Convexity Maven

A Commentary by Harley Bassman

December 3, 2019

"Holiday Stocking Stuffers - 2020"

(A Model Portfolio)

Come this time every year, I tend to 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.

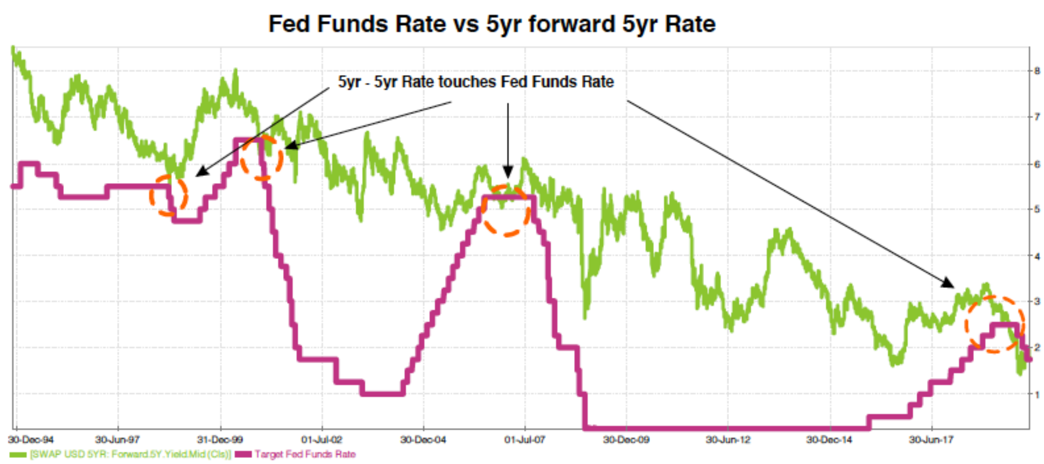
Also in repetition, western Central Bankers still refuse to take off the training wheels and let the financial markets toddle without a push. This is a strange juxtaposition since the Federal Reserve (Fed) claims to value its independence; yet it refuses to offer a similar proposition to those it supervises. The Fed has not lost a step to Baby-Boomer "snowplow parents"; and both might take notice of the unintended consequences when one will not let the kids grow up.

Let me offer a few leafy greens before I serve the main course.

There is little primary evidence that our Service-sector focused economy is near a recession; as such, a Central Bank repressed US Treasury Yield Curve that is mostly under 2.00% may well be able to support an S&P 500 above 3000.

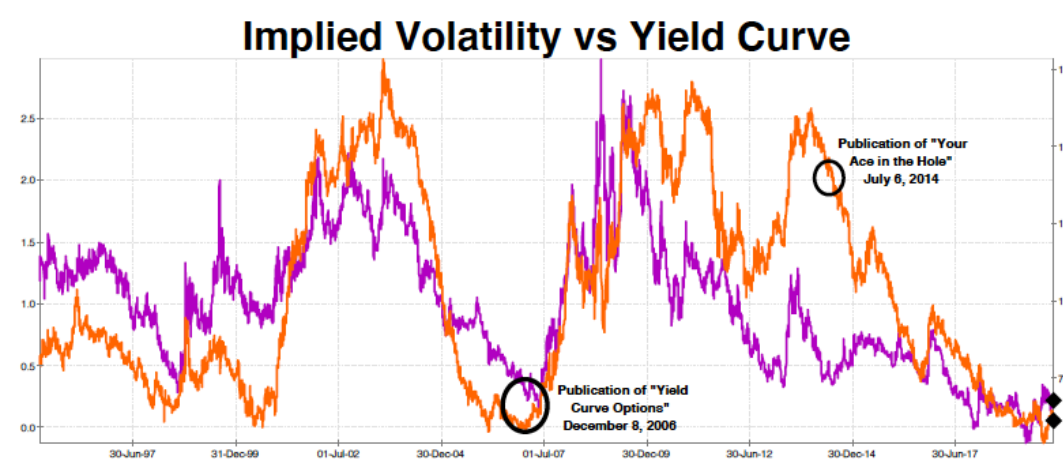
That said, **it is never different this time**. The Yield Curve inverted in December 2018 and history often suggests that a recession should follow 18 months hence – roughly July 2020.

