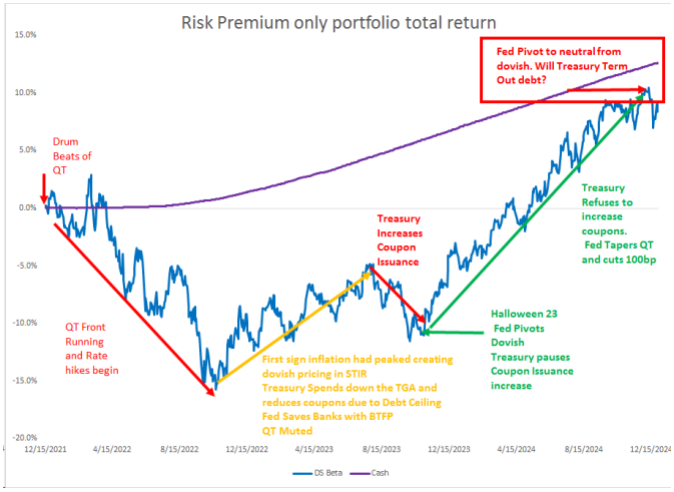
The Damped Spring Report

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

12/29/2024

At the December 2021 FOMC meeting, the Fed hinted it would begin quantitative tightening. We described this as the "Drumbeats of QT" and said it would be Kryponite for asset markets. Over the next 10 months, asset prices, led by bonds, collapsed. The tightening of financial conditions driven by expanding term premiums resulted in a few encouraging inflation prints in late 2022. From then on, QT has been mostly muted, resulting in higher Fed Funds rates for longer and inflation that remains stubbornly above target.

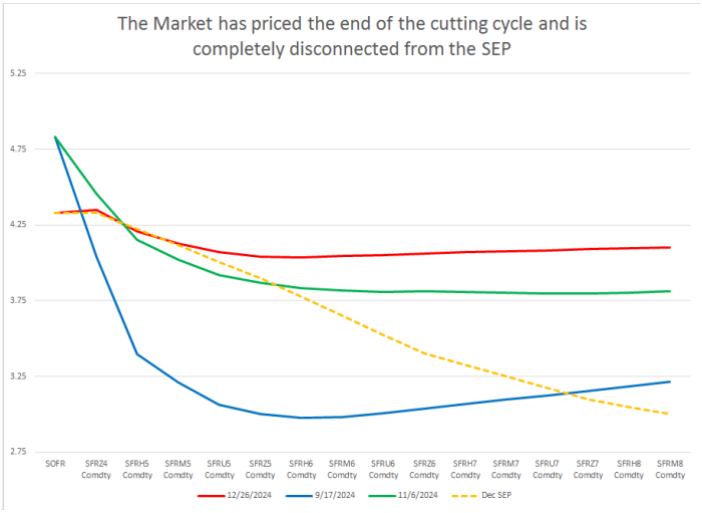


We have described how QT has been muted many times in prior DSRs. The primary force has been the extensive use of bills issuance to pay back the Fed. However, the Fed has been complicit in this muting impact. It has refused to directly sell assets in favor of a runoff policy. The Fed has continued to reinvest proceeds in long duration Treasuries, enabling Treasury to extend WAM while not tapping the private market. During the March 2023 banking crisis, the Fed provided financing with the BTFP program so that banks could continue to hold Treasuries instead of selling, and they also tapered QT itself in an overabundance of caution regarding financial stability. The incoming Treasury Secretary and Chairman of the Council of Economic Advisors have both been outspoken critics of these policy choices. The question is: Will these officials act and unmute QT by terming out the Federal Debt or will they continue to mute QT. Their decision will determine the future path of assets. We expect a continuation of term premium expansion and falling asset prices ahead of the next QRA.

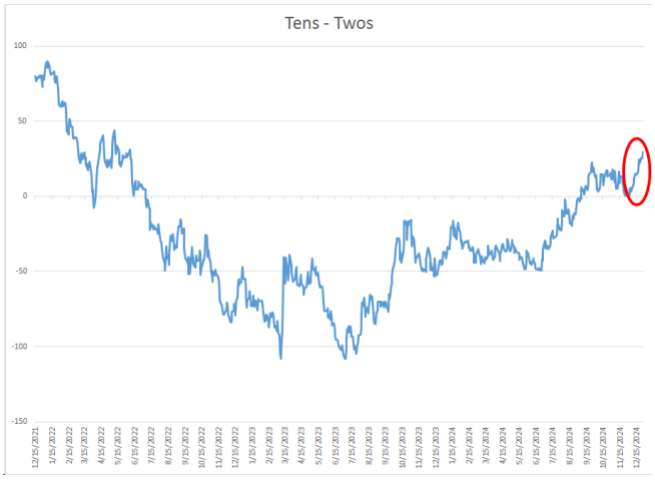
FOMC Meeting and Reaction

In our FOMC Preview, "The Fed can't out hawk the market," we expected the Fed to deliver a hawkish 25 bp cut that would be **more hawkish than the equity market expected and not hawkish enough for the bond market.** This played out as we expected with two tweaks. We were surprised the committee raised the 2025 dot to 3.9, projecting only two cuts if the data met projections. We were disappointed, but not surprised, that the longer run dot only moved up by 0.1 to 3.0. The press conference followed the dots and was hawkish. However, the following Friday both Williams and Goolsbee reversed the hawkishness and made clear the divisions within the FOMC. Since the FOMC, the yield curve, which was not impressed by the hawkishness, bear steepened and risky asset markets like stocks, gold, and crypto have sold off.

