The Damped Spring Report

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

4/30/2023

This week will be pivotal for markets at many levels. There will be a tremendous amount of news flow starting Sunday night with the resolution of the First Republic Bank and ending the week with Apple earning and US Employment Data. During the week the Fed will hike 25bp and remain data dependent. We hope that the balance sheet runoff will be mentioned in the press conference and a hint that acceleration of QT will be provided. However, we aren't holding our breath for that outcome. The Treasury will release two important pieces of data in the Quarterly Refunding Announcement on Monday and Wednesday. History show that the Treasury will ignore the debt ceiling in this release and project large issuance. Information about that future liquidity may be largely ignored as in order for new money issuance to come to market the debt ceiling needs resolution. Perhaps given the timing of this release and the politics involved the Treasury will also formally announce the day they will begin government shutdown of non-essential services. We call this D-Day, and we expect D-Day to be between July 14th and August 7th. The timeline we are watching starts in a few hours.

- **Sunday night we expect First Republic Bank will be seized and sold.**
- **Monday at 3:00 PM EDT we expect the Treasury to project a sizeable deficit and large issuance of bills and coupons in Q3.**
- **The Treasury may formally announce when the government will commence shutdown of non-essential services and employees.**
- **The likely timing of that shutdown is between July 14th and August 7th.**
- **Wednesday morning at 8:30 the Treasury will announce the composition of Q3 issuance and a larger than expected coupon issuance schedule to fund the rising deficit. Bills issuance will also be very large.**
- **At 2:00 the Fed will hike by 25bp, and the press conference will be hawkish. We do not expect any signaling that the Fed is done. Furthermore, there is a small possibility that the balance sheet will be mentioned in a hawkish sense.**
- **Thursday, AAPL reports and is priced richly ahead of its earnings.**

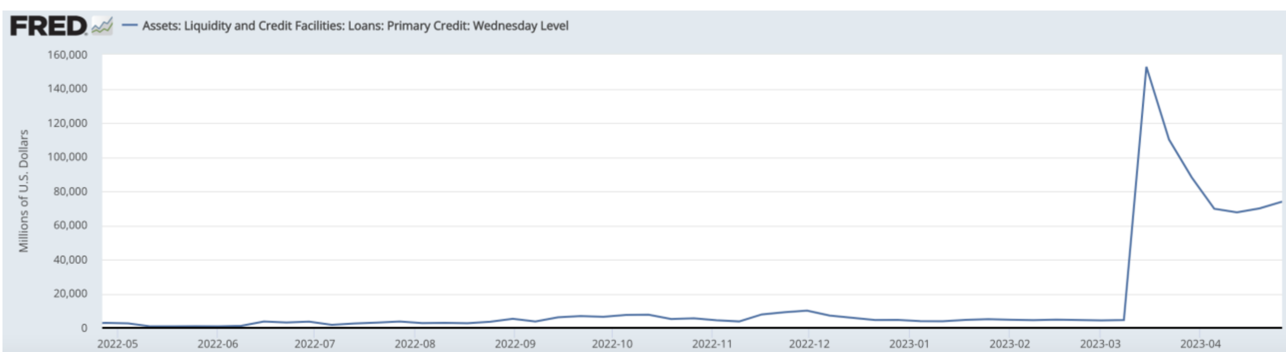
- **Lastly the Non-Farm Payroll data will be released at 8:30 on Friday. We see little signs of any meaningful easing in the labor market.**

We remain bearish two's and spoos and all assets in general.

First Republic Resolution

First Republic will be seized by the FDIC, and they will succeed in auctioning the bank to another bank. Based on estimates of the discount price necessary to attract buyers the equity and preferred shareholders will be wiped out. If the Deposits exceed the value of the assets, we expect the deposits will be fully assumed by the buyer with a contribution of between $10-15BN provided by the FDIC. Any other non-deposit liabilities are hard to value but may be wiped out as well.

