The Damped Spring Report

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

6/15/2025

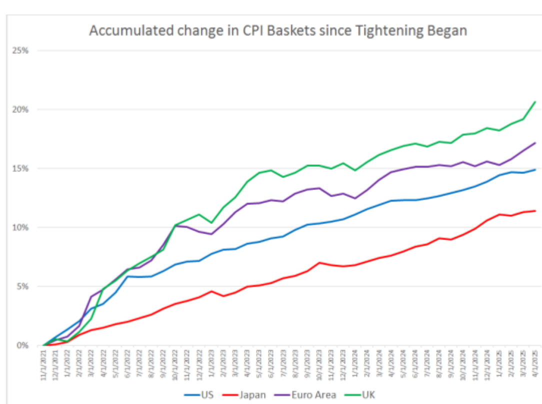
Policymakers in the four largest developed economies have faced a difficult choice over the past few years, a choice they will continue to face going forward. The choice is between:

- **Addressing root causes, or**
- **Alternating between temporarily saving their long-term bond market or their currency.**

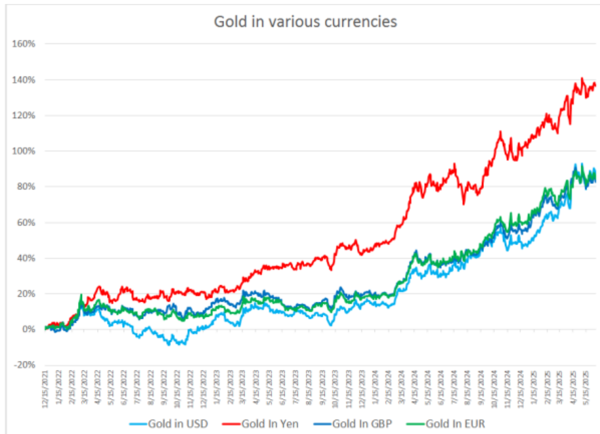
So far, policymakers have done nothing to address root causes, which is too painful. They have chosen to save their long-term bond market at the direct expense of their currency markets. Bonds are simply "future" money and bond yields are the compensation investors receive for the loss in value of their money in excess of interest on "spot" money. By suppressing "future" money yields, policymakers have placed all the pressure of rising debts and high deficits on "spot" money. As seen recently in Japan, which, of all the big 4, is in the best shape due to massive savings, by not addressing root causes eventually policymakers can save neither "spot" money nor "future" money. We see no signs that policymakers are willing to address root causes. In this DSR, we focus on the choice of saving the currency (spot money) or the bond market (future money).

Currency markets

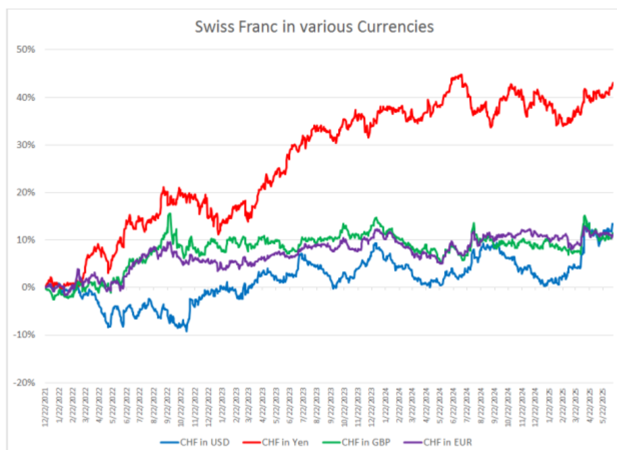
Currency weakness, measured in various ways, has been broad-based despite central banks engaging in tightening post-Covid. The rise in the price of the consumption basket has slowed and instead has accumulated and is above YoY target:



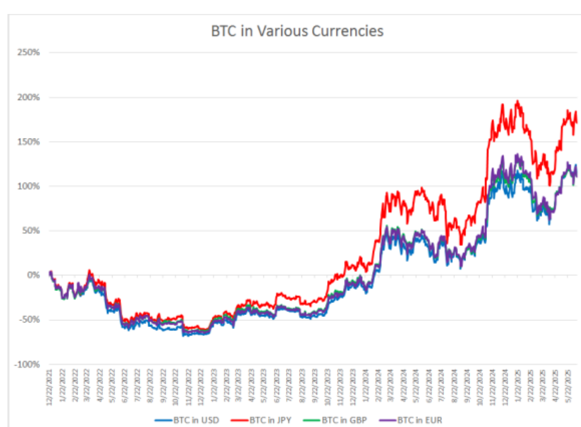
Against Gold, the four major currencies are depreciating and that depreciation has become more rapid since easing began:



The Swiss Franc has a long history as a store of value and, despite practically zero interest rates, remains strong:

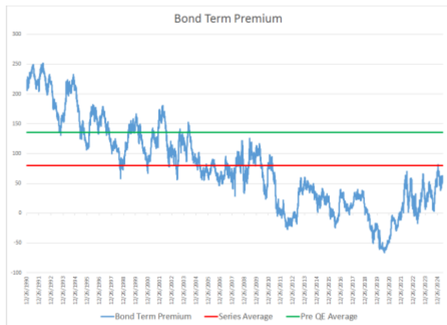


Bitcoin continues to have some "risky asset" premium but as a store of value (and risky asset), it has benefited across major currencies, albeit with high sensitivity to large risky asset drawdowns:

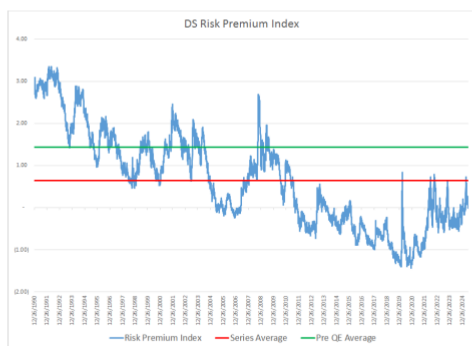


Bond markets

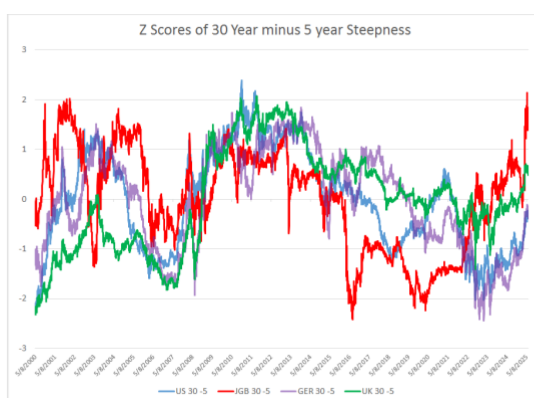
Despite “spot” money depreciating, bond market yields are only up modestly and remain suppressed by many measures. Term premiums have risen since QT started but have plateaued well below pre-QT era term premiums, and even below longer-term averages. Policymakers have repeatedly intervened as term premiums have peaked:



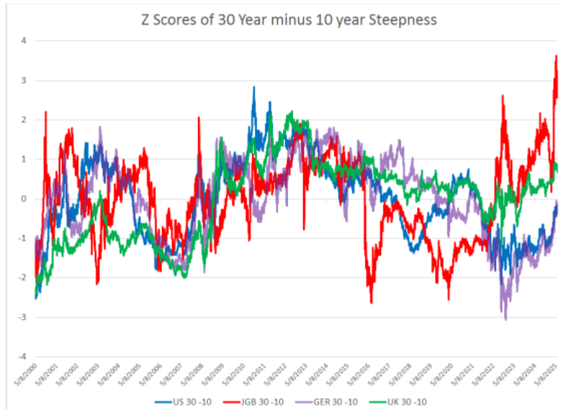
Broader measures of risk premium are also suppressed, as below-average term premium in the bond market has been arbitraged to all global assets. Low and stable term premiums are bad for currencies compared to stores of value and consumption baskets, as high asset prices and low long-term interest rates encourage levering up and spending:



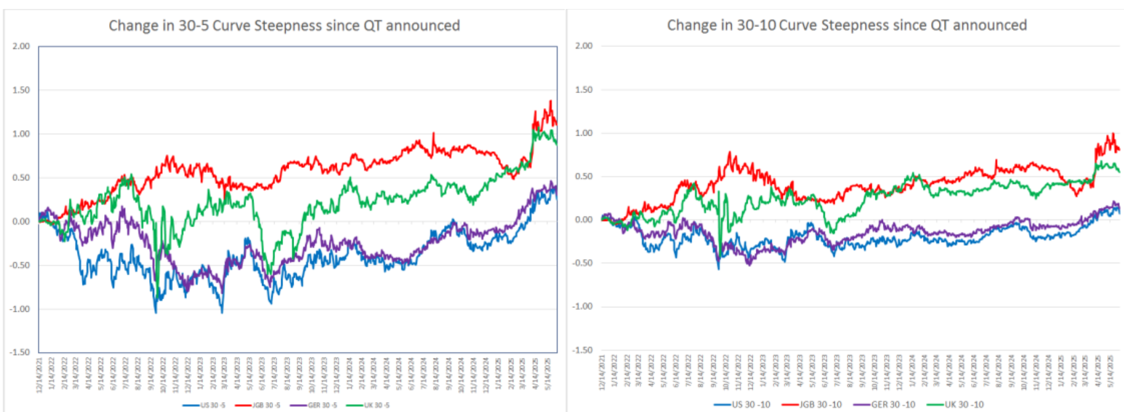
Looking at the steepness in the back part of the yield curve, until very recently all global bond markets were quite flat and US and European curves are about average:



The distal end of the yield curve, which has the most sensitivity to supply and demand, is also quite flat. The exception is Japan where for years they have favored depreciating their currency and now find they can no longer save their bond market:



Since QT was announced in the US, yield curves have hardly steepened until quite recently led by Japan and the UK:



"Spot" Money vs "Future" money mechanics

"Spot" money (like a bank deposit) can be used at any time to purchase goods and services or financial assets. "Future" money (bonds) must be sold to someone else for spot money or it can be used as collateral to borrow spot money from a bank, which banks create out of thin air, to provide money to purchase goods and services or financial assets. In both cases, the "spot" money can also be used to purchase foreign currency assets or hard assets like gold.

When a government deficit spends, it could, conceptually, just print money and spend, thereby giving the private sector more "spot" money. In practice, governments do not print, but instead simply spend "spot" money financed with the issuance of "future" money in the form of bills, notes and bonds. The "spot" money spent by the government does take a few turns through the economy but ends in savings of "future" money. Conceptually, the "future" money can only be used to buy financial assets or consumption through leverage. The holder of "future" money can only spend “spot” money. To get “spot” money today, they either must sell to someone who pays “spot” money, or they must borrow using their "future" money as collateral.

The key point of this mechanic is that bills provide more collateral value than long-term bonds and the demand from those with "spot" money for bills is much deeper than for longer-term bonds because bills do not have much price volatility and have much tighter bid offer spreads.

A bill used as collateral can generate 99.5% notional of “spot” money, while a long-term bond used as collateral can only generate 92.5% of “spot” money. In addition, once used as collateral, the collateral holder can also lend a bill a second or third time in what is called rehypothecation. Besides the leveraging, the minimal risk and high liquidity of bills creates easy ignition of animal spirits versus long term bonds.

Printed money has the highest potential for stimulating consumption and asset investment and currency depreciation. Bills are just barely less "spot" money-like, and long-term bonds are quite a bit more "future" money-like and much less "spot" money like.

For these reasons, the composition of the national debt held by the private sector and the composition of the issuance offered to the private sector has an impact on currency markets and the economy, with more bills providing more “spot” money and more currency depreciation, and asset and consumption basket inflation potential. In periods of deflationary recessions, when deficit financing needs rise, this force is quite useful to stimulate the economy. However, today the amount of almost "spot" money bills outstanding and being issued seems unwarranted, which suggest policymakers are making a choice. The choice is to avoid higher yields on long-term bonds at the cost of weaker currencies.

Policymaker levers

The solution to the “Big Debt Cycle” is not within the scope of this DSR. We are much more interested in policymaker behavior over the next few months that could indicate a shift in priority to protect one form of money over the other. The trend of depreciating money of all sorts is highly likely to continue, given what we see in 2025. We are paying attention to some of the potential wiggles and reversals of this trend over the next six months.

