

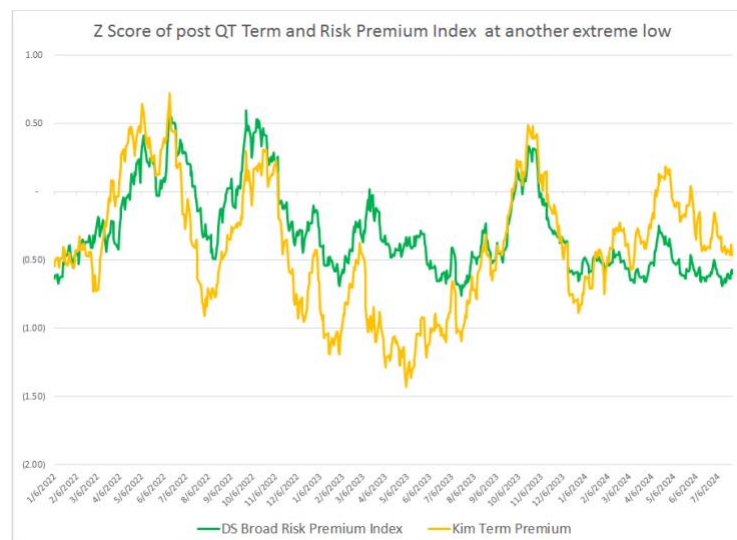
The Damped Spring Report

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

07/28/2024

The three most important Bond market participants are Irresponsibly Long. The impact of this positioning (and expectations it will continue) has led to negative Bond term premiums, inverted yield curves, and extremely easy financial conditions, despite continued Fed gaslighting. The Fed states that financial conditions are restrictive, based on Taylor Rule real fed funds myopia, as if the lever of the prior century remains effective today. However, the economy chugs on with higher than desired inflation and above-trend growth as easy financial conditions support the economy.

This week, two of the key participants have an opportunity to address their Irresponsible Longs: first, when Treasury announces its Q4 Financing Needs and then, when the Fed has an opportunity to begin discussing the next phase of its balance sheet normalization. We expect Treasury to maintain current auction sizes and TGA target balances. We also expect the Fed will continue its focus on short rates and ignore the impact of its balance sheet policy. While both entities could act, we expect both are likely to compound their mistakes and once again kick the can down the road. The Bond market is currently extremely attractive for issuers and sellers. Why delay? Both our Risk Premium Index and Kim Term Premium Model suggest conditions are very attractive to sell and issue duration.



The third major participant Irresponsibly Long are Commercial Banks. Banks hold significant duration exposure in Held to Maturity (“HTM”)

portfolios, which is getting more expensive to carry each day. Dealer subsidiaries are loaded to capacity with cash Bonds against payer swaps, resulting in historically negative swap spreads across the curve. The most vulnerable banks have thin reserves and the BTFP program runs off in under a year.

While the upside to assets is capped by the duration overhang, as long as these three participants fail to address their positioning, financial conditions will remain extremely easy, and inflation will remain sticky. With these participants showing no movement to address their exposures, active participants are comfortable leveraging up and continuing to pick up diminishing gains like dimes in front of the proverbial steam roller. Unlike many can kicking exercises, the problem is right in front of us and delays will rapidly compound the damage, particularly as we enter 2025 and reserves become less abundant and BTFP loans mature. The markets have already begun to front run this duration overhang in certain markets. The main asset markets, however, remain gaslighted by hopes of rate cuts that will not and cannot offset the inevitable duration deluge. While these three participants delay the inevitable, at a minimum the Fed and the banks ain't buying. Only real money is buying, and they are going to get buried by Treasury's duration issuance.

In this DSR, we will:

- **Outline the Irresponsible Long of each participant.**
- **Describe our view on how to address their individual circumstances.**
- **Provide our detailed outlook on this week's QRA and FOMC meeting.**
- **Deliver an action plan for DS Alpha, and our economic forecast based on the potential outcomes of these events.**

Irresponsible Longs

In this section we will review each of the three participants positioning and what they can do to responsibly adjust positioning over time.

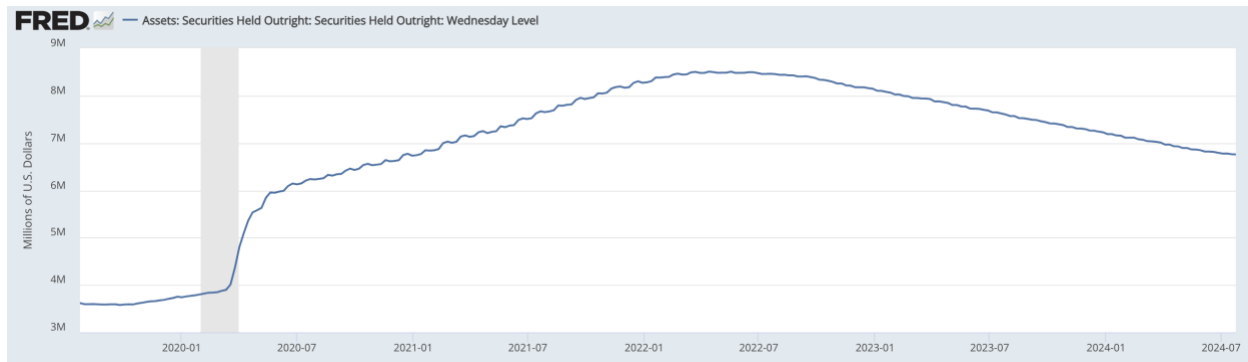
The Fed's SOMA Portfolio

What is

The Fed continues to implement its QT policy to reduce its balance sheet by allowing maturing Treasuries holdings to runoff. The Fed's balance sheet shrinks as Bills and Coupons mature and as principal is repaid on its MBS portfolio. To smooth the lumpiness of maturities on its balance sheet, the Fed has capped the amount it will passively allow to mature. When monthly maturities exceed its cap, the Fed reinvests "excess" proceeds in new Treasury securities issued directly to the Fed in "side deals" held concurrently with that month's auctions. When the Fed's Coupon runoff is under the cap, the Fed allow Bills to runoff to make the total runoff equal

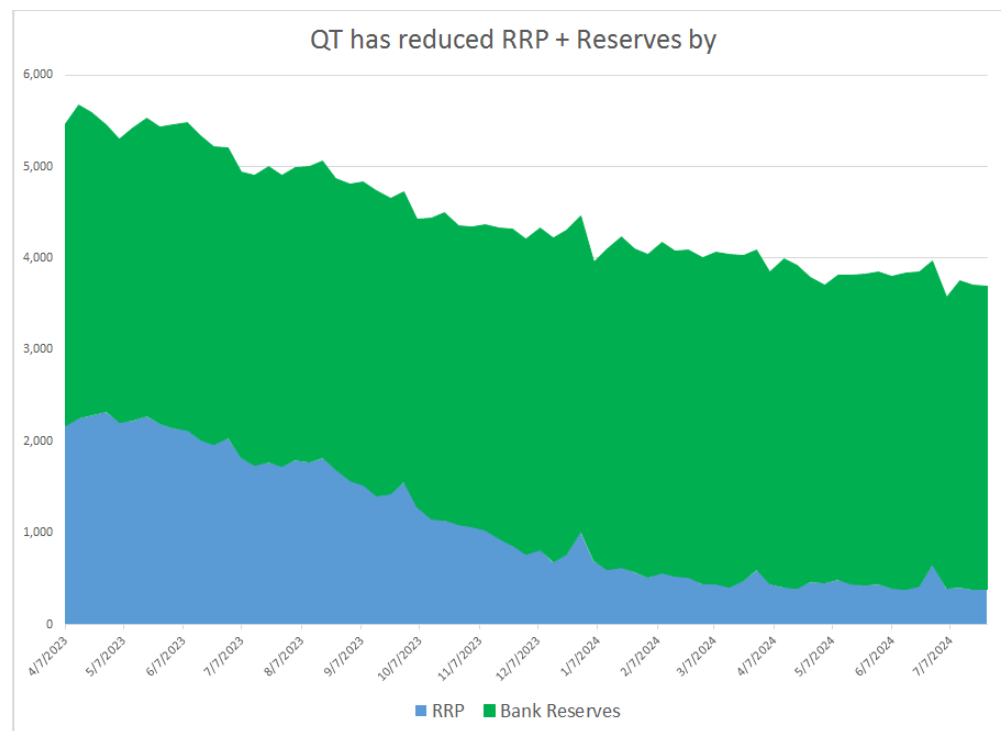
to the cap. Recently, the Fed tapered QT by lowering the cap on its runoff to \$25BN per month.

The Fed's SOMA Portfolio has been reduced by \$1.75TN since QT began.



QT has had two objectives: reserve withdrawal and transferring duration risk back to the private sector. The Fed's primary objective is to withdraw excess reserves from the private sector financial system. Since banking SLR exemptions instituted during Covid lapsed in March 2021, the Fed has considered both the Reverse Repo Program ("RRP") and Bank Reserves as the target for QT excess cash withdrawal. As expected, QT succeeded in reducing RRP + Bank Reserves, with RRP + Bank Reserves now reduced by \$1.75TN plus a little bit more as Treasury has been keeping a larger balance the TGA on deposit with the Fed.

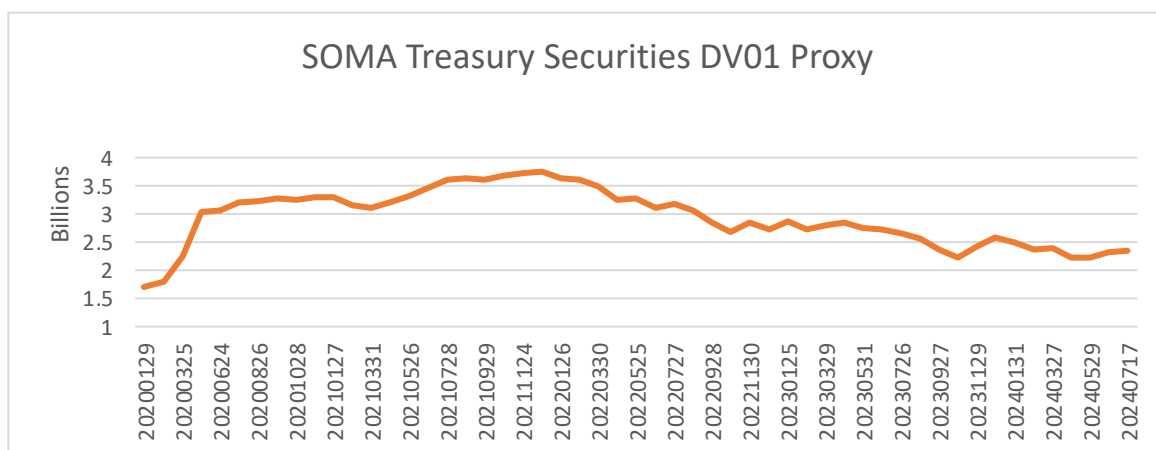
It should be noted, however, that all the reduction of "cash" in the private sector has come from the RRP. Bank Reserves haven't moved much at all.



