Andy:	**00:01:44**	Shhh. Hey, guys. Quiet.
Adam:	**00:01:47**	Yep, you're right. We'll try to be more quiet, Andy. Just kidding. Welcome, Andy Constan and welcome to everyone who's joining us to this Friday's Riffs. Bearing the lead, we've got Andy Constan here today. And probably, Mike, you should do your spiel before we get started.
Mike:	**00:02:08**	Well, yeah, first of all, cheers.
Adam:	**00:02:10**	Cheers.
Mike:	**00:02:12**	Happy Friday, everybody. And as always, this is not investment advice. We don't know your personal situations, and so we're just going to have a wonderful wide ranging, sometimes deep, and hopefully, very interesting conversation. And that is your warning not to take investment advice from three dudes on a YouTube channel at four o'clock on Friday. I think we've got that wrapped.
Adam:	**00:02:37**	Exactly. So, with that said, welcome, Andy. And thank you so much for coming on the show.
Andy:	**00:02:43**	Thanks for having me. Looking forward to it.
Adam:	**00:02:47**	Yeah. Actually, I've been really looking forward to this episode because I've been following your feed on Twitter for some time. And I have poked through some of your *Damped Spring* commentaries, which are great. And I think you bring a really novel framework to how to think about markets, especially on sort of a trader's timeline. So, I definitely want to get into some of the details of that. But before we do, how I would really like to sort of start this conversation is for maybe, you can kind of hit the major headlines of your career arc. And then I want to maybe stop at each point on the journey and dig into some of the lessons, experiences and wisdom that you gleaned from each of those stops. But maybe let's outline the stops and then we can go one by one.

Backgrounder

Andy:	**00:03:37**	Sure. Briefly, I spent 17 years at Salomon Brothers in equity, equity derivatives and convertible bond trading. Started in 86 and left in 2003. At the time, I was running the global equity derivatives franchise for what had become Citigroup. And I decided to start my own hedge fund with a couple of Salomon fixed income traders. At the time my specialty was equity relative value, convertible bonds, capital structure arbitrage, risk arbitrage, and volatility trading across many different dimensions. And so I brought that to my hedge fund. We launched, my partner's all did various forms of fixed income, arbitrage, relative value and vol and mortgages and credit and government bond arb. And after four years, the partnership didn't survive, but the firm did fairly well. Thankfully, it didn't -- we

got lucky, actually, and that it didn't survive before the financial crisis. We were out of business and the money had been returned to our investors before the financial crisis.

But, half of us wanted to carry on with a better partnership. And so we created a new fund and our largest investor seeded that. And we had the objective of doing exactly what we had been doing at our prior fund, but our timing was terrible. We started fundraising in the summer of 2007. And by November, we had hardly put any money to work. By November, we weren't getting a single meeting, because people were in the midst of redeeming from the financial crisis, the beginnings of the financial crisis.

So, I missed the financial crisis, I was managing my own money and looking for the next thing to do. And what I had noticed throughout my career, both as a sell-side trader and risk taker, and as a hedge fund manager, that RV looked like beta when markets were under stress. So, whether that was 94 where mortgage arbitrage blew up creating a whole crisis in all RV trading strategies, to 98 when Long-Term Capital blew up and did a similar thing. And then the financial crisis where some major opportunities and relative value just got completely trashed and had to be unwound.

So, I realized, looking at RV, that I really needed to understand how macro worked. And so thankfully, I was able to get a job at what I think is the premier shop in terms of understanding how the world works. They're not always right, but their thinking is just phenomenal. And so I spent a little over three years at Bridgewater Associates. And then after that, we did -- I did well there, it was incredibly hard work, and the culture is a challenge. To make it three years as an outside hire is extremely rare. But I did move on, and started at Brevan Howard. And Brevan Howard was, also Alan is one of the great macro thinkers of his time. And joining him, I got to see a completely different way of approaching macro, which if you guys want to come back to on both, that difference, we can talk about that.

Adam: **00:07:38** We definitely do. Yeah.

Andy: **00:07:40** But that lasted about three years. Alan's fund, unfortunately, during the time had seen a lot of redemption. And so by the time I left, the staff had, in New York where I was located, had fallen from 50 to 3. And so Alan generously helped me start Damped Spring and is still a major client of mine, providing what I had been doing for him, which was what I would broadly call his macro strategy for his portfolio managers. I provided that for him as a third party research that he helps startup for me. And now I have a wide range of clients.

And then, I guess about a year ago, I started levering what I was thinking about markets into the occasional Tweet. And somehow my voice struck a chord with an audience and I enjoyed it, I enjoyed the process. And I started interacting with people who I never, ever would have known. And now they know me via my Twitter handle, not personally, but we have great conversations in front of everybody about what's going on in the markets. And thankfully my following has grown to about 36,000, and it's been a great journey. And so some of those people have now become clients as well.

Bridgewater and Macro Information

Adam: **00:09:05** Yeah, that's a tremendous story. So, if you don't mind, I want to pick up at your time at Bridgewater as kind of a place to start. And so what I'd love to do is dig into the sort of base level framework that Bridgewater used to think about macro and think about investing using macro information. And then I want to do the same thing for Brevan Howard, and then it would be great if we could try to sort of pull together some common threads from both of those experiences and then maybe that'll help lead us into how that informs some of what you currently do. So, maybe let's start with Bridgewater and what you learned there.

Andy: **00:09:55** Sure. So, everything. Bridgewater was just an incredible education. They spent a tremendous amount of resources at all levels, including Ray and Greg and Bob, the CIOs in teaching and explaining and reviewing and testing everyone's understanding of their framework, and also challenge, so that they can get challenged on their framework. The one thing I would say about Bridgewater, it's a firm that is extremely committed to marginally improving their process at every moment. So, every moment of everyone's work time at Bridgewater is about making the system better. And so when you said, what's their framework? Well it's constantly evolving. And it needs to, to keep up with the competition. This is a highly competitive market, where alpha is very hard to get to begin with. And so …

Adam: **00:11:03** Especially at scale.

