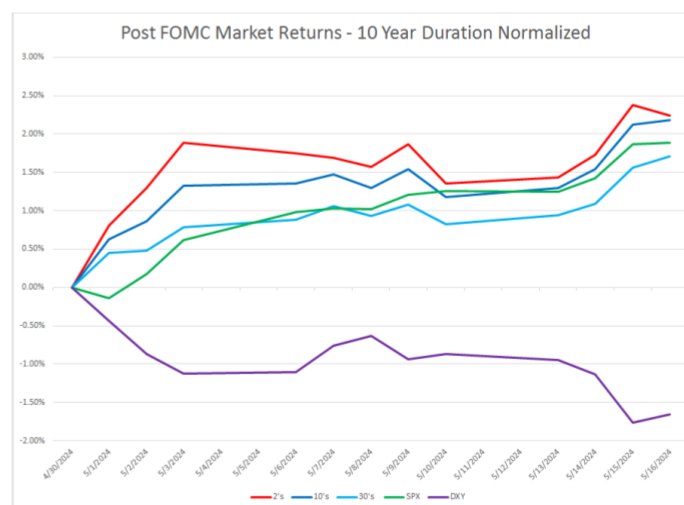
The Damped Spring Report

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

5/17/2024

Does supply matter? Yes, it does over time. The FOMC and Treasury announcements in early May were a short-term non-event, with one notable exception. In line with our expectations, Coupon auction sizes were maintained, the buyback plan was implemented, TGA surprised on the upside but was financed with Bills, and the FOMC left rates unchanged and announced QT Taper. What was unexpected and seems to have made a large difference to global asset markets, was that Chair Powell explicitly took rate hikes off the table. Taking rate hikes off the table resulted in a bull steepener, an equity market rally driven almost entirely by this easing, and a dollar selloff.

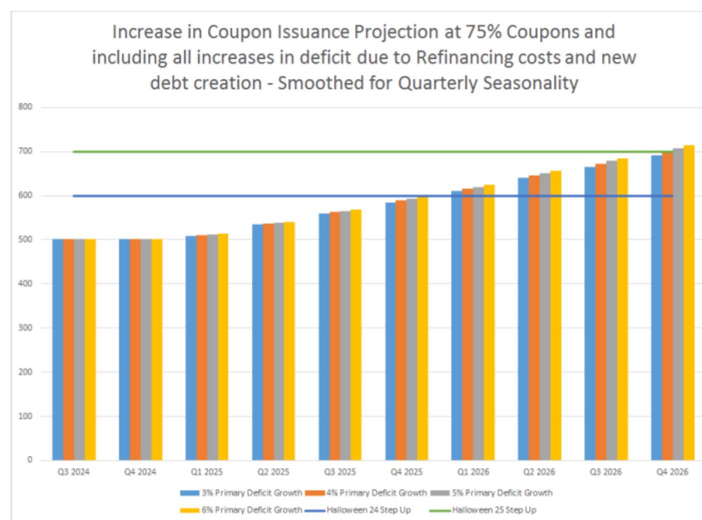


While forestalling rate cuts clearly resulted in an easing, the week's other events reinforced our view that asset prices, and thus the economy, face a major headwind of bond supply. Despite the rally in broad assets to new post QT highs, Act 3 of our script – in which term premium expansion drives long term assets (particularly equities) down, and aids policymakers in slowing the economy, remains our central case. If we are wrong, Powell will be forced to put rate hikes back on the table. Which way the play breaks will be determined by data and policymakers between today and the June FOMC meeting. In this DSR, we review the key information about bond supply and demand and the performance of global markets. The question for markets and policy makers is: Does supply matter?

Follow-up from the QRA.

The QRA came in exactly as we expected with one small exception: the 3Q24 TGA target was increased by $100BN. Many pundits expected Treasury to pump the economy and markets for dubious political benefit by reducing the TGA, which mechanically would have resulted in less issuance and less of a headwind on assets. However, Treasury simply followed its mandate and did what it said it would do.