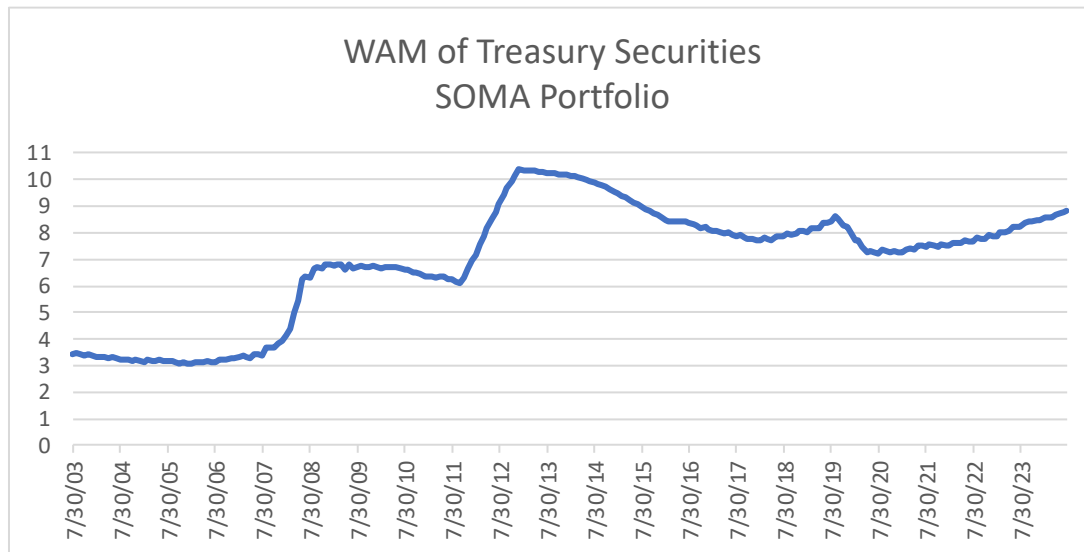
Now that the Fed has tapered QT (and reduced the monthly caps), a slower but longer process of achieving their target goal - roughly \$3TN of total bank reserves and an RRP that is small, awaits. We expect the Fed will reach its target in 4Q25, although most market participants currently forecast the Fed ending QT much earlier. We note, however, that, at a pace of \$45BN per month, the particular end point is not that relevant.



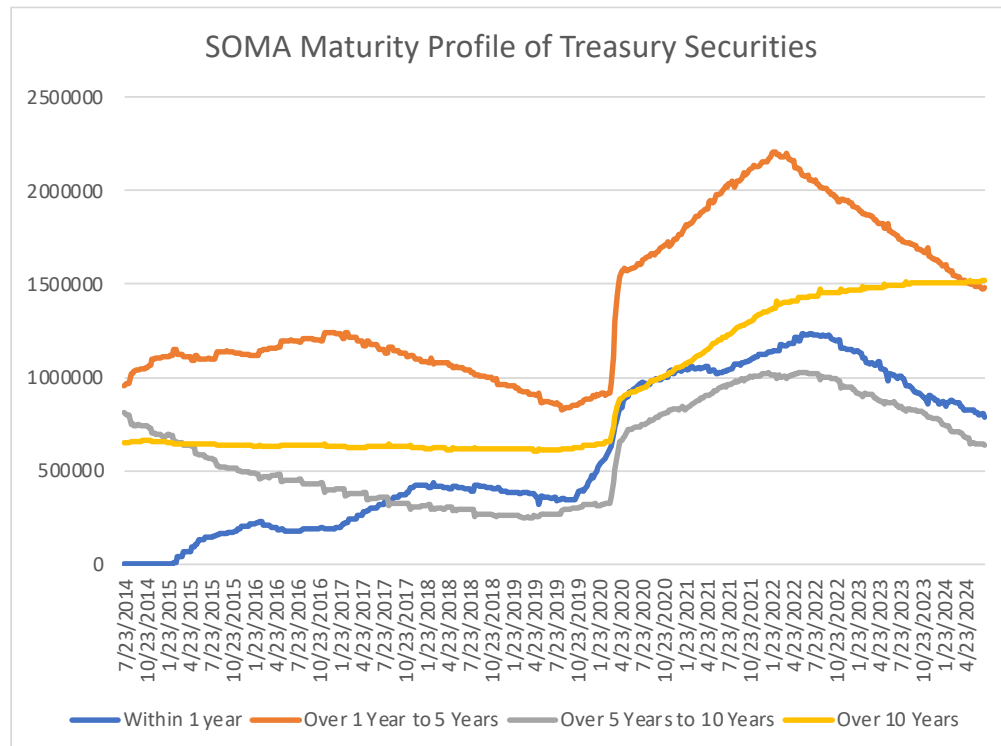
The end of QT does not mean, however, that the Fed's balance sheet is no longer relevant. Even today, while QT is ongoing, the Fed's balance sheet continues to change. The reason it changes is due to interest rate changes, which, in turn, change the duration of the Bonds held, extend the duration of the MBS portfolio, and, most importantly, the reinvestment of excess funds when runoff exceeds the current cap and, in the future, when QT ends. When QT ends, the Fed will be a constant buyer of Treasury's new issuance. Although the Fed doesn't participate directly in setting auction prices when it reinvests proceeds, its choice of what to buy impacts how much of what Treasury wants to sell is sold to the private sector. Despite the Fed reducing its Treasuries holdings meaningfully, the reinvestment of proceeds in long-duration Treasuries as short-duration Treasuries have runoff has resulted in a flat line of the total DV01 of the Fed SOMA Treasury portfolio. While the SOMA Portfolio is shrinking notionally, it is absorbing Coupon issuance:



This can be visualized by looking at the weighted average maturity of the SOMA portfolio. Essentially, the shorter stuff is running off and being replaced with longer stuff. When QT ends, this situation will be exacerbated.

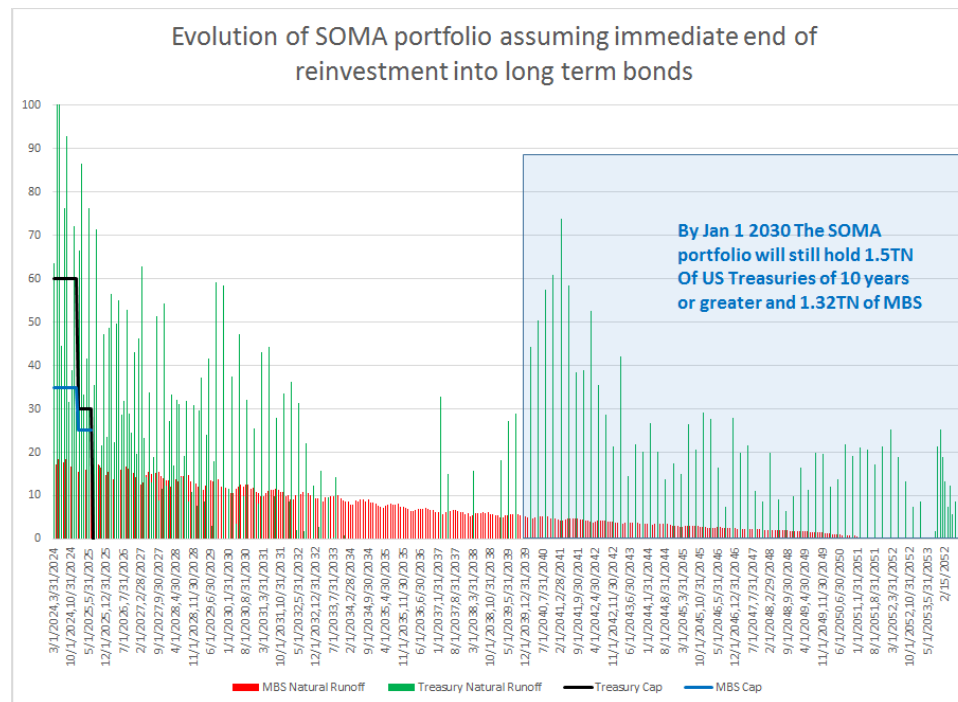


Another look at the portfolio shows the impact of runoff of short-term securities bought during Covid and some of the longer-term securities that were already on the balance sheet from 2008 and the GFC QE period. But 10Y Bonds are not moving. This chart uses the original maturity date:

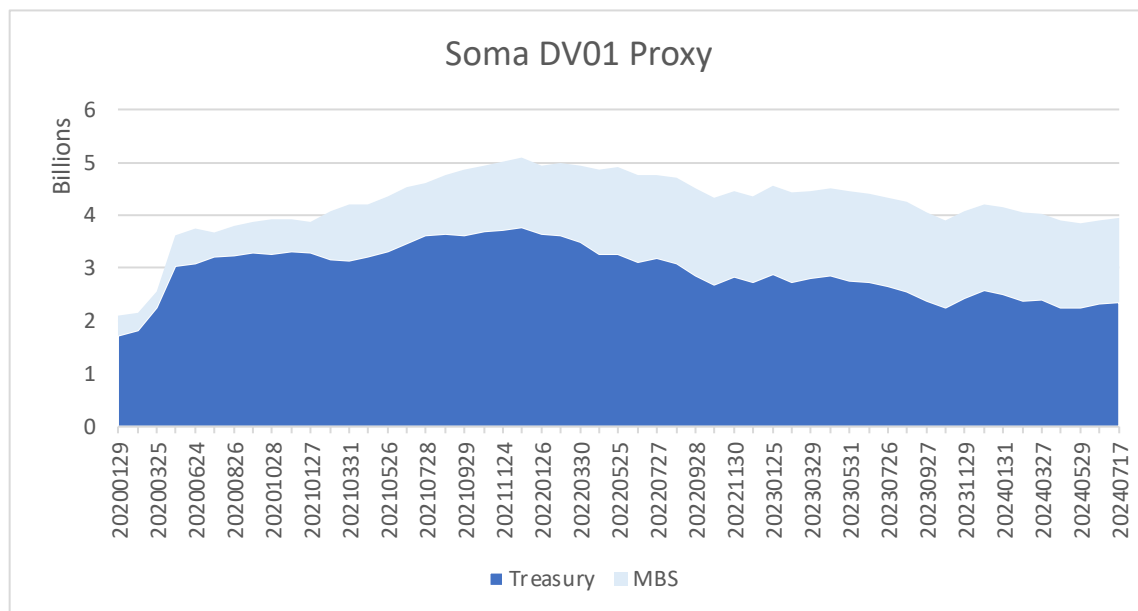


We have looked at the portfolio and assumed that the Fed would no longer reinvest proceeds in long duration assets but would continue runoff. If they proceed on this

path, the SOMA portfolio would continue to hold \$2.8TN of 10 year or greater maturity Treasuries and large MBS holdings. They will continue to be Irresponsibly Long for no obvious purpose:



The combined MBS and Treasury portfolio gross DV01 is simply not falling and will grow further if the current reinvestment policy remains intact. The stock of duration is clearly not being reduced. **The flow of duration is also a factor as the reinvestment policy allows Treasury to issue less duration to the private sector while appearing to maintain their WAM:**

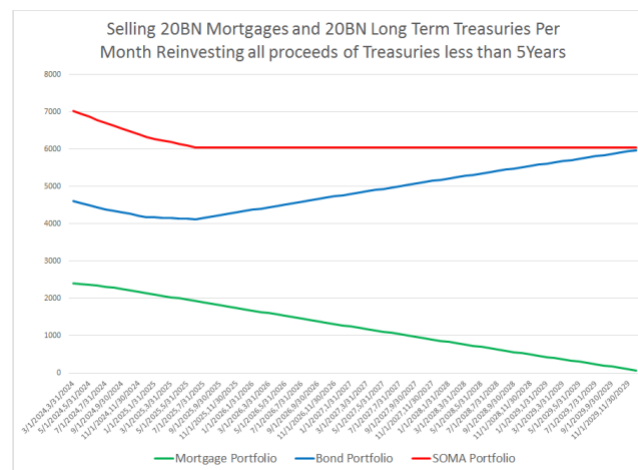


What the Fed could do about its Irresponsible Long

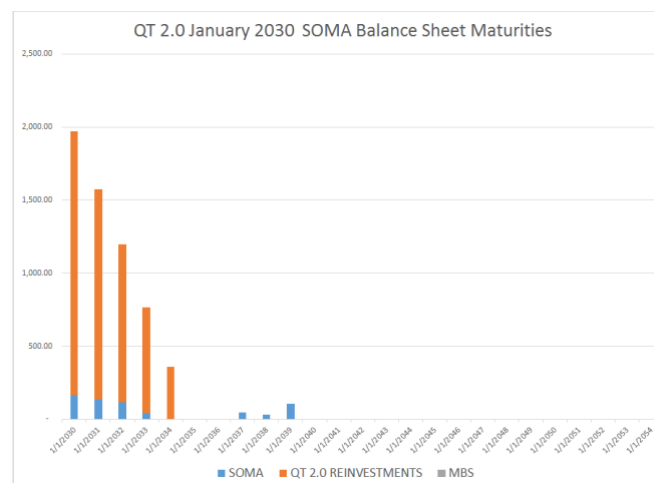
We humbly suggest the Fed considers the following policy changes:

- **Immediately change its reinvestment policy to only purchase Bills and short-term notes. Over time, that would lower their stock of DV01 while also requiring the private sector to take on more duration, assuming Treasury maintains its WAM target.**
- **Begin to make modest outright sales from the SOMA portfolio of both Bonds and MBS.**
- **Reinvest proceeds from runoff and the sale of long-term holdings in Bills and short-term notes to have no net impact on "Reserves."**

The combination of existing runoff and our proposed outright sale/purchase policy would have a meaningful impact on the Fed's balance sheet. By January 1, 2030, the MBS portfolio will fall to zero while the 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:



We think this idea achieves the goal of a balance sheet consistent with the Fed's mandate and stated desire. Our interpretation of the goal for the Fed's future balance sheet synthesized from comments by Waller and others is:

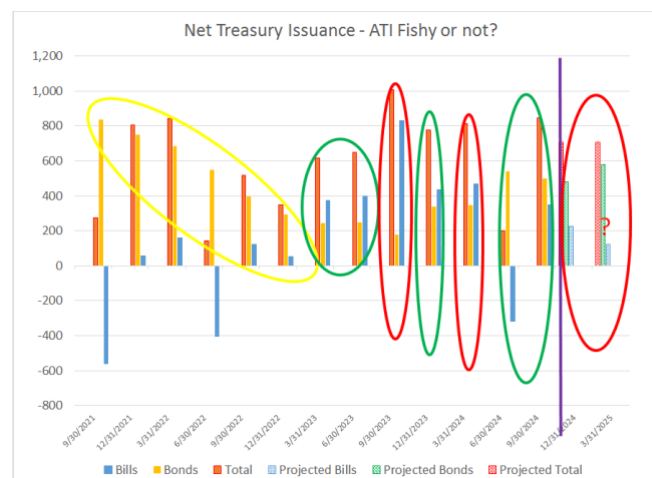
- **A Balance Sheet which supports Ample Reserves to allow banks to operate smoothly.**
- **No MBS to avoid distorting the private mortgage/housing market.**
- **Shorter duration to avoid distorting the yield curve and to clean up the Balance Sheet for future crises.**
- **Consistent with monetary policy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

We expect the Fed to begin deliberating on this topic in the months to come but are not holding our breath. The Chair and a large portion of the committee seem oblivious to the balance sheet's ongoing influence and how it facilitates Treasury issuance goals.

Treasury

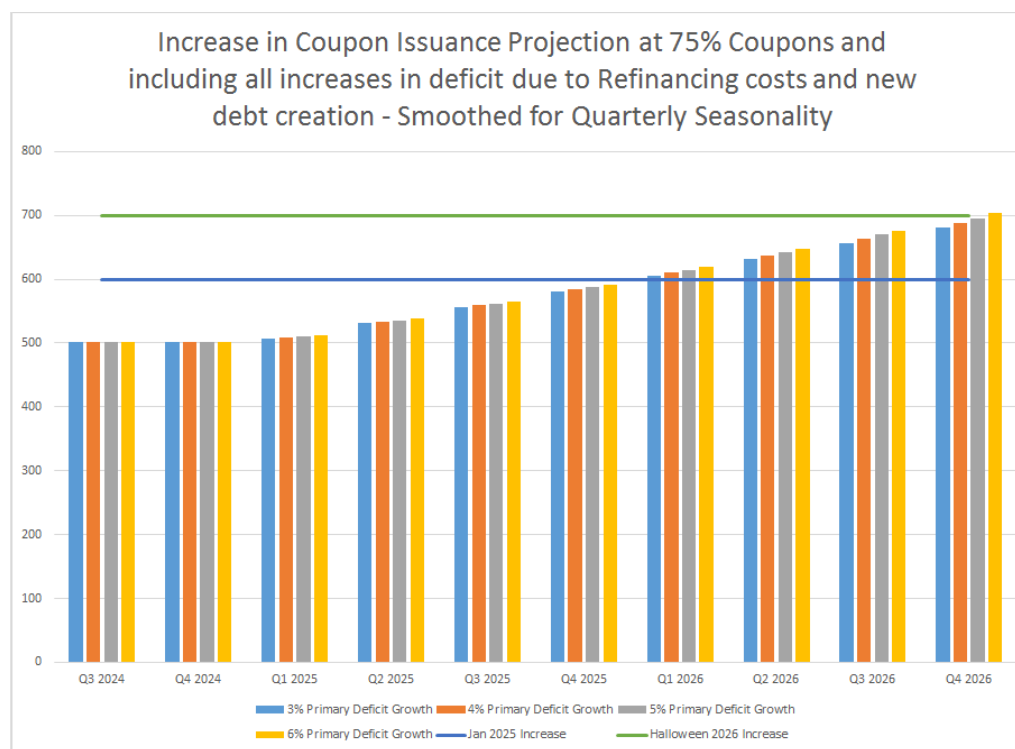
What is

The Treasury has violently adjusted Treasury Coupon issuance since QT began. There have been many ostensibly valid reasons given, but to us this is nothing like the purported policy of Coupon issuance as "regular and predictable." Coupon issuance peaked at close to \$1TN per quarter but then fell rapidly as QT began to a low of \$178BN and is now ramping up again and must increase further to over \$600BN. Last week Nouriel Roubini and former Trump-Treasury official Stephen Miran offered a controversial take on Treasury issuance policy as being activist. They called it ATI [here](#). Although we are politically neutral, it is certain that by choosing runoff the Fed ceded monetary policy implementation to Treasury via its issuance choices. When Coupon issuance falls, term premiums contract and financial conditions ease. When Coupon issuance rises, term premiums expand, and financial conditions tighten. The understanding of this dynamic before any other market participant has been a significant source of edge for Damped Spring. What have they done?



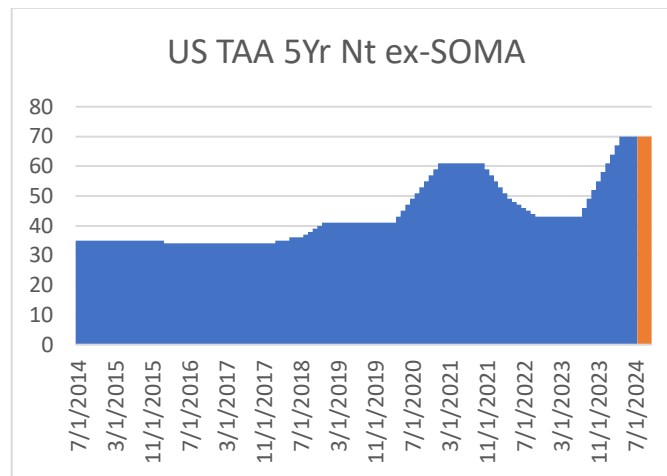
We have no idea what Treasury's motivation could be and don't care. What we care about is what they do. When we review Treasury's post-QT behavior, we see two decisions – marked above in red ovals, that are at best fishy. The post debt-ceiling move to issue only \$178BN of Coupons while issuing more than \$1TN in financing made no sense to us at all. Clearly, the most notable act was the Halloween 2023 decision not to increase Coupon auction sizes. While we respect the decision - Bond markets had well and truly puked ahead of that announcement, the motivation may be more complex. Indeed, since the beginning of the QT process (when Bond yields were extremely low), we saw a significant reduction in Coupon issuance which could have refinanced the massive Bills issuance of the Covid period. These moves, indicated in yellow ovals above, seem fishy-ish.

