“2018 Stocking Stuffers”

“Don’t confuse brains with a bull market”
Humphrey Neill – 1963

Usually at this time of year I publish a “Model Portfolio”, a summary of my best investment ideas for the New Year. [http://www.convexitymaven.com/themodelportfolios.html](http://www.convexitymaven.com/themodelportfolios.html) I use the word “investment” purposefully as these are not nips-to-blips relative value trades, but rather clever constructions of macro ideas often sourced from panic-stricken counterparties who lack the courage of their convictions. I will note that since I have a personal ISDA, I tend to eat my own cooking; as such, rest assured I have plenty of (fully disclosed) skin in the game.

With the T10yr closing within a nickel of its January open, and the S&P 500 posting a 6%-handle realized volatility, I have only a few changes from last year’s portfolio. So, for brevity, refer to this link and I will add a few additional comments. [http://www.convexitymaven.com/images/Convexity_Maven_-_2017_Model_Portfolio_.pdf](http://www.convexitymaven.com/images/Convexity_Maven_-_2017_Model_Portfolio_.pdf)
Surely the most interesting idea offered last year was the suggestion to buy the listed Dividend futures on the SX5E for 2020 settlement; they were just plain the wrong price.

Since the publication date, this contract has rallied 24.6%, and that’s before the 12.1% gain in the currency. A year ago, this contract traded at a 19-point discount to Spot, it now trades at a premium. The ECB is expected to continue QE for another year, and dividends are projected to increase by many analysts, so I would suggest you roll the 2020 contact to 2022, which is presently marking at a 7-point discount. This takes cash out of the trade and resets your basis.

The other investment where I would consider a modification is the long-dated SX5E risk reversal. Last year I noted that you could buy the four-year (expiry = December 2021) K=3000 strike call, which was close to the spot price, in combination with the sale of the 26.7% out-of-the-money K=2100 put as a costless package.

With the spot Index up nearly 18% to 3570, I like the idea of closing the K=3000 call, and then entering into a new K=3600 call vs K=2600 put, taking out a net credit of 500 points. This is not a slam dunk since it leaves you short two puts (The K=2200 and the K=2600), but does monetize much of the gain (500 points of the 3000 to 3600 spread). This ticket carries well in a quiet market since the K=3000 call you are selling is close to the forward price. [Remember, time value is greatest when the strike is at-the-money forward.]

The buy of the MXN local currency bond has been a winner, although not quite as well as I had hoped. This 5-year MBono has declined in price by 1.75%, yet the currency has rallied by 5.5%. Toss in the 6.5% coupon and the package has returned roughly 10%. I like this position and I would hold it. The only significant risk on the horizon is the Mexican election, yet I have given up on predicting those types of outcomes.
The other trades were mostly different manners to buy Implied Volatility. The long-dated 10-year into 20-year payer swaption has lost a quarter of its value as its ImpVol has declined by 10%; nonetheless, please hold this one. You have nine years to go and 4.0% is not a ‘lottery ticket’ strike level.

The NKY five-year straddles would have been fine if left unhedged, but a blood bath if you managed the delta. The delta profit from the 24% market move mostly offset the losses from Theta and Vega. However, the alternate NKY vs SPX Vol Swap has done well since that spread has collapsed by over two points. I would hold the long vanilla NKY options, but I would take off the NKY vs SPX Volatility spread.

As for the Hybrid option, that will expire worthless. My comment on that is: “When you buy life insurance, you don’t win when you die.” This was a super cheap tail hedge against a uniform stock and bond pullback (which will happen someday). Definitely reload this trade when you can buy the Hybrid at an 80% (or greater) discount to the vanilla.

Finally, the portfolio of Closed-End Funds (CEFs) performed as advertised. Most were up, some were down, and the total return was a bit over 10%. I significantly increased my allocation to this asset class during the year. If you would like to see my current CEF portfolio, send me a note.

**My outlook for 2018 from 30,000 feet:**

Primarily driven by demographics, the T10yr will not breach 3.5% for the next five years.

Risk assets are fine until the first quarter of 2019, that is when the G-4 Central Banks will collectively be net drainers of liquidity (QT - Quantitative Tightening)

The IRS will determine that BitCoin holdings of over $10,000 require an FBAR filing: [https://www.irs.gov/pub/irs-utl/irsfbarreferenceguide.pdf](https://www.irs.gov/pub/irs-utl/irsfbarreferenceguide.pdf)

If you take a more sanguine view of crypto-currencies than I, you may agree with this BitCoin prophet: [https://www.facebook.com/awakenwithjp/videos/1968519879830531/](https://www.facebook.com/awakenwithjp/videos/1968519879830531/)

Enjoy your family, and have a safe holiday.

Your comments are always welcome at: [harley@bassman.net](mailto:harley@bassman.net)

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