Convexity Maven

A Commentary by Harley Bassman

June 17, 2019

"For Propeller Heads Only"

Poindexter: Felix the Cat - 1959

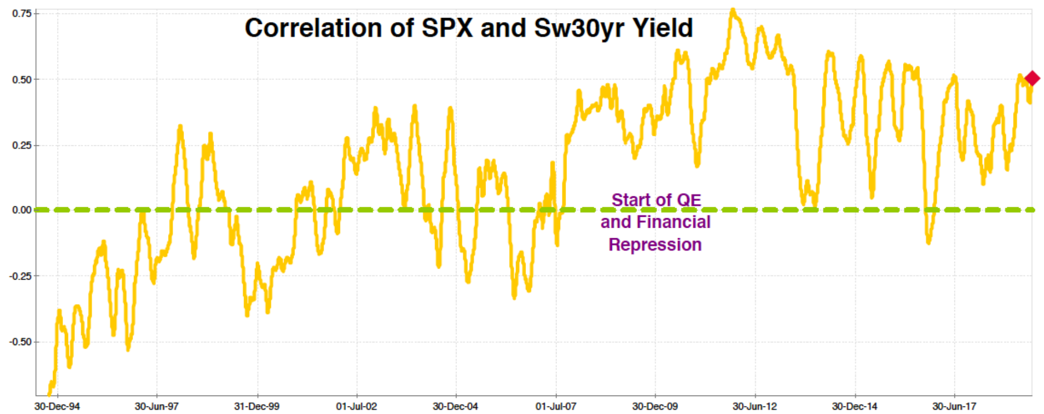
In my recent commentary, *"Can't You Hear Me Knocking"* – May 30, 2019, I noted the strange configuration of the Yield Curve and how it likely presaged a macro-political or -economic disturbance. This view has not changed. And while the exact timing and nature of a financial reversal is above my pay-grade, I can remind you that historically such events occur about eighteen months after the first inversion. As a rough prediction, I would target a date in mid-2020, serendipitously in the middle of the election cycle.

Over the next few pages I would like to detail a terrific strategic trading opportunity. Unfortunately, the structure of this investment involves a rather complex derivative product whose supporting concepts require a bit of concentration. Moreover, only professionals (or those with an ISDA) can execute this transaction – I apologize. If you have an interest in high-level finance, please continue; otherwise, save a tree and don't print this commentary.

For full disclosure, I own this position in my personal account.

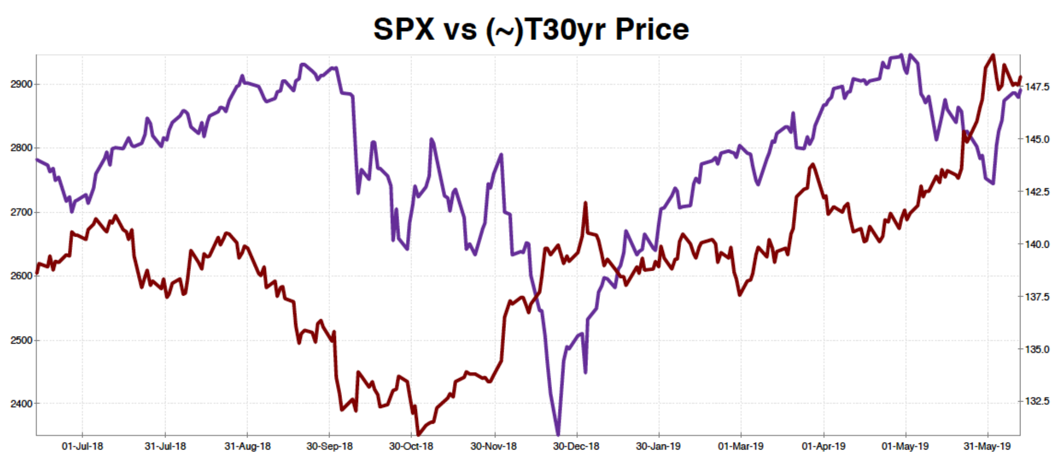
As I first detailed in *"How Will I Know"* – March 19, 2018, since the implementation of Quantitative Easing (QE) and Financial Repression as Great Financial Crisis (GFC) unfolded, stocks and bonds have moved in opposite directions. The –limoncello line- is the three-month moving average of the three-month correlation between the SPX price change and the Sw30yr yield change.

(Note: this would be a negative correlation if we measured the price change of both stocks and bonds.)



Source for all charts, except where noted: CS Locus

What is curious is that despite a decade of moving in opposite directions, the prices of both the –chambord line- S&P 500 (SPX) and the –kahlua line- Thirty-year UST bond are approaching their all-time highs.