Last July, the QRA surprised the markets and a big selloff in assets ensued. On Halloween, Janet paused issuance increases and markets were surprised the other way, resulting in a massive collapse of term premium. This past February was another surprise and bond markets continued their selloff while equities remained bid through March before selling off in April. While the May QRA was as expected, the big reaction (as mentioned above) was to Powell's comment on rate hikes. Risk premiums fell a little bit in the recent bull steepening but have not collapsed. We expect the ongoing supply and, perhaps more importantly, the path of future QRAs, will begin to expand term premiums toward 100bp by year-end.



The TBAC minutes were very clear. No changes to Coupon issuance in August, which means $500BN of net issuance. However, the Committee acknowledged the need to increase Coupon issuance soon due to persistent primary deficits, increases in interest expenditure as bonds runoff, and increases in debt to fund the total deficit (offset by reduced QT repayments), all of which will combine to require a step up in net issuance twice in the next two years:

> In terms of issuance, the Committee recommended that Treasury keep nominal auction sizes unchanged for this quarter. Turning to TIPS, the Committee supported increasing the 5y and 10y TIPS auction by $1bn. While the T-bill share would be expected to remain slightly above the current 15 to 20% recommended T-bill range, on balance, the Committee felt this would best achieve Treasury's objective of minimizing cost to the taxpayer by operating in a regular and predictable framework. The Committee supported a return to the 15-20% range in the medium term, noting this may happen without further coupon increases. There were some members who felt the T-bill share recommendation could be revisited at a later date, given market developments and continued robust demand in the years since the original recommendation. Regardless, the Committee recognizes that it may be appropriate in the future to consider incremental increases in coupon issuance depending on how deficits are realized in the coming years.
>
> Respectfully,
>
> Deirdre K. Dunn
>
> Chair, Treasury Borrowing Advisory Committee

The net duration issuance is a one-way street to higher issuance. **We believe this increased issuance will be a persistent influence for term premiums to expand for years.**

Japan

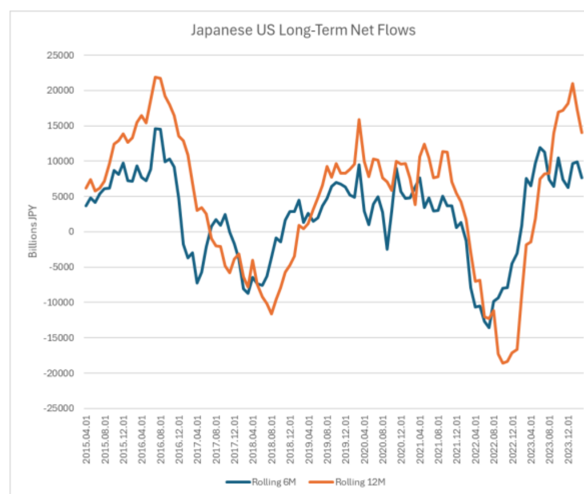
Shifts in BOJ monetary policy have resulted in a rise in long-term JGBs with 10Y JGBs threatening 1% and 30s nearing 2%. The implication for global bond markets is significant due to the large holdings of Global Fixed Income in the Japan's private sector. Japan's institutional investors invest abroad for two primary reasons:

- Absolute Yield Pickup on Unhedged Bonds. Due to the persistently low interest rates in Japan, unhedged bonds from foreign markets offer a higher absolute yield. This makes them attractive investments as they provide a higher return compared to domestic bonds. Currency weakness has only enhanced the unhedged returns.

