The Damped Spring Report

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

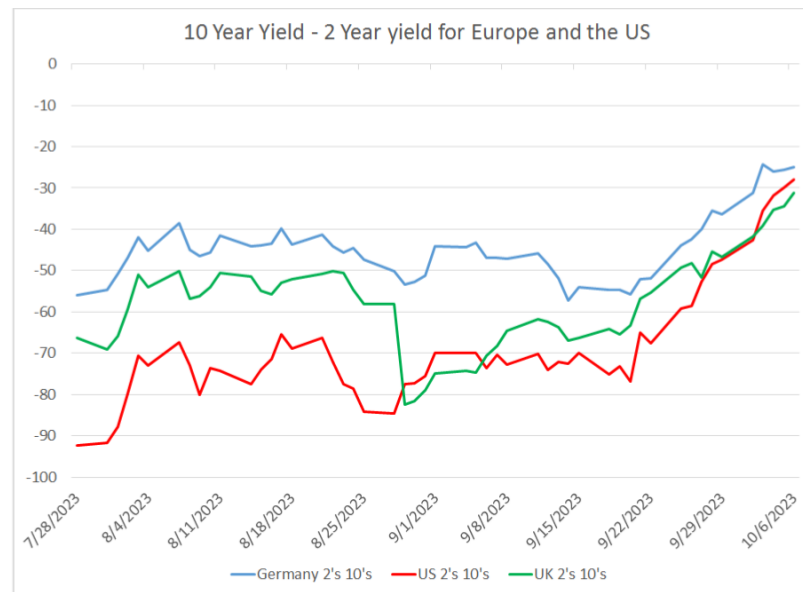
10/8/2023

US bond market yields have dramatically bear steepened since the supply catalyst of the QRA on 7/31. That catalyst resulted in bond market selloffs around the globe. The selloff has been compounded by YCC easing by the BOJ, Asian currency managers potentially selling UST to defend weak currencies, and regulatory pressure on US Banks. Bond markets may have now fully adjusted to the announcement and the supply that is now being issued in Q4. We will look at the QRA on 10/30 and 11/1 for more hints about the next leg for the bond market but our expectation is that there will be no respite in the supply for Q1.

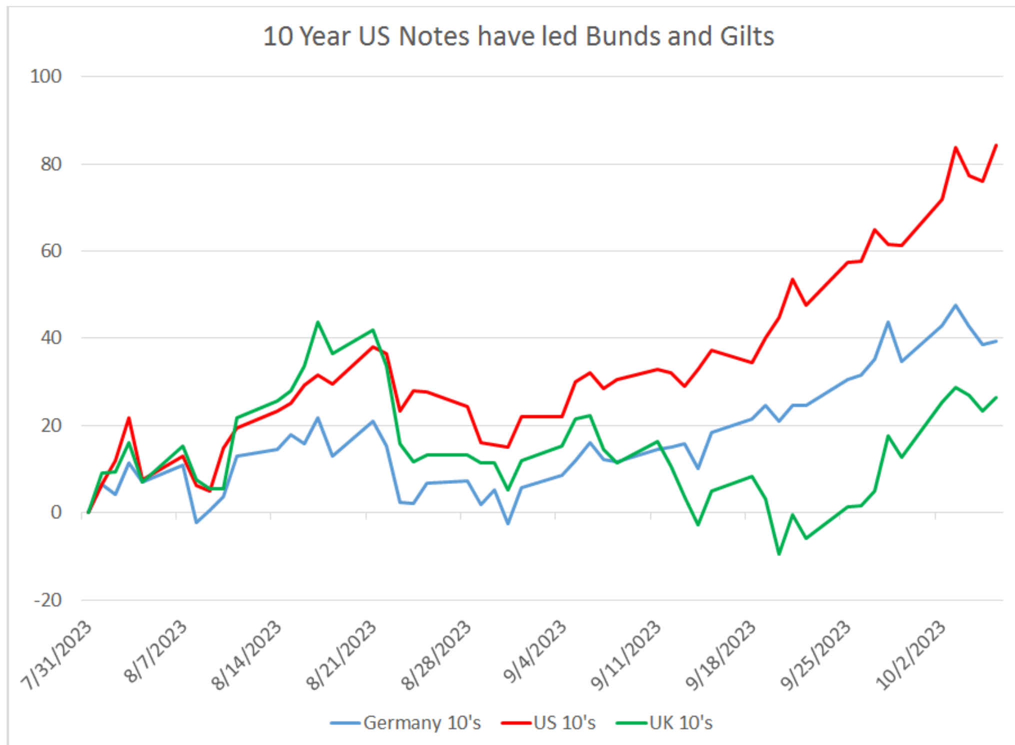
However, we believe that European bond markets are much less likely to bear steepen along with the US market due to a lack of a local supply catalyst and a fundamental difference in the transmission mechanism of monetary policy.