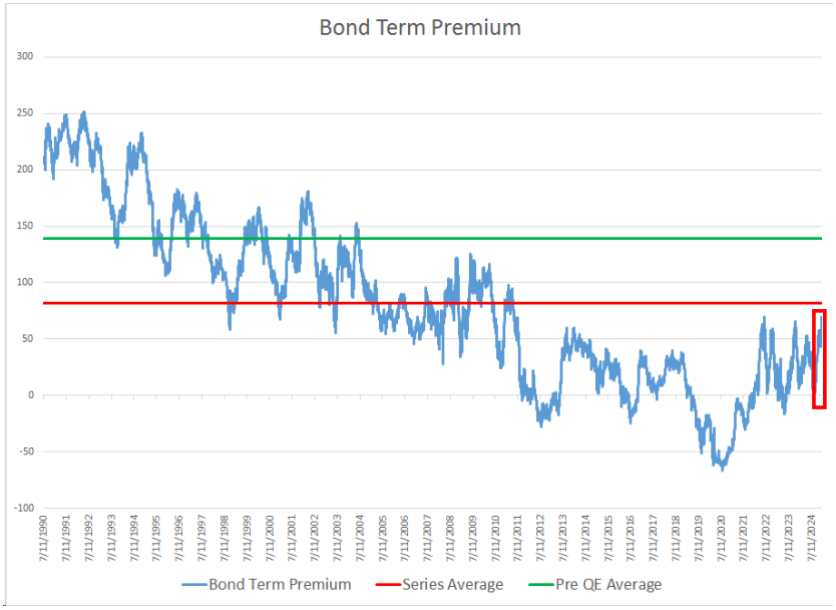
The STIR market no longer considers the SEP relevant as forward guidance:



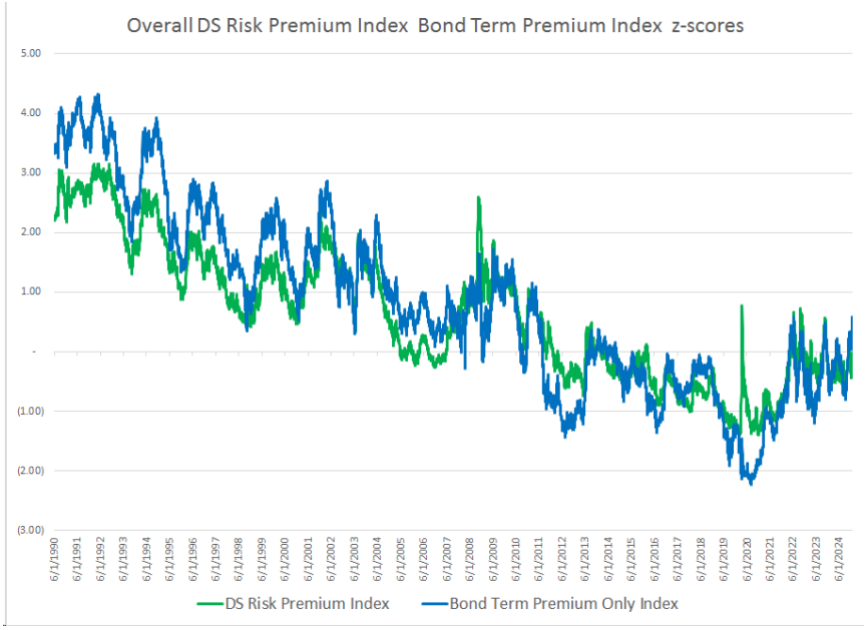
The yield curve steepened as the longer-term bond market began to catch up to the STIR market, recognizing that the Fed is unconvincingly hawkish and nGDP remains hot:



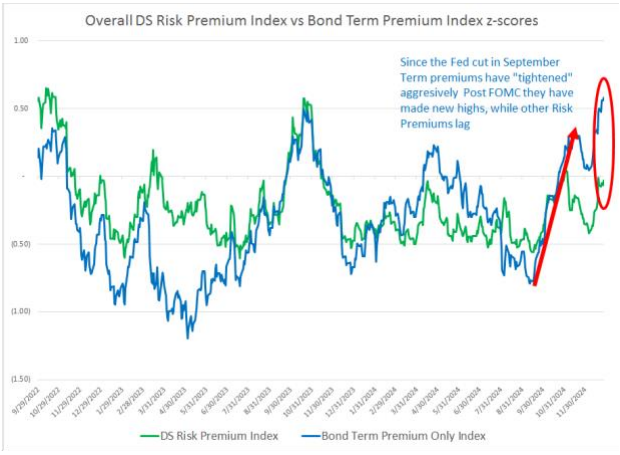
Perhaps the most important aspect of the bond market selloff has been bond term premium, which has expanded rapidly since the Fed's September cut. Term premium is conceptually independent of growth and inflation, but practically it is likely that the summer's recessionary positioning was reversed rapidly ahead of the election. The recent term premium expansion is front running the future supply and demand of bonds. However, bond term premium remains well below normal:



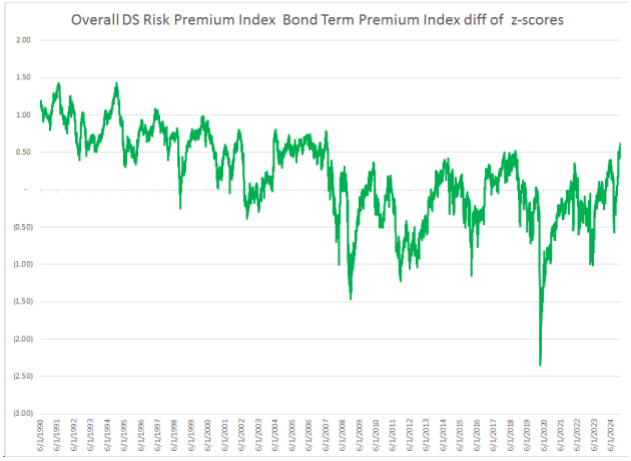
Our Risk Premium Index is built with many bonds term premium models, volatility measures, credit spreads, and non-market-based measures. DS Risk Premium Index has also expanded over the last three months:



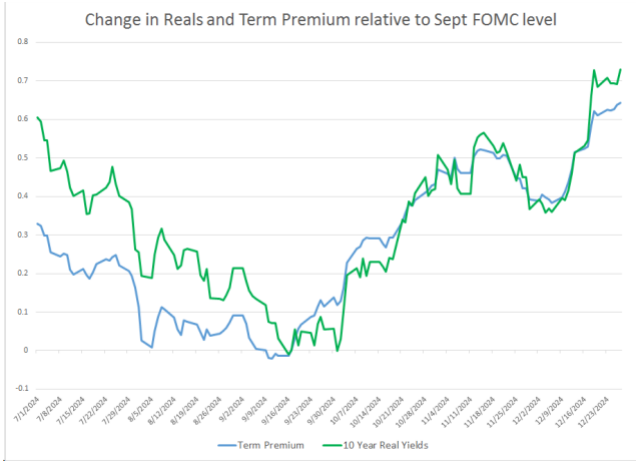
Comparing our index to bond term premiums, it is notable that the post-FOMC expansion of term premium has not resulted in broad risk premium expansion. We expect risky assets to catch down to bonds to tighten this spread.



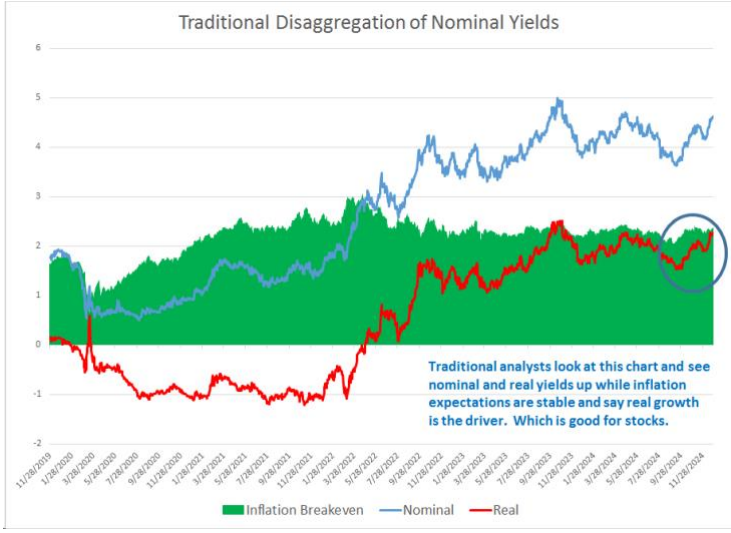
Looking at the difference major dislocations have led to rapid convergence:



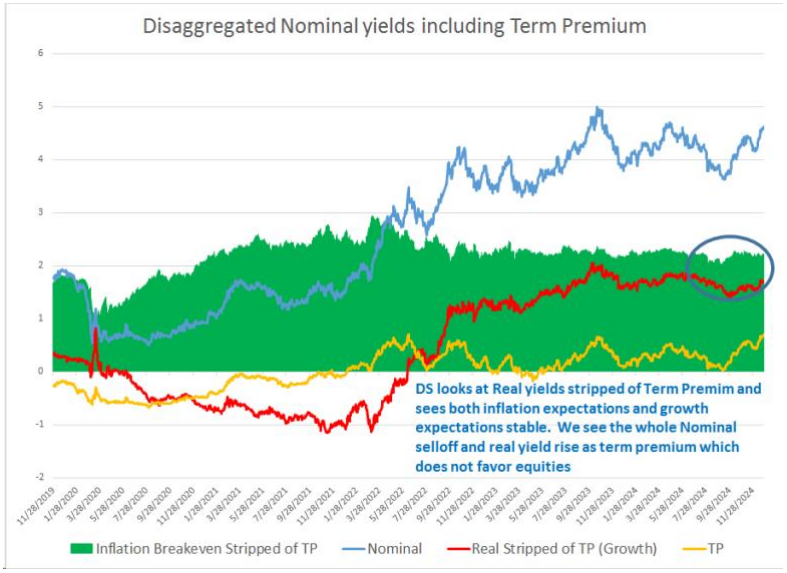
Real yields are useful because they are driven by growth expectations. However, the real yield is also driven by term premium as TIPs have investment risk:



Many who attempt to disaggregate changes in bond yields to assess changes in inflation and growth expectations seem to ignore term premium in their analysis. The traditional disaggregation is: Nominal yields = real yields + inflation b/e. When looked at without considering term premium, the traditional disaggregation looks healthy. Nominal yields are up quite a bit, but that is mostly due to real rates rising and anchored inflation expectations. Rising real rates can simply be the result of increases in real growth expectations. In other words, the selloff in long-term bonds could simply be investors shifting from discounting the summer slowdown to a recovery with stronger than expected data or it could be enthusiasm for the new administration. We think it is neither.



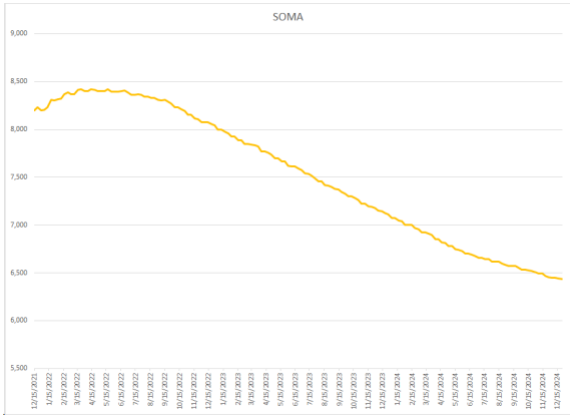
Our view is that growth and inflation expectations have both been stable and nominal and real yields are up due to term premium because 2025 looks to be a period of increased duration supply and increased risk in bonds and assets in general. We expect that in 2025 the impact of QT will finally arrive.



