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Musings from Harley Bassman:

THE CONVEXITY MAVEN

Value Concepts from the BofA Merrill Trading Desk
January 12, 2011

“The 2011 Model Portfolio”

(Our Annual Stocking Stuffers)

Buy "Big Oil" + "Big Pharm" + "Big Tobacco" (+ etc) Equities.

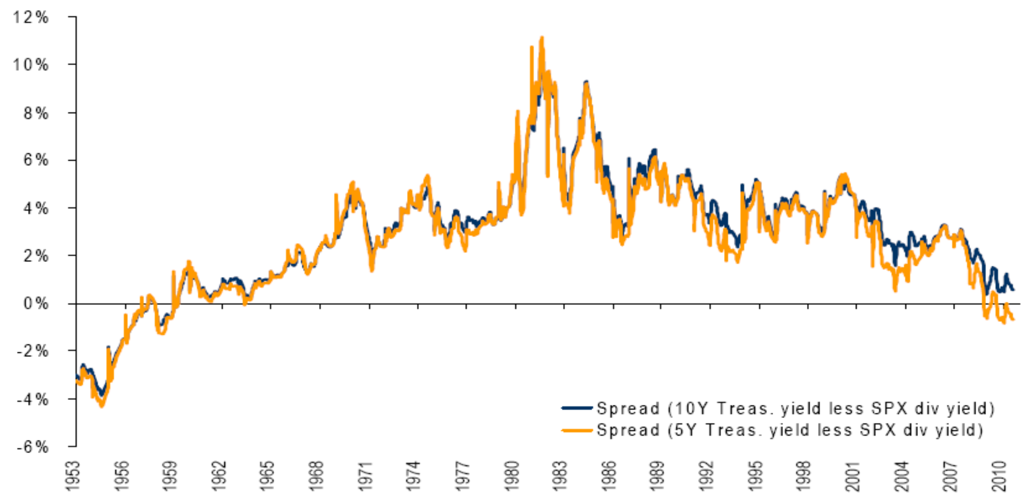
I am precluded from making specific recommendations, but you know what I like: Mega Cap international stocks with patent protection and pricing power. Stocks with P/Es of 12 to 13 (an earnings yield of 7½%) and Dividends rates of 2½% to 4½%. The FED will encourage Retail investors to reverse out of Bonds and into Stocks.

The FED's "double kick" of low rates and QE is meant to create Velocity in the system. Lower rates encourage leverage and QE forces cowards out of bonds and into everything else. Big Mega Cap stocks have both Economic and Currency diversity. Implied Earnings Yields of +400bp to Treasuries is a silly Risk Premium. The massive "Flow of Funds" into bonds over these past two years will reverse over time. Long Liability ERISA+Insurance are underinvested in Equities. Mega Caps have longer Durations than 30 year bonds; combine this with hard asset pricing power and you have a better Inflation Hedge. High Dividends make you cash flow neutral to bonds. If inflation does not increase, P/Es will expand. This is a Win//Win versus bonds.

For "non-stock pickers": Buy the S&P Index Five years Forward at a discount to Spot; Sell long-dated (Five to Ten year expiry) calls.

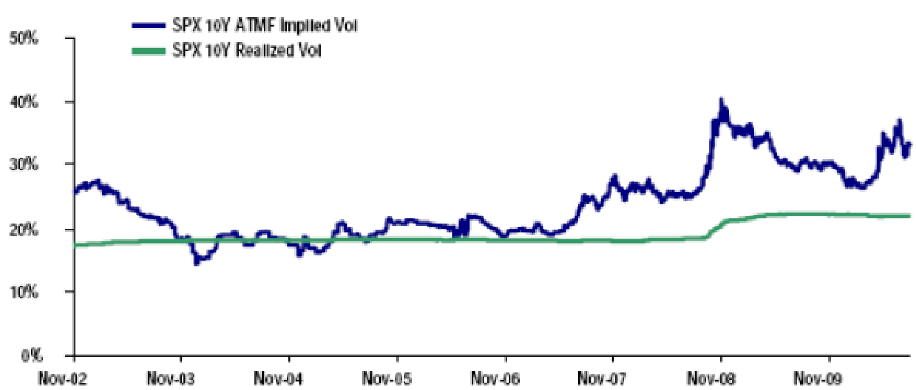
We detailed a version of this trade a few months ago when we offered a Structured Note based upon the spot S&P Index that, over ten years, lost dollar for dollar on the downside yet gained eight to one on the upside, limited to a 220% total return cap.

The bottom line here is that FED policy has inverted the S&P dividend rate versus the Treasury Five year rate for the first time in over 50 years. This means the Forward price of the S&P will be BELOW the spot price.



All charts, unless otherwise noted, are sourced from BofA Merrill data

Additionally, FED induced low rates has forced regulated long-liability managers to buy long-dated S&P options. This has pushed Implied Volatility on Five year to Ten year expiry options to a nearly 50% premium to Realized Volatility.



