The Convexity Maven

A Commentary by Harley Bassman

September 17, 2024

"Forests and Trees"

Sequoia National Park

The nattering nabobs of financial punditry are burning ink on whether the Federal Reserve Bank (the FED) will reduce their overnight Federal Funds rate by 25bp or 50bp….I don't care.

The more relevant question is what happens over the next twelve months.

Most informed investors are aware of the massive disconnect between the various asset classes; but some may not appreciate the fireworks in the bond market since the celebration of July 4th a few months ago.

Today's commentary will be brief, and unlike most "two-handed" economists I will offer an opinion. But what is almost certain is that the financial markets will soon have that "Come to Jesus" moment of sudden realization, comprehension and recognition that often precipitates a major change.

What I repeat ad nauseum, and cannot stress enough, is that "Forward rates" are not the market's prediction of the future. Rather, Forward rates are simply the mathematical break-even between two different maturity investments.

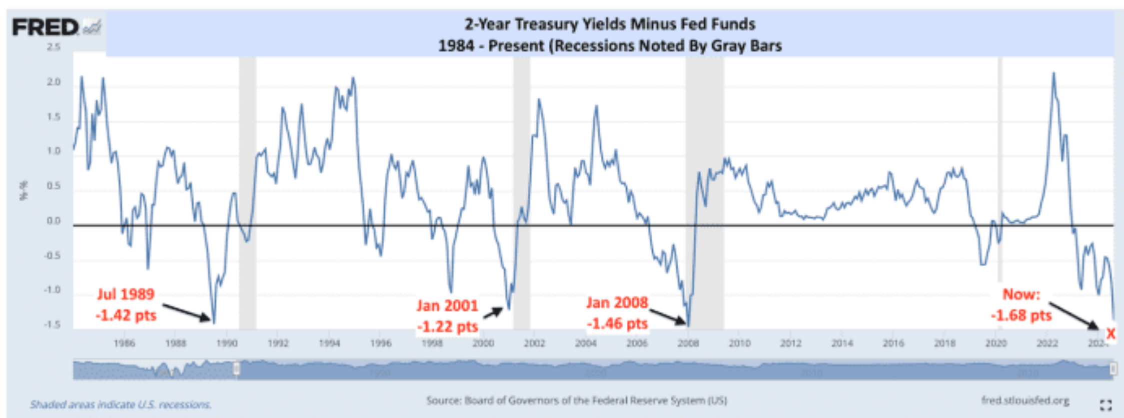
In a nutshell, if Grandma can buy a one-year CD at 3% or a two-year CD at 4%, she would only buy the one-year CD if she thought that in twelve months, she could buy another one-year CD at 5% or higher. We would call this 5% rate the one-year rate one year forward (or the break-even rate).

Waving off a few details, earning 3% for the first year and 5% for the second year is like earning 4% per year for the full two years. For any two dates one can solve for the "break-even" rate for the third leg such that one is indifferent.

When the Yield Curve is inverted, that math is a bit upside down, but computationally the same. If the one-year rate is 5% and the two-year rate is 4%, then the breakeven for the one-year rate next year will be 3%.

In this example, Grandma would only buy the two-year bond at 4% if she thought the one-year bond a year from now would be less than 3%.

Such is the financial landscape presently where the US Treasury two-year rate has declined from 4.71% on July 3rd to a current rate of 3.58%. This has created a record -nila line- inversion between the current Fed Funds rate and the two-year rate; a spread usually associated with an economic train wreck.



While not a prediction of future, the break-even for such a constellation is rather astounding. I will save you the math and offer that the current UST one-year rate would need to decline from its current 3.97% to 2.97% by the end of next summer to make owning a UST two-year a profitable proposition.

Since calculating Forward rates for civilians is a headache, let's convert the current Yield Curve construction into a profile that is more intuitive.

Using similar calculations from above, the -hara table- below offers the break-even level of the Fed Funds rate over the next year.

