The Damped Spring Report

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

11/05/2023

Last Wednesday the TBAC and Treasury decided to pause the rapid increase in Treasury coupon issuance. Instead of increasing coupon issuance to finance a growing need of 816BN in Q1 they issued 57% bills and "only" 348BN of coupons. When we saw that number, we immediately reacted and covered all shorts in bonds and stocks. Over the next 72 hours bonds rallied 50bp and equities rallied 4-7%. Term premiums collapsed. By Friday the weak employment number squeezed two-year notes down to 4.85 and cuts of 105bp were priced into 2024. We think the actions of the Treasury have caused these moves and if the moves persist will result in "The Script" returning to Act 1 where rate hikes have yet to achieve the goal.

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**.

Our positioning in markets is small as the rally last week has priced long term bonds and stocks too rich to buy. While we believe the market has overreacted to the QRA the bias remains toward higher prices for assets, and we are not quite ready to recommit to a large short position. We expect to short further rallies and buy assets if last week's rational exuberance retraces substantially. By year end, the recent lows in asset prices will hold and the 7/31 highs are not going to be surpassed.

Reflecting on the events of last week we have many questions.

- **Is Treasury concerned about their ability to issue coupon bonds?**
- **The Fed governors have all been commenting on the rise in long term yields doing some of the work in tightening financial conditions and if so, does the massive easing that has just occurred impact their thinking?**
- **What of the real economy? While we agree wholeheartedly that the rise in long term yields is a necessary step in the script to kill inflation, the actual rise in yields was brief and now has reverted and the tightening and resultant slowing which may have been seen in the recent jobs report may be transitory. If so, are we back to Act 1?**
- **Does the rate of change in bond issuance matter more than the level of bond issuance and has the bond market calibrated the news and the future of both rate of change and level of issuance correctly in current near zero term premiums?**

The answers to all these questions are critical to trade markets and we will address each in this report.

Most markets recovered half of the July 31st QRA release selloff in 3 days.

The rapid rally in all asset markets since the QRA has placed asset prices firmly in neutral territory relative to our equilibrium expectations of the impact of the news. Equities retraced 50% of the losses. Long term bond yields retraced 33%. Ironically, and perhaps due to the Fed and the NFP but more likely due to positioning, the two-year note rallied sharply and now prices in 105bp of cuts in 2024.

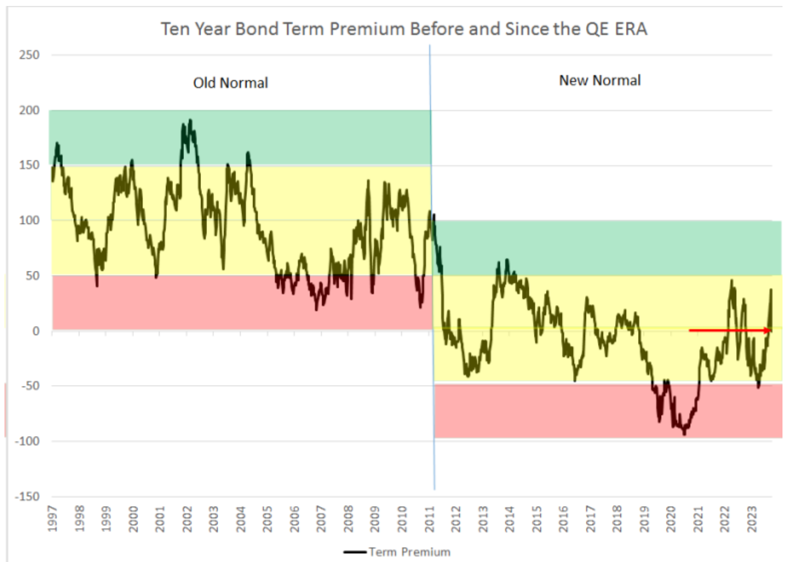
Asset Returns

	SPX	NDX	RTY	2 Year	10 year	30 year
Move from 7/31 to 10/31	-8.6%	-8.5%	-17.0%	21	97	108
Move since 10/31	3.9%	4.8%	5.9%	(25)	(36)	(33)
Retracement	46%	56%	35%	118%	37%	30%

As we will describe below, we think that the result of the easing in financial conditions due to the lower-than-expected issuance supply will result in the Fed having to eventually return to a hiking cycle and Higherer for Longerer. In addition, the brief time long term yields stood above 5% may have had a modest impact on growth but the rally back will undue that damage.

Term premiums collapsed.

