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# The Damped Spring Report

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

1/29/2023

**Any of the followers of the Damped Spring Report know that since April 2020 we have been tracking the massive flows of fiscal issuance, fiscal spending, and Federal Reserve asset purchases and runoff. We believe these flows have been the dominant driver of all asset classes. In addition, the MMT of fiscal stimulus financed by monetary money printing has been the principal demand driver impacting both growth and inflation.**

**Over the next week the markets are likely to get a rude surprise when**

- **The Fed hikes 25 and guides higherer for longerer**
- **The Quarterly Refunding Announcement shows the Treasuries issuance schedule in the context of the debt ceiling will maintain 200BN or more of duration sales in Q2**
- **Chairman Powell expands on Governor Waller's recently mentioned theory of pairing of Reserves and RRP as the "New Reserves" which will once again remind markets that quantitative tightening will last many years.**
- **Perhaps in the press conference, but more likely in the minutes in three weeks, some comment on QT continuing, regardless of rate cut timing.**

Implications

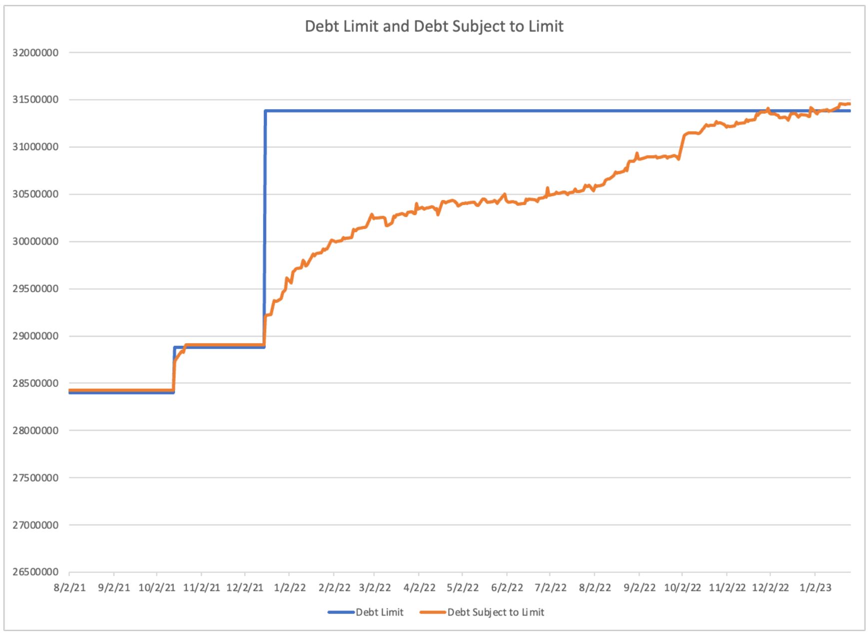
The Fed hike and the messaging has been completely ignored by both the short-term interest rate market and the equity market. It is hard to believe that Chairman Powell could do a better job as a hawk than he did in Jackson Hole. We think he will try. Will he succeed? Probably not. Could the FOMC hike 50? We think they should but doubt they will. But we also believe that the other items on our list above are far more important than the hike or message. In this DSR we will go into detail on our thoughts on:

- The Debt Ceiling and how it will impact issuance.
- Our expectations for the QRA announcement
- The Waller theory of RRP and Reserves and steps that will likely be taken to ensure bank stability and adequate reserves to allow QT to continue for many years
- The rationale of continuing QT while cutting rates.

## The Debt Ceiling

The debt ceiling has begun to dominate the political news.  Influential macro research providers and the mainstream sell side research firms have even posited that the debt ceiling will in the near term prevent the US Treasury from issuing duration.  We strongly disagree.  We have researched this issue extensively and triangulated with highly informed parties.  The simple synthesis is that coupon bond issuance will continue until and after the debt ceiling negotiation reaches its ultimate resolution.  The mechanism of QT depends on the US Treasury issuing duration to fund the Fed Runoff.  It will remain a strong headwind on asset prices.

Here's how things work.