The economic outlook for Europe is dire indeed. We believe that dire outlook is fully priced into European bond markets and believe that there are good odds to bet on less bad outcomes in the European economy. Given the lack of supply catalysts and the dire economic outlook we favor bear flatteners in Europe particularly vs bear steepeners in the US.

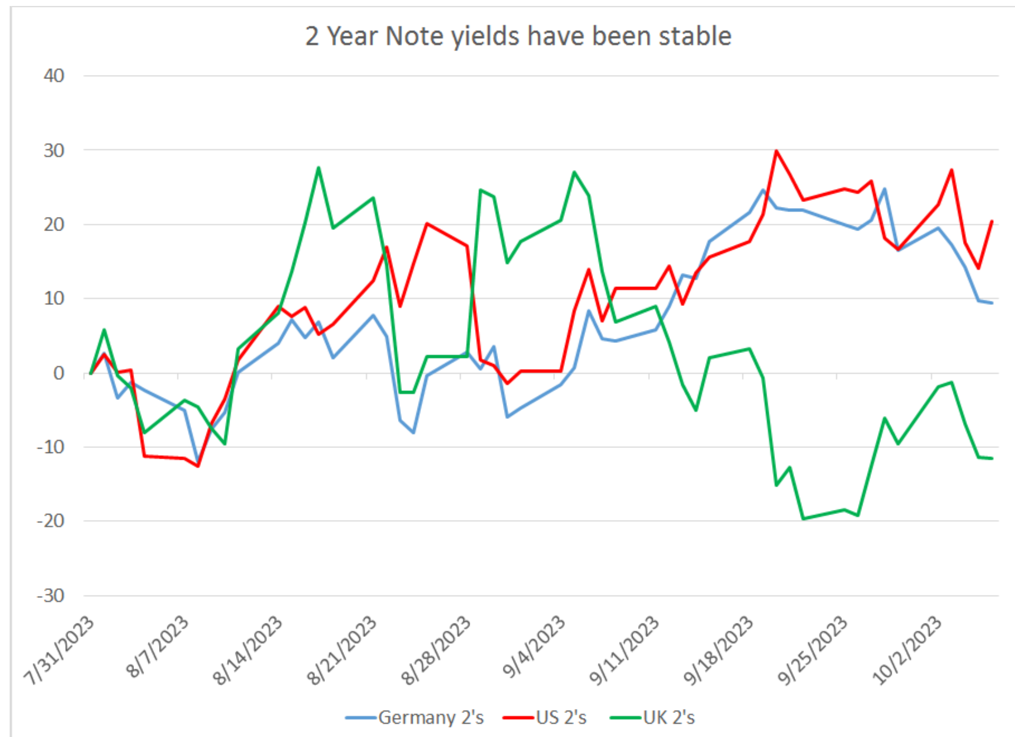
US Curve leading the bear steepening.



The US curve has steepened by 64bp since the QRA, but that steepening has only resulted in the German and UK curves steepening by 30bp and 38bp respectively. 10 Year rates have shown a similar lower increase in European rates.



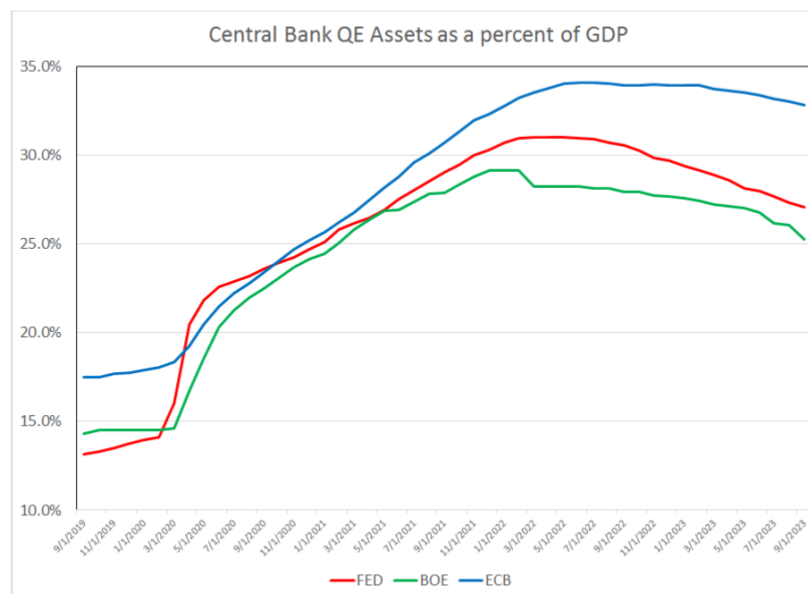
Central banks have also paused, the UK even surprised by not hiking, and projected a long pause resulting in stable two-year yields.