Fed Funds Futures Projections

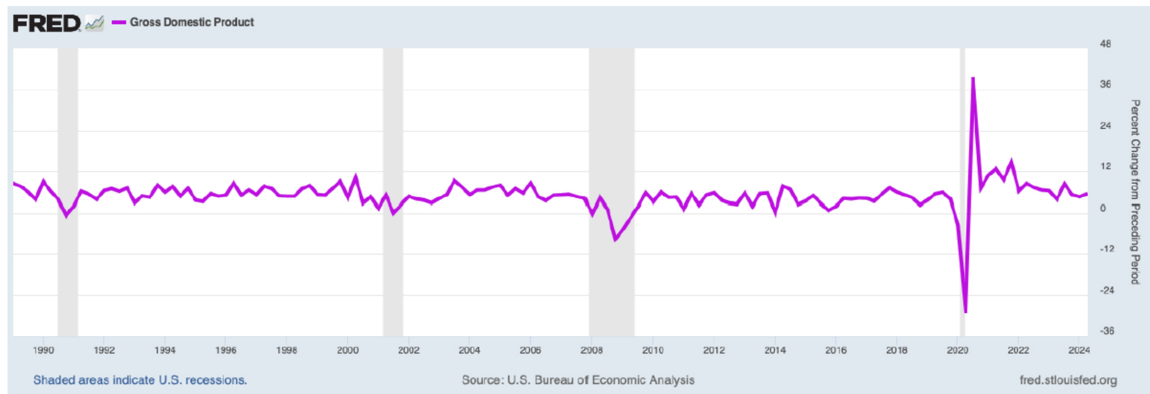
Current	**5.38%**	
		Reductions
24-Sep	5.17%	
24-Oct	4.93%	0.45%
24-Nov	4.63%	0.75%
24-Dec	4.37%	1.01%
25-Jan	4.11%	1.27%
25-Feb	3.77%	1.61%
25-Mar	3.64%	1.74%
25-Apr	3.43%	1.95%
25-May	3.25%	2.13%
25-Jun	3.13%	2.25%
25-Jul	3.02%	2.36%
25-Aug	2.92%	2.46%
25-Sep	**2.89%**	**2.49%**

Source – The CME and Bloomberg

Notice that the market has priced in a break-even Fed Funds reduction for tomorrow of 45bps, close to the much-anticipated 50bp rate cut advertised in the press. While I think this is a bit more than warranted, I can swallow this.

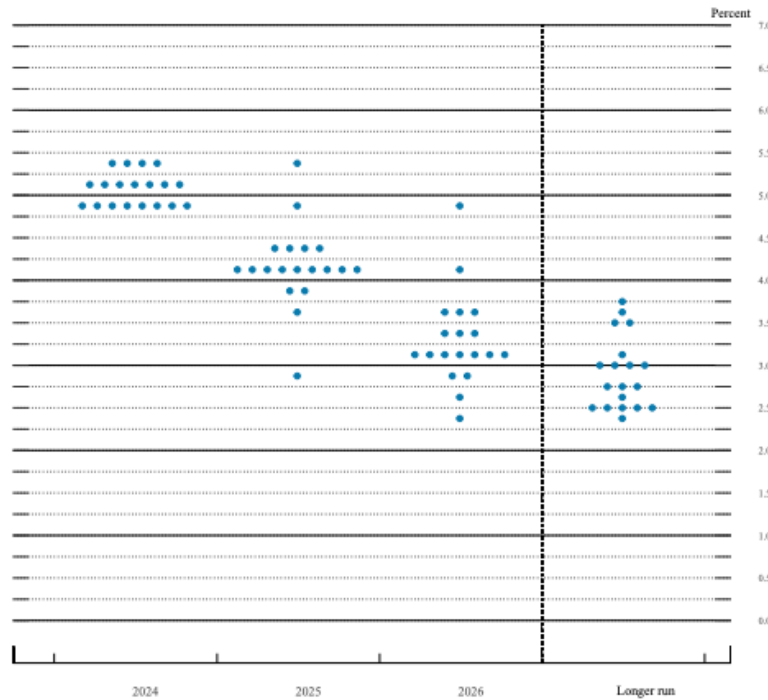
What is clearly the "wrong price" is the 249bp of rate cuts anticipated from now to September 2025. This implies not a much bandied "hard landing", but rather it is bond investors fearing an imminent "crash landing".

This would be quite a surprise since the latest -jamani line- Nominal GDP clocked in at 5.9%, the same zip code as its 35-year average.

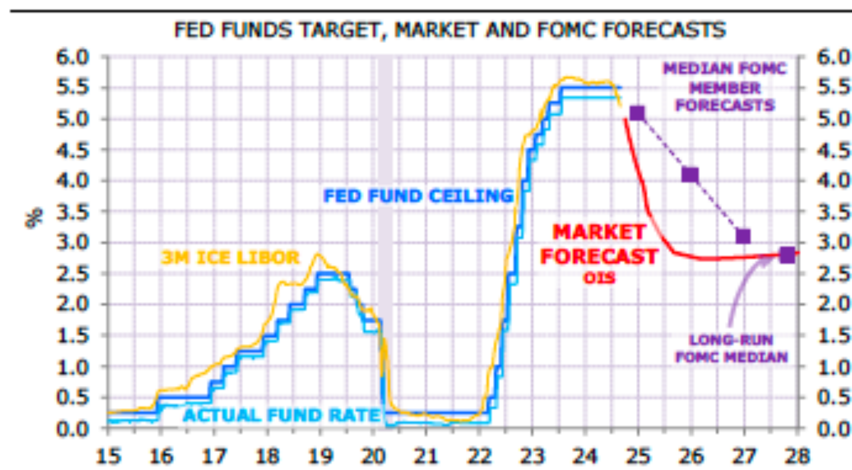


This would also be a shock to the FED whose -asamana- June DOTs plot assessment of monetary policy expected their rate to close 2025 near 4.0%.