Currently the Federal Government is at the Debt Ceiling. That means the Government cannot issue any additional debt besides issuance that pays off maturing debt. It does not mean that the Treasury can't pay its bills.  They have a checking account called the Treasury General Account.  The TGA accumulates all issuance proceeds and tax receipts and pays all government expenditures including its normal spending plus any maturities of existing debt.

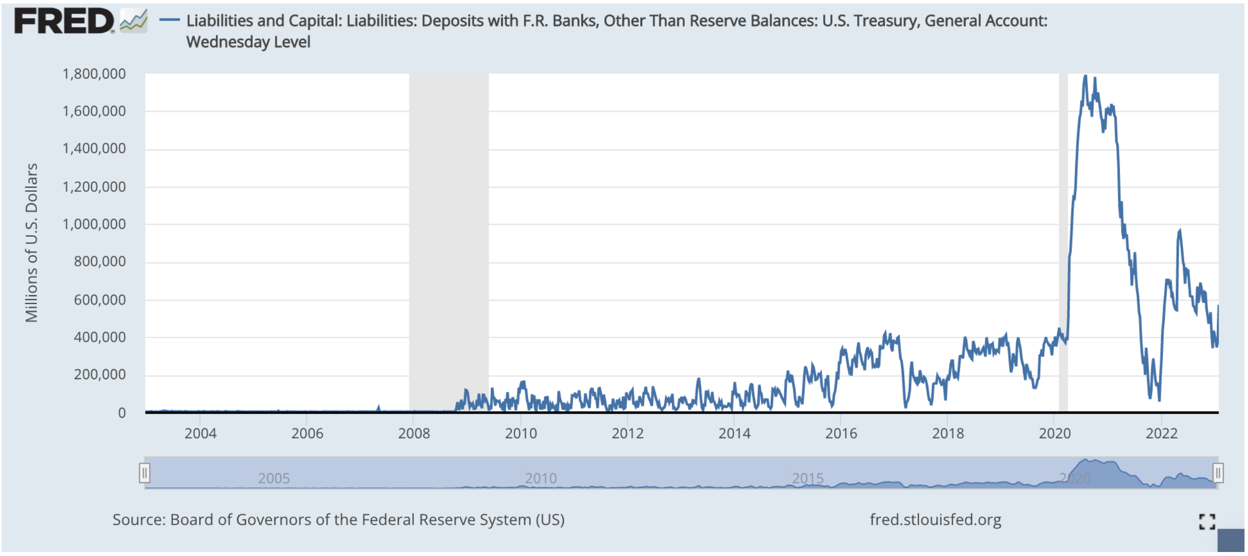
The US Government continues to run a fiscal deficit. That means that the tax receipts are less than the government expenditures. Which means all else being equal they must issue more debt to fund the deficit. But as shown above they cannot issue new debt.

Two things delay the inevitable crisis from occurring.

- The TGA balance
- Extraordinary measures

## The TGA Balance

The TGA Balance is currently 572BN that allows the Federal government to fund its deficit for about 5 months. There is some noise around the timing of tax receipts and real economy expenditures but over the next 5 months that is not particularly important




Notice the big spike last week. During the week the Treasury auctioned a bunch of coupons and bills and that boosted the checking account balance. The issuance given the debt limit required the Treasury to invoke extraordinary measures

## Extraordinary Measures

The Treasury has been authorized by Congress to take "Extraordinary Measures"

**DEPARTMENT OF THE TREASURY**
**WASHINGTON, D.C.**

**Description of the Extraordinary Measures**

**January 19, 2023**

Secretaries of the Treasury in both Republican and Democratic administrations have exercised their authority to take certain extraordinary measures in order to prevent the United States from defaulting on its obligations as Congress deliberated on increasing the debt limit.

The extraordinary measures currently being considered are: (1) redeeming existing, and suspending new, investments of the Civil Service Retirement and Disability Fund and the Postal Service Retiree Health Benefits Fund; (2) suspending reinvestment of the Government Securities Investment Fund; (3) suspending reinvestment of the Exchange Stabilization Fund; and (4) suspending sales of State and Local Government Series Treasury securities. These measures will continue to be evaluated on an ongoing basis.