These two anomalous risk vectors will allow clever managers to create advantageous payout profiles. Call us to help you optimize this FED induced opportunity via either trading components or purchasing a packaged structure.

Buy Brazilian Local Currency Bonds.

Yes the "Real" at 1.685 is rich, but a yield in excess of 10% for three to six years will more than offset the Government's effort to weaken the Currency. Unlike China or India, Brazil is a "hard asset" country.

As a Monetarist and an Inflationista, I want to diversify away from the USD. However, the other G-7 countries, except Canada, have the similar problems and will look for similar solutions (inflation). Most of the other "high coupon" countries have a Currency risk I don't want. However, Brazil is a "hard asset" country with high local yields. In fact, Brazil has the highest inflation adjusted yields available. Institutions can set up accounts to buy local currency while small fry can buy Structured Notes issued by financial firms that "pass thru" the coupon. The risk is a currency devaluation; however, the 11.15% yield on the nine year bond breaks even versus a 13 cent per year decline in the Real. This is a great Diversification bet, size it accordingly, minimum two year hold.

Buy Russian / / Mongolian / / Southern Caucus Equities.

I want "hard assets", not cheap labor. Yeah, this region is sort of lawless and it is unclear if your legal claim will be upheld. But at some point Russia, et.al., will need to bring in Capital, so reform is likely. Most important, this region is a "negative beta" versus the G-7's "Race to the Bottom".

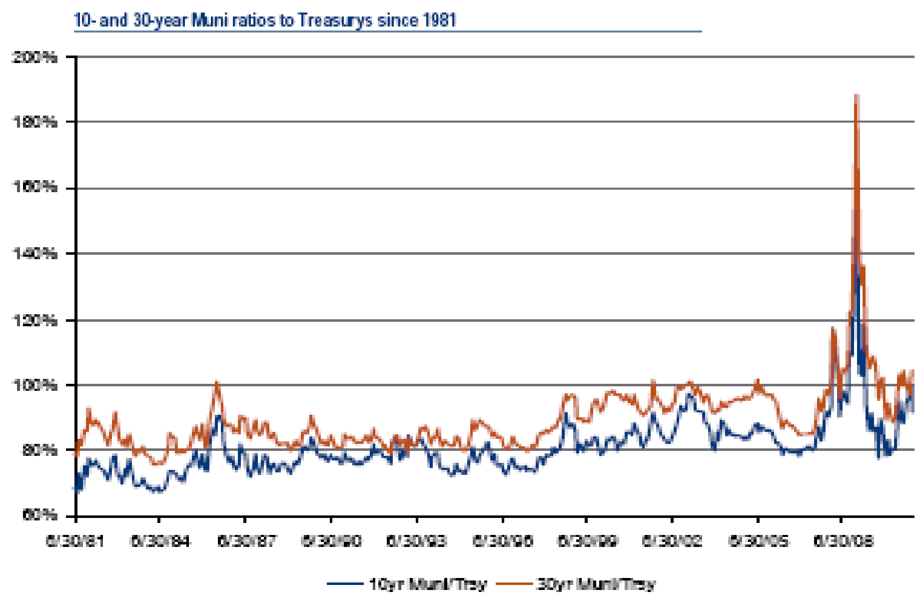
Any investment here requires Super Human tolerance for Mark-to-Market pain. The high to low draw down on the S&P was 57.6%; over a similar time frame, the max draw down on the {RTSI$ Index gpf w <GO>} was 80.3% !!

Nonetheless, this is the World's cheapest "major" market with an 8.6 P/E ratio. Compare this to India with almost an 18 P/E (or even Pakistan weighing in at nearly 11). Certainly the Khodorkovsky trial was a crushing blow for the "Rule of Law"; but this part of the world wins with either G-7 inflation or EM growth. Investment choices include Open and Closed Funds as well as Specialty HFs.

Check out the recent news on Mongolian coal mines near the Chinese border. Look for a "bidding war" from Eastern mining interests.

A diverse portfolio of Longer-dated Municipal Bonds.

You can find a selection of AA bonds in the +22 year sector that yield 5% or more. Since rates can only rise if the FED is successful in re-inflating the economy, a higher rate world would tighten Muni ratios since default risk should be lower. Furthermore, massive budget deficits at both the State and Federal level do not presage lower taxes anytime soon.



There are basically two risks with this trade. One is the default risk, which can be reduced via diversification. The second is Duration risk. The offset here is that Muni's have a significant negative spread correlation to Treasury rates because the marginal buyers (retail investors) have rock solid "yield bogeys". As such, longer term Muni bonds will simply not trade below 4% on the downside and will start to compress at 5% to 6% on the upside.

Buy Closed-End 35% leveraged Muni Bond funds.

