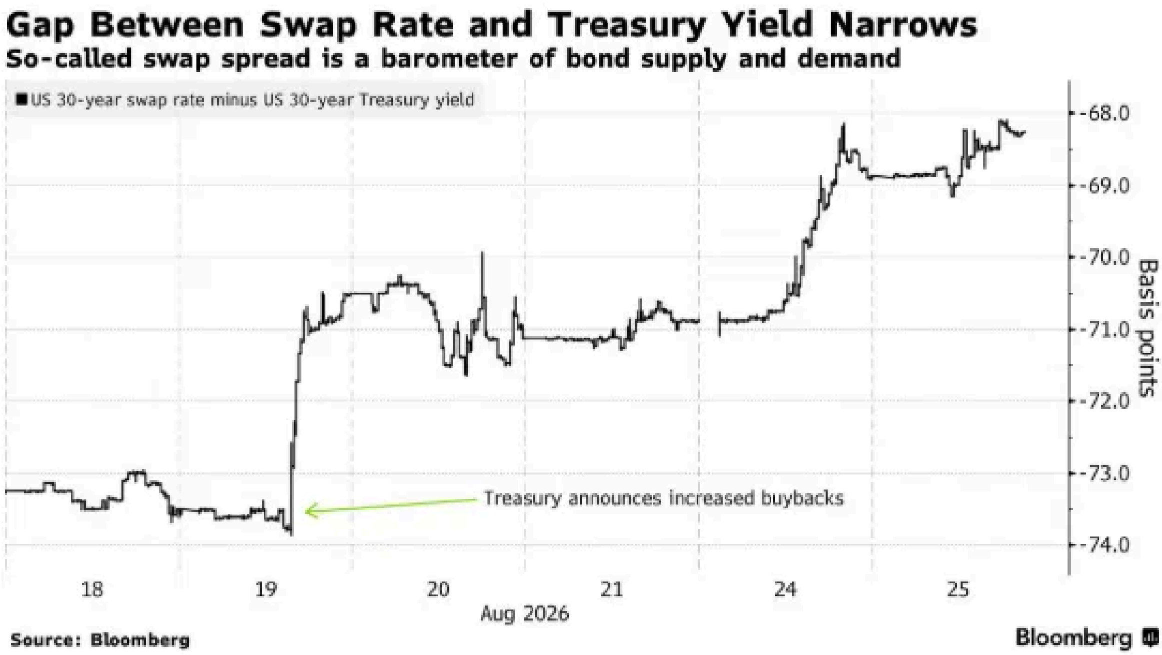
MACRO UPDATE (THE FED'S FISCAL BACKDROP)

You know, sometimes I do wonder if I should actually do the math and see if I spent more time on macro related research this year than all previous years combined, because it certainly feels that way. After extensively covering the macro drivers, bond market and other prevailing macro related circumstances in two seperate updates and the previous newsletter respectively, there is still more to cover as Jackson Hole is underway. It's not just the data coming in from a bunch of policy makers meeting in what is honestly a pretty stunning location, as there is more to discuss and don't worry, this time I go pictures to go with it folks!

