The Damped Spring Report

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

07/24/2023

Over the next two weeks Act 1 of "The Script" may come to an end and policymakers will signal Act 2 has begun. In the last Damped Spring Report, we described in detail the script of the play titled "The only way to kill inflation." It is a play in 5 acts.

Act 1.	**Higherer for Longerer Island - Hikes continue and don't achieve goal.**
Act 2.	**Long end yields rise to new highs – Requires a supply catalyst.**
Act 3.	**Multiple compression – Higher yields take the legs out of the equity market.**
Act 4.	**Earnings contraction – The tightening of Act 2 and Act 3 hit demand.**
Act 5.	**Recession Island – Finally. as equities sell off, companies fire workers**.

Global central banks will speak this week. We don't expect a supply catalyst from the Fed as they continue to refuse to review or even mention the impact of QT. The BOJ has leaked that they are staying the course on YCC for now. We will pay attention to both major events to see if any drumbeats will be heard signaling future adjustments to these central bank's balance sheets. We will react accordingly if we hear anything which would result in a supply catalyst, but we think a shift from status quo is unlikely.

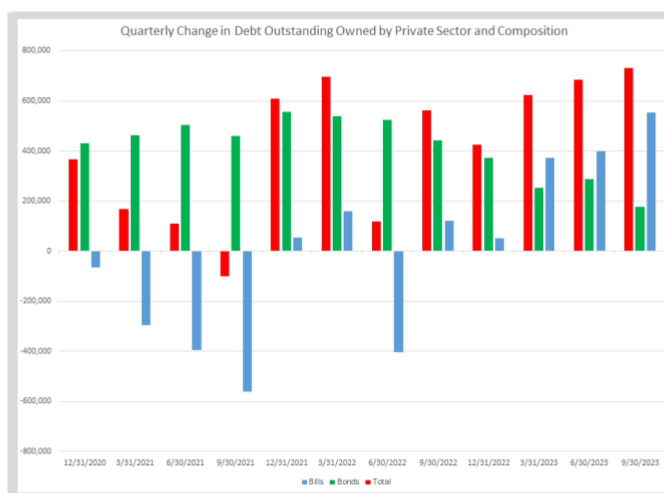
The more likely supply catalyst will come on August 2nd with the quarterly refunding announcement of debt issuance schedule. Since the Fed decided to passively run off the balance sheet the Treasury has held the monetary policy lever and they have been muting QT ever since.

The aggressive use of bills to fund the TGA and the growing fiscal deficit has tapped the RRP, which makes sense to us, but has changed the composition of the debt structure of the government. Our expectation is that the Treasury will begin a path to normalization in their issuance and we may see the first step on August 2nd. That first step may be enough to be the supply catalyst for Act 2 to begin. Perhaps Act 2 begins immediately, perhaps it will take until November's QRA, but the Treasury is now in an unsustainable position and more coupon issuance is the inevitable path which means Act 2 will start in the next 100 days. Maybe sooner.

Framework – Janet holds the QT lever.

QT runoff operates by demanding the private sector pay back the Fed by funding Treasury issuance. The form of that issuance matters. When it is in the form of T-bills, QT is completely muted. If it were 30-year bonds, it would have the maximum impact by forcing private sector investors to load up on risky 30-year bonds.