Looking forward to future deficits (driven by the need to finance the growing interest burden, and the likely unwillingness or inability of fiscal policymakers to tax more and spend less), we see a continuing rise in the total deficit. Using a projection of interest rates unchanged and various primary deficit growth paths, we expect Treasury to need to issue increasing Coupon debt even if they maintain the already elevated level of Bills and FRN issuance at 25%:



If Treasury continues to tolerate the 25% outstanding level of Bills + FRNs, Coupon issuance still grows and shows that Treasury is Irresponsibly Long Coupon issuance regardless of the proportion of Bills issued. However, if Treasury intends to do what it has said it will do (which is also in-line with the TBAC recommendations), it will need to term out the short-term debt outstanding by 5% at least of outstanding debt. That quantity of duration issuance replacing short-term issuance would be

\$1.5TN. One can pick a reasonable time period to achieve that goal. To keep the math easy: If Treasury decided to get back below 20% over the next 15 quarters, net issuance would increase every quarter by \$100BN, representing a 10% increase in every auction. Auction sizes are already historically large:



The increase in Coupon issuance due to QT, deficit growth, and the stated desire one day to return to lower Bills outstanding is why we describe Treasury as Irresponsibly Long.

Treasury isn't in control of the amount of financing needed. The Federal Budget, changes in financing costs, repayment of maturing debts, and a prudent cash balance determine the need. Recently Josh Frost, Assistant Treasury Secretary for Financial Markets, provided very clear information about Treasury Issuance. [Here.](#)

"Borrowing needs are largely driven by three factors: (1) the deficit, (2), the amount of maturing securities that Treasury needs to refinance, and (3) changes in the size of Treasury's operational cash buffer."

However, the Treasury is in control of the issuance to fund the need. Their framework is solid:

Treasury Financing

Objective

- › Fund the government at the least cost to the taxpayer over time

Strategies

- › Offer high quality products through regular and predictable issuance
- › Promote a robust, broad, and diverse investor base
- › Support market liquidity and market functioning
- › Keep a prudent cash balance
- › Maintain manageable rollovers and changes in interest expense

Constraints

- › Uncertainty – legislative commitments, macro-economic forecast errors, technical modeling factors all create uncertainty in deficit forecasts
- › Size – Treasury is too large an issuer to behave opportunistically in debt markets

Policy Outcomes

- › Treasury is a regular and predictable market participant, not a market timer
- › Treasury doesn't react to current rate levels or short-term fluctuations in demand
- › Treasury requires flexibility to respond to uncertainty – to rapidly raise cash or pay down debt – shorter maturities provide more flexibility
- › Treasury seeks continuous improvement in the auction process
- › Treasury strives for transparency and regularly consults with market participants

▶ 4

We focused on a few of these bullet points when considering the proportion of Bills and FRN issued. Perhaps the least understood point is the impact on the TGA of issuing a lot of Bills. The relevant bullet point is "Keep a prudent cash balance." The cash balance is held in the TGA at the Fed. How does the Treasury define prudent? Each business week, Treasury 1) spends money, 2) repays maturing liabilities, 3) receives taxes and other revenues, and 4) receives proceeds of debt issuance. All but 4) happens no matter what, unless the country defaults. Item 4) requires markets to be open. After September 11, 2001, when the markets were closed for five days, Treasury instituted a policy which (outside of debt ceiling crises) they have followed precisely. They take the sum of 1), 2) and 3) and hold enough cash in the TGA such that, if they have no access to market for 5 days, they will not default.

So why do Bills outstanding impact this policy? By far the biggest component of 4) is the issuance of Bills to refinance maturing Bills. Lately, Treasury has refinanced \$1.1TN of maturing Bills every week. In other words, approximately 16% of total Bills outstanding refinances every week and requires market access. Notice the TGA has been roughly \$800BN for many months. Also notice that, prior to Covid, the TGA was never more than \$400BN. The biggest change in that period to the algorithm described above that determines the size of the TGA has been Bills outstanding due to the sizable weekly maturities.

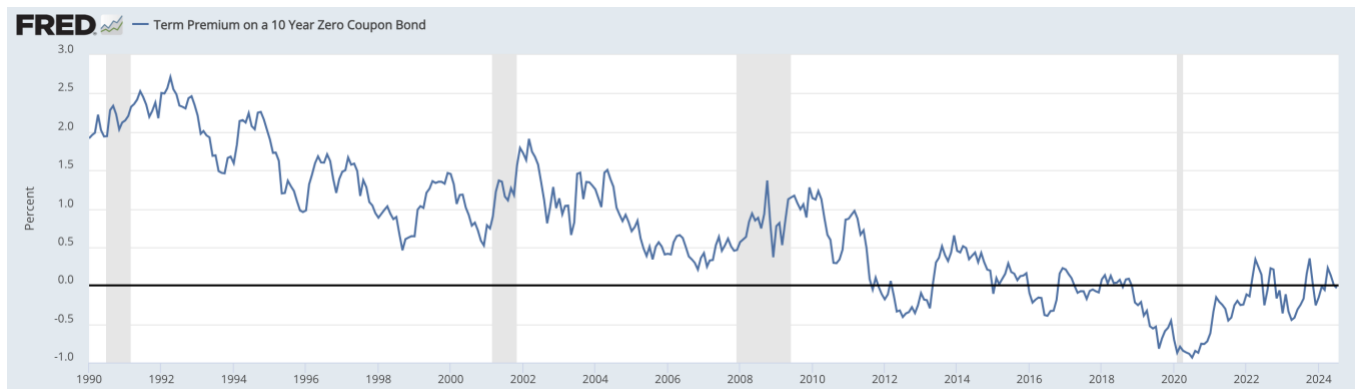


In other words, Treasury must keep \$800BN in its checking account earning zero interest as a precaution to ensure it can satisfy its weekly Bills refinancing obligation. They just take it from Bills buyers and put it under the mattress. More Bills necessitate a bigger mattress. Of every dollar of Bills issuance, 16 cents dies in the TGA. The owners of the Bills get interest paid on 16 cents of their investment directly from taxpayers. Because of this prudent cash balance policy, which we fully endorse, Bills are an incredibly inefficient form of financing.

Besides this inefficiency, Bills are expensive financing at this time as well. Long term Bonds are priced based on market expectations of the future interest rate path of short-term debt like Bills. As Treasury states above, they are not "Market Timers." If they were market timers and had an edge over all other investors, Treasury perhaps could justify maintaining Bills issuance based on that edge: Bills interest rates would fall, and, by delaying terming out to longer-term Coupon issuance, Treasury could harvest the benefit for taxpayers. Listen, we get it. If Bills fall by 200bp, presumably the WAM portfolio would fall by 100BP, and Treasury will have saved the taxpayer by delaying the reduction in Bills outstanding and locking

in the lower WAM portfolio financing. But what are we really talking about? As we said above, it will take a terming out of \$1.5TN to get Treasury back in-line with its target 15-20% Bills outstanding level. In a moment, we will address whether that guideline is even a thing. Anyway, the impact on the taxpayer of waiting for rates to fall to 3% and financing at the WAM at an improved rate would save the taxpayers $\$1.5\text{TN} \times 1.00\%$, or \$15BN per year. We understand \$15BN is a whole lot of money, but it is ridiculously small in the context of the Federal Government. Treasury officials aren't market timers and, even if they were really really good at it, it wouldn't really matter.

More relevant perhaps is the current pricing of long-term Coupons versus their historical value. The best measure of the tradeoff between long-term debt and short-term debt is the excess return received by investors for locking in a long-term fixed rate Bond. This is called the term premium. Collecting term premium is free money for long-term asset investors. It doesn't require a view on the future path of interest rates. In fact, it assumes that the future path of interest rates is fairly priced by market participants, meaning there is no edge in market timing for an investor because the market is efficient. However, for both investors and Treasury the term premium is useful in term of shifting one's investments or issuance from shorter-term Bills to Bonds. It's a pure manifestation of the supply and demand of Treasuries. Currently, term premium on long-term Bonds is negative. A negative term premium implies that investors are willing to have no return in excess of cash (Bills) to assume the price risk of a Bonds. Sounds like an awful deal for investors and a good deal for Treasury. We think that Treasury is not (and should not be) a market timer, and this sounds a whole lot like market timing. Nonetheless, given the relative inefficiency of Bills financing and the already elevated level of Bills outstanding, it makes sense to us for Treasury to shift toward Coupon issuance. While the post QE term premium has been suppressed, in "old normal" times, a term premium of 125bp was consistent with a .25 Sharpe Ratio for holding Treasury Bonds. At a negative term premium, we consider it a no brainer for Treasury to shift to more Coupons and fewer Bills. They are Irresponsibly Long, and the market is willing to buy their long at extremely attractive levels.



The last big issue regarding sizable Bills outstanding is that in a recession, war, or other crisis, the deficit rises as spending increases and tax receipts fall. Bill issuance has always been a buffer for such events as money can be raised rapidly.

The big question is whether there is a limit to the total amount of Bills that can be issued. Deficit spending does eventually result in savings as the money spent flows through the economy. But bumps can happen along the way. For instance, cash savings in MMFs is currently deployed in Bills and RRP, which are government liabilities, but some of that cash in MMFs supports leverage in the private sector for financing levered asset ownership via the private sector repo channel. To the extent that Bills start crowding out repo, the private sector financial system can experience temporary sand in its gears.

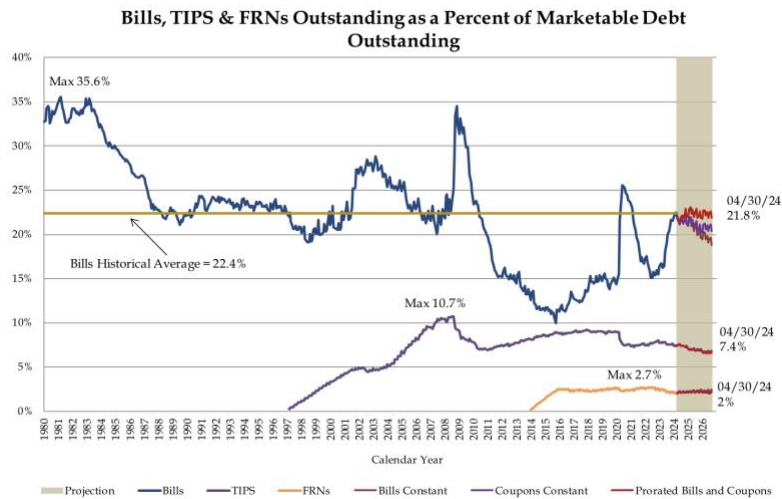
The Treasury is Irresponsibly Long. They acknowledge the existence of the 15-20% rule but consider it more of a guideline. Recently, Josh Frost addressed this issue in remarks:

Another common misperception that bills as a share of total marketable debt need to remain in a 15–20 percent range. This is not the case. Going back to 1980, bills have been as high as 36 percent of Treasury debt and as low as 10 percent and have been in the 15–20 percent range only about 13 percent of the time during that period.^[4] The notion of a 15–20 percent range has its roots in late 2020. In November of that year, the TBAC recommended that Treasury allow the bill share to gradually decline into the 15–20 percent range after it had moved briefly above 25 percent to finance the pandemic response. The TBAC’s recommended range was centered below the long-term average of 22 percent, but above the average during the prior decade. In November 2021, the bill share had dropped to 17 percent, and the TBAC reiterated its recommendation to maintain a 15–20 percent range, noting that cuts in coupon issuance were needed to prevent bill supply from dropping too low, which would present risks to market functioning. However, the TBAC emphasized that “there is flexibility in the TBAC’s recommended range for bills to either fall below 15 percent of outstanding stock (in which case excess cash will likely get absorbed by the RRP facility) or for bills to rise modestly above 20 percent while still maintaining financing flexibility for Treasury.” In August 2023, the TBAC reiterated that it was “comfortable running T-bills in the range of their longer-term historical share of 22.4 percent for some time before returning to the recommended 15–20 percent range, in order to maintain a regular and predictable approach to increasing coupon issuance.”