That is enough rambling from my side, time to dive in and what better way to start than with a look at the UST market. Given I already extensively covered the workings of the UST market, current state of global bond markets and how it all ties together, I won't go all broken record again and have this piece act as another one of my melatonin macro supplements, so let's get right to the point. Please keep in mind I am writing some of this on Wednesday and Thursday (today, Friday, is for the Jackson Hole data), so I might be a few basis points off here and there, but the 30-year has come down roughly 14 basis points since I last wrote to you about the bond market and I would not spend a minute celebrating it. It trades near 5.17% now, with the 10-year around 4.64% after tagging 4.75% late last week, its highest since early 2025. Lower is lower, sure. The deficit did not improve though. No new buyer appeared for 30-year paper. Inflation did not roll over either folks. The Treasury announced it would start buying its own bonds in size and the market decided that was good enough for now. A bit over a week ago the Treasury said it would at least double its liquidity support buybacks in the 10 to 20 year and 20 to 30 year sectors, taking the maximum from $2 billion per operation to at least $4 billion, effective early September and running through the current refunding quarter. The 10-year closed down almost 6 basis points on the news and the 30-year down 9. Then it faded and inside of 2 sessions the 30-year was back above 5.27% and the whole move had been handed back, because $4 billion an operation against $2.1 trillion of deficit financing is a rounding error dressed up as a rescue. Then came the reporting that the purchases could be funded straight out of the General Account, the roughly $950 billion of cash the Treasury parks at the Fed. Bessent has taken to calling it a "Treasury Twist", which is wonderful branding for something that historically required a central bank to execute, I got to give him that. Oh and before I forget, he can bolster the TGA with higher gold prices as well and I think gold may be feeling that.



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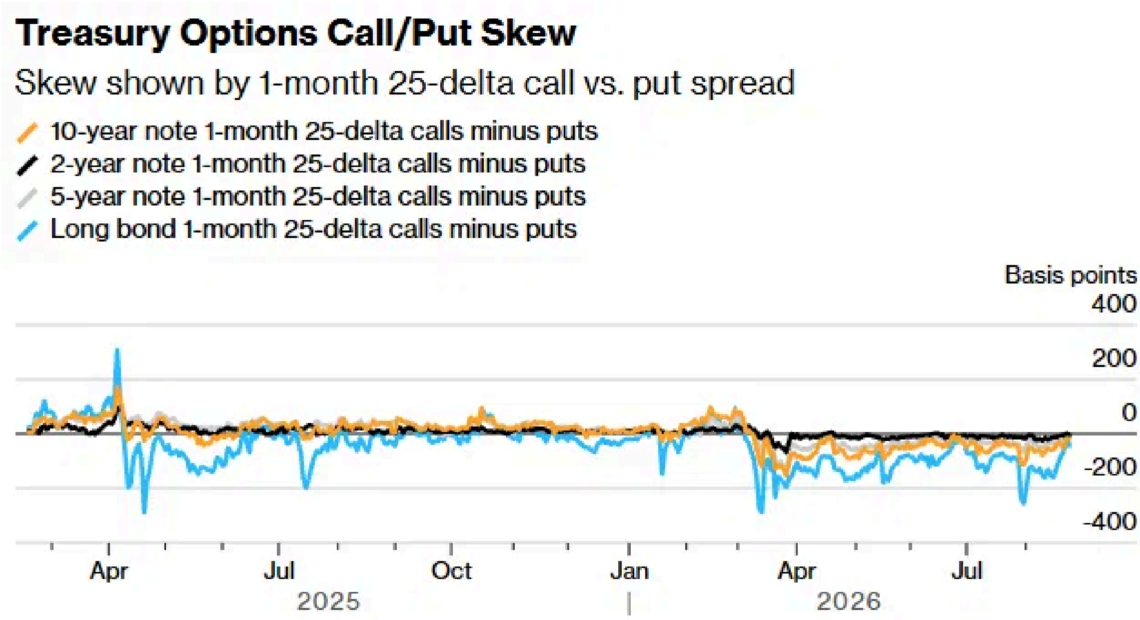
Alright time for some more numbers as treasuries have outperformed equivalent maturity swaps since the announcement and the 30-year gap between the two narrowed to its tightest since February. A swap spread is a rough read on how willing investors are to hold actual government paper instead of a derivative carrying the same rate exposure, and years of ballooning supply had pushed Treasury yields well above swap rates. Hedge fund positioning in that trade hit something like $305 billion last year against under $50 billion in 2022, so there is real money leaning on the answer to be fair. The narrowing prices in some probability that the buybacks get raised again, and again, and again. A backstop, if you will, a light one, but a backstop.



