Convexity Maven

A Commentary by Harley Bassman

December 23, 2024

<u>"2025 Stocking Stuffers"</u>

Come this time every year, I publish a list of "Investments" that I think will do well over the intermediate horizon – two to five years. These are NOT meant to be nips to blips RV trades, but rather longer-term notions that capitalize upon either my strongly held themes or the trembling hands of Sharpe Ratio focused portfolio managers.

As many of you know, I am the Managing Partner at a firm I cannot mention, where I create and manage financial "strategies" whose tickers I cannot name.

We utilize Professional investment products (Futures, Forwards, Options, Total Return Swaps, etc.) <u>to offer civilians access to the best-in-class</u> **asset construction** with NYSE-listed liquidity and transparency at a modest fee.

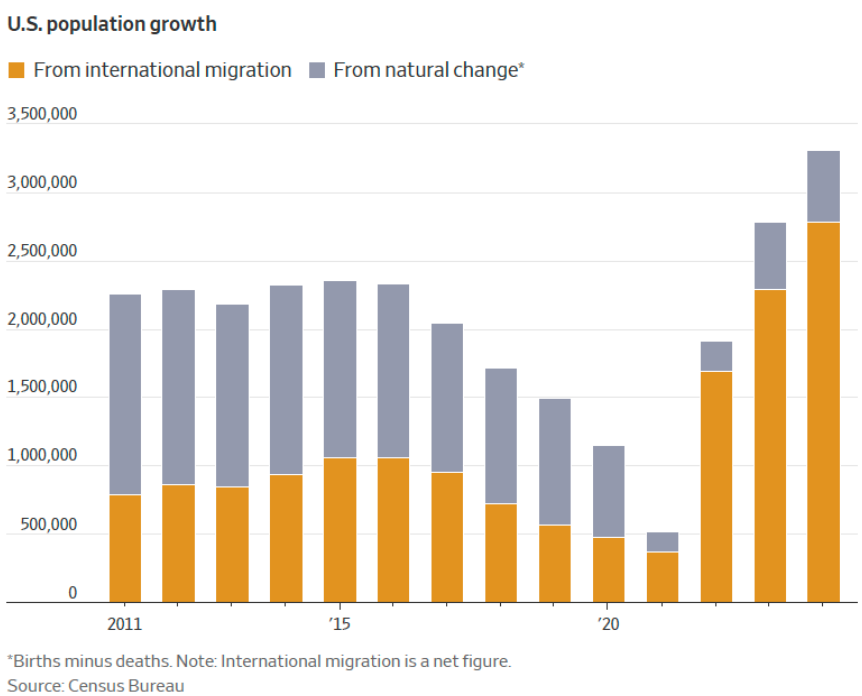
Before I detail this year's Model Portfolio let's consider the macro-landscape; and repeat my mantra that **sizing is more important than entry level**.

The Macro View

I have been relentlessly trash-talking those I refer to as “Team Transitory”. These would be the financial bloviators who have insisted that inflation is transitory; and indeed, inflation tagging 9.1% in 2022 was “transitory”.

But the implication was that inflation would return to its 2012 to Covid average of 1.6%; and I would propose this is unlikely. **Thus, my macro-interest rate view is “higher for longer”** with the Yield Curve rotating around the T10yr.

Hiding in plain sight is the -tala bars- massive influx of immigrants, legal or otherwise, that occurred over the past few years.



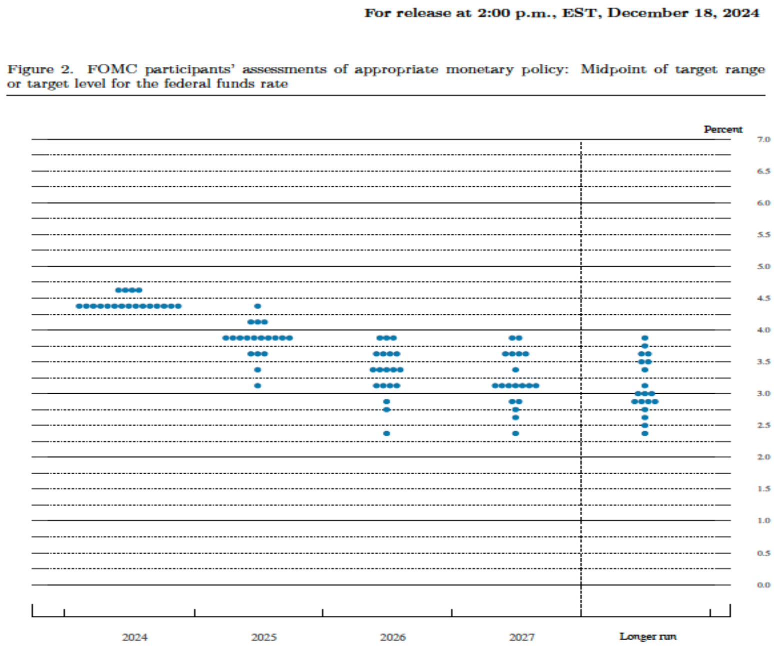
No matter your politics or counting skills, we should all agree that <u>an increase in the number of workers will increase GDP</u>.

