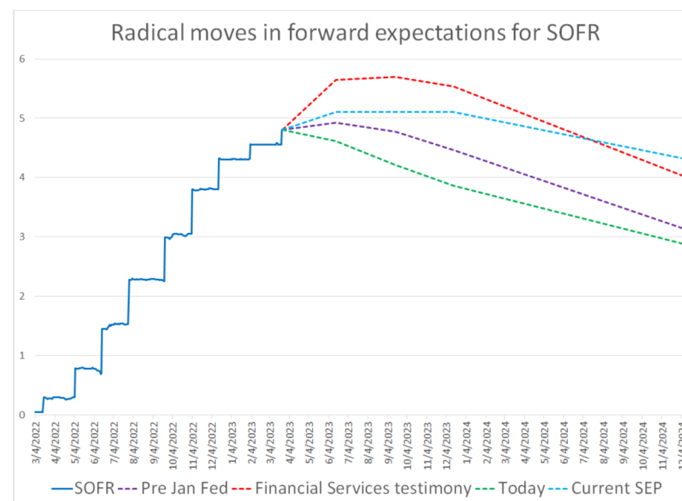
K The Damped Spring Report

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

3/26/2023

Over the last two weeks many markets have shifted radically. The Powell testimony on March 7th and 8th was clear that the Fed was going to raise its terminal rate in the SEP at its next meeting due to persistent economic strength and labor tightness. The next day a run, on Silicon Valley bank and a FDIC seizure began the shift in market pricing. Over the weekend another bank seizure and the establishment of emergency programs to stop bank runs fueled the move as fear of a banking crisis emerged. A large selloff in all the regional banks ensued. In Europe, a shotgun marriage was arranged for CS. Finally, in response, the ECB and the Fed shifted from forward guidance of aggressive hikes to pure data dependent paths. The shift can be seen most vividly in the short-term yield curve. We believe the banking crisis is a Tempest in a Teacup and after resolution of a few more vulnerable banks, and the massive deleveraging of offside levered positioning abates, the path of interest rates will once again be H4L as the inflation fight is far from over.



Synthesis

- Bank crisis is limited - Actions by Fed do not stimulate the economy.
- Economy is driven by three factors. Credit creation is not the dominant factor in today's economy.
- Primary drivers for inflation are labor, ample savings, and 3D's of Deglobalization
- Fed will have to hike more and pause longer.
- Pricing is not for a recession it is for a soft landing.
- De-grossing is the ring that unites them all, driving market pricing.

Bank crisis is limited - Actions by Fed do not stimulate the economy.

One bank in the US took a levered position long duration with 2.7% insured deposits providing the funding. In our last DSR “Do they hedge” we did a full review of the banking system and concluded that a few more banks could be in trouble without government assistance and FDIC reform. However, Policymakers provided assistance via the discount window and the new BTFP repo program. We continue to expect FDIC reform to be announced in a matter of weeks which will result in increased deposit insurance, albeit at an increased cost, for some but nowhere near all depositors. This reform will provide smaller and regional banks all they need to stabilize their bank and assess their need to hedge or deleverage. We also believe that on the margin retail deposits will move toward MMF/RRP funds if banks don’t increase deposit rates. Wholesale competitive deposits have already de-banked over a year ago to the RRP as they were pushed out of the banking system when reserves were deemed no longer exempt from the SLR. Notice the RRP has grown a bit since the crisis began but that is likely composed of corporate wholesale deposits foolishly left at SIVB and other troubled banks. We expect corporate transactional accounts to remain at banks and potentially get high-cost FDIC insurance in the reform plan.

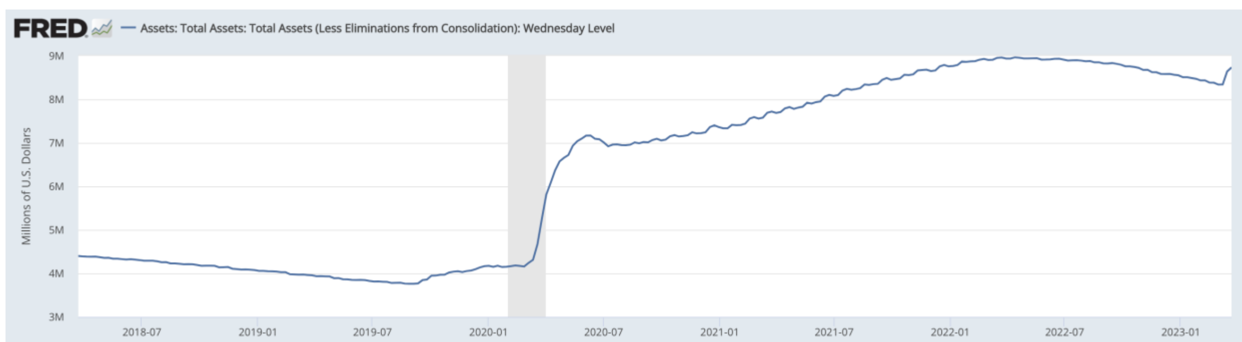
The combination of tweaks to the BTFP plan, the discount window, and meaningful FDIC reform should stabilize the banking system.

