The Damped Spring Report

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

03/05/2024

As Fed discussions begin on the path of quantitative tightening, we thought it timely to broaden the QT discussion and plot a path for the Fed's Balance Sheet in the years to come. Governor Waller recently spoke of his own goals for the Balance Sheet, and we largely agree with his suggested direction. In this report, we discuss what we would do were we in the Fed's shoes. Our first action would be to announce the following in May:

- We expect to continue QT at current caps for the next six months and then reduce caps at our December meeting from $60BN to $30BN on UST and from $35BN to $20BN on MBS.
- We will be cautious of the impact of QT on Bank Reserves + RRP – SRF but expect to conclude QT after the June 2025 FOMC meeting. We expect Bank Reserves + RRP – SRF will reach our long-term goal around that date. Thereafter we would maintain our portfolio through reinvestment of runoff in perpetuity.
- We also believe that the current and projected future Balance Sheet is not well-suited to our long-term goals. Accordingly, we are announcing additional changes to our Balance Sheet policy to transition to a Balance Sheet consistent with those goals, as follow
    - All reinvestment above the caps will be in Bills and short-term Notes, effective immediately. This will not only stop the increase in duration of our portfolio over time but also allow runoff to hit the $60BN cap each month in 2024.
    - Along with continued runoff, in June we will begin outright selling $10BN per month of long-term Notes, Bonds, and Tips, and $10BN per month of MBS. With the sale proceeds, we will purchase as add-ons the same quantity of Bills and short-term Notes to neutralize any impact on Reserves + RRP. We plan on increasing that monthly total to $20BN of each in September and continue until we reach our goals.

We think the long-term goals for the Balance Sheet should be:

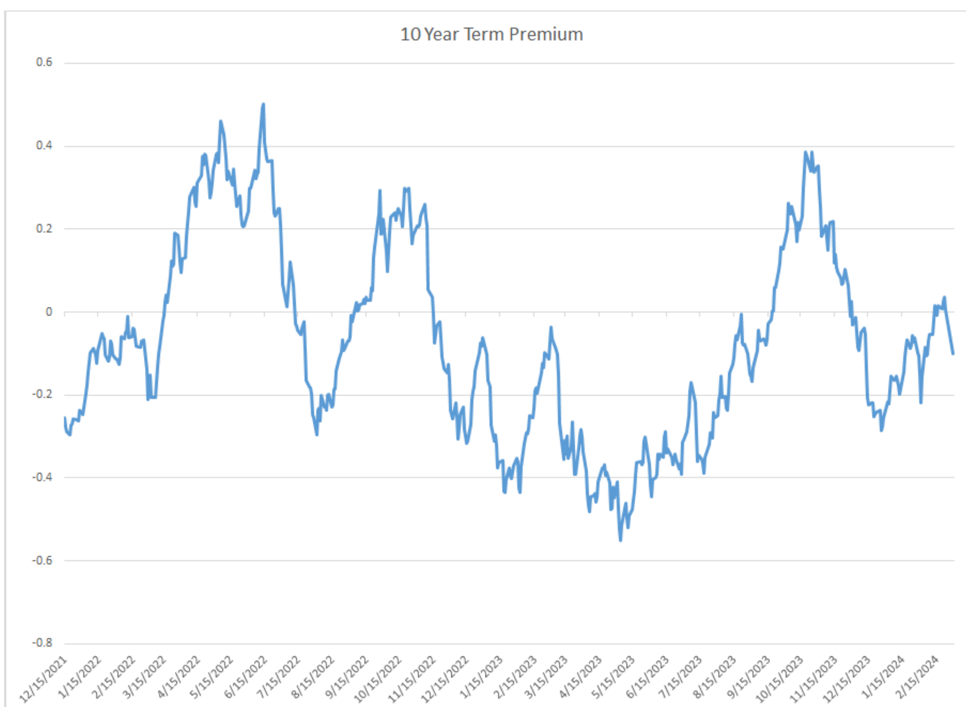
- **A Balance Sheet which supports Ample Reserves to allow banks to operate smoothly.**
- **No MBS to avoid distorting the private mortgage/housing market.**
- **Shorter duration to avoid distorting the yield curve and to clean up the Balance Sheet for future crises.**
- **Consistent with monetary policy goals.**
- **Transparent.**

We think these steps would put the Balance Sheet on the path to achieve the Fed's long-term goals while placing short-term modest pressure on the mortgage market and long-term Treasury markets to better transmit quantitative tightening by increasing term premiums on assets.