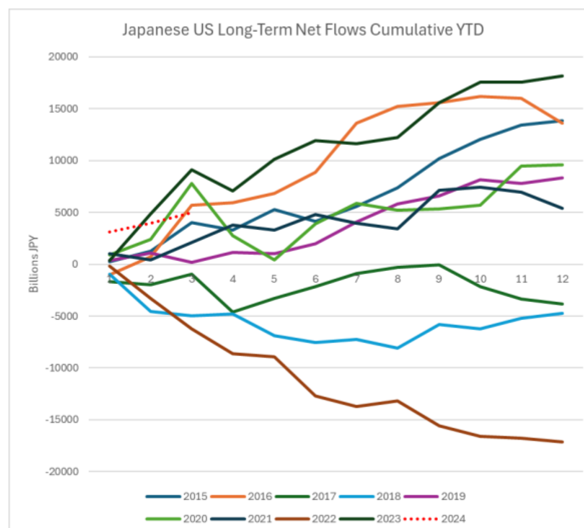
- Steeper Yield Curve Outside Japan. Foreign markets often presented in the past a steeper yield curve compared to Japan's curve. This created opportunities to profit from currency-hedged bonds relatively to JGBs. The profitability of this strategy is highly dependent on the shape of the yield curve in markets like the U.S. relative to Japan. If the U.S. yield curve is steeper Japan's this strategy can be attractive. Conversely, if the curve is inverted, the trade becomes less attractive.

Currently, Japanese investors benefit from the unhedged yield pickup due to the higher yields available in foreign markets compared to Japan. However, they face challenges in making profitable bets compared to JGBs on any currency hedged investments. 10–30Y US Treasuries swapped fully to Yen are currently about 30-40bps lower than the yield on equivalent JGBs. During much of the past decade, long-term US Treasuries fully swapped to Yen had lower yields than JGBs, so current pricing may not seem particularly unusual. However, during that decade 10Y JGB yields were held steady by yield curve control at 25bp. Now that YCC has evolved and the BOJ is allowing JGB yields to rise, JGBs are more attractive outright and allows potential mark to market gains on hedged positions. **We suspect JGB yields will continue to rise as YCC and rate policy evolve, and don't particularly want to buy JGBs outright yet. However, JGBs are much more attractive to Treasuries with the Yen weaker by 35% and yields higher while hedges remain attractive.**

Notice demand for US Treasuries in Japan seems to have peaked:



Cumulative flows remain positive but at a slow pace so far:



Japanese investors that *mainly* hedge their foreign exchange risk are banks, trusts, and life insurance companies. These institutions manage their FX exposure to protect against currency fluctuations and ensure stable returns on their foreign investments. Life insurance companies and banks mostly reduced their foreign bond holdings over the last 2-3 years while trust banks increased their holdings.

We think that inflows into US long-term bonds will be limited from Japanese *hedged* institutions going forward as the hedged cohort has limited incentive to buy USTs. Here, we summarize the sentiment of Japanese life insurance companies.

	Sentiment	JGB Bias	Trigger for more	Foreign Hedged	Foreign Unhedged	JGB 10 range	JGB 30 range
Nippon Life	"We are steadily buying 30-year securities as they are becoming attractive," Nippon Life Insurance Co. plans to buy super-long Japanese government bonds and will accelerate purchases when the 30-year yield rises significantly above 2%.	Increase	30yr 2%		Flat	0,6%-1,2%	
Sumitomo Life	Sumitomo Life Insurance Co. plans to buy super-long Japanese bonds in fiscal year "We will invest flexibly this fiscal year trying to see the highest possible returns, rather than purchasing them at a constant pace,"	Increase	30yr 2%			0,5%-1,2%	1,4%-2,2%
Dai-chi Life	Dai-ichi Life Insurance Co. plans to boost holdings of yen-denominated bonds in the fiscal year	Increase		Decrease	Decrease	0,7%-1,5%	
Meiji	Meiji Yasuda Life Insurance Co. plans to increase holdings of foreign sovereign bonds without currency hedging in the fiscal year	Increase	30yr 2%	Decrease		0,01	
Japan Post	Japan Post Insurance Co. sees domestic bond yields rising as the central bank is expected to lift interest rates again, which may spur the company to shift to yen-denominated debt from overseas bonds with currency hedges,	Increase	30yr 2%	Decrease		0,9%-1,4%	1,9%-2,3%
Taiyo Life	plans to increase holdings of Japanese sovereign and corporate bonds in the financial year	Increase		Flat	Flat	0,6%-1,1%	
Taiju Life	, will also increase investment in super-long Japanese bonds this fiscal year. Taiju could buy more super-long Japanese bonds if their yields rise substantially above 2%	Increase	30yr 2%	Flat		1,10%	
Fukoku Life	will wait for a further rise in yields before boosting its holdings of Japan's super-long government bonds. But the average yields need to be above 2% on debt maturing in 20 to 30 years for Fukoku to aggressively increase its investment. The company plans to reduce holdings of Japanese sovereign bonds by ¥30 billion	Decrease	30yr 2%	Flat	Increase	0,5-1,3%	