Of course, banks have been and continue to be levered long credit. This is basic business of banking. The blowups that the market is dealing with today is rogue banks betting recklessly on bond markets. That is likely to be where regulatory reform will occur. Credit risk management was reformed in the GFC and remains a risk to banks. At the same time the amount of extrapolation done by banking and economic bears regarding the pending CRE credit crisis seems extreme to us. We believe it is something that needs to be handled well and is a risk inherent in banks but it’s not the issue for today. We will leave this chart here just to put a scale on the problem.

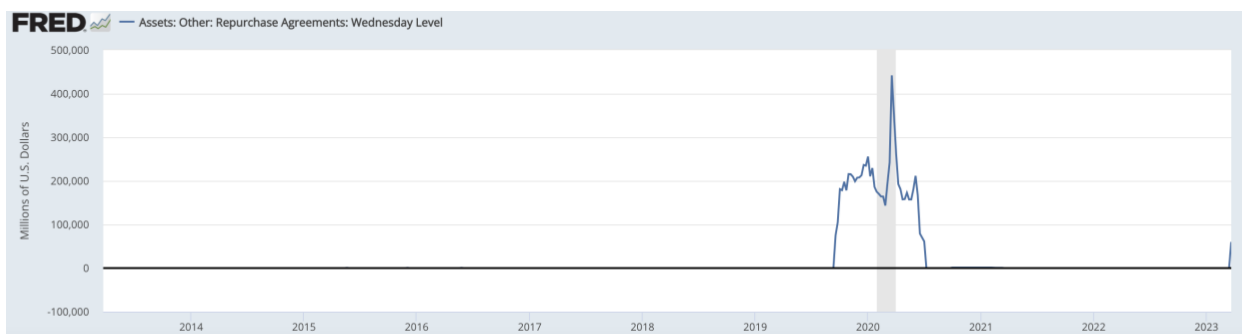
The Fed Balance sheet increase is not stimulative if you follow the money.

The Fed balance sheet has spiked over the past two weeks. Respected economists and sell side analysts believe that this balance sheet increase, if not the same as QE, is a major increase in liquidity and asset prices have begun to respond as if QT has ended. We have analyzed the mechanics of this "liquidity injection" and while it is certainly more supportive to assets than an uncontrolled deleveraging of the financial system it is neither stimulative to assets nor to the economy.

Yep, the balance sheet is larger.



The increase in the balance sheet is mostly the increase in BTFP from zero to 54BN and the increase in the discount window usage by 110BN. The rest of the increase comes from the temporary financing of the two banks that are being liquidated by the FDIC and a mysterious usage of the Repo Facility offered by the Fed to the official sector of foreign governments. We suspect that is the SNB who is tapping currency swap lines but may also need repo cash in order to bridge the CS/UBS marriage. We will see. Nonetheless this jump in repo is nothing like the 2019 Jump which required Fed response. The 2019 issue was a lack of private sector repo capacity. We know that the RRP stands at 2.2 TN. Plenty of repo capacity there. That little blip on the far right is last week's official sector usage.



Focusing on the 164BN of money creation done by the Fed in response to bank stress, and ignoring the other noise, it pays to think about who gets the money and what they do with the money to determine if the "liquidity injection" is stimulative.

The two programs are not something a bank wants to access. It will result in extreme scrutiny by regulators. The rates aren't particularly attractive if you have stable deposits. Since the program began two weeks ago it has also remained

stable at 164BN though the composition has shifted as banks become more comfortable with the operations of the BTFP. A bank who uses these programs is likely to be experiencing a deposit run. In normal times a loss of a deposit for a solvent bank has no impact at all on the bank's risk to its equity. The equity risk hasn't changed at all. The banks balance sheet has been reduced on both sides by a loss of a deposit and a reserve. However, as the reserves get depleted the bank must consider three different ways to raise cash to satisfy the depositors withdrawal. The bank can

- Borrow from other banks or the Fed in one of these programs.
- Issue equity, CD's or corporate bank debt
- Sell assets.

Prior to the SIVB run, all these options were open to banks. But then the run began. That lead to a potential fire sale of assets. The Feds liquidity injection stopped the fire sale. But troubled banks will face regulatory pressure to sell assets, shareholder pressure to right size the bank, and Fed pressure to repay the loan in 1 year.

The Troubled bank is going to deleverage, not in a fire sale but its actions will tighten financial conditions.

