The Damped Spring Report

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

5/24/2024

Over the last 15 months fear has motivated the changing stances of policymakers. What fear? Very simply: The Fed and Treasury are terrified that the Treasury market's long-end will reprice to levels that reflect the reality of a strong real economy, sticky and above-target inflation, and a normal reward for the risk of holding long-term assets relative to cash. Ten months ago, we outlined a policy recommendation - the Script, that would have killed inflation:

- **It discouraged the Fed from further use of ineffective changes to the short rate.**
- **It encouraged Treasury to correct its overuse of Bills, which has muted QT almost since its inception.**
- **It did create a risk of recession and job loss, but it would have worked.**
- **By allowing long-term Bond yields to rise to restrictive territory, the real economy would have slowed, and demand would have followed.**

If policymakers had followed the Script, inflation would be back to target and the economy likely would have normalized. Policymakers had no courage to make this happen and instead acted out of fear of a sizable Bond market selloff. Their failure to act decisively will result in significant market and economic dislocations in the next 18 months. Policy has elevated asset prices to levels where the potential return from holding long-term assets is so low that new asset creation to finance future growth, or Treasury issuance to term out US Debt, will likely be met with a buyers' strike. Policy has also allowed inflation to remain sticky and real growth to remain extremely strong. The markets and the economy are operating in the thinnest of air. A stall is inevitable and unpreventable. At the same time, fear has caused policymakers to do almost everything possible to foam the runway for a Bond hard landing. Policymakers have shot their wad. Only extreme and irresponsible measures are left to prevent the rapid repricing of long-term yields.

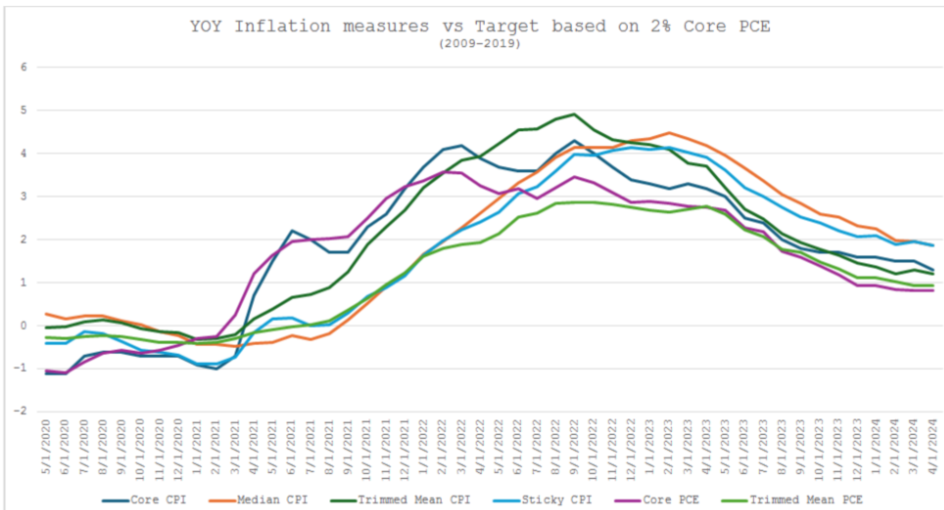
Policymakers now have an empty quiver at a time when the supply of all assets is growing and expected returns from assets is awful versus cash. We expect a meaningful and sharp selloff in Bonds to above 5% in the

next 3 months which will drag down the US Dollar and all assets except possibly hard money. Unless some irresponsible creative action is taken by policymakers, a significant slowdown will ensue by year-end.

We are raising cash in our beta portfolio. We are adding short risk in long-term Bonds, and equities and cutting our STIR exposure to flat.

Now that we've had our rant lets dig in.

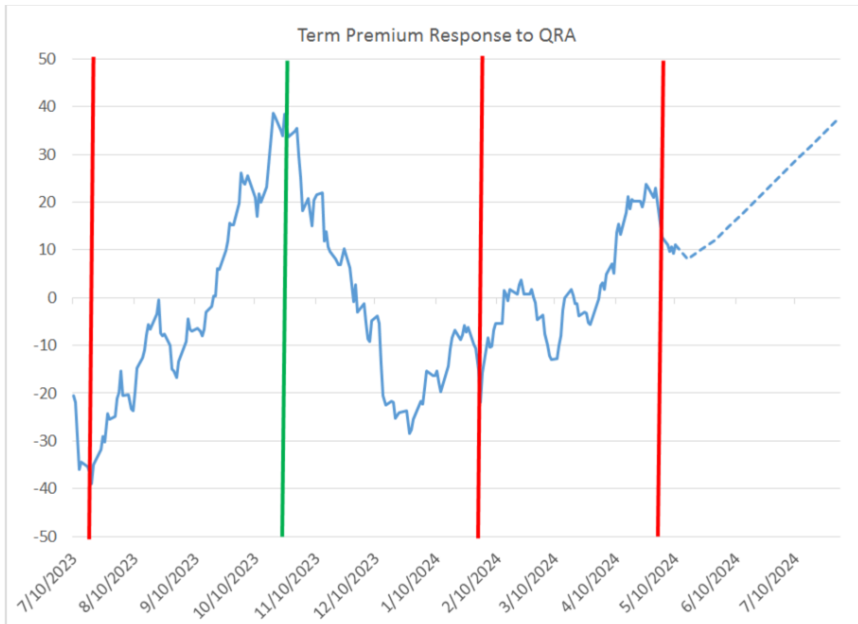
As the economy reopened at the end of 2021, a combination of pent-up spending and supply disruptions generated substantial inflation. The Fed decided to begin removing accommodation, confident that the supply disruption resolution and people returning to the workforce would result in abundant supply and slowing inflation. They were right on these points: Supply driven inflation was indeed transitory, but the Fed missed demand badly. A combination of sizeable transfer payments and robust real growth resulted in unexpectedly large and continuing wage growth and an ongoing income-driven expansion.