Calls on long bond futures have run up sharply against puts over the past week while the skews on shorter maturities have stayed near the neutral levels they have held for months. The fear has inverted and a couple of weeks back it was yields grinding higher without end, and now it is being caught short into an intervention.

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A trend following simulation from one of the larger liquidity providers puts ultra-long-end fixed income at a z-score of -2.28, the most stretched short reading in a sample going back to the start of 2024. That same desk was warning about a cruel summer for bond investors about a month ago and has flipped constructive, arguing further declines trigger only limited additional selling while a sustained rally forces the shorts to cover. Their cross-asset model apparently finds 64 comparable episodes since 2003 where yields fell 71% of the time over the following 120 days, average decline 25 basis points. Meaningful, sure, but a crowded short describes who owns what today and says nothing about who funds $2.1 trillion next year. I would rather not be short duration into a squeeze. Basic English conclusion, the structural problem is untouched either way.

Investment grade issuance has run close to $1.5 trillion so far this year, up something like 36% year over year and on pace to eclipse the 2020 record. The biggest technology borrowers alone account for roughly $200 billion of that, about 25% of the Treasury's net note and bond issuance to private investors and around 5 times what the same group did last year. A single multi-tranche deal printed near $53 billion. Somebody sold a century bond. 100 years of duration, into this. Hyperscaler capex is projected near $800 billion this year and above $1 trillion annually from 2027, with full year AI-related issuance estimated somewhere between $300 billion and $570 billion. One estimate puts roughly 30 basis points of this year's move in the 10-year on corporate and mortgage supply combined. So the term premium thesis picks up a second engine it would appear. Sovereign supply meeting a shrinking pool of price-insensitive buyers was always the core of it folks.

As a reminder for the people in the back, toward the end of last month the Treasury bought yen alongside Japan's Ministry of Finance, the first joint operation of its type since 1998, and funded the purchase by selling euros rather than dollars, sparing anyone from having to liquidate Treasuries into a market that was already choking. Days later Bessent publicly asked the Fed to upsize the FIMA repo facility, the $60 billion per counterparty line that lets foreign official institutions pledge Treasuries for dollars instead of selling them. Japan holds around $1.1 trillion of Treasuries and its recent intervention is estimated at $60 billion to $80 billion, so the existing cap runs straight into the constraint. Every element of that architecture is engineered around one objective, making sure nobody has to sell a Treasury. Expanding FIMA requires an FOMC vote, which puts a Treasury Secretary in the position of publicly asking the central bank to resize its own balance sheet in service of an allied government's exchange rate policy, right into the new Chair's first Jackson Hole address. Does that sound like an independent central bank to you? That is fiscal dominance at work.

Core PCE came in at 0.2% on the month and 3.3% on the year, in line, while headline ran 0.2% and 3.7%, a touch hot. That is the 65th consecutive month above the 2% target. 65 months. Remind me what the target is for again? The policy rate has been parked at 3.50% to 3.75% for 5 meetings, 3 regional presidents dissented in favor of hiking in July, and futures have a September hike somewhere in the 36% to 40% range with a hike still live into year-end. Cuts are not on the menu at all, which is a strange sentence to write given where the long end has been trading. The energy component of the July PCE fell 1.5%, so the crude move is not in this print just yet as it lands in the August and September data instead. Warsh spoke today, his first Jackson Hole as Chair. He said nothing usable after the July meeting and the long end filled the silence by itself, which is precisely how we got to 5.31%. Nothing stops that repeating, but it does depent on what Jackson Hole brings and guess what, I got you covered on that front, but there are a few things we need to tackle first.

