The Damped Spring Report

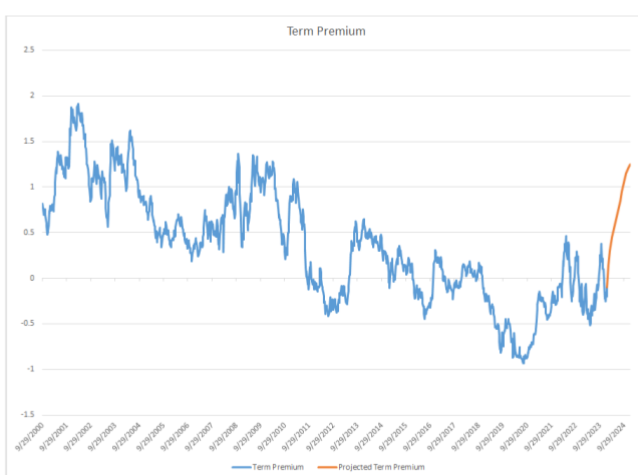
"Shifts in growth, inflation, risk premium and positioning all lead to opportunities in markets"

1/26/2024

On Monday at 3:00 PM, Treasury will announce the Estimate of Financing Needs for 2Q24 (the "Financing Estimate"). On Wednesday at 8:30 AM, Treasury will announce the composition of the issuance ("Issuance Composition"). We think the TBAC will advise Treasury to step up Coupons now while term premiums are negative, and Bills are at best a fair deal and so we expect Coupon issuance to climb for 2Q24. We also believe Treasury will make its last step function increase in Coupon issuance, which will leave Coupon issuance high and stable for years to come. However, Treasury may delay such a step up until after the election.

One thing is certain: Over the next few years, the refinancing of Covid era Bills issuance and sizable ongoing budget deficits will force the private sector to buy more duration than they can swallow at anywhere near this current level of risk premiums. We are confident that, over time, term premiums on bonds will rise by 125bp, putting a 20% headwind on long-term assets. Despite the attention now placed on the upcoming QRA, the markets are not at all priced for our expected outcome. Until term premiums rise to a sufficient level, we see no reason to expect demand to offset the supply coming from Treasury. <u>By 2/15, we expect equities to be down at least 5% and 30-year yields to tick at 4.75, assuming:</u>

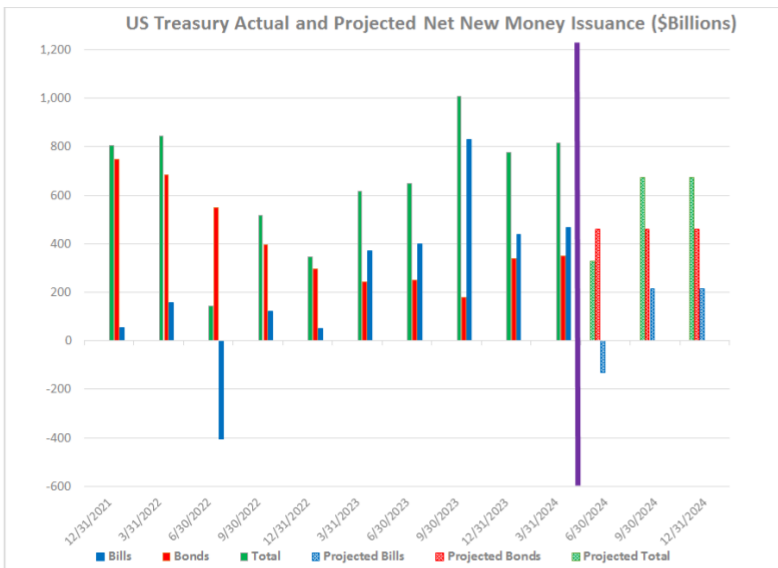
- **Powell's presser takes a March cut off the table and reiterates SEP.**
- **QT taper is pushed to 2H24.**
- **Janet increases total Coupon issuance above $1.05TN.**
- **Earnings beats are met with muted price action.**



The increase in term premiums back to normal will not likely transmit directly to 135bp higher long-term bond yields. We expect "The Script" to end inflation will take time and that Acts IV and V will result in the falling of the expected path of interest rates to counterbalance the rise in risk premiums. However, the ordering matters and a **10-year bond yield of over 5.0% is highly likely over the next few months.**

Our base case for QRA

We don't think there is much value in accurately predicting the QRA outcome. We plan to interpret the outcome based on what happens and react accordingly. We will provide that interpretation with real-time notes to clients. Regardless of the announcement details, the trend will be obvious.



Our prediction which we will compare to the outcome is an increase in Coupon issuance for 1Q24 of roughly $100BN, which will set a floor for many quarters to come of $450BN of net Coupon issuance. Last July's QRA resulted in a $160BN increase in net issuance. Last October, Treasury and TBAC, perhaps worried by the significant increase in interest rates, decided to delay increasing issuance and indicated a large step-up in Coupon issuance would occur at a future meeting. We think they should, and very likely will, act now.

