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The Damped Spring Report

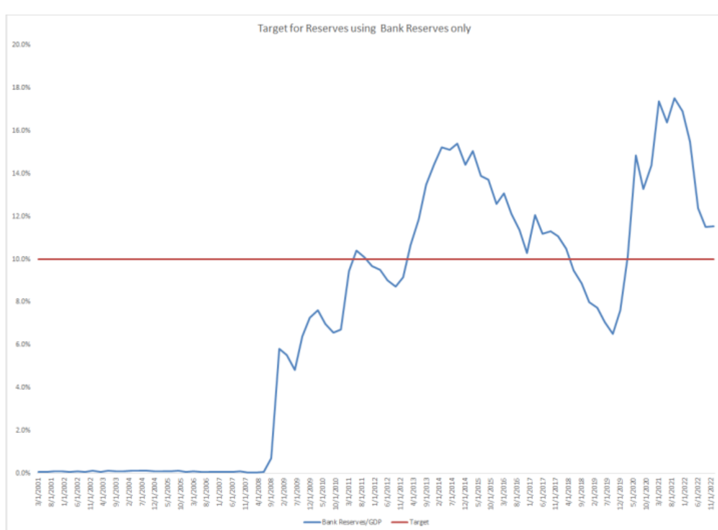
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

2/22/2023

At 2:00 PM today the Fed minutes for the recent FOMC meeting will be released. While market participants will look for information regarding the Fed rate hike path, we will be focused on only one thing. Will the balance sheet be discussed at all? We would be delighted but extremely surprised if there is any new discussion of quantitative tightening. However, the Fed must soon address the balance sheet. QT could and should be increased and outright mortgage sales must be implemented. We hear the drumbeats of more powerful QT faintly off in the distance. We expect them to become obvious to the Fed and the markets within the next few Fed meetings. The consequences for asset prices are meaningful. Almost certainly today's minutes will be boring, but more QT is inevitable as are outright sales of not only mortgages but eventually UST.

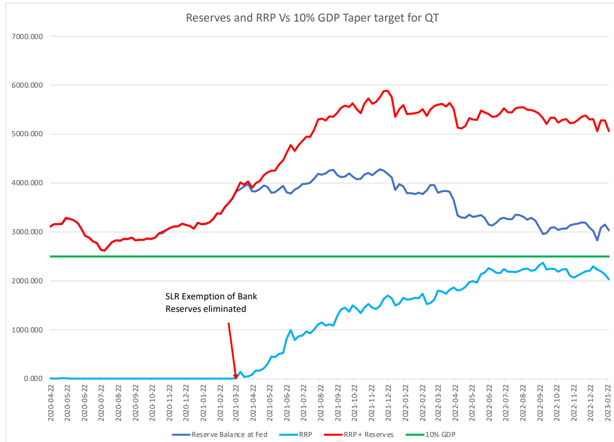
Why is faster QT important?

In January Governor Waller described the "New Reserves" framework. He rightly stated that withdrawing the reserves in the system toward a level of 10% of GDP before tapering QT made sense. Since the financial crisis reserves have been quite a bit higher than in prior history. It should be noted that since QT started, reserves have indeed fallen toward target. One might assume QT could end soon.

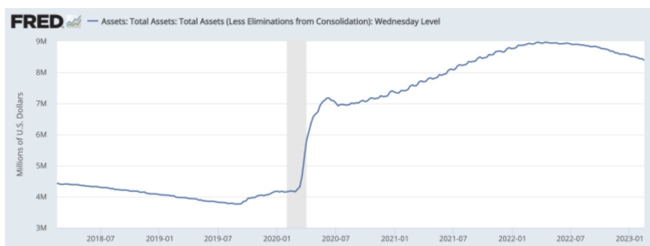


But as Waller stated "reserves" are no longer bank reserves but reserves + RRP.