Today, inflation remains well above target and shows little sign of returning to target. Private sector balances sheets are strong, and demand-driven inflation shows little sign of ebbing. While certain narrow parts of the economy are getting pinched, PCE core services (ex-housing) remains above 5%. Clearly, the actions of policymakers over the past two years have not caused an adequate destruction of demand to kill inflation.

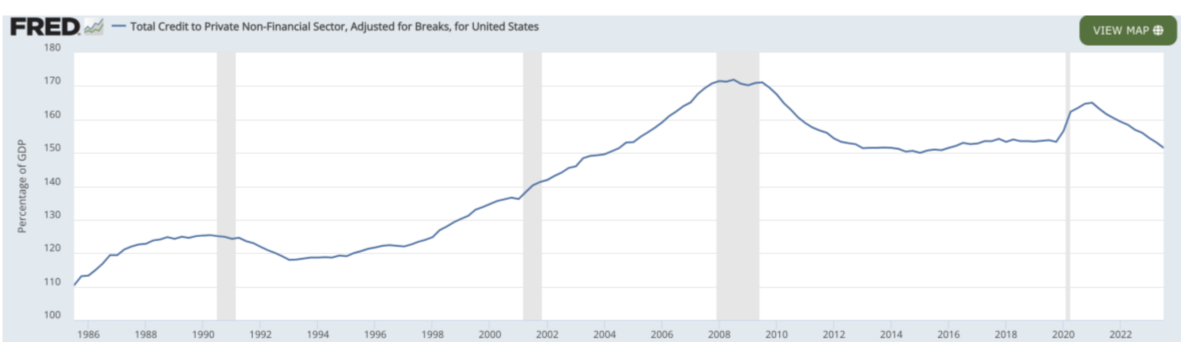
Myopia

With all due respect, the Fed appears to have a myopic belief that the short-term rate is the only tool necessary to kill inflation. Only once during the major Bond selloff last fall did they mention the long-term Bond market doing the Fed's work in slowing the economy. As soon as the long end started to do its work, the Fed and Treasury panicked. Both policymakers showed what they were truly afraid of - a hard landing in the long-term Bond market. The Fed took the economic slowdown in late 4Q23 and went fully myopic. They trotted out the most respected Fed officials and proclaimed that rate cuts would be necessary to maintain restrictive short-term interest rates as inflation fell. Treasury refused to increase Coupon issuance despite Bills issuance running well over the long-term average Bills to Coupon issuance ratio. Both the Fed and Treasury sold the market a huge put on Bonds and unsurprisingly yields and term premium collapsed. The green line below shows the fruits of policymaking driven by fear of a hard landing for Bonds. But a hard landing is now almost inevitable and shouldn't be feared as it will get the job done.



Fighting inflation with short rates while selling puts on Bonds won't get it done.

For the past two years, we have been bullish growth and expected inflation to remain higher for longer. Why? Because we believe the US economic expansion is being influenced by factors that are different from past expansions in the last forty years and that are not responsive to the policy choices made by the Fed over the past two years. This expansion has been driven by income growth and wealth creation in the private sector. All other expansions of the past few decades have been driven by private sector debt growth.



A credit driven economic expansion responds very well to an increase in short-term interest rates. Banks create the money to fuel the expansion by financing borrowers short-term. When short-term rates rise, banks immediately pass on that cost to new borrowers. New borrowers with lofty expectations of private sector real economic growth accept the higher rate, but ultimately are unable to service their debts as further Fed interest rate hikes slow demand and growth. Banks may also over leverage and can lose on both credit losses and high financing costs for their asset books. Credit supply dries up and the economy slows.

In an income-driven expansion, none of this mechanism is present. Furthermore, the current cycle has a few other characteristics that make it insensitive to higher short-term interest rates without an increase in long-term rates:

- The GFC and resultant banking regulatory changes has led to a banking system flush with capital and able to withstand significant stress.

- Many borrowers are sitting on very low long-term fixed rate loans.

- The economy is more service oriented than ever before, leading to limited need for capital intensive business investment and reducing the share of consumer spending on goods with large upfront costs that need financing.

