



**VERMA
ANALYTICS**

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INCOMING TREASURIES VOLATILITY: SHORT SQUEEZE IN A SECULAR BEAR MARKET

IN THIS REPORT

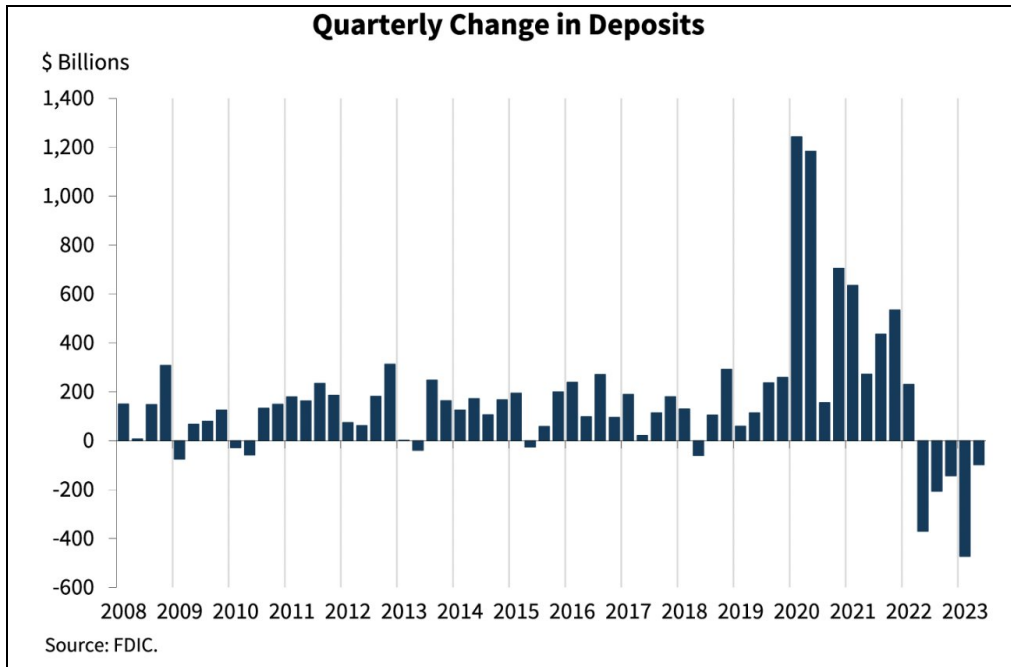
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BANK FAILURE, AGAIN?

At surface level, banks appear to be largely benefiting from the rapid increase in interest rates. Q2 earnings reports amongst the major players boasted strong gains in net interest income (NII), with the likes of Bank of America (NYSE: BAC) reporting a 14% rise in the quarter, and J.P. Morgan (NYSE: JPM) reporting new record-highs in NII. Net income for BAC and JPM also both jumped a whopping 18.58% and 67.33% respectively. Beneath the surface, however, lie significant structural issues throughout the banking industry, specifically in the regional sector.

The two major contributing factors to the collapse of Silicon Valley Bank, First Republic Bank and Signature bank in March were duration risk – that is, a bond's price sensitivity to changes in interest rates – and a run on deposits. The rapidly deteriorating assets on the banks' balance sheets proved to be insufficient to match the flood of withdrawals by depositors, causing the banks to fail. Based on these two factors, ***the fundamentals have deteriorated significantly since the first wave of the regional banking crisis***. Firstly, duration risk has elevated since March, as evidenced in the 10 Year Treasury yield making new highs in the month of August – the highest yield on the 10 Year Note since 2007. Using the iShares 20+ Year Treasury Bond ETF (NYSE: TLT) as our proxy, we can see bonds with 20+ years remaining to maturity coming under significant pressure as well, as TLT continues to trade near the lows of October 2022.

Secondly, banks face an increase in deposit withdrawals as money market funds continue to offer increasingly attractive yields relative to those available through a retail bank savings account. The flight from bank deposits to higher yielding money market funds is highly evident when looking at the quarterly change in deposits, as pictured below.