The depositors now have their cash. They need to find another place for that cash and where it ends up matters. The depositor has four options.

- Buy financial assets – which then shifts the deposit to someone else.
- Consume – which then shifts the deposit to someone else.
- Deposit in a strong bank
- Buy a Money Market Mutual fund who then buys either T-bills or more likely goes to the RRP to invest the cash.

The first two choices would be stimulative to the economy and/or financial assets but both seem highly unlikely. The depositors had their money in a deposit at a bank for a reason. If they had wanted to consume or buy financial assets, they could have done that before the run. So more likely they choose one of the other two options.

The Depositors just moves their money from one place to keep cash to another. No net easing or tightening.

If the strong bank receives a deposit, it effectively is the beneficiary of the Fed's liquidity injection. They now have a bigger balance sheet.

As you can see in this chart typical banks lever their deposits between 1.2 and 1.6x. That suggests that the natural response to an increase in reserves and deposits is to create money and purchase more assets. That would be stimulative as the assets would be either financial assets or loans to support consumption in the real economy. But does the transmission of this liquidity injection provide the ability for the bank to lever? If they already had the ability, it is unclear why they would lever up today. Our read of strong banks is they have had the ability to lever up, but have demonstrated unwillingness to lever up, and have in fact acted to de-lever for many months. We see no path that would generate a reversal from unwillingness to lever to willingness and no change at all in their ability to lever.

The depositors can also choose to move their money outside the banking system. If so, they most likely would deposit into a government money market mutual fund which would then invest that money in RRP at the Fed. In this case the "liquidity injection" goes full circle and no stimulus is created.

Following all the money and who gets it and what do they do with suggests that the liquidity injection will slow the deleveraging of the deposit losing banks from a fire sale to a one-year managed deleveraging and the liquidity will die on either the strong banks books who don't need the money to lever, or the Fed itself in the RRP. On balance the growth in the balance sheet itself is better than the alternative of fire sale deleveraging but the whole situation of reckless banks resulting in deposit runs and government policies is almost certainly going to tighten financial conditions instead of easing them.

For more information about the flow of money from the fed watch our explainer video at youtu.be/9T_Xyrh3yYA

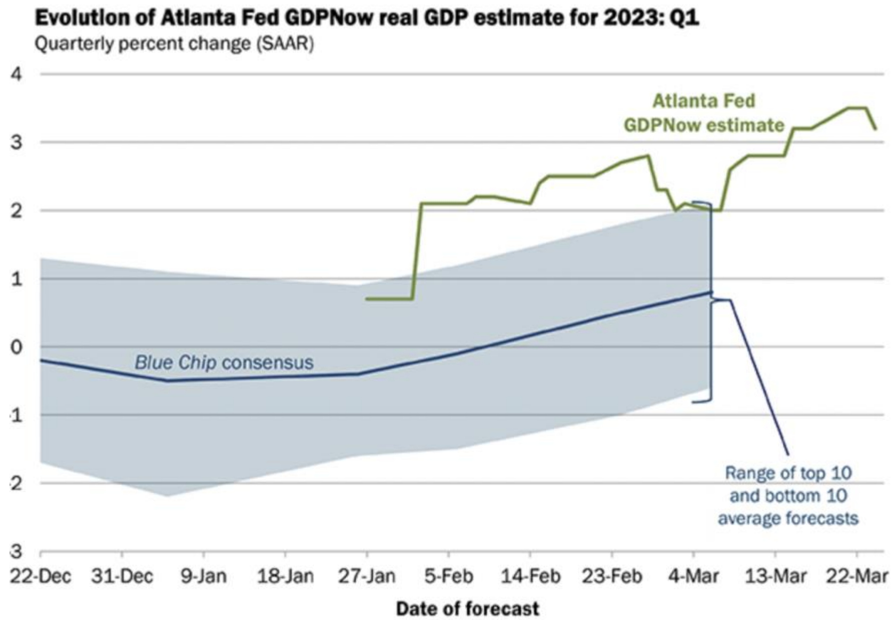
Economy is driven by three factors. Credit creation is not the dominant factor in today's economy.

Trend growth is generated by population growth and productivity advances. Three factors generate above trend growth.

