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*A Commentary by Harley Bassman:*

# The Convexity Maven

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Value Concepts from the Credit Suisse Trading Desk
June 12, 2013

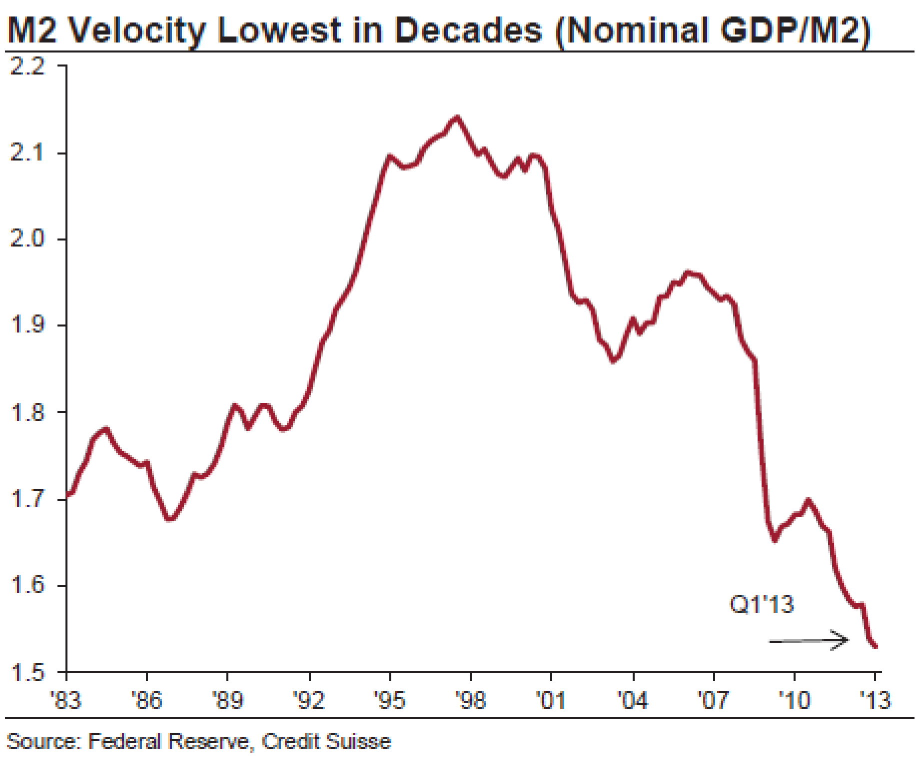
## "**The Economic Hunger Games**"

Regular readers of these Commentaries know that I am an unrepentant Inflationist who refuses to accept that fiat currency can be printed with impunity. To think otherwise would pave the way for Governments to recklessly print currency, helicopter drop these bundles to the 99%, and thus allow the entire populace to soon become the 1%. To be sure, unlike some of my erstwhile philosophical monetarists, I recognize that the horizon to realize this inflation could be somewhat distant; nevertheless, I was never offered a "free sandwich" at the Quadrangle Club, and it seems highly unlikely that this policy will soon change.

To remind you, the FED's clearly (implied) goal is to use inflation as a tool to de-lever the system of its excess debt. Since one can only default or inflate away debt (inflation being a slow motion default), this policy is quite rational. Some could argue that there is a third path, namely significant growth in GDP, but I will stipulate that the current political gridlock in Washington has ruled out any reasonable fiscal solution. That is unless you consider inflation to be the great "silent tax on the middle class" which would then count as a fiscal policy tool. I would suggest to you that the squirming "tax pledgers" on Grover Norquist's list are fully aware of this small detail and have happily acquiesced as it allows them to structurally raise long-term revenues without a vote, but I digress.