Despite inflation under their 2.0% target, and unemployment sporting a 3%-handle, a worried Fed again began to reduce their -cerise line- benchmark interest rate soon after it converged with the -fern line- 5yr forward 5yr Rate.



Source for all charts unless otherwise noted: Credit Suisse LOCUS

While the Equity markets are shouting "Party on, Garth", measures of Implied Volatility are still somnambulant with the VIX at 11.5 and the MOVE at 60 despite cold wars in Washington and Hong Kong, and hot wars across Mesopotamia.



As detailed in *"Your Ace in the Hole"* – July 6, 2014, the -sinensis line- shape of the Yield Curve has the best correlation to the -damson line- Implied Volatility as the curve slope is driven by uncertainty (risk); and the level of Implied Volatility is effectively the "cost of risk".

The Yield Curve is still flat; thus, it can only steepen. This is why so many of the trades I will outline involve buying long-dated options that have a significant positive exposure to an increase in Implied Volatility (vega).

Notwithstanding my view that the Yield Curve will steepen, most of my investments have a long bias to interest rates since bond rates should not run away to the upside; I believe the T10yr is capped at 3.5% until 2023.

Demographics is the iceberg of investment management; it is 90% underwater and moves quite slowly. The cycle is generational, so one cannot 'trade' the process, but ultimately it is the primary determinant of the economy.

GDP = Workers * Hours * Productivity

The -gujarati line- captures the "Baby Boomers" accelerating the Labor Force growth rate as they matured in the 1970's. The -chili line- of interest rates (and inflation) followed this trend (with a lag) as the Boomer's demand for goods and services (and money) outstripped the supply available from the (smaller) previous generation. Both have declined over the past thirty years.

Source: Gerard Minack, Minack Advisors

As a macro-economic concept, interest rates (and inflation) should rise sometime in the next decade as the Millennials increase household formation, and demand goods in excess of what retiring Boomers can offer.

As a reminder, I am not an investment advisor, nor is this a solicitation. You should not rely upon this Commentary for accuracy and you should seek advice from a professional. Finally, I personally own a variation of these investments.

Buy AMLP call options

The AMLP listed ETF is a collection of the larger fossil fuel MLPs that have not converted to a C-Corp profile. Notwithstanding its disadvantageous tax structure, its current yield of nearly 10%, or about 825bps wide to the T10yr, can only be explained as either a stupendous tax-loss motivated liquidation, or the realization that MLPs are a feat of financial engineering that is inherently flawed.

Fossil fuels will not be eliminated in the near future, and their transportation from the ground to the gas tank is a necessary function that at some point must be a profitable venture. It is my fervent hope that MLPs are not the subject matter for Betheny McLean's next best seller.

Spot price = $7.85, Current yield = 9.95%
Option expiry - January 21, 2022
Buy the call struck at $8.00 @ 60 cents
Max loss – the premium; Unlimited gain.

I detailed AMLP options in *"Fail Better"* – October 22, 2019. I predicted a bumpy ride with an expected drawdown: OUCH ! The stock promptly dropped 12% in four weeks, despite an increase in the dividend. As suggested, the option structure has cushioned the mark-to-market loss; but it still hurts.

A 10% dividend for a listed 20-stock Index is the wrong number; either AMLP will rise in price, or the 19.5 cent dividend will be reduced to 14 cents.

I suppose it is possible that the underlying MLPs are functionally a $200bn Ponzi scheme that relied upon rising oil prices to maintain the illusion of profitability; but I suspect the answer is a bit more banal. What we likely have here is a mismatch in capital where Retail investors have tossed in the towel and Institutional investors can't or won't buy a (K-1) partnership structure.