As we have mentioned, the only explanation for the selloff in all assets since 7/31 and the recovery last week has been the supply driven impact on term premiums. On 7/31 term premiums were negative. Prior to last week's QRA they peaked at a still historically low 38bp. Today we estimate term premiums are 5bp which is about average in the QE Era and does not compensate investors adequately for risk. **We began shorting 30 Year bond futures on Friday and expect to add to this short and add a short in 10 Year bonds on any rallies.**



Why did the Treasury decide to slow the increase in coupon issuance?

Our strategy for this QRA was to wait to make positioning changes until we saw what the Treasury announced. That said we also predicted an increase in coupons and were wrong. We saw the news and reacted by covering all shorts. Nonetheless we had reasons to expect higher coupon amounts. Those were.

- Term premiums were very low and attractive for coupon issuance over bills.
- Bills outstanding were high and likely to rise regardless of the decision.
- Choosing bills delays the inevitable extension of the debt.

So why did Janet choose bills? There are two basic reasons why the Treasury decided to keep the level of coupons basically constant. They were either panicked about the impact that the 160BN increase in coupons in July caused or they were not at all panicked and decided to let the market digest the new high level of coupon issuance for a quarter or two. We think the idea that the Treasury is panicked at this stage is pretty silly. If so, they would have reduced the level of coupon issuance instead of modestly increasing the level. We will discuss the tactics later in the report but for anyone who has had to move a large amount of risk in markets this tactic of easing back a bit should be quite familiar.

Long term interest rates may not "do some of the Fed's work"

The Fed has been repeating the phrase "rising term premium could do some of the work cooling the economy."

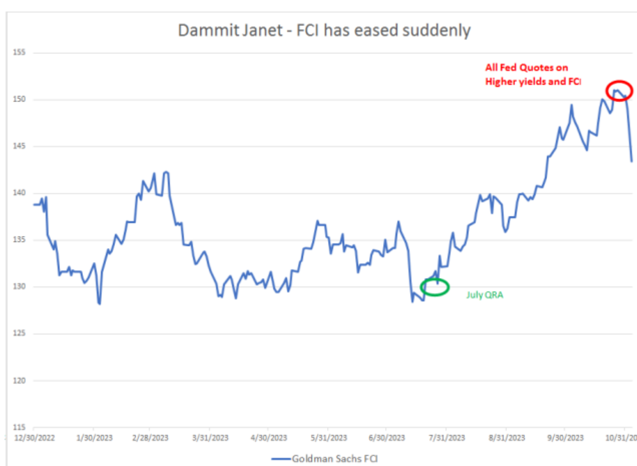
Lorie Logan "if term premiums rise, they could do some of the work of cooling the economy for us, leaving less need for additional monetary policy tightening to achieve the FOMC's objectives."

Christopher Waller "The financial markets are tightening up and they are going to do some of the work for us...We are just keeping a very close eye on that. We will see how those higher rates feed into what we do on policy in the coming months."

Philip Jefferson "I will remain cognizant of the tightening in financial conditions through higher bond yields and will keep that in mind as I assess the future path of policy,"

Neel Kashkari "It's certainly possible that higher long-term yields may do some of the work for us in terms of bringing inflation back down," and added "But if those higher long-term yields are higher because their expectations about what we're going to do has changed, then we might actually need to follow through on their expectations in order to maintain those yields,"

Jerome Powell "Financial conditions have tightened significantly in recent months, and longer-term bond yields have been an important driving factor in this tightening. We remain attentive to these developments because persistent changes in financial conditions can have implications for the path of monetary policy."



We strongly agree with the Fed Governors' statements on higher term premiums and tighter FCI as being a necessary Act in "The Script" to kill inflation. But the supply catalyst may have been withdrawn which leads us to conclude that further easing, rallies in stock and bond markets, will force the Fed to hike again and perhaps multiple times. We have begun adding SFRH4/Z4 spreads expecting the recent surge in rate cut expectations to reverse sharply as the Fed Governors walk back their October statements.

What of the Real Economy

We have been lonely for 15 months or so on Higherer for Longerer island. We believe that the labor market, the cash from prior stimulus yet to be meaningfully withdrawn from the RRP and Bank Reserves, the spending bills associated with Deglobalization, Domestic onshoring, and Duplicate supply chain investment, a large fiscal deficit, and the scarcity of duration issuance to finance spending has led to an economy which has of course slowed but remains resilient. Clearly the recent GDP print is evidence that the Fed's hiking has not gotten the job done. We were hopeful that the rise in long term bond yields which was the catalyst to transition from our Act 1 to Acts 2 and 3 would put the economy on a path toward well and truly killing inflation. Over the last three months of tightening of financial conditions it is possible that the economy was indeed impacted. We expect weaker data which may have been evident in the NFP data on Friday. That weaker data may persist for a month fueling further pivot hopes and asset price rallies. However, the current easing of financial conditions and any further easing will be self-defeating. Before the Treasury provides another catalyst, which won't happen before January 31st's QRA, the Fed will meet twice. We expect they will be concerned, as we are, that the easing of financial conditions will result in stronger data by year end and require a return to hiking. By choosing to pursue QT through runoff they have ceded yield curve control to Treasury and Treasury has taken pressure off the long end. Dammit Janet.