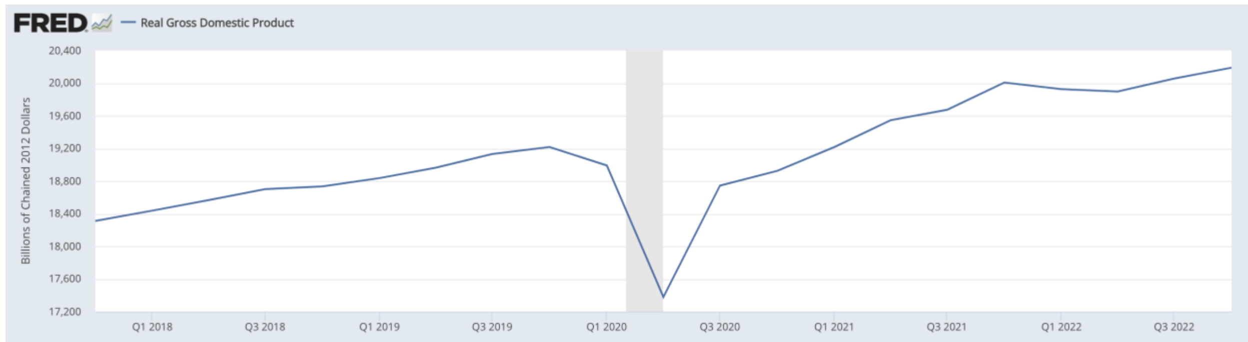
- Credit creation which allows economic participants to borrow and consume or invest.
- Real wages increasing allow labor to consume more goods and services.
- Dissaving allows investors to sell assets to consume today.

In any economic cycle it is important to see which factor is more important as a change in any one factor may be large but may have limited impact on the economy when the others have been the drivers. The Fed is now watching closely whether the duration crisis in banks will result in a credit contraction. Its sensible that it will, but how much and how impactful it will be to the economy is unclear. What is known is that big banks and small banks have been creating credit at a much slower rate than the economy has grown over the past year and even the past weeks well before the crisis. That would indicate that wage pressures and continued dissaving of accumulated fiscal transfers from the covid stimulus are much more powerful drivers for continued real growth and inflation.

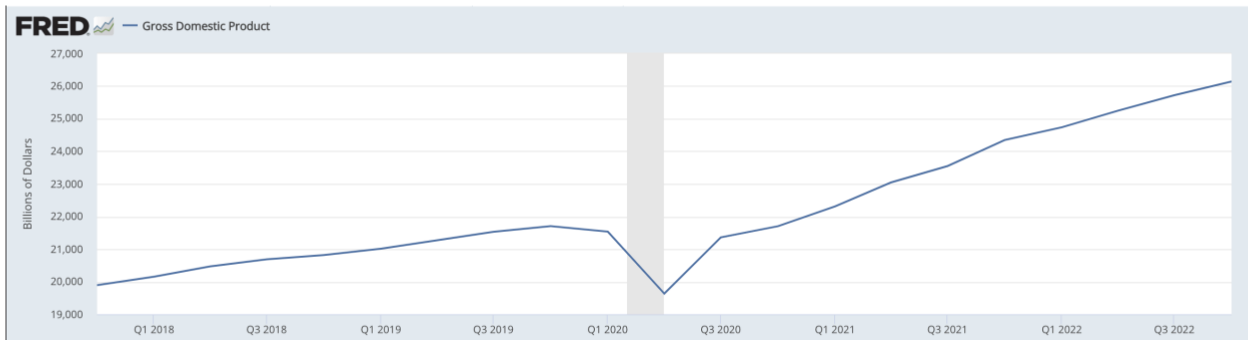
The Real economy continues to roar along.