This bank resolution is highly unlikely to result in changes or expansions of the Fed lending programs in fact given the high usage of the discount window by First Republic the Fed balance sheet may shrink quite rapidly. Market participants paid undo attention to the balance sheet expansion as the discount window and BTFP programs were used. Perhaps a surprise in the other direction of balance sheet shrinkage will have a similar and opposite effect. It would not surprise us at all if the usage of the discount window falls by 75BN.

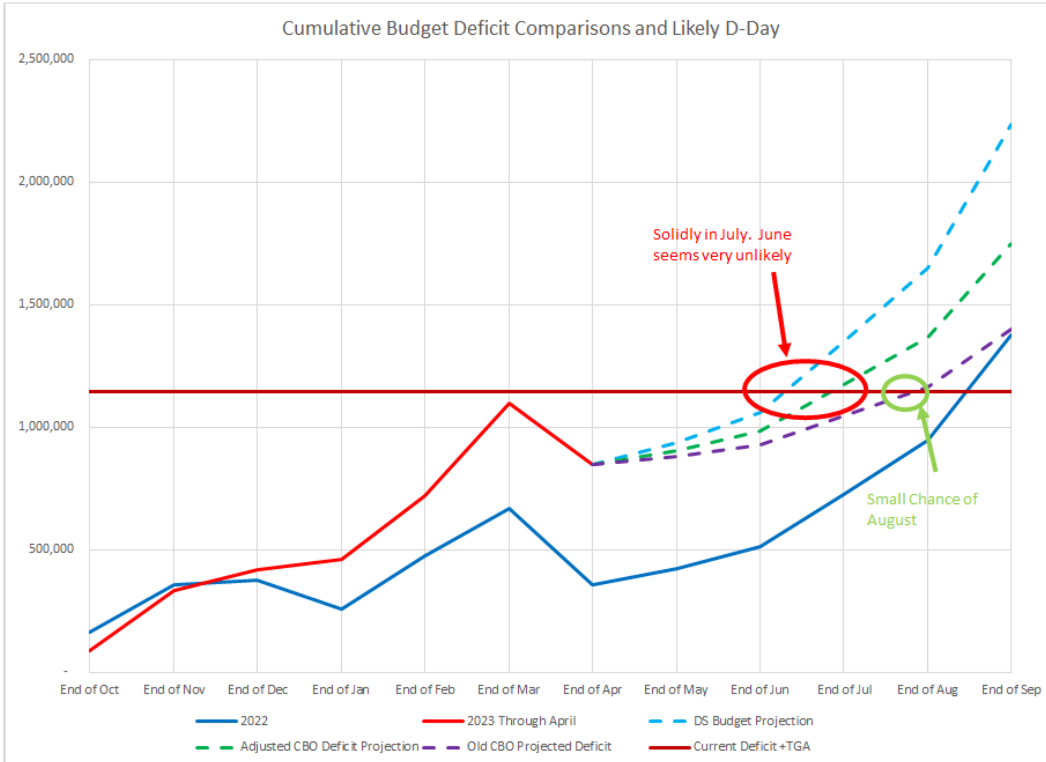


In terms of market reaction, it seems mixed.