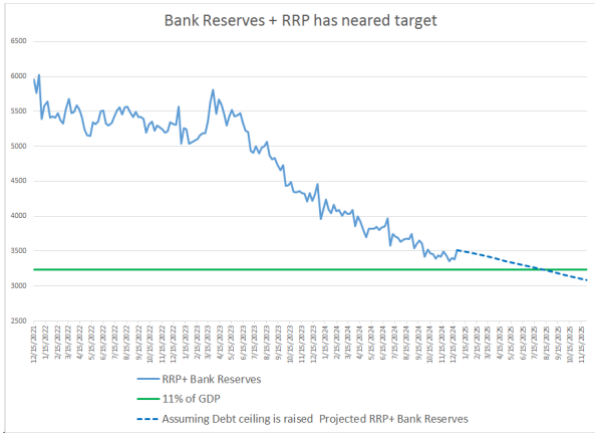
How has QT been muted and what will unmute it?

To understand how QT will finally arrive we must first understand its mechanism and the ways that policy decisions have muted its impact over the last three years. Simply put, the private sector has simply not had to absorb any meaningful duration since QT began. Furthermore, the first ten months of QT impact that commenced in December 2021 was simply front running. The reversal of that front running was sharp once the actual QT was muted. We believe that front running has begun since the election. We also are cautious that the Bessent/Miran team may have talked a big game about terming out the debt and won't have the courage in the seat. The Fed, on the other hand, shows absolutely zero interest in discussing balance sheet policy.

The QE asset portfolio has declined by $2TN since QT began. This was slower than planned as MBS runoff has been well below expectations. Nonetheless, the Fed can point to the reduction in the balance sheet as an accomplishment:



The Fed has been remarkably inconsistent about QE and QT impacts. The Fed certainly thought QE was worth doing and made an impact, but QT seems to be simply about bank reserve management. We strongly disagree and believe that the Fed is either wrong about QT or intentionally vague about its impact for fear of tightening conditions meaningfully. Once again, the Fed can point to Reserves + RRP approaching their target, allowing QT to end by late this coming summer:



We have been blunt since QT was announced: QT has largely failed to achieve its goals.

Before the program was formally announced, we said in March 2021 that the Fed had handed the implementation of this powerful monetary policy to Treasury. By choosing runoff, Treasury was able to choose what bonds the private sector was going to have to absorb:

> This DSR will be devoted to what really matters. What matters is whether Secretary Yellen will use the lever she has in one way or another to either offset or enhance the impact of QT. Here is our base case updated QT Tracker.

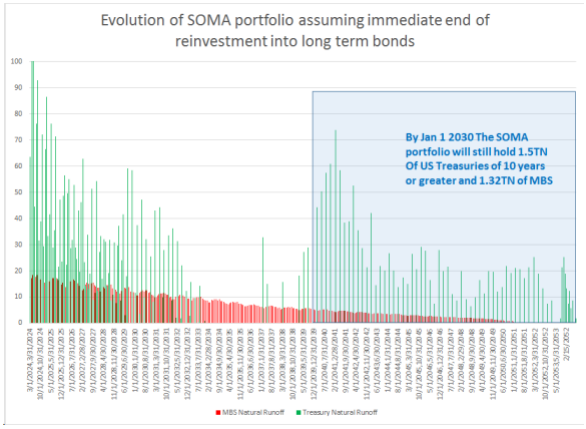
In March 2024, we gave concrete recommendations for a QT2.0 that would lead to a more sensible balance sheet while also seizing monetary policy control back from Treasury. We started with our view of the goals for the balance sheet (which we think the committee ostensibly shares):

> **We think the long-term goals for the Balance Sheet should be:**
>
> - **A Balance Sheet which supports Ample Reserves to allow banks to operate smoothly.**
> - **No MBS to avoid distorting the private mortgage/housing market.**
> - **Shorter duration to avoid distorting the yield curve and to clean up the Balance Sheet for future crises.**
> - **Consistent with monetary policy goals.**
> - **Transparent.**
>
> **We think these steps would put the Balance Sheet on the path to achieve the Fed's long-term goals while placing short-term modest pressure on the mortgage market and long-term Treasury markets to better transmit quantitative tightening by increasing term premiums on assets.**

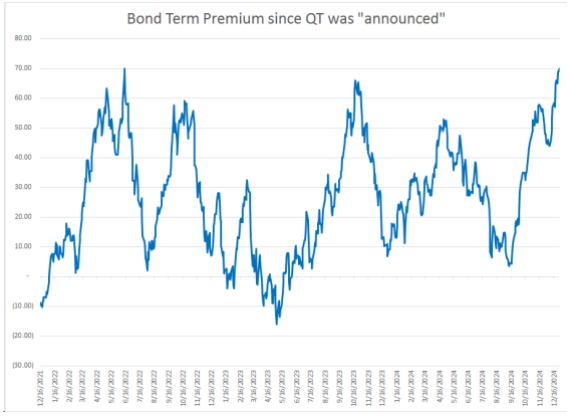
We then suggested steps to achieve their goals:

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

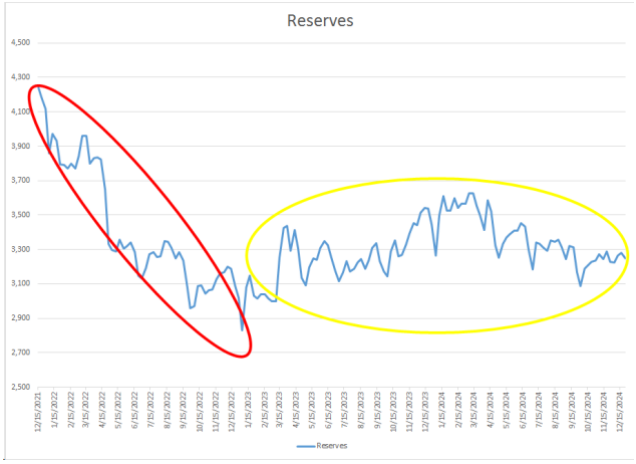
The Fed has done none of what we suggested. Even if the Fed simply changed its reinvestment policy, in 5 years the balance sheet would still have $1.3TN or half of its current MBS and $1.5TN of Treasuries of 10 Years and greater maturity:



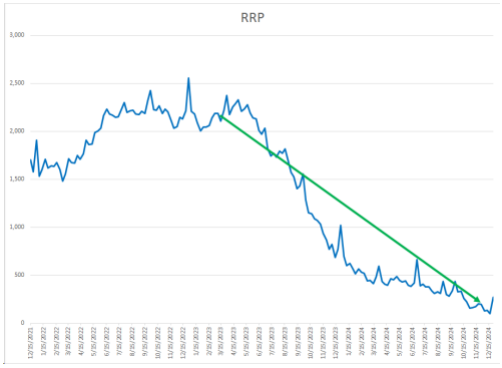
It is worth mentioning our framework for QT. We believe QT works by increasing supply of long-term Treasuries available to the private sector. In so doing, the private sector demands an increased term premium to lever up and buy the excess supply. It is the term premium expansion that tightens conditions as the cost of borrowing in the private sector is higher than it was before QT. It is also important that the level of nominal yields is irrelevant. If economic conditions support a 2% nominal rate or a 10% nominal rate, either rate could be neutral. It is the higher than neutral rate that arises from QT that does the tightening. Since the announcement of QT, term premium is modestly higher than before QT. However, it has never been particularly high, averaging about 30bp. Sometimes (like today) it has been high but has only remained high briefly because policymakers have muted QT whenever a hint of tightening was occurring. In the next section, we will show the periods where QT was impactful and was muted and the mechanics of why this occurred.



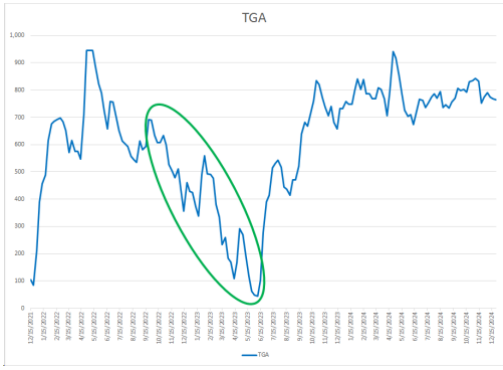
Initially, Treasury issued a ton of coupons in 2022 as QE ended and QT started. That had an impact on bank reserves, which cratered. After the first year, QT's impact on reserves has been nonexistent:



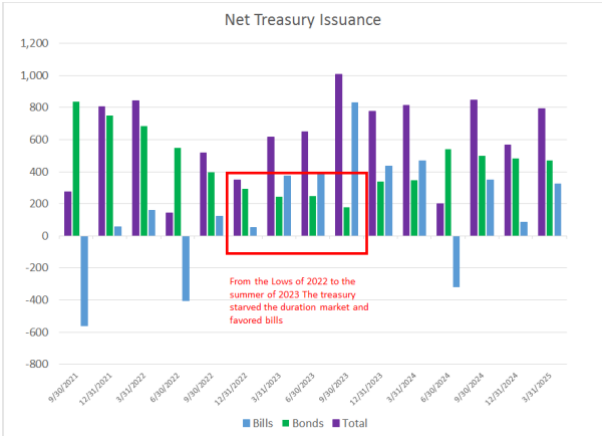
The RRP has been the biggest source of financing for QT runoff. By issuing bills, Treasury was able to provide an alternative for Money Market Fund cash. The MMFs bought the bills, and Treasury paid back the Fed.



From late 2022 through the end of the debt ceiling, Treasury also used its checking account (Treasury General Account) to pay back the Fed. This placed zero pressure on the private sector as this financing impulse had happened in the prior year while QE was ongoing. Not surprisingly, equity and bond markets bottomed and began to rally at once after this spenddown.

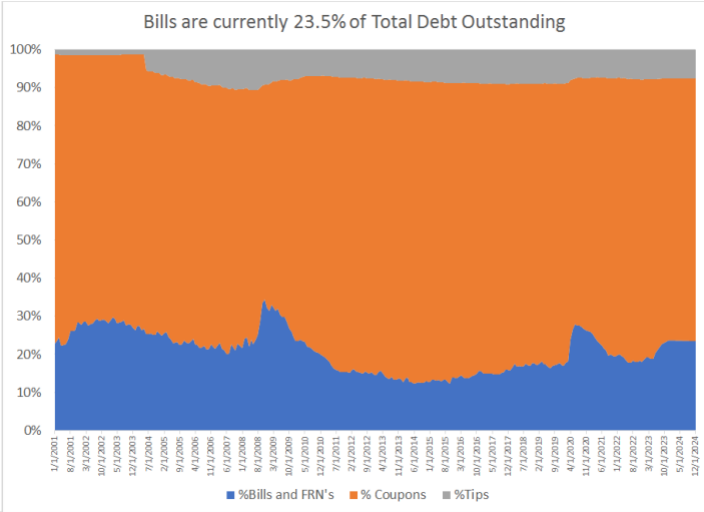


The basic mechanic of QT is whether Treasury issues long-term coupon bonds to pay back the Fed runoff or bills and/or spends down TGA. As shown above, Treasury used TGA when markets were weak. Treasury also issued the fewest long-term coupon bonds during the same period, despite still large deficits:



Treasury issuance policy

The new economic team of Bessent and Miran have been outspoken critics of the Yellen Treasury's use of bills issuance to manage monetary policy via the impact of QT. We are less sure about the intent of using the policy to achieve political goals. However, we agree completely that Treasury's actions affected the effectiveness of QT and delayed/prevented inflation returning fully to target. As we mentioned, balance sheet runoff will likely end by mid-summer. However, the big point of this report is that QT can be temporarily muted via bills issuance, but cannot be delayed permanently unless Treasury decides to maintain the elevated bills to outstanding debt ratio. We suspect some to the recent term premium expansion is front running some terming out of this heavy bill-dominated debt.