The biggest by far is (2) the so-called G-Fund reinvestment. That single measure essentially causes one of the government obligations that falls within the Debt

Subject to Limit to disappear temporarily. The money is still owed. It's a complete smoke and mirrors game but suddenly the Debt Subject to Limit can drop by $294BN with this measure alone. In total $346BN of these measures can provide headroom for further debt issuance. The measures are not used all at once. For political reasons it behooves the Administration to continue to have the debt subject to limit right up against the cap. So, these measures are used as needed. For instance, some of the measures have already been used to allow issuance that funded the recent spike in the TGA. In addition, the actual flows of tax receipts and to a lesser extent expenditure needs are hard to estimate. Janet Yellen has stated that the government would exhaust the TGA and any issuance funding available from headroom created by use of extraordinary measures by the early part of June. Let's assume she padded that number. Our estimate is certainly the debt ceiling will need to be lifted by the end of July or the new money issuance calendar will need to be adjusted. But not today. In fact, even if the issuance calendar no longer can raise new money that does not mean that the issuance of duration would necessarily have to stop. Composition matters. At the debt limit the Treasury cannot fund a deficit. But it can roll its existing debt. Almost every day the government has a debt maturity. They can issue new debt at exactly that size. That means that if they want to issue duration to fund the maturities that is their prerogative. Alternatively, they can issue bills. Just no new net debt.

### Quarterly Refunding Announcement

On January 30th the first part of the quarterly refunding announcement will be released. It will look like this

October 31, 2022

Sources and Uses Table

**WASHINGTON** -- The U.S. Department of the Treasury today announced its current estimates of privately-held net marketable borrowing[1] for the October – December 2022 and January – March 2023 quarters.[2]

- During the October – December 2022 quarter, Treasury expects to borrow $550 billion in privately-held net marketable debt, assuming an end-of-December cash balance of $700 billion.[3] The borrowing estimate is $150 billion higher than announced in August 2022, primarily due to changes to projections of fiscal activity, greater than projected discount on marketable securities, and lower non-marketable financing.

- During the January – March 2023 quarter, Treasury expects to borrow $578 billion in privately-held net marketable debt, assuming an end-of-March cash balance of $500 billion.[3]

The Jan–March quarter will be adjusted in the first bullet, and we will see the TGA balance for March will almost certainly be lower. In addition, in the second bullet we will see the plan for issuance in Q2. In past debt ceiling negotiations, the

Treasury announced its plans with complete disregard to the debt ceiling. We expect the QRA this time to stick with that pattern. But will pay attention to the details.

During the following day the Treasury will meet with the Treasury Borrowing Advisory Committee (TBAC). This group is composed of both primary dealers and buy side investors. They will discuss the funding needs and the needs of the market across the yield curve for duration and come up with a recommended issuance calendar including sizes and tenors. The issuance philosophy of the Treasury is well established.

> The Treasury Department's primary goal in debt management policy is to finance the government at the lowest cost over time. To meet this objective we issue debt in a regular and predictable manner, provide transparency in our decision-making, and seek continuous improvements in the auction process. In creating and executing our financing plans, we must contend with various uncertainties and potential challenges, such as unexpected changes in our borrowing needs, changes in the demand for our securities, and anything that inhibits efficient and timely sales of our securities. To manage these risks, we closely monitor economic conditions, fiscal policy, and market activity, and, where appropriate, respond with appropriate changes in debt issuance based on our analysis and consultation with market participants.