The mechanism in place is term premium arbitrage across countries as US Bonds faced with larger supply cheapen and then drag up European rates. Now that 2's 10's is basically the same in Europe and the US this begs the question if Europe's bear steepening has more to go given the modest relative move or if the economic circumstances and supply situation for European bonds relative to US bonds are likely to result in a bear flattening in Europe relative to the US. We think the supply from the US market will continue and favor bear steepening in the US but in Europe the supply of bonds is quite different, and the economic sensitivity suggests that if inflation and growth rebound, particularly in Europe given the dire outlook, hiking more than is priced is a more likely outcome in Europe than a bear steepening.

QT Differences

Let's review the form of QT each of the major US and European Central banks are using. Both the US and the ECB are using runoff which results in the choices made by the fiscal side regarding composition to determine the effectiveness of the transmission mechanism. The UK is using outright sales as most of their portfolio of QE purchased Gilts are longer maturity and must be sold outright to market participants. When looking at the impact of QT assuming in the runoff cases that the fiscal side is tapping liquidity across the curve the pace of the balance sheet reduction is the key determinant of its impact.



The Fed increased its holdings the fastest and the most post COVID. However, the pace of QT is fairly rapid. The UK also increased fast but is now reducing the balance sheet at the fastest pace. The ECB Used the PEPP program during COVID which favored countries facing greater difficulty. The current runoff is only on the APP program and is extremely slow paced. This is partly due to the fact that the PEPP is large and not running off but even the pace of APP runoff is slower than both the Fed and the BOE. This slow runoff needs to be watched carefully and clearly any move on the PEPP would have significant impact on weaker countries particularly Italy.

Runoff vs Outright sales

UK

The UK QT uses outright sales. The BOE holds the QT lever firmly. Choices by the fiscal side do matter in this environment even in the UK if for instance the UK decided to finance with short dated or long dated bonds to roll existing debt and fund any deficit. Following the duration issuance of gross and net money is necessary to understand the supply and demand of risk in the private sector. However, we see little actionable catalysts that would suggest the UK would shift its funding. The experience last fall in which the prior PM attempted to significantly increase the deficit is not likely to be repeated in the near term. Nonetheless we will continue to track the fiscal side. The bigger point is that the BOE holds the lever and they have been extremely transparent about QT. They are rapidly reducing their balance sheet. They have recently increased the pace of QT by 25% and they are likely to maintain that pace well into 2024. Given that transparency and the fiscal situation we believe idiosyncratic supply demand in Gilts associated with domestic policymakers is neutral. **This also likely means that the UK will tug the short rate lever if economic conditions shift first before impacting the long end with QT or issuance levers.**

US

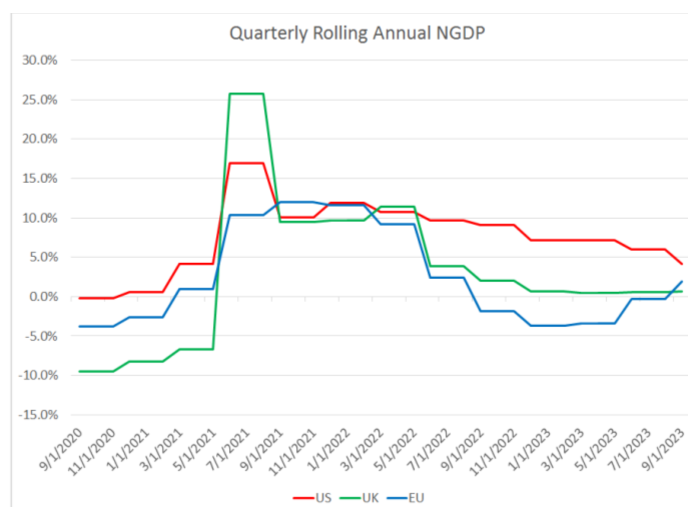
The US QT uses runoff. We have written many DSRs on this topic. We will have a DSR on the Halloween QRA at the end of the month. **A preview is that we see almost zero possibility that bond issuance in 2024 will fall below the 338BN of coupon issuance pace planned for this quarter and there is significant upside to potential bond issuance.**