As we mentioned above, JGBs are attractive right now relative to UST, and life insurance companies will probably increase their JGB purchases going forward. A sustained move above 2% on 30-year JGBs will likely attract even more flows out of foreign bonds.

The unhedged players are the Ministry of Finance and pension funds. Five years ago, the Government Pension Investment Fund (GPIF) modified its investment allocation strategy to increase its allocation to foreign bonds, moving away from JGBs. As yields in Japan normalize, we believe there is a possibility that GPIF might increase its JGB allocation, starting within the error bands and potentially making an official adjustment later. All in all, we think Japanese flows into USTs will slow over the coming quarters and will be another demand side factor pushing longer-term Treasury yields higher. (Note: thanks @Danielsimonyi for his work on this section).

China

In February, we wrote the DSR "Year of the Dragon" (see here). Since then, China's equity market has taken off by 20-30%. We built our view based on Ray

Dalio's "Beautiful Deleveraging" framework, as we knew China had the resources to attempt this sort of deleveraging and was showing signs of having the will to do so.

In summary, when all is said and done, only a few things distinguish whether a deleveraging is managed well or poorly. I have outlined them below. A lot of pain can be avoided if policy makers can learn from the common pitfalls and understand the policies characteristic of beautiful deleveragings.

	Well Managed	Poorly Managed
Bubble	• Central banks consider growth in debt and its effects on asset markets in managing policy. If they can prevent the bubble, they can prevent the bust. • Central banks use macroprudential policies to target restraints in debt growth where bubbles are emerging and allow debt growth where it is not excessive. • Fiscal policies are tightened.	• Big bubbles are fueled by speculators and lenders over-extrapolating past successes and making further debt-financed investments, and by central banks focusing just on inflation and/or growth and not considering debt bubbles in investment assets, thus keeping credit cheap for too long.
Top	• Central banks constrict the bubble either with the control of broad monetary policy or with well-chosen macroprudential policies and then ease selectively (via macroprudential policies).	• Central banks continue to tighten well after bursting the bubble.
Depression	• Central banks provide ample liquidity, ease short rates quickly until they hit 0%, and then pursue aggressive monetizations, using aggressive targeted macroprudential policies. • Governments pursue aggressive and sustained fiscal stimulus, easing past the turn. • Systemically important institutions are protected.	• Central banks are slower to cut rates, provide more limited liquidity, and tighten too early. They also wait too long to pursue aggressive monetization. • Governments pursue austerity without adequately easing. • Systemically important institutions are left damaged or failed.
Beautiful Deleveraging	• Reflations begin with aggressive monetizations through asset purchases or big currency declines, enough to bring nominal growth above nominal rates. • Stimulative macroprudential policies are targeted to protect systemically important entities and to stimulate high-quality credit growth. • Nonsystemically important institutions are allowed to fail in an orderly way. • Policy makers balance the depressive forces of defaults and austerity with the reflationary forces of debt monetization, currency declines, and fiscal stimulus.	• Initial monetizations stutter and start. Asset purchases are more muted and consist more of cash-like instruments rather than risky assets, so that purchases don't produce a wealth effect. Stimulation of the central bank is undermined by fiscal austerity. • Overindebted entities are protected even though they are not systemically important, leading to zombie banks and malaise. • Ugly inflationary depressions arise in cases where policy makers allow faith in the currency to collapse and print too much money.