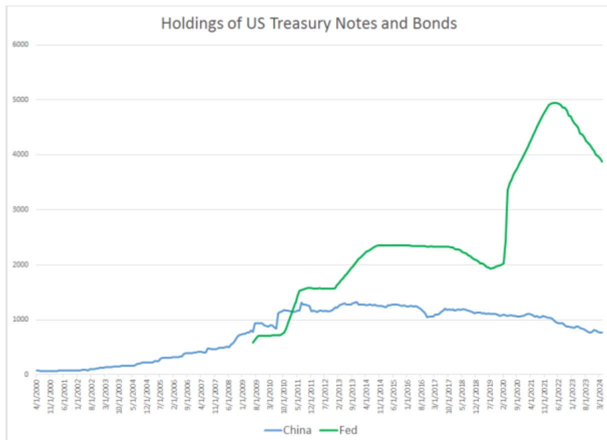
- Lastly, increases in short-term rates generate income growth for Bills and Money Market Fund savers, which, though small, were sizable income drivers in the first part of the hiking cycle and more than offset the cost of financing increases for borrowers.

While it is certainly true that raising Fed Funds influences the economy, as compared to prior economic cycles its impact is attenuated. In all cycles, overall financial conditions, including long-term Bond yields and the ability and willingness of borrowers and lenders to create credit, has an impact. In this particular cycle, short-term rates have had minimal impact, lenders are quite able to provide credit and borrowers don’t need credit, which leaves long-term Bond yields as the most important factor able to stimulate or restrict economic activity. Under no measure (except for two weeks in October 2023) have long-term rates approached restrictive territory. It should be noted that even those two weeks resulted in a rapid cooling of the economy in the following months. The worst fears of policymakers were almost realized and, in response, policymakers adopted a Fear Policy and sold puts on Bonds.

The Origin and Evolution of the Fear Policy

The problem with depending on long-term interest rates to slow the economy is that long-term Bond markets are fickle partners.

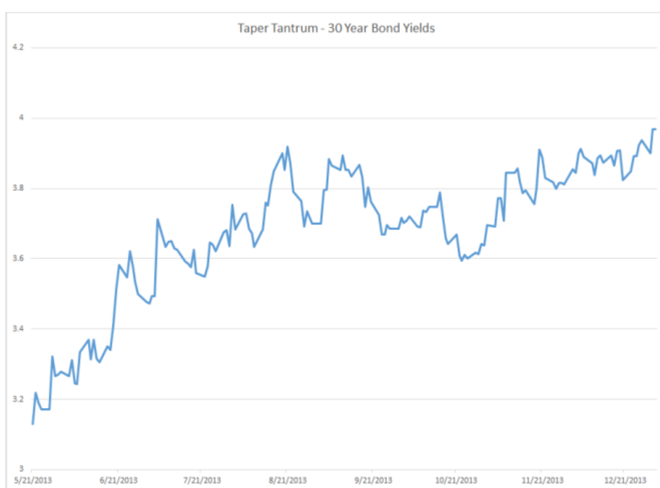
For most of the past 20 years one buyer dominated the long-term Bond market. First it was China as trade opened up and a US trade deficit needed financing. Then, during the GFC, the Fed took over. Then, of course, things got spicy in the last four years. Today there is no obvious price insensitive buyer of Bonds. The grandaddy of them all was Japan, which now has a much more attractive local Bond market and needs to sell USD assets to defend its weak currency. China is selling and so is the Fed.



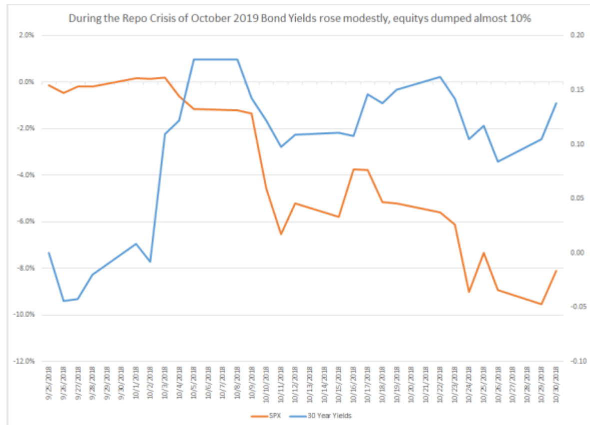
So here we are, with no price insensitive buyer of Bonds. Let's look at the origin story of the Fear Policy.

Origin

Let's go way back. In 2013, Chairman Bernanke announced that the Fed would slow QE, resulting in what came to be known as the "Taper Tantrum." The mere announcement that the Fed would consider slowing QE caused 30Y yields to rise by 85bp.



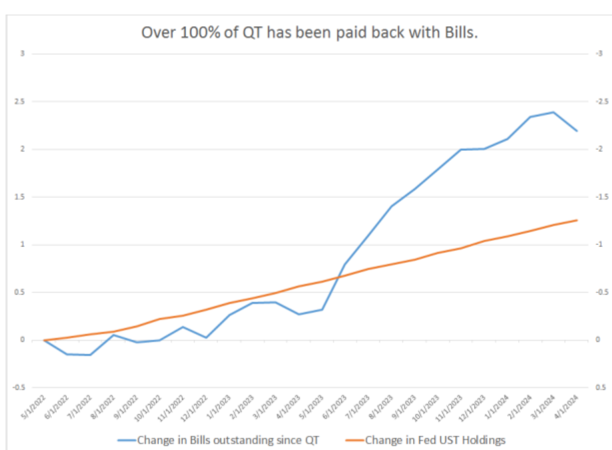
The 2019 Repo Crisis. In this case, the Fed began balance sheet runoff in 2018. After the Fed had reduced its Treasury holdings by $300BN, by fall 2019 the repo market broke. Investors who were buying Treasury's Bond issuances were suddenly faced with exploding costs to finance those purchases in repo. Bond yields rose but, due to uncertainty, equities fell almost 10%. The Fed stepped in and created the Standing Repo Facility and RRP and ultimately had to reverse QT.