ECB

The ECB uses runoff. Furthermore, it currently limits runoff to the APP related holdings. PEPP related runoff is reinvested in the country's debt that is running off. As we mentioned above the pace of APP runoff is anemic relative to other central banks. Down a level we will describe the country-by-country runoff later in this report. As of June, the ECB stopped using a cap of 15BN per month of runoff and will now let all the APP runoff occur without reinvesting proceeds. That was a small tweak to APP runoff, and it creates some lumpiness in the runoff amounts per month but in aggregate over the next year will not make much of a difference in pace. It will still be too small. In addition, as the ECB has now gone to uncapped runoff the only lever for them on QT of the APP would be outright sales which may be quite a hurdle. The fiscal policy of the EU given the various rules in place for membership and a relatively austere set of members has resulted in much lower deficit volatility and thus much lower impact from the fiscal issuance lever. The elephant in the room in terms of levers is the runoff of the PEPP. It is largely the financing of the PIIGS during COVID. Clearly if the ECB were to begin runoff of the PEPP BTP/BUND spreads would explode higher. **We think that given the QT lever is now either outright sales of APP holdings or PEPP runoff the ECB will favor rate hikes by a wide margin over alternatives if the economy recovers or inflation increases.**

Economic Differences

The economic situation in the US, UK and EU is different. The US fiscal response was much larger than any fiscal response in the world in an absolute sense and in a % of GDP sense. The UK has Brexit and Ukraine energy price moves to deal with and certainly did themselves no favors with the mess of politics last October. The EU was aggressive in supporting the south during Covid with aggressive PEPP support. NGDP has fallen rapidly in the UK and EU given the fall in energy prices and the weakening real growth and the US has also slowed as post covid spending slowed and monetary policy had some impact. However, based on US growth ticking up and extremely dire consensus outlook in the EU and UK we favor the idea that NGDP will reaccelerate and faster moving data suggest that as well.



US vs Europe and UK – Rate hike effectiveness and fiscal policy flexibility

The big monetary policy difference between the US and the rest of the world is the relative effectiveness of rate hikes to slow the economy. The big fiscal policy difference is the willingness of the US to run a much larger budget deficit than the rest of the world and particularly Europe.

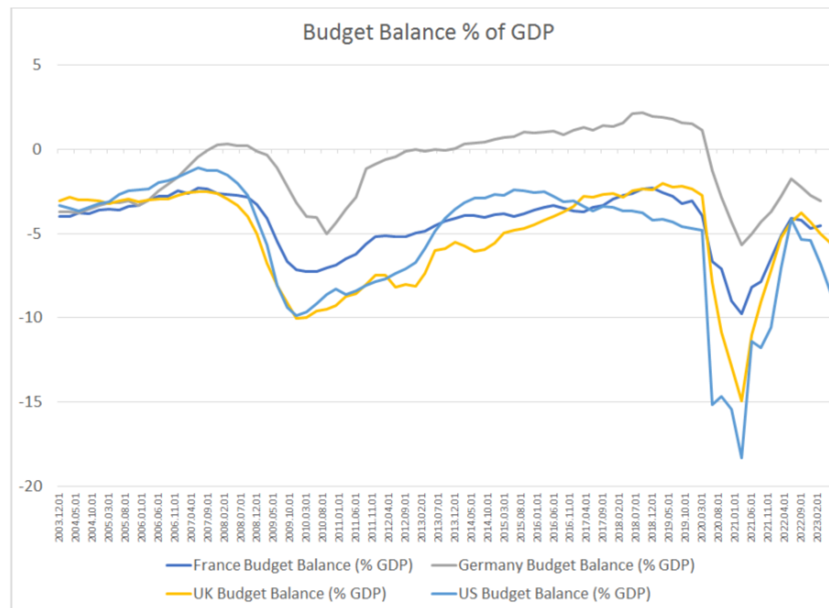
Monetary policy

The transmission of rate hikes depends on its impact on those who borrow and those who save and as we have seen after over a decade of low or zero interest rates also depends on the stock of long-term borrowing locked in at low rates. In the US savers are seeing significant returns available on cash and are banking income. This income is particularly strong for corporations with large cash holdings that can tap money market or wholesale bank deposit returns. Consumers and high-grade corporates have also locked in long-term borrowing at very attractive rates. This has dulled rate hikes as a monetary policy tool and has been the reason the Damped Spring Report has focused on QT as the way to cool the economy. The Fed preferred to use the rate hike lever and we get that, but it's clear QT is also necessary to transmit the impact on what was until very recently a heavily inverted curve. The rest of the world has a structural difference in how households