National or Single State listed Funds offered by the major Mutual Fund Companies. They trade at a 5% to 8% discount to NAV and sport pre-tax yields between 6% and 7%. The only risk here is that these funds never mature. As such, the effective duration is quite long. That said, well managed diversified portfolios should be credit protected and the NAV discount will compress as the world stabilizes.

It goes without saying I hate Treasuries, especially 3yrs to 7yrs.

It is not even a matter of wanting to be short the market; it is that there are so many other trades/investments that have a much better return profile. Buying belly rates for the "roll down" is similar in concept to being short options; and if you must be short options, there are better executions. Long belly Treasuries is the classic "picking up pennies in front of the steamroller" trade.

Buy 10yr into 10yr 6.0% swaption payers (puts) at 425bps.

This trade is analytically "Positive Carry" for the first three years as 9yr, 8yr and 7Yr payers also struck at 6.0% costs 435bpb, 450bps, and 460bps respectively.

1 Expiry	2 ATM Vol	3 OTM Vol	4 Fwd Rate	5 Strike Yield	6 Put Price
2yr	113nv	130nv	4.37%	6.00%	*152bp*
3yr	111	122	4.72	6.00	*272*
4yr	109	116	4.96	6.00	*363*
5yr	106	110	5.11	6.00	*421*
6yr	102	106	5.19	6.00	*447*
7yr	99	102	5.23	6.00	*460*
8yr	95	97	5.23	6.00	*450*
9yr	92	93	5.22	6.00	*435*
10yr	89	91	5.19	6.00	*425*

Notes:
Spot = 3.41%
Mid-Market Levels

For a more detailed examination, please refer to our December 8, 2010 write up.

A variation of above:

Sell 3y-10y 5.30% payer vs. Buy 10y-10y 6.00% payer for zero cost.

This trade is long a 10% delta, so there can be some severe mark-to-market risk. Nonetheless, this trade is a carry monster. Moreover, I do not think we can break T10yr above 4.05% as long as the FED is on hold, which should be sometime into 2012. Pure "roll down" on this package carries at +175bps for the year and the net delta decays from 10% to 3%. Unless the FED radically changes policy, look to buy back the front leg early next year and own the tail for less than 3 points.

I hate to say it, but I kinda like owning some GOLD.

I am not going to expand upon the entire Gold-Bug mantra; however, Gold as a monetary proxy for total M-3 is cheap. Inflation adjusted Gold is cheap. Most important, long Gold is an inexpensive option on Asian Central Banks deciding it is time to diversify their holdings. It will not take too much of a tweak to send Gold a lot higher. This day may be sooner than you think since the big SWFs have been none too successful in buying strategic stakes in Western hard asset companies.

Instead of an outright purchase, I would execute via either a costless collar trade (buy OTM call versus sell OTM put) or via our famous "Quiet Bull" structure (long an ATM call spread funded by short an OTM put).

A sample trades:
Buy GLD January 2012 160 calls versus Sell GLD 2012 120 puts for a 25c credit.
Or
Buy GLD Jan 2013 140 to 170 call spread versus Sell the 115 put for a $1 credit.

And of course, Buy the CMM versus CMS Spread 6 months Fwd at 59bps

The “forever” average of this risk vector is +71bps. The “basic range” is +60bp to +80bp. The current “drop” from Spot to the six month Forward is -10bps.

This means you earn 10bps positive carry every six month to be long a spread widener with an entry point below the lower end of the range. It is effectively a positive carry call option on “event risk”, the perfect overlay to a Credit Portfolio.

SUMMARY

It is so clear that the FED, with the help of the US Government, is going to engineer some type of Inflation to reduce the value of both our Private and Public Debt. Since Inflation is the only solution, it will happen; it is just a matter of time. Unfortunately, the entire G-7 is in the same boat; as such, trading in the Euro or the Yen is purely a short-term speculation since all of these currencies will be heading south versus “hard assets”.

The question is: "When will the non-Western USD/EUR/Yen buyers take actions that will defend their long-term Purchasing Power? At some point, Asian Central Banks and other SWFs will need to re-allocate to assets that will maintain value.

Since this process could be six months to six years away, portfolios need to be structured to tolerate long lead times. Outright bond shorts or short term option (gamma) longs will “bleed” too quickly to be maintained.

Most critically, entry level is not your key decision point, it is sizing; There can be some significant mark to market volatility on any of the investments.

If you are reading this note, congratulations on having survived the Great Wall Street meltdown. As I have noted previously, this period is identical in many repects to the last Great Financial Markets Meltdown from 1989 to 1994; and I can assure you, it will end in a similar manner: FED steepens Curve to allow banks to re-capitalize via Positive Carry and then raises rates to stabilize the currency. The only difference this time is that the FED’s inflation target is much higher than publicly advertized.

I look forward to discussing these ideas with you in the near future.

Happy 2011

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January 12, 2011

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