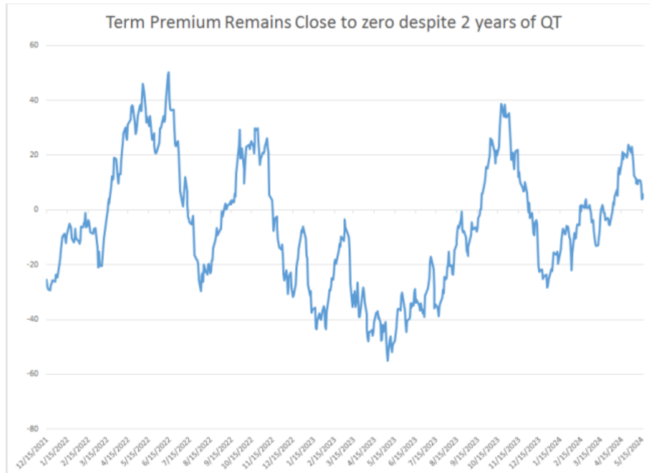
The selloff that occurred in 2022 was intended. Inflation was high and monetary policy was needed to tighten conditions. However, all of the tightening was front-running central bank actions. The implementation turned out to be flawed. **The implementation of QT was the origin story of the Fear Policy.**

The Fed's biggest mistake

At the December 2021 FOMC meeting, the Fed hinted that it was going to look more carefully at the balance sheet. The next month it disclosed in the December meeting minutes the likely implementation of quantitative tightening. The desired impact of quantitative tightening is to cause long-term asset prices to sell off as increased Treasuries supply pushes up risk premiums and yields. However, as we have learned, implementation matters. Unlike the Bank of England, which outright sells Bonds, the Fed decided to use balance sheet runoff as their method of quantitative tightening. We commented here that the Fed decided to hand monetary policy to Treasury by choosing runoff instead of outright Bond sales. The effect of this was to transfer from the Fed to Treasury the funding decision (what gets sold) to finance the Bond sales. By financing the Fed's Bond sales with Bills, Treasury muted QT.

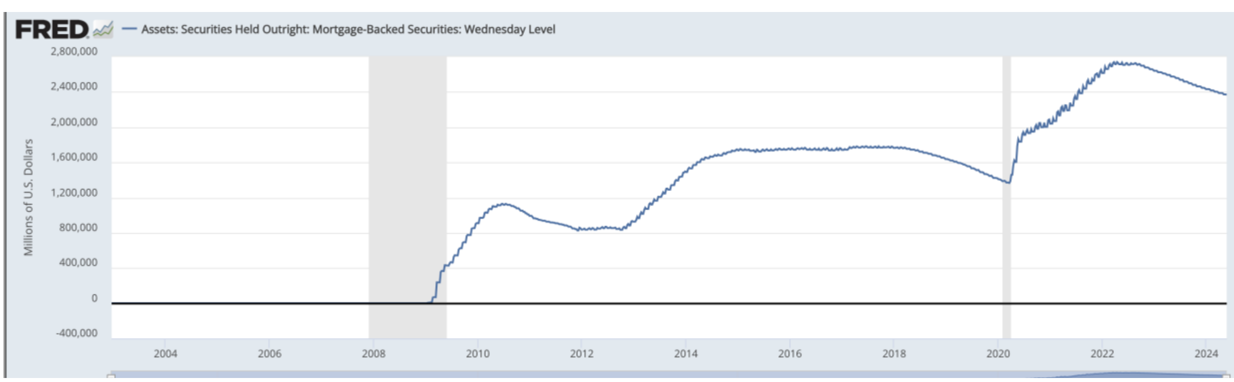


Throughout the entire QT period, term premium has been stuck in a narrow range. QT has not achieved its goal because Treasury has increased Bills outstanding faster than the Fed's balance sheet has runoff and thereby prevented QT from flowing through to asset prices.