Setting aside the small detail that daily volatility offers sparse information about the final destination of an asset (thus my recent disparaging comments on Sharpe Ratios); clearly the Equity market did not receive the email from the Bond market that a storm is brewing.

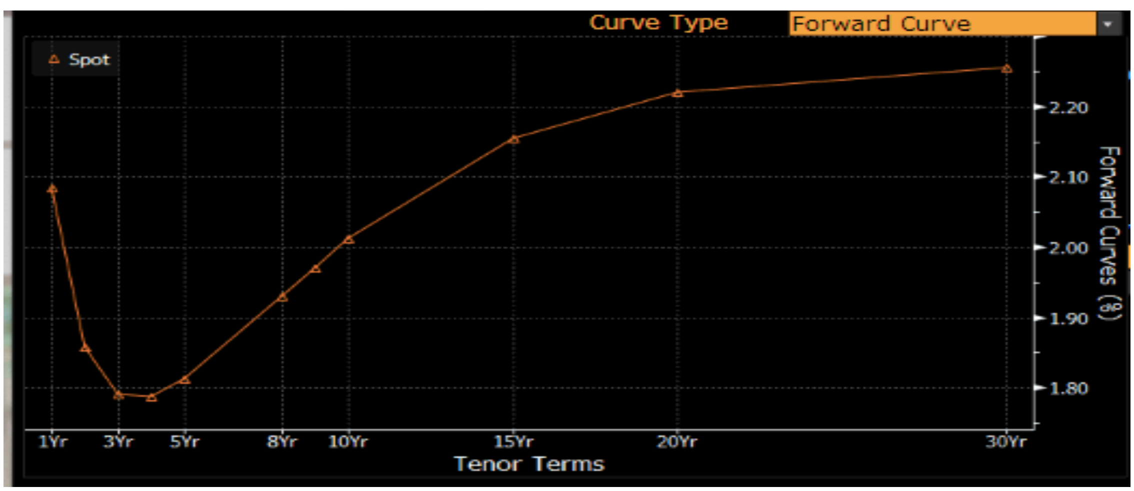
It is an interesting juxtaposition that short-term interest rates (the Reds) declined by 37bps in a week while the SPX closed last Friday a mere 2% below its forever peak.

A quick glance at the –campari table- might offer becalming comfort since the one-year rate of 2.08% is almost equal to the ten-year rate of 2.035%.

X: Swap Tenor, Y: Expiry/Forward

	1YR	2YR	3YR	4YR	5YR	6YR	7YR	8YR	9YR	10YR	15YR	20YR	30YR
Spot	2.080	1.858	1.794	1.792	1.817	1.858	1.904	1.949	1.994	2.035	2.180	2.247	2.283
1M	2.007	1.816	1.769	1.777	1.807	1.851	1.899	1.946	1.991	2.033	2.179	2.246	2.282
3M	1.889	1.752	1.733	1.754	1.794	1.844	1.895	1.944	1.991	2.034	2.180	2.246	2.281
6M	1.771	1.696	1.705	1.741	1.791	1.846	1.900	1.951	1.999	2.042	2.186	2.250	2.283
1Y	1.633	1.648	1.694	1.749	1.812	1.873	1.930	1.982	2.030	2.072	2.207	2.265	2.292
2Y	1.663	1.726	1.790	1.858	1.923	1.982	2.036	2.083	2.125	2.161	2.269	2.309	2.320
3Y	1.789	1.854	1.925	1.990	2.049	2.102	2.148	2.187	2.221	2.249	2.329	2.352	2.348
4Y	1.921	1.996	2.060	2.117	2.168	2.212	2.249	2.280	2.306	2.326	2.380	2.389	2.370
5Y	2.071	2.132	2.185	2.232	2.273	2.307	2.335	2.358	2.375	2.389	2.421	2.417	2.386
7Y	2.294	2.337	2.372	2.401	2.423	2.440	2.452	2.461	2.466	2.471	2.467	2.450	2.398
10Y	2.490	2.504	2.513	2.517	2.518	2.518	2.518	2.515	2.512	2.508	2.477	2.452	2.380
15Y	2.517	2.515	2.509	2.503	2.496	2.487	2.477	2.468	2.459	2.452	2.424	2.384	2.304
20Y	2.439	2.426	2.416	2.409	2.404	2.401	2.398	2.394	2.389	2.382	2.338	2.293	2.220

Yet a closer look at the –cointreau line- of forward two-year swap rates highlight a deep contortion in the belly of the Yield Curve.