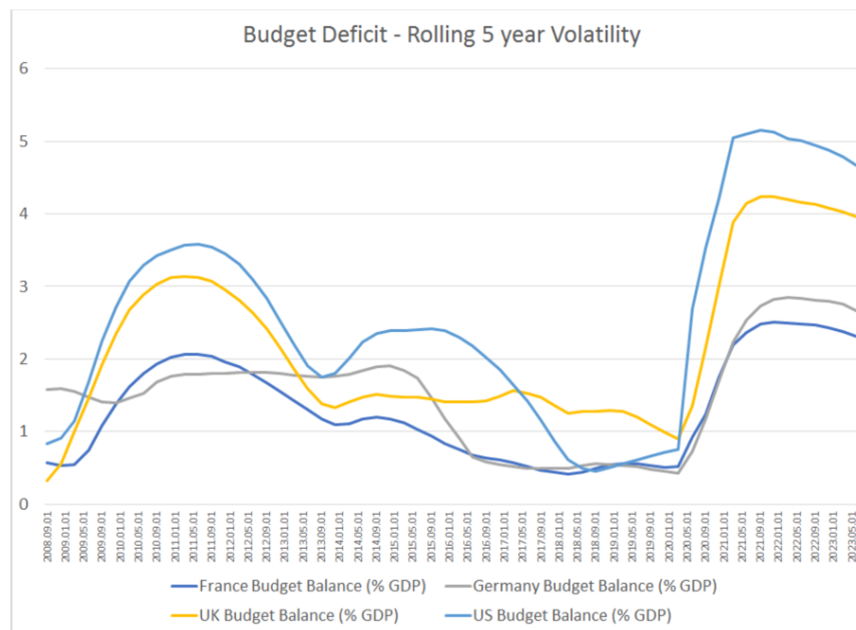
finance their homes. Floating rate mortgages are the major difference, and we believe that rate lever is much more useful in slowing the economy outside the US.

Fiscal Policy

The US Fiscal policy flexibility has a major impact on both the real economy and issuance to finance fiscal spending. UK Fiscal policy is a distant number two showing some flexibility relative to the EU, but nothing compared to the US. The US runs a much bigger fiscal deficit when it wants to.



But perhaps more importantly it is essentially unanchored by fiscal budget constraints and thus has much more volatile fiscal impulses.



Synthesis

Europe and the UK do not have a supply catalyst that will generate a bear steepening like the one seen in the US. 2's 10's curves in the US, UK and Europe have converged to about the same level. We expect further steepening in the US as the reality of QT, the budget deficit, and the percentage of existing bills issued, results in further sizable issuance of duration into a weak demand market for risk. This further risk premium expansion will impact European and UK curves, as they have in recent months, but without a significant increase in BOE outright sales, ECB APP outright sales, or heaven forbid PEPP runoff, European bond supply and demand will remain balanced and cause US Tens to underperform Gilts and Bunds. We also believe that the EU and UK paused prematurely and suspect a reacceleration of NGDP which will require further hikes. At this moment particularly with a Gaza war brewing we are not changing our positioning. However, we favor and will be looking to enter these trades.

- **Long bunds and/or gilts vs short US Tens**
- **Short Schatz and 2-year gilts vs long US two's**

In appendix, we have examined intra EU issuance and runoff and describe our findings below. While it's fairly clear that without a change in PEPP runoff there is little opportunity today to arbitrage any runoff/issuance local supply demand imbalance with intra Europe bond spreads we will continue to focus on any imbalance we see and distortions if they present themselves. Thanks @DanielSimonyi for help preparing this report.

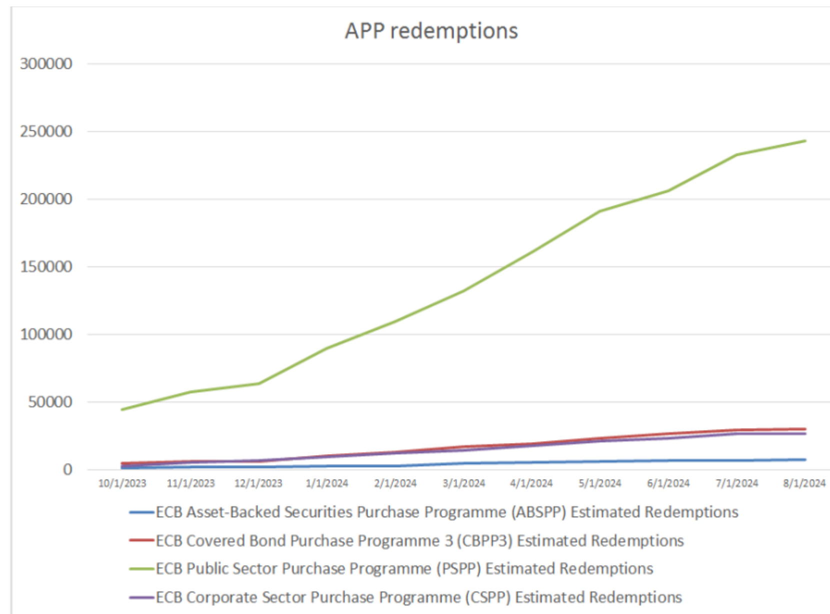
Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 66,837,851		
Total Return	66.84%	YTD Return in excess of cash	21.54%
Today's Date	10/8/2023	Portfolio Created	4/15/2019

