Dispatch #7 – 2021

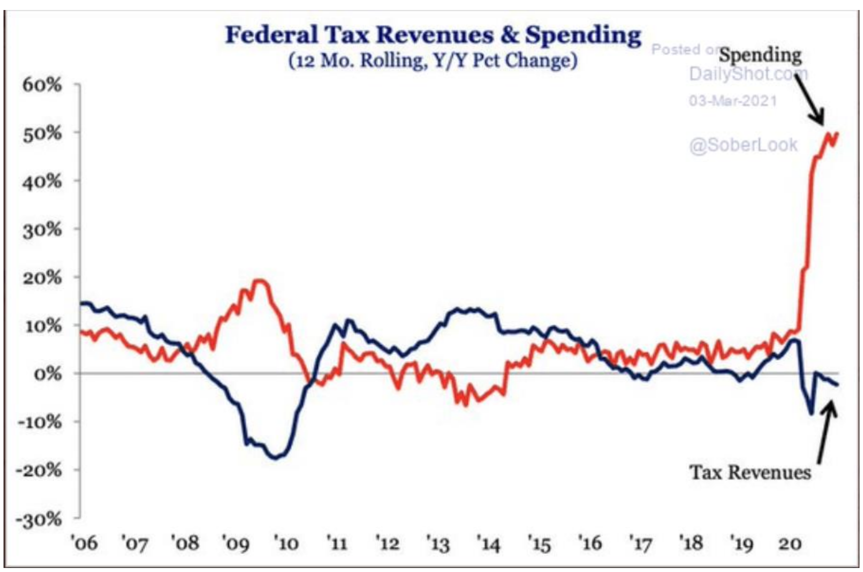
March 5th, 2021

I was hoping to write about something other than yields this week, but the issue isn't going away quietly! If yields rise, it is likely to dominate all asset markets, with the US$ rising along with higher US yields and risks markets selling off. Equity markets did rally on Friday, but note that the 10yr yield only dropped from 1.58% to 1.57% that day. The signs of excess risk-taking has been all around us for months now, so the ingredients for a forceful move are present. This Dispatch **looks more closely at why rates have gone higher and potential further risks to the upside.** The letter also looks at the following:

- Overnight repo rate goes to unprecedented negative yield
- Wall Street banks embrace bitcoin: JPM - 1% allocation & Citi - Bitcoin at tipping point
- Plenty remain bitcoin skeptics
- February bitcoin highlights

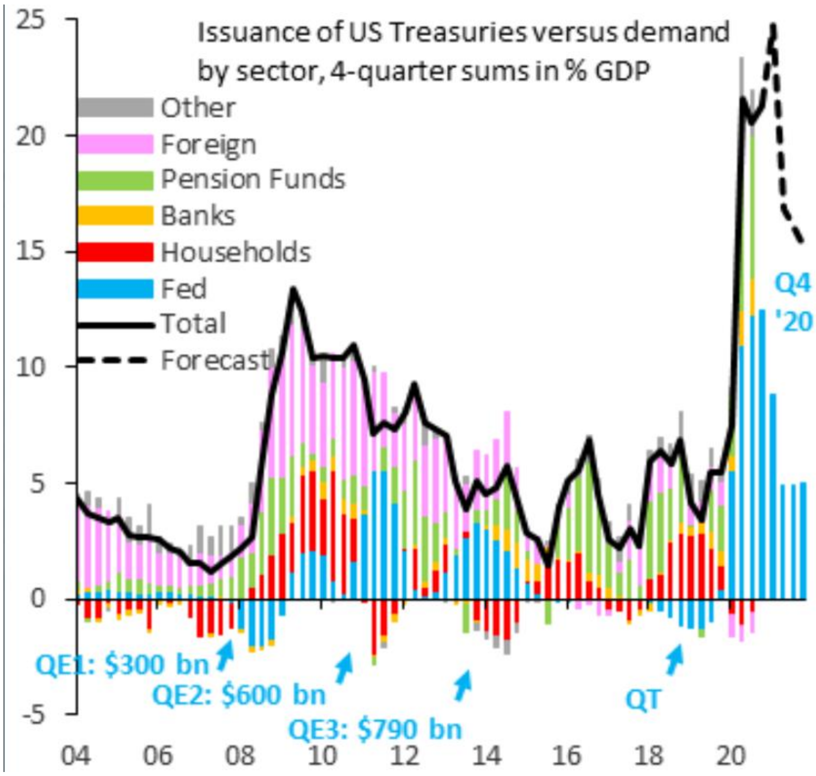
Why have bond yields risen?