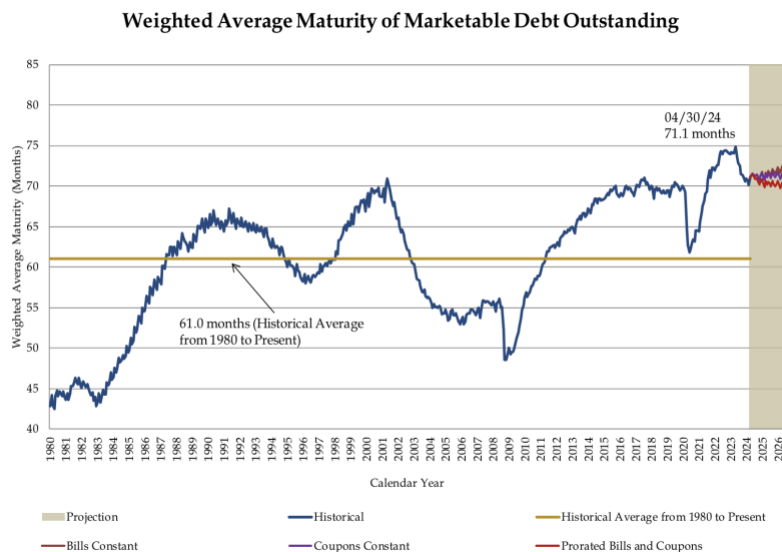
In short, the TBAC recommendation of a 15–20 percent range is relatively recent, and the TBAC has repeatedly said that Treasury should maintain flexibility on the 15–20 percent range in support of regular and predictable issuance. This is consistent with the “bills as a shock absorber” tenet I described earlier. If the 15–20 percent range were to be considered a hard rule, responding to shocks would require large and rapid changes to coupon auction sizes, contrary to our longstanding approach.

We agree that Treasury should be flexible. We also see that TBAC (and even apparently Treasury) think that the direction should be toward 15-20%. As mentioned, if Treasury wants to reach that range in 4 years, they need to increase

auction sizes by \$100BN or 10% higher than current levels immediately. Will they? We will describe our expectations for this week's QRA at the end of the report. Treasury projects a decline in Bills but stability in FRNs. For this to occur, the mix of Coupons and Bills needs to change.



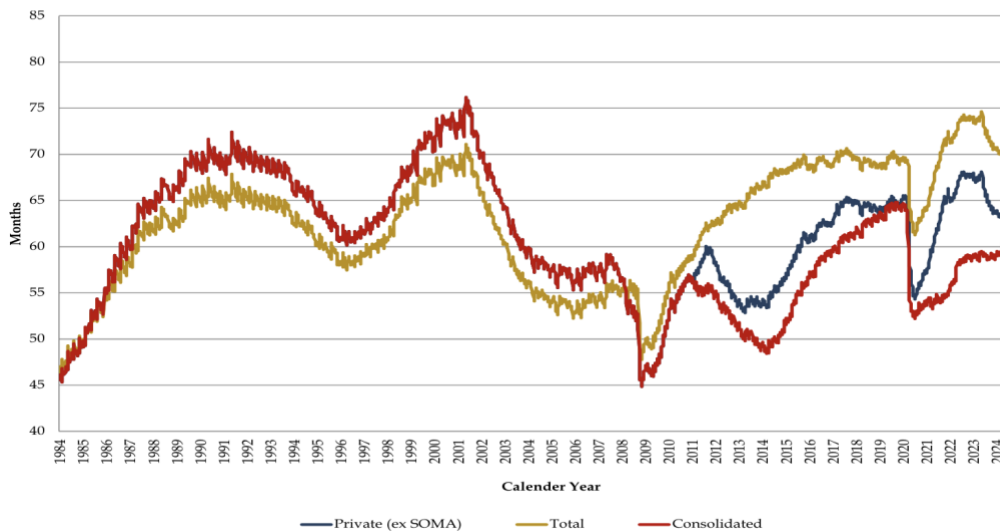
Treasury has also stated that its WAM is above historical levels. We agree with this but also don't much care about the long history of the WAM because 30Y Bonds are relatively new and recently the WAM has fallen. Furthermore, the change in the WAM will not be much given the current WAM of the Coupon schedule in place is heavily weighted to the belly of the curve. Coupon auction WAM is currently 91 months. Using 20% Bills, the marginal WAM is roughly 72, and 25% Bills takes it below 70. Of course, the marginal WAM is only on debt financed each quarter. That is 3% or so of total debt. In consequence, the WAM just won't change much over the mid-term:



Before leaving the policymaker section, we think it is relevant to look at the holders of duration and the direction it is going. The Fed's reinvestment policy is purchasing

a 91 WAM auction schedule. The Fed does these repurchases as an add-on to auctions, but the Bonds the Fed buys are included in Treasury's WAM. When Treasury consolidates the Net WAM, the picture is much different. The Fed's reinvestment results in lower WAM to be owned by the private sector and so obscures Treasury's actual WAM. Perhaps this is a bit of double counting, but what is clear is the private sector doesn't have many Bonds to own and the public sector is Irresponsibly Long and doing little so far to address that situation.

Consolidated **WANRR** Calculation*



What they could do about their Irresponsible Long

Treasury has its hand directly on the lever and has the ability to address its situation. We suggest they:

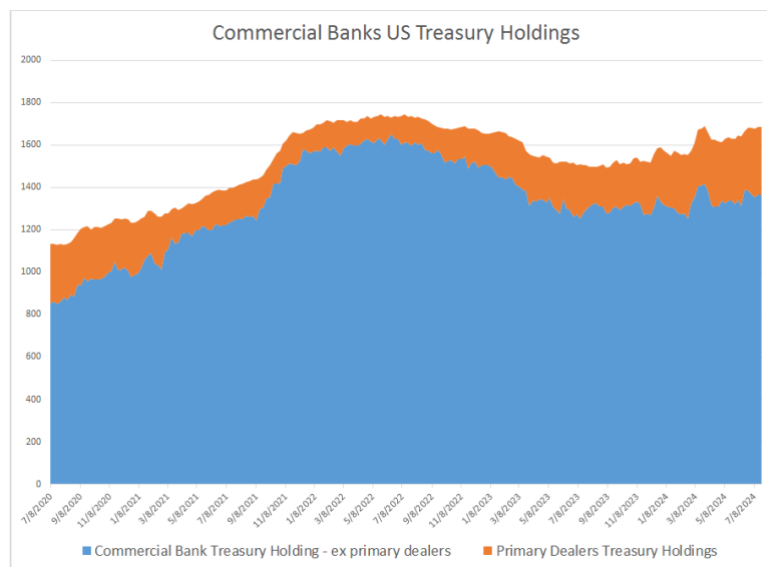
- Increase Coupon auction sizes by 10% across the board at this week's QRA.
- Prepare markets for another 10% increase in 2025 to address both the Bills share and growing deficit.
- Encourage the Fed to reinvest in Bills and short-term Treasuries and increase the auctions to the private sector for those notes and Bonds that the Fed no longer buys.
- Lastly (and it relates to the functioning of the private sector banks which we will cover below), incorporate an SLR exemption for Treasury notes and Bonds held by Primary Dealer subsidiaries of banks on a fully hedged basis. While we think that post SVB any SLR exemption that allows for duration speculation is tone deaf and inappropriate, the stress on balance sheets that are obvious in swap spreads deserves a policy response. As issuance increases this particular aspect of today's markets needs an update for better functioning of the Treasuries market.