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Starting with the geopolitical front, because whether we like it or not it all comes in the same macro package. It appears that 50% tariffs are now live on somewhere between $20 billion and $28 billion of Canadian goods depending on which report you trust, with Canada matching dollar for dollar from the second week of September and Carney using the word war out loud. This is a relationship carrying close to $900 billion of two-way trade, roughly $426 billion of US exports and $454 billion of imports. A framework existed as far as I was able to tell. Metals producers ran a pressure campaign against the tariff relief, Commerce ran a parallel negotiating channel alongside the trade representative's office, the auto concession narrowed from all vehicles to light vehicles only and put a GM plant and a Ford plant in Ontario (or is that called America now as well? Or is that just the lake?) in the firing line and the Canadians walked. Buried in the wreckage is a package that reportedly covered critical minerals, aerospace and export controls. Correct me if I'm wrong here, but I struggle to construct a path where you run 50% tariffs in both directions against your largest trading partner and get a disinflationary outcome out the other end, into a Fed that already has a hike priced and 65 months of above-target inflation on the board. See how this all ties together? Not great folks, not great.

I'm very sorry for dragging you all through another ~6 pages of macro analysis, but it's important for the whole picture, so time for just a bit more geopolitical before we arrive at Jackson Hole. Treasury promised an economic onslaught against Iran's financial connections, rolled out dozens of designations and then threatened secondary sanctions against anyone still trading with Tehran. China buys something like 90% of Iran's oil, so any serious version of this runs through Chinese firms and eventually Chinese banks, weeks before Trump and Xi are supposed to meet next month. Beijing has already warned it will take all necessary measures to protect its interests. The retaliation lever I would watch is a fresh round of critical minerals export restrictions, because that is the pressure point Beijing reaches for every time it gets squeezed and there is no reason to think it has found a better one. For now the market read the package as softer than feared, noted the trading partners were spared, but if that changes and new sanctions arrive that can really mess with the market.

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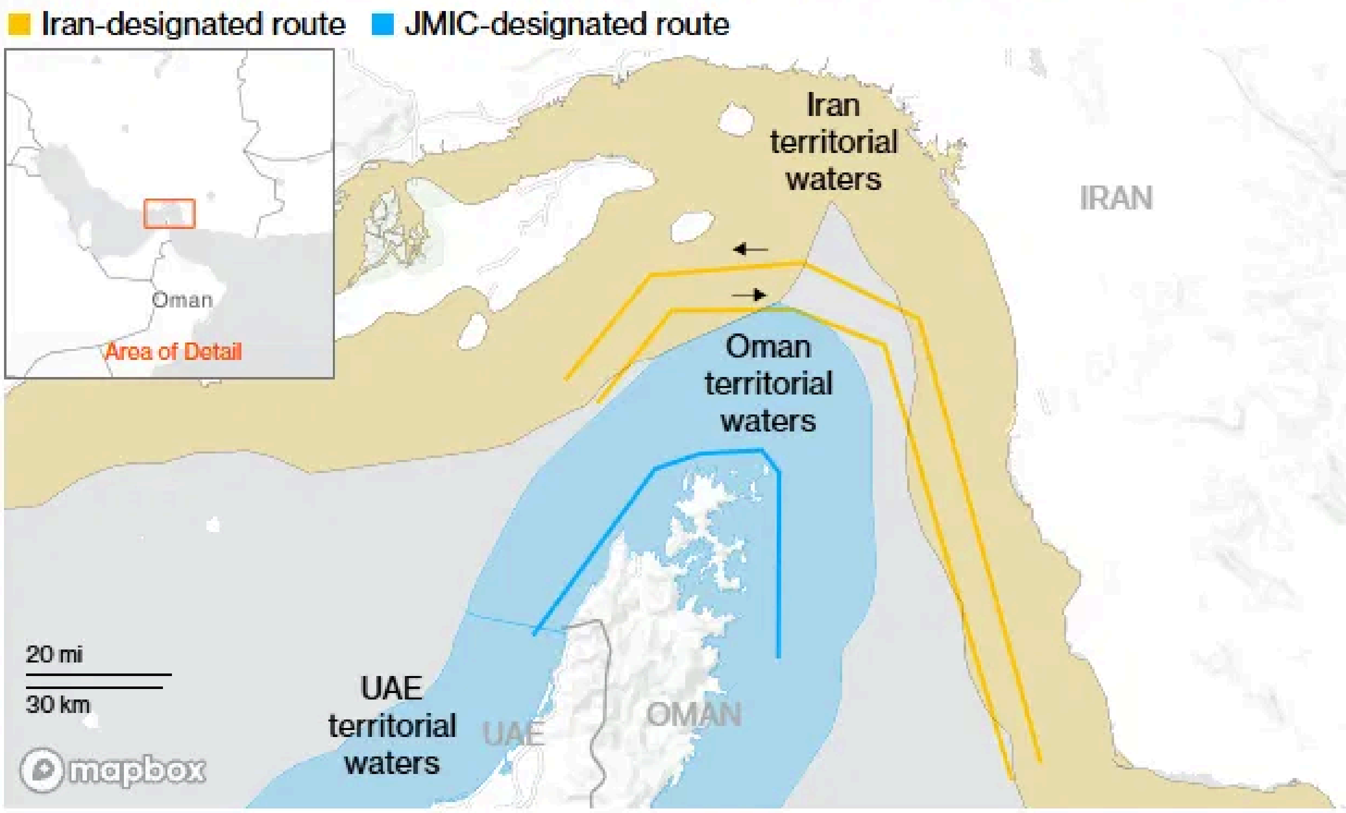
The IRGC says a revenue-sharing agreement has been reached with Oman covering each country's share of the strait's waters and the fees. Both foreign ministries were considerably more careful, describing an interim framework for resuming transits and declining to confirm anything about money. Iran has designated one corridor running through its own waters and the western naval coordination group another running south through Omani waters, which is the whole dispute drawn on a map. Trump says the mines are gone, the strait is open and 10 million barrels made the passage in a single day. The head of the IMO said last week the strait is not open and there is no confirmation the mines were cleared. I do have some more thoughts on Hormuz traffic for the next newsletter report, so stay tuned for that, as it may be very surprising to some.