My best guess is that Private Equity will enter this space next year. PE firms have bulging commitments from desperate Pension and Insurance managers who need a 7%-handle return to close the gap with their liabilities. In the past six-months BPL jumped 28% and SEMG advanced 58% on take-over bids.

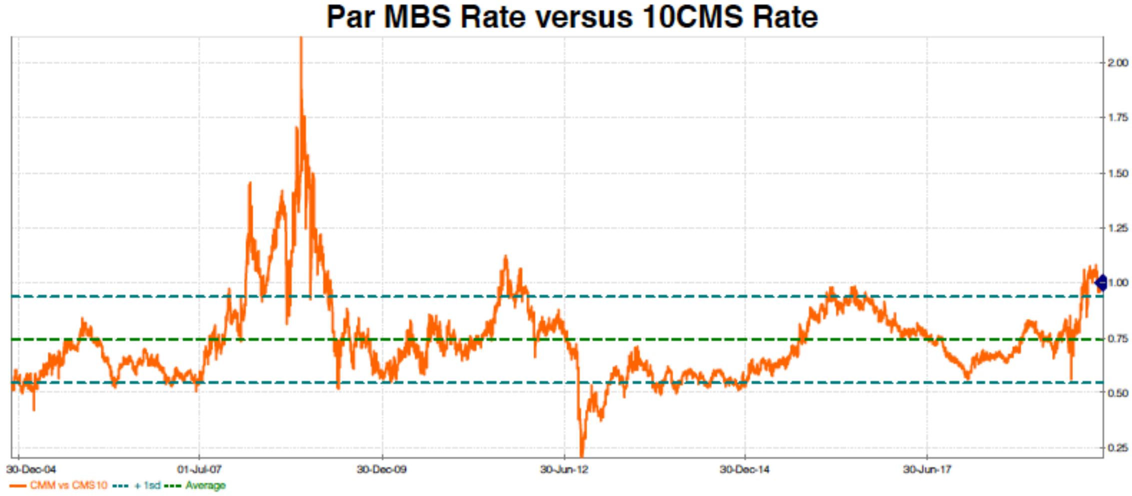
Assuming the MLP business model is sound; this is Private Equity's raison d'etre.

Closed-end Funds:

Closed-end Funds (CEFs) are particularly attractive at this point in the rate cycle. This is because almost all CEFs employ about 30% leverage, in other words they buy $130 of assets with $100 of equity and borrow the balance. Since the next move by the Fed will almost surely be an ease, the reduction in borrowing costs will likely increase the dividend. In expectation of this, one would expect the frequently discounted spread between the market price and the NAV to narrow. Highly levered CEFs might even trade at a premium to NAV.

I am particularly fond of CEFs that invest in MBS bonds. For reasons I may detail in a subsequent Commentary, the -carrot line- yield spread of MBS bonds versus the ten-year swap rate has widened significantly. This spread, presently a shade over 100bps, is a full standard deviation north of its "forever" average of 75bps. If this spread were to return to its average, some of these CEFs could see their NAV increase by as much at 10%.

Par MBS Rate versus 10CMS Rate



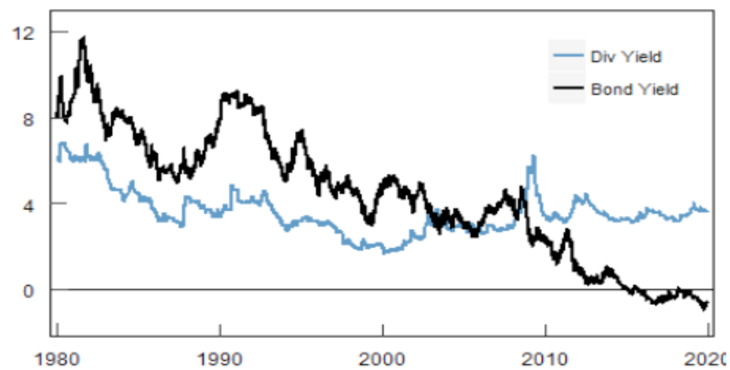
Yield Curve options (professionals only):

Perhaps a bit early in *"Catch A Wave"* – June 27, 2018, a Yield Curve option is still the only way to purely capture the shape of the Yield Curve with a limited loss profile. The option price of 28bps for a five-year option is the same, but the strike level is now 10bps higher at 30bps. This trade will be a winner if the spread between the two-year and the ten-year swap rates is wider than 58bps.