Andy: **00:11:04** Right. And then you take into account that they, if they want to shift from 100% long bonds to 100% short bonds, for some reason, they have to sell 150 billion bonds.

Mike: **00:11:18** That's a lot of bonds.

Andy: **00:11:20** Which is a lot of bonds to move, and doesn't take. It takes you know, QT is about reducing bond purchases by 50 billion, they're going to do that over a month. So, you can see that there's some serious issues around alpha at that scale and the horizon. One has to find that alpha. And again, I think at every level from how they execute the next tick of the next 10-lot of futures that they're buying to the highest level issues around portfolio construction and signals, directional signals, and macro-economic data, that whole canvas is constantly being worked on.

Adam: **00:12:10**

Right. And Ray is famous for his breaking down the investment portfolio into kind of a diversified risk premia portfolio, which he calls *All Weather* and others have since sort of adopted this idea of Global Risk Parity, and an Alpha Portfolio. And I remember at some point around 2011-2012, he brought the two together and called it the *Optimal Portfolio*. Right? So, what is the basis of his kind of, the thinking behind his beta portfolio? And then maybe we'll get into some of the data that Bridgewater has got a close eye on, for example, to inform their macro trading. But let's start with the beta first.

Andy: **00:13:00**

Sure. I wanted to just say that, the *Optimal Portfolio*, I left in 2013, and it hadn't been invented yet, so I'm not -- I have no understanding of what that is. I could guess, but it's not my thing. But in terms of -- the one thing that Bridgewater really focuses on is making sure that investors are paying for alpha and not paying for beta. And so they have two products. One that is literally defined as pure alpha, and the other is their beta product, which is, as you mentioned, their *All Weather* product, and what they -- that's very important to them, that they separate those two, because beta is just market exposure. There's good beta and bad beta and how you choose to express market exposure. You know, there's lots of different opinions on how that can work, and what's the best way to do it.

But in the end of the day, it's market exposure over time, that pays you a risk premium that you collect. And so whatever your form of beta is, anyone can do it, you just have to buy stuff and then hold it. And that shouldn't -- you shouldn't pay for that. Bridgewater has an in-basis-points fee, for its *All Weather* exposures. It's a bit sophisticated, but nonetheless, it is that. It is just trying to own assets and collect risk premium.

Alpha is a completely different thing. Ignoring for the moment, non-economic players who participate in markets, alpha is only gotten by taking somebody else's money. You can't get alpha from the market. You have to get alpha from someone and that person has negative alpha. And so it's a zero sum game. And I mentioned that there are some non-economic players out there that perhaps provide alpha, like the Federal Reserve and currency intervention and a variety of other, not directly. Well, let's just say this, these players are in the market, participating in the pricing of assets, buying and selling assets. But their objective isn't to make P&L, their objective is to make larger economic effects. So, …

Adam: **00:15:37**

Yeah. They're trying to achieve political objectives. And they don't … short-term losses.

Andy: **00:15:43** Right. And so they can provide alpha, but in the end, it's taking from somebody else and that person is really smart and trying to eat your lunch just as much as you're trying to eat theirs. And so staying ahead of the game is the game.

Adam: **00:16:02** Do you think … yeah, yeah, exactly. I always wonder because a lot of people write newsletters, I know you do too. A lot of people do their own homework and have their own personal investment frameworks. They try to run money themselves. They don't just invest directly in betas. They're not just seeking balance and diversity, like an *All Weather* portfolio, but they're trying to pick stocks. What kind of chances do you think a typical individual investor has to generate alpha in markets?

Andy: **00:16:39** So, I guess what I would say is this: passive index strategies, or even passive buy and hold strategies. I'm a John Bogle type. I believe that the best way to own passive is passive because you're not paying transaction costs. And so if you layer in transaction costs into active managers who are saying I'm going to buy this stock because it's cheap, which by the way, is a form of alpha, if they are correct, when they buy a stock, and they sell another stock. And they outperform for alpha reasons, not just because the long happens to be leveraged and the market goes up or other things that are just easy to do. You'll find, I think the history says, that active management underperforms principally because they pay transaction costs. So, let's start with that.

And these are professional money managers. Individual investors pay higher transaction costs. Right. I guess what I would say is that it would be very hard for me to have confidence, if I was sitting as an individual investor, knowing as much as some of them appear to know, I would think it would be extremely hard to generate consistent alpha through time after transaction costs. And with, you know, this is a complex market, and always has been. And so given what performance of professional money managers as alpha generators, the odds are stacked heavily against everyone. And more so the more transaction costs and the less understandings you have.

Adam: **00:18:47** Yeah, I mean, to your point about Bridgewater being one of the most sophisticated institutions of the world, dedicating hundreds of 1000s of man hours a year to incrementally improve their investment process and these are the very entities and agents that you're competing against, right, in the market.

Andy: **00:19:06** Yeah. I mean, if they have a .8 Sharpe ratio on a particular strategy, which is a measure of your return versus risk, it's a home run for the year, if that's a meaningful, let's say bonds. And they can improve that ratio from .8 to .83, that's a Grand Slam for the firm. Not only does it help them this year, but it helps them for the rest of their existence until it decays back to lower numbers. So, they really invest in their improvement of their long term alpha.

Structuring the Beta Side

Mike: **00:19:45**

So, can we just, I want to pull on this thread about the beta and sort of the Boglehead side of things and… okay, so we're going to be passive with some set of assets. But what we often observe is that that pacificity is a function of recency bias. And if we look now, you see this great predominance of US 60/40, which was not the case back in the mid 00s. It was a case of making sure you had maximum exposure across emerging markets and commodities.