We study the regular and predictable manner, in fact our opinion on such is sought by the US Treasury as part of their financial community outreach process that adds richness to the TBAC meetings. Over the past 18 months due to high nominal growth the US has needed to issue less new money. In order to provide regular and predictable long term debt issuance in late 2021 and most of 2022 the Treasury has modestly reduced duration issuance. Due to the lack of need for debt financing which fell quicker than the desired reduction in duration issuance of bills had dropped radically. This has sent more money to the RRP seeking government backed money market alternatives. However, all of this has shifted in the past 6 months. As nominal growth falls with CPI the tax receipts funding the government have fallen. This has led to much higher issuance. The Treasury can no longer reduce coupon sales and has had to ramp up bills issuance to plug the increasing deficit. Our view for the Quarterly Refunding Announcement is that on Monday at 3:00PM is that new money issuance will remain at 577BN for Q1 as planned and at least 375BN of new money issuance for Q2. This assumes that the Treasury ignores the debt ceiling in this report as has been their habit. On Wednesday at 8:30 they will announce the composition of this issuance. We expect that anything above 200BN of issuance of duration will be a surprise to markets. Our estimate is stable issuance from prior quarters after a significant reduction from two years ago.

**US Treasury Issuance - DS Expectations**
**No adjustment for Debt Ceiling**

| Calendar | Bills | Bonds | New Money |
|---|---|---|---|
| Q1 2022 | 221 | 508 | 729 |
| Q2 | (433) | 407 | (26) |
| Q3 | 124 | 320 | 444 |
| Q4 | 100 | 300 | 400 |
| Q1 2023 | 300 | 277 | 577 |
| Q2 Est | 100 | 275 | 375 |

In the unlikely event that the Treasury adjusts issuance based on the expectations of a drawn-out fight past Q2 for Debt Ceiling resolution the duration issuance is unlikely to fall and instead bills will be allowed to roll off. This would further reduce bills available to money markets and increase flight to RRP.

| US Treasury Issuance - DS Expectations Adjusted for Debt Ceiling | | | |
|---|---|---|---|
| Calendar | Bills | Bonds | New Money |
| Q1 2022 | 221 | 508 | 729 |
| Q2 | (433) | 407 | (26) |
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| Q1 2023 | 300 | 277 | 577 |
| Q2 Est | (100) | 275 | 175 |

So how does this all interact with the debt ceiling and QT. The Treasury will prioritize coupon issuance. Because duration will be sold to the market in large quantities the QT effect will remain a strong headwind to asset prices. Mechanically:

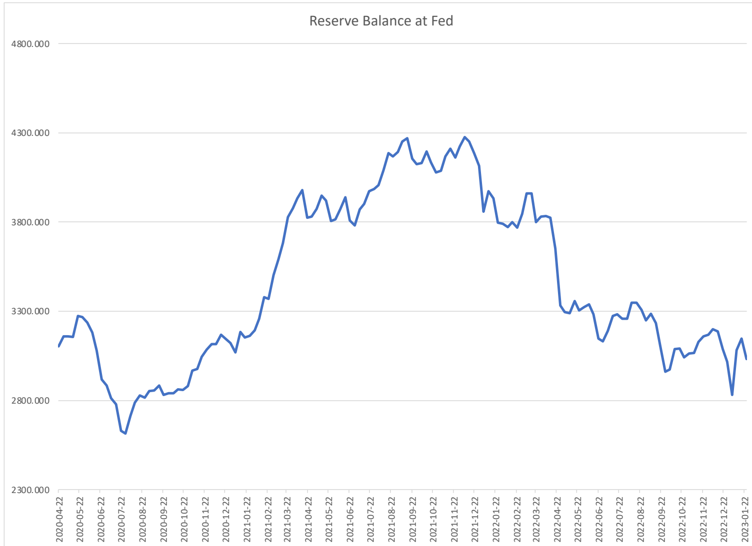
- The Fed runoff is happening at 60BN per month which reduces debt subject to limit and allows the Treasury room to issue duration.
- The Treasury can cancel bills issuance plans without much market disruption in order to provide headroom for duration issuance
- The Treasury can pay down maturing bills and issue duration to fund without impacting debt ceiling.

We have stated many times that Janet (not Jay) holds the lever to manage the impact of the QT by choosing the composition of the issuance used to pay back the Fed. Bills sterilize QT, Duration allows it to work. But at this point we see no political objective to stimulate the economy, nor do we see and room to reduce duration further given the Treasuries stated policies. The duration will come regardless of the Debt Ceiling. At least until Janet steps down or 2024 primary season steps up. Asset headwind from QT will remain strong and surprise casual observers. Don't miss this. If we see a significant shift, we will absolutely shift our positioning but that is not likely.