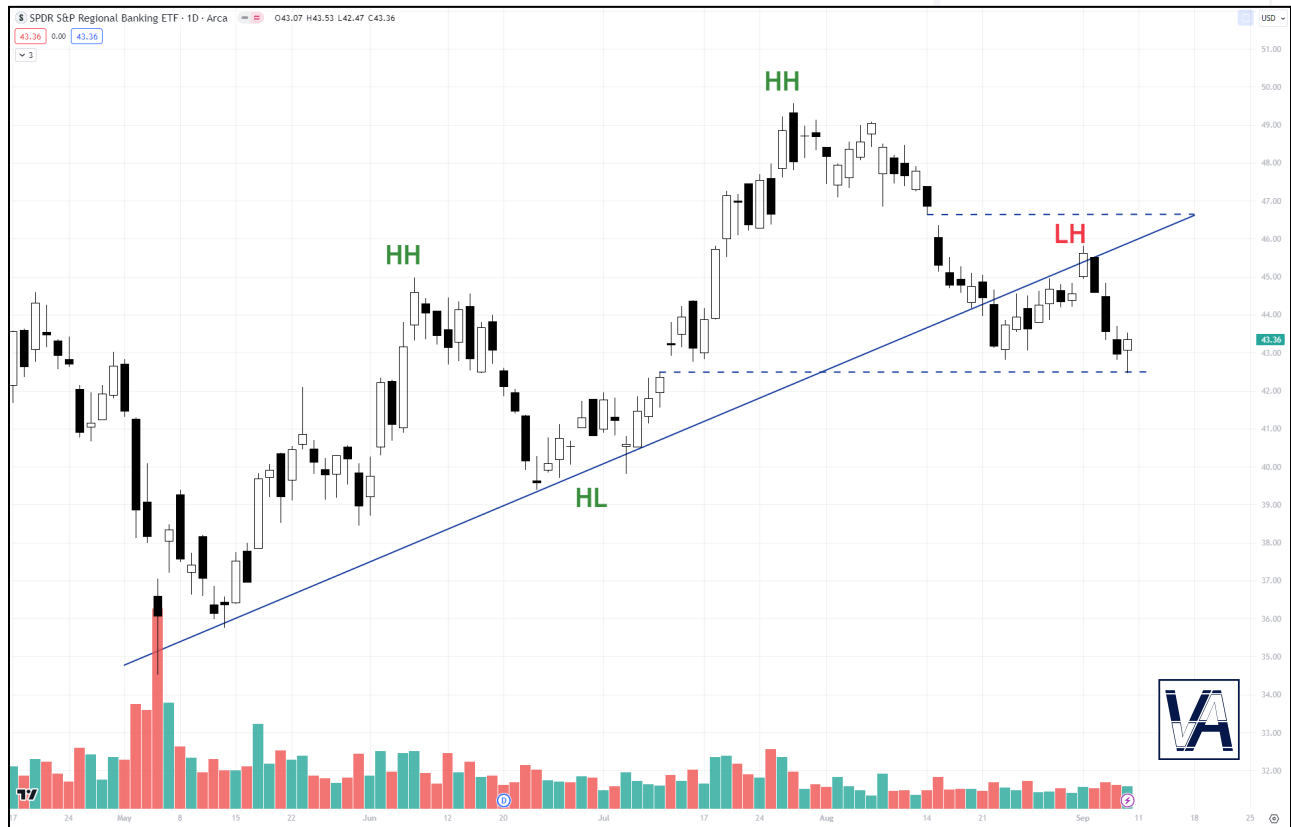
Whether intentional or not, Secretary of the Treasury Janet Yellen piled on further incentives for depositors to withdraw funds from smaller banks while testifying on Capitol Hill following the initial regional banking crisis in March, stating that only those banks that are:

“deemed to create systemic risk, which I think of as the risk of a contagious bank run...we are likely to invoke the systemic risk exception, which permits the FDIC to protect all depositors, and that would be a case-by-case determination.”

The statement by Yellen has incentivized depositors with accounts larger than the FDIC insured limit of \$250,000 to move funds to where they will more likely be fully insured (any global systemically important bank).

Under the double-edged sword of higher competition through both money market funds and larger banks, and crumbling assets, the regional banking sector appears to be nearing another major crisis. Using the SPDR S&P Regional Banking ETF (NYSEARCA: KRE) as our proxy for the regional banking sector, the technicals speak volumes on the market's weariness of the dreadful fundamentals in this

space. KRE is now trading below the trendline from the established lows in May, printing the first weekly close below it this past Friday. Weakness in the regional sector chart is further exemplified by the failure to fill the gap above, followed by a down move filling the gap below (as highlighted by the dotted blue lines in the chart below). KRE also appears to now be in the midst of establishing the first lower-low since beginning this uptrend, which would be a strong indication of a confirmed reversal in the trend.



A bank failure will almost certainly be immediately accompanied by Fed stimulus of some sort, as demonstrated in March 2023 when the Fed balance sheet expanded by over \$300 billion in response to the regional crisis – wiping out several months progress in monetary tightening in just one week. The injection of stimulus and “flight to safety” trade in the light of a banking crisis would apply significant downward pressure to yields of all maturities.

CREDIT EVENT

A scenario such as the one described above which brings a “flight to safety” trade would have the potential to trigger a credit event due to the sudden uptick in bond volatility causing a short squeeze in treasuries. According to a recent Federal Reserve research paper by Daniel Barth, R. Jay Kahn and Robert Mann, Hedge Funds are “probably”, or at least to some degree, increasing their positions in the Treasury cash-futures basis trade. The cash-futures basis trade is a levered arbitrage trade strategy involving a long cash Treasury and short Treasury futures using borrowed funds from the repo market, leaving funds heavily exposed to interest rate volatility risk. The likely trade is evidenced by the data in the table below, which shows the uptick in hedge fund sponsored repo borrowing vs lending as well as the surge in levered fund Treasury shorts.