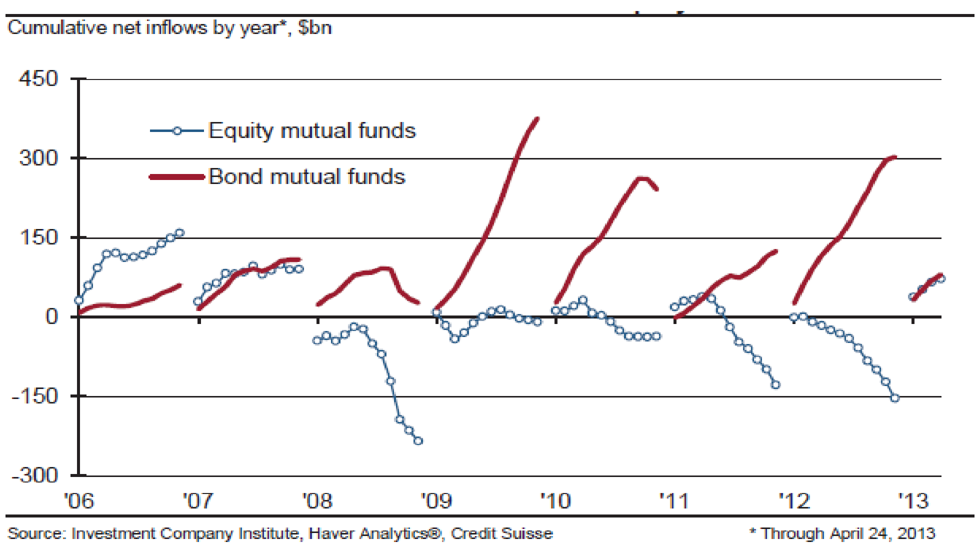
# M*V = P*Q = GDP

So the main plan remains unaltered: With Fiscal tools unavailable, the FED prints a massive amount of money [M] and injects it into the system in the hope of jump starting the economy. The impediment here is that Velocity [V] has been shrinking at about the same rate. This leaves GDP roughly unchanged. What is needed is a policy tool to increase Velocity.




To achieve this goal, the FED has used the heavy hand of Financial Repression to coerce investors into Asset Substitution. First the FED dropped the bank deposit rate to zero (ZIRP). Then they used Quantitative Easing (QE) to pull down long-term interest rates. Finally they purchased over 20% of the fixed-rate MBS market to the effect of selling $1 Trillion 3yr into 10yr interest rate options, crushing Implied Volatility.

Thus the adage of "don't fight the FED". During the fourth quarter of 2012, the average rate on the US Treasury Ten-year note was 1.69%; concurrently, the Par MBS rate was not even 50bps higher at 2.18%. These rates were substantially below the dividend yield of both the Dow and the S&P at 2.80% and 2.40% respectively.



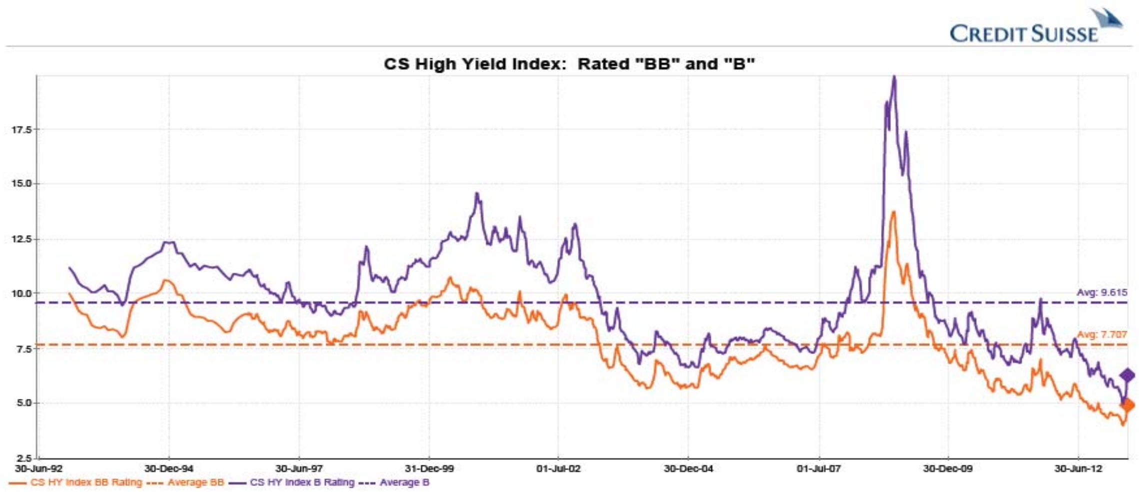

Under heavy duress, monies that had been ever flowing into safe fixed-income assets started to migrate out of cash and into Credit, Stocks, Private Equity, Hybrids and any other investment that might have a positive "real yield".