GDP ≡ NUMBER OF WORKERS * HOURS WORKED * PRODUCTIVITY

Team Transitory has proposed that various measures of inflation and employment are flawed, and that there will soon be a “Wylie Coyote” moment when the “long and variable lags” of economic data reveals itself.

I suspect the disconnect between Household and Establishment employment as well as Owner’s Equivalent Rent (OER) versus home prices is the under count of undocumented laborers who find work via any means possible.

The FED has come around to this view. Their -abi DOTs- most recent Summary of Economic Projects now forecasts a 2025 year-end rate of 3.88% and a long-term Fed Funds rate of closer to 3.00%, both up from prior estimates.



So too has the market. Prior to the Fed commencing their first rate cut (which surprised me since I expected nothing until after the election), the market anticipated close to a dozen 25bp rate cuts. After the Fed's "hawkish cut" last week, the market is now on top of the Fed's 3.88% projection.

Fed Funds Futures Projections

	9/17/24		12/20/24	Anticipated
Spot Rate	**5.38%**		**4.38%**	Reductions
		Difference		
24-Dec	4.37%	0.10%	4.47%	-0.09%
25-Jan	4.11%	0.22%	4.33%	0.05%
25-Feb	3.77%	0.54%	4.31%	0.07%
25-Mar	3.64%	0.63%	4.26%	0.12%
25-Apr	3.43%	0.76%	4.19%	0.19%
25-May	3.25%	0.91%	4.15%	0.23%
25-Jun	3.13%	0.99%	4.11%	0.27%
25-Jul	3.02%	1.05%	4.07%	0.31%
25-Aug	2.92%	1.13%	4.04%	0.34%
25-Sep	2.89%	1.13%	4.02%	0.36%
25-Oct	2.84%	1.16%	4.00%	0.38%
25-Nov	2.80%	1.17%	3.97%	0.41%
25-Dec	2.78%	1.18%	3.96%	0.43%

My investments for 2025 circle around the notion that **"Fair Value" for the UST 10yr rate is 4.35%.** That is 147bps (the 35-year average) over a long-term Fed Funds rate of 2.88%. T2yrs will head to 3.35% and T30s to 4.75%.

Buy newly-issued Mortgage-backed Securities (MBS)

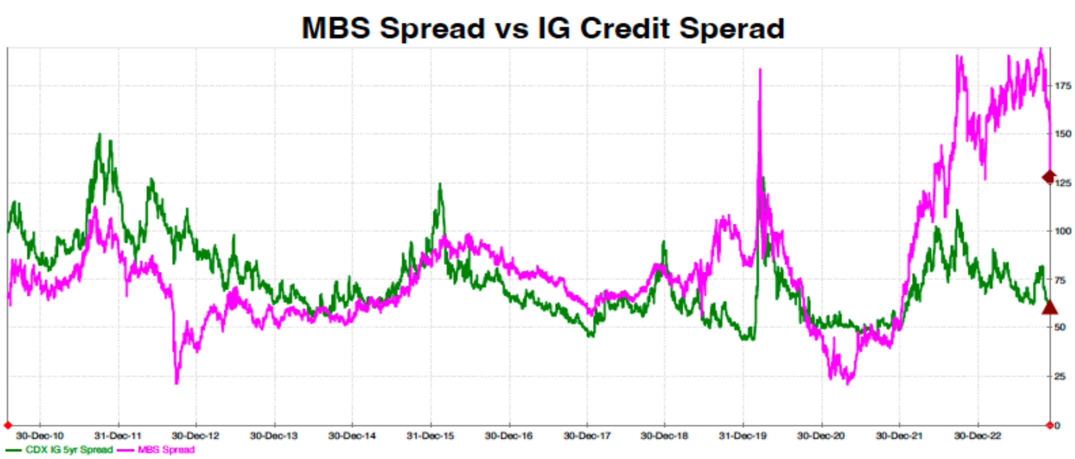
As a reminder, Mortgage-backed Securities issued by Fannie Mae are for all intents and purposes guaranteed by the US Government. If you think otherwise, I urge you to buy a gun, cans of tuna, and small denomination Gold coins as those would be necessities if Fannie (or Freddie and Ginnie) defaulted.