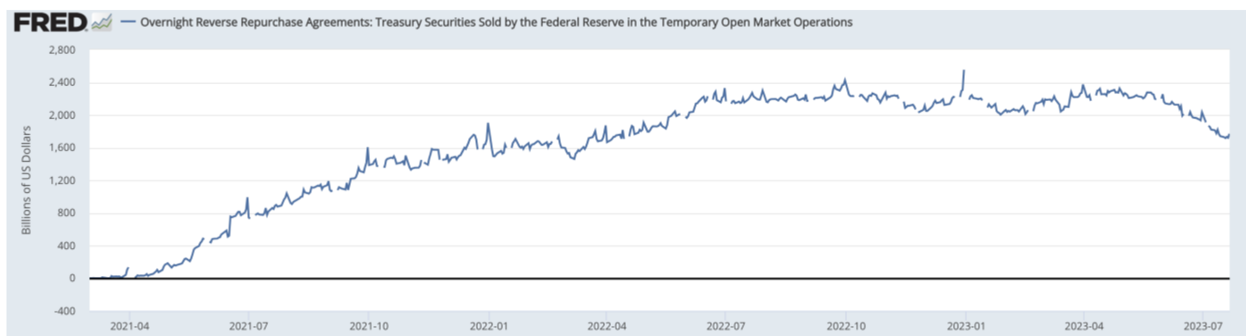
The Treasury has been reducing the amount of new issuance of Treasury notes and bonds continuously since the moment QE ended. The Debt Ceiling further exacerbated that net new money coupon supply. The plan for Q3 2023 is to further reduces bond supply to the Private Sector.



The Treasury has been starving the market for duration for 3 quarters. The rise in overall asset prices, the extreme negative term premiums in long term bond yields, and potentially strong economic growth and inflation stickiness may have been partly supported by this lack of duration supply. We expect the bond drought is near an end. **Our projection is for steadily increasing substantial bond issuance.**

Treasury Framework for issuance

Why has Janet decided to significantly reduce Treasury Bond issuance and potentially mute QT? We think it has been logical for the Treasury to manage debt issuance composition as they have over the past three quarters. During the first half of 2023 the Debt Ceiling was in place and all new money issuance was capped due to the limited ability to issue using extraordinary measures. Both bills and bond issuance were low. Perhaps the banking crisis in late March impacted the thoughts on duration issuance in Q2 but we can't be sure. Throughout the first half of the year the TGA funded the government. TGA spending didn't radically change the real economy, but the reduced issuance given the bulging deficit allowed financial assets breathing room. Now that the Debt Ceiling has been resolved and the plan for Q3 in motion it made sense to us to refill the TGA via bills issuance that taps the RRP.



The RRP has fallen by almost exactly the increase in the TGA. It makes sense to issue bills when the RRP exists as the Federal Government is already paying the short term interest on the RRP and can simply replace that cost with bills interest. Tapping the RRP though is not a simple thing. The combination of RRP + Bank Reserves only falls when the TGA is being built up and/or QT runoff are being funded. Regular old deficit spending increases money in the private sector, through, spending at exactly the pace that issuance occurs. RRP + Reserves won't change much once the TGA is fully rebuilt so the option to tap the RRP only amounts to the pace of QT. The Debt Ceiling Relief legislation specifically mentions the TGA and prohibits filling the TGA above a reasonable amount necessary to manage the Treasury Departments cash needs. We think 600BN is that number and do not expect an increase from the September 30th target in the forthcoming QRA. The consequence of TGA stability is that further RRP reduction will be limited to QT Flows and those flows offer little incentive to issue bills.

The US Treasury has a well articulated framework for their debt issuance mission. It is quite clear that they do not attempt to time markets or manipulate the economy despite the fact that they hold the QT lever. It will be interesting whether the Treasury Department will attempt to market time or mute the policy goals of the Federal Reserve. We think it is highly unlikely and they will soon be on a path to Issuance Normalization.

The Mission Statement of the US Treasury for Treasury Financing

Treasury Financing

Objective

- Fund the government at the least cost to the taxpayer over time

Strategies

- Offer high quality products through regular and predictable issuance
- Promote a robust, broad, and diverse investor base
- Support market liquidity and market functioning
- Keep a prudent cash balance
- Maintain manageable rollovers and changes in interest expense

Constraints

- Uncertainty – legislative commitments, macro-economic forecast errors, technical modeling factors all create uncertainty in deficit forecasts
- Size – Treasury is too large an issuer to behave opportunistically in debt markets

Policy Outcomes

- Treasury is a regular and predictable market participant, not a market timer
- Treasury doesn't react to current rate levels or short-term fluctuations in demand
- Treasury requires flexibility to respond to uncertainty – to rapidly raise cash or pay down debt – shorter maturities provide more flexibility
- Treasury seeks continuous improvement in the auction process
- Treasury strives for transparency and regularly consults with market participants

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Least *Expected* Cost Over Time and Regular and Predictable

Least Cost

- Interest expense is important, as the Fiscal Year 2020 Mid-Session Review forecasts that the U.S. government will reach primary surplus in 2025.
- For a given amount of debt issuance, the expected relative cost – over time – of issuing at different points on the curve matter.