Current path of the Balance Sheet

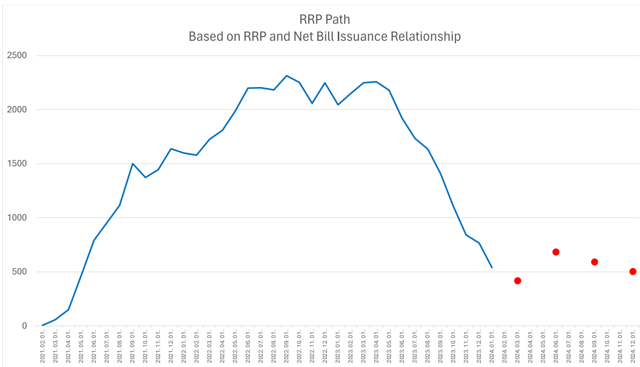
The runoff of the SOMA portfolio has been slower than many expected when it was originally designed. Higher interest rates have resulted in fewer prepayments, with the result that mortgage runoffs have been well below the $35BN monthly cap. The Treasury runoff has gone fine, although, as we have said repeatedly since the program was announced, the Treasury's issuance composition to fund repayment of maturing Treasuries has mostly muted QT's effect. Next June and then again in September and December, maturing Treasuries will be substantially below the cap. This is usually not a problem because the SOMA portfolio has in the past had plenty of Bills maturing each month to fill the hole. However, because Bill holdings have fallen, these months will have runoff less than the cap if the Fed doesn't change its reinvestment policy. **We think that the Fed should change its policy and tweak the Bills reinvestment policy in order to continue to runoff Bonds at the cap.**

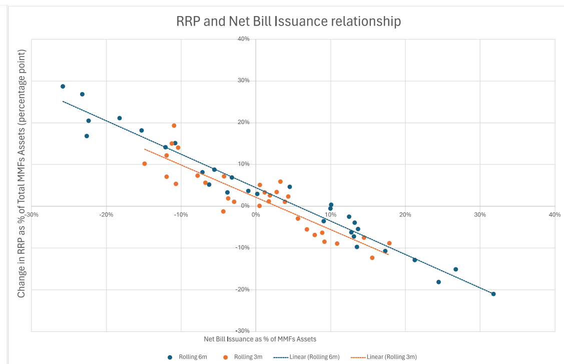
The principal monetary impact of QT is not on the level of rates but on the relative attractiveness of assets vs cash. After a significant rise in term premium since QT was hinted in December 2021 through the implementation of QT, term premiums have been volatile, essentially tracking the composition of Bond issuance by the Treasury. Today it seems clear financial conditions are no longer impacted much by QT.



We agree with most Fed Governors that RRP and Reserves are largely fungible, and that QT should look to further reduce these forms of liquidity. Clearly the duration market is willing to accept assets and the banking system and Money Market Mutual funds savings pool reflect ample "Reserves". We see a clear runway to continue QT as is, tapering around YE2024, and ending the program in June 2025.

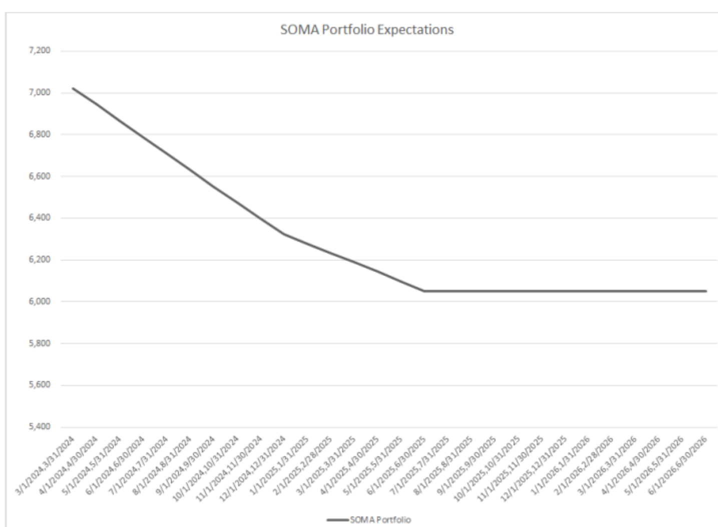
We are watching the stabilization of the RRP facility, which we expected as TGA reached its target level, Bills issuance will fall rapidly in 2Q24, and will be low for the balance of the year. Our model suggests that RRP will bottom around $350BN in March and then increase modestly for the rest of 2024. We think frictions in the banking system could arise as RRP + Reserves fall and that these frictions may intensify as RRP reaches zero and SRF take-up begins. However, these frictions are not likely to manifest as issues in 2024.