February 4 will be the next Refunding Announcement. Guidance contained in the last QRA prepared by the Biden-Harris administration suggests no need to increase coupon auction sizes:

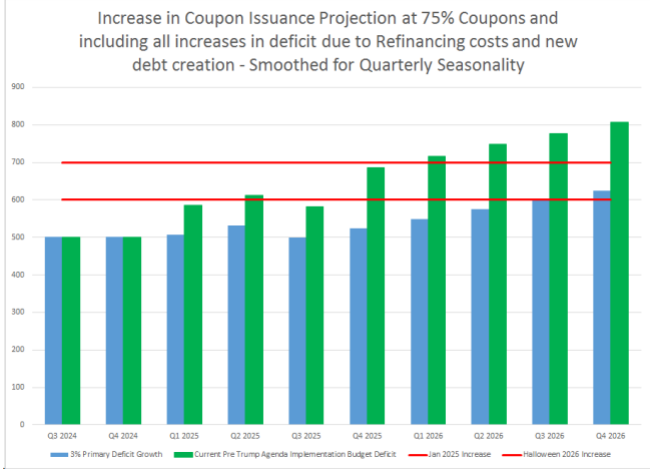
> Treasury believes its current auction sizes leave it well positioned to address potential changes to the fiscal outlook and to the pace and duration of future SOMA redemptions. Based on current projected borrowing needs, Treasury does not anticipate needing to increase nominal coupon or FRN auction sizes for at least the next several quarters.

The February QRA will be the first for the new administration and we expect they will keep auction sizes the same but change the forward guidance language. The QRA will be for Calendar 2Q25, which is also the seasonal low in financing needs. But it is simply too early to make predictions for this QRA. Tune in here in late January for a detailed outlook.

The outlook for duration supply is not likely to be affected by either budget negotiations (which are for future budgets and less for current fiscal 2025 budget) or the Debt ceiling (which we will discuss below). However, the budget deficit is a key area of focus for both the economic team and the Trump Agenda.

Unless meaningful budget deficit reduction occurs, it is highly likely that the auction sizes will go up in 2025. Below we assume that bills continue to be used at a bloated rate of 25% and no debt is termed out. In these scenarios, the projections of budget deficits prior to any Trump shifts suggests $100BN of coupon issuance increase twice over the next two years. To make any progress on the bills ratio, another $1TN of existing bills needs to be "termed out".

There are scenarios which we could imagine in which coupon issuance does not increase, but they are unlikely at best:



Debt Ceiling and TGA spend down

Last week, the lame duck elected officials averted a US government shutdown with a stop gap funding bill that allows the government to continue to spend through March 14th. This bill did not address any meaningful issues about spending, the national debt, or future budgets. The bill simply kicked the can to the new administration and Congress. Sometime between when the new Congress is sworn in and March 14, it is likely that the Debt ceiling (which is now binding) will be raised. How much it is raised, suspended or eliminated will be part of the sausage-making of our political process. This section will not attempt to predict the outcome; however, one thing is certain: there is zero chance that the debt ceiling will remain in place at current levels. Like it or not, I see no possibility that the deficit will turn into a surplus during any part of the next four years. More deficit = higher debt. The debt limit will go up.

Despite the obvious and certain outcome of the debt ceiling being raised or eliminated, the path to that outcome could be bumpy. The next bump is whether the Trump administration can negotiate largely with its own Republican House an

increase in the debt ceiling for spending cuts. March 14 is the forcing date for this negotiation, but we could imagine that the administration would like to be working on its full agenda in its first hundred days instead of spending much of that time negotiating with Congress. If the administration and Congress fail to agree, either the government shuts down on March 15 or another stop gap bill kicks the can again. When does this all end with an actual hard stop forcing date? By roughly August, the US government will run out of money to spend given the Debt ceiling. So that is the timeline at play.

With that preamble this section is about the implications for markets not about the politics. We will deal with 3 major topics:

- What debt will be issued, what debt will be retired, and what debt will briefly be forgotten?
- How will the government pay its bills?
- The mechanical implication for private sector liquidity.

Debt Ceiling

Until January 2, the Debt ceiling has been suspended. As of January 2, the Debt will be capped at the current debt limit (perhaps after the bill with an extra $100BN for Disaster relief). Regardless, until the limit is raised, the U.S government can no longer take on additional debt. Any new debt obligation must be met with an old debt retirement. No new net debt can be taken on. In past situations like this, Treasury has continued to issue coupon bonds in a "regular and predictable" manner. In fact, the schedule for issuing debt in 1Q25 has already been announced and $469BN of net new coupon issuance will occur. Hold on, however: didn't we just say that no new net debt issuance can occur? Sorta. During 1Q25, over $5TN of bills will mature. During 1Q25, Treasury could simply retire $469BN of those bills and remain under the debt ceiling. In fact, they have another trick up their sleeves (authorized by Congress fwiw). That trick is called an extraordinary measure. The government owes money to various intragovernment entities. Specifically, the G fund, which is a retirement fund for governmental employes "owns" US debt that is subject to the limit of $300BN. Treasury can "cancel" that debt while winking and nodding that its only temporarally cancelled. Voila: $300BN of room to issue and

spend. **So going forward with an extended debt ceiling, Treasury will issue coupons and retire bills and "cancel" some debt. But this doesn't last forever.**

TGA

Every dollar spent, every tax dollar received, every dollar raised with issuance, and every dollar retired with maturity payments flows through the US government's checking account. That account, called the Treasury General Account, is held at the Federal. At the moment, that account has $800BN in it. Two things are important:

1. Why is it so large?
2. Can it be spent down?

The TGA is as large as it is by a policy Treasury adopted to avoid a situation in which some disruptive exogenous event occurrs that would prevent the government from being able to honor its obligations. How does that work? Well, every business day, the government spends, receives tax revenue, pays off maturities of debt obligations and lastly issues debt obligations. The last thing is the one that is vulnerable to a disruption. After September 11, 2001, markets were close for a few days. The government risked failing to honor its obligations because Treasury could not issue debt with the markets closed. For that reason, every day a Treasury function estimates all four of the uses and sources of the cash for the next 5 business days and keeps a "checking account" balance that covers the needs if issuance is unavailable. So, the TGA is very large today for two reasons, one is the budget deficit but more importantly is the high level of bills financing which are constantly maturing and may not be able to be issued. **Big bills outstanding results in big TGA.**