Table 1. Hedge Fund Repo Borrowing

[Make Full Screen](#)

	As of date		
	31-Jan-19	4-Oct-22	9-May-23
Levered fund Treasury shorts			
2-, 5- and 10-year	631.17	304.03	714.92
Total	745.52	433.77	860.26
Hedge fund sponsored repo			
Borrowing	234.85	113.59	233.23
Lending	16.16	30.84	38.74

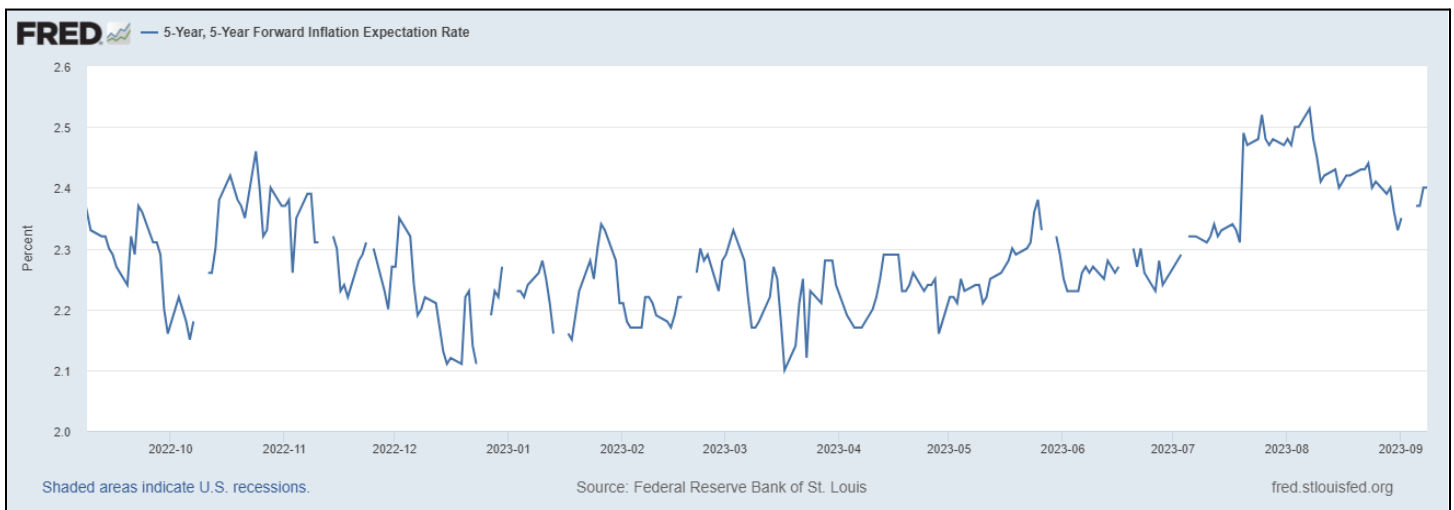
Note: Futures positions are in contract notional dollars.

Source: OFR Cleared Repo Collection and CFTC Traders in Financial Futures Data

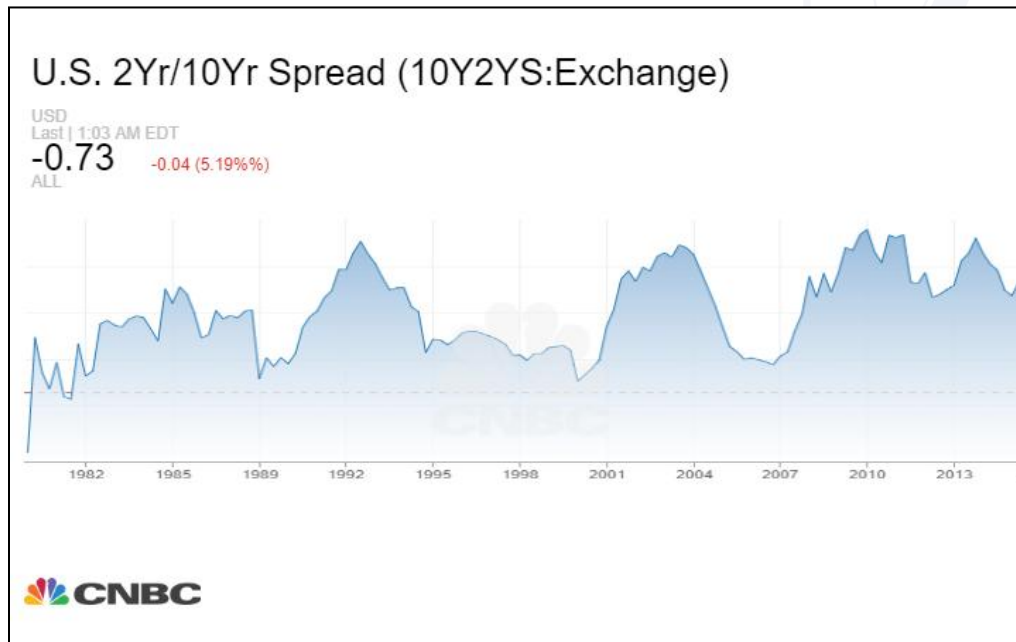
A rapid and disorderly unwind of the bond shorts could shock the markets and pose a potential threat to the stability of the financial system, as seen in March 2020, when the rapid unwind of the basis trade by funds caused illiquidity in the bond market and forced the Fed to intervene.

INFLATION – MARKET’S CURRENT EXPECTATIONS

A simple glance at the 5 year and 10 year breakeven rates make one fact highly evident – after having experienced a full year of relatively sharp disinflation, investors have been lulled into complacency and seem to be convinced the inflation beast has once again been tamed. With the 5y5y and 10y10y rates reading 2.40% and 2.33% respectively as of Friday’s close, investors are indicating they expect Fed chair Powell to fulfill his mandate in soon returning inflation to 2% and keeping it there.