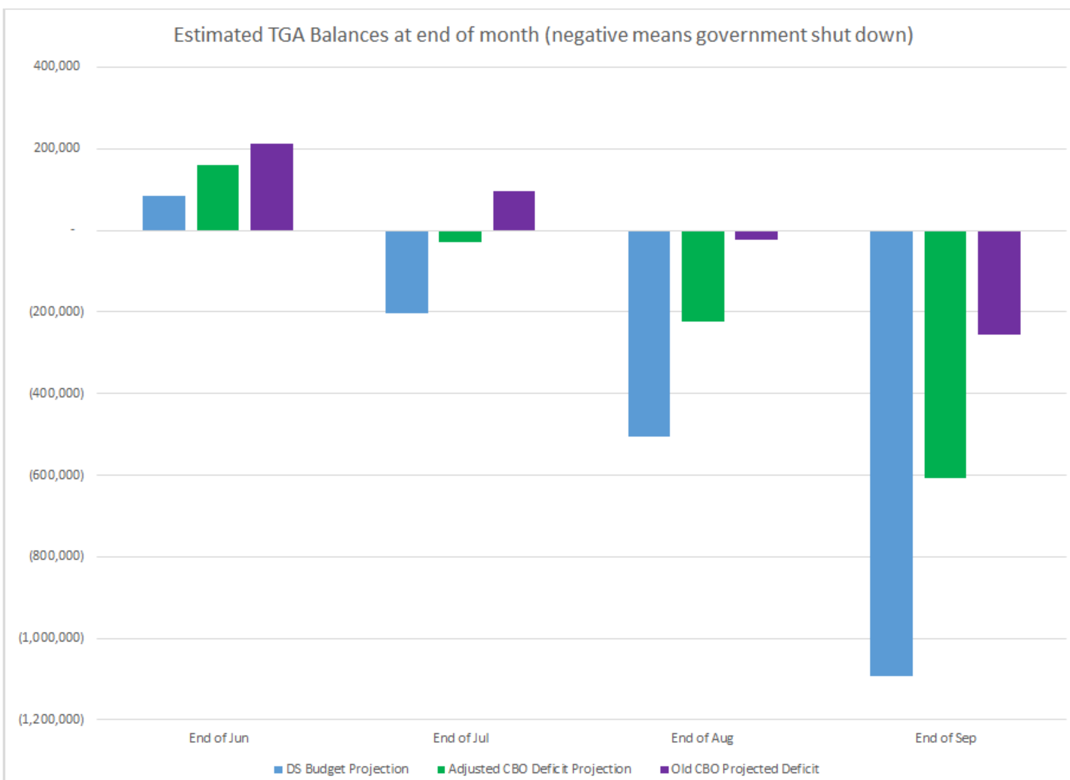
- Uncertainty regarding this particular bank will be resolved.
- A successful resolution is likely to free the Fed's hand.

Debt ceiling

Using the baseline deficit projections last provided by the CBO in February, D-Day is likely Late July or Early August. However, those deficit projections have not been adjusted for recent tax receipts (also adjusted for California). Using CBO baseline and adjusting for recent data or simply extrapolating 7 months of deficits adjusted for seasonality it is clear that D-Day is in Mid-July

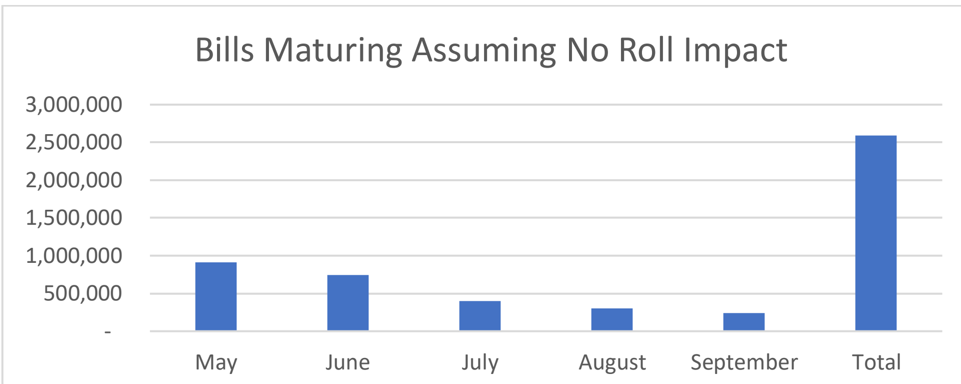


Shown another way, the Treasury General Account will go negative in July.