So, I mean, I guess there's… how do you conceive or what advice do you have for those who are trying to construct a beta with respect to how are they going to stick with it through the thick and thin of underperformance vis-a vis, some behavioral benchmark that they have? I mean, that's a really hard situation to address. And it's not just retail. I mean, we're seeing that institutionally, that institutions have been caught fairly flat-footed here with this inflationary impulse, and have all but left their commodity exposures in the dust years ago. So, is it -- how do you think through that when you're thinking about the beta side of it, or what advice would you give those out there?

Andy: **00:21:08**

Well, so I think you have to start with this basic assumption that all that and this is -- I'm not going to be theoretical at all. Let's just say that all assets are fairly priced right this second. And then you say, how are those assets going to behave in all scenarios? And then you weight your asset allocation based on those, and you …

Adam: **00:21:39**

So, what assets are you considering, Andy? Just to pull a little bit deeper.

Andy: **00:21:42**

Well, I mean, I think Bridgewater has a great box diagram for how they consider asset allocation for *All Weather*. I like those two dimensions, I think those are really the only two dimensions, which are growth expectations rising or falling, and inflation expectations rising or falling. And that's basic framework, I think, for everyone that does macro, but I think it's right. And the 60/40 box exposure, for instance, is just for one, heavily pro-growth and really misses inflation exposure. And so not surprising, that portfolio has massively underperformed. Listen, no portfolio of long assets has done well this year. And there's a reason for that which we can come back to. But 60/40's done a lot worse than a balanced beta portfolio.

And I read Harry Brown's book about "inflation proofing your portfolio", which I think was written in the late 70s, early 80s. You know, he was really the first one to have a sort of all-weather framework from back then, and now it's much more common. I think Bridgewater is still the number one in it, but much more common. And it's also, I think, a little bit trendy now because people are recognizing they need exposure to gold, exposure to commodities, exposure to

TIPS, inflation protected bonds instead of just … loans and nominals, corporates and equities.

Adam: **00:23:35** Yeah. One thing that a lot of people get wrong, I think is… Sorry, Andy. Keep going. Yeah.

Andy: **00:23:39** That actually might be squeezing some of the prices of various inflation, pro inflation assets up a little bit, and that actually might be an alpha opportunity, as flows are chasing that type of investment as they de-lever the 60/40. But those are short-term alpha-type ideas. Longer term, the way I do it is I go and look at how my portfolio is going to behave in many, many different environments, and weight it accordingly.

Adam: **00:24:17** I wanted to talk about the inflation linked bonds for a minute because my understanding is that Bridgewater doesn't just invest directly in TIPS but they invest in *break-evens.* Right. So, it's not just a long TIPS portfolio, but their inflation hedge is a long *break-evens* portfolio. Right. So, long TIPS, short nominals. Is that right?

Andy: **00:24:37** Yeah. So, I guess what I would say is, I know way more than I can let on.

Adam: **00:24:43** Oh, okay. Fair enough. No, that's totally fine.

Andy: **00:24:44** I would also say that. Bridgewater is really focused on that 75, I don't know what they're on now, $75 billion of alpha, they're really focused on liquidity. And I would say the break-even market is not liquid.

Adam: **00:25:00** Right. Gotcha. So, yeah. I mean, you can achieve these with inflation swaps and these different sorts of derivatives and so forth.

Andy: **00:25:09** And derivatives. You know, it's an interesting thing. Where liquidity is, people think the derivatives market adds liquidity. It conceptually really doesn't. We can come back to why I think that. But you look at just regular nominal bonds, nominal bonds, nominal bond futures, and nominal and interest rate swaps all are giving you exposure to Treasury bonds, essentially. Interest rate swaps have a little other component to it. But you can't add those three things up and see what the total quantity or volume or however you want to measure liquidity, you can't add all three of those things up and get the total liquidity, it just doesn't work that way. It's a fraction of the sum. And so Bridgewater is very conscious, as I think most of the big houses are very conscious of where real liquidity is versus going into the swaps market, for instance, and expecting your experience is going to be different than the bond futures.

Adam: **00:26:14** Well, yeah. I mean, I guess your counterparties can take on some basis risk and try to lay off risk in other different liquid markets and stuff. But in the end you're taking risk in one direction or another, you're taking basis risk or you're taking liquidity risk, and there's no getting rid of it.

The Fed and "The Balance Sheet"

Yeah. I also want to -- you said that we could come back to why this environment has been, has sort of deflated all risky assets and how it's been impossible for a diversified long only portfolio to preserve returns this year. And I think it's worthwhile visiting this idea as well. So, maybe walk us through how that works.

Andy: **00:26:54** Yeah. I mean, I think that's by far the most important thing that's been going on. On December 15th, Jay Powell had a short phrase in his press conference after the Fed meeting of that day, and mentioned that they're looking at the balance sheet. And it was really just as innocuous as that. And I immediately tweeted that that was a game changer. It was not anticipated, and I'll tell you why, and it was a game changer. December 29th, I wrote *The Drum Beats of QT,* which was my piece about what the impact on financial markets would be when QT started. And at the time, it still didn't seem to matter, asset prices had rallied almost through that date, really just a little tail off in December. But really just an incredibly robust environment for all assets.

But then the minutes came out on January 4th, and the world woke up. And from then on, all we have seen is front running of quantitative tightening. And that's because quantitative tightening will result in the need for financial markets to absorb bonds that the Fed would have otherwise bought from the US Treasury. And that'll start in June, June 1st. And so quantitative tightening has done nothing to hurt assets either December 15th or January 4th, because it hasn't even happened. In fact, the first quarter, there was still quantitative easing through mid-March. And that's actually buying bonds from the market, from the Treasury that they would have otherwise had to sell, and that was going on. So, all of this has been front running.

And what I mean by that is that in the world, you can collect essentially free money by letting somebody, if you have savings, if you have dollar savings, or any currency savings, and somebody wants your dollar, to consume or to invest in the real economy, they will issue a security and for that security, you're taking risk, and you need to be rewarded for that. It's like is there any incentive if somebody comes up to you and says, I'm going to flip a coin and pay you a 50/50 -- and we'll do a 50/50 payout, and you have the money and they want half of your -- either all your money or they'll give you twice your money. You don't have any incentive to do that. There's no economic incentive to just bet without positive expected return.