In this DSR we will:

- Assess the likely range of the Financing Estimate and Issuance Composition.
- Examine two possible kinks in communications this coming week:
  - The Treasury Buyback program (the "Buyback") may start and confuse the release.
  - The TBAC may shift to a new format.
- Look forward to future quarters and who will buy bonds.
- A brief note on the FOMC and QT.

1/29 Financing Estimate.

The factors that determine the net new financing needs of the US Government are:

- Size of the fiscal deficit
- Runoff of Fed balance sheet
- Change in the Treasury General Account
- The Buyback

The Fiscal Deficit

The fiscal deficit has some potentially significant volatility due to tax receipts and interest expense, but the budgetary portion is in gridlock. We start with a baseline assumption for the 2024 Fiscal deficit of $1.8 Trillion. The seasonality of tax and spending flows suggest a low net need in Q2. In aggregate, we estimate the deficit funding need at $150BN for Q2. We see very little chance of a lower need and a fair amount of upside to the number.

Runoff

QT is fixed at $180BN per quarter. While taper is being discussed as a concept, it will not be settled, and is unlikely to be a factor, in this report.

TGA

Treasury policy states that the TGA is designed to fund the US government for all expenditures and debt maturities for a week to ensure the government can honor its obligations even if the issuance market is disrupted. Projecting weekly expenditures and debt maturities for the next year sets the minimum TGA at $700BN. The TGA will be volatile during the quarter due to seasonality, but we expect a stable TGA target.

Treasury Buyback Program

We will cover the Buyback later in the report. The odds are about 50/50 that the Buyback is implemented in 2Q24. The Buyback should have no impact on net issuance but will affect gross issuance and perhaps composition.

Range of Financing Estimates:

Those factors add up to a minimum case of $300B in 2Q24 financing. The variable is the budget deficit. We think both 1Q and 2Q24 budget estimates have upside risk and limited downside risk. **Our range for the 2Q24 financing needs is $300BN – $400BN.**

Potential implications for markets on Monday, 1/29/24

Because the financing needs will be released first without composition and the Coupon issuance is the key piece of data, it is possible that the market may extrapolate the number of Coupons from the quantity headline. Our range of Bills to total percentage is from -40% to +10% Bills as a percentage of needs. Applying the high percentage to the low financing need would generate our lowest bond issuance estimate. Of course, we could be wrong and so we have a table to quickly look at the financing estimate and imply a bond issuance amount. Assuming the Financing Estimate is within the range in which composition is relevant, the proportion of Coupons to Bills issuance will determine the impact on markets.

Remember, the first step before applying this headline is to confirm a stable TGA target. A substantial drop in the TGA target would temporarily support assets and the economy due to less issuance. We have studied the future weekly flows and think, if anything, the TGA target gets revised upward, requiring more not less financing. Assuming no change (and using the headline for 1Q24), the implication for asset prices can be determined. Coupons less than 1Q24 would be bullish assets. Coupons modestly higher will be neutral assets and Coupons above 400BN are bearish.

Q2 Financing Estimate - 1/29 3:00 PM

Headline	Net Coupons (BN) with -40% Bills Issuance	Net Coupons (BN) with -20% Bills Issuance	Net Coupons (BN) with 10% Bills Issuance
200	280	240	180
250	350	300	225
300	420	360	270
350	490	420	315
450	630	540	405

Our central case of $330BN is likely bearish assets but if the headline comes in line with our estimate, we will wait for the 8:30 Composition data on Wednesday.

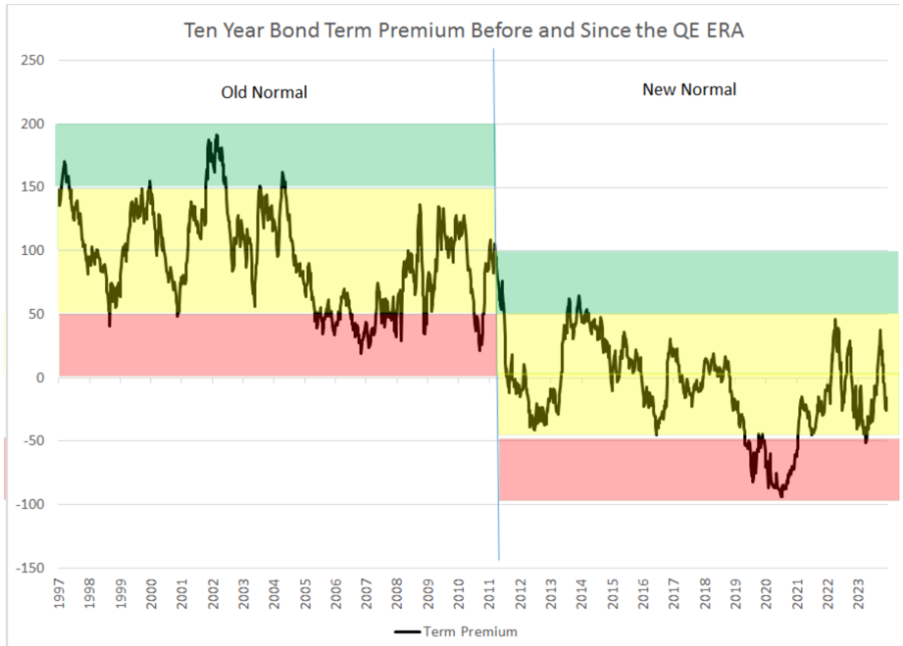
TBAC Recommended Issuance Composition

Once the Financing Estimate needs are known, the next piece of data – Issuance Composition - will be released Wednesday morning. The increase in gross Coupon issuance is key. The amount of Bills used to raise the needed financing is the lever Treasury can use to limit bond issuance. We believe the Treasury will increase bond issuance significantly because:

- Term premiums are negative.
- Bills outstanding are high.
- Choosing Bills delays the inevitable and requires higher TGA balances.