There is a huge difference between the MBS Index "benchmark" which is mainly bonds with coupons between 2.0% and 3.5% and newly-issued MBS that primarily have coupons between 5.0% and 6.0%.

As detailed below, newly-issued MBS have a higher distribution (dividend) and yield to maturity, yet also a lower duration (risk). This past year, newly-issued MBS outperformed other high-credit (not junk) bond assets. Most important, its "Sharpe ratio" (which measures return vs risk) was significantly higher.

Strategy (12/20/24)	Newly-Issued MBS	MBS Index	Bond Aggragate	IG Bond	7-10yr UST	3-7yr UST
Price	$49.90	$91.66	$96.96	$106.98	$92.61	$115.34
Monthly Coupon	$0.250	$0.294	$0.316	$0.385	$0.307	$0.331
Distibution Yield	6.01%	3.85%	3.91%	4.32%	3.98%	3.44%
Yield to Maturity	5.72%	5.09%	5.04%	5.59%	4.51%	4.41%
Duration	4.50	5.96	6.07	8.38	7.11	4.27
YTD Total Return	1.91%	1.29%	1.37%	0.99%	-0.46%	1.63%
YTD Volatility	4.81%	6.48%	5.67%	7.32%	6.94%	4.34%
Sharpe Ratio	1.19	0.79	0.89	0.76	0.65	1.02

Newly-issued -sorti line- MBS trade about 130bps above the UST 10yr, still well above its long-term average of +75bp. More important, this is about 80bp more than the -sabz line- spread of Investment Grade (IG) Corporate bonds.



Remember, newly-issued MBS can only be purchased by civilians through my NYSE-listed "strategy", which now has an AUM of $1.62bn.

My highest conviction trade is to sell MBS Index products (legacy MBS) and buy my newly-issued MBS "strategy". Just make sure to buy back a bit of duration to balance out your rate exposure. I would also suggest you reduce (sell) credit risk and buy this strategy plus the "Bond Bull" (detailed below).

This is my best investment idea for 2025; and while the train has left the station there is still plenty to go on this ride.

Buy ultra long-dated bond call options for Capital Efficiency

For reasons beyond the scope of this Commentary, there is an active and liquid market for options on Stocks, Bonds and Foreign Exchange that expire from five to ten years. Strangely, and this too is a bit complicated, the Implied Volatility for long-dated expiry bond options trade lower than shorter-dated options.

The -naranji shaded- boxes mark the peak Volatility while the -asman shaded- boxes mark their nadir. This makes longer-dated expiry options on Equities and Fx costly to own as they decline in price both by decay (theta) as well as the slide in Volatility (vega).

Implied Volatility

	1 month	6 month	1 year	3 year	5 year	7 year	10 year
Equities (SPX)	14.2%	16.1%	17.1%	18.8%	20.2%	21.2%	21.3%
Fx (Euro)	8.3%	8.3%	8.2%	8.9%	8.8%	9.2%	9.6%
Bonds (10yr)	91.1	101.9	102.3	98.9	95.3	87.9	82.1

Thus, owning long-dated expiry bond options can be rather clever since much of the decay from the passage of time is offset by the increase of Implied Volatility.