And so when somebody asks you for your cash savings, they need to compensate you for that. And that is through what we call risk premium. And all investments have it; stocks, bonds, commodities, currencies really don't, except emerging markets. And yes, real estate, all assets, anything that people will give you for your money that is an investment for you. Pay you a risk premium just if you hold it. What people forget is that, that risk premium that you collect each day is also -- can be also marked to market. Meaning, in certain environments, the risk premium you can receive is high and in other environments, the risk premium you can receive is low. And so that fluctuation can have a big impact on asset prices.

So, when do risk premiums contract? They contract when, for instance, you have quantitative easing, in which the Fed is buying assets in the marketplace. And they're competing with everybody else who has savings for these assets. And so there are less assets available to buy, because the Fed's bought some. And that inflates assets prices, and that inflation is seen in essentially the contraction of what you would expect to earn for from beta. And so that's what's happened since quantitative easing started in 08, 09 and then rapidly happened with a massive quantitative easing that started in April of 2020.

And so that's coming to an end. Risk premiums need to expand because people need to be rewarded more, to lever up their own risk to take on the US Treasuries that the government is selling, that the Fed isn't buying anymore. And so that's really what this whole thing has been about this -- last people think about the path of interest rates, the hiking of interest rates. It really hasn't been about that. It's just been getting set for what is going to be a supply and demand imbalance between those who have money and credit to invest, and those who need money and are selling those investments. And I think that's really all that's happened in the last… And so what's happened? Every asset has gone down since then.

Adam: **00:33:05** Because global risk premia have needed to expand because -- in anticipation of having to absorb, either at some point maybe even flows from the Fed into the market, but at the very least now, from the Treasury into the market, because the Fed will no longer be absorbing the Treasury issuance.

Andy: **00:33:23** Right. And that's big enough. The details of the quantitative tightening are now, I think, in stone. And I think it'll really be and I predicted these in January, but I think they'll really be -- they'll stick to this, and that is this $95 billion cap. And so what that means is that they will -- every day they get proceeds from redemptions of their existing inventory. And up till today, up till June, they've reinvested those proceeds. Now, each month, subject to this $60 billion cap on treasuries and 35 on mortgages, making 95 in total, they will not reinvest up to 60 billion.

Adam: **00:34:21** So, 60 billion will expire, right? Because they're letting T bills run off and other notes, so that that runs off, they expire, and typically they would be lying …

Andy: **00:34:32** If 70 ran off and that month, but 60 was the cap, they'd still reinvest 10 billion.

Adam: **00:34:39** Okay, that's a good point. Right. Gotcha. And then on mortgages.

Andy: **00:34:45** And mortgages are trickier. And mortgages are trickier because politically they regret, I think, some more than others, the amount of mortgages they have in their inventory, and also mechanically, these mortgages have -- are no, are not going to be prepaid anymore. With interest rates this high, no one can refinance the Treasury's mortgage -- the Fed's mortgage portfolio. And so and they are 30-year amortizing bonds and so the prepayments or sorry, the monthly proceeds just aren't large enough to take the mortgage …

Adam: **00:35:27** The duration is lengthened on the mortgage portfolio. Right. So, they're …

Andy: **00:35:31** Right. And the cash flows just don't come off fast enough. So, they're going to have to sell *in the marketplace* mortgages, and I think that's well understood. But the point I'm making is I don't think they're going to change that. I don't think they're… even if inflation picks up in September, which … now pointing to the next time, they're actually going to have a decision to make, at least today she said that, I don't think they're going to ever increase the speed of QT beyond the 95 billion. It's possible, but I don't think that we're going to pull that lever. And the reason why is just as QE was highly effective for inflating assets, QT is highly effective in, and we've seen it in deflating asset prices, just the front running has deflated asset prices.

But the linkage back to the economy is, the goal is to reduce demand. And the linkage for QT and QE has always been the wealth effect, which is the people that are experiencing portfolio gains spend more and the people who are experiencing portfolio losses consume less. It's weak. And the only reason why we ever used QE to bail out the economy in the last 10-12 years is because interest rates were at zero, and we didn't have any more levers. But it was very, it wasn't particularly effective until 2020 in generating inflation. In fact, inflation undershot for most of the first 10 years of, you know, when QE started in 08. So, it's not a very strong mechanism to create inflation, and it's not a very strong mechanism to reduce inflation because of this weak linkage of the wealth effect.

What really matters is, and the Fed has repeatedly said this, is changing the borrowing and saving rate, increasing deposit interest, which will take, there'll be a lag before the banks ever do this. But money funds will start that transmission mechanism quickly. Just keeping money in the bank is actually going to be more compelling than spending I,t and that'll reduce demand. And that's just the short term interest rate being hiked, very effective. Mortgage rates have been impacted by the short term interest rate going up a lot, which has made housing affordability lower. And so they really believe that to tame inflation, they're going to have to increase rates and it's not about QT, though QT will do its job too. It just won't be as strong.

Adam: **00:38:32** But running off mortgages will obviously raise rates in the mortgage market to a greater degree than in the general treasury market. Right? So, that should help too.

Andy: **00:38:43** The mortgages should widen the mortgage basis between treasuries and mortgages, and that'll be passed on to the end mortgage user, the borrower.

Adam: **00:38:55** Right. Got it. So, we're expecting this to persist for some time. They're going to run down their balance sheet, they're especially going to make sure to run down their mortgage book, because there are members of -- they're decision makers that precede that their mortgage book is much too large. The other side of this equation, which you've commented on quite extensively is the Treasury, right. So, to what extent is the Treasury issuing bills, notes and bonds and in what duration and at what time, right is going to impact the liquidity conditions? So, maybe walk us through that side of the equation?