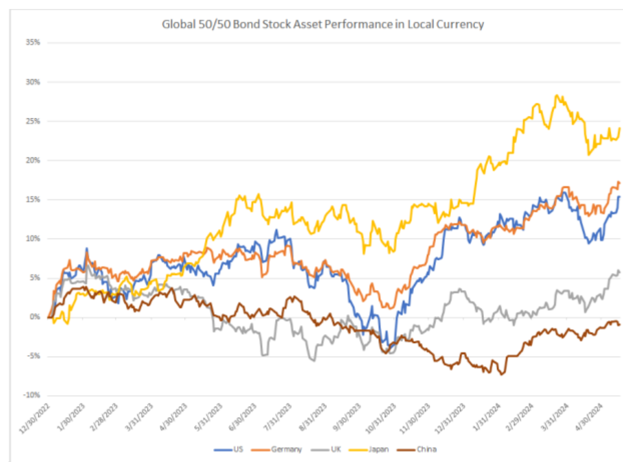
China is now beginning to engage in the steps Ray mentions on the lower left of this chart. Most recently, China's government has:

- Decided to issue $138BN of ultra-long debt to provide stimulus to the ailing economy.
- Floated the idea of buying empty homes from troubled banks and real estate companies.
- Raised the possibility of debt monetization via government bond purchases.
- Sold or allowed to runoff the largest amount of US Treasuries in many years.

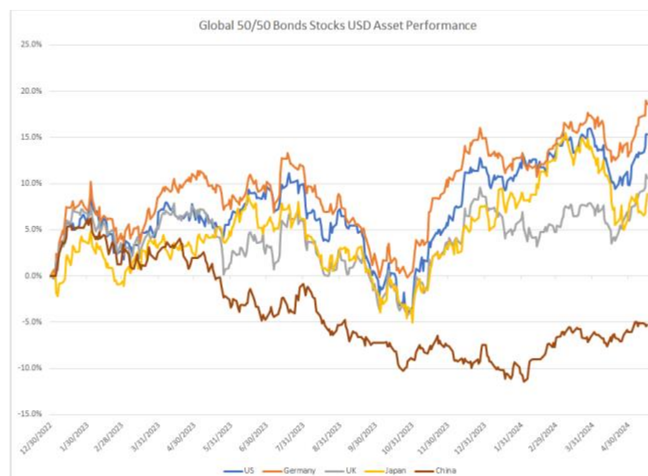
For now, all of these efforts are consistent with an attempt to engineer a "Beautiful Deleveraging," but their scale is woefully inadequate to the task at hand. Will it fail or is this just the beginning? We suspect it is just the beginning but are unsure China will pull it off. However, the immediate supply of bonds may add to the pressure on global bond markets. We will pay attention to potential QE announcements as the markets absorb stimulus financing. This is a fluid situation and its impact on global markets and economies will only become known with time. To the extent China spends via private sector borrowing, or by selling reserves, we expect upward pressure on global term premiums.

Global Markets

Global asset markets have rallied meaningfully since the 2022 sell off and China has only recently joined the party. In local currency, the rally in Japanese equities has generated the largest returns for investors. Germany and the US have had excellent performance despite weak bond markets, while the UK has lagged:



Notably, in USD-terms, the returns are quite different. Germany leads the globe while its economy is amongst the weakest. Japan's asset returns have been largely nullified by Yen weakness. The supply of local investments, a weak Yen, aggressive stimulus in China, and positive yield curves offering low financing costs, provide opportunity for superior returns in Asia's local markets. Western bond markets in particular offer poor valuation comparisons. We expect capital repatriation to the East which will further weaken demand for US assets. Certainly, major global investors have begun to move money from US assets to Asia, notably Warren Buffet in Japan and David Tepper in China.