QT 1.0

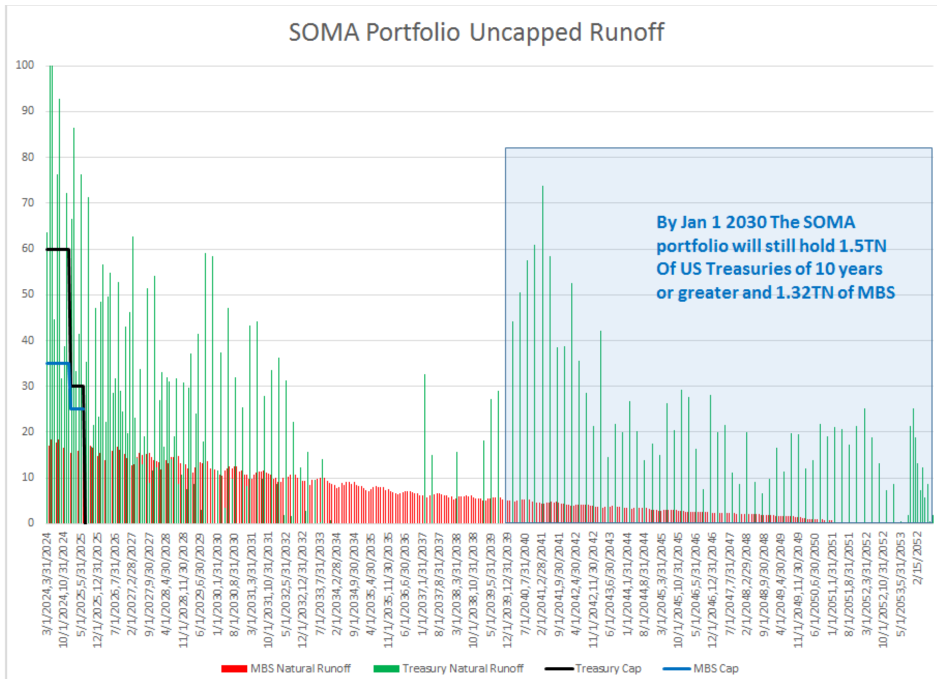
Assuming the Balance Sheet runoff policy continues (adjusted for the Bill reinvestment change mentioned above) and ends in June 2025, the SOMA portfolio should fall by $1TN and settle at about $6TN. We expect Bank Reserves + RRP – SRF to settle at $3TN.



That seems all well and good in terms of achieving the goals of QT 1.0. Excess bank reserves are withdrawn while staying ample. However, it is not yet clear that the monetary policy goals in general and the goals of QT in particular have been achieved. Specifically, the remaining Balance Sheet is far away from a sensible composition to become steady state.

The Post QT 1.0 Balance Sheet.

In the chart below, we have plotted the maturities of the Treasuries in the SOMA portfolio and the likely runoff of the MBS portfolio. When Balance Sheet reduction (QT 1.0) ends as "Reserves" reach target, the SOMA portfolio will still be actively managed. As runoff occurs, reinvestment will take place. Under the Fed's current reinvestment policy, in months in which the Treasuries runoff exceeds the cap, the Fed must engage in add-on buying across the entire yield curve.