After a brief pause in H1 2022 real growth remained positive

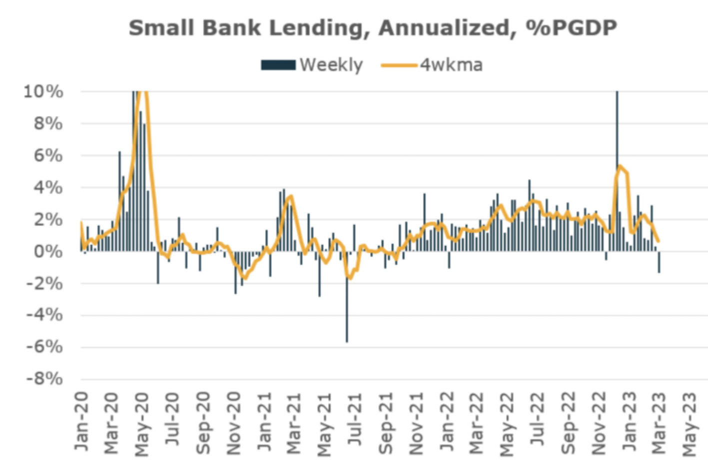


And last year's nominal GDP was close to 8%



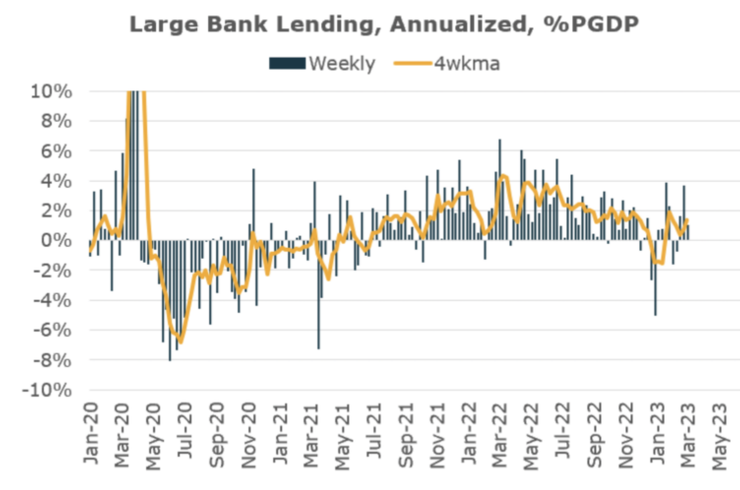
At the same time banks were slowing credit creation at a fast rate.

Small bank lending has been in a downtrend for over 9 months and fell again before the bank runs began.



Source: Bob Elliott from Unlimited Funds

Larger banks have also been reducing credit for almost a year.



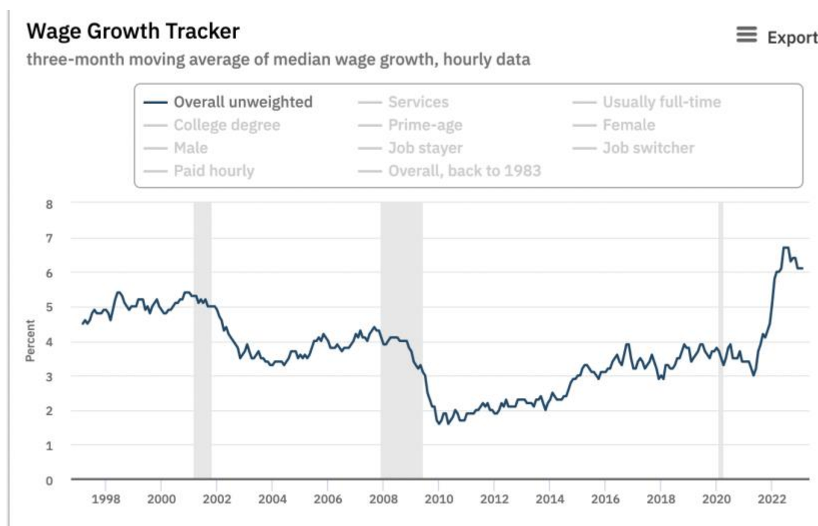
Source: Bob Elliott from Unlimited Funds

Further slowing of bank credit creation from the troubled banks seems certain. This will leave some sectors and regions with reduced credit availability. However, the larger banks have the ability to advance credit right now. The willingness may take some time particularly in the areas where the human presence and knowledge of the customer base is withdrawing from the market. Frictions will occur. Nonetheless the trend of credit contraction has already been in place. The economy has continued to grow.

Primary drivers for inflation are labor, ample savings, and 3D's.

The US economy continues to grow and labor conditions remain quite tight overall. Savings as represented by RRP and Bank Reserves continue to be very deep. It is likely that these savings have been redistributed to corporations, commodity producers and the wealthy and the conditions for dissaving for most consumers are

becoming strained. However, the savings are available for these entities that have them to consume or invest. Corporations with great savings can hoard workers for longer until demand drops rapidly. The impact of the savings regardless of their distribution cannot be underestimated as the average consumer has greater confidence in his job and that can lead to a low savings rate for labor and strong demand. Wages also now are growing on a real basis. Nominal wage growth has been greater than 6%



Lastly the 3D's cyclical shift seems close to becoming secular. The 3D's are.