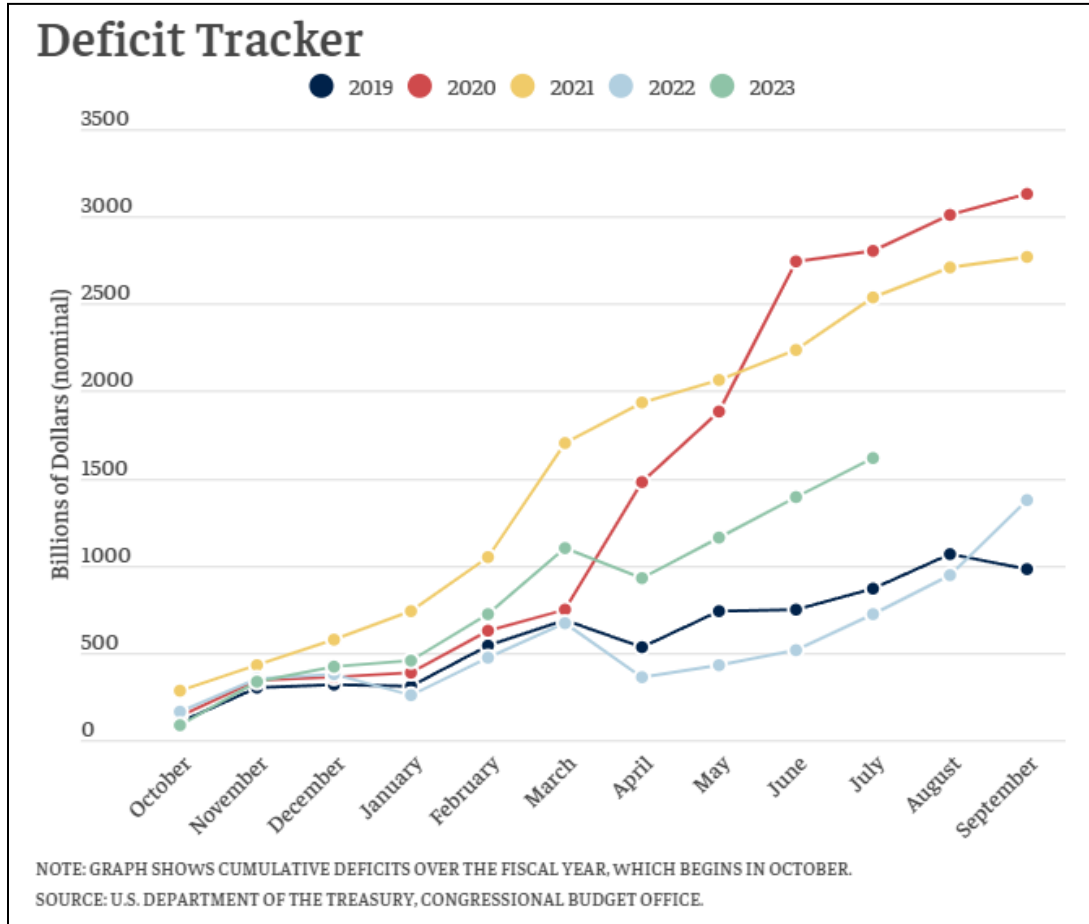
The answer in regards to *how* investors expect inflation to be returned to 2% lies in the 10-2 Year U.S. Treasury yield spread, which breached -109 basis points (bps) earlier this month, creating the greatest inversion of the 10-2 spread since 1981. The deep inversion tells us investors are expecting a Fed-induced recession in the near future to tame inflation for good, as higher unemployment applies downward pressure to aggregate demand and thereby lowers wages and prices.



The reality is, however, CPI remains well off the 2% target after managing just one read with a 2-handle in June. Even more worrisome for long duration investors, the Fed's preferred metric, Core PCE, has remained stable > 4%. While the recency bias in regards to CPI reads has led investors to this false belief of a return to 2% inflation, it is important to remember that ***CPI is a metric which reads through the rear-view mirror***. That is, to say - YoY CPI accounts for the change in prices which have already taken place over the previous year, rather than focusing on the change in prices which are likely still to come, which bond investors *should* instead have their eyes on. To understand where prices are likely to head moving forward, we're going to examine two key factors: fiscal policy and commodities prices.