Figure 2. FOMC participants' assessments of appropriate monetary policy: Midpoint of target range or target level for the federal funds rate



An overlay of the -lala line- market vs the -saraba line- FED DOTs highlights the near-term disconnect between traders and policy makers.



Source: Federal Reserve, Bloomberg, NBER; Minack Advisors

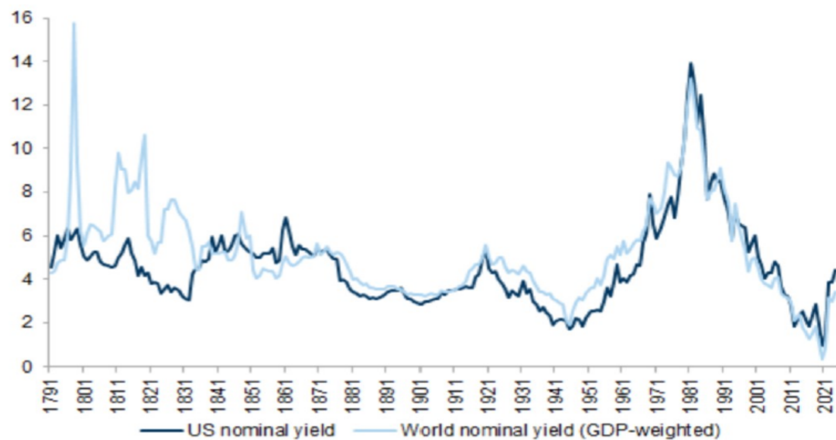
What this all means….

Without a significant change in the economy, we have reached cruising altitude.

1) The FED's stated inflation target is 2.0%
2) The FED's DOTs target is inflation +50bp, or 2.50%
3) The 2yr rate will settle in at Fed Funds +50bp, or 3.00%
4) The 10yr rate will settle in at the 2yr +100bp, or 4.00%

The one-year forward UST 2yr rate is now 3.05%; stick a fork in it we are done.

Moreover, the –pachi line- UST 10yr rate at 3.65% has finally bounced back to near its ultra-long-term average.



I suppose the Casandras reading their tea leaves could be right that a hard landing is just around the corner, but tell that to the SPX near its all-time high.

In a nutshell, the gas tank is empty on long maturity bonds.

The market has twisted itself into a construction where it will be difficult to earn a profit from owning longer-term bonds; and in fact, I would propose the market has overshot and will pull back as this reality is revealed in the fullness of time.

If it is indeed the case that interest rates have limited downside, then the clever investment idea is to execute a bond "covered-call" strategy; and the most efficient way to do this is via the purchase of newly issued Mortgage-backed Securities (MBS).

Buy Newly issued MBS

As detailed in *"Of Horses and Water"* – July 2, 2024, newly issued MBS offer the best risk vs return in the fixed-income market.

Not only is their Distribution and Yield to Maturity substantially better than legacy MBS Index products, but also, they have less interest rate risk.

MBS Index Strategy:	Newly Issued MBS Strategy:
Price ~ **96.51**	Price ~ **51.84**
Coupon ~ **3.81%**	Coupon ~ **6.0%**
Distribution ~ **3.95%**	Distribution ~ **5.79%**
Effective Duration **5.55**	Effective Duration ~ **3.25**
Yield to Maturity ~ **4.18%**	Yield to Maturity ~ **4.93%**

Source – The Bloomberg

In fact, their year-to-date -satari line- risk adjusted performance has exceeded most other bond strategies.