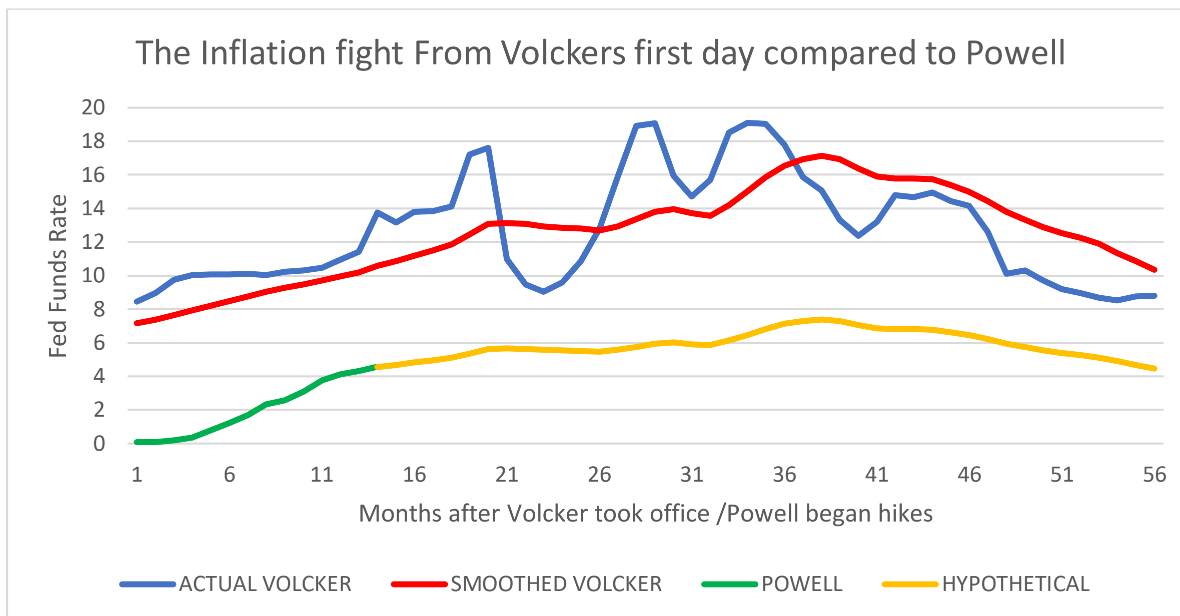
- Deglobalization – Onshoring of production
- Domestic energy independence
- Duplicate supply chains built closer to home with allies.

Each of these initiatives need funding putting stress on financials assets. The real economy investment initially hands the private sector additional spending. The investment leads to construction jobs and demand for technically trained workers which are in short supply. Support industries especially services see increased demand. Pursuing these initiatives is a strong tailwind for inflation which compounds the Fed's problems.

Fed will have to hike more and pause longer.

We believe that the Bank Crisis is a "Tempest in a Teacup". We expect the various tools necessary to support banks that are in trouble will be used where needed and FDIC reform will result in a more stable banking system. We do not think that these tools are going to generate significant stimulus. Lastly, we expect banks that are supported by these new tools will also face much more stringent risk management regulations which will lead to less duration risk. If we are correct, we would expect the Fed will once again focus on its inflation fighting role. That will require the Unemployment rate to rise to 4.5% or higher and the balance sheet to fall by 2TN dollars. The Fed has a long way to go.

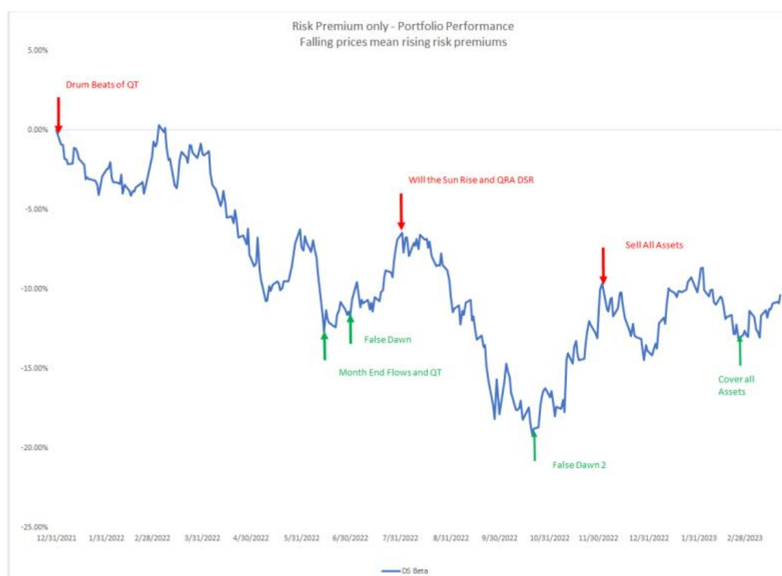
Imagine if Volcker didn't blink.



While 1978-1984 is not the same as today the lesson from Burns and from Burns 2.0 (the Volcker pivot) is that inflation is hard to kill. A recession may kill it. But that doesn't seem imminent. Powell doesn't want to be Burns 3.0. We think he will be higher for longer until inflation is well and truly dead. We are alone on this Island based on current market pricing and sentiment. But what has changed in two weeks. Not much in our view.

Pricing is not for a recession it is for a soft landing.

While the narrative has clearly switched to an imminent recession in the bond market pricing. Asset pricing in general remains priced for a soft landing. Risk premiums have contracted in the past two weeks. Bonds, gold, stocks, Tips have all rallied. Only energy has fallen. This isn't recession pricing. There will be no soft landing in our opinion.