Commercial Banks

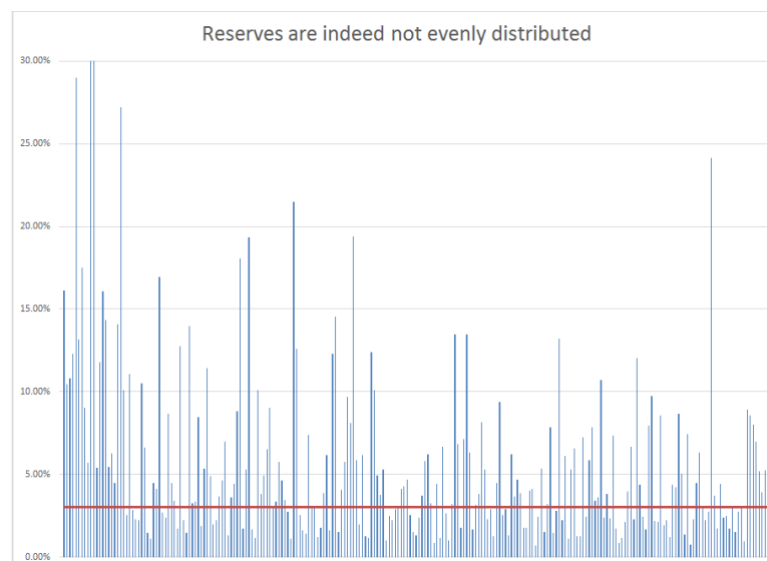
What Is

Overview

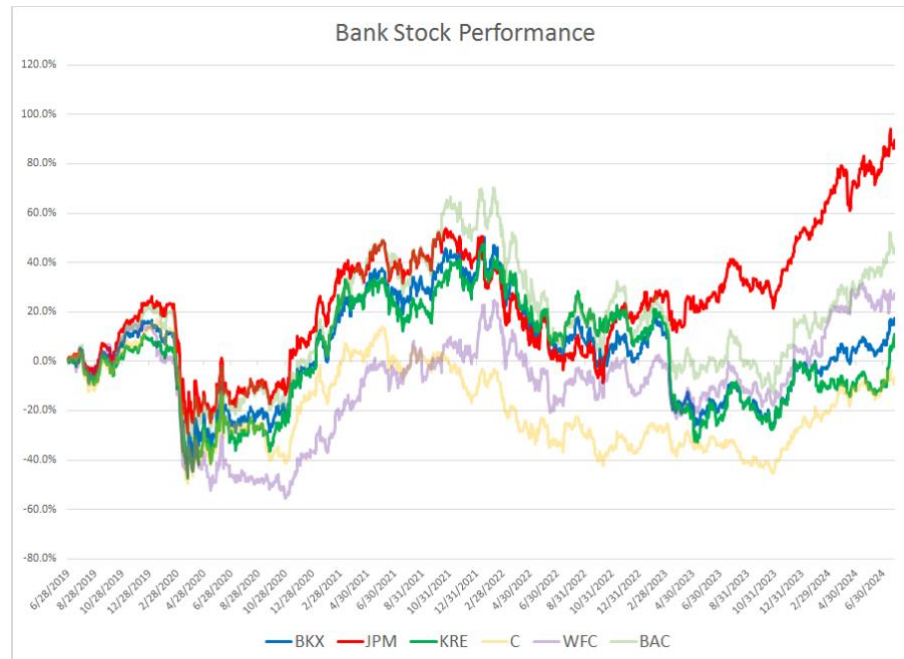
Commercial banks were obviously Irresponsibly Long duration purchased at the absolute low yields during Covid. Thanks to various government interventions and support, they remain Irresponsibly Long. Banks have done virtually nothing to address their position, yet they at least have not gotten longer. The Primary Dealers have bought steadily but these purchases are not reflective of demand. We will cover repo and swap spreads later:



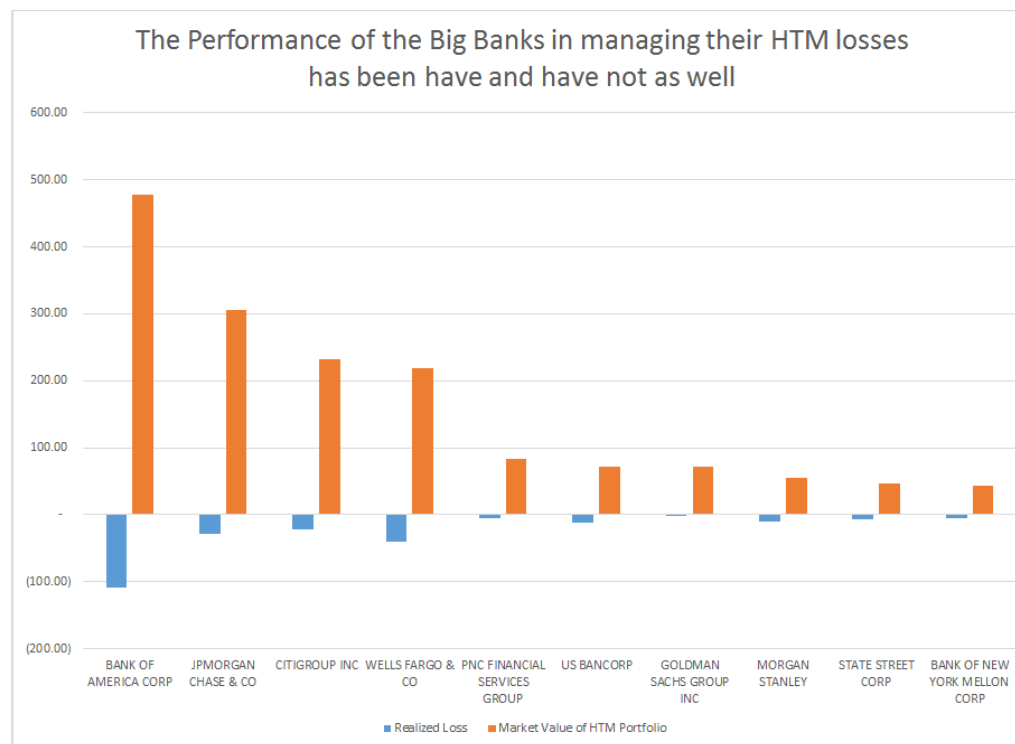
The banking system, like perhaps the real economy, is a tale of the haves and the have nots. The largest 30 banks have abundant reserves. The next 220 largest banks have highly variable levels of reserves:



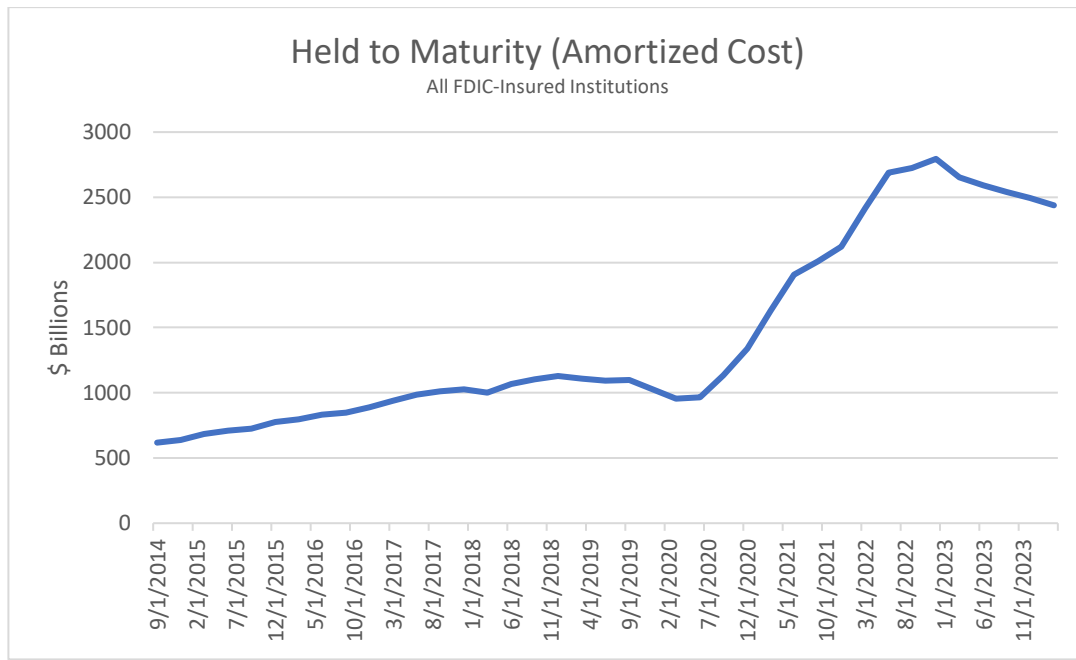
The “Have” that has eaten the banking system remains JP Morgan. JPM has massively outperformed its peers. Until the last week or so, the big cap banking index was up modestly for the past 5 years and had outperformed the regional bank index, but that has corrected as the KRE has rallied 23% in three weeks:



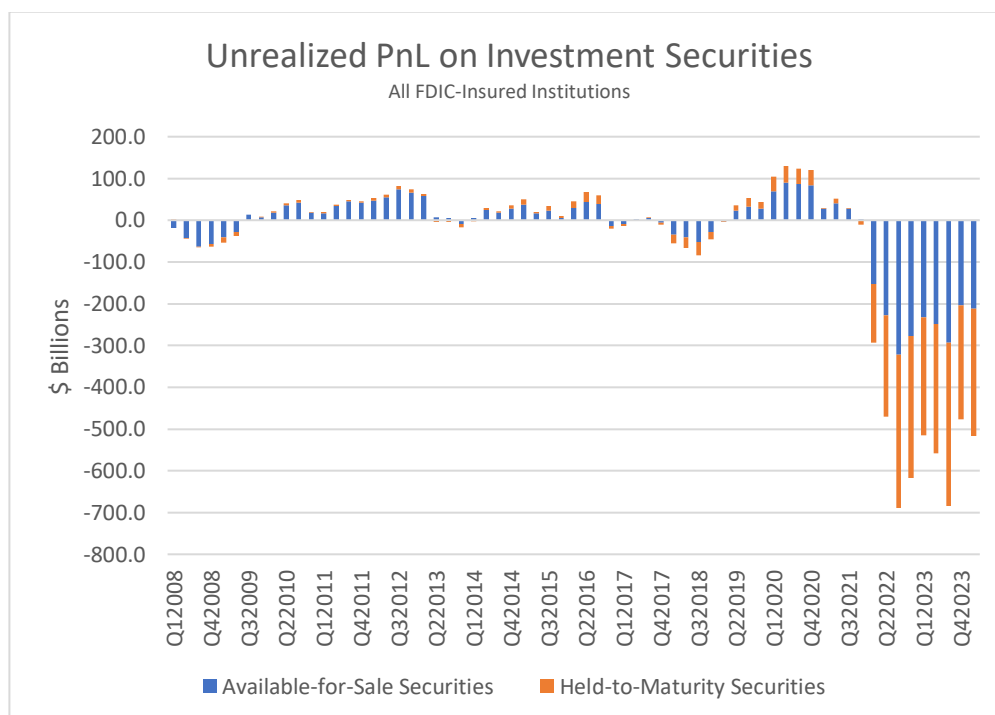
Idiosyncratic experiences dominate the picture of the big banks:



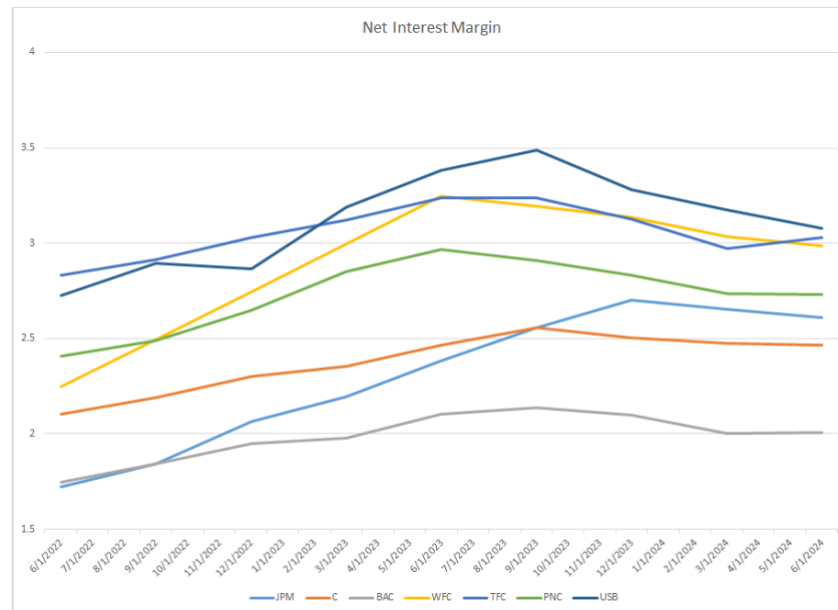
The overall banking system is doing little with their held to maturity portfolio except amortizing its cost. Of course, that's the nature of a held to maturity portfolio as it is not for sale. As holding these assets over time without being forced to sell will return par, the "cost" of these large holdings is the financing cost and the capital necessary to hold the assets, which may be better deployed elsewhere:



While the unrealized PnL has moved along with interest rates, most banks remain underwater on these assets:

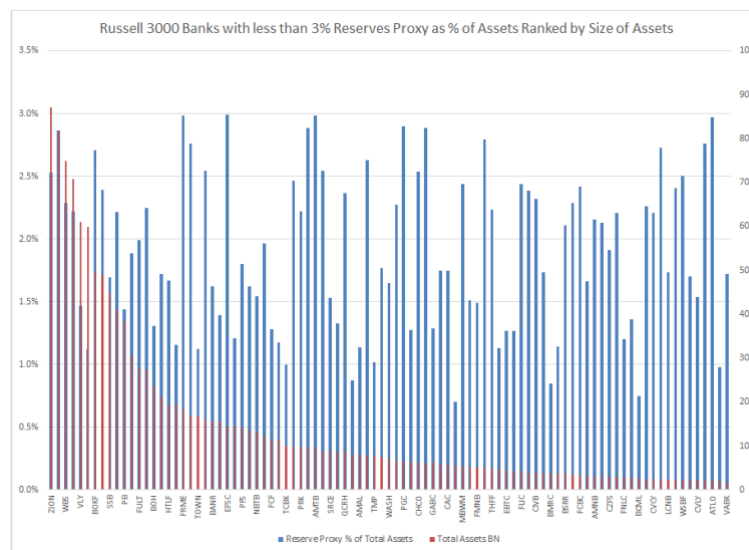


The drag on PnL will be realized by declining NIM as deposit rates creep higher:



KRE

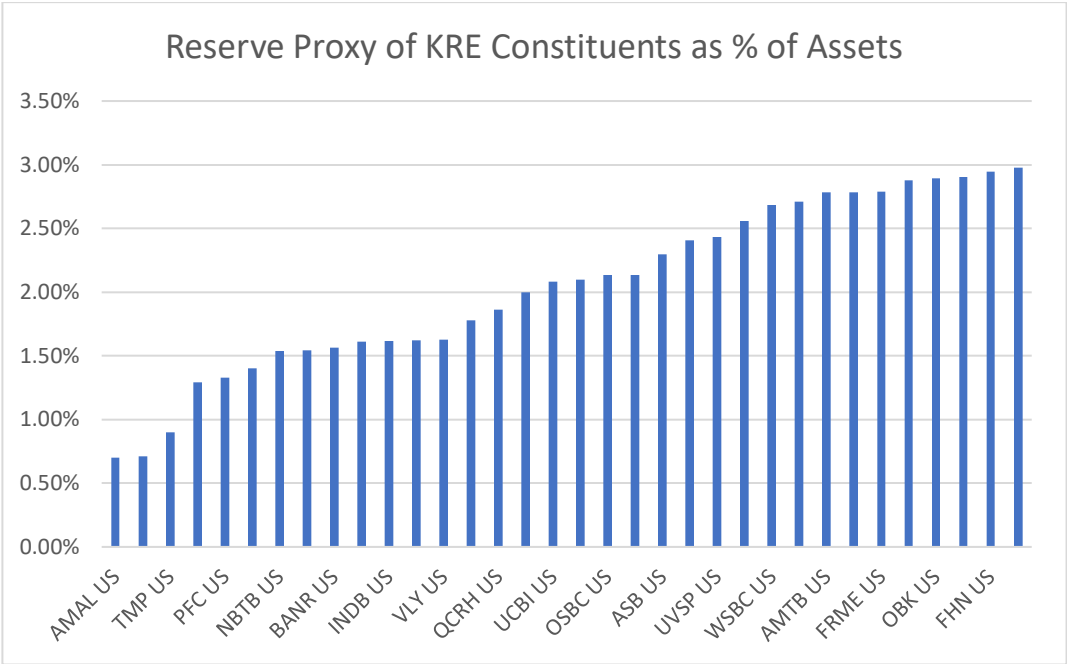
The regional banks are in a more vulnerable position. Many have both large HTM portfolios and thin reserve balances:



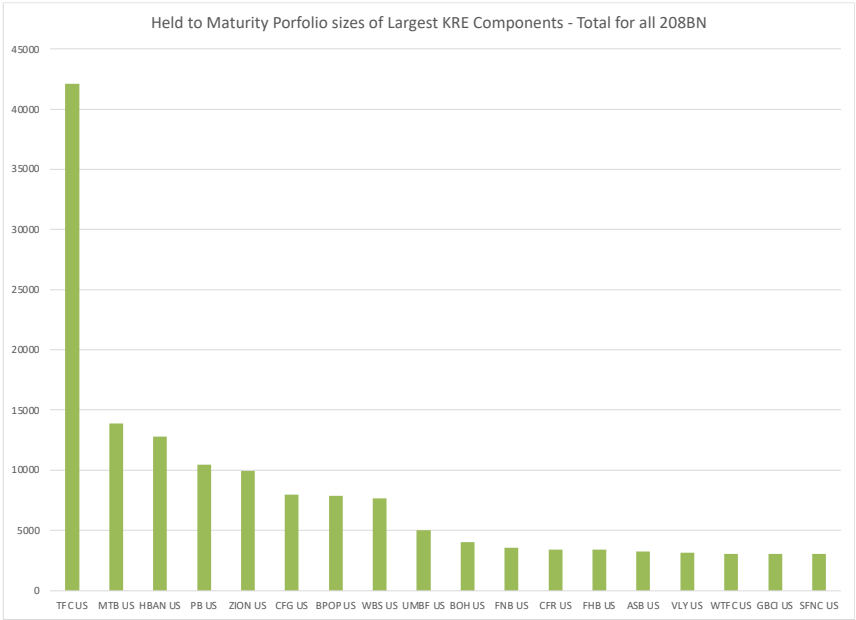
While reserve balances are no longer a constraint in the regulatory framework, they remain the literal way that banks settle interbank transactions. As QT continues to draw down reserves system-wide, the potential for many of these banks to experience a short-term liquidity squeeze increase. In an environment where rates stay higher for longer, poorly positioned banks will suffer more NIM erosion and many of those same banks are overweight loan portfolios which will

suffer in a marked economic slowdown. Despite this difficult outlook, the KRE regional bank index is up 23% in three weeks.

Once again within the KRE there are haves and have nots. Ranked by Reserves proxy many constituents have very little cash liquidity to manage their transaction volume.



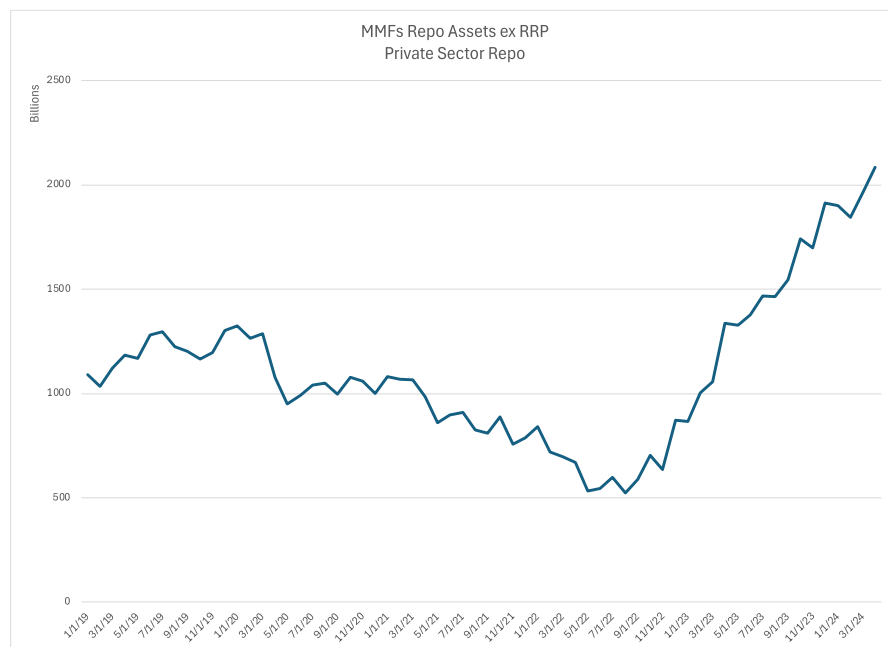
Also, some of the HTM portfolios are quite large. This is not our lane, but it wouldn't surprise us if one of the big BTFP loans was made by Truist or some of these other banks



KRE Constituents have \$208BN of HTM portfolios. The BTFP stands at \$100BN, and each loan matures in March 2025. We consider KRE vulnerable to forced sales and NIM squeeze. The performance the last few weeks seems to be a short squeeze. We started a short position on KRE last week and intend to grow it.