Tehran says only its own officials know where the explosives were placed. Take your pick, and all that jazz, because it's another case of mixed messaging olympics from everyone involved. The EIA does not expect Middle East production near pre-conflict levels until early 2027. Tehran still wants sanctions lifted, the blockade ended and its assets unfrozen, none of which Washington has shown the slightest sign of conceding just yet. So the risk premium has deflated on a framework nobody has signed, that would not reopen the waterway by itself, and that depends on concessions nobody has agreed to make. The way I see it that optionality is being sold far too cheaply here and I want to see more confirmation on shipping volumes (again, more on that in the next newsletter) and diplomacy before more positioning action will be undertaken.

Hormuz Transit Routes Emerge

Iran and a key western naval group have proposed one corridor each



Note: Territorial waters extend at most 12 nautical miles from a country's coast or internal waters.
Sources: Joint Maritime Information Center, Persian Gulf Strait Authority, Flanders Marine Institute

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And finally, after 5 pages of me rambling about macro once again, time to discuss the Fed at Jackson Hole. I will try my best to make sure it all fits on one page so everyone can get back to their day. Warsh gave no timetable, no forward guidance and no reaction function, which will have surprised nobody who has watched him operate since May. The Fed will "have work to do" if it cannot be confident inflation is heading to 2% clearly and at sufficient speed, and price stability is the "predominant focus" right now. He called the 2% target firm and fixed, said the summer inflation data came in better than expected while the underlying trend has not meaningfully improved, and put progress over the past 2 years at modest. The 2-year sold off 7 to 9 basis points to around 4.30%, its highest in a month. September hike odds went from about 35% before he opened his mouth to 46%, then above 50% inside the hour.