Regular and Predictable

- "Regular and predictable" issuance argues against being opportunistic.
- Issuance experience, complemented by surveys of the primary dealers, informs Treasury's view on the speed of any adjustment to auction sizes.
  - Greater liquidity reduces Treasury's funding costs over the long-run.
  - However, limiting the speed of adjustment of issuance implies slowly adjusting to shifts in expected cost.

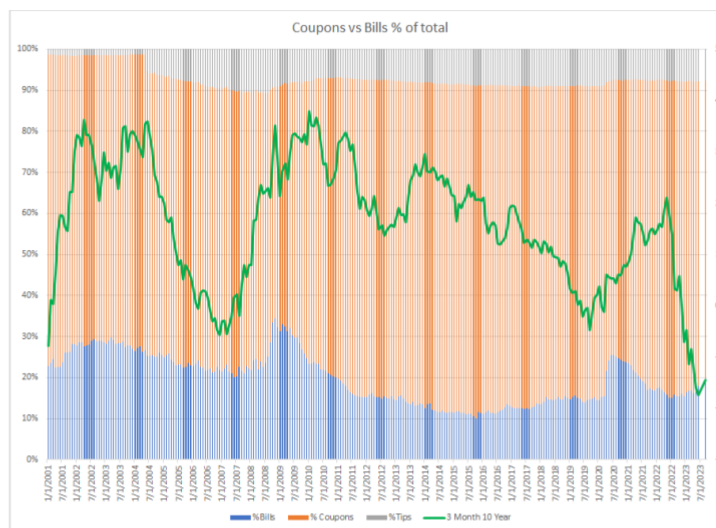
The high-level message from the Treasury is:

- Fund the Government at lowest cost over time.
- Not market timer
- Use of bills when short term cash needs are high.
- Prudent cash holdings (TGA)
- Regular and predictable issuance of bonds

Assuming the Treasury is not a market timer that presumes that the yield curve is a fair representation of market yields, and the Treasury should spread issuance across a wide breadth of maturities. They have used bills in Q3 when cash needs were high as the objective was to rapidly rebuild the TGA. They have reduced bond issuance. Going forward with their framework, and absent the "Regular and Predictable Issuance of bonds, principal they should increase bonds quite a bit.

There is a guideline to which the Treasury hews fairly closely, the guideline suggests that 20% of private sector owned marketable Federal Debt is composed of bills. Typically, in times of crisis outstanding bills rise above that number and after the crisis the bills are refinanced with bonds. While the US economy is not in a crisis now, a very high projected fiscal deficit suggests that bills issuance will remain high. Bills will remain high as the deficit needs funding and the limiting factor is how quickly bond issuance totals can be increased. Nonetheless it makes sense to rapidly increase long term bond issuance as, interest rates are quite a bit lower than bills rates, term premiums on bonds are quite low, and demand is strong. Yet, the Treasury needs to be cautious as increasing supply too rapidly will violate the "Regular and Predictable" standard. This leads to the conclusion that a significant increase in bond issuance will occur with increases spread over a few quarters.

It is useful to look back in history how the Treasury has balanced bills issuance and bond issuance. In 2001, 2008 and 2020 Bills issuance spiked dramatically and outstanding bills to total debt grew to 25-32%. It should be noted that this bills issuance took place during recessions and when the yield curve was steep. Today's extreme yield curve inversion makes the use of bills seems highly unusual and unsustainable.



Expectations for the QRA

Given the Treasury has now filled the TGA, and the fraction of bills outstanding is over 20%, our expectation is that Bills issues as a percentage of total issuance will fall over the next year and a normal ratio of Bills to total issuance will return. The combination of the shift from bills to bonds, a large projected deficit, and the need to raise money to pay off the Fed's maturity runoff will result in substantial increases in bond issuance.