This seems likely since the average spread since 1990 is 119bps. Moreover, the spread tends to reach about 250bps when the Fed power-eases into a recession. While shorter expiry two-year and three-year options are optically cheaper, I like the five-year option as it has a "vega kicker" when the Curve steepens.

EURO Stoxx 50 (SX5E) Long-dated Options:

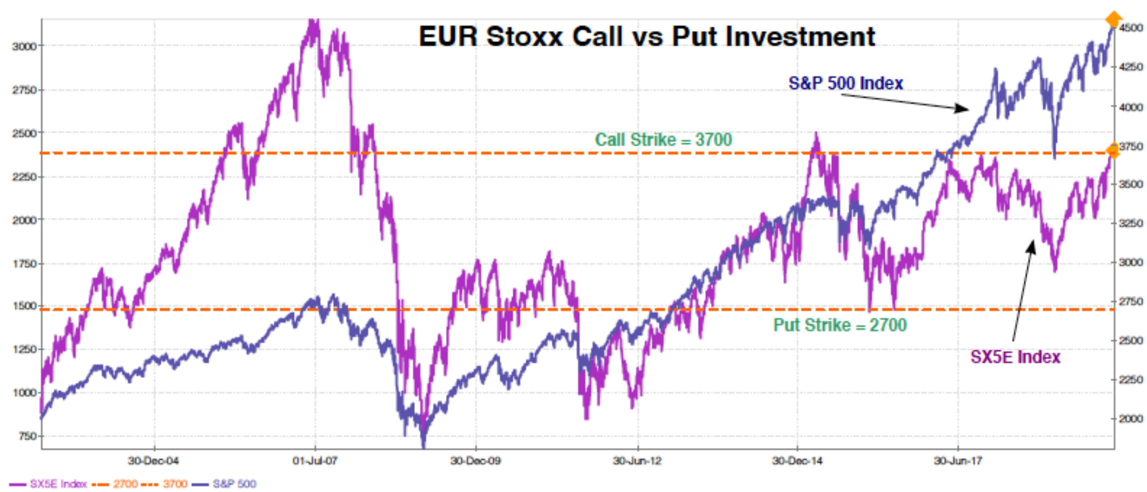
As a Special delivery from the Department of Unintended Consequences, the ECB's self-defeating policy of negative interest rates (NIRP) has depressed forward asset prices. (*"The Opposite of Bad is Worse"* – September 24, 2019) Notice how the -fossil line- five-year European interest rate and the -vinca line- dividend yield for the benchmark Euro Stoxx 50 (SX5E – Dow Jones of Europe) sharply inverted soon after Mario Draghi's "whatever it takes" speech.



Source – JP Morgan

This inversion has pressured the "arbitrage-free" five-year forward price 15% below the spot price. Since derivatives are priced via the forward, the calls artificially cheapen while the puts richen. Using exchange (EUX) traded options:

Buy December 2024 expiry SX5E call option, Strike = 3700 (~at-the-money)
Sell December 2024 expiry SX5E put option, Strike = 2700 (27% out-the-money)
Costless



Please do not try to sell the -maya line- S&P 500 versus the -taffy line- SX5E. Rather, notice the relative performance of both, as well as the strike locations for this option package. This structure is simply a better way to be long Europe.

Long-dated JPY vs USD option (professionals only):

Advocates of Modern Monetary Theory (MMT), as well as Nobel prize winning NYTimes columnists, point to Japan as proof that deficits do not matter; and many others insist that Central Banks cannot create inflation – This is just wrong.