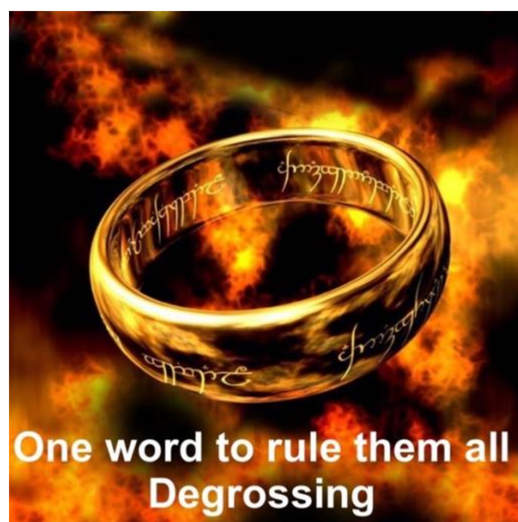


De-grossing is the ring that unites them all, driving market pricing.

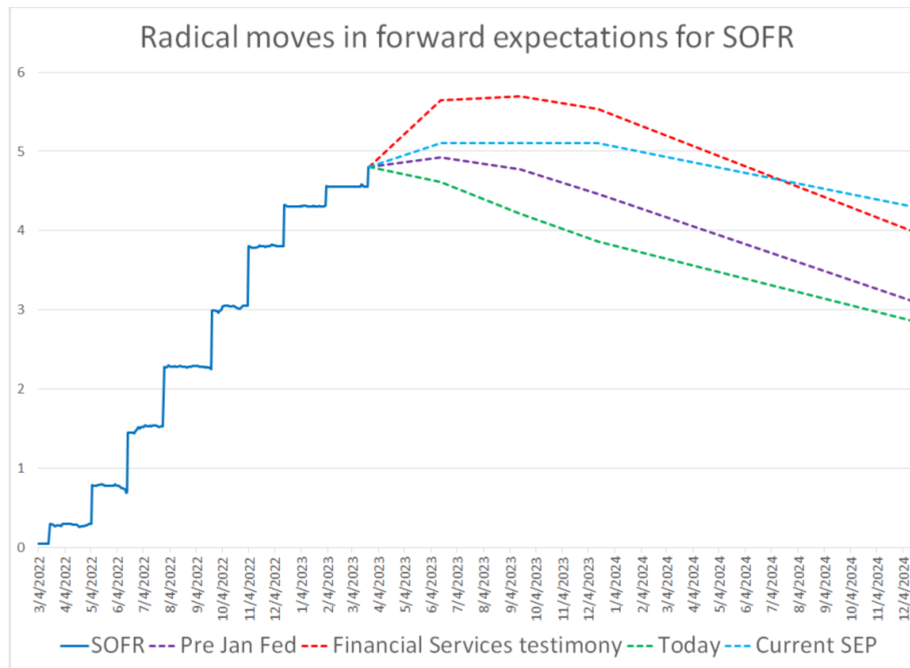
We have lived through many levered positions forced unwinds.

- 1987 The myopic portfolio insurers attempted to all get out at the same time.
- 1989 Drexel and the S&L's get a margin call.
- 1994 Surprise hikes result in a mortgage short gamma deleveraging which spreads to every levered fund from narrow convertible bond hedge funds to Orange County pension funds.
- 1997 Asian crisis spills over to a huge move in SPX via the Niederhofer contagion.
- 1998 LTCM reminds the author most of the current deleveraging as a catalyst came from Russian (today SIVB) and the damage spread to every levered fund. This time they even have a consortium.
- 2001 Enron and the credit crisis was a great deleveraging.
- 2004 The authors partners were deep in the Mezzanine Tranche blow up of synthetic credit CDO's catalyzed by an auto and auto parts bankruptcy. The impact on all credit risk and equities was widespread.
- GFC. Enough said.
- 2010 The Flash clash and the return of portfolio insurance was catalyzed by far away Europe credit crisis yet blew up the entire long term equity volatility pricing for months.
- 2013 Taper Tantrum
- 2015 China Devaluation
- 2019 Repo crisis
- 2022 The great correlation crisis
- 2023 SIVB bank delevers every hedge fund in the world at once

Perhaps this is different, and a true deep recession is imminent and like Bear Stearns in 2008. Lehman is ahead of us. We don't think so and believe that the Fed can get back to business as soon as the next meeting, but we are sure a Degrossing has been underway for weeks and in our experience ends suddenly.