FISCAL POLICY

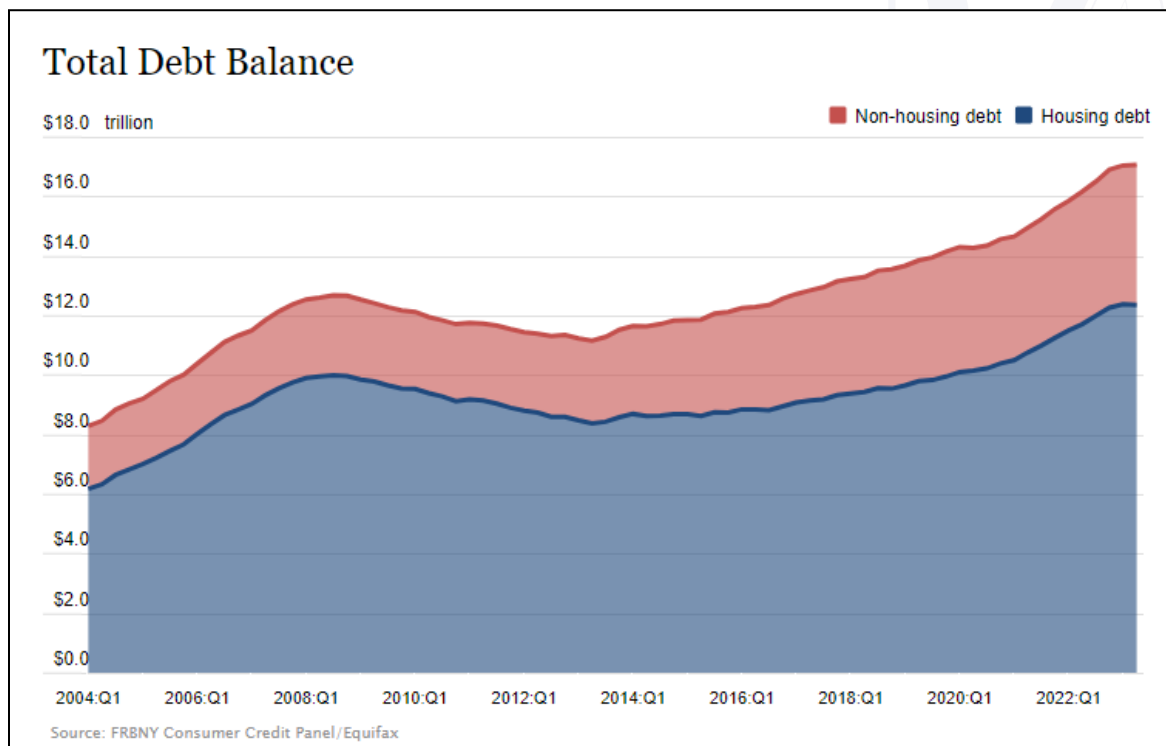
True to its word regarding tighter monetary policy, the Fed has delivered the fastest rate hikes in modern history in an attempt to tackle inflation. However, the Fed is essentially fighting this inflation battle with one arm tied behind its back, as ***fiscal policy remains highly inflationary***. The purpose of rate hikes is to tame aggregate demand by causing a leftward shift in the demand curve, transforming spenders into savers and borrowers into lenders. With the federal deficit for 2023 continuing to trend higher well above pre-pandemic levels, fiscal policy is working at odds with monetary policy and applying upward pressure to aggregate demand (ie. causing a rightward shift in the demand curve).



The persistence in consumer demand is evident when looking at consumer debt levels, which continue to rise despite the dramatic rise in the cost of servicing

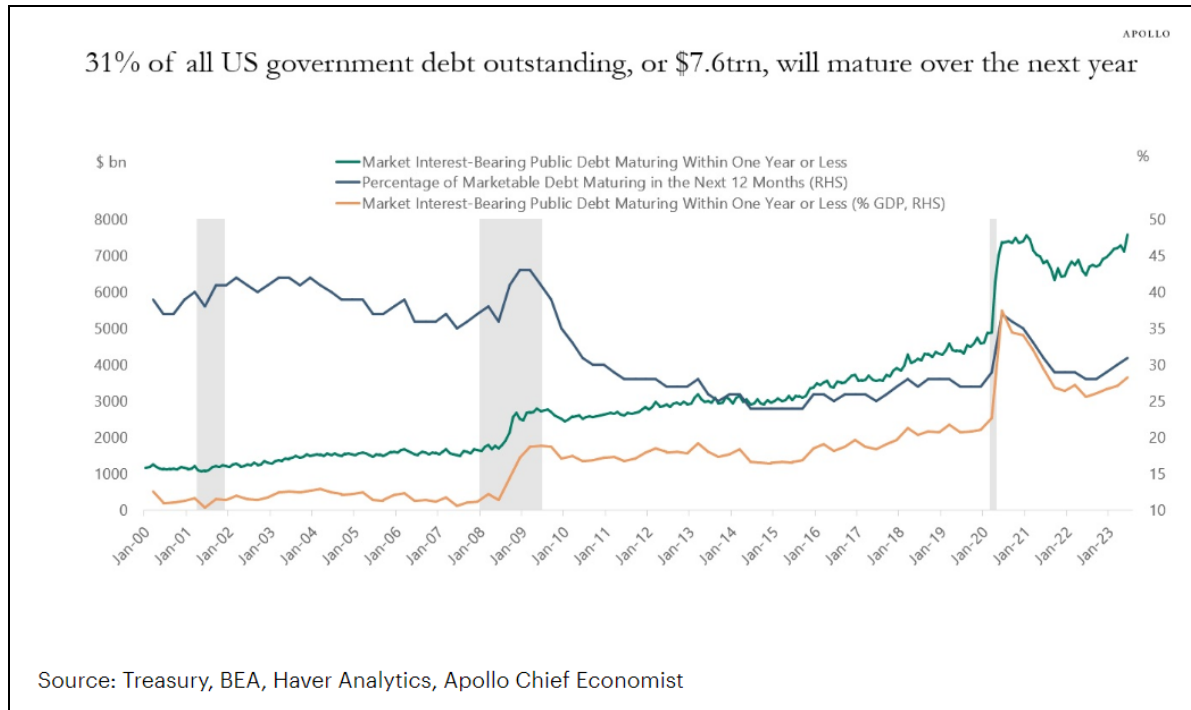
those debts and further fuels this inflation fire. Outstanding U.S. credit card debts even surpassed the \$1T mark for the first time in history earlier this year (Source:

Federal Reserve Bank of New York)*



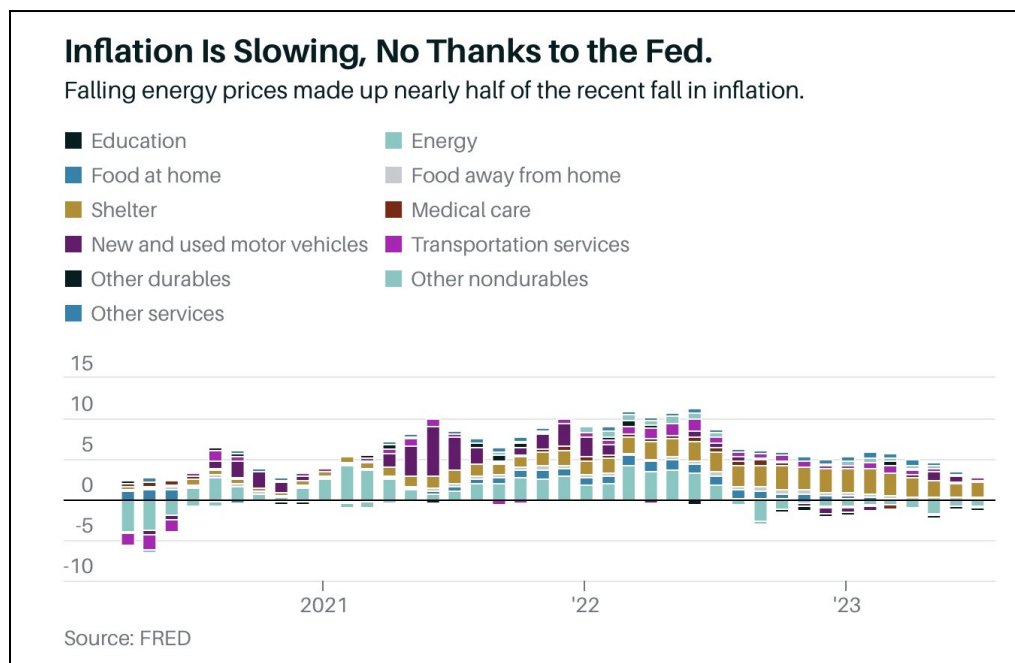
In addition to its effect on aggregate demand, the soaring federal deficit equally applies upward pressure on bond yields as the supply of U.S. Treasuries (USTs) continue to climb. The issuance of new debt at near-record pace comes at a time when demand from foreign institutions continues to trend downward, such as in the case of Japan and China, who have both seen their market share of UST holdings sink to record lows at 4.4% and 3.4% respectively (Source: Reuters)*

While the longer-term fundamentals for Treasuries may seem troublesome now, ***things are likely to go from bad to worse for bond investors as the cost of servicing the federal debt explodes, with a significant portion of the outstanding debt maturing and rolling over at astronomically higher rates than at which they were taken on.***



COMMODITY PRICES

Commodity prices played a significant role in the disinflation that has been experienced throughout most of 2023, as evidenced by the YoY PPI which read as low as 0.1% in June and by the figure below.



Again – these falling prices are a thing of the past, as **commodity prices have rebounded in rather viscous fashion as of late** and appear to be nearing the end of a consolidation/accumulation period. Using the Invesco DB Commodity Index Tracking Fund (NYSEARCA: DBC) as our proxy, we can see the commodity sector has cleanly broken out of this year-long falling wedge pattern and is indicating a reversal in the overall trend.