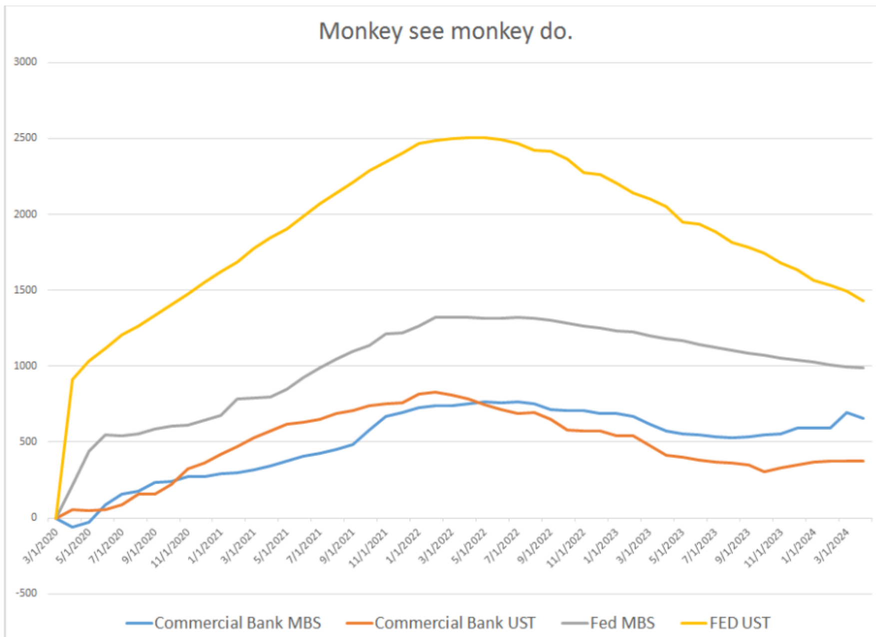


Mortgage mistakes.

The second origin mistake was in the design of the Fed's program to runoff Mortgages, a decision also based in fear. The Fed owned seasoned low coupon mortgages purchased during Post GFC ZIRP and new low coupon mortgages purchased during Covid. Looking back to the GFC, QE purchases were essential to enable the banking system to deleverage. There was a mortgage crisis. However, oddly the QE during Covid built the mortgage portfolio while no mortgage crisis appeared to exist. During Covid, the SOMA Mortgage portfolio doubled, growing by $1.4TN.



Why did the Fed buy mortgages? One can only speculate, but by the time QT was announced many Fed Governors had expressed a strong preference to reduce the Fed's mortgage portfolio. As with Treasuries, the Fed chose runoff for its mortgage portfolio. At the time, with Fed Funds still at zero and before the hiking cycle began, mortgage refinancing activity was still vibrant. Homeowner mobility was not constrained by widespread below-market mortgages. The pace of the runoff started near the Fed's caps. However, the Fed's rapid hikes in summer 2022 and the pricing of further hikes into the curve resulted in runoff well below target, which continues to slow as homeowner mobility is now constrained by widespread below market mortgages. Perhaps buying mortgages in size during Covid was necessary and perhaps the Fed simply failed to understand or miscalculated how its mortgage runoff program would be affected by higher rates on mortgage prepayments when it designed the runoff program. The Fed would have had far more impact and more control over the tightening of financial conditions by selling mortgages outright. In our view, the Fed was fearful of the effect of mortgage sales on the stability of the banking system. The Fed bought a large fraction of Treasuries and mortgages during QE but the other purchaser alongside them buying the exact same Bonds was the banking system.



Commercial banks bought $1.5TN of MBS and Treasuries during QE. The Fed did not have the courage to sell MBS and Treasuries. Fear of bank financial instability drove the runoff policy, which has resulted in Treasury muting QT and MBS Runoff leaving the Fed with over $2.3TN mortgages on their balance sheet today despite a strong and repeated desire to have none.

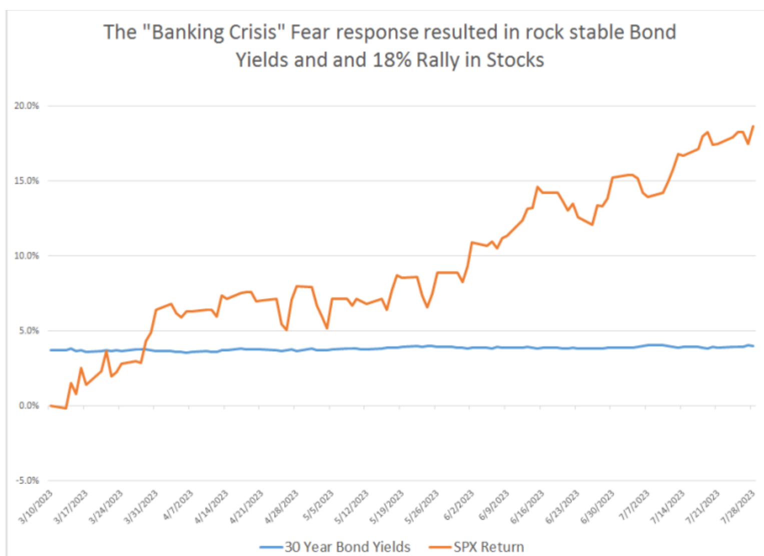
The origin of the Fear Policy was choosing balance sheet runoff over outright sales. We are convinced that had Fed simply sold its assets outright like the BOE QT strategy, inflation would be dead and short-term rates would never have risen to anywhere close to current levels. The curve would now be positively sloped, and the economy would have normalized. But no: Fear of financial instability driven by a long-term Bond selloff led the Fed to its current predicament.

The BOE Hiccup

We get it. In fall 2022, the UK gilt market had a few weeks of instability. A combination of ongoing QT and PM Truss' massive budget mistake caused the BOE to restart QE and buy gilts. The agile flip to QE dealt with the liquidity crisis from the insurance schemes and politics took care of Truss. A month later things were back to normal, and the BOE restarted QT. While the Fed takes months to notify markets of shifts in QE/QT (due in part to the Taper Tantrum experience), this results in inflexibility and delay, as we saw in 2022 when, despite signaling that QT was imminent, the Fed continued QE for another quarter. Market participants are by and large mature adults and don't need to be spoon fed quite so much.