| | 12-month Cumulative Flows ($bn) | | | |
|---|---|---|---|---|
| | Equity | Hybrid | Bond | Mny Mkt |
| Dec-04 | 177.9 | 42.7 | **-10.8** | -156.6 |
| Dec-05 | 135.6 | 25.2 | 31.3 | 63.1 |
| Dec-06 | 159.4 | 7.1 | 60.6 | 246.9 |
| Dec-07 | **90.8** | 24.2 | 108.8 | 661.4 |
| Dec-08 | -234.4 | -18.4 | 27.6 | 637.1 |
| Dec-09 | -9.1 | 22.8 | 376.1 | -539.1 |
| Dec-10 | -36.7 | 23.1 | 241.4 | -524.7 |
| Dec-11 | -128.3 | 29.4 | 125.1 | -124.0 |
| Dec-12 | -153.1 | 45.9 | 303.6 | -0.3 |
| Q1-2013* | 66.5 | 25.3 | 69.1 | -101.0 |

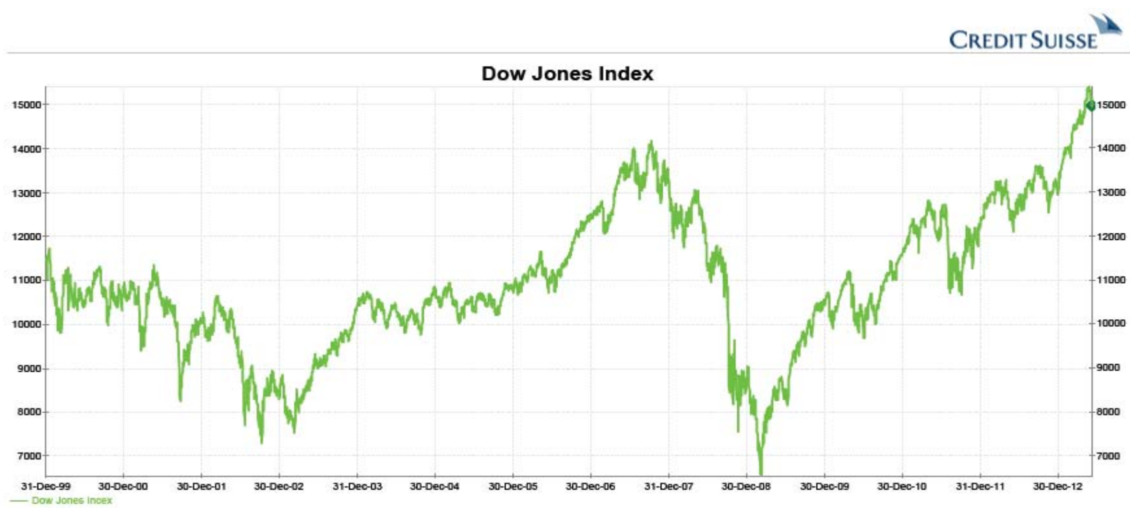
Source: ICI, Haver Analytics®, Credit Suisse *3mo. cumulative flows

One might think of this as the Mary Shelley method as the FED has slowly ratcheted up "the Juice" until USD investors were finally jolted awake and jumped off of the table. To the extent that investment dollars are now rapidly chasing various assets, I guess one might call this a success. And in fact, I do think that an increase in "Asset Velocity" will likely lead to an increase in "Monetary Velocity", and thus serve the FED's goals. The problem, as George Romero might have suggested, is that Force Majeure finance sometimes does not result in a Goldilocks Economy.