On 7/31 at 3:00 PM The Financing Estimate will be released for Q4 We expect

- The Deficit will be 360BN in Q4.
- The TGA will be targeted to remain at 600BN.

- Including the 180BN of QT runoff from the Fed **the New Money Issuance needs will be 540BN.**

On 8/2 at 8:30 AM The Recommended Debt Issuance Schedule will be released.

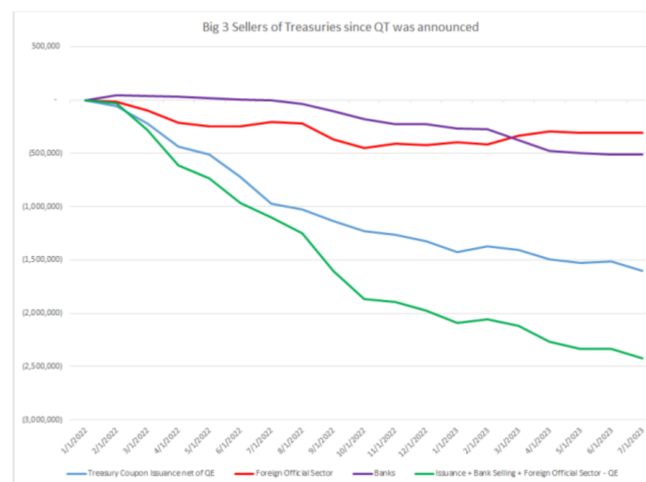
- 80% Bonds is the absolute upper limit and would generate a 432BN new bond issuance. This is the ultimate direction for bond issuance over the next few quarters but is highly unlikely for Q4.
- 178BN Bonds is the Q3 issuance. We think this is also an unlikely amount given it would mean a 362BN Bills issuance which would take bills outstanding up to 21% of total.
- **Our estimate is for 250-275BN** in bonds We think that is a substantial and market moving amount of bonds that would increase 10-year yield term premiums by 10-15bp and reduce equity multiples by 4-5%
- **However, any number above 275BN of bonds would signal an intension for Issuance to walk a path to normalcy and would be a Supply Catalyst leading to Act 2.**

Bond market supply and demand - the big 3 sellers

Of course, supply and demand in the bond market is complex but it pays to look at the various players in the bond market and what they have been doing and what they are likely to do in the future.

Since QT was announced three cohorts were the primary sellers of bonds.

- The Fed runoff and lately the TGA Refill paid for with Treasury issuance.
- Commercial banks
- Foreign Official Sector



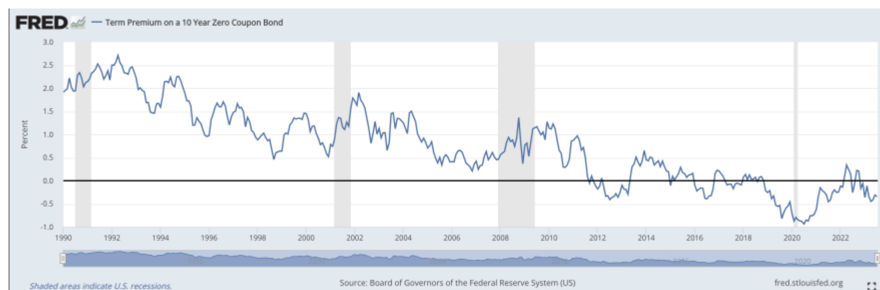
In the first three quarters of 2022 they sold 1.8TN Bonds at a monthly pace of 200BN. Since the 2022 Equity lows on 9/29/2022 the Big Three have significantly reduced their selling. The Foreign official sector even began buying bonds as their currency strengthened against the USD. Banks essentially stopped selling once the BTFP was implemented allowing banks to finance underwater bonds. Treasury due

to the debt ceiling was constrained. In the last nine months the big 3 have slowed their pace of selling to 60BN per month

Other cohorts

- Hedge funds continued to sell bond futures but that seems likely to be spreading against cash bonds and other fixed income products like corps munis and mortgages.
- Slow and steady investors like mutual funds, pension funds and insurance companies have been the buyer of dwindling bond supply.