## Waller Reserve Theory

> "We'll start slowing as we approach maybe reserves being 10% to 11% of GDP," Waller said at a Council of Foreign Relations event in New York. "And then we'll kind of feel our way around to see where we should stop."

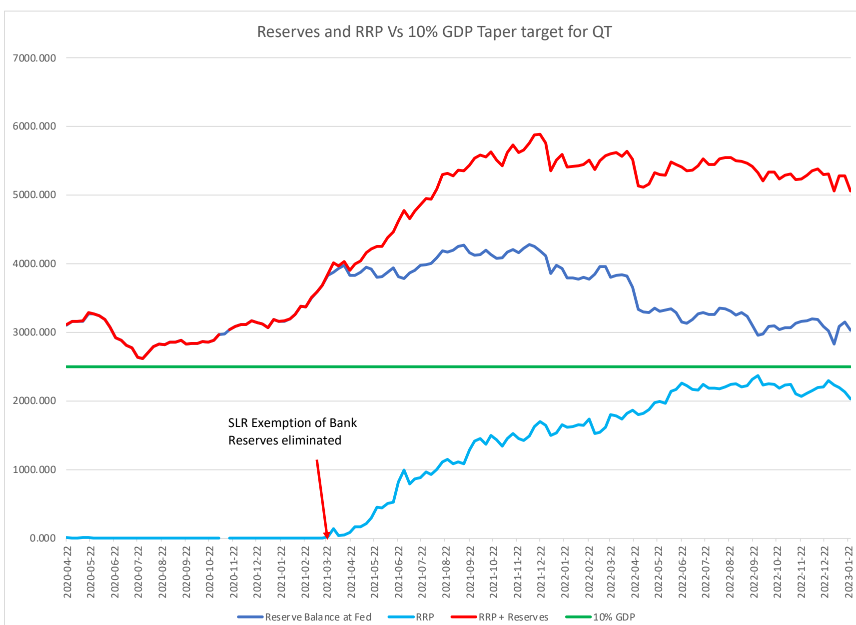
With this one statement Governor Waller plotted a path for the end of QT. QT would likely be tapered (less runoff) when Reserves reached $2.5TN. That's a big deal if that's all you read, as current reserves are 3TN and that means QT Taper in 9 Months.




But then Governor Waller placed his words in context and revealed at least his own thoughts about what constitutes reserves in this new world.

> "We have the standing reverse repo facility and everyday firms are handing us over $2 trillion in liquidity they don't need. They give us reserves, we give them securities. They don't need the cash," Waller said. "It sounds like you should be able to take $2 trillion out and nobody will miss it, because they're already trying to give it back and get rid of it."

RRP Grew for two reasons. One regulatory, SLR exemption was lifted the day RRP started growing, and one a small yield advantage, which the Fed controls. Both can be changed with the stroke of a pen. RRP is Reserves




If the Waller theory is correct, which we strongly believe it is, and is consistent with the views of the Chairman and the rest of the FOMC, which logic would dictate, then QT has not 9 months to run but 3 years. Big difference and we would like to hear more about this in the statement, presser, or minutes.

### QT during rate cuts

As we find out more information regarding the future of QT and the Treasury's ability to dampen or heighten its impact the obvious question comes up. If a cutting cycle begins what does that mean for QT. Let's look back at some milestones. QE was not a desired lever for the Fed to pull. It was the only lever they had. The mechanism operates via pushing investors into riskier assets until they finally consume instead of investing. That elevates asset prices far more than goods and services prices. Over the QE era the first 10 years was dominated by asset inflation and below target CPI. Each quarter, during that time, the various Fed Chairman would sit before Congress and say that the Fed is doing its part to recover from the GFC, but Congress needed to do its part as well to get a robust recovery. Since April of 2020, The Government certainly did its part. They pumped $6TN into the economy. That is helicopter money that continues to exist in the economy as shown by the $5TN Waller Reserves. It is a tinder box which can be unleashed on real investment, consumption, or assets. QT keeps that tinder box from bursting into flames.