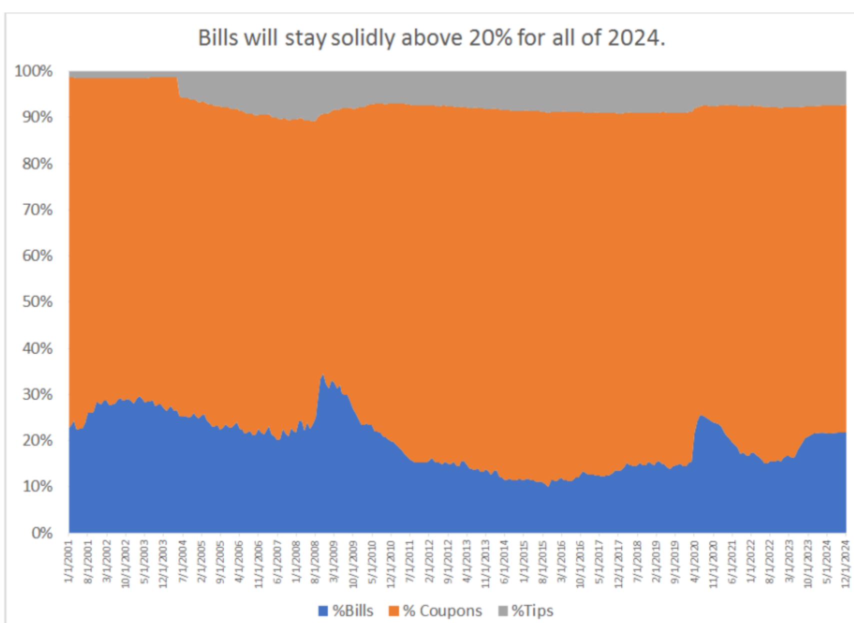
Term premium levels suggest Coupons over Bills.

Since the October QRA, term premiums have gone from modestly positive to negative. Clearly, the term premium is well below pre-QE era levels. As term premium is the price that Treasury pays to compensate investors for taking on price volatility when purchasing Coupons over Bills, we believe current levels of term premium are a great deal for the US taxpayer to pay. Treasury uses a term premium model for issuance and are conscious of the highly attractive financing levels consistent with negative term premiums.



Bills outstanding are rising and will likely rise further.

Given the high fiscal deficit, the slow and predictable increase in Coupon issuance, and the continued Fed runoff, it is simply impossible for Treasury to make much progress in reducing Bills outstanding percentages in 2024. However, that results in a larger overhang of Coupons in 2025 as quarterly Bills share moving back to less than 20% of issuance would be required to make a dent on current outstanding debt levels.



Choosing Bills delays the inevitable extension of the debt.

By late 2024, Bills issuance will likely drop each quarter to below 20% per quarter but, with significant deficits and the destination of QT, net Coupon issuance will likely settle at a level substantially higher than current levels. Perhaps this quarter, the full implications of the duration issuance will begin to be front run. However, frontrunning $1.0TN of QT and the necessary duration extension is simply too large. Eventually the supply will come to market and term premiums will rise.

What to look for on the 1/31 TBAC Tables?

It is likely that Monday's Financing Estimate will lack adequate clarity and the TBAC table will be necessary to evaluate the size of Coupon issuance. Treasury may also adopt a new format to the report, which will confuse many on what to look at. In addition, Treasury may begin the Buyback in 2Q24, which will have no impact on net issuance but will skew gross issuance higher. Below we will prepare you for the release in more detail and provide guidance on the Buyback. Assuming no communication changes or complications, our base case is:

- We expect gross bond issuance for 2Q24 to be **$1.1TN vs $984BN in 2Q**.
- We expect net issuance for 2Q24 to be **$500BN vs $348BN in 2Q**.