This led me to create the NYSE-listed "Bond Bull" strategy, initially priced at $60:

1) $60 of short-term USTs (or similar high-quality assets);
2) A 7-year call option (March 2032 expiry) on $1000 of 10yr maturity bonds. [The strike level is equivalent to 3.25% on the UST 10yr bond]

The Bond Bull is **duration on steroids** with a "modeled" duration of about 43 years (2.60x the UST 30yr). This long-dated option has a low "theta" with a modeled <u>static one-year return of positive 2.0%</u>. [Parallel rate shift; constant Imp Vol]

These long-dated options are professional products that are not available to civilians; you will not find them on any listed exchange. You can only access them via such strategies (or illiquid Wall Street Structured Notes).

While the Bond Bull can certainly be used as a **tactical** hedge against a swift decline in interest rates, its better use is as a **strategic** duration substitute.

Instead of $1000 invested into an Aggregate bond fund, mix the Bond Bull Strategy with other fixed-income assets to attain a superior return profile.

	Price	Investment	Yield	Duration
Aggregate Bond ETF	$99.33	**$1,000**	**4.84%**	**6.2**
AAA CLO ETF	$50.75	$875	6.38%	1.0
Bond Bull	$60.00	$125	2.04%	43.0
Synthetic Portfolio		**$1,000**	**5.84%**	**6.2**

		Investment	Yield	Duration
Aggregate Bond ETF	$99.33	**$1,000**	**4.84%**	**6.2**
High Yield (Junk) ETF	$79.90	$900	7.08%	3.3
Bond Bull	$60.00	$100	2.04%	43.0
Synthetic Portfolio		**$1,000**	**6.58%**	**7.3**

The Bond Bull is the **"151 proof" of duration assets**; a 15%-dollar allocation will match the duration of the Aggregate Bond Index. And its massive **positive convexity** will improve most investment profiles if markets become violently dislocated, a feature not a bug of this new administration.

A more detailed description of the Bond Bull can be found on my December 10, 2024, Commentary – "Hard Landing". [https://www.convexitymaven.com]

Lend your balance sheet to Wall Street

After the Great Financial Crisis (GFC) of 2008/09, bulge-bracket Wall Street dealers had their wings clipped; not only was "proprietary trading" (in-house Hedge Fund trading) eliminated, but also their balance sheets were constrained.

Nonetheless, Wall Street dealers still needed to hedge their inventories. So, they devised a deal whereby they could sell assets to a professional investor without actually giving them the stocks or bonds.

It is called a "Total Return Swap" (TRS). Here, the dealer will pay the total return of some Index and receive back a rate linked to short-term interest rates. Often, the rate they receive back is at a significant discount to the market.

In a simple example, a Wall Street dealer may offer to pay a professional investor the Total Return (price movement plus interest and dividends) on the High Yield Index. In return, the professional would pay the dealer the three-month interest rate less 50bps.

So instead of owning a High Yield Index product, the investor would buy three-month UST bonds at current rate of 4.32%. They would receive the total performance of the High Yield Index product, but only pay the dealer 3.82%.

Thus, this professional investor would exactly own the performance of the Index, plus earn an additional half percent (50bps) by earning 4.32% on their UST bonds but only paying the dealer 3.82%.

Total Return Swaps (TRS) are only available to professionals who have an (ISDA) agreement with Wall Street dealers. However, some NYSE-listed product issuers / managers (hint, hint) have created "strategies" that embed TRS into their products to pass through the yield advantage. These high yield beta strategies via total return offer a similar risk profile, with a higher return.

Buy a NYSE-listed Managed Futures "Strategy"

I am not going to try and sell you on a "managed futures strategy", which is more commonly known as actively managed trend following.

You either believe or you don't. These trend following strategies are all rather similar, except some have a greater focus on commodities rather than equities.

The main features of an NYSE-listed "strategy":

1) <u>Diversification</u> from the standard 60%/40%
2) No lock ups, as it is <u>listed on the NYSE</u>
3) A significantly <u>lower fee</u> of 75bps rather than 2%/20%

Buy a Multi-QIS Alternative "Strategy"

Quantitative Investment Strategies, or QIS, are central to how the largest Hedge Fund managers earn their profits and can afford their condos at 220 Central Park South. These are computer-driven systematic investments where perhaps a few dozen are grouped together such that their volatility is reduced relative to their return profile (Sharpe ratio).