Andy: **00:39:37** Yeah, sure. So, the way I like to think about it is in liquidity terms. The Treasury has a budget to finance. It has bonds that are maturing that need to be -- some of which the Fed owns that need to be refinanced. And so it needs to sell securities, it's still running a budget deficit. We'll come back to that in a second because that, I think, is very important. And so they need to issue. And if they had to issue a trillion dollars of bills, that would change the portfolio a lot. And there are some guidelines and things that prevent them from issuing only bills. But if they were to do such a thing that would have a minimal impact on -- possibly even no impact on financial assets.

On the other hand, if they issued a trillion dollars of 30-year bonds, the 30-year bond would crash. You know, they issue a couple 100 billion a year of 30-years. So, if they were to weigh on the curve all that, they would crash the 30-year, which would crash corporates, which would crush equities. And so those impacts are very important. So, what are they doing is -- so you have to ask yourself, okay. So, what they might do is they have -- the Treasury has a different political -- different role than the Fed does. The Fed is trying to fight inflation. The administration is trying to fight inflation, they're using gimmicky things like petroleum drops, of the SPR. Yep. And also scary things like politically, potentially very appropriate.

But from an inflation standpoint, misguided things like globally, this is happening; handing people who are buying gas, credits, which saves them the money, and it's a wealth transfer. I'm not making any judgment on that. But it doesn't reduce, in fact, it increases the demand for the commodity that's already in short supply. So, administrations are going to do what they're going to do.

Some are going to be gimmicky, some aren't. In Janet's case, she has a real, legitimate lever. And if she believes, which she's given no indication that she does believe this, but if she believes that by issuing long-dated bonds, the wealth effect will fight inflation, and that's attractive to her, she may go in that direction.

On the other hand, Janet also has a, I think, it's politically difficult to crash the stock market and get reelected. And so the Fed doesn't have those concerns. It just needs financial stability and another 20% on the stock market doesn't matter to them. But it probably matters to the Democrats chances. I think they've probably written off 2022. But for even 2024, they don't want a Democratic administration to have a stock market crash. That's just very hard to recover from. So, she has both sides to concern herself with. So, then let's talk about, briefly, what she has done. And the answer to that is she has used her levers intelligently.

Firstly, she has -- while the Fed was still doing QE, she issued a lot of coupon bonds and a lot of bills in Q1. And she completely funded what's called the *Treasury General Account,* which is her, essentially the government's checking account where they spend the money. They collect taxes in it, and they use that account for spending. And she funded that from what had, for all intents and purposes, was zero at the end of Q4 because the debt ceiling was in place and she couldn't issue more debt. She really pressed out a lot of money and funded that and it's almost a trillion dollars right now.

In, I guess, February, late January the quarterly re-funding announcement came out and she had reduced coupons significantly. And that's an important thing. It said we get, QT's coming. We funded our checking account. We're going to lay off the bond market a little bit. But it was still, you know, so coupons have come down, coupon issuance, long-dated Treasury has come down. But then this very unusual thing has started to happen. And that is when you have high nominal GDP and nominal GDP is not the reported number. It's the sum of the reported number plus inflation.

So, last quarter, we had a negative 1.4% annualized real GDP, but we had an 8% annualized inflation rate. And so the nominal GDP was six and a half-ish. And taxes are paid in nominal dollars. And we really grew, in a nominal sense, we really grew last quarter. And so our tax revenues have come in quite a bit. Sorry, gone up quite a bit. While our budget hasn't changed. So, what that means is our deficit has come down. And when our deficit comes down, our need to issue comes down. And so it turns out that, and I put a lot of attention on this last week, May 2nd was the first date that had happened. But the new quarterly refunding announcement came out. And it showed that even though they had planned on borrowing $66 billion in Q2, which again, was a very, very small number; they reduced that to negative $26 billion. So, in fact, this quarter, our net issuance is going to be negative. That means we're going to actually retire some of the country's indebtedness, which means supply is lower.

And so I looked at that when it came out at three o'clock on Monday, before the Fed and got very bullish very quick. I was flat going in and really expected that to have a major impact. Two days later, they announced the details. And interestingly, they reduced coupons, but because they still had so little to finance, they really cut bills issuance. And so bills issuance is now substantially negative and coupon issuance was higher than I expected, even though the total issuance was much lower than anyone had expected two days earlier. Then the market started cratering soon after that weird spike on Powell saying 75 was off the table that reversed the next day. Because in my view, there's once again a reason to front run quantitative tightening after that quarterly refunding announcement. So, I think that was a very subtle issue. But if you caught that you could have traded a very wide range effectively.

Adam: **00:48:03** So, what do you think that signals about Janet's intentions here? I mean, she had an opportunity to just issue less, and instead, she decided to introduce some very subtle yield curve management. So, what direction did she try to note? Okay.

Andy: **00:48:27** Yeah. I don't think she was really intentional in this way. In that coupons still came down a lot, about 100 billion from the prior quarter. And that's a lot less coupons, but she was more concerned of the proper functioning of the yield curve and still wants supply out there, and QT hadn't been specifically dealt with. So, I think at the high level, she reduced coupons. She didn't reduce them anywhere near as much as she could have. And the most important thing is she's now, and this is a war chest building idea.

When you reduce bills that means the money markets are starved for assets. Where do they go when they need assets and bills aren't available? Well, they go to deposits, typically. They don't go out the yield curve, or buy equities or anything. They need short term money because their clients may redeem at any moment for their money. So, they can put money at banks, but banks a year ago were told that the Fed didn't want them to suck up the deposits anymore when they didn't extend the supplemental leverage requirement.