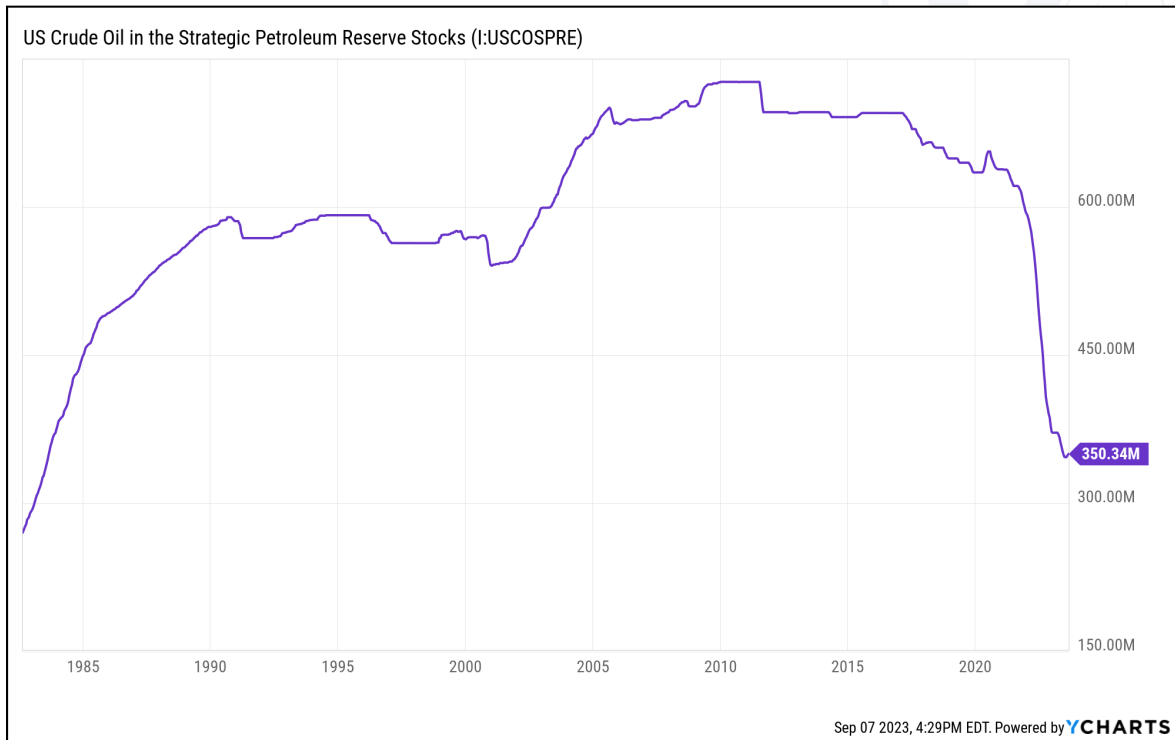
While the commodity index gives us a general idea of the trend at a glance, I'd like to take a closer look at a few individual commodities who's charts and fundamentals are most intriguing.

Crude Oil

Let's start with one of the most significant commodities in terms of industrial and commercial demand – crude oil. The sell-off in crude from the 2022 highs was largely driven by recession fears, as investors anticipated an imminent recession to cool aggregate demand, thereby significantly reducing demand for oil (as seen in 2008). A closer look at the tape of CFDs on WTI Crude Oil suggests largely algorithmic selling on any weak economic news, as many investors pre-programmed the same “sell oil on recession fears” trade. For example, on March 15th, 2023, the poorer-than-expected economic reads coming from the NY Empire State Manufacturing Index (expected: -8, actual: -24.6) and Retail Sales (expected: -0.3%, actual: -0.4%) were swiftly met with an extreme wave of selling, as evidenced through the large spike in trading volume and extreme oversold reading of RSI 14 (> 20) on the 1-hour chart.



The decline in the price of oil was also significantly influenced by a flood of supply to the market, courtesy of the draining supply of the U.S. Strategic Petroleum Reserve (SPR). The SPR has been taken to levels not seen since the reserve was initially filled.



While selling oil in anticipation of recession may have seemed logical in theory, it has been disastrous in reality. For starters, shorts were never able to make much real progress past \$70, as the extreme waves of selling and floods of supply from the SPR were met with strategic production cuts coming out of OPEC in May, to the tune of 1 million barrels per day – a policy which has now been extended to at least December of this year. Furthermore, the supply of oil faces further complications due to rising interest rates increasing the cost of storage and underinvestment in the sector, as recently noted by Trafigura Group’s Ben Luckock. The underinvestment in the energy sector is evident when looking at the sector breakdown of the market-cap weighted S&P 500, which has just a 4.4% allocation to energy as of August 31st, 2023.

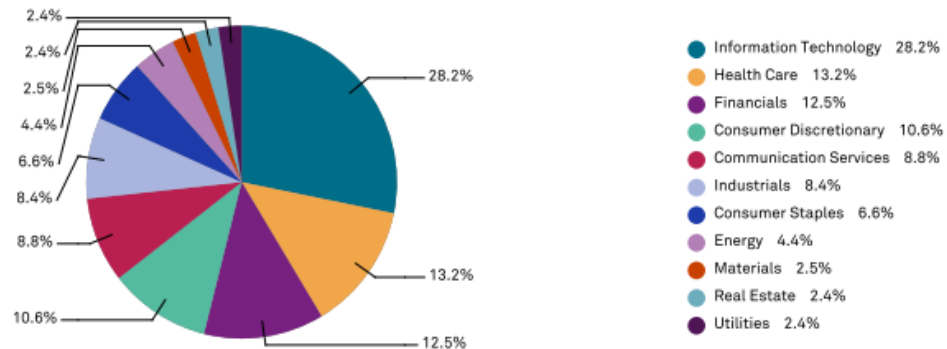
S&P Dow Jones Indices

A Division of S&P Global

Equity
S&P 500 (SEK)