The gap between government spending and tax revenue has ballooned and this gap shows no signs of easing. We are close to passing a $1.9trillion stimulus and there's talk of an additional infrastructure bill in the $3trillion+ range.



Source: Lance Roberts of realinvestmentadvice.com

This is driving government bond issuance higher, and the Federal Reserve was the largest buyer of US Treasury bonds in 2020. However, **the gap between debt issuance by the Treasury Department and what the Fed is buying has widened in 2021**. The Fed continues to buy $120bn worth of treasuries and mortgage-backed bonds (called MBS) each month, but as the chart below shows, that's quite a drop off from 2020 levels.

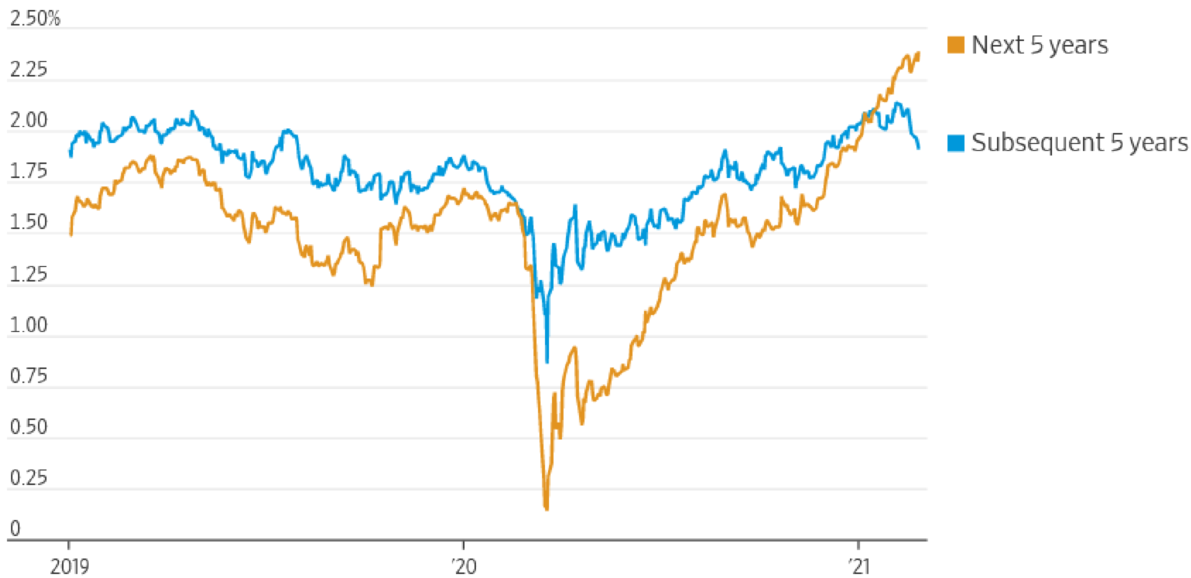


Source: Robin Brooks at the Institute of International Finance:
https://twitter.com/RobinBrooksIIF/status/1367089286764519428?s=20