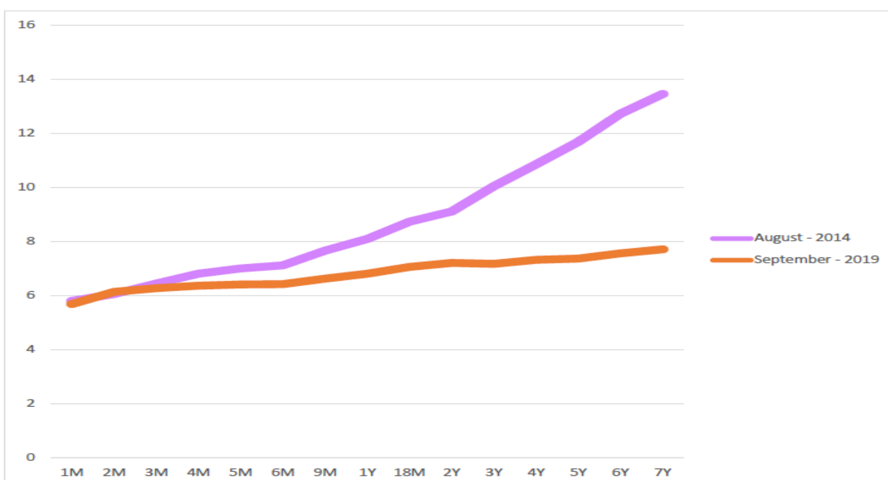
CB's can surely create 10% inflation; the challenge is producing 2.0% inflation, which is the equivalent of landing a jumbo jet onto a football field.

The Bank of Japan (BOJ) has almost fully monetized their economy. This Central Bank owns about 43% of all Government bonds (JGB) and nearly 77% of the ETF market. Total JGBs issued top 235% of GDP. To put that in perspective, Greece clocks in at 182%, Sudan at 176%, and Venezuela at 172%.

I can assure you this will not end well; I just do not know when it will occur.

I have written about this trade before, *"Money for Nothing"* – July 29, 2014; but the entry level has improved with the steep decline in JPY Implied Volatility.

In another unintended consequence of financial repression at the hands of the Western Central Banks, the JPY/USD Implied Volatility Term Surface (the measure of IVol over time to expiry) has collapsed. Notice the -ipomoea line- for 2014 versus the more recent -lilium line-. The IVol for long-dated options (7yr) are presently not much higher than that for short-dated options (3mth).



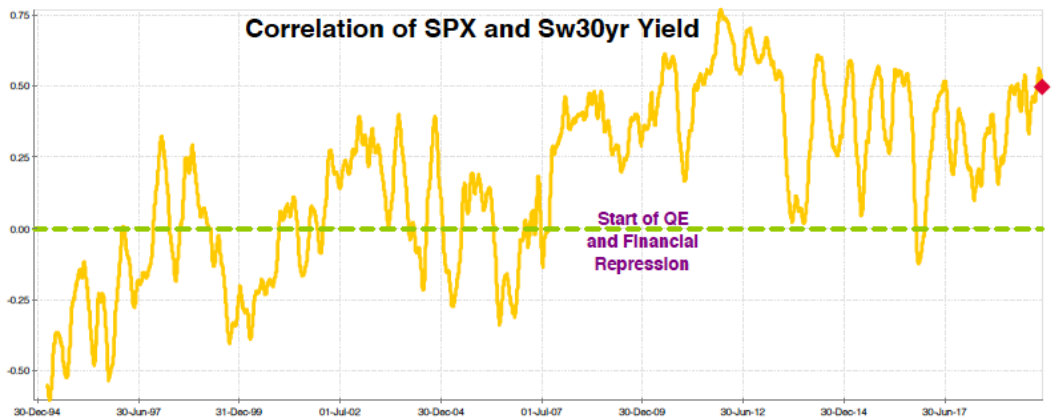
Spot JPY / USD = 109.52
Buy JPY put / USD call, Dec 2026 expiry (7 years), Strike = 100, Px = 4.75%