The impact of the slowing of selling has clearly been felt in bond yields as they remain heavily inverted vs short rates and with a sizable negative term premium.



Synthesis and Implication for a large increase in bond issuance

While the Big 3 were selling at a 200BN per month pace risk premiums on assets increased by 75 bp. Since the selling slowed to 60BN per month risk premiums have contracted by 75bp. **Our expectation is that an increase in bond issuance of 25bn per month or 75BN for the quarter will lead to a 10-15bp increase in risk premiums and a 4-5% decrease in multiples. The QRA on August 2nd will only be the beginning of the increased duration supply and November it will become apparent that risk premiums are going to return to normal along with issuance. A supply driven 50bp increase in 10-year yields will most certainly be the opening to Act 2. Will that happen on 8/2. Maybe. Can Janet still starve the market for bonds. We think not but if she does the transmission mechanism for QT will be further muted and the Fed will find itself forced to hike more than the current SEP provides. Equities will remain bid, and the economy will not slow.**

Given the uncertainty of the QRA we have this game plan

1. **A bond issuance below 200BN for Q4 indicates a continued lack of supply. That means long term assets stay bid as does the economy. Short the front end of the yield curve is the best bet as the Fed will be forced to hike more than the SEP and pricing suggests**
2. **Bond issuance from 200BN – 25OBN will signal a willingness to begin the path to normalization and the likely consequences of our five act play. However, a rapid repricing of assets isn't likely. That augers for maintaining a short asset bias but buying the dips on equities.**

3. **Bond issuance above 250BN is the potential "Supply Catalyst" which would favor a large long term bond and equity short position.**

We will communicate our view as the data unfolds on August 2nd.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 47,520,182		
Total Return	47.52%	YTD Return	2.22%
Today's Date	7/24/2023	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Close
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	0.05	$ (976,190)	Open
5/25/2023	NDX August 13000 Put	250.00	60	$ 1,500,000	11.5	$ (1,431,000)	Open
6/9/2023	SPX Call Spread August 4320/4400	48.00	-250	$ 2,000,000	70	$ (550,000)	Open
6/9/2023	SPX August 4185 Put	48.00	250	$ -	5	$ (1,075,000)	Open
2/1/2023	SFRZ4 ShortTwos and Spoos	97.085	-1600	$ 2,000,000	96.01	$ 4,300,000	Open
7/5/2023	ZF Sept for August expiry 106.5/105.5	0.359375	5565	$ 2,000,000	0.25	$ (608,696)	Open
7/12/2023	ZNU 111.5/113.5 Call Spread	0.84375	-865	$ (1,000,000)	1	$ (135,135)	Open
5/17/2023	NVDA 280/300 Call Spread	11	-111	$ 100,000	19	$ (88,889)	Open
5/17/2023	AAPL 160/175 Call Spread	9.8	-192	$ 100,000	14.99	$ (99,808)	Open
5/17/2023	AMZN 105/115 Call Spread	6.42	-279	$ 100,000	9	$ (72,067)	Open
5/17/2023	GOOG 110/120 Call Spread	6.57	-292	$ 100,000	6.62	$ (1,458)	Open
5/17/2023	META 230/245 Call Spread	8.4	-152	$ 100,000	14.05	$ (85,606)	Open
5/17/2023	MSFT 300/315 Call Spread	9.47	-181	$ 100,000	12.17	$ (48,825)	Open
6/15/2023	DS Beta Short Component GLD	182.52	-16495		182.18	$ 5,663	Open
6/15/2023	DS Beta Short Component SPY	449.01	-16925	$ 1,200,000	452.18	$ (53,652)	Open
6/15/2023	DS Beta Short Component TIP	107.68	-69506		107.61	$ 4,981	Open
6/15/2023	DS Beta Short Component GSG	20.26	-151863		20.86	$ (90,373)	Open
6/15/2023	DS Beta Short Component TLT	102.38	-87527		101.73	$ 56,455	Open