Convexity Maven

A Commentary by Harley Bassman

April 14, 2020

"Sending in the Snakes"

Inspiration - TK

My children have accused me of being a "COVID-19 denier", which is false; all I have said, which I suppose is un-PC, is that this is not some horror movie disease which makes your skin melt off or your eyeballs pop out of your head. Moreover, this will not be a 1918 Spanish flu redux that kills integer percentages of the population; not because this flu is less contagious or dangerous, but rather that science and health management have vastly improved.

As a bit of morbid but relevant trivia, the mortality rate of the Spanish flu peaked slightly before the November 1918 armistice; a war that was fought mainly in tightly packed trenches filled with soldiers transported in poorly ventilated ships and trains – social distancing does work, so do it !

I have often used the shorthand of "QE~" as a snarky jab at the Federal Reserve (FED) to stand for "infinite Quantitative Easing"; but hey, I thought I was just kidding. Presently, a variation of QE~ has been announced: Hhhhmmm….

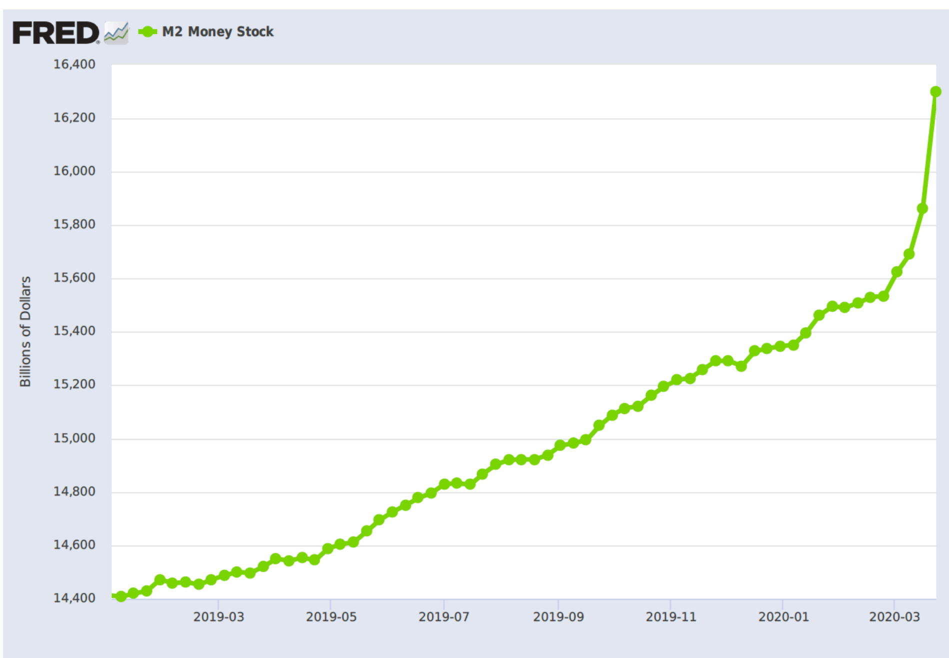
Thus, to borrow from the Department of "no good deed goes unpunished", and as a comment I will surely regret at a later date, at some point one must consider whether the FED's latest cure is worse than the disease.

A few years back, at exactly the wrong time, our dishwasher conked out. (Check that, is there ever a good time ?) In any event, after scrutinizing the fuse box (the extent of my skill set) we called in the repair service. It was quickly diagnosed: A mouse had nibbled the cloth wrapper on the power wire to secure some nesting material for a cold winter.

A few ideas were offered to prevent a reoccurrence, but one that was refused out of hand was sourcing a few snakes to rid the house of mice. Indeed, the snakes would have solved the mouse problem, but then I would be left with a house full of snakes.

As a card-carrying graduate of UChicago, I will stipulate (again) that a fiat currency cannot be created at a faster rate than the growth of the economy without inflation. Over 5000 years of collective civilization, we have no record of the Sovereign printing the coin of the realm at such a pace without the currency becoming devalued.