Fundamentally, investors should prefer a balanced portfolio of stocks, bonds, gold, and commodities with an accommodative central bank and recovering economy. As mentioned above, after many years of being uninvestable, JGBs now provide

some balance to portfolios and both China and Japan are accommodative. The implications to the USD and other Asian crosses will be reviewed in future DSRs, but we are looking for a dip to buy Asian assets unhedged.

Synthesis

Despite a 15bp reduction in term premium and a rally in long-term assets as cuts were priced into the front end of the yield curve, we are bearish bonds. Increased net supply of Coupon Treasuries with limited interest from large buyers is likely to be a headwind to any further rally. We also believe that the inflation battle is not dead, and that Fed Funds will need to remain above 5% for the balance of 2024. Equities are rich in the US and all developed markets, and we continue to expect a topping process and correction that will usher in an economic slow down in late 2024. We will sell rallies on bonds, stocks, and gold opportunistically. On the other hand, Asian assets are looking attractive and as JGB yields deal with the distribution issues mentioned above and a bottoming of the Yen we look to go long in both China and Japan on dips.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000						
	LTD P/L	$ 70,780,700						
	Total Return	70.78%		YTD Return in excess of cash		11.90%		
	Today's Date	5/17/2024		Portfolio Created		4/15/2019		
Date	**Position**	**Entry Price**	**Amount**	**Worst case loss**	**MTM**	**P/L**	**Open/Closed**	**Type**
4/29/2024	ZBU4 7/26/24 109/106 Put Spread (SETFORGET)	0.50	2000	$ 1,000,000	0.22	$ (562,500)	Open	0
4/29/2024	ZNU4 7/26/24 106/104 Put Spread (SETFORGET)	0.38	2667	$ 1,000,000	0.20	$ (458,333)	Open	0
4/29/2024	SPX 7/19/ 4800/4500 Put Spread (SETFORGET)	23.80	420	$ 1,000,000	10	$ (579,832)	Open	0
4/29/2024	NDX 7/19/ 16600/15600 Put Spread (SETFORGET)	127.00	79	$ 1,000,000	50	$ (606,299)	Open	0
4/29/2024	GCQ4 7/25 2200 Put (SETFORGET)	13	769	$ 1,000,000	8	$ (384,615)	Open	0
4/25/2024	SPX May 17th 4900 Put (added 4/26)	20.55	486	$ 998,730	0.33	$ (982,692)	Open	2
5/3/2024	SPX June 21 2024 5100/4800 Put Spread	56.00	179	$ 1,000,000	28	$ (500,000)	Open	2
5/6/2024	AAPL Call Spread 175/200	12.00	-192	$ 250,000	13	$ (19,231)	Open	2
4/4/2024	SFRZ5 Consolidated Positions	96.02	5500		95.85	$ (2,337,500)	Open	3
4/10/2024	ZNM4 5/24/24 108 Put	0.70	3000	$ 2,109,375	0.23	$ (1,406,250)	Open	3
4/10/2024	ZBM4 5/24/2024 115 (adjusted for cover of 112)	1.19	2000	$ 2,375,000	0.45	$ (1,468,750)	Open	3
5/1/2024	ZBN4 115/117 Call Spread	0.77	-810	$ 1,000,000	1.09	$ (265,823)	Open	3
5/1/2024	ZNN4 108/110 Call Spread	0.69	-762	$ 1,000,000	1.06	$ (285,714)	Open	3
4/22/2024	GCM4 5/28/2024 2300/2200 Put Spread	18.5	270	$ 500,000	9	$ (256,757)	Open	4
			Risk	13.108%		4.0%		