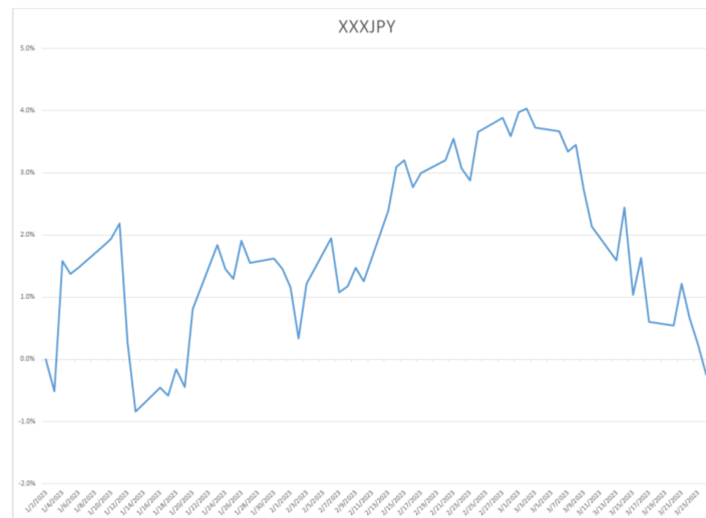
As we have mentioned the immediate implication of the external catalyst of SIVB was short term rates. This has been ground zero for the deleveraging.



Right in the midst of the blast zone we can find direct evidence of extreme disruption in the swaptions market with implied volatility of 1-month options on 1-year rates jumping well above the 2008 peaks. There are many dead bodies surfacing on this one exposure. This is a Volmageddon that makes 2019 (oops should have that on our list) tiny in comparison given the size and depth of this market.

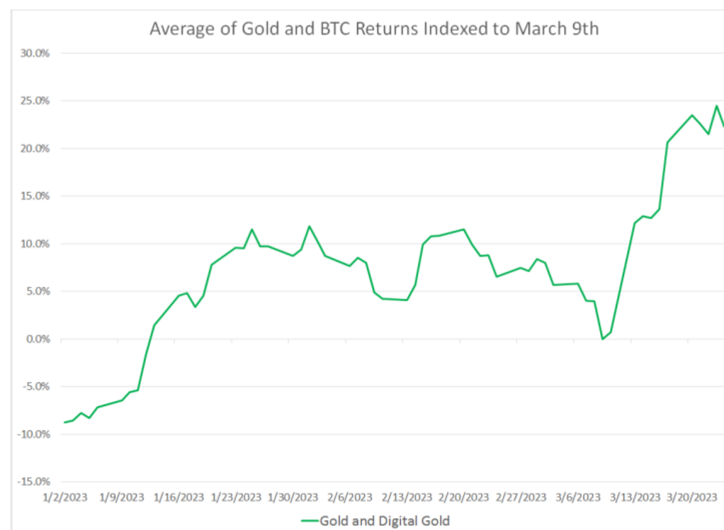
The closely watched 2's 10's spread steepened massively resulting in additional peripheral damage.

Currency Markets delevered all the crowded anything against JPY long carry trades, despite the clear need for relative ease in Japan vs the crosses.



In equities all shorts on big cap tech vs anything else had too suddenly de-gross. Not only where these positions offside but like each of the above are poorly positioned for the actual fundamentals of an imminent recession.

Then there are the second order moves by those who believe that either, current new programs are equivalent to QE, or further chaos will lead to an abandonment QT and inflation fighting itself. While this is not likely to be the result of contagion from degrossing it rhymes.



Commodities also saw position liquidation with virtually all the backwardation of Oil prices removed from the market.

<u>Conclusion</u>

We believe that the bank duration crisis is nearing an end. The economy continues to be too strong and inflationary pressures are increasingly structural. The past two weeks has seen massive unwinds of positioning which may not yet be over. We will be opportunistic about adding risk in this market due to these dynamics, elevated implied volatility and criminal bid offer spreads. But we are even more certain that a soft landing is impossible. We think the Fed has a lot more to do and will act incrementally but will get the job done.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000						
LTD P/L	$ 47,306,388						
Total Return	47.31%		YTD Return		2.01%		
Today's Date	3/26/2023		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	$ (523,810)	Open
1/4/2023	FXI ETF	30.28	115,000	$ 500,000	28.83	$ (166,750)	Open
2/24/2023	NDX 11500/10750 4/21/23 Put Spread Recession Isl	165.00	61	$ 1,000,000	25	$ (848,485)	Open
2/24/2023	SPX 3750/3350 April 21 2023 Puts Two's and Spoos	42.50	235	$ 1,000,000	15	$ (647,059)	Open
3/2/2023	SPX 3750/3350 April 21 2023 Puts Two's and Spoos	36.00	278	$ 1,000,000	15	$ (583,333)	Open
3/16/2023	NDX 12500/11750 6/16/23 Put Spread	230.00	43	$ 1,000,000	180	$ (217,391)	Open
2/1/2023	SFRZ4 ShortTwos and Spoos	97.085	-1600	$ 2,000,000	97.08	$ 20,000	Open
3/15/2023	ZN 117/113 Call Spread	1.8125	-914	$ 2,000,000	1.75	$ 57,143	Open
3/17/2023	SFRZ3 Short	96.02	-400	$ 1,000,000	96.1	$ (80,000)	Open