AS OF AUGUST 31, 2023

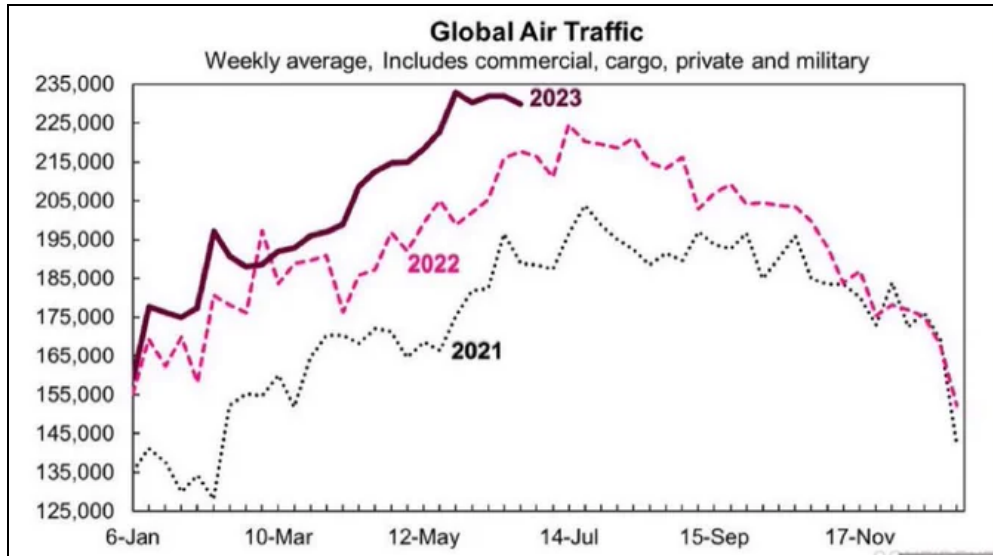
Sector* Breakdown



*Based on GICS® sectors

The weightings for each sector of the index are rounded to the nearest tenth of a percent; therefore, the aggregate weights for the index may not equal 100%.

Although the supply side of the oil price has been disastrous for the oil shorts, the demand side of the equation has been that much worse. Contrary to the prior beliefs, consumer demand has remained robust, in-turn causing the demand for oil to remain elevated. Evidence of strong oil demand can be seen in the aviation industry, as global air traffic continues to trend higher relative to the previous two years. Oil demand faces additional upward pressure as the U.S. Department of Energy (DOE) attempts to refill the SPR; after adding to the reserves in August and an expectation to add again this month, the DOE has slammed the brakes on previously planned October and November purchases amidst soaring crude prices.



Source: X.com/CornerstoneOil

With consumer demand refusing to fade, the many oil shorts that piled into the recession trade have been forced to begin unwinding their positions. As a result, crude oil has broken out of the year-long falling wedge formation and is suggesting a reversal in the overall trend. **Verma Analytics maintains a price target of \$105.00 USD/Bbl for WTI Crude.**



Natural gas

Having shown strength in recent months, natural gas has been setting higher-lows since the YTD lows in April, as pictured below. This appears to be an accumulation/bottom processing that is nearing its end. The fundamentals for natural gas remain strong as European demand for LNG is likely to reach the U.S., as Europe looks to increasingly reduce its reliance on Russian natural gas. **Verma Analytics maintains a price target of \$4.40 USD/MMBtu for Natural Gas.**



Copper

The copper chart is currently flashing a bullish triangle pattern, suggesting a move to the upside equating to the highest and lowest points of the triangle – a move which would ultimately take copper to new all-time highs. Being a key industrial

metal, the elevated copper prices would undoubtedly apply significant upward pressure to the PPI. **Verma Analytics maintains a price target of \$5.75 USD/Lbs for Copper.**



Uranium

Finally, Uranium continues to ride a near-parabolic trend line and appears set to test the 2022 highs. Uranium demand continues to heat up as the global shift away from fossil fuels gains further momentum. **Verma Analytics maintains a price target of \$72.00 USD/Lbs for Uranium.**



The change in trend in commodities has already seen rippling effects throughout the economy, with PPI jumping back to 0.8% following the 0.1% read the month prior. With the commodities sector threatening to continue ripping higher in the coming months, there is a strong chance we've already seen the bottom in the PPI prints for some time to come. The upward trend in PPI and CPI that is yet to come will ultimately force bond investors to re-evaluate their long-term inflation expectations, and apply upward pressure to yields as a result.

TREASURIES TECHNICALS

The path highlighted throughout this report – that is, a crisis in the financial sector triggering a flight to safety trade and thereby a short squeeze in treasuries, followed by inflation fundamentals taking bonds lower once again – is largely supported by the technicals of the U.S. 10 Year Treasury Note.

The likelihood of an imminent reversal is highlighted by the negative divergence on the weekly chart. Having already posted two negatively divergent highs, you could make the argument that a third negatively divergent high has already been made. The trendline in RSI 14 and the recent weakness in the 10 year note, however, suggests a final push higher in yields, bringing RSI 14 to the resistance line just above 70 and creating the third negatively divergent high at those levels.



The TLT chart also supports a reversal in treasuries with the following signals: double-bottom formation with the highest volume at the lows, nearing a bullish MACD crossover with MACD at historical lows on the monthly chart, and RSI also trending higher out of historical lows on the same timeframe.



Although the technical and fundamental pictures for a treasuries short squeeze remain strong, I maintain the stance that increased volatility in the bond market presents investors with a short opportunity, as ***bonds remain in a secular bear market due to deteriorating fundamentals***. The 10 Year Note chart suggests a pullback as far as the lower trendline of our previously formed bullflag channel,

which aligns with a key historical support level in yields. **Verma Analytics** maintains a short-entry target of 2.60% on the U.S. 10 Year Treasury Note.



IMPORTANT DISCLOSURES

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