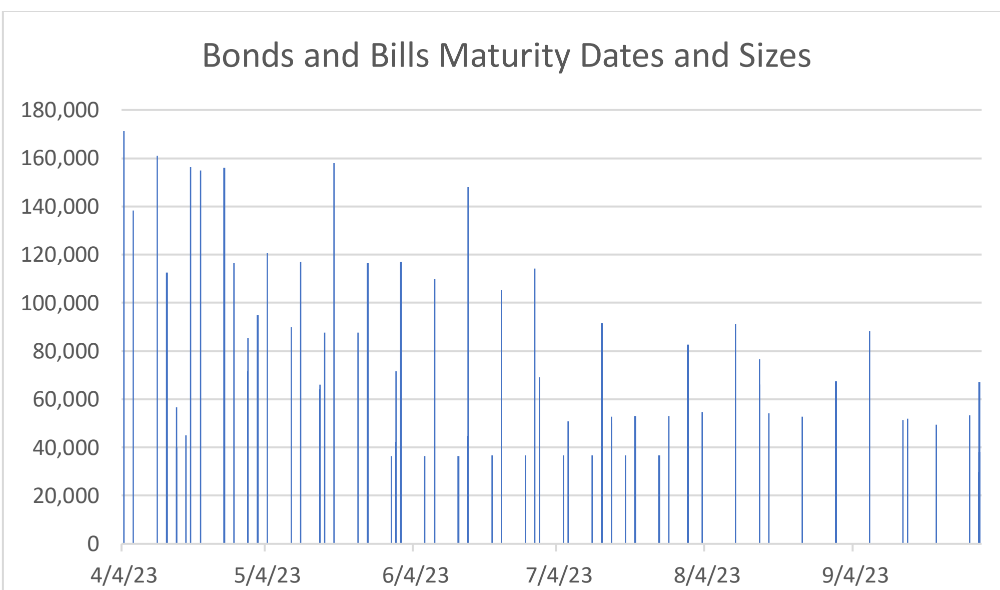


Budget Implications on Quarterly Refunding Announcement

The QRA has historically ignored the debt ceiling in order to schedule debt issuance well in advance. We expect the Treasury to stick to that plan. The Treasury also provides markets with a consistent and predictable supply of coupon issuance and manages the budget with shifts in bills issuance. Today with 98% of extraordinary measures used up the net new money cannot be positive. However regardless of the debt ceiling we are certain that a full slate of duration will be issued by the Treasury. It is important to understand that the Federal Government has tremendous flexibility to reduce bills supply in order to issue new coupons without jeopardizing borrowing over the Debt Ceiling limit. Over $2.5TN of Bills will mature in the next 5 Months. Most of those bills will be rolled at least once and some will mature 4 times this cycle. This will allow the Treasury to issue as much coupon debt as they like.



In addition to the Bills maturities, a significant amount of debt is coming due over the balance of the fiscal year. All of that debt can be refinanced with long term issuance if desired. Once again ignoring bills rolls 1.5TN of Coupon bonds come due on top of the 2.5TN of Bills. New money may be constrained but new duration may be large.



Our QRA Tracker estimates the total long amount of new money that will come to market assuming the Debt Ceiling is increased. We are assuming for this analysis that the 1.5TN of maturities of coupon debt will not be funded with duration and instead use bills. If we are wrong our estimates of duration schedules will be woefully too low and bond markets will be badly surprised. However, we do project much larger new money demands than in past quarterly refundings due to weak tax receipts (adjusted for California) but consistent with the lower nominal growth in fiscal 2023 than in 2022, and higher expenditures due to inflation linked costs and higher interest expense. We estimate QRA based on three deficit projects. The unadjusted stale CBO deficit projection, our own adjusted CBO projection, and our estimate based on extrapolation of the trends in place the last seven months. Lastly, we assume a modest TGA target of 300BN which may be conservative, resulting in underestimates of actual supply. Regardless the numbers are eye popping.

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	655	277	932
Q2 Plan Announced	28	248	276
Q3			
Damped Spring Aggressive Estimate	893	500	1,393
Damped Spring Base Case Estimate	506	400	906
Old CBO Estimate from Q1	256	300	556

The market may shrug off this sizable supply until the debt ceiling is lifted but we think this supply will have a significant impact on both asset risk premiums and overall market liquidity.