US Banks own Bonds and some don't know what they are doing

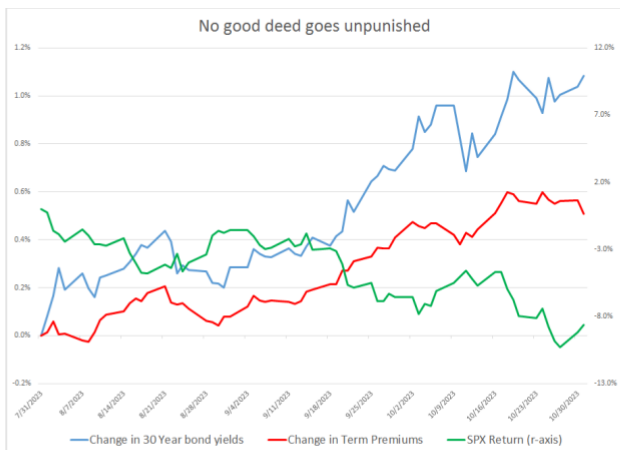
The Fed's own hiccup and its Fear policy response happened in March 2023. Most notably, SVB, a bank that was allowed to hold over $100BN in low coupon Bonds and MBS while simultaneously financing those assets with 97% uninsured deposits, failed. Several other leveraged, illiquid, and poorly financed banks followed. The fear of a Bond market hard landing caused by banks being forced to panic sell Bonds and MBS to deleverage gripped policymakers. The GFC regulatory changes, which were well-crafted for a credit crisis, were simply not equipped to deal with a duration crisis. A failure to oversee the banking system's duration exposures and acceptance of the industry model of deposit duration to offset assets duration left the Fed with little choice. To save the Bond and MBS markets, the Fed pushed bank sales into the future via the BTFP program, which delayed the bank deleveraging and once again offered the market a put on long-term Bonds. Markets once again responded, as Bonds stabilized and stocks rallied.



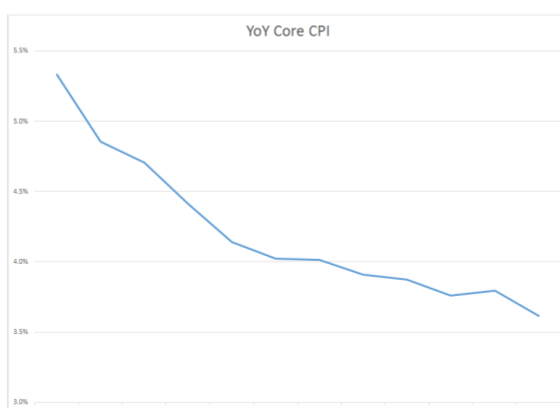
More evidence of policymaker fears of a Bond hard landing emerged during the noisy period of the "Banking Crisis" and "Debt Ceiling Battle." At the time (but not in these pages), the QRA was largely ignored by market participants. However, on May 2, 2023, Treasury (anticipating resolution of the debt ceiling impasse the following month) correctly projected its largest debt issuance since the 2021 Covid related issuance. Over $1.2TN net new money was issued in 3Q23. Treasury sensibly used Bills to restock the depleted TGA, but inexplicably **reduced** Coupon issuance to the lowest since pre-Covid. Asset markets ramped all the way to July 31, 2023

One courageous act

At the end of last July, as term premiums on Bonds were deeply negative and the yield curve was highly inverted and equity prices at 2023 YTD and post-2022 selloff highs, and with the Fed expected to hike three more times, Treasury decided to finally begin terming out the debt from primarily Bills to Bonds. Treasury increased net Coupon issuance for 4Q23 by $150BN. It was the first step toward a stable funding profile for the US Debt, yet, even with the increase, the money needed to fund the primary deficit, pay the higher interest cost on the massive amount of Bills outstanding, and finance the Fed's runoff, resulted in Bills issuance well above 50% of total issuance. Again, a good and courageous first step. Pow! The market punched Treasury in the face.



30Y Bond yields rose 110BPs, term premium rose 60bp, and equity prices fell almost 10%. The worst fear was realized. Simply beginning the process of extending the duration of the US debt and reducing the amount of Bills outstanding caused policymakers to lose the long end of the Treasury market, which took the equity market and perhaps the economy down with it. Over at the Fed, certain central bankers with deep experience on the impact of QE and QT began saying that the long-end yields were doing the work of the Fed. Yes! That's because the long end is the only mechanism that transmits policy in today's economy. CPI fell rapidly.