What about the price action? Well, pretty all over the place if you ask me. The dollar index added roughly 0.55% to just under 99.7. Equities barely moved, the Dow up a couple of tenths and the Nasdaq flipping either side of flat all morning. Gold slipped toward $4,500 going in and stayed heavy on the way out and is still weak as I am writing this. Look at what did not move though and you will sort of get the ‘all over the place’ comment. The 30-year finished roughly flat near 5.16%, the 10-year barely budged around 4.67%, and the entire repricing happened inside 2 years. A hawkish Chair delivered a hawkish speech, mentioning the word ‘hike’ like 5 times in the first 10 minutes, and the long end shrugged at him. The market has fully separated the policy rate from the term premium, which is the argument I have been making a lot over the past year. Warsh confirmed the separation himself as well, as those who listened to the speech will have taken note of.

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Short-term interest rates remain the Fed's main policy tool. The task force recommendations will have no bearing on current policy decisions. Market signals should stay "as unfiltered as possible". Not one word about the buybacks, not one word about FIMA, not one word about the long end. Asked implicitly whether the Fed intends to participate in the Treasury's operation, he answered by declining to acknowledge that the operation exists. So he is neither joining it nor standing in front of it and Bessent gets to keep running the long end by himself with a $4 billion hose and a checking account. What an operation you have going there guys, this sure helps clear some of the uncertainty... Worth noting is that he noted that financial conditions are hard to describe as restrictive, credit and loan markets show few signs of policy restraint, business investment is rising rapidly and the economy appears to strengthen. Set that against a Treasury that has spent the past 2 weeks deliberately easing financial conditions at the long end and at the same time forcing me to write one massive macro update after another (thanks Scott). Both arms of policy pulling in opposite directions with the Chair pointing it out and declining to name the culprit. It may just be me, but that doesn't strike me as a stable arrangement for very long. He also argued that the potential for substantially higher growth is on the rise because of AI, which was to be expected. That is the grow-our-way-out-of-it argument, the same one Bessent and Trump have been running on the debt, now coming out of the Fed (nothing stops this train). A Chair reaching for productivity optimism to square a 3.7% headline print against an economy he describes as strong ends up mattering for the fiscal side whether he intends to or not. Now, where have we heard that one before?

Bessent has skewed issuance hard toward bills and the front end, which I flagged for you when the refunding math first turned. If Warsh hikes in September, the government's own funding cost rises immediately across the largest and fastest-repricing part of the stack. Tightening the short rate is mechanically expensive for a Treasury that has parked itself there on purpose. Layer on 50% tariffs running in both directions with Canada and an energy component that has not passed through yet and the hike gets uncomfortable real quick. He is right that inflation expectations tend to look durable until they don't. He is also boxed in by an issuer who needs him not to move, at least the way I see it. Warsh told us he will manage the short rate and let the long end fend for itself, which leaves the release valve precisely where it has been all along with USD written all over it and for those who have been reading my work for... any amount of time, that is what I expected too.

The market wanted Warsh to say who controls the long end. He told it nobody at the Fed does. Which brings us to what is next, as the next 3 weeks hand us a rate decision that is close to a coin flip (52% for September and 56% for October as I am writing the final part of this), 50% tariffs running in both directions with Canada, a Hormuz framework nobody has signed and a Treasury managing the long end on its own. Any one of those can produce a violent 2 or 3 day move in either direction and I have no interest in pretending I know which one goes first. So the 10% to 20% cash position still makes sense to me here. Cash in a regime like this, with literally everything being so uncertain, one is optionality on somebody else's forced selling and forced selling turns up in our sectors with some regularity and especially as you can see today across the commodities space with the USD strengthening. It also lets the gold asset core stay untouched when the front end reprices and the metals go heavy for a week, which tends to be the exact moment people sell the thing they should be adding to. The right number is not the same for everyone though. Remember your sleeping level. If 20% is what stops you checking prices at midnight, hold 20%. If 10% keeps you calm and fully engaged, hold 10%. That 10-20% range at this time is a healthy one and we can reassess in 3 weeks. Until then though, I hope this was informative and that you have a good and healthy rest of your weekend! ~Mart

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