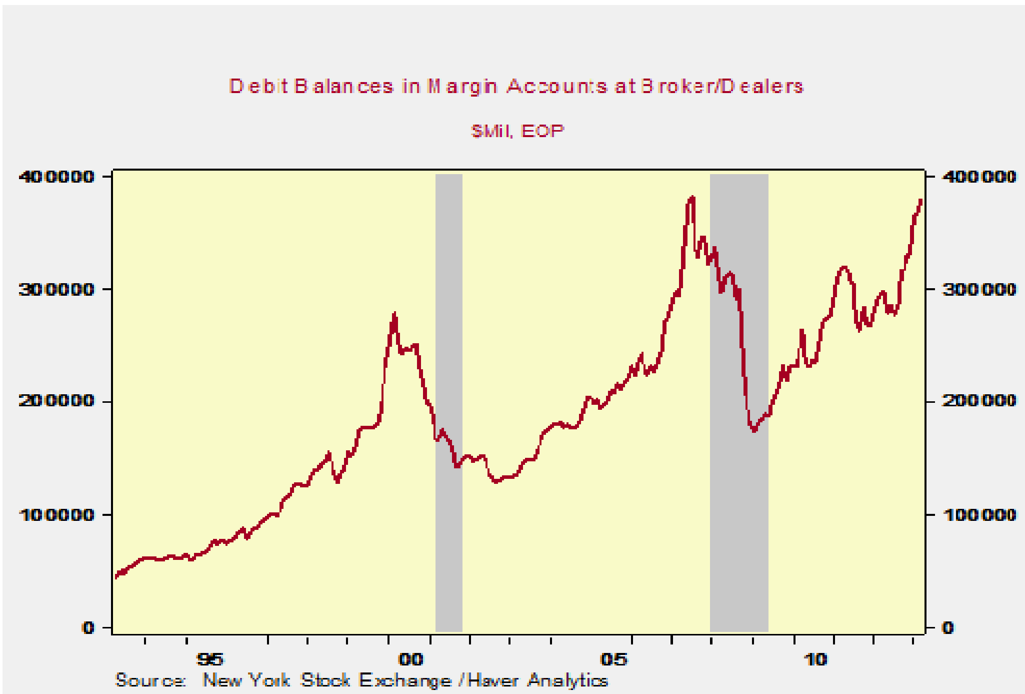
Thus we have now entered what I call the *Economic Hunger Games* where investors faced with a zero percent nominal overnight rate, and surely a negative real term rate, are competing against each other to earn a positive return.




How else might one explain the total collapse Speculative Grade Credit yields such that the –orange line- "BB Index" actually breached the 5.00% barrier for the first time ever; or that the true "Bottom of the Capital Structure", aka the –lime line- of Equities, has reached an all-time forever high.



I will remind you that I have been crazy bullish on US stocks since I first suggested executing long-dated S&P risk reversals in my 2012 Stocking Stuffers (published on December 7, 2011 and repeated in this year's 2013 edition published on December 5, 2012). However, I do take pause when the last run up in price was funded by borrowed money, as shown in the –vampire- line below.



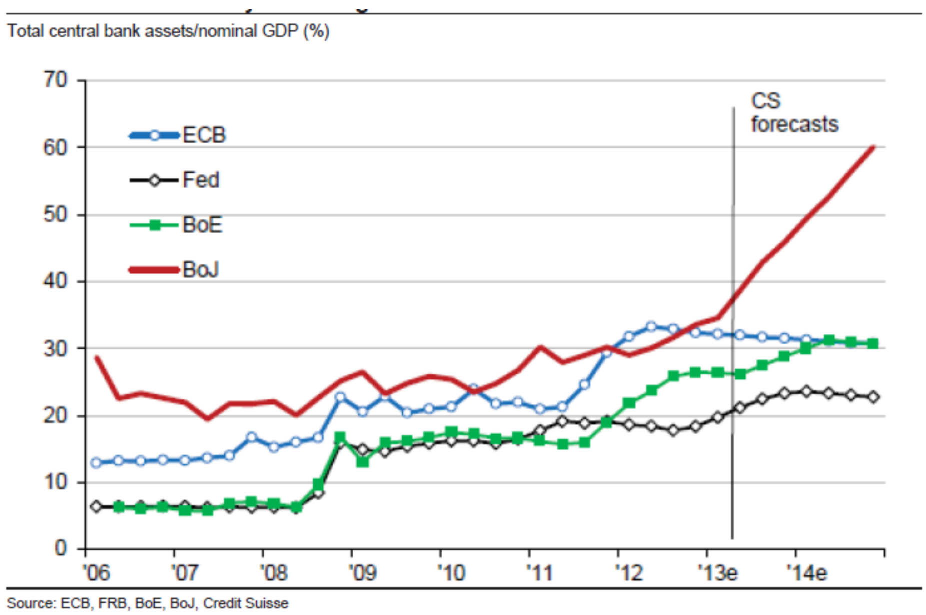

Though I have been dismissed as a Monetary Neanderthal, I will repeat that the FED can easily create inflation, as they did in 1934. If they merely "opened the window" and announced a $5,000 an ounce bid for Gold, I can assure you we would have inflation; we would also have mobs roaming the streets with pitchforks and torches. So the issue is not whether the FED can produce inflation, it is whether they can create a moderate 2% to 4% inflation rather than a destabilizing 8% to 12% inflation.