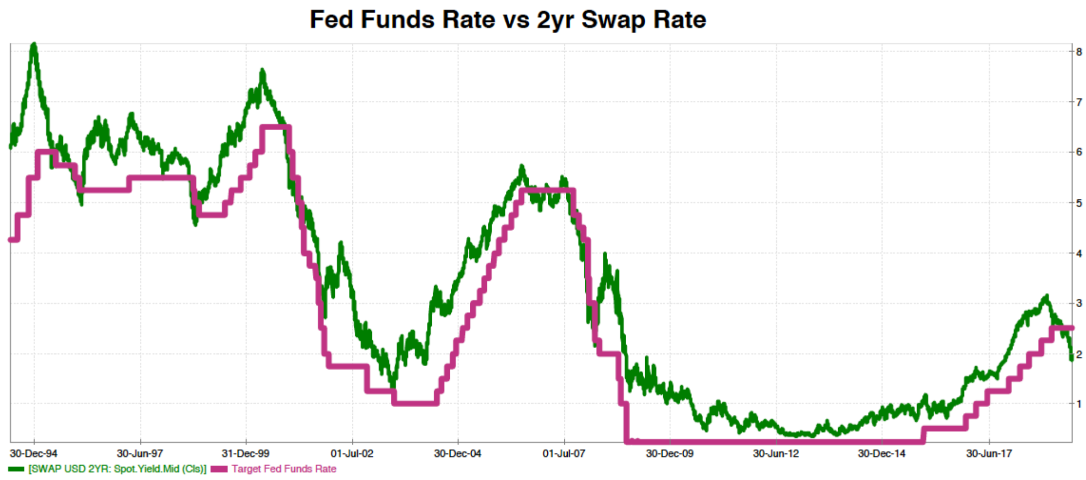


Source: Bloomberg

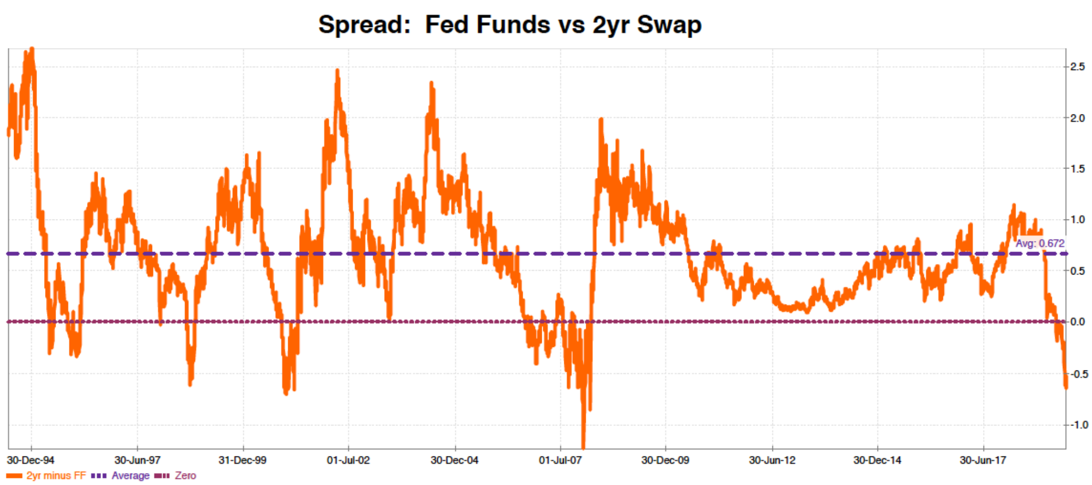
To spare your eyes, while the effective Fed Funds rate is presently 2.375%, the two-year swap rate is 51.7bp lower at 1.858%; and as will be important soon, the two-year rate six months forward is 1.696%, or 16.2bps lower.

Let’s pause for moment and consider why the relationship between the Fed’s Target rate and the two-year rate is important.

Below, the –midori line- is the two-year swap rate while the –heering line- is the effective Fed Funds rate; this difference is generally a positive spread.