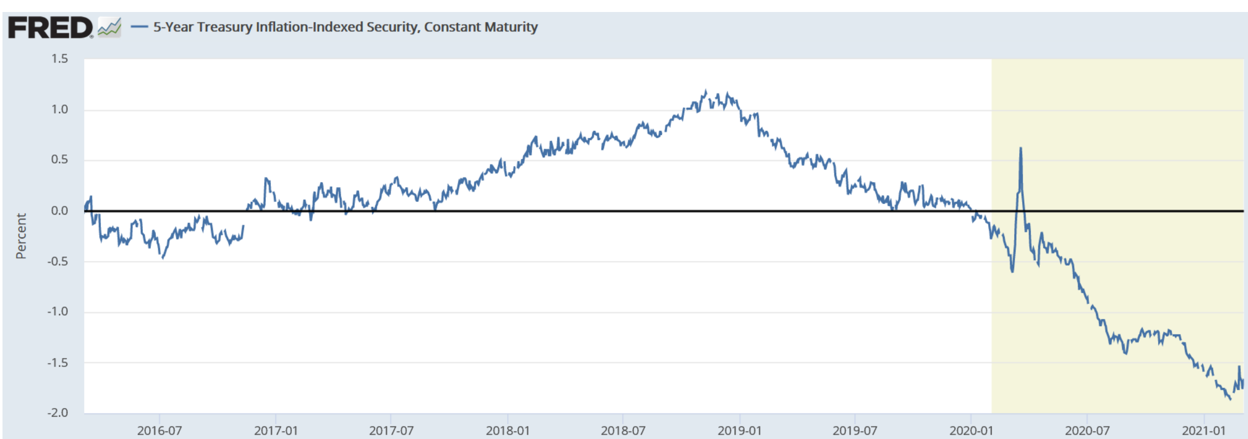
Rising inflation expectations are further troubling fixed-income (aka debt) investors. Inflation, as measured by CPI, remains in check but inflation expectations (more details below) have risen. This WSJ story does a good job of explaining the many facets of the inflation debate.

The following chart from the WSJ illustrate sharp rise in inflation expectations

Future inflation implied by Treasury yields has risen sharply since a plunge in March



Expected inflation is gauged by the yield gap between treasury inflation protected (TIPs) bonds and regular treasury bond yield. The media widely reports on the rising nominal yield of regular treasury bonds. However, much less discussed but equally important are the inflation expectations indicated by the TIPs yield. As the chart below of the 5yr TIPs yield illustrates, the rate has dropped sharply since the pandemic began, and is at -1.66% today.



Source: St Louis Fed

The Fed remains resolute in keeping rates low as the headline from Fed chair below highlights. The headline is based on statements made this week on March 4th. The WSJ article is here

ECONOMY | U.S. ECONOMY

Powell Confirms Fed to Maintain Easy-Money Policies

The real-world implications are coming through as this WSJ headline illustrates. The article is here. Just remember what often matters more is the marginal change of rates/affordability and not the absolute level of rates, which remains low by any historic measure.

MARKETS

30-Year Mortgage Rate Tops 3% for First Time Since July

Rate hits 3.02% after falling for most of 2020. Rising rates have already started to weigh on mortgage applications in recent weeks.

The other real-world reality is that with a total debt of $28tn, higher rates lead to meaningful increase in interest costs. The US also has $7.7tn maturing in 2021, according to this Bloomberg article. A simple way to think about higher rates is that for **each 0.5% increase in rates the interest service goes up by roughly the Navy budget!** (back of the envelop $28tn x 0.5% = $140bn or ~ 20% of the FY2021 base defense budget of $671bn).

As the above example shows, the **US is unable to absorb higher rates and pursue its geopolitical ambitions**. We are therefore quite likely to see Yield Curve Control (YCC), in my opinion. YCC means buying unlimited amounts of government bonds (by printing money) to get the rate to a level that the Fed will determine. YCC is likely to result in a rally in scarce assets with the impact on equities less clear. **SLR (supplemental liquidity ratio)** for banks and **Operation Twist** are two terms we may begin to hear more of in the coming months.

Repo rates go to unprecedented negative levels this week

While the popular narrative is focused on longer term rates increases, the very short dated **overnight lending market is seeing unprecedented stress**. The overnight repurchase rate dropped below negative 3% at points this week, which has many observers worried. The tweet below from a Bloomberg reporter flags the best-case reason – shorting of 10yr treasuries. A worst-case outcome is that the negative rate points to severe liquidity stress in funding markets. This is a complicated and opaque subject for another time.

> **Tracy Alloway**
> @tracyalloway
>
> More weirdness in U.S. Treasury plumbing with the 10-year trading even more special in the repo market and below the fail-to-deliver charge of -3%, which suggests *a lot* of shorts in the cash market.