Tactics and the future issuance from Treasury

When a market moving order needs to be executed in financial markets a complex game occurs. That game is a contest between the seller of a large block of an asset and the various market participants who will buy that asset for either investment or to provide liquidity for the seller until a buyer is found.

The buyers and liquidity providers are always seeking information about the size and quantity of the seller's order and their desire to complete the order in a particular time frame. The seller has various levers to pull to catch the buyers offsides when the buyers have begun front running the order. However, the seller tends to have a motivation to get the order done and the buyers can estimate the size of the order and how much is left. In private sector secondary market transactions, the seller also can behave secretly and attempts to tap liquidity without the buyers being able to identify the size of the order. In the primary market and in Government financing the seller has fewer levers because the size of the order flow is well known and public. That leaves timing as the only defense a public sector seller can use to minimize its price impact.

Every few days the Government auctions coupons. By and large most auctions occur at market and a very limited time of trade market impact is observed. This is due to the market impact being spread out throughout the days and hours leading up to the auction and at the time of the auction that supply is fully discounted in the price.

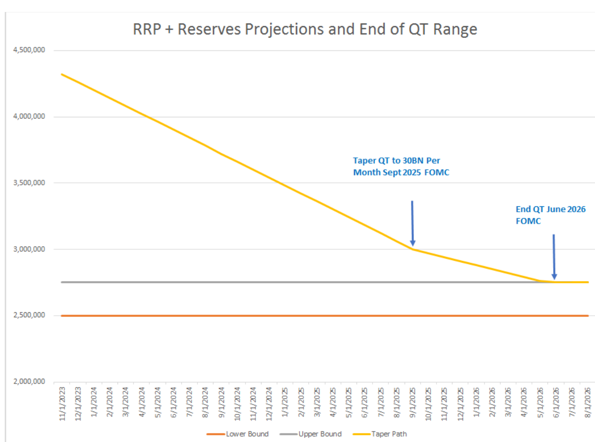
When thinking about the issuance pattern of the US Treasury and the price impact the Treasury had already set the timing of issuance in a highly predictable way. We know the approximate schedule of issuance of each different type of Government bill, note and bond officially 5 months in advance and by extrapolation as far in advance as we choose to guess. We also can estimate with fairly high accuracy the quantity of each of these things that will likely be issued over the next few years. What we don't know is the tactics the Treasury will employ to optimize its price received for its issuance. Those have two dimensions. 1. What is the level of issuance they plan. 2. What is the change in level they plan on making to achieve their end goal.

Are they going to keep issuance at a constant level for a long time? Are they going to issue a lot upfront and reduce issuance in the future? Are they going to increase issuance each quarter and keep pressing until they can ease back issuance to an even pace? Lots of options. The goal they have is to be adequately predictable to not damage the market but also be unpredictable enough as to punish those who try to take advantage of their order flow. The reason why they do this is because they want a relatively constant buyer elasticity.

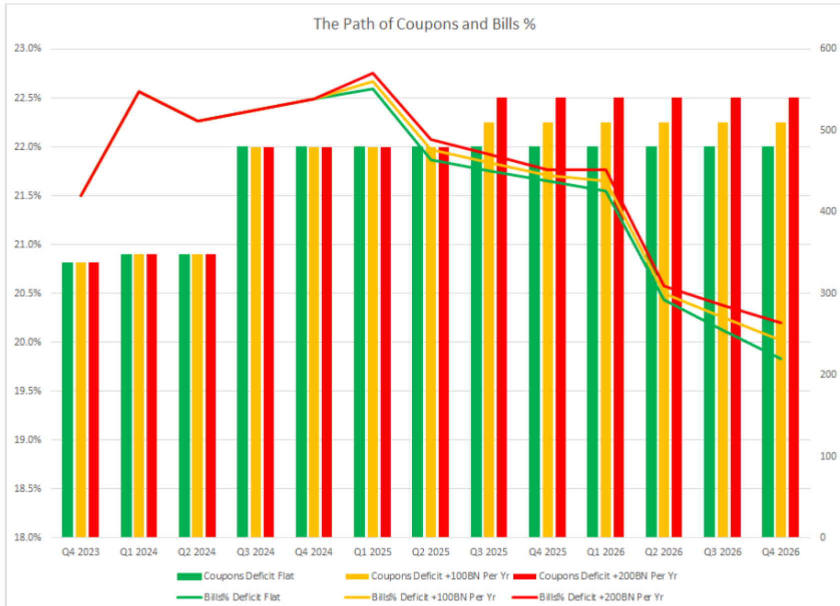
By looking at private sector and public sector market impact from large market moving order flow we have observed this game in real time and each trick that a seller and buyer have up their sleeves. In the private sector the most important trick is to remain secret. Once you are identified as a seller your order is sized relative to your public holdings or your typical size relative to AUM. This secrecy advantage isn't available for the government. But regardless the one thing you as a seller do not want to happen is for the actions you pursue to cause demand elasticity to become more elastic. If the behavior generates more elasticity the same size order flow will have a bigger price impact. Again, the only lever the government has, is to slow or speed up issuance. The market can predict the governments total picture pretty accurately but also cannot hold front running risk indefinitely at the size that the government must move over a horizon that the government issuance requires.