The simple thing to do this quarter is to look at the gross issuance and compare to this table:

Q2 Offered Amount TBAC Table - 1/31 8:30 AM

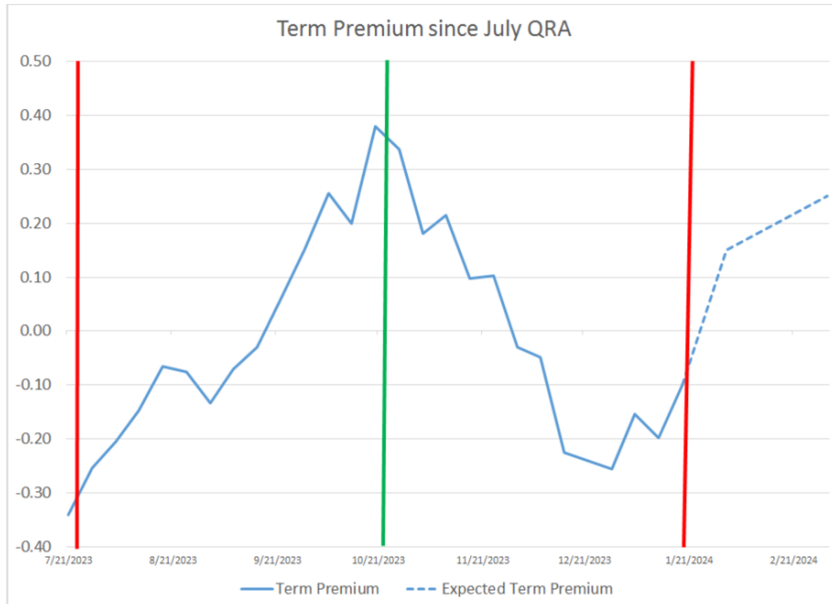
Headline	Probability	Action
950	No Chance	Buy Assets
1000	Almost No Chance	Buy Assets
1050	Medium	Neutral
1100	High	Sell Assets
1150	Medium	Aggressive Sell
1200	No Chance	Aggressive Sell

What does this mean for markets?

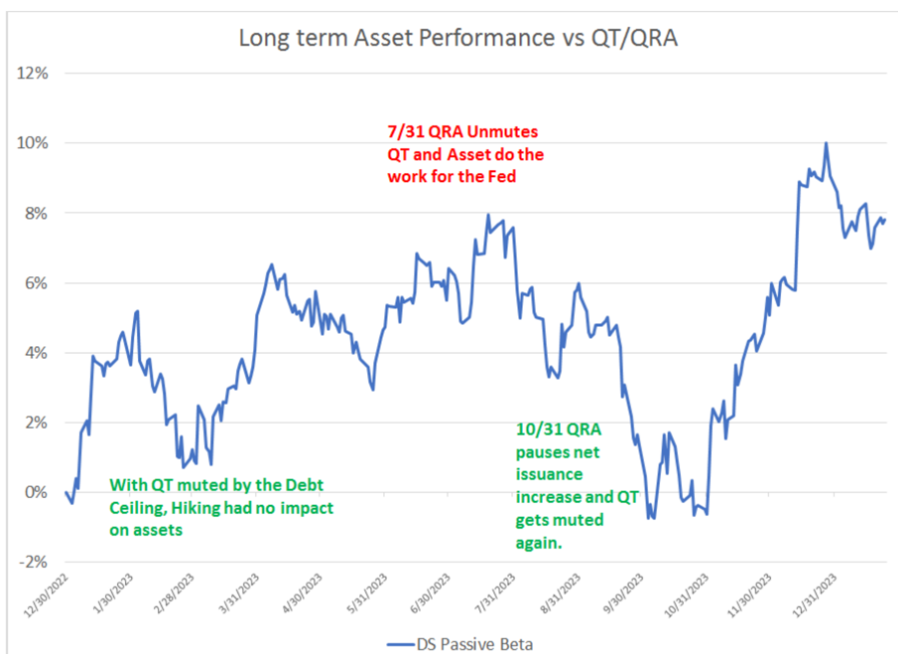
Given the sizable increase in gross and net issuance, we expect risk premiums to once again expand as they did last July. **We expect SPX to fall to 4500 and 30Y yields rise to 4.75% in February.**

Sensitivity analysis

The last two QRAs have had major impact on asset prices and term premiums. A $160BN net Coupon increase led to a risk premium expansion of over 60bp. On Halloween, a pause in the increase in net Coupon issuance catalyzed a 50bp risk premium contraction. As seen below, term premium has been highly sensitive to QRA data. We see a milder reaction this quarter and expect term premium to expand by 35bp.



The last two QRAs caught the market in very vulnerable positions. Last July, asset prices were bid up and term premiums were at lows and in October the setup was reversed. Today, term premiums are negative once again and equities are particularly bid up. We see the potential for Treasury to once again delay the inevitable increase in bond issuance, but don't think they will. Regardless of the decision, we see little upside for assets. Term premiums are much closer to 7/31 levels than 10/31 levels. The market has asymmetric risks.



Some kinks in the release may be confusing.

There is a strong likelihood that the 1/31/24 release will be in a new format. To further confuse the release, it is 50/50 that Treasury announces the details of the Buyback. Key to understanding a release that is new to markets is to assess the gross issuance of bonds minus the Buyback amount. Where can you find that?

Change in format.