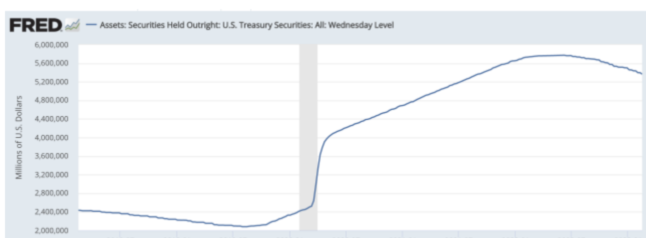
Waller and Powel have both confirmed a long-drawn-out QT to get to target. Using the "new reserves" number 30 months of QT at current pace will be necessary.



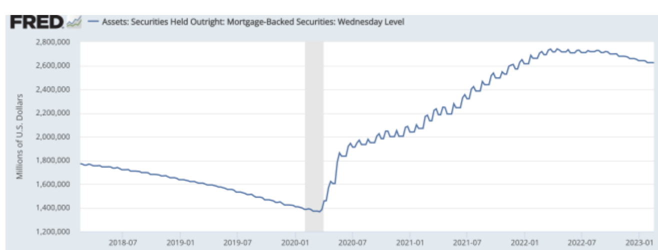
Reviewing what has happened to the Fed's balance sheet so far. Modest progress has been made. The Fed's balance sheet has fallen by 560BN from peak.



Just under the surface, the US Treasury runoff has been precisely in line with plan. Treasury bonds and bills on the Fed balance sheet have fallen in aggregate 405BN.



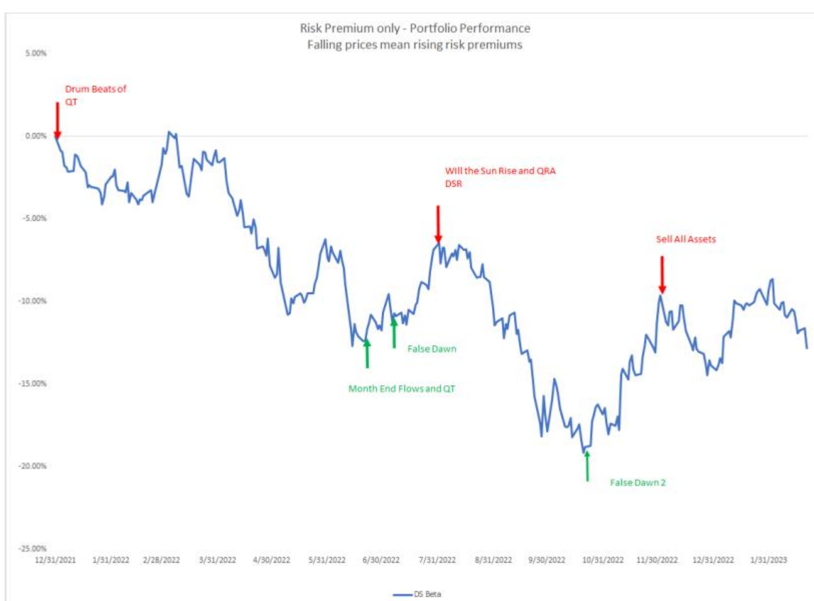
Unfortunately, mortgage bonds have not run off at a pace even close to the cap set last Spring. In aggregate since the beginning of QT mortgage runoff was capped at 17.5BN and then the cap rose to 35 BN in September. If Mortgage runoff had been hitting the cap each month, then 262BN of Mortgages would have runoff. Instead, the runoff has been much slower. In total mortgage holdings have fallen 116BN.



