignment and even more so if the Dem's lose both or one of the legislative chambers in 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

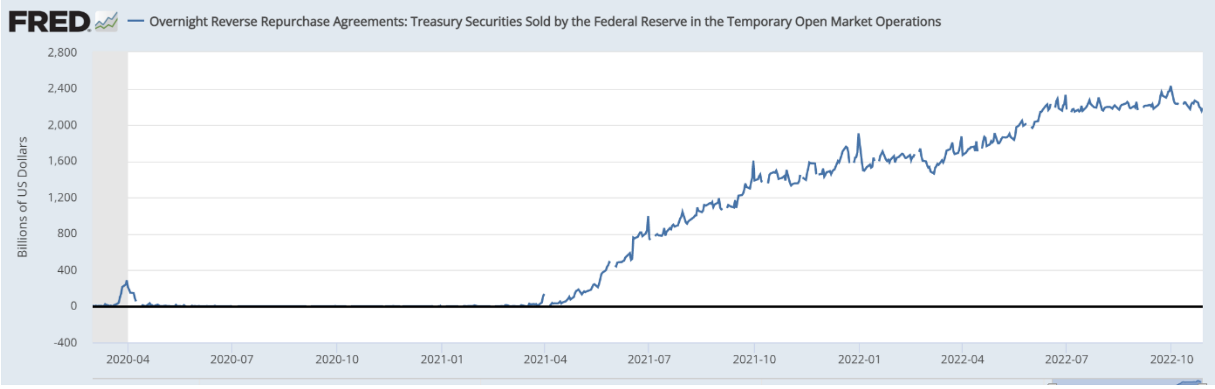
- Inflation fighting is a clear political issue for the Biden Administration. US Treasury can overweight coupons vs bills in order to place pressure on all asset markets via the risk premium expansion channel which would affect wealth and curb consumption amongst asset holders

- 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.
- If Treasury wants to further support markets and offset the inflation fighting impact of QT they can also Buy Back long term treasuries and issue bills.

We think that Janet Yellen has the levers we have described, knows their powers and can essentially affect asset prices through her choices. Based on the QRA outcome we will see how much she intends to pull.

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 increased the RRP money looks pretty much stuck. But it does represent untapped demand for bills if anything goes haywire with the economy.

FOMC Meeting

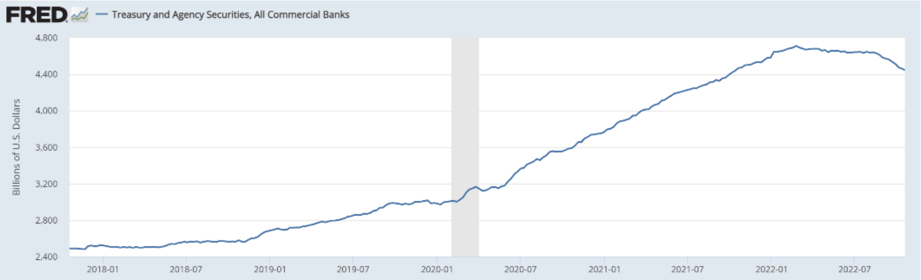
Our expectations for the FOMC are a 75bp Hike and a press conference that reitereates the September SEP and the strong desire to kill inflation.

"Who is going to buy?"

This question is still relevant. Let's look at important holders of bonds. Many have been selling aggressively all year

Banks

Banks remain long a ton of treasury bonds but have also sold over $260BN this year. As you know banks also use interest rate swaps to shift their duration. Based on financial reports JPM is short 20MN Dvo1. Assets have come down and banks have hedged. They are short. Will they buy? They are certainly in better shape to do so.