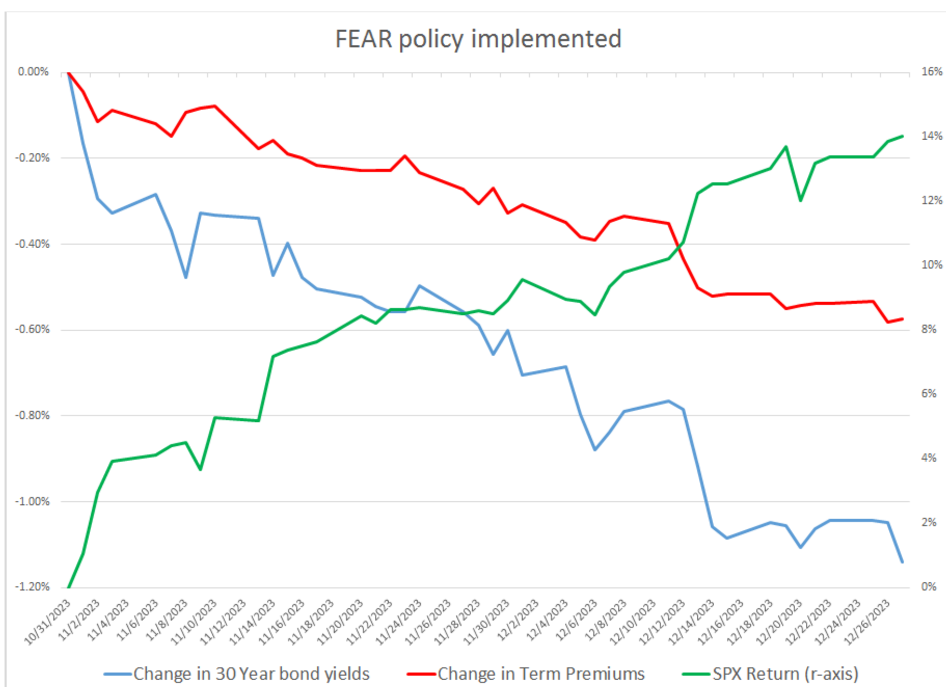


The Policy of Fear

By Halloween, the Bond market looked as if it was going to gap higher in yield. Perhaps for some Fed officials like Waller, Williams, and Powell, the myopic view of a Taylor Rule world, in which falling inflation required short-term rate cuts, began to dominate the rhetoric. Certainly, their rhetoric pivoted as the data fell. We think they feared the Bond market as well. Many Fed officials had commented on the Bond market doing the Fed's work, but that rhetoric ceased when markets punched policymakers in the face. Treasury, of course, responded as any large seller would and decided to take a break in increasing Bond supply. **Perhaps it was just prudent to slow increases or perhaps they were advised that the Bond market couldn't handle the supply. Reread that sentence: Can the Bond market handle the supply?**

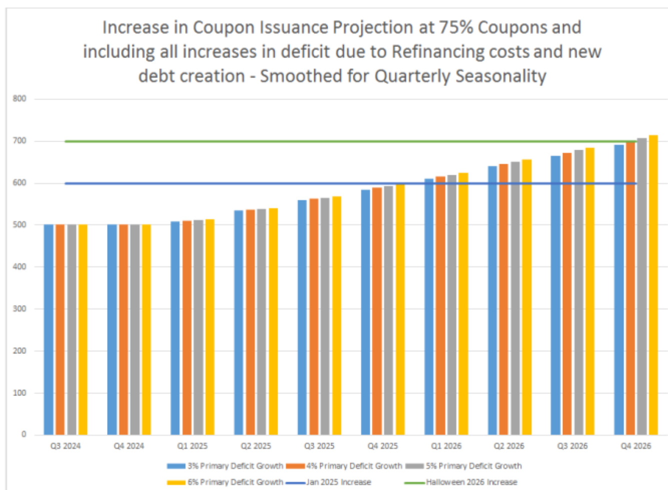
The actions of the Fed and Treasury confirmed our view that the policymakers are either confused about the impact on the long-end on the economy or fear that the long-end needs to be eased into higher yields to absorb supply to avoid a hard landing for Bond investors and thus a hard landing for the economy. We are conflicted, but our synthesis is that the policymakers remain convinced publicly that the short rate is the appropriate tool but behind closed doors fear the long end.

The result of the implementation of the Fear Policy caused a massive rally in both stocks and Bonds. By year-end equities were up 14% and have continued rising, now up 26% as the Fear Policy immediately transmitted an easing to the economy and growth expectations spiked. Bonds rallied 115bp and term premiums fell 58bp and ended 2023 deeply negative.

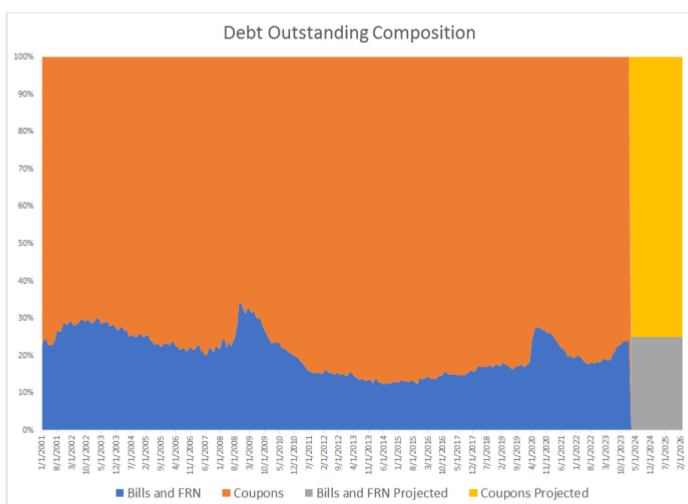


The inevitable increase of supply.