We will return to Mortgages in the appendix but suffice it to say **we strongly believe that Fed outright sales of mortgages is inevitable and will likely be announced in the next three fed meetings.**

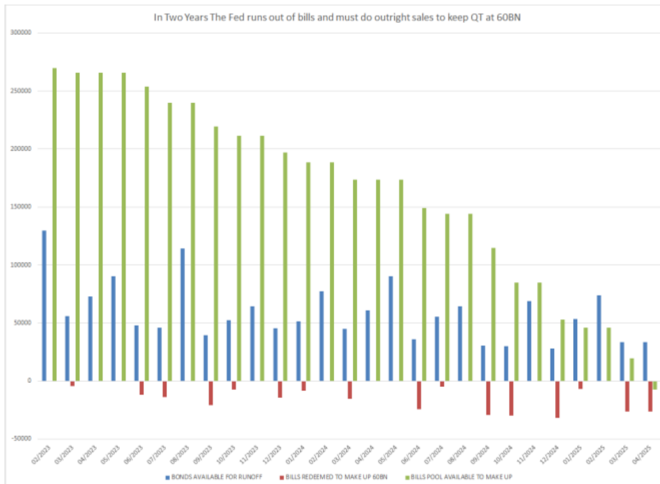
From a policy point of view, we believe that getting to target is both necessary and must be done more quickly because the combination of RRP + Reserves represents liquid savings in the economy and are a tinder box for igniting consumption, real economy investment, and financial asset investment. In order to truly kill inflation both raising the opportunity cost of holding cash through rate hikes AND withdrawing liquidity is necessary.

The impact of the announcement of QT and its expected path has now likely been fully discounted. The Headwind of the actual flows will still have a modest impact on asset prices assuming no change in the speed, duration or composition. Since we predicted the impact of QT In December of 2022, asset performance has been poor. However, after frontrunning the entire first half of the year took assets lower we currently are priced right where assets were priced 8 months ago. Even the actual QT flows have had mixed impact. This of course is because QT flows are only part of the drivers of risk premium. Given the level of assets and the limited impact of the QT over the past eight months it seems clear to us that more QT is possible, and the market is adequately healthy to be able to absorb more assets. By increasing the size of QT by say 50% the Fed can reach its goal of RRP+Reserves at 10% of GDP a year sooner. They will have a balance sheet that is more flexible to handle the next crisis and will also "surprise" the market reducing asset prices and through the weak wealth effect impact demand. The QT headwinds today are largely ignored. A stronger wind is necessary and not likely to cause a financial sector accident. **We think this inevitable, and the Fed will announce a more aggressive QT program in one of the next three meetings.**



Outright US Treasury sales

Yep, you read this right. The Fed will begin making outright treasury sales even if they keep QT at the current size. It is two years off, but it is simple math that it will be required to get the balance sheet to target. If they want to increase QT, they will have to make outright sales sooner but one way or another in order to reach target outright sales of UST will be necessary. The Fed will need to get ahead of this fact eventually. We think they will sooner than later.



In the chart above the Blue bars represent the Treasury bonds maturing each month. The Green bars represent the pool of Tbills the Fed owns. Whenever the Blue bar is above the 60BN target the Fed lets 60BN runoff and reinvests the proceeds above 60BN in new treasury bonds. In months when the Blue bar is below 60BN the Fed allows some of its pool of Tbills to mature to make up the difference. The Red bars represent the Tbill runoff. In two years the Tbill assets of the Fed will be zero. At that point to maintain target of 60BN in months when the blue bar is below 60BN they will have to sell UST in the open market.

Open market sales of UST and/or Mortgages are coming before the Fed reaches its target. They have 2.6TN to go and have no hope of achieving their 95BN target today without outright mortgage sales. Even if they do, they will take close to 30 months to achieve their goal. After 24 months outright sales of UST will be certain.

In synthesis, the current level of RRP+ Reserves represents a major risk to escalation of real economy and asset inflation and must be withdrawn rapidly. The Fed has spent a year observing the impact of the QT announcement and implementation on asset prices and should be comfortable expanding the program given the strength of asset markets. Financial stability and the economy are strong, and it behooves the Fed to reduce its balance sheet while times are good. We think they will make a logical and thoughtful evaluation and come to this conclusion in the next few months. Listen to the Drumbeats in today's minutes. You may not hear them today, but they are inevitable.