And so what's happened is all of that money has now gone into the reverse repo program of the Fed. And so that number is now 2 trillion, just shy of $2 trillion. And those are people that want bills and can't get them. And so to me, that is a war chest that can be tapped at any time, that Yellen has. She's already paying the interest too. The Fed pays essentially, Fed Funds. It's not exactly but essentially Fed Funds, and so it's now paying 75, 80, 90 basis points on the RRP facility. And that money is paid by our taxpayers, the Fed, it flows through from the Treasury. And so, and that's higher actually, than what bills are paying. So, she could issue bills and pay less. So, it's very -- I haven't yet figured it out. But it's definitely a war chest, which could be …

Adam: **00:50:49** Well, I guess, there's a couple of different reasons, right? Well, the truth is more than two, but one is obviously, is she concerned about potential deficit -- well, what do they call it when they put a cap on debt issuance, they go through this battle every … the debt ceiling issue, yeah. So, she's worried about maybe more battles there. And is she also trying to prepare for QT. What's that?

Andy: **00:51:23** I think the TGA addresses fear of a change in the composition of Congress, and more difficulty getting budgets passed and debt ceilings increased. So, I think the TGA staying large is preparing for such a thing. The RRP, the only way they can get that is by issuing, and they don't need the money. That's the interesting thing. As long as nominal growth continues to be higher than their nominal cost of interest, which is like 2% now, we will see a, without additional deficit spending, budgetary deficit spending, we'll actually continue to see a reduction in the net supply of bonds that the government issues. And so it's an interest--

We're in an interesting point, they have all this $2 trillion. They have the Fed that is rolling off its holdings, and yet they continue to issue coupons to finance a falling deficit. At some point that's going to run out and that will be a meaningful turn, potentially. Inflation better be low by then, because releasing any of this pent up money to suck up bills and reduce coupons would have an asset inflation and the … effect impact. So, she has to be really careful when she pulls that lever, that inflation is in our rearview mirror. But who knows when that'll be? I think you can keep very close track of it and know. And I think that's the signal, that's the flow information that I think is dominating markets since COVID bottomed. And this is now the element -- this is now the transmission mechanism. The Fed has said what they're not going to buy, and that's unlikely to change in the near term, or even in the long term. And so it all depends on issuance and the impact of that …

Future Treasury Options

Adam: **00:53:38** Walk it forward to September-October, and let's assume that inflation stays uncomfortably high; what options does the Treasury have at that point?

Andy: **00:53:53** Well, again, I think it's anything they do to reduce coupon issuance is good for assets, good for bonds and stocks, good for all-weather, good for risk parity, good for 60/40, good for savers. And is not good for inflation fighting. So, I think that'll be dependent on the balance that she strikes between damage in the

		markets and it's trying to assuage that damage if she chooses to, will make it harder to deal with inflation. So, you can't tell. You just have to watch the levers.
Adam:	**00:54:39**	What happens after the election?
Andy:	**00:54:42**	Sorry?
Adam:	**00:54:43**	What happens after the election, right? Because I mean, at the moment, the Treasury, Janet is navigating a complicated political path, right, where, like you said earlier, they want to keep inflation low. They know that inflation is politically unpopular, but so is a stock market crash, right? So, once the election is over, obviously the number of degrees of freedom she has at her disposal should increase dramatically, right, like they should have more flexibility to pursue a more direct agenda.
Andy:	**00:55:23**	Yeah, it's certainly possible that… So, I have no idea about politics. I'm not a political guy. I don't have any predictions regarding who or who should or who shouldn't be making these decisions. I just try to pay attention to what they're doing.
Adam:	**00:55:44**	No, I guess, just to press pause**,** I heard, like Janet was on -- She was out with some PR just last week saying that she felt that asset prices were still too high. Right? So, I think that her bias is she wants to contain inflation, and she will sacrifice asset prices to do so. But she won't do that aggressively before the election for political reasons. After the election all bets are off.
Andy:	**00:56:15**	I could easily make the case that, I think, that if you've written off 2022, you're better off crashing the market ahead of the election and having it recover into 2024. I don't know. I mean, that's just… But I've made it up, it seems like a reasonable potential strategy.
Adam:	**00:56:35**	No, no, fair enough. So, what should we be watching in terms of her messaging, but also in terms of their bills and coupon issuance over the next quarter or two, to help us divine some signal about which path they might want to take?
Andy:	**00:56:55**	Right. So, I think the highest thing to do, and it's something that most macro shops do systematically, is to pay attention to the potential, the spending versus the revenue, because that ultimately drives issuance. And so you need to look at every single coupon that's coming due, every single bill that's coming due, knowing those need to be refinanced, because our debt isn't falling. And then you need to know how much new money is coming. And so that's the number one signal I look at as it relates to this topic.

And in regular times it really is extremely important, because you aren't having massive fiscal policy and then massive fiscal cliffs happening. You're having more steady debt financed activity nonetheless, but it tends to be more steady. And the revenues tend to be more steady, or have been more steady in low inflation, low growth environments, like we've been in for many, many years. Now, it's quite volatile. And so paying attention to what -- being able to predict how much issuance they're going to announce is better than knowing -- than waiting till they announce it. So, that's one thing.

And then the issuance side, I think you have to, I would just describe it as -- my company is named Damped Spring for a reason. I have both a spring, like a car has a spring and a shock absorber. I think Janet's in the position of having both a cap, where she's writing a call, and a put where she's selling a put to dampen volatility in both ways. Whereas the Fed really, at the moment, only has written a call. And so they're pressing on markets, that's their entire agenda. And markets have reacted to that pressing. Should they react more? I think markets are volatile, but they got the main direction from last six months ago. And I don't know what the strike is. But at some strike, Janet is going to shift away from coupons as her -- because that's her lever to dampen the downside. So, you can almost think of it in that way. As you know, how much pain is the administration going to take before they pull a lever?