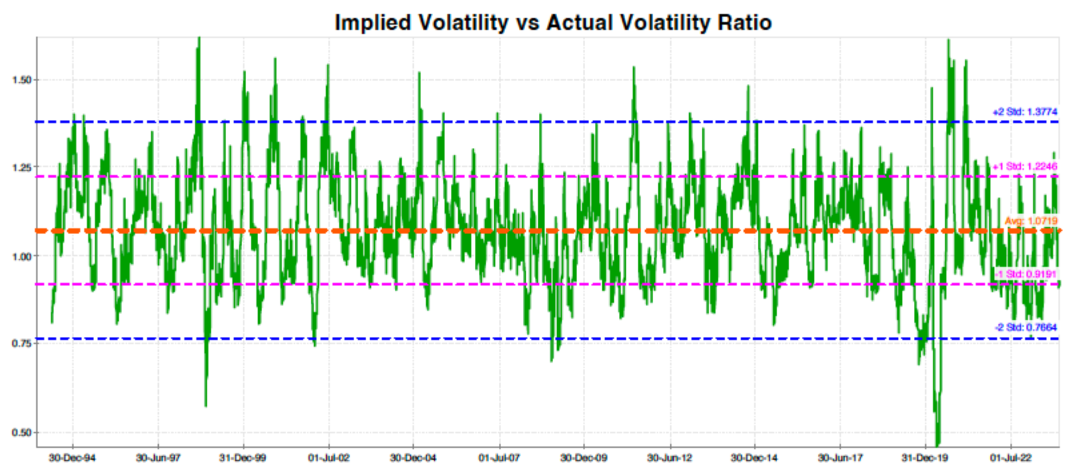
Again, using a professional ISDA the "strategy" buys 3-month USTs and enters into a selection of Total Return Swaps that complement each other.

The value proposition is identical to the managed futures "strategy". Both offer <u>professional products to civilians</u> as NYSE-listed strategies with a low fee.

VIX Income roll-down "Strategy"

As noted, the Implied Volatility term surface is steep for the SPX where 1-month options now sport a Volatility of 14.2% while 1-year options trade at 17.1%.

Generally, the short-term -marchubeh line- Implied Volatility on liquid assets (Bonds, Stocks, and Commodities) trades about 8% above their Actual Volatility.



There are many reasons for this, but primarily it is driven by the fact that <u>risk preference is not neutral</u>, i.e., the pain of losing a dollar is greater than the pleasure of making a dollar.

This 8% risk premium can be modeled as an insurance profit, but in fact it is closer to the net income of a casino where a slight mathematical edge can fund glittering chandeliers, a Celine Dion residency, and a $5 steak and egg buffet.

This is why some of the largest Hedge Funds employ a strategy of systematically selling one-month options and "delta hedging" every day at the close.

Orthogonally, there is significant upward pressure on longer-dated options as various entities need to purchase protection, often by regulation or accounting.

The persistent negative spread between the first and second VIX futures is wider than their economic fundamentals support, exaggerated by conflicting forces of income sellers and hedging by regulated buyers.

As such, a clever "strategy" is to sell the second contract until it becomes the first contract in thirty days, and then roll the exposure by covering the now front contract and re-selling it into the second contract – lather, rinse and repeat.

While Hedge Funds will often drink this strategy in its pure form, NYSE-listed strategies will employ less leverage and overlay some VIX call options as "crash protection".

NOTE: Not mentioned here is an allocation to a diverse Equity Index, which should be 40% to 60%, with the remaining spread across the above as suits.

Concluding Comments

Regular readers of my Commentaries know that I am a UChicago trained monetarist who strongly believes that excessive money printing will lead to inflation. Moreover, inflation in the US is presently a feature, not a bug.

We have too much debt, and the only ways to reduce it is to either default or inflate, where inflation is a slow-motion default. There is also the post-WW2 path of GDP growing faster than debt, but that presently seems unlikely.

The greatest problem facing our country is how to process the "pig in the python" of the aging of the Baby Boom generation as the mandatory fiscal spending policies of Social Security and Medicare soon overwhelm the budget.

Herbert Stein noted that "If something cannot go on forever, it will stop"; and this is what will happen. As I have said: "Pigs can fly if shot out of a large enough canon, but they eventually they return to Earth as bacon".

The Modern Monetary Theory salve was always rubbish; proven when the inflation of 2021 was not met with prescribed spending cuts and tax increases.

I predict there will be an income limit applied to the largest mandatory policies, which effectively is both a tax increase and a spending cut.

Harley S. Bassman
December 23, 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.