The old format of the TBAC financing tables have all the information one needs. The reason for the change is to have the information line up with refunding quarters vs calendar quarters. Nonetheless, the preview of the new format leaves a lot of information missing and doesn't total any issuance amounts. The new format is very practical for bond auction numbers, but much less for macro impact. Here is the old format from 1Q24:

TBAC RECOMMENDED US TREASURY FINANCING SCHEDULE FOR 1st QUARTER 2024*
BILLIONS OF DOLLARS

	NEW MONEY
Net BILLS Issuance for the quarter	*467.60*

ISSUE	SETTLEMENT DATE	OFFERED AMOUNT	CHANGE^	MATURING AMOUNT**	NEW MONEY
COUPONS					
20-Year Bond (r)	*1/2*	*13.00*	*0.00*		
2-Year Note	*1/2*	*57.00*	*3.00*		
5-Year Note	*1/2*	*58.00*	*3.00*		
7-Year Note	*1/2*	*40.00*	*1.00*	*104.80*	*63.20*
3-Year Note	*1/16*	*52.00*	*2.00*		
10-Year Note (r)	*1/16*	*38.00*	*3.00*		
30-Year Bond (r)	*1/16*	*22.00*	*2.00*	*91.82*	*20.18*
20-Year Bond (r)	*1/31*	*13.00*	*0.00*		
10-Year TIPS	*1/31*	*18.00*	*1.00*		
2-Year Note	*1/31*	*60.00*	*3.00*		
2-Year FRN	*1/31*	*28.00*	*2.00*		
5-Year Note	*1/31*	*61.00*	*3.00*		
7-Year Note	*1/31*	*41.00*	*1.00*	*179.24*	*41.76*
3-Year Note	*2/15*	*54.00*	*2.00*		
10-Year Note	*2/15*	*44.00*	*3.00*		
30-Year Bond	*2/15*	*27.00*	*2.00*	*105.13*	*19.87*
2-Year FRN (r)	*2/23*	*26.00*	*2.00*	*0.00*	*26.00*
20-Year Bond	*2/29*	*16.00*	*0.00*		
30-Year TIPS	*2/29*	*10.00*	*2.00*		
2-Year Note	*2/29*	*63.00*	*3.00*		
5-Year Note	*2/29*	*64.00*	*3.00*		
7-Year Note	*2/29*	*42.00*	*1.00*	*98.33*	*96.67*
3-Year Note	*3/15*	*56.00*	*2.00*		
10-Year Note (r)	*3/15*	*41.00*	*3.00*		
30-Year Bond (r)	*3/15*	*24.00*	*2.00*	*56.28*	*64.72*
10-Year TIPS (r)	*3/28*	*16.00*	*1.00*	*0.00*	*16.00*
		984.00		*635.60*	*348.40*
Estimates are italicized. r = Reopening		RAISED THIS QUARTER:			*816*

** This Financing table is meant to be illustrative based on meeting discussions and does not indicate how Treasury will actually issue*

Note that in the green box is the new money Bills amount. In the red box are total Coupon gross issuance, maturities and net issuance. In the blue box is the Total Cash raised, which foots to the financing estimates from two days prior. Lastly, the changes in issuance size by auction is in its own column.

- During the January – March 2024 quarter, Treasury expects to borrow $816 billion in privately-held net marketable debt, assuming an end-of-March cash balance of $750 billion.[4]

Everything needed is displayed on one report. If the Treasury wanted to add a column for the Buyback, that could easily be done with the existing format. The green donut is the number to compare to the stop and go chart.

The new format is:

TBAC RECOMMENDED US TREASURY FINANCING SCHEDULE FOR NOVEMBER 2023-JANUARY 2024 QUARTER

*** BILLIONS OF DOLLARS**

	Auction	Notes					Bonds		TIPS			FRN
	Month	2-Year	3-Year	5-Year	7-Year	10-Year	20-Year	30-Year	5-Year	10-Year	30-Year	2-Year
Historical Reference	May-23	42	40	43	35	35	15	21		15		22
	Jun-23	42	40	43	35	32	12	18	19			22
	Jul-23	42	40	43	35	32	12	18		17		24
	Aug-23	45	42	46	36	38	16	23			8	24
	Sep-23	48	44	49	37	35	13	20		15		24
	Oct-23	51	46	52	38	35	13	20	22			26
Recommendations for this Refunding	Nov-23	54	48	55	39	41	16	25		15		24
	Dec-23	57	50	58	40	38	13	22	20			24
	Jan-24	60	52	61	41	38	13	22		18		28
Provisional Indications for Next Refunding	Feb-24	*63*	*54*	*64*	*42*	*44*	*16*	*27*			*10*	*26*
	Mar-24	*66*	*56*	*67*	*43*	*41*	*13*	*24*		*16*		*26*
	Apr-24	*69*	*58*	*70*	*44*	*41*	*13*	*24*	*23*			*30*

* This financing table is meant to be illustrative based on meeting discussions and does not indicate how Treasury will actually issue debt in the future.