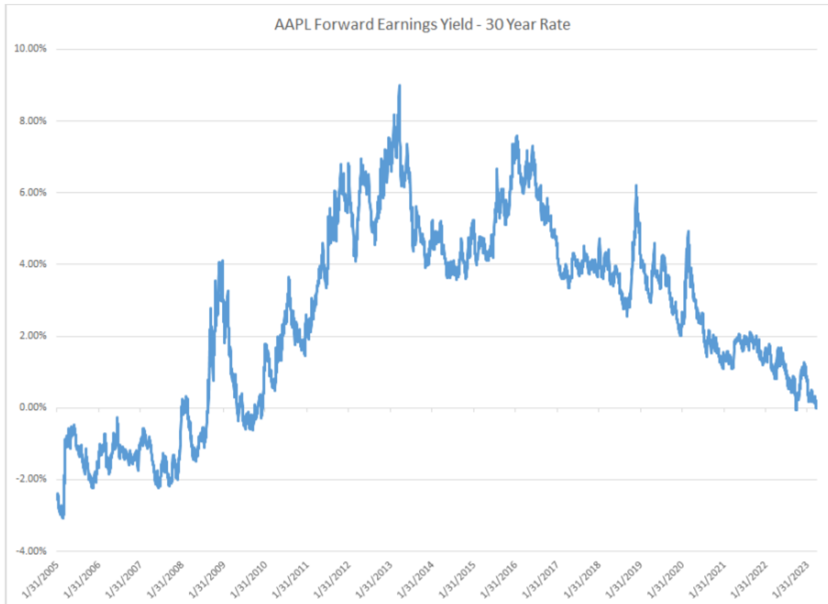
The Fed

The Fed will

- Hike 25bp
- Remain data dependent.
- Give no signal that the hiking cycle is over.
- Once again, the Chair will futilely attempt to give guidance of a long pause.
- In the unlikely event that the Chair mentions Reserves + RRP size, or QT pace the market will react violently.

AAPL

Apple announces its earnings after the close on May 4th. It is currently at its richest valuation since they invented the iPhone. Perhaps AI is the next iPhone. But it better be.



Non-Farm Payroll

The employment picture is likely to remain tight. We see no reason for the Fed to take its foot off the brakes and easy in any way. Jobs need to break sharply for us to change our view. We don't expect that to happen on Friday.

Our synthesis that all assets have been driven up by risk premium contraction due to insatiable demand for bonds remains in place described in our last Damped Spring Report. All of the news of this coming "Big Week" will likely support our view.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 45,155,410		
Total Return	45.16%	YTD Return	-0.14%
Today's Date	4/30/2023	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	0.6	$ (714,286)	Open
1/4/2023	FXI ETF	30.28	115,000	$ 500,000	28.5	$ (204,700)	Open
3/16/2023	NDX 12500/11750 6/16/23 Put Spread	230.00	43	$ 1,000,000	85	$ (630,435)	Open
3/28/2023	NDX 12500/11750 6/16/23 Put Spread	170.00	59	$ 1,000,000	85	$ (500,000)	Open
3/28/2023	SPX JUNE 3900/3500 Put Spread	60.00	333	$ 2,000,000	23	$ (1,233,333)	Open
4/27/2023	NDX 13100/13200 4/28/23 Call Spread	52.00	-104	$ 500,000	65	$ (135,417)	Open
2/1/2023	SFRZ4 ShortTwos and Spoos	97.085	-1600	$ 2,000,000	97.05	$ 140,000	Open
3/15/2023	ZN 117/113 Call Spread	1.8125	-914	$ 2,000,000	2.4	$ (537,143)	Open
4/25/2023	ZF 110.5/109.5 July Put spread	0.421875	4741	$ 2,000,000	0.42	$ (8,889)	Open
4/13/2023	DS Beta Short Component GLD	189.805	(5,269)		184.8	$ 26,369	Open
4/13/2023	DS Beta Short Component GSG	21.05	(47,506)		19.91	$ 54,157	Open
4/13/2023	DS Beta Short Component SPY	410.5	(6,090)	$ 500,000	415.93	$ (33,069)	Open
4/13/2023	DS Beta Short Component TIP	110.805	(22,562)		110.18	$ 14,101	Open
4/13/2023	DS Beta Short Component TLT	106.9	(28,064)		106.46	$ 12,348	Open
4/13/2023	Net Positive carry	2.00%				$ -	Open