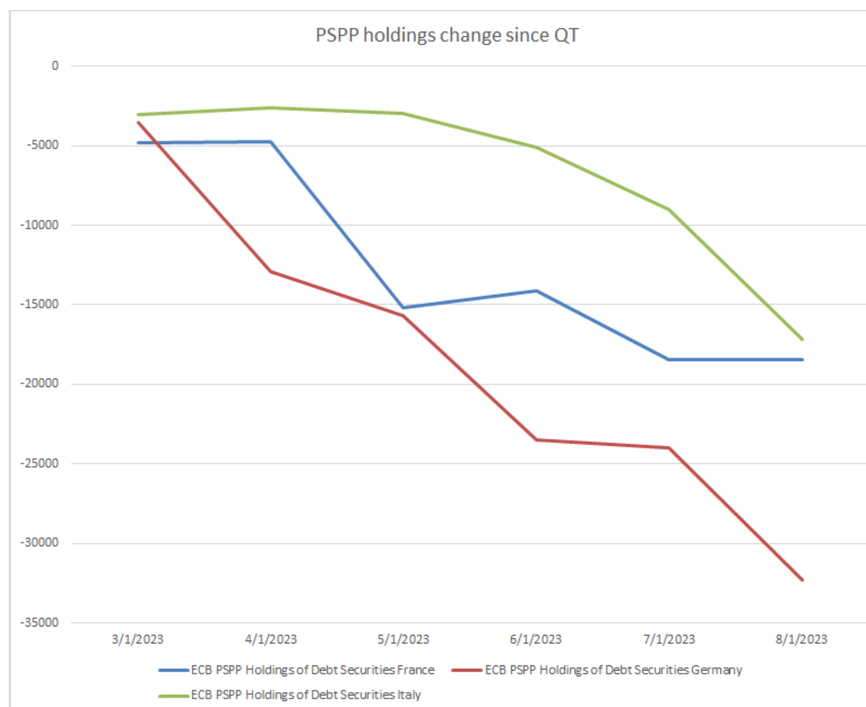
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Close	Type
10/20/2022	CLZ23 95/105 Call Spread	2.1	476	$ 1,000,000	0.5	$ (761,905)	Open	1
9/7/2023	NDX 10/20/23 Expiry 13900 Put	82.00	-84	$ (2,000,000)	12	$ 588,000	Open	2
8/2/2023	NDX 10/20/23 Expiry 14500 Put	245.00	40	$ 1,000,000	69	$ (704,000)	Open	2
8/4/2023	NDX 10/20/23 Expiry 14500 Put	228.00	44	$ 1,000,000	69	$ (697,368)	Open	2
8/24/2023	NDX 10/20/23 Expiry 14500/13900 Put Spread	95.00	53	$ 500,000	53	$ (221,053)	Open	2
9/22/2023	SPX 10/20/23 4200 Put	28.58	700	$ 2,000,000	16	$ (880,336)	Open	2
9/8/2023	DAX 11/17/23 15500/16000 Call Spread	301.00	-503	$ 500,000	155	$ 366,834	Open	2
10/2/2023	NDX 11/17/23 14700 Put	360.00	28	$ 1,000,000	275	$ (236,111)	Open	2
10/6/2023	NDX 11/17/23 14700 Put	300.00	33	$ 1,000,000	275	$ (83,333)	Open	2
10/2/2023	SPX 11/17/23 4275	77.00	130	$ 1,000,000	69	$ (103,896)	Open	2
10/6/2023	SPX 11/17/23 4275	69.00	145	$ 1,000,000	69	$ -	Open	2
9/8/2023	RXZ3 11/17/2023 132 137 Call Spread	1.17	427	$ 500,000	0.32	$ (363,248)	Open	3
9/7/2023	ZBZ 10/27/2023 118 Put	1.58	2363	$ 3,729,109	7.64	$ 14,325,688	Open	3
9/15/2023	ZBZ 10/27/2023 115Put	0.63	-2363	$ (1,476,875)	4.88	$ (10,042,750)	Open	3
9/21/2023	UNWIND Of ZVZ 10/27/2023 118/115 Put Spread	1.41	-591	$ (831,094)	2.76	$ (800,066)	Open	3
9/25/2023	ZBZ 10/27/2023 114/112 Put Spread	0.58	-1772	$ (1,024,438)	1.41	$ (1,467,438)	Open	3
10/3/2023	ZBZ 10/27/2023 112/111 Put Spread	0.39	-1641	$ 1,000,000	0.58	$ (307,692)	Open	3
10/3/2023	TNZ 10/27/2023 107/106 Put Spread	0.36	-1561	$ 1,000,000	0.42	$ (97,561)	Open	3
10/4/2023	EURUSD PUT SPREAD 1/4/2024 1.05/1.02	0.77	(44,843,049)	$ 1,000,000	0.6	$ 76,233	Open	4
			Risk	11.897%		10.5%		