** Shaded area indicates actual prior auction sizes provided for reference.

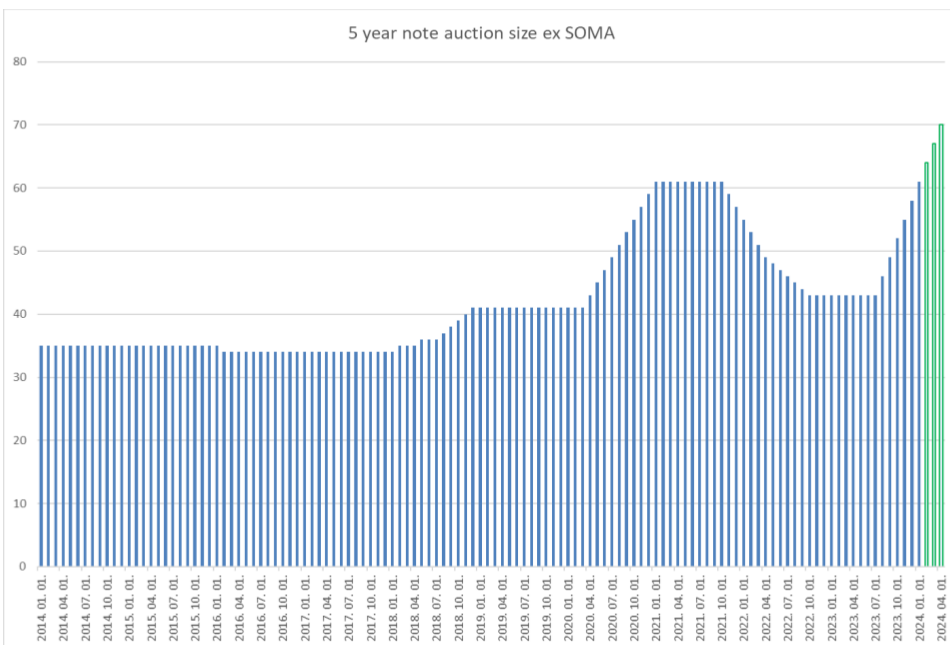
Notice in this format there is an extra month, which is nice. However, everything else useful is missing. No gross issuance totals, no changes, no maturities, no net issuance or totals, no Bills, and, importantly, no place for Buyback data. It is a mess. If 1/31 is released with this chart, we will add up the relevant rows (in green) for the gross issuance total and compare it to our chart above. We will calculate the net issuance from the maturities we source from other data. If announced, we will look for any Buyback quantities (estimates are 10BN per month). With those numbers, we will determine the net issuance and infer the Bills amount from the Financing needs from 1/29. We are ready, but the market may not be.

Buyback

The odds that a Treasury Buyback is started in 1Q24 are probably even. We are highly confident that the Buyback will be duration-neutral at the level of the forest and almost certainly not at the level of the trees. Each Buyback will be a particular cusip and will be financed with Treasury's overall financing. Net net, we are quite certain that the duration of issuance outstanding will remain unimpacted by the Buyback program, but will look for details in the announcement. However, the odds are that markets will perceive a QE-like impact of the start of the Buyback, despite it not being that at all.

Regardless of the outcome, markets are living on borrowed time.

Treasury may delay Coupon issuance increases by a quarter, but the size of Coupon issuance today is already quite large and gross issuance will need to be at a higher level for a year or two. We expect Treasury to increase issuance in a step function this quarter and then hold issuance at this level until QT ends and budget deficits stop growing. QT has about $1TN to go as we discussed in the last DSR (https://dampedspring.com/wp-content/uploads/2024/01/The-Evolving-Fed-Balance-Sheet.pdf), but that path may slow if the Fed decides to taper. The budget is another matter. The deficit has grown partly due to interest payment increases, which would likely decline if growth fell. However, any progress on rates may be offset by counter cyclical fiscal spending or falling tax receipts. It's not a pretty picture. Duration supply will weigh on the markets for years. To put in context the auction sizes, a picture of 5-year auction sizes both historic and for the first quarter already scheduled is useful:



This past Wednesday's 5Y auction was poorly received. The size of the auction was as large as the Covid auctions when the Fed was buying trillions of MBS, secondary Treasuries, and primary add-on's (not included above). The step-up in size when it occurs will take 5Y notes to $70BN gross per auction. While we think this will take time to manifest in term premiums, it is a massive headwind for assets.

The supply picture is bearish bonds based on expanding term premiums to compensate new buyers.

Who will buy all these bonds?

Once QT ends, our framework of the "circle of life" - public sector spending leads to private sector savings leads to public sector funding leads to public sector spending - will continue. However, the composition matters and the compensation for risk-taking matters as this circle revolves. QT, which we expect will continue longer than most market participants assume, breaks that circle and places higher upward pressure on term premiums. The important potential buyers are not the unlevered real money investors; the amount of risk that needs to be taken on rapidly over the next couple of years swamps even their steady demand. It is players that can lever or print money that will have to assume this risk. Those are:

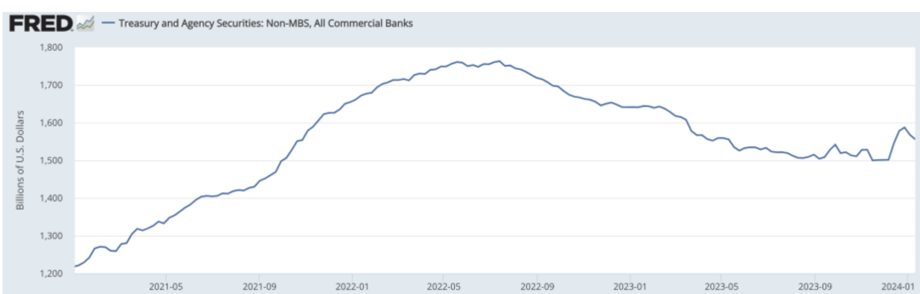
- Foreign central banks who manage their currency.
- Commercial banks buying with money they print out of thin air.
- Hedge funds.