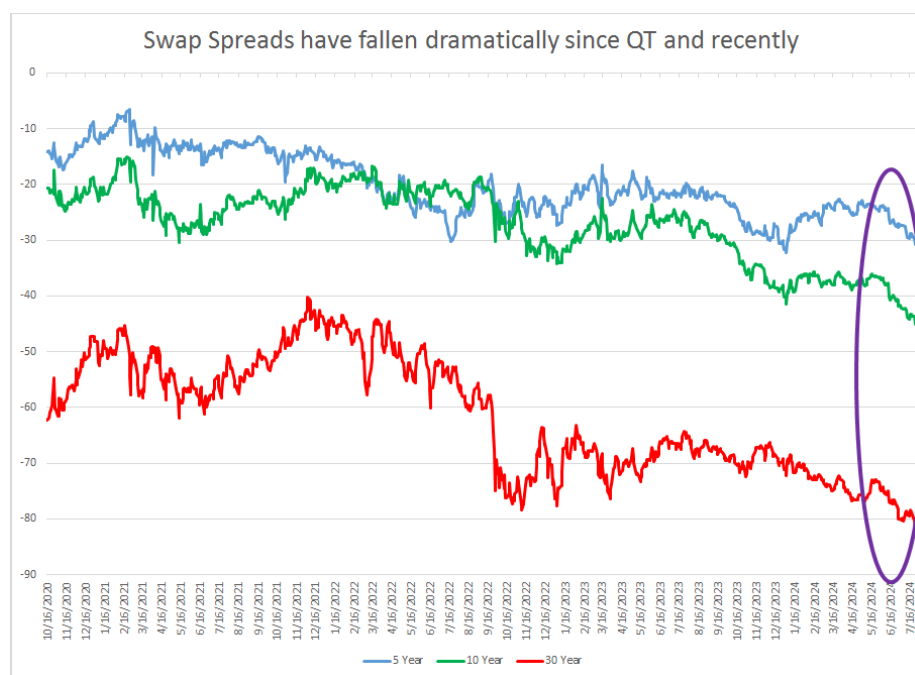
Primary dealers, repo and swap spreads

Primary dealers have been buying some Treasuries year to date, as noted above, and they are really the only demand for Bonds coming from the banking sector. However, they are not betting on falling interest rates. The financial system is experiencing a lack of balance sheet given the onslaught of issuance. Private sector repo - which provides financing for asset swaps, basis trades, and for cash hedges for dealers who provide long exposure to balance sheet-constrained buyers, has continued to climb rapidly:



The RRP is still resting at \$400BN and so, on the face of it, MMFs should be able to meet private sector demand by redeeming from the RRP, but as that number falls to zero various idiosyncratic frictions may result. Furthermore, the Fed's SRF can provide unlimited additional repo if the private sector taps out. Nonetheless, the potential for hiccups due to frictions exists. The growth of repo is symptomatic of the supply of Treasuries. Bills issuance also competes with repo availability, as mentioned above. We expect some volatility over 2H25, which may lead to some unwinds of levered positions.

Swap spreads are also cratering, indicative of an ample supply of cash Bonds and a lack of balance sheet, all while levered longs continue to want exposure. We are surprised receivers haven't begun to go on a buying strike.



As a rough example, Primary Dealers who have clients who are willing to buy duration for term synthetically through asset swaps or receivers and who are unable or unwilling to hold that exposure on their own balance sheet and use the repo market daily for leverage, can pick up 80 bps a year for 30 years on 50 to 1 leverage. This seems like a dream. However, a 10 bp widening of swap spread like we have seen recently can completely destroy the equity on such a trade. Dealer balance sheets are priced internally to prevent this sort of reckless trade. The primary dealers are clearly charging more and more to rent their balance sheets for 5, 10 or 30 years, which is a sign of a capacity problem. We mentioned the idea of providing SLR relief for Treasury holdings that are fully hedged. Absent some regulatory change, the likelihood is that more supply will cause balance sheet capacity to become tighter and more expensive. Of course, we do have to consider those who have already locked up their balance sheet at lesser fees and what a mark to market will do their ability to hold the exposure.

Banks are Irresponsibly Long. They hold HTM portfolios which continue to get squeezed by increasing marginal deposit costs. Those portfolios have potential mark to market risk that could lead to liquidity crises and forced sales of assets or equity. The BTFP runs off in March 2025 and new forms of financing will be needed for those who are partaking in the program today. Repo volumes and swap spreads are showing signs of tightening availability. The Irresponsible Long (except for certain vulnerable banks) is not likely to be sold as the "have" banks are flush with liquidity. However, we see little chance of banks becoming buyers until term premiums are attractive and yield curves disinvert meaningfully. Will that be a bear steepening or a bull steepening? We aren't yet sure. Given that all three of the Irresponsible Longs are holding their longs, we believe a bear steepening likely will occur first.

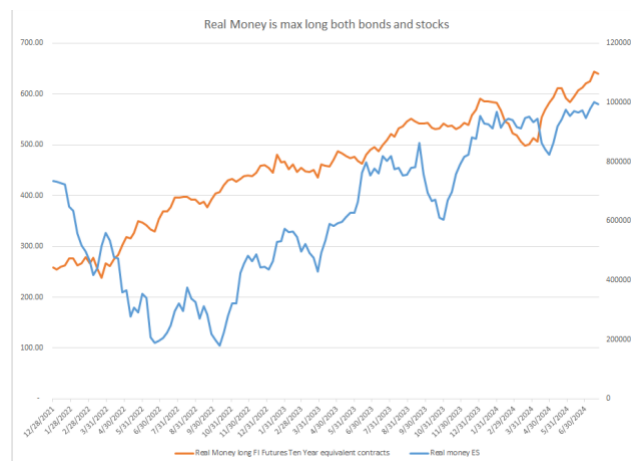
Real Money

What is

Real money investors are happy to bid up both Bonds and stocks to minimal risk premiums confident that the supply of Treasuries doesn't matter, and that the Fed will be able to cut interest rates. Except for a small correction the last few weeks, assets of all sorts are bid up to post QT Peaks



While only a portion of the positioning picture, Asset managers are long the most equity futures and ten-year Bond futures equivalents that they have ever been:



We see no value in long-term assets. It seems clear that markets participants disagree. We believe that policymakers and banks are on a path that inevitably will result in cash generating far better returns than Bonds and stocks. We also understand the animal spirits that expect policymakers to delay the inevitable and provide once again aid to help banks to kick their own can as well. This is a slow process, but we expect a straw piled on the camel's back will finally break the momentum and cause a repricing of term premium.

Economic Implications

As long as the three irresponsible longs delay the inevitable, the easy financial conditions that drive today's economy will persist. Easy financial conditions will lead to persistent above-target economic expansion, tight labor, and upward pressure on inflation. Without a hawkish surprise from either or both policymakers this week, we expect a bounce in the data leading up to the September rate decision. If so, rate cuts will come out of the front end and a bear flattening is likely.

Detailed Outlook for QRA and FOMC

QRA preview

Financing Estimate

On Monday at 3:00 pm, Treasury will announce its revised financing estimate for Q3 and its financing estimate for Q4. This QRA has much more narrow degrees of freedom in our opinion, so the financing estimate itself is irrelevant. Regardless of the aggregate financing, we expect Bills to handle any near-term fluctuation. However, the TGA target for December 31, 2024, is a possible signal. We do not think it will change much from the current \$850BN target for September 30, 2024. Any number withing \$150 BN of that number is noise. We consider the possibility that the TGA target would be substantially lower (i.e., below \$500BN) to be remote at best. However, if it is a shocking low number just buy anything that isn't tied down. Start with gold, stocks of any sort, crypto but it really doesn't matter what you buy.

Composition

On Wednesday at 8:30 am, the composition announcement will be made. We expect no change in auction sizes and a better than 50/50 chance they change the language for future auctions to guide to next quarter. If they in fact increase auction sizes (as we believe they should), that will result in a meaningful steepening.

Composition announcement - 7/31 8:30 AM		
Headline	Probability	Action
Reduced auction sizes	No Chance	Aggressive Buy
Maintain Auction sizes/No change in forward guidance	High	Neutral
Maintain Auction sizes/Indicate imminent increase in auction sizes	High	Sell Assets
Increase Auction Sizes	Very Low	Aggressive Sell

The relevant language will be in the Report from TBAC to the Treasury Secretary and it was the last sentence in the last Report:

“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.”

FOMC

The FOMC will leave interest rates unchanged and, as the committee has two full cycles of employment and inflation data AND the market is already pricing a certain cut in September, we expect no explicit or implicit commitment to a cut in September. The Chair has no need to influence pricing and has no upside in locking himself into a particular path. Powell has Jackson Hole to jawbone markets after the July NFP and Inflation data. Nonetheless, as our view sounds like a hawkish pause relative to expectations, we recognize that Powell is always dovish and so we don't expect anything particularly hawkish in the press conference. As always, we will pay attention to any comments on financial conditions beyond the standard myopic Fed Funds Taylor rule stuff. We have high hopes that one day the Fed will address its evolving balance sheet, and we are strongly recommending the first step is to stop facilitating Treasury by limiting all reinvestment going forward to short term obligations. Our expectations of the odds of financial conditions and balance sheet to be discussed are exactly 0%

Synthesis

The three major Bond market participants are Irresponsibly Long. They will either continue with their current incremental policy which will delay but worsen the inevitable expansion of Bond term premium and resultant economic impact or they will begin to act. The odds favor continued delay. Nonetheless, we believe that markets will begin front running their future actions over the weeks to come. We are quite short equities and are looking to increase shorts across the yield curve. We have started a short on KRE and remain bullish XLE.

Current Portfolio and Performance

	Assumed Portfolio size	\$	100,000,000						
	LTD P/L	\$	69,441,064						
	Total Return		69.44%		YTD Return in excess of cash		10.56%		
	Today's Date		7/28/2024		Portfolio Created		4/15/2019		
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed	Type	
6/28/2024	GCU4 2300 Put 8/27/24	23.5	426	\$ 1,000,000	10.7	\$ (544,681)	Open	1	
5/6/2024	AAPL Call Spread August 175/200	12.00	-192	\$ 250,000	23.5	\$ (221,154)	Open	2	
6/28/2024	SPX 8/16/2024 5400 Put	41.00	244	\$ 1,000,000	77	\$ 878,049	Open	2	
6/28/2024	NDX 8/16/2024 19000 Put	138.00	36	\$ 1,000,000	494	\$ 2,656,800	Open	2	
7/5/2024	SPX 9/20/24 5650/5750/5850 Call Butterfly	17.70	565	\$ -	10.5	\$ (406,800)	Open	2	
7/11/2024	SPX 9/30/2024 5450/4950 Put Spread	35.70	840	\$ 2,998,800	105.3	\$ 6,846,400	Open	2	
7/15/2024	XLE with 87.5 Stop	90.91	250000	\$ 852,500	91.79	\$ 220,000	Open	2	
7/25/2024	KRE with 61.35 stop	58.35	-80000	\$ 24,000	58.22	\$ 10,400	Open	2	
5/29/2024	ZBQ4 115 Put Spread 7/26/24 after covering 112 Put	1.17	1829	\$ 2,000,000	0	\$ (2,143,359)	Open	3	
6/5/2024	ZNQ4 110 Put Spread 7/26/24 after covering 108 Put	0.75	1524	\$ 1,000,000	0	\$ (1,143,000)	Open	3	
7/1/2024	ZBU4 8/24/24 116 Put	2.19	925	\$ 2,023,438	0.609375	\$ (1,459,766)	Open	3	
7/25/2024	ZNU4 8/24/24 110.5 Put	0.59	1684	\$ 1,000,000	0.609375	\$ 26,316	Open	3	