Appendix - Europe drill down on supply and demand.

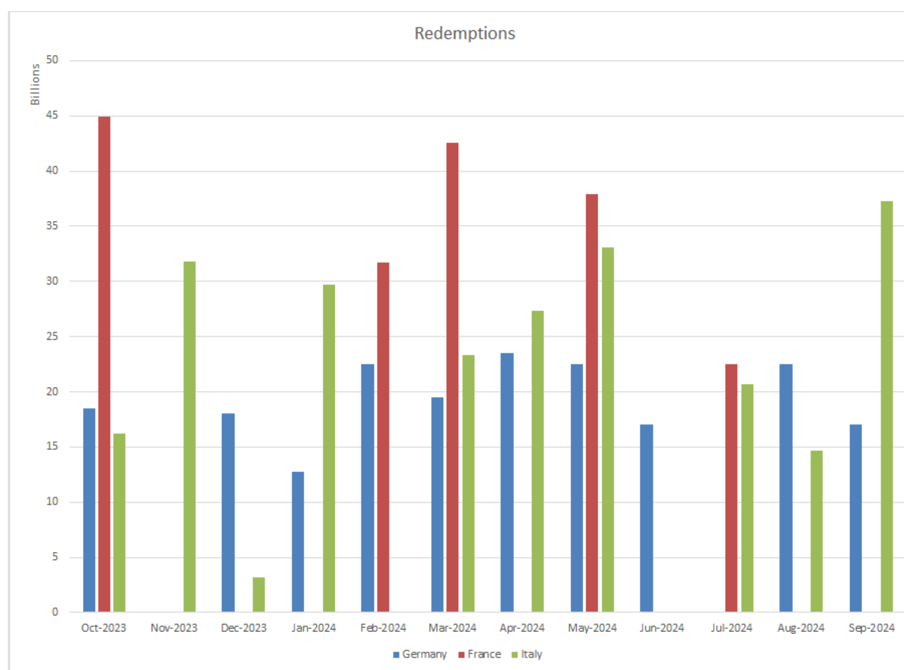
The runoff of the APP is now uncapped which means whenever a country's bond matures the ECB will not use any proceeds to reinvest in the issuance used to pay the ECB or any other holder of that maturity. That will create some country specific lumpy and large refinancing pressure. However, over time the APP redemption schedule is smooth, and the pace is low. Included are non-government holding runoff as well.