Mortgage Market Appendix

The reasons that mortgages have not runoff anywhere near to the cap are likely linked to the assumptions made in March of 2022 regarding each factor that drives mortgage prepayments. The Fed's mortgage portfolio is primarily 2 and 2.5% mortgages. At the time that the caps were determined mortgage rates were 4%. While that already means low likelihood of prepayment due to financial motivated refinancing, at least it was a possibility. Today there is no chance runoff will be financially motivated.

The Fed has a legitimate problem reducing its mortgage portfolio through runoff. Jay Powell has dodged the question about mortgage outright sales by saying they are not currently considering the idea. But at a pace of 5% reduction so far and given the level of interest rates and broader mortgage market activity the Fed will likely take a decade before their balance sheet becomes anything like UST only as desired. In fact, if a recession and a fall in interest rates does occur the runoff will jump rapidly tightening financial conditions at exactly the wrong time by flooding the private sector with new even lower coupon mortgage used to refinance the 2.5% Fed holdings.

Mortgage applications are now at a 30 year low.

This is consistent with a US population, that has great incentive to stay in their house and maintain their existing mortgage, work from home resulting in less need to move to take a new job, and low new household formation due to poor housing affordability. The on the run mortgage market is poorly supplied.

Besides the lack of supply in the on the run mortgage market the Fed doesn't really have exposure to that part of the market. What they own is very long duration very low prepayment risk assets. While these are not coupon Treasuries the lack of prepayment risk and the government backing suggest that buyers away from the mortgage investor would be happy to own these securities if they came cheap.

The mortgage holdings of the Fed must be sold outright, and it is inevitable they will be sold unless financial stability is threatened. Today that is not even close to being an issue. We recognize the political theater that would be created by selling holdings at a loss but also know that from a policy point of view that loss is irrelevant. We also recognize that mortgage sales by the Fed put a bid into fixed income volatility which has been elevated. However, given the very low coupons this will have very limited impact on the affordability of current mortgages.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 48,150,439		
Total Return	48.15%	YTD Return	2.85%
Today's Date	2/22/2023	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	1.2	$ (428,571)	Open
1/4/2023	FXI ETF	30.28	115,000	$ 500,000	29.19	$ (125,350)	Open
1/26/2023	SPX 3900/3500 March Put Spread Two's and SPOOS	36	139	$ 500,000	40.6	$ 63,889	Open
2/1/2023	SPX 3900/3500 March Put Spread Two's and SPOOS	28.67	523	$ 1,500,000	40.6	$ 624,419	Open
2/16/2023	QQQ 298/318 March 17 Call Spread RI	11.15	-550	$ 500,000	6	$ 283,250	Open
2/1/2023	Short SFRZ4 Twos and Spoos	97.085	-1600	$ 2,000,000	96.28	$ 3,220,000	Open
2/14/2023	long SFRU3 Twos and Spoos	94.75	1600	$ (2,000,000)	94.645	$ (420,000)	Open
2/16/2023	TLT 104/100 March 17 Put Spread	1.95	-2500	$ 500,000	2.59	$ (160,000)	Open
2/6/2023	USDJPY 131/136 Call Spread	1.18	84,745,763	$ 1,000,000	1.95	$ 652,542	Open
12/1/2022	DS Beta Short Component SPY	407.38	-30680	$ 500,000	399.31	$ 247,588	Open
12/1/2022	DS Beta Short Component TLT	105.76	-141831		102.73	$ 429,748	Closed
12/1/2022	DS Beta Short Component TIP	109.37	-114290		106.985	$ 272,582	Open
12/1/2022	DS Beta Short Component GLD	167.84	-29790		170.66	$ (84,008)	Open
12/1/2022	DS Beta Short Component GSG	21.47	-232880		20.15	$ 307,402	Closed
12/1/2022	Net Positive carry	2.00%				$ 227,397	Open