So that sounds like a prudent reason to keep a large TGA. But a debt ceiling forces Treasury to choose between stopping spending and/or defaulting on maturities or taking on risk of a market disruption event causing a default. Treasury has always chosen to spend down the TGA despite its peril. Treasury will do so again, but it can only go down to zero. When the TGA goes to zero, the government has to default. Of course, that is a choice, because simply raising the debt ceiling and

issuing more debt is the solution. **When looking at the current TGA balance, the extraordinary measures available, the daily flow of taxes and spending and maturing obligations, one can zero in on a date that the government is forced to make a decision. We think that date will be sometime during the summer of 2025. Until that date, political sausage-making can occur without much consequence.**

"Liquidity"

There are many pundits that track an amorphous term they call "Net Liquidity." The idea is sound, and we track these flows as well. Basically, if the US government gives the private sector money, the private sector buys assets. That idea is a tautology of course as private sector "money" must be saved in some way. The time of keeping hard currency in the mattress has long gone. So when the government provides money, savings are increased in the private sector and those savings must be placed in some sort of investment. Of course, without actually printing money the liquidity injection must be temporary. Eventually, an injection of money must be sterilized by issuing new government obligations or increasing taxes to pay for the injection, which sops up that liquidity. Tracking the ebbs and flows of spending and issuance and tax payments is a worthwhile endeavor, but one also has to look at the mechanical plumbing in depth to assess the impact. All that said, TGA spend down is literally a liquidity injection because it is money that was already borrowed from savers being released to the private sector. Let's dig in how that injection occurs.

As you can see from the above sections, the TGA is being forced to be spent down. Mechanically what will happen is that bills issuance will be negative as long as the Debt ceiling is in place and until the government raises the Debt ceiling or defaults on its obligations. Negative bills issuance means fewer bills are issued than mature. The negative bills issuance results in TGA funds being handed to private sector bills owners. Who are these guys?

1. Money Market Funds
2. Private sector non-banks
3. Foreign

4. Banks - but they don’t play any role here because of better alernatives.

MMF

When an MMF gets a net maturity, it needs to find a place to save that cash. It has four options:

- Dividend money to shareholders.
- Push money back into an undersupplied bills market.
- Push money into the private sector repo market.
- Push money into the Fed’s Reverse Repo Program, which has infinite capacity.

Private Sector Non-Bank

When someone like us or a corporation is invested in bills, and we receive a bill maturity we have these options:

- Push money back into an undersupplied bills market.
- Leave the money in our bank deposit.
- Push money into an MMF.
- Buy some other financial asset for savings.

Foreign

When a Foreign entity is invested in bills and receives a bill maturity they have these options:

- Push money back into an undersupplied bills market.
- Leave the money in their bank deposit.
- Push money into an MMF.
- Buy some other financial asset for savings.

Banks

Banks can buy bills, however given the high interest on reserves balance paid by the Fed and until recently the inverted bills curve, they don’t really own much.

However, as you may have noticed, banks may see an increase in deposits from all of the above sources when bills have negative issuance. Because banks have more deposits and more bank reserve assets on the same equity capital, banks may react by:

- Buying financial assets and leveraging up.
- Pushing loans to clients in order to leverage up.

Okay, what does all this mean for markets?

To understand the flow through to asset prices of a net negative bills issuance (also known as a "liquidity injection"), we must examine these cohorts and their options in more detail.

MMF

- Dividend money to shareholders. This option may result in shareholders getting more bank deposits and as these shareholders are nonbank private sector and foreign we can deal with that when examining those cohorts.
- Push money back into an undersupplied bills market. This may happen at a specific fund, but is impossible to have happen in aggregate.
- Push money into the private sector repo market, which may reduce the cost of leverage for investors but that cost savings is rarely the constraint for such investors. These investors leverage when asset prices are attractive, not when leverage costs fall.
- Push money into the Fed's Reverse Repo Program, which has infinite capacity. **This is highly likely to be the best choice for MMFs and when done sterlizes the liqudity injection completely as the Fed's balance sheet reduces TGA and adds RRP as a liability.**

As private sector nonbank and foreign have the same options, let's look at them as one cohort.

Private Sector Non-Bank/Foreign

- Push money back into an undersupplied bills market. Of course, some of this cohort will do this but in aggregate that is impossible.
- Leave the money in bank deposits. This is a tough tradeoff for investors as FDIC insurance amount becomes a possible constraint and the interest rate will be relatively low.
- Push money into an MMF. **As these investors are already in bills and prefer that investment versus other sorts of investments, this is the most likely shift. That shift will take us back up to the top where the MMF will now want more RRP.**
- Buy some other financial asset for savings. Prior to the maturing of the bill, investors wanted bills. **All else being equal, one would expect them to maintain their risk exposure but it is possible that some spills into more riskier longer duration government bonds. Of course, if this occurs, someone has to sell the more risky government bond and now has cash, which they may then use to buy a corporate bond or, if the seller is a corporation, the proceeds may be used to buy back their shares. In this case, the seller of shares then has cash and they want shares so they may buy riskier shares, and the seller of riskier shares may want to remain invested and they may buy crypto, the seller of crypto may buy a lambo.** Anyone that has read my work in the past probably recognizes this progression. The same thing happens from a flows standpoint when QE is done. That is why some people equate TGA spend down to Not QE QE. While the idea is valid, the question is scale and the cohort. In QE, when MBS and longer duration bonds are bought and cash is injected, the selling cohort has little alternative but to push out the risk curve. In the case of TGA spend down, the cohort receiving the cash is a CASH-interested account and they mostly have the RRP offering infinite capacity via the MMF path.