Over the years, with outright purchase during QE and throughout the ongoing reinvestment policy, the Fed now owns $1.5TN of Treasuries that mature in 15 or more years. The MBS rundown has another $1.3TN that will be on the Balance Sheet for a long time. Our view is that holding duration on the Balance Sheet makes little sense during normal times. Nonetheless without a change in policy these assets aren't going anywhere. **At a minimum, we expect the Fed to change its reinvestment policy in May and only reinvest in Bills and short-term Notes.**

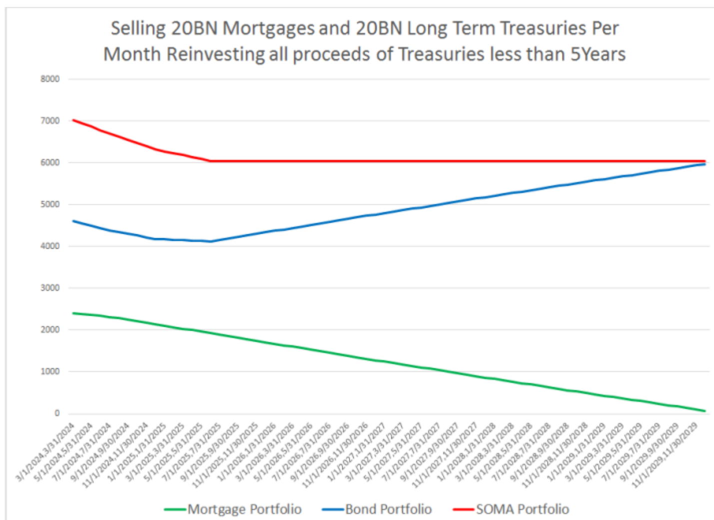
QT2.0 – Shifting the Balance Sheet composition.

QT 2.0 is unrelated to Reserves + RRP. QT 2.0 is actively crafting the Balance Sheet to both achieve immediate monetary policy goals and to position the Balance Sheet sensibly both to create minimal influence on the economy and to be well positioned for a future crisis. Because of the composition of existing holdings in the SOMA portfolio, however, this path will not evolve toward the goal without action. However, action can be implemented cautiously without risking market functioning or financial intermediary health.

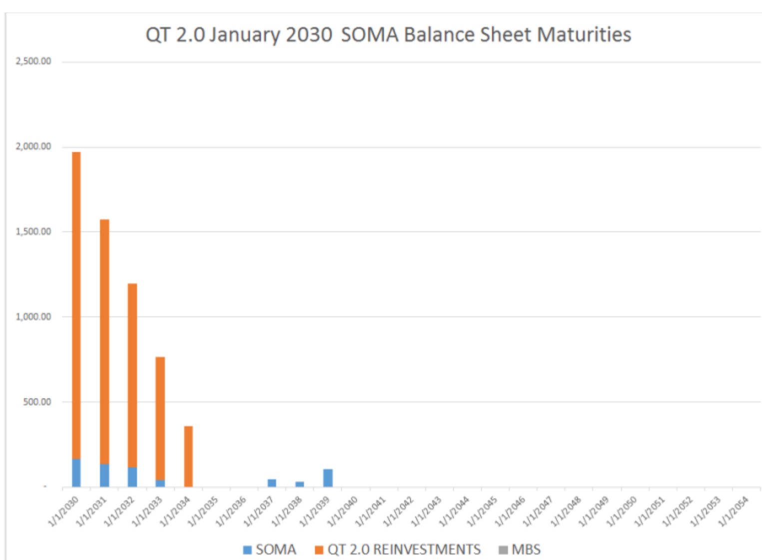
We humbly suggest the Fed considers the following policy changes:

- **Immediately change its reinvestment policy to only purchase Bills and short-term Notes.**
- **Begin to make modest outright sales from the SOMA portfolio of both long-term Bonds and MBS.**
- **Reinvest proceeds from the sale of long-term holdings in Bills and short-term Notes to have no net impact on "Reserves."**

We will explain why this makes sense and the implications for asset prices, but first the benefits. The combination of existing runoff and our proposed outright sale/purchase policy will have a meaningful impact on the Fed's balance sheet. By Jan 1, 2030 The whole mortgage portfolio will fall to zero while SOMA portfolio remains at $6TN, supporting Reserves:



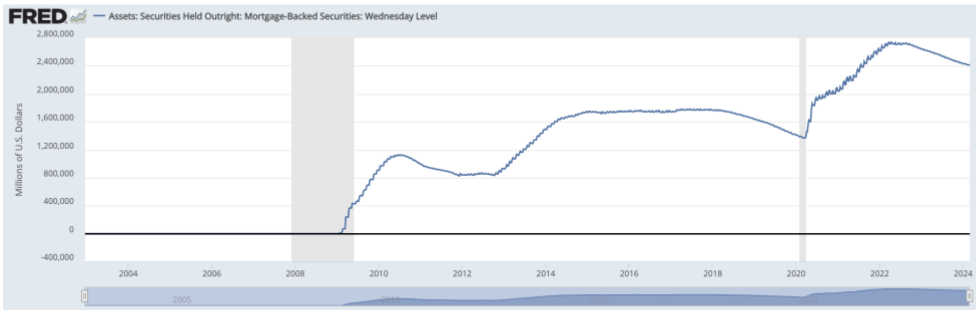
Under this plan, by 2030 the SOMA portfolio would also no longer hold any assets maturing in more than 10 Years.



Why this is a good idea.

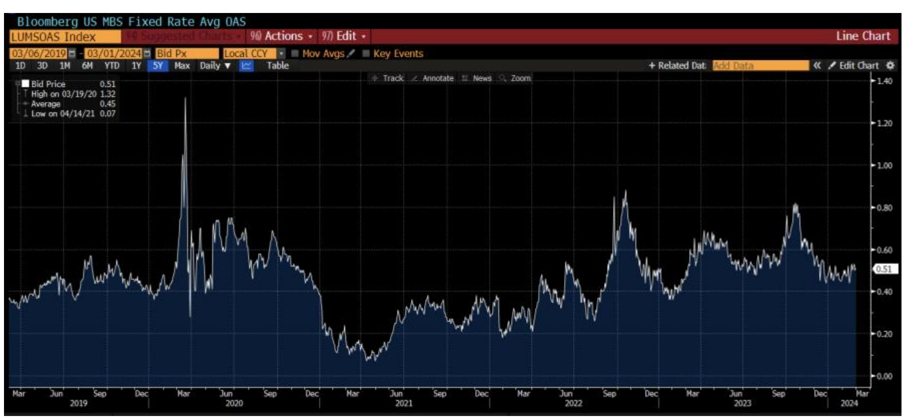
Mortgages

In the GFC and particularly when QE1 was started, the asset that most needed support for financial stability reasons was mortgages. The GFC was a real estate problem. Roughly half of the SOMA MBS holdings are still GFC-related mortgages. The Covid-related MBS purchase was a modest $1.3TN In retrospect, perhaps the mortgage purchases were on the margin excessive, but given the uncertainties at the time, it’s hard to argue with the decision.



Nonetheless, holding mortgages may have distorted certain aspects of the post-Covid recovery. In addition, absorbing some of the duration extension that would otherwise have potentially stressed the private sector has had some benefits, although, unfortunately, those benefits did accrue while the Fed was attempting to tighten. We agree with most Fed officials that ongoing MBS holdings should be worked down. However, given the current and projected runoff pace, that will require action.

The mechanism for mortgage runoff results in the Fed being paid back by the mortgagee who either refinances or dissaves. To the extent that mortgage runoff has been due to refinancing, the private market absorbs new mortgages when the Fed’s mortgages runoff. Given the Fed was willing to set a $35BN runoff cap and given the average pace of projected runoff is below $20BN, it makes sense to us to begin outright sales of MBS at $10BN per month with the intent to go to $20BN. MBS Option Adjusted Spreads have been tight, suggesting demand for mortgage securities:



However, outright sales of mortgages do generate two concerns. The first concern, which we take seriously, is that the SOMA portfolio holds low coupon MBS of a vintage that many of the more vulnerable banks own. Those banks have had plenty of time to work out of their troubled assets and continue to have access to the BTFP (assuming they extend by March 10) and to the Discount Window. We think a slow outright sale program will be tolerated by the market. The other concern is that outright sales would cause the Fed to realize losses. Having calculated the potential realized losses, we think this is a red herring and that such losses are tolerable. In fact the Fed already marks its balance sheet fair value to be a loss of 500BN on the SOMA mortgage holdings. Take the pain on half. It doesn't matter anyway.