Sovereign reserve managers

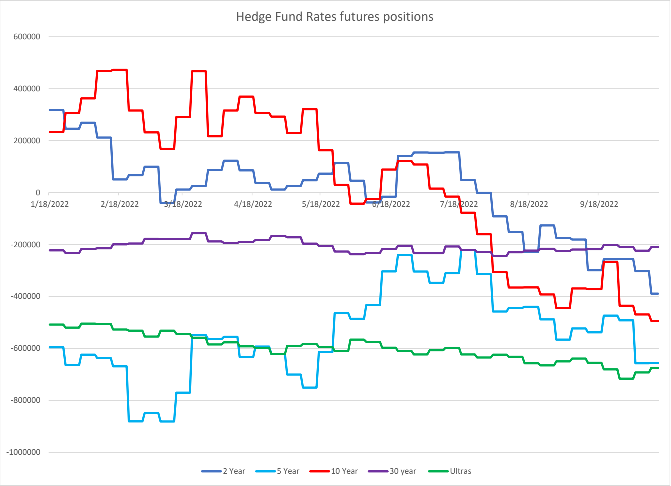
Over the course of 2022 Foreign Reserve managers have sold 250BN of US Bonds. Any weakness in the USD like we have seen lately will reduce this sort of selling for currency intervention purpose

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

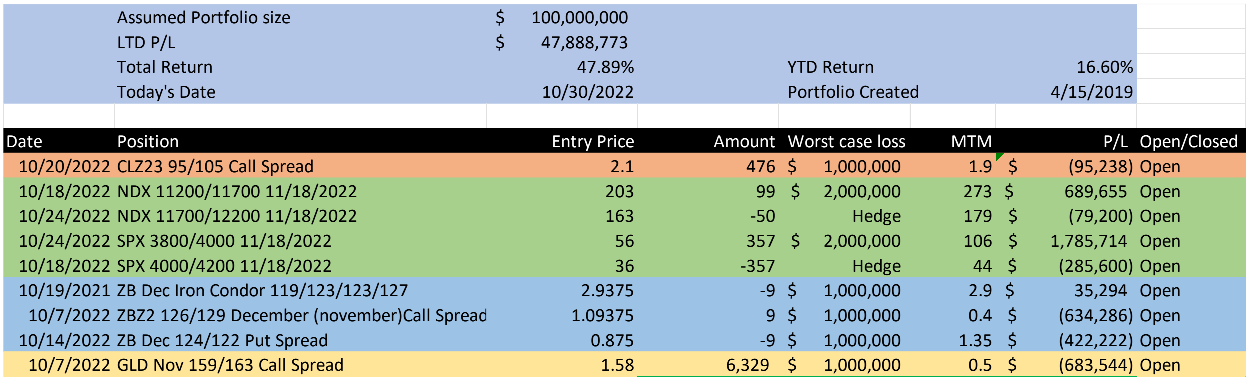
Positioning is extremely short. They are short every point on the curve and have sold 100BN in 10 year note futures alone



Synthesis

Based on the quantity and composition of the Treasury Issuance announced over the next three days the False Dawn 2 will either, extend over the next month as releveraging, return chasing, and supply reduction drive asset prices higher, or end with above expectation issuance and duration supply. We predict the former and are positioned long assets. However, we will be looking to scale out of our longs and enter shorts more consistent with our medium-term outlook. That outlook is bearish assets as QT headwinds and higherer for longerer inflation and Fed policy rates limit upside and threaten meaningful downside. For us, all this pivots on the days to come and look out for real time analysis and rapid positioning shifts here at Damped Spring.

Current Portfolio and Performance



Assumed Portfolio size	$ 100,000,000				
LTD P/L	$ 47,888,773				
Total Return	47.89%		YTD Return		16.60%
Today's Date	10/30/2022		Portfolio Created		4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	1.9	$ (95,238)	Open
10/18/2022	NDX 11200/11700 11/18/2022	203	99	$ 2,000,000	273	$ 689,655	Open
10/24/2022	NDX 11700/12200 11/18/2022	163	-50	Hedge	179	$ (79,200)	Open
10/24/2022	SPX 3800/4000 11/18/2022	56	357	$ 2,000,000	106	$ 1,785,714	Open
10/18/2022	SPX 4000/4200 11/18/2022	36	-357	Hedge	44	$ (285,600)	Open
10/19/2021	ZB Dec Iron Condor 119/123/123/127	2.9375	-9	$ 1,000,000	2.9	$ 35,294	Open
10/7/2022	ZBZ2 126/129 December (november)Call Spread	1.09375	9	$ 1,000,000	0.4	$ (634,286)	Open
10/14/2022	ZB Dec 124/122 Put Spread	0.875	-9	$ 1,000,000	1.35	$ (422,222)	Open
10/7/2022	GLD Nov 159/163 Call Spread	1.58	6,329	$ 1,000,000	0.5	$ (683,544)	Open