Foreign Central Banks

Foreign central banks continue to slowly let their US Treasury holdings run off. However, news this week from China may cause some volatility to that plan. In particular, efforts to boost China's domestic economy and its financial markets may result in Yuan strengthening due to current account pressure. Yuan strength would be undesirable for exporters, which may lead the PBOC to offset strength by printing Yuan and selling them for USD assets, which, in turn, would lead to demand for US Treasuries. We think that is unlikely, but if it were to occur the PBOC would become a marginal buyer of US Treasuries.

Commercial Banks

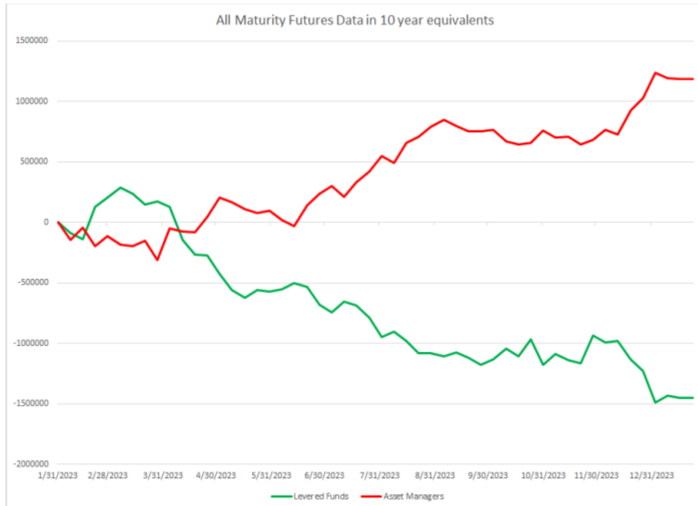
Commercial banks have stopped buying Treasuries until quite recently. We don't think commercial banks have much appetite to buy Treasuries aggressively with the curve inverted, but they have likely stopped selling. Regulatory pressure may also prevent some banks from levering up on Treasuries if the curve evolves and term premiums are attractive, even if the commercial bank are willing and able. This regulatory pressure is overhang from the "Bank Crisis".



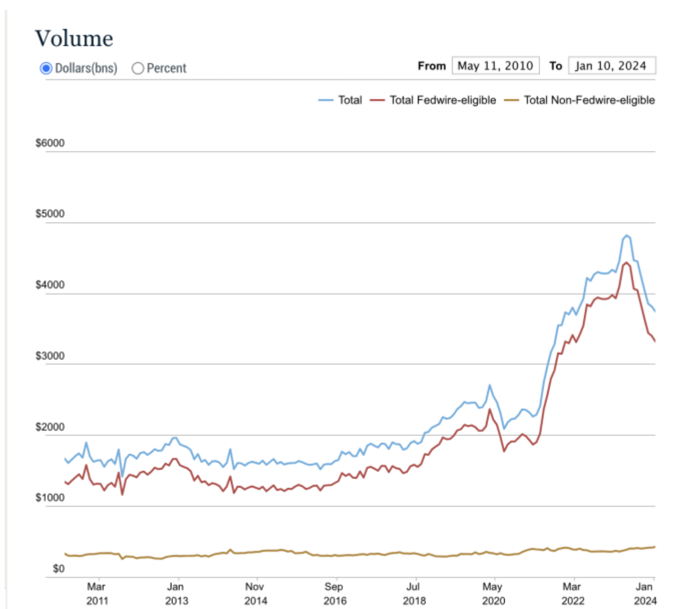
Hedge Funds

Levered players able to take risk with borrowed money (repo) have been very active in the basis trade. They have sold futures to real money investors, who prefer the convenience of futures vs holding physical bonds, and have bought physical bonds. The positioning data confirms their holdings.

Hedge funds have their largest short futures position in a year and real money is at its longest.



Repo balances are off the highs, which suggests unhedged shorts by hedge funds and possible future demand. However, most hedge fund exposure is to the basis trade. This should be no surprise as the hedge funds are set up to provide off the run bonds to Treasury when the Buyback is put in motion.



Pricing

As we have noted, term premiums have significantly contracted over the last three months. Holding Treasury price risk vs holding cash is far less attractive today than it was last fall. Other metrics of Treasury demand are based on the curve. Levered players must fund their purchases with short term borrowing. A steep curve encourages the carry trade. An inverted curve encourages holding Bills and cash. As compared to the highly vulnerable period last July, levered buyers are more likely to be able to absorb bond supply based on less unattractive negative carry.