If you'd like to dig further on the repo market stress, this *ZeroHedge* article from Thursday and this one from Friday go into more details and concerns.

Wall street is quietly embracing bitcoin

Many Investment Banks that were vocal opponents of bitcoin in the past are now writing research on the asset and suggesting it is an investible asset. This week, **JP Morgan suggested a 1% allocation to bitcoin** according to this Fortune story. This follows JPM's 86-page report on bitcoin that was flagged in Dispatch 5.

> "In a multi-asset portfolio, investors can likely add up to 1% of their allocation to cryptocurrencies in order to achieve any efficiency gain in the overall risk-adjusted returns of the portfolio," the investment firm said in a note Wednesday.

Not to be outdone**, Citibank this week published their own 102-page report titled *Bitcoin at a Tipping Point*.** This report is available to download here, which is unusual as Wall Street research is typically not publicly available. So, what does the report say, you ask. Let me present the opening paragraph of the conclusion on page 102 as a hint of the tone of the report Full disclosure – I did not read all 102 pages.

> **Conclusion**
>
> The philosopher Schopenhauer once remarked that "All truth passes through three stages. First it is ridiculed. Second it is violently opposed. Third it is accepted as being self-evident."[188] Though this sentiment was expressed more than 150 years before the emergence of Bitcoin, the introduction and evolution of the cryptocurrency illustrates this very human response to change.

Bitcoin skeptics abound, though

Wall Street may be embracing bitcoin, but it hasn't diminished skeptical commentary from media outlets and public figures. Read this FT article that takes down the Citi report. Yes, the report misquoted basis points into % points on a single point, but the takedown is broader.

And, the tweet below from the NY Attorney General is another example. It's ironic that two NYC HQed banks – Citi and JPM – are coming around to the potential/benefits of bitcoin/crypto and the AG says this.

> **NY AG James**
> @NewYorkStateAG
>
> There are extreme risks in investing in virtual or cryptocurrencies and it's imperative that we act to protect investors' wallets.
>
> I'm warning New Yorkers and investors across the country that investing in this unstable market is not prudent and could cause devastating losses.
>
> 11:54 AM · Mar 1, 2021 · Twitter for iPhone

Widespread skepticism illustrates that we are still early in the adoption curve, which is ultimately what provides upside potential as the network has further to grow. A global monetary asset that is fully adopted should have exceptionally low volatility and low price movement in either direction. That is clearly not the case today.

February bitcoin highlights

FEBRUARY HIGHLIGHTS

- TSLA Buys $1.5bn of Bitcoin on Balance Sheet
- Microstrategy Raises $1.05bn Convert to Buy Bitcoin; Purchases 19,452 Bitcoin at $52,765
- Square Buys $170mm of Bitcoin on Balance Sheet
- Tether Settles Longstanding Case with NYAG for $18.5mm; Does Not Admit Wrongdoing; Agrees to Future Quarterly Audits of Reserves
- BNY Melon to Custody Crypto
- MasterCard to Enable Crypto Purchases for All Merchants
- Bitcoiner Cynthia Lummis Named to Senate Banking Committee
- Former TD Ameritrade Head of Digital Assets Named Fed's Chief Innovation Officer
- BlackRock Begins Buying Bitcoin
- Microstrategy Buys $10mm Bitcoin at $33,810
- Bitcoin Company Casa Raises $4mm Seed Round Led by Fidelity's Avon Ventures
- Deutsche Bank to Offer Crypto Custody and Prime Brokerage
- BlockFi Raises Series D at $2.85bn Valuation
- Dapper Labs Raises $250mm at $2bn Valuation
- Jack Dorsey and Jay-Z Allocate $23.5mm in Bitcoin to Fund Development
- Miami Mayor Activates Bitcoin Across the City, Including Treasury, Employees, Taxes & Fees
- BitPay Card Adds Support for Apple Pay
- Bitfinex Repays $550mm Outstanding Loan from Tether
- Ruffer Sells $750mm of Bitcoin After Original $740mm Position Doubles in Two Months

Important Disclosures