We are interested in near-term policy choices that affect the total amount of issuance in 2025 and the composition of “future” money policymakers force upon the private sector. The policymakers have these short-term levers, which we will watch for signs of shifts:

- Near-term deficits including tariff revenues.
- Issuance composition.
- How the US navigates the debt ceiling and refilling the TGA.

- As the TGA refills, the RRP will certainly go to close to zero, which will have important impacts on money markets, including impact on bank reserves, interbank reserves borrowing and lending, and the viability of the standing repo facility to absorb individual financial institution reserve volatility.
- Central bank balance sheet moves, including changing QT amounts, QT composition, and reinvestment policies.
- Regulatory action to foam the runway for certain entities to buy more bonds.
- Currency or bond market direct intervention.
- Importantly, market pricing, as ultimately market pricing that evolves could create adequate demand if expected returns are attractive to stem currency depreciation and bond market yield increases without policymaker action at all.

Near-term events to watch

The pressure on "spot" and "future" money is driven by unaddressed root causes and seem unlikely to be addressed in the near term. Furthermore, the ebbs and flows of this pressure are dependent on economic outcomes, which have their own cyclicality and policymaker response. It is a lengthy process with lots of wiggles, but the trend is clear until policymakers take radical action or markets reprice.

Near term, we have seen a few decisions that are worth noting and we see several decision points which we will watch carefully to determine whether policymakers remain biased to currency weakness versus choosing to protect the currency and allow bonds to reprice.

Japan

Policymakers in Japan have reacted to the extreme spike in long-term bond yields. The Ministry of Finance is considering reducing long-term bond issuance and even buying back long-term bonds. The BOJ may slow its planned reduction in long-term bond buying. Both steps are designed to protect "future" money at the expense of "spot" money. More details could emerge after this week's BOJ meeting.

UK

The UK Debt Management Office has already decided to shift issuance from long-term debt to shorter-term debt, correctly noting that UK does rely more heavily on long-term debt than the ROW. The BOE is considering tapering its QT, which is direct selling of long-term bonds. Both steps are designed to protect "future" money at the expense of "spot" money. More details could appear after the BOE meets this week.

Germany and the EU

At any time, details of expansionary fiscal policy throughout the EU and specifically Germany may affect both currency markets and long-term bond yields.

The Fed

The FOMC may announce at this week's meeting changes to its reinvestment policy and other possible balance sheet shifts as part of the 5-year framework review. Given the rhetoric of FOMC members about balance sheet direction, it would only be in the opposite direction to where the UK and Japan have headed. Given the last three years of protecting the long end of the bond market every time there has been even a hint of stress, we are not holding our breath that the Fed would withdraw their support and act on the sensible long-term project of normalizing the balance sheet. The Fed and Treasury have been suppressing long-term bond yields for years. They seem deathly afraid to let the private sector set the long-term interest rate. Our analysis shows that a 50-75bp increase in long-term bond yields would result in plenty of demand for Treasuries from investors who are not currently interested, given the issuance overhang and the Fed's intervention through reinvestment policy duration extension. The bond market's fear is misguided, and the actions of policymakers has pressured the currency market.

Budget and tariffs impact on deficit

The reconciliation bill must pass through both houses, either in the form of the OBBB or something else. Perhaps this gets done before the x date, but we suspect it will take a forcing mechanism to ensure passage.

Treasury Issuance

Secretary Bessent has been outspoken about the prior administration's use of issuance to stimulate the economy. We agree. Bessent is likely resting his view on issuance on his confidence that the deficit will fall. If so, Bessent can term out the debt, consistent with his stated desire to maintain coupon auction sizes and simply reduce bills. However, if deficits do not fall, coupon auctions sizes must increase. We will be paying attention to the QRA process between July 28-30. We are certain a large bills issuance to refill the TGA will occur in late 3Q25 if the debt ceiling has been increased by the meeting time. If not, however, the bills issuance will be announced anyway due to the TGA target and the likely very low TGA at the time.

RRP, TGA, Reserves will be volatile

With RRP likely completely drained post-debt ceiling increase, the rapid issuance of bills will tap bank reserves, which could create stress in money markets.

