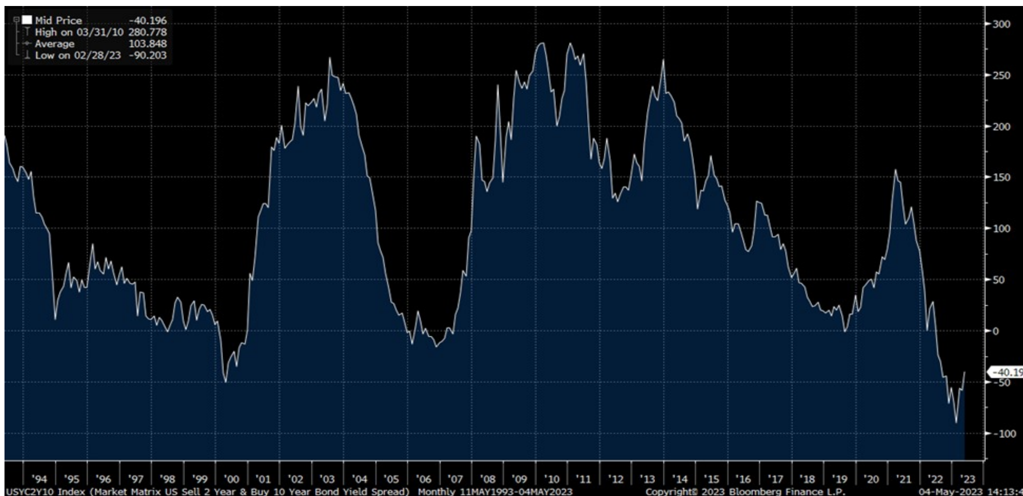
DAVIS COMMODITIES LLC

April 2023 Macro Commentary

The month of April certainly did not go as planned with a larger than usual drawdown. That said, the pieces are lining up for the current positioning to be highly profitable for the portfolio. The foray into the Japanese yen was ill-timed, but could be revisited over time. The core position will continue to be the yield curve steepening (specifically the 2 yr vs 10 yr treasury notes).

Regarding the yen, the thought process that the new governor of the Bank of Japan (BOJ), Ueda, would abandon their yield curve control (YCC) turned out to be premature. In their latest communique, the BOJ stated that it would take approximately a year and half to perform its due diligence on the effects of YCC. The market was disappointed at the extended length of time and quickly sold off. The overall trade was a small loss for the program. However, with the unfolding banking crisis in the US, it might be one that needs to be revisited over time. In general, if the US is heading into recession, repatriation by Japanese investors would be the norm. That repatriation would create a headwind for the US stock market while buoying the yen.

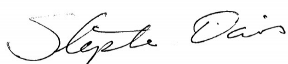
The core position in the portfolio continues to be the yield curve steepener. At the risk of repeating the deluge of news lately, the US regional banking system is facing serious headwinds. At this point, three of the four largest bank failures in history have occurred in the past two months. In addition, there are swirling rumors that another three regionals could be susceptible to failure. The majority of the problems have stemmed from a combination of depositors moving their assets into higher yielding instruments at the same time that the bank assets have been moving lower in value. One item that is flying a bit under the radar is the potential problem in the commercial real estate (CRE) market. While the large banks in the US have a relatively small portion of their assets in CRE at 6%, the smaller, regional banks hold roughly 29% of their assets in CRE. With the major shift in working patterns largely due to the Covid shutdowns, many commercial buildings are seeing an outflow of lessees. While not an issue today, the beginning of loan maturation will start at the end of this year. Those commercial loans will need to get rolled or there will be defaults. These problems could be exacerbated if the Fed forces the economy into a recession. If that happens, firms will be laying off more employees and lowering lease space at the same time that the loans are maturing. This combination would point to a long-term problem in the regional banking sector.



In addition to the banking problems, the US government could be entering crisis mode at the same time. With the refusal of both sides of the aisle to compromise in the slightest, odds are increasing that there will be a government shutdown or default on debt payments. While the latter seems long odds, we have seen the former several times. Either one of these outcomes would heighten the odds of the US entering recession. Odds are extremely high that during the recession, the Fed would cut short-term rates which would allow the short end of the bond market to break faster than the long end which plays directly into our steepening trade.

The last point I will make is the level of debt that will need to be issued by the US government. Currently, Treasury is running down their cash balance in order to avoid hitting the debt ceiling. When that ceiling gets raised, they will be forced to sell debt in order to pad their cash balance all while trying to sustain deficit spending. Early estimates indicate a ~$2 trillion deficit. With foreign entities not increasing their purchases of US debt, who will buy it? Odds are that it will have to be the Fed. All of the increased debt, banking problems, and likely recession all point to a move from an inverted yield curve to a more normal carry. Historically, once the move starts, the market will move from short rates over long rates to a more normal yield curve with the 10 year note running at least 150 basis points over the 2 yr.

Sincerely,



Stephen Davis
May 4, 2023

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9047 Poplar Ave; Suite 101
Germantown, TN 38138

sdavis@daviscomllc.com

T: 901-766-4446
F: 901-766-4406