Adam: 00:59:43 So, let me just unpack that for people and it'll help me to understand it as well. So, I think what you're saying is, the Fed has already committed to putting pressure on liquidity and asset prices. But the Treasury has an opportunity by the rate of issuance and the duration of issuance in terms of where they issue along the curve,. where if they issue fewer coupons, then that will support bond prices and lower rates, and be supportive of asset prices. If they issue fewer bills and more coupons, that'll put pressure on bonds, higher rates, higher mortgage prices, lower asset prices, right?

Andy: 01:00:31 Those are the levers, but I would say that she doesn't have control of how much issuance. That is the economy and spending, which seems to me to be very much gridlocked. She obviously has the ability. If she could pass a spending bill, she has the ability to stimulate, but politically, there's no ability to get it through Congress. So, that lever she can't pull. So, the issuance is going to be whatever the economy creates. But the lever you mentioned, in terms of the composition of whatever issuance is done, is her lever, and she has two interests to weigh.

Adam: 01:01:17 Right. And what about stuff like …

Andy: 01:01:19 …which way she -- and right now it's clear which way she is laying, which is she is singing from the same hymn book as the Fed?

Adam: 01:01:31 Which is, we're going to continue to put pressure on asset prices.

Andy: **01:01:35** Yep. And inflation is the only thing we care about.

Economists and Traders

Adam: **01:01:40** Gotcha. Gotcha. So, day-to-day, I mean, are these the primary things you're watching? And what else are you keeping a close eye on as impacting your day-to-day trading?

Andy: **01:01:52** Right. So, this is the thing that, you know, the big, big lesson that I've learned in my career, is that there are people who are -- really understand all the things we just talked about in great depth, can predict growth, can predict inflation, are what is commonly called economists. And then there are people that trade markets. And there is something that's lost in translation when you don't have breadth and depth in the whole picture. And so what I try to do is offer that broad picture, and at a level of depth that because I've done all of the various jobs that we just talked about, I hope I can add value, that's my value proposition is, is doing all those things. And so that's what I try to do every day.

I'm both being an economist, and also looking at very specific, even at the security selection level detail of trading strategies, and trying to put together a best portfolio and a synthesis that isn't wishy-washy. People can predict that growth is going to be lower next quarter. But you have to connect it with what's priced in. And it's an unusual -- and people that are very focused on portfolio managers in particular, really sort of get an understanding of what's priced in, but may not connect it well to what the actual economic outcome will be. And economists struggle to make money with their predictions, because they don't connect it to what's priced in. And so that's what I'm trying to do every day.

Adam: **01:03:56** So, are you able to articulate at all, some of the steps that you go through to try and connect those dots, to connect the kind of macro themes to actual trading tactics and the trades that you recommend and put on?

Andy: **01:04:11** Sure. So, I come from a firm, Bridgewater was a firm that had 99.8% of its positions were built because of a wide set of systematic indicators on everything that could drive a security's price. Security selection was actually not a big deal for them. And they didn't even trade certain asset classes and still don't trade certain generic asset classes. So, ideally, I'd have signals of that breadth and depth. Obviously, as a one man shop, I don't know. So, I try to systemize what I think matters and have signals for each asset class. Then I also spent a lot of time at Brevan, and I would say that Brevan did no systematic trading, it was purely discretionary. And they were really deep experts at security selection for trade expression; using options, using volatility products, using derivatives, using swaps, using everything you could imagine, barrier options, everything you could imagine to express a particular view.

And so as a derivative specialist for most of my career, I do -- every one of my trades is trying to optimize both a directional view and an option volatility structural path view. So, that's my process, I look at the systematic indicators. And I would say that the current discussion that we spent most of the time on is not systemized, because there hasn't been enough back history to systemize anything like this. So, that's where I'm looking at discretionary information. And then I keep -- I have many different metrics for pricing, what's priced in. The highest level, I think, is risk premiums, which I don't particularly care about the level of risk premiums. But I do care and track things that indicate that risk premiums are changing. And so that could be, that is credit spreads, volatility, volatility surface, positioning, which is always …

Adam: **01:06:57** Like COT positioning type stuff?

Andy: **01:06:59** What's that?

Adam: **01:07:00** How are you measuring that position, like COT data?

Andy: **01:07:02** Yeah. COT data has a lot of limitations. In fact, the best information I can give to people is that COT is for commodities and financial futures. You're much better off if you go to what's called the same producer of data, but the traders and financial futures, which has, I think, better data for that. But that's one. There's so many -- the thing that we just talked about is positioning data, knowing exactly how many Treasuries are going to run off in June, and how much buying is still going to be done even though QT is happening. And where that likely will happen is a flow and positioning basis. And then some of the -- you can get --

So, I'm constantly looking for information. I'm not adequately systemized to say, hey, go and do this. But I'm looking at - one of the big things on Twitter that I spent a lot of time on is an extremely large collar that has been rolled every quarter. So, something as simple as looking at that for S&P flow. And then I have models for what I would call rebalancing flows. A lot of people pay a lot of attention to month-end and quarter-end rebalancing. I don't. I certainly pay quite a bit of attention, but it's not my primary focus. My primary focus is to understand when it is likely various portfolios will require rebalancing. Whether it happens at month end or not, depends on the characteristic of their benchmarking, but you want to know when the 60/40 portfolio is 65/35, you want to know that, even if it's not month end.

Adam: **01:09:07** Right. Because many institutions will have a band of tolerance that they will rebalance at, right. And so that would attract rebalancing, even if it's not some important calendar date.

Andy: **01:09:21** Right. And so you're looking at margin. One of the things I think of for -- and I also look at momentum, I look at mean reversion, just price data, which I think you need all of these little tiny bits of alpha to generate enough alpha to actually position. And so that's what I'm trying to build up. And that's each day, I'm trying to improve that bit. But for instance I think we're in a world in which it's really important to know how an investor is experiencing the markets. Right now most investors are still up from almost any horizon except the last six months. So, there is quite a bit of resilience, I would say, in the average unlevered portfolio.