Regulatory Reform

The path toward bank capital regulatory reform is still bumpy and slow moving. We have studied the various stresses faced by banks and the regulatory changes floated by many policymakers. Our view is that, at the macro level, banks are not constrained to increase lending and/or own more US debt obligations due to any of the recently floated regulatory reforms designed to remove nonexistent constraints. Clearly banks and their lobbyists want less regulation because the most likely impact will be to increase stock buybacks and dividend payout ability. One recent development (which may take back some of the easing constraints on banks) floated is the idea to set a tiered structure for reserves such that interest on "required" reserves would go to zero to stop the US taxpayer and debt holder subsidy of the banking system. We expect the road to remain bumpy and slow moving.

The calculus of the choice

The trend of money deprecation versus hard money alternatives and the consumption basket is strong. Temporarily policymakers have favored protecting "future" money. How do they choose? Assuming they will not address the trend, the tradeoffs are relatively straightforward.

Favor "Future" money

When "future" money is protected, asset and the consumption basket remain inflated or inflate more. High asset prices support demand for goods and services from those who own assets. Borrowing rates for corporations and good household borrowers is cheap, which supports asset and goods and services demand. Unfortunately, this comes at the expense of currency weakness. While this is a desirable outcome if that weakness is against the currencies of major trading competitors, most of the trade surplus countries continue to have very weak currencies and the other major trading partners are depreciating their currency just as fast. A "run it hot" economy is likely to keep those who do not have asset wealth or borrowing capacity employed; unfortunately, they are highly unlikely to see real wage gains and their standard of living will decline. Lastly, favoring "future" money requires depending on financing deficits with short-term debt, which significantly increase the imbalances, and like in Japan recently, will result in not being able to protect either form of money.

Favor "Spot" money

Choosing to stop suppressing long-term interest rates results in asset price declines and higher cost of financing for long-term private sector financing. Demand destruction is the likely result, and a slowdown of some sort should occur. The positive of this outcome would be the Fed's ability to lower short-term rates and steepen the curve. This would actually "protect" future money as well as demand would show up in the long-term bond market from both foreign and leveraged domestic actors. Foreign demand would occur due to currency stability and domestic demand due to adequate returns. Unfortunately, there would be an increased risk of a leveraged private sector "accident" and greater risk of a deflationary slowdown, which is more impactful on employment.

Outlook

As noted above, we expect the spiral to continue as long as the root cause is not addressed. Along the way, we will assess the events over the summer to trade the wiggles tactically. Absent action on root causes, the spiral also can end simply due to pricing or based on economic outcomes. Pricing that attracts demand for both the currency market and bond market does exist and frankly does not seem wildly far away from current pricing. The economy, both locally and globally, is controlled by policymakers and a wide variety of outcomes could occur in the next year regardless of what levers policymakers pull.

What's normal?

We have written extensively here about what "normal" for assets looks like. It is simply that a private sector investor purchasing a diversified set of financial assets will get roughly 600bp of excess return over cash while experiencing a 10% annualized volatility. Each asset class would need to have a .25 Sharpe ratio to make its contribution to the portfolio return. Currently, no asset class offers that expected Sharpe ratio. In terms of 10Y bond yields, we calculate a 75bp steepening in yield relative to Fed Funds would generate adequate return for investors to generate all the demand necessary to absorb future issuance predicted by policymakers and bipartisan groups. 75bp of increased yield on the 10Y would be a roughly 5% drop in bond prices. We think that is the inevitable path of bonds relative to cash and should happen soon unless substantial intervention to suppress yields occurs.

The "fair value" of currencies relative to hard money and the consumption basket remains somewhat lower than current price in our estimation. If asset returns in a local currency are kept suppressed, the entire pressure will be placed on currency markets. We estimate policymakers continuing to favor "future" would depreciate the four major currencies by 5% against the consumption basket, 10% against Gold, 20% against BTC (with the caveat BTC is still a risk asset) and 5% against CHF. If, however, policymakers allowed bond yields to rise these assets are wildly overbought short term.

What about the economy can fix the spiral?