Treasury Assets

Buying longer-dated Bonds is the most direct way to perform QE. By buying long-term Bonds, the Fed (and the BOE) generated the most impact on term premiums per dollar spent. Buying Bills and short-dated Notes simply pushes the seller into other cash-like assets instead of into riskier assets, and, ultimately, into consumption. But now the Fed is left with long-term holdings. Those holdings create p/l volatility that flows directly through to the taxpayer via remittances. In addition, by reinvesting as add-ons and further absorbing duration, the Fed has enabled the Treasury to extend it WAM without tapping private sector demand for duration. Lastly, with a Balance Sheet already full of long-term assets, the Fed may be less flexible in providing support to the economy in a future crisis.

We consider the desired steady state SOMA Treasury holdings as being "anti-reserves" that are best held in assets that most reflect the Fed's rate path while containing the minimum of term premium. By selling $20BN of longer-term Bonds monthly to the private sector and buying $20BN of Bills and short-dated Notes from Treasury, the Fed will also place upward pressure on term premiums, which we think is a desired outcome for monetary policy success. Unfortunately, the term premium impact can still be muted by a shift in by Treasury issuance decisions away from the long-end in response to Fed selling. We would hope Treasury doesn't shift its WAM and related issuance and mute the QT 2.0 "Reverse twist" but that is for another discussion. Assuming Treasury continues with its pattern of regular and predictable issuance of coupon Treasuries, we think that the extra $20BN of outright Bond sales will clear the market while also putting some much-needed upward pressure on long-term risk premiums.

Synthesis

We think the Fed has an opportunity to reset QT and the goals for its Balance Sheet during the review of QT taking place in the next few meetings. The Fed has a clear runway to get the SOMA portfolio to a good place without stressing the financial system. More importantly, the Fed can take modest steps towards a mortgage-free and short-duration Balance Sheet that avoids distorting the mortgage market and asset term premiums while, in the short-term, placing pressure on term premiums to

assure the success of its inflation fight, which has been hampered by persistent low and negative term premiums.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 55,173,610					
	Total Return	55.17%		YTD Return in excess of cash		-3.71%	
	Today's Date	3/5/2024		Portfolio Created		4/15/2019	

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
2/8/2024	CLK4 Long 80 Call	2.13	469	$ 1,000,000	2.08	$ (23,474)	Open
3/1/2024	CLK Short 84 Call	1.38	-469	$ -	0.87	$ 239,190	Open
12/13/2023	ESH4 Two's and SPOOS (doubled on 1/12/24)	4,764.00	-200		5124	$ (3,600,000)	Open
1/19/2024	NDX 3/15/2024 17000/16300 Put Spread	89.00	112	$ 1,000,000	7	$ (921,348)	Open
2/22/2024	NDX 3/28/2024 17500/17000 Put Spread	96.00	104	$ 1,000,000	55	$ (427,083)	Open
3/1/2024	NDX 3/28/2024 17500/17000 Put Spread	55.00	182	$ 1,000,000	55	$ -	Open
12/22/2023	SPX 3/15/2024 4600 Put	54.40	184	$ 1,000,000	1	$ (981,618)	Open
2/2/2024	SPX 3/15/2024 4600 Put	14.00	714	$ 1,000,000	1	$ (928,571)	Open
2/15/2024	SPX 3/15/2024 4950/4750 Put Spread	26.00	192	$ 500,000	3	$ (442,308)	Open
2/22/2024	SPX 3/28/2024 5000/4700 Put Spread	38.00	526	$ 2,000,000	20	$ (947,368)	Open
2/7/2024	"David Hunter" +7/24 5400 C - 12/24 5400/5600 CS	(22.00)	500		-7	$ 750,000	Open
1/23/2024	FXI	22.80	438596	$ 500,000	23.2	$ 175,439	Open
2/13/2024	ZBM4 3/24/24 117/115 Put Spread	0.5625	6400	$ 3,600,000	0.30	$ (1,680,000)	Open
3/1/2024	ZBM4 3/24/24 120/121 Call Spread	0.40625	-1684	$ 1,000,000	0.38	$ 52,632	Open
2/13/2024	ZNM4 3/24/2024 108 Put	0.2582	5070	$ 1,309,074	0.1	$ (802,074)	Open
2/28/2024	ZTM4 Two Years Futures	102.34	-450		102.50	$ (140,625)	Open
12/27/2023	"Sell All Assets Basket" SPY	475.80	-15763		512.3	$ (575,347)	Open
			Risk	14.909%		4.7%	