Strategy	9/13/24	Newly-Issued MBS	MBS Index 1	MBS Index 2	Bond Aggragate	IG Bond	7-10yr UST	3-7yr UST
Price		$51.85	$96.51	$46.92	$101.74	$113.21	$98.88	$120.08
Monthly Coupon		$0.250	$0.318	$0.196	$0.312	$0.405	$0.288	$0.320
Distibution Yield		5.79%	3.95%	5.02%	3.68%	4.30%	3.50%	3.19%
Yield to Maturity		4.93%	4.18%	4.53%	4.26%	4.93%	3.61%	3.47%
Duration		3.00	5.44	6.62	6.22	8.77	7.25	4.35
YTD Total Return		4.21%	5.00%	5.44%	4.82%	5.03%	4.76%	4.46%
YTD Volatility		5.11%	6.59%	6.94%	5.72%	7.14%	7.06%	4.42%
Sharpe Ratio		0.96	0.63	0.65	0.74	0.69	0.51	0.79

Most anomalously for a market anticipating a hard landing, -gulabi line- MBS still trade 75bp cheap to -barokali line- Investment Grade (IG) corporate bonds.

MBS Spread vs IG Credit Sperad

Concluding Thoughts

The big picture is that the Bond market is orthogonal to the Stock market. Unless history has been rewritten, one of these two markets must relent.

I suppose Stocks could be looking at the market-suggested 250bp reduction in rates by next year as a bullish condition, but then what would be the impetus for the FED to cut rates so sharply without an economic hard landing that would crash the Equity market.

The price of Gold has rallied to forever highs, which does offer support to the Bond market's view of the world; but I think Gold's price is more linked to the geopolitics of a Smoot-Hawley style redux of our tariff system.

If I had to point a finger, I would say the continued Yield Curve inversion is mostly a hangover from the FED's fat thumb on the scale via the excessive use of ZIRP (zero interest rate policy) and QE (quantitative easing).

The FED still owns way too many long-maturity bonds (and MBS) while Janet Yellen at Treasury is front-end loading UST debt issuance into T-Bills.

A UChicago geek might consider GDP to be the "income" of the US while the T10yr is the "cost of capital". As such, a business will borrow when the cost of capital is less than the income it can produce (and vice versa).

The current 225bp spread between 10yr rates (3.65%) and nominal GDP (5.90%) is wide and will limit further declines in rates without a recession.

I do not think the FED will cut rates as quickly as the market is pricing.

What I can say for sure is that newly issued MBS will be 40bp tighter (lower in yield) by June of next year; mark your calendars.

Remember: For most investments, sizing is more important than entry level.

Harley S. Bassman
September 17, 2024

Follow me on Twitter: **@ConvexityMaven**

Your comments are always welcome at: harley@bassman.net
If you would like to be added to my distribution, just ping me.

To become better educated on macro-economic fundamentals and policy, I urge you to connect with my partner, Michael Green, better known as @profplum99.

Special Coda: *Some of the ideas I suggest can be particularly complex via the use of futures contracts and options embedded into Strategies for leverage and/or convexity that is both clever and tricky. I urge you to ping my associates who are waiting for your call to detail these strategies more fully.*

For reference literature on the financial markets - particularly about options and derivatives - I will immodestly direct you to my educational archive at:

http://www.convexitymaven.com/themavensclassroom.html

If you still have kids in the house, please take a vacation that is more interesting than the Four Seasons, Costa Rica – life is not a dress rehearsal. Turn off the Crackberry (did I just date myself ?) and explore with the family. You don't need to break the bank, rent an RV and see the U.S. We traveled with our four kids on five incredible RV trips.

http://bassman.net

Special credit to Gerard Minack, the best macro analyst on the planet.

The Convexity Maven ("CM") is a publisher, not a registered investment advisor, and nothing in CM's Commentary is intended, and it should not be construed, to be investment advice. CM's Commentary is for informational and entertainment use only. Any mention in CM's Commentary of a particular security, index, derivative, or other instrument is neither a recommendation by CM to buy, sell, or hold that security, index, derivative, or other instrument, nor does it constitute an opinion of CM as to the suitability of that security, index, derivative, or other instrument for any particular purpose. CM is not in the business of giving investment advice nor advice regarding the suitability for any purpose of any security, index, derivative, other instrument or trading strategy, and nothing in CM's Commentary should be so used or relied upon.

CM hereby expressly disclaims any and all representations and warranties that: (a) the content of its Commentaries are correct, accurate, complete, or reliable; (b) any of its Commentaries will be available at any particular time or place, or in any particular medium; and (c) that any omission or error in any of its Commentaries will be corrected.

Although from time-to-time CM's Commentaries may link to or promote others' websites or services, CM is not responsible for and does not control those websites or services.

CM's Commentary is published and distributed in accordance with applicable United States and foreign copyright and other laws.

For the record, the Convexity Maven publishes Commentaries and maintains a website as an exercise of the unlimited right to offer non-commercial speech and publication under the First Amendment of the United States Constitution; notwithstanding our past President.

At any given time, CM's principals may or may not have a financial interest in any or all the securities and instruments discussed herein.