But if you look at portfolios that are levered, things like hedge funds that are long-short hedge funds, who have had poor performance and have had extra poor performance lately, you would expect certain deleveraging trades. And so I'm also sourcing performance, both in the short-term, and long-term, and then looking at leverage. But then there's also just general government flows, things like the tick data, things like the balance of payment data, all are important to understand currencies, and all are -- what I'm not doing, which I've had a chance to look at some of this stuff, what I'm not doing is using a lot of alternative data.

Take-home Ideas

Adam: **01:11:09** Right. Just haven't found the utility in that yet. We've got about four minutes left. And Andy, I'm curious to hear your thoughts on that. Because I mean, obviously, the vast majority of people don't have the time or inclination or background to be able to follow your newsletter and your trading recommendations. For most people, how would you recommend that they sort of position a core portfolio here, right? Like, I mean, not like, you should diversify, but like, on the ground, what are some kind of take home ideas that people can actually use today? What kind of funds would you buy? What type of asset classes would you want to own? How would you want to think about weighting those different asset classes and/or strategies? What are some strategies maybe that are well-suited to this type of environment that you kind of see going forward? Any insights there that kind of people on the ground can run with?

Andy: **01:12:15** I'm going to give the stock answer, which is, I don't know which way markets are going over the long-term, and I don't think anyone does. And so because of that, you need to have balance. And so a portfolio with a fair amount of bonds, both inflation linked and regular nominal bonds, and allocation to stocks and allocation to commodities, and allocation to gold is an essential portfolio and everybody should have a portfolio that is broadly like that. And that should be levered to one's ability to take on risk, because for at least the next year, maybe two, could be three, the Fed, and the Fed primarily, but also potentially, the US government and the global central banks are not asset holders' friends. The problem is that cash is even worse, that cash is massively underperforming and losing purchasing power.

And so it does -- there is a bit of me that says you should look for a purchasing power portfolio. Now, what that would be, would be something like five year TIPS, which aren't going to move much due to the change in real interest rates, but are really going to pay you the inflation that happens and thus keep your purchasing power, and hard assets. Not hard assets that often get levered because those like housing, is going to suffer as it's just another levered asset. But there's a bit of me that says you should begin to at least consider a portfolio that really is designed specifically for purchasing power.

Now, the good thing is, you don't have to jump from 60/40 to owning five-year TIPS and gold. Buy a little bit of gold, buy a little bit of TIPS and start transitioning your portfolio to one of balance versus what you have. It'd be my number one recommendation for, you know, again, not financial advice, but my number one recommendation for the average investor is: begin the transition to a balanced portfolio that's better designed to protect your purchasing power.

Mike: **01:14:49** All right. A truly balanced portfolio that addresses the inflationary impulses. That is a pretty massive blind spot to the typical portfolio today, sort of where the average individual might sit at this moment in time.

Andy: **01:15:02** Right. But …

Adam: **01:15:03** Kind of a *permanent portfolio*, *all-weather-type bias*, right.

Mike: **01:15:09** Every step in that direction is. I think the other thing to stress here is it's not too late. You know, I think there's a fair bit of complacency and sort of that, as you mentioned, Andy, that confidence that maybe it's going to get better. Every other pullback that we've had has actually healed itself. And we've gone to new highs. But it's a pretty significant change in the regime that's occurred. And it's just not too late.

Andy: **01:15:39** It's a headwind. This headwind is not going away. The headwind's not going away. We could go up, I think we will go up 5-10% in the next month or two. I'm fairly constructive on assets. In fact, my portfolio is pro-assets as big as it's ever been, since the COVID lows. And so I'm optimistic in the short-term. But the headwinds are blowing, and they're not going to change until inflation is turned. And so you know, that's…

Mike: **01:16:14** And the sad part is the emotional pull over the next while. I generally agree with you that we've reached some sort of critical selling point. And there's lots of, maybe, indicators that suggest that might ease a little bit. Those sort of portfolios, and those persons are going to feel relief in that 10% rally, which is not going to get you anywhere near the highs. And it's going to give you confidence to stay the course, where you should be using those reversionary spurts to rebalance to take the opportunity to spread those assets across more inflation protection type assets that you've alluded to.

Andy:	**01:16:59**	Right. Not necessarily go to cash, because again, cash is not going to protect you're -- if inflation does in fact, keep persistently high as I think you said earlier, cash isn't going to do it. So, you need to find some other asset when you have an opportunity to sell these assets that are not going to help you.
Mike:	**01:17:20**	And I think as the inflationary volatility sort of continues and persists, you're going to see asset prices have to reflect higher future expected returns in order to justify that increase in just the inflationary volatility, which means you have to have lower prices today, in order to get there.
Andy:	**01:17:43**	Right. Future volatility is one of my key concepts in what drives risk premiums besides the availability of money and credit. If we are in a regime in which volatility persists assets are going to struggle.
Adam:	**01:18:02**	Yeah. All right. We're going to have to put a pin in it there. This has been absolutely fascinating, Andy, even better than I had hoped. Thank you so much for sharing so much really unique wisdom. Where can people find you?
Andy:	**01:18:17**	So, my website is Damped Spring, D-A-M-P-E-D spring.com. And follow me on Twitter at @dampedspring.
Mike:	**01:18:29**	Love it. And we'll be sure to have you back on too .I can't wait to actually have you back in a quarter or two.
Andy:	**01:18:36**	I was trying to talk about my outlook on currencies today, and we got in the muck, so maybe one day we'll talk about currencies because I think we're at an interesting inflection point on what has been an amazing *King Dollar* story.
Mike:	**01:18:50**	Oh, that's a great teaser. We'll have to fast track that.
Adam:	**01:18:57**	Love it. Love it. All right. Well, look, we'll put a pin in it there. Thanks again, Andy. And have a great weekend, everybody. Thanks for joining us.
Mike:	**01:19:04**	Yeah. Thanks for joining.
Andy:	**01:19:05**	Appreciate it.
Mike:	**01:19:06**	Cue the music.