This fully explains the FED's grinding but persistent increase in Monetary accommodation since the Lehman meltdown. Policy must be strong enough to be effective yet not so great that they lose control after the economy gains some traction. They need to shoot an arrow through a keyhole at 100 yards. In support of the FED, I will state that this amazing feat can be accomplished, it is just extremely difficult.

The naysayers among you will offer the common refutation that Japan is proof that inflation is not under the purview of Government officials. My retort is that

Japan is only proof that they have not tried hard enough. Japanese Government officials implicitly agreed that they had yet to try hard enough with their newly announced "Quantitative and Qualitative Monetary Easing", cleverly dubbed by our Neal Soss as the "Double-Double" 2-2-2-2 Policy. Their stated goals are to (1) Double the Monetary Base via a (2) Doubling of the maturity of JGB purchases to (3) create a 2% inflation rate in (4) two years. The market quickly confirmed that this was indeed a much sterner effort as the JPY collapsed by 25% in six months while the Nikkei jumped by 65% over the same period.

The BOJ is executing a QE-type policy of equal magnitude to the FED's on an economy that is barely 40% the size of the US. The chart below illustrates the ultimate impact if the BOJ stays the course on these policies.




Without commenting upon the ultimate denouement of these policies (which we have detailed in a previous Commentary – "Grabbing the Wrong Tail"), <u>the more salient issue is the fact that this massive money printing is occurring in a G-3 currency as opposed to the "usual suspects" in the Emerging Markets</u>.

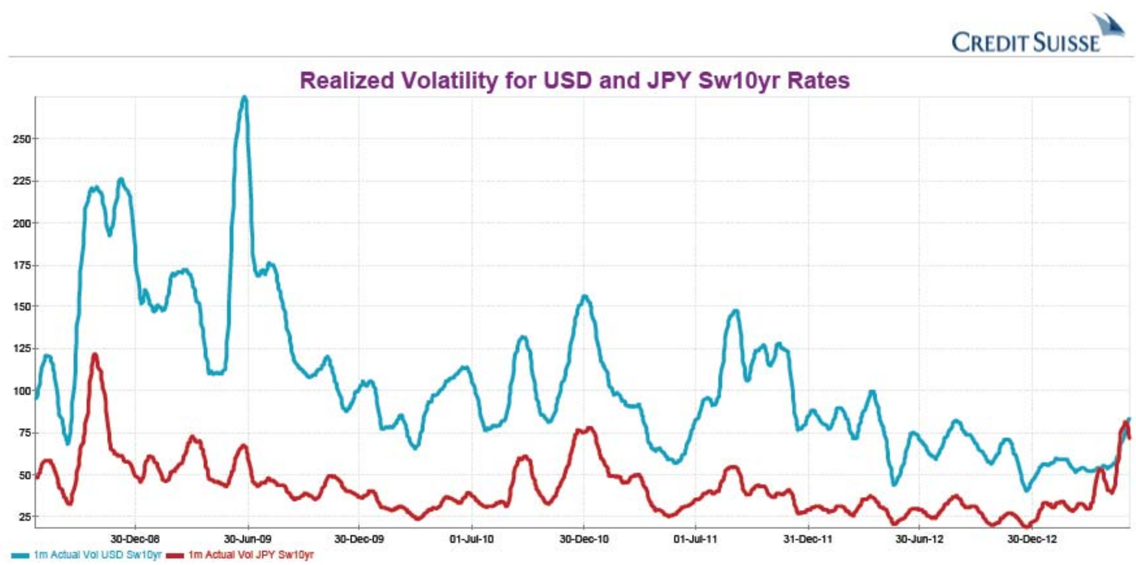
History is replete with examples of non-G-7 countries printing money to cushion some sort of fiscal debacle. During the crisis, the currency is massively devalued as capital controls try to stem the tide of asset flight. The situation is exacerbated by the fact that the market for these currencies is usually small, consequently the impact tends to be limited to the local economy.

This situation here is entirely different. The Japanese Yen is a fully convertible currency that trades in a deep and liquid market. It is fungible with nearly every other financial or hard asset in a completely unrestricted fashion.