In 2021 The Fed began slowing QE by tapering asset purchases. The pace of that tapering and their stated philosophy that ongoing QE and Rate hikes served cross purposes, resulted in a long delay to April of 2022 before the first rate hike. The Fed even accelerated QE taper in Q4 2021 to speed up the timing for rate hikes. But still they were clearly too late.

It makes sense at the high level that policy of both QE/QT and Cuts/Hikes should be aligned. Why act in cross purposes? There are two reasons that we think are worth considering

- Practically - large shifts in QE and QT are disruptive and result in unpredictable outcomes. Reducing QE took time in 2021/2022. Time that the economy didn't have.
- Fundamentally
    - QE/QT acts on asset prices primarily and in the real economy very weakly through the wealth effect.
    - Rate Cuts/Hikes act on the real economy as they affect the return on cash and the cost of debt much more directly.

We believe that QT reducing Reserves + RRP is a necessity regardless of what is happening in the real economy and while in a very weak way is at cross purposes in the event rate cuts are necessary, we believe it should be continued well past when any future rate cuts begin. Let's see if any hints of such an idea made by Governor Waller morph into Fed guidance.

## Current Portfolio and Performance

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| | Assumed Portfolio size | $ 100,000,000 | | | | | |
| | LTD P/L | $ 42,108,013 | | | | | |
| | Total Return | 42.11% | | YTD Return | | -3.19% | |
| | Today's Date | 1/29/2023 | | Portfolio Created | | 4/15/2019 | |

| Date | Position | Entry Price | Amount | Worst case los | MTM | P/L | Open/Close |
|---|---|---|---|---|---|---|---|
| 10/20/2022 | CLZ23 95/105 Call Spread | 2.1 | 476 | $ 1,000,000 | 2.5 | $ 190,476 | Open |
| 12/23/2022 | SPY 360/325 Dec 2023 Put Spread (GC) | 10 | 250 | $ 250,000 | 6 | $ (100,000) | Open |
| 1/10/2023 | SPX 3750/3550 March Put Spread (GC) | 43 | 116 | $ 500,000 | 20 | $ (267,442) | Open |
| 1/26/2023 | SPX 3900/3500 March Put Spread | 36 | 139 | $ 500,000 | 36 | $ - | Open |
| 1/4/2023 | FXI ETF | 30.28 | 115,000 | $ 500,000 | 33.29 | $ 346,150 | Open |
| 12/23/2022 | TLT 100/90 Dec 2023 Put Spread (GC) | 3.33 | -375 | $ 250,000 | 2 | $ 49,850 | Open |
| 1/5/2023 | Long SFRM3 Short SFRZ4 (H4L) | -1.7 | 909 | $ 500,000 | -1.91 | $ (190,909) | Open |
| 1/26/2027 | Short SFM4 Unwind of spread | 95.11 | -1808 | $ - | 95.11 | $ - | Open |
| 1/12/2023 | Long SFRM3 Short SFRZ4 (H4L) | -2 | 909 | $ 500,000 | -1.91 | $ 81,818 | Open |
| 1/13/2023 | GLD Feb 17 2023 178/181 Call Spread | 1.3 | -1471 | $ 250,000 | 1.55 | $ (36,765) | Open |
| 12/1/2022 | DS Beta Short Component SPY | 407.38 | -30680 | $ 2,500,000 | 403.781 | $ 110,417 | Open |
| 12/1/2022 | DS Beta Short Component TLT | 105.76 | -141831 | | 106.955 | $ (169,488) | Open |
| 12/1/2022 | DS Beta Short Component TIP | 109.37 | -114290 | | 109.4 | $ (3,429) | Open |
| 12/1/2022 | DS Beta Short Component GLD | 167.84 | -29790 | | 179.435 | $ (345,415) | Open |
| 12/1/2022 | DS Beta Short Component GSG | 21.47 | -232880 | | 21.48 | $ (2,329) | Open |
| | | | | Risk | | 6.413% | |