1) Option is 9.52% in-the-money, yet you pay only 4.75% (European option)
2) A five-year option with same strike costs 5.50% (Do not sell as package)
3) Positive convexity (gamma) with positive carry (theta)

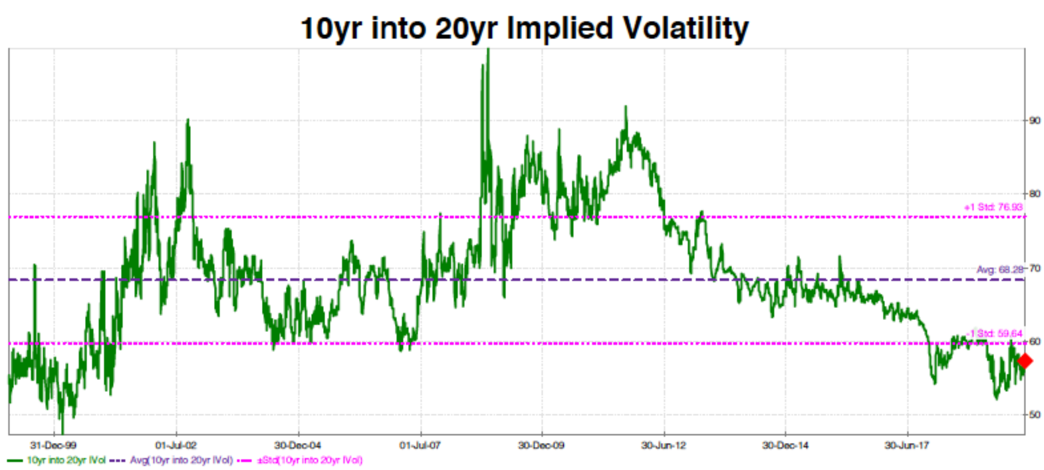
Long-dated interest rate catastrophe option (professionals only):

Despite my confidence that long-dated interest rates will not exceed 3.5% for the next five years, if I am wrong, it will be 'lights-out' for the financial markets.

I have often highlighted the -cyber line- correlation between Stocks and Bonds; how their prices have moved in opposite directions since the Great Financial Crisis (GFC). Functionally, this creates a self-hedging portfolio if weighted between these two assets.



Evidence suggests this correlation will reverse if interest rates rise above 4.0%; at that point both stocks and bonds would decline in unison. With almost perfect serendipity, the -hellebore line- cost to mitigate this risk is near its decades low.



Buy a 10yr into 20yr payer swaption (put), Strike = 4.5%, Px = 135bps.

This trade is effectively a ten-year option on the TLT ETF, struck at 95. While not a great substitute, I suppose one could buy the listed January 2022 expiry put struck at 100 for about 75 cents.

Gold

"Rumpelstiltskin at the Fed" – April 19, 2016 is my all-time favorite Commentary. With no math, it is entertaining and informative for both the layman and professional; and its fundamental thesis is still valid.

Contrary to Warren Buffett's 2012 dismissal, Gold is not an asset; rather it is an alternate currency.

For the record, I am not a Gold-bug; but buy me a few well-mixed Sidecars and I may genuflect in that direction. In 5000 years of human history there is no record of a kingdom printing the fiat currency of the realm at a faster pace than the economy without generating inflation. Perhaps it will be different this time, but you know my thoughts on that topic.

Gold is not a trade; it is a twenty-year horizon asset diversification to hedge against a blimp-sized black swan landing in your backyard. A 5% allocation is likely dead money for quite a while, but I sleep well at night.

Please remember that sizing is more important than entry level. Invest enough to move the needle, but not so much that you cannot tolerate a worst-case loss.

The professional trades outlined here require an ISDA. If you are qualified and interested, my coverage team at JPM is terrific as it includes some of my institutional colleagues from my time at Merrill Lynch (RIP).

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

Harley S. Bassman
December 3, 2019

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