This main point here is that the BOJ's actions are NOT limited to Japan's domestic economy; they are effectuating a massive Global Monetary Policy. In past times, when Russia, Mexico, Argentina, etc implemented huge devaluations, the impact was basically limited to the edges of their national borders; this is entirely different. The hundreds of trillions of JPY that may be created by this policy will quickly move through the global markets in ways that could become out of the control of the BOJ (or the FED).

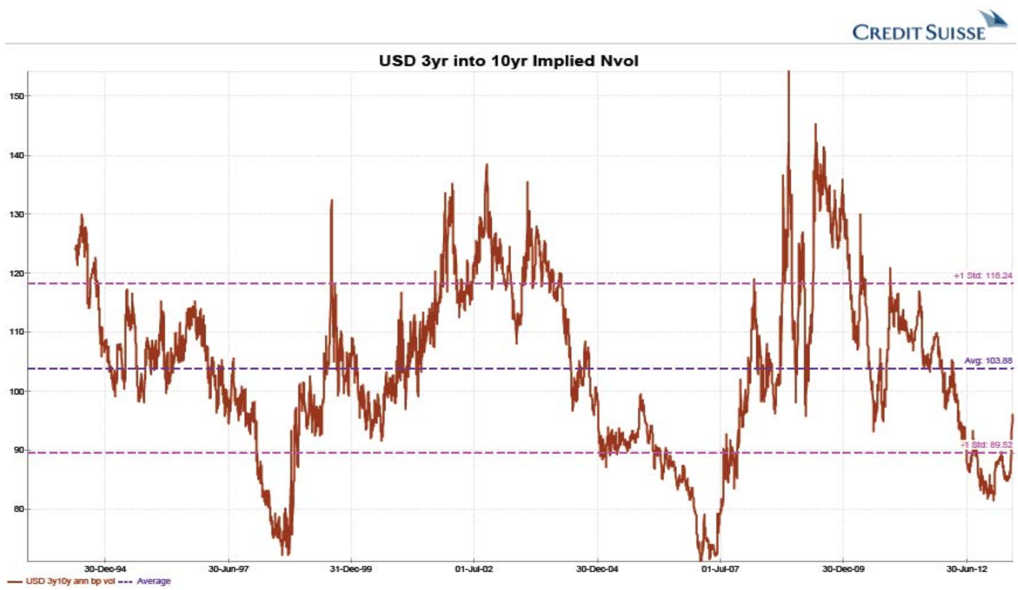
In the "real" Hunger Games, the playing field can be quickly tilted in an unforeseen manner when a new danger is suddenly materialized into the game.

This too has happened in the macro financial markets. The –poinsettia line- below is the Realized Volatility for the JPY sw10yr rate. Amazingly, this formerly docile rate is now more volatile than the –aero line- US sw10yr rate. To place this in proper context, since the JPY rate is less than half the USD rate, the Actual Yield Volatility for the JPY sw10yr is over double that of the USD sw10yr.




Presaged by the collapse of the Bear Stearns' hedge funds in 2007, the financial tsunami reached its crescendo when Lehman Brothers/Merrill Lynch/AIG roiled the markets in 2008. Since that time, the FED has reached into its quiver to pull out ever more powerful tools to implement the time honored Government Policy of Financial Repression to allow time for the markets to heal. The great risk is that disrupting the Economic Information Conduit, often referred to as the Financial Capital Markets, usually injects a massive dose of Moral Hazard into the economy; the usual “risk signals” are delayed or ignored which tend to result in a seismic shift when the controls are relaxed.  Thus can one point to the FED’s policy of “Measured Pace” from 2004 to 2006 as one of the four horseman of the apocalypse; or further back, the 1970’s inflation that followed Nixonian Price controls.

The FED is now trying to bring the financial “boat into the harbor without taking out the dock”; this job has been vastly complicated by the BOJ.  While the FED may have been dropping money from a Huey, the BOJ is using a Blackhawk.




The Implied Volatility for the -sienna line- benchmark 3yr into 10yr swaption has risen sharply since the word “taper” was first uttered, yet it is still 8% below its forever average; and I will remind you that markets do not go from cheap to fair.

The tranquility of the forest has been disrupted as each district seeks to survive the return to a normally functioning Capital Market.  This will not happen overnight, but I can assure you it will happen (and not gently).

“May the odds be ever in your favor.”

Harley S. Bassman
Credit Suisse US Rates Trading
June 12, 2013

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