What's the Governments picture?

In order to understand the path of issuance one must start with an estimate of Fed Balance sheet runoff. If the Fed holds to its goal of RRP + Bank Reserves targeted for 11% of GDP QT will go on for about 22 months and then taper and end by June 2026. Consensus is shorter and would reduce issuance needs sooner.



From there one needs an estimate of the budget deficit. We have chosen three scenarios with different budget estimates. Because we are uncertain about when the Treasury will ramp up coupon issuance due to the low seasonal funding needs in Q2 we assume that the next step up in coupon issuance is in Q3.



Simply increasing the issuance one more time either in Q2 (less likely) or Q3 (highly likely) the Treasury can get below its 20% Bills target fairly easily over time. As an important note, which we will have more on in the months ahead, this coupon issuance is net of Treasury Buybacks and assumes that the Treasury does not pursue monetary policy (QE) by financing buybacks with bills but instead with duration neutral issuance. The implication on FCI, the path of bond issuance, and the bills ratio to outstanding will be heavily affected by this assumption. We are confident that the intention of the buyback is to be duration neutral but could easily imagine the messaging getting botched badly and generate a bid for assets.

Crazy Ivan

It's clear that the Government pulled a Crazy Ivan and generated an inelastic cover of bonds last week. This was a reasonable strategy and it seemed to work. We believe it was a mistake given the extremely low term premium and the need to allow QT to be transmitted but like a scene from "The Hunt for Red October" it can catch participants off guard when they expect the Treasury to increase bond issuance and they choose not to increase.

But the picture remains the same. The level of issuance is high already. The Treasury succeeded in maintaining buyer elasticity by punishing the front runners. But they have limited room to maneuver as time goes on and we will be paying close attention once again on January 31st when we see the Q2 bond issuance. Another step up in bond issuance on that date is probably a coin flip slightly weighted to the May QRA but it's coming one way or the other.

For now, markets must still get accustomed to the current quantity of supply. That's where we will be after the inelastic flow unwinds its front running. We have outlined bond demand and what levels of term premium and/or positive carry will be required to unlock significant long term bond demand in our last DSR. We thought that demand of this sort that could accommodate the Treasury's full picture is 75-100bp above 5%. Tack on another 35 bps after the rally last week.

Synthesis

Treasury pulled a Crazy Ivan and caught the market short. The easing of financial conditions removes the cover that the Fed had to stop hiking. We will see if the rally in all assets persists, and we wouldn't be surprised at all if it does. However, this will almost certainly be a "False Dawn" for assets, and we expect the market to be less blind this time and aware that in one of the next two QRA's "The Script" will return to Act 3. Perhaps this time the catalyst will not be a slap in the face. At the moment, we think the market is range bound and we will trade opportunistically.

Current Portfolio and Performance

The DS Alpha Portfolio is now up 27.89% YTD in excess of cash.

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 73,188,093					
	Total Return	73.19%		YTD Return in excess of cash		27.89%	
	Today's Date	11/5/2023		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
10/11/2023	CLZ3 83/81 Put Spread	0.99	-495	$ 500,000	1.27	$ (138,614)	Open
9/8/2023	RXZ3 11/17/2023 132 137 Call Spread	1.17	427	$ 500,000	0.37	$ (341,880)	Open
11/1/2023	SFRZ3SFRZ4 Spread	-0.95	1000	$ 1,000,000	-1.05	(250,000)	Open
11/3/2023	ZBH4 12/22 114/116 Call Spread	0.875	-1143	$ 1,000,000	0.81	$ 78,022	Open
10/18/2023	GCZ3 Dec 1925/1875 Put Spread	12.41	806	$ 1,000,000	3.12	$ (748,590)	Open
			Risk	5.000%		2.6%	