In aggregate, the picture on the demand side looks much less fragile than it did last July, which is part of the reason we are both more confident that next week's QRA will step up Coupons and that the market impact will be milder initially. However, this does not auger well for an extended supply of duration.

Brief Note: FOMC

We think the Fed will not specifically address QT and will not add more dovish language in the statement. We think Powell will push back on imminent tapering and certainly push back on ending QT. In terms of rate guidance, the data is clearly supportive of the cuts baked into the December SEP based on nominal rate cuts to maintain real rate levels. However, Powell will likely be less myopic on that particular model and reference broader data and perhaps the easing of financial conditions. We expect a mildly hawkish Fed, but not a game changer.

Synthesis

Asset markets are quite elevated and risk premiums are thin at best. Regardless of the outcome of the QRA, we think assets will struggle to outperform cash particularly with the eventual (if not next Wednesday's) duration issuance increase. Nonetheless, we will wait until the QRA to deploy meaningful risk as a light Coupon issuance, coupled with any hint of more cuts or an imminent end to QT will cause a rally in assets. If the dovish case from the Fed and Treasury comes true, we don't expect anything near as violent a reaction as we have seen since last October's lows. If we are correct and Treasury increases Coupons and the FOMC pushes back on QT taper/end, we do not expect as violent a reaction as was seen in August through October. We do expect an asymmetric reaction and, as term premiums expand, we do not expect a bounce. Slower until lower is our central case for assets. We will send emails as the numbers come out.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000		
LTD P/L	$ 58,115,011		
Total Return	58.12%	YTD Return in excess of cash	-0.76%
Today's Date	1/26/2024	Portfolio Created	4/15/2019

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
1/12/2024	CLK4 Long Call Short put spread 780 /75/72	1.15	241	$ 1,000,000	2	$ 204,819	Open
12/13/2023	ESH4 Two's and SPOOS (doubled on 1/12/24)	4,764.00	-200		4894	$ (1,300,000)	Open
11/29/2023	NDX 2/16/2024 15500/15000 Put Spread	85.00	118	$ 1,000,000	7	$ (917,647)	Open
12/1/2023	NDX 2/16/2024 15500/15000 Put Spread	101.00	99	$ 1,000,000	7	$ (930,693)	Open
12/28/2023	NDX 2/16/2024 16500 Put	205.00	49	$ 1,000,000	50	$ (756,098)	Open
1/19/2024	NDX 2/16/2024 17000/16600 Put Spread	90.00	111	$ 1,000,000	61	$ (322,222)	Open
11/29/2023	SPX 2/16/2024 4400/4300 Put Spread	12.20	820	$ 1,000,000	1	$ (918,033)	Open
12/1/2023	SPX 2/16/2024 4400/4300 Put Spread	12.40	806	$ 1,000,000	1	$ (919,355)	Open
12/22/2023	SPX 3/15/2024 4600 Put	54.40	184	$ 1,000,000	19.32	$ (644,853)	Open
1/19/2024	SPX 2/16/2024 4750/4650 Put Spread	15.00	667	$ 1,000,000	9.3	$ (380,000)	Open
1/16/2024	SPX 3/15/2024 4400 Put	24.00	-184	$ (441,600)	9.38	$ 269,008	Open
1/25/2025	FXI China ETF	22.82	438212	$ 500,000	22.62	$ (87,642)	Open
12/1/2023	ZBH4 2/23/24 114/110 Put Spread	0.90625	1103	$ 1,000,000	0.20	$ (775,862)	Open
12/8/2023	ZBH4 2/23/24 114/110 Put Spread	0.67	1493	$ 1,000,000	0.20	$ (696,828)	Open
1/18/2024	ZBH4 2/23/24 119/117 Put Spread	0.65625	1600	$ 1,050,000	0.61	$ (75,000)	Open
11/29/2023	ZNH4 2/23/24 108/106 Put Spread	0.375	2667	$ 1,000,000	0.06	$ (833,333)	Open
12/8/2023	ZNH4 2/23/24 108/106 Put Spread	0.375	2667	$ 1,000,000	0.06	$ (833,333)	Open
1/18/2024	ZNH4 2/23/24 110/108 Put Spread	0.328125	1255	$ 411,797	0.328125	$ -	Open
1/12/2023	SR3Z24 SR3Z25 Spread -30 stop	-55	1600	$ 1,000,000	-62	$ 280,000	Open
11/28/2023	ZTH4 Two's and Spoo's (doubled on 1/12/24)	102.578125	-450		102.59	$ (14,063)	Open
12/27/2023	"Sell All Assets Basket" SPY	475.80	-15763		488.47	$ (199,716)	Open
12/27/2023	"Sell All Assets Basket" TIP	107.67	-69661	$ 1,000,000	106.78	$ 61,650	Open
12/27/2023	"Sell All Assets Basket" GLD	191.88	-15635		186.945	$ 77,158	Open
12/27/2023	"Sell All Assets Basket" GSG	20.66	-145208		20.9101	$ (36,317)	Open
			Risk	16.520%		7.3%	