Banks

Banks themselves are not directly impacted by bills net negative issuance, but their deposit/reserve base is. They have these two options:

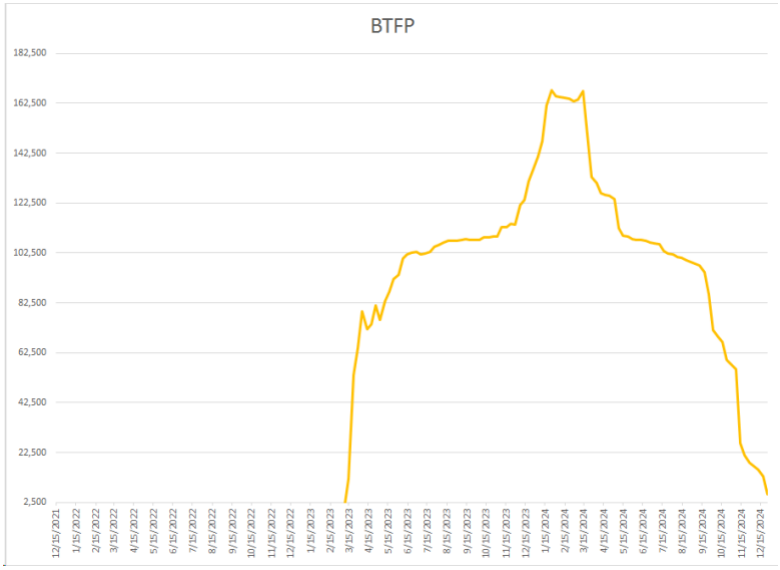
- Buying financial assets and leveraging up.

- Pushing loans to clients in order to leverage up.

But what is important to realize is the banks have zero current constraint to do either of these things. They can buy financial assets or create loans today without a change in reserve balances or deposits. It is possible that the liquidity injection of TGA spenddown may cause a slight leveraging up, but again there is no mechanical reason for it to occur.

RRP and BTFP Evolution

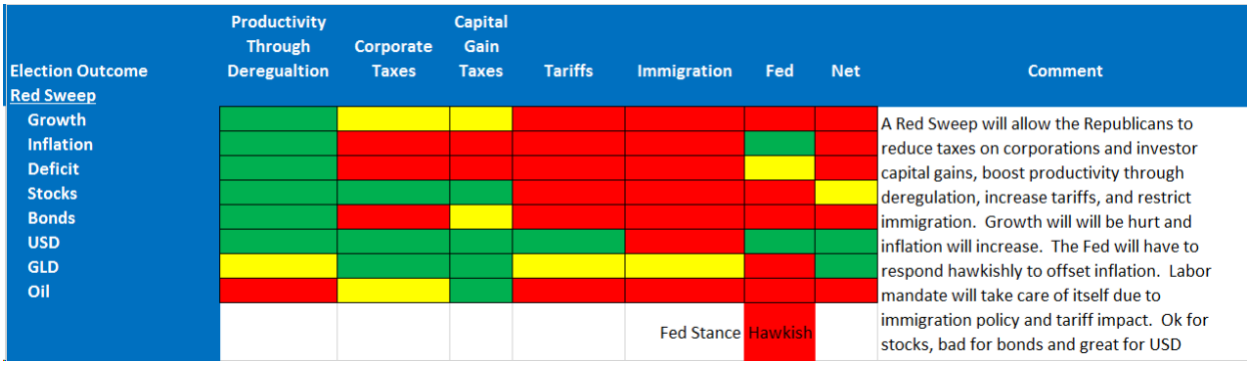
If not for the Debt ceiling and potential TGA paydown, we expect the RRP will continue to shrink to close to zero by summertime. The BTFP is now effectively closed. The program expires in mid-March, but it is almost fully paid off. As it is near zero, financial conditions (which may have been modestly tighter as banks tapped new sources of financing) will no longer be tight:



If the Debt ceiling is not raised or eliminated, the TGA will begin spending down. As shown above, the impact will be a short-term rise in the RRP, which will fully reverse when the debt ceiling is ultimately raised.

The Trump Agenda

Hopefully the Debt ceiling is dealt with early on the Trump Administration. We would like to see the Trump Agenda to be the focus over the first 100 days instead of the distraction of the Debt ceiling drama. Of course, it is also possible that the drama is intentional. Regardless, we have already shared some thoughts, reprinted below, about the key agenda items and, as they are fleshed out, we will provide additional thoughts.



Synthesis

Until the Trump Economic Agenda is fleshed out, the next few months will be impacted by a continued strong economy, a Fed that remains less hawkish than the bond market and more hawkish than the equity market, front running of potential Treasury issuance policy changes, and the Debt Ceiling, government shutdown theater. We end the year expecting weak asset prices in the last two days of the year followed by a "January Effect" where some meaningful selling occurs in the best performers for tax realization in 2025 that has been delayed and some strength in those assets that were sold late this year for tax loss harvesting.

We are no longer short long-term bonds and if anything, favor them over equities. However, given pricing we particularly like STIR and expect to hold a long position in SFRM6 against a new put position in equities on any bounce in equities.

Happy New Year All.

Current Portfolio and Performance

Assumed Portfolio size	$ 100,000,000				
LTD P/L	$ 68,543,611				
Total Return	68.54%	YTD Return in excess of cash	9.66%		
Today's Date	12/29/2024	Portfolio Created	4/15/2019		

Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
11/7/2024	SPX Dec 31St 5560/5460/5360 Put Butterfly	1.65	1515	$ 250,000	0.00	$ (250,000)	Open
11/13/2024	SPX 5900/5500 12/31/2024 Put Spread	45.65	438	$ 1,999,470	8.00	$ (1,649,070)	Open
11/13/2024	NDX 20000/19000 12/31/2024 Put Spread	100.21	200	$ 2,004,200	4.00	$ (1,924,200)	Open
12/17/2024	Jan VIX Futures 15.05 Stop (profits baked in)	16.53	500	$ 500,000	16.95	$ 1,215,000	Open
12/17/2024	SFRM6	96.025	2668	$ 2,000,000	95.965	$ (400,200)	Open
			Risk	6.754%		3.7%	