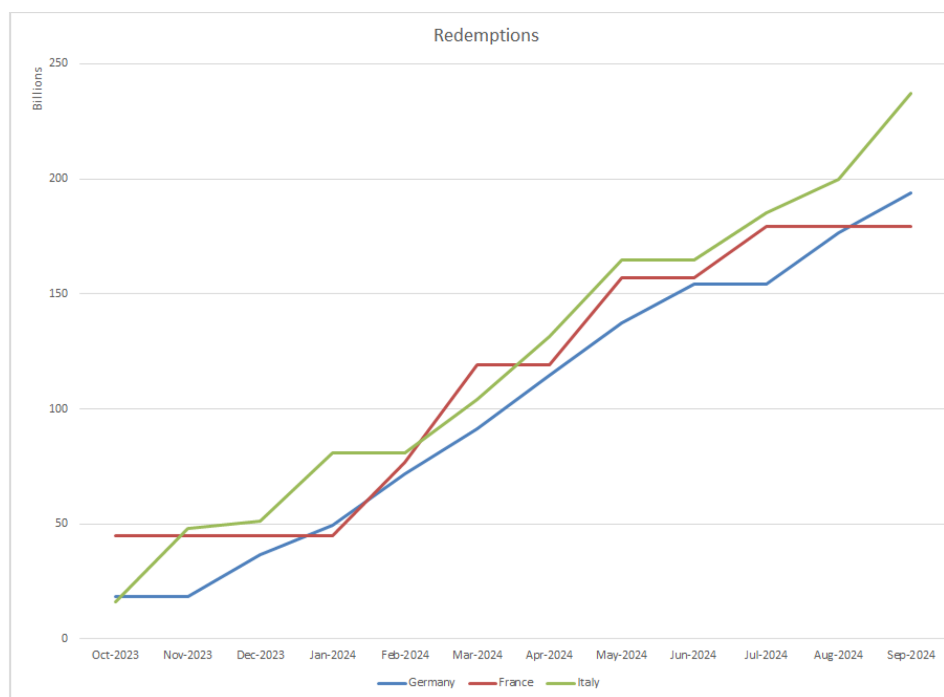
Looking backward to how runoff has occurred for each of the major economies the French runoff has been a bit slower than Germany and the nature of the APP and original purchase key has the EU having less Italian holdings in APP.



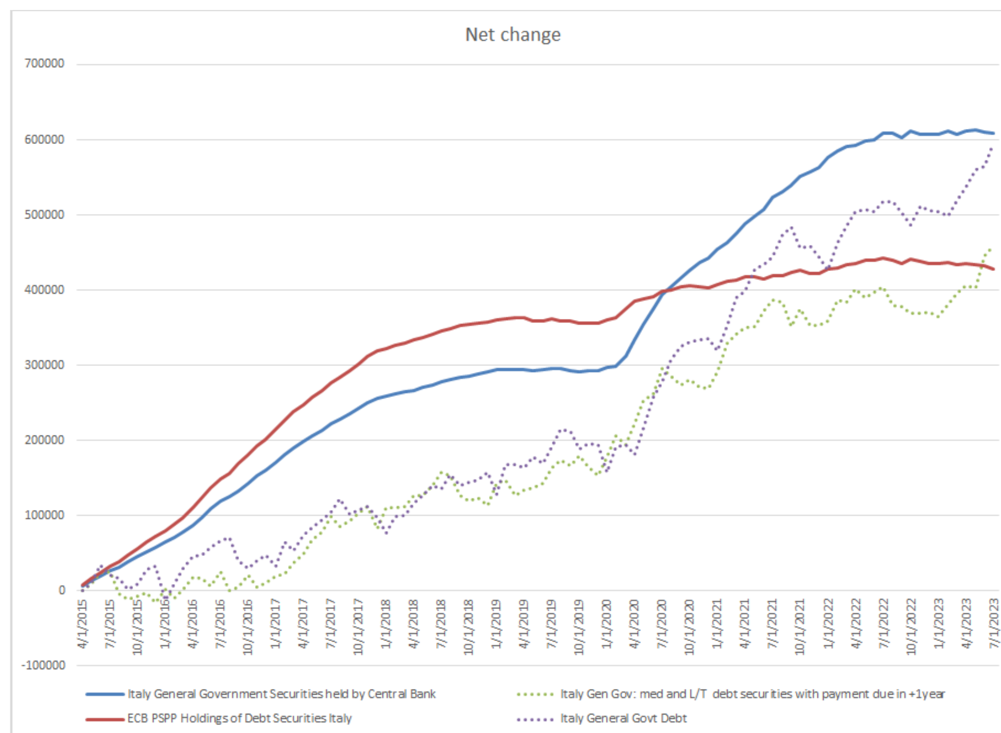
In the year to come runoff in Germany remains stable but French runoff and the necessary private sector financing is quite spiky and large going forward and Italy begins to be forced to fund runoff in the private sector as well in 2024. There also is a pause in overall runoff in the November and December



Shown a different way our leaning is towards being short oats and btp and long bunds particularly ahead of some spikes in redemptions. However, we are not sure this will dominate and of course in the event of a shift in PEPP BTP's will get destroyed and to the extent BTP's already are priced for a too high probability of PEPP runoff that may dominate the pricing.



One thing is sure the EU owns a ton of BTP's, and the maturities are approaching.



In addition, the buyers of BTP's post QE have been narrow and would not be able to absorb PEPP runoff. Well worth watching developments but as said above. First ECB hikes, Then ECB does APP outright sales, then and only then would they likely consider crashing BTP markets with PEPP runoff.