Disinflationary economic slowdowns or healthy real growth are good for bond markets in general. However, the root cause problem is one of the "Big Debt Cycle" dynamics not the "Normal business cycle" dynamics. The root cause is too much "spot" and "future" money. A disinflationary slowdown would increase the problem as falling nominal tax revenues and deficit increasing stabilizers would increase the money overhang. Rising real growth fueled by productivity and population increase (which realistically can only come from increased legal immigration) is the best medicine. If this economic outcome were to occur, the spiral could be reversed for as long as that impulse continued. We suspect such an outcome would be irresistible to politicians and they may fritter away that successful outcome with tax cuts and/or increased spending, but that outcome is too far in the future for us to realistically assess.

Synthesis

Policymakers have not addressed rising debt and high deficits. Until they pivot, "spot" money and/or "future" money will almost certainly continue to depreciate relative to the consumption basket and stores of value. That trend has largely been seen exclusively in the currency markets due to policymaker actions that have favored short-term issuance to finance deficits, a failure by central banks to change their reinvestment policy and pursue normalization of the composition of their balance sheets, and other policy tweaks to support bond market yields and term premiums, which remain stimulative and abnormal. We would not fade the broad trend but are looking at the policymaker wiggles to determine if being short spot money or future money is the best tactical trade. What seems clear to us is that a short of fiat money - both spot and future, remains a trend unlikely to reverse.

This DSR was not meant to result in immediate action. With new wars breaking out in the Middle East and the events outlined above, we remain at low risk in our book and will adjust positioning as events unfold.

Current Portfolio and Performance

	Assumed Portfolio size	$ 100,000,000					
	LTD P/L	$ 93,402,103					
	Total Return	93.40%		YTD Return in excess of cash		23.34%	
	Today's Date	6/14/2025		Portfolio Created		4/15/2019	
Date	Position	Entry Price	Amount	Worst case loss	MTM	P/L	Open/Closed
4/10/2025	SPX 6/30/2025 4580/4480/4380 Put Butterfly	1.80	1389	$ 250,000	-	$ (250,000)	Live but worthless
4/22/2025	SPX 6/20/2025 5100/4800 Put Spread	63.60	79	$ 500,000	-	$ (500,000)	Live but worthless
5/12/2025	SPX 6/30/2025 5410/5310/5210 Put Butterfly	3.00	833	$ 250,000	-	$ (250,000)	Live but worthless
5/1/2025	SPX 7/18/2025 5600/5100 Put Spread	104.90	188	$ 1,972,120	26.45	$ (1,474,860)	Open
5/1/2025	NDX 7/18/20025 19200/18200 Put Spread	214.70	92	$ 1,975,240	37.70	$ (1,628,400)	Open
5/27/2025	SPX 7/18/2025 5800/5300 Put Spread	65.35	153	$ 1,000,000	48.80	$ (253,252)	Open
6/3/2025	SPX 6/27/2025 5855/5905/5955 Call Butterfly	4.00	2500	$ 1,000,000	4.95	$ 237,500	Open
5/2/2025	SFRZ5 (Sized based on soft stop)	96.42	1600	$ 1,000,000	96.15	$ (1,068,000)	Open
5/9/2025	RX (Bunds) 6/20/2025 129.5/127.5 Put Spread	0.48	1166	$ 559,680	0.05	$ (501,380)	Open
6/12/2025	ZBU5 8/22/2025 112/108 Put Spread	0.94	1067	$ 1,000,000	1.12	$ 191,667	Open
6/4/2025	6JU5 JPYUSD 8/8/2025 .00715/.0074 Call Spread	0.0000600	667	$ 500,000	0.000045	$ (125,000)	Open
5/27/2025	"Sell All Assets" Short SPY	591.15	(21,145)	$ 2,000,000	596.11	$ (104,775)	Open
5/27/2025	"Sell All Assets" Short TLT	85.73	(174,968)		86.32	$ (102,356)	Open
5/27/2025	"Sell All Assets" Short TIP	108.87	(114,816)		108.64	$ 26,982	Open
5/27/2025	"Sell All Assets" Short GLD	304.50	(16,420)		316.32	$ (194,007)	Open
5/27/2025	"Sell All Assets" Short GSG	21.39	(233,732)		23.06	$ (388,697)	Open
			Risk	12.0%		5.62%	