Using reasonable projections for the primary budget (excluding any change in politics or 2017 TCJA impact) and including the expenses of financing rising interest payments as debt runoff and assuming QT ends in 2025, the demand for financing will remain high for years. Also, conservatively assuming that Treasury will be willing to hold Bills issuance at 25% (instead of past guidance of 15-20%), we expect Treasury to increase net Coupon issuance by $100BN in January 2025 and again on Halloween 2025. There is simply no more delaying the inevitable, particularly if for some unknown reason the Treasury market continues to offer attractive and historically low term premiums.



The implication of this policy for proportions of Bills versus Coupons debt composition will lead to a 25% fraction that will then be steady for years. We believe that 25% Bills are dangerous policy and think there is more upside for Coupon issuance than downside, but the point remains that Coupons are for sale going forward.



Foaming the runway

Given the inevitable supply and its potential to cause a hard landing for the Bond market with long-term yields rising above 5%, we believe policymakers are foaming the runway to minimize the damage of a crash landing. To this end, they have:

- Tapered QT, which reduces issuance needs modestly and takes some pressure of the RRP.
- Implemented a buyback in case stress occurs in off-the-run Treasury markets.
- The BTFP has 10 months to run with existing participants.
- Attempted to destigmatize the Discount window.
- Perhaps most importantly they have capped short-term rates by taking further rate hikes off the table.

Each of these steps either reduces supply, adds a bid to the market or provides financing for potential future buyers. Capping short rates also provides an anchor in case the curve disinverts to attract levered carry-oriented buyers.

As mentioned in many prior DSRs, price insensitive buyers - the Fed and other currency/reserve managers, have turned seller. JGBs offer real money longs increasingly attractive yields for domestic Japanese buyers relative to Treasuries. Banks and other levered buyers are the bid but find today's zero term premium and inverted curves unattractive. Foaming the runway minimizes the potential impact of increased Coupon issuance and provides future buyers attractive financing options. Unfortunately, the foaming also has unleashed speculation, which distends prices and causes the inevitable descent to occur from greater heights. We expect a crash landing given the supply and also note that the foaming efforts have been exhausted.

Out of arrows and only irresponsible options left.

We think each of the above efforts to cushion a hard landing were reasonable ideas, but we do not expect an end to QT or an increase in the buyback. The next set of policy actions to offset a Bond selloff seem irresponsible to us.

- Regulatory changes which boost ability to buy without impacting willingness. SLR exemptions for banks holding Treasuries is floating around as is a FDIC deposit guarantee increase. Both of these regulatory changes would encourage Bond speculation by banks. Given the uneven reserves and the events of the SVB bank crisis a year ago, enabling banks to buy more duration is completely tone deaf and unlikely.

- Spending down the TGA. Some market participants continue to hope Treasury will violate its soundness and safety guidelines and spend the TGA. We think it's incredibly unlikely and, in any case, this "fix" is only temporary.
- Reducing Coupons is always possible, but would only delay and worsen the refinancing issue

Hope

Monetary and fiscal issuance policy have operated in fear of the long end. The Fed and Treasury would prefer a soft landing for Bonds, one in which Bond yields slowly disinvert and rise to 5.5% and slow the economy while not causing an economic hard landing. That will require real demand for long-term Treasuries. However, an inverted curve and zero term premium are not going to work. We think policymakers are willing (and need) to let Bonds fall but are preparing for the worst. Given the tools are limited to have this happen, we think further guidance will take the form of rising R*. As rates rise, that R* guidance will peak and hopefully support Bond prices at whatever yield they settle.

Cutting will lose the Bond market.

What if Bonds do overshoot? This will likely lead to a self-correcting phase in which the economy slows, which will support Bond prices. However, along this path market-based inflation expectations will rise, not because inflation expectations actually rise but because term premium (which is buried in B/E Inflation measures) will have expanded. Unfortunately, market participants may not dig that deep and may well react poorly to rate cuts. The communication as this repricing unfolds will be critical to the outcome.

What if high long-end yields don't kill inflation?

It is also possible that the rising long-term Bond yields don't sufficiently cool the economy. We have made suggestions on how the Fed should then use its tools but would discourage hikes. Much more effective tools would be:

- Changing the reinvestment plan to only Bills and short-term Bonds, reducing the demand for Bonds which would then have to be absorbed by the private sector.
- Proper QT of selling Bonds and/or Mortgages.
- Treasury could step up in a quarter or two and increase Coupons.

For now, hope and preparation seem like the plan.

Synthesis and action plan

Policymakers have foamed the runaway and now need courage to let the Bond market land. Will it be soft? Hard to say. A 5.25% long Bond for an extended period of time would probably do the trick, but there is no

assurance it would stop there. That will depend on whether the economy normalizes. Financial stability is an important goal but fear of the Bond market due to its impact on financial stability has resulted in policy failure. Continued coddling of the markets and economy will lead to Bond premiums expanding slowly, but also would likely fail, and a sudden and hard landing for Bonds would cause hard a hard landing for everything else. We hope policy makers have courage, but they are largely out of tools and will have to accept what comes. We think that is negative for asset markets and will slow the economy but believe strongly that killing inflation is the only path. We are well-positioned for a meaningful selloff in assets in the next two months and expect the 30Y will surge past 5% and equities will fall below 4800 by the end of July. We look to deploy more risk on the short side over the next few days.

Current Portfolio and Performance

As this DSR is being widely distributed positioning and performance will be available to clients on the paywalled section of the website.