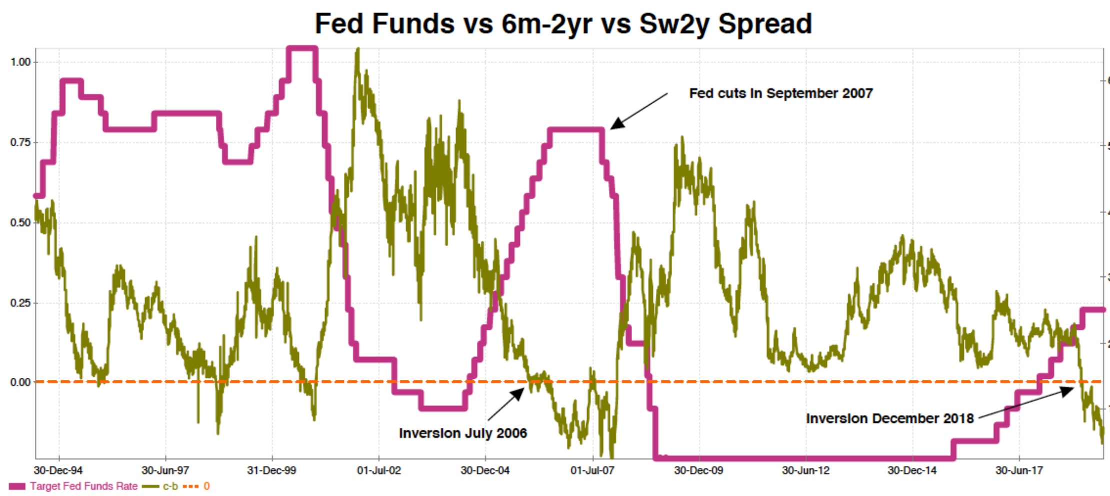


For clarity, the –drambuie line- is this spread. Since 1994, it has averaged about 74bps, and since the start of the GFC, the gap has been about 62bps.



Employing only grade school math, a reversion to the decade average would entail the need for the Federal Reserve to cut its target rate five times in 25bp increments by the end of the year. [1.696% minus 62bp equals 1.076%; and 2.375% minus 1.076% equals ~130bps]

Unless you are a newbie, you know my favorite saying is: It's never different this time". And indeed, the –chartreuse line- forward spread does invert prior to –heering line- Fed rate cuts. However, one might note it is not an instantaneous event. In the last rate cut cycle, this spread inverted in July 2006 yet Fed rate cuts did not commence until 14 months later in September 2007.



The bottom line is not that the bond market is wrong, rather only a bit too early. It could be fears of a Trade War or an Immigration meltdown, or perhaps twitter has finally become fully weaponized. In any event, except for interest rates, <u>fundamental economics presently do not support an immediate rate cut by a "data dependent Fed</u>"; and certainly not four rate cuts by December.

If you have read this far, it is time for your reward…..
Hat tip to my friends at MS

As noted, the two-year forward swap rate is 1.696%, 16.2bps below the spot rate. If one believes rate cuts will not be as speedy or as often as implied by market rates, the simple ticket is to short the forward and earn the 31cents of "roll up carry" as the forward grinds up to the spot.

I don't like this trade because of the potential for unlimited loss. Of course the easy alternative is to buy a six-month expiry payer swaption (similar to a put option on the UST two-year note), but this option would cost about 46cents upfront, a fee greater than the pure carry of 31cents.

Another way to reduce the price is via an option spread. One could buy an at-the-money (ATM) option struck at 1.696% and sell an option struck 25bps (1.946%) or 50bps (2.196%) OTM for a total net cost of 26cents and 36cents respectively. This is better, but the fee still eats up the carry profits.

Here is the clever idea:

Buy the ATM option struck at 1.696% and sell the 50bp out-of-the-money option struck at 2.196%

But: Make it contingent upon the SPX being 5% lower than today's price.

This reduces the cost by 78% to only 8cents.

If the rates market is unchanged, and the SPX backs up by 5% to 2743, this position would produce a 3.75x pay out. And if the bond market realizes it is over its skis and spot rates increase just a bit, the pay out can be much higher.

The hook is that you need to have some confidence that stocks can decline over the next six months, without rates sinking further. While I am not a super bear, a small pull back is more than just possible. Corporations purchasing their own stock have been largest buyers of equities, and this buying has just passed its seasonal peak. Also, the recent rate move may shake out out a few sellers who want to cash in their chips before election politics begins to heat up.

I absolutely love this trade as it offers a near-the-money option at the price of a tail hedge. Moreover, it is well suited for any portfolio that is constructed to use interest rate risk to partially offset equity risk. (Clever eyes will notice that Closed-end Funds, which I own in abundance, exhibit this sort of exposure.)

The massive discount of this Hybrid option is sourced from the high correlation between rates and stocks, as described on page 2. This trade is effectively a sale of that correlation.

There is no free lunch, but I have a 16.2bps wind at my back via the curve inversion, and the SPX is near its local top.

If I am right, **this is a convexity monster**; and you know I love that.

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
June 17, 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

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