So, while inflation, as measured by the CPI, has been rather somnambulant over the decade, the -vanadium line- measure of the M-2 money supply should give one pause. For the calendar year 2019, M-2 grew at a 6.5% annual rate; as the first quarter of 2020 closed, M-2 grew at nearly a 35% annual rate.

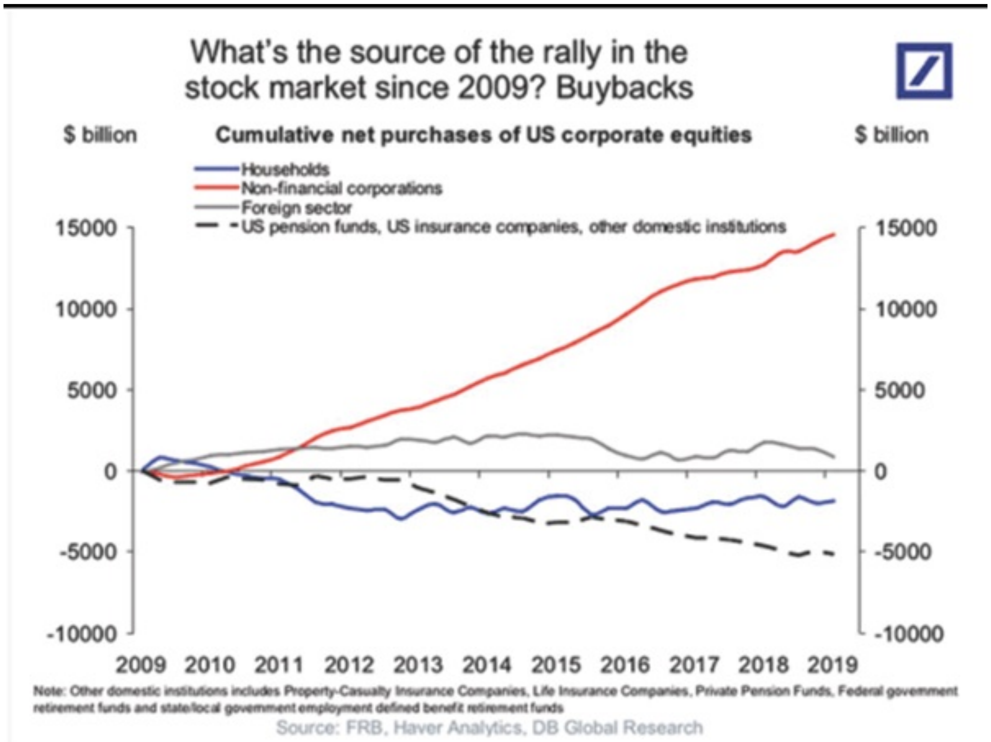


While it does seem hard to reconcile ten years of M-2 growth at 6.25% with a decade of CPI at less than 2.0%, perhaps we are using the wrong metric.

The FED's master plan, which I endorsed at the time, was to combine a Zero Interest Rate Policy (ZIRP) with QE to create wage inflation for the middle class. Banks were supposed to be the conduit, but for various reasons unforeseen at the time, the money jammed up and Monetary Velocity collapsed.

Contrary to good public policy, Corporations borrowed these funds and recycled them into stock buybacks that soon funded the purchase of real estate, art, etc. It is the asset market where one can find the missing inflation.

There are many charts on this topic, some reporting this past decade's stock buybacks as high as $4tn. But for our purposes, this one is informative. Notice the -manganese line- of equity purchases by non-financial corporations as effectively the sole buyer; and to their regret, the -chromium line- household sector has been a net seller.



But away from the FED's printed money being spent in a less than productive manner, the much greater worry about their recently expanded policies to buy Municipal and High Yield bonds is **the introduction of Moral Hazard**.

The most important feature of a free market system is not the price of an asset, but rather the signaling process to capital allocators and risk managers.
The old expression is that "the cure for high prices, is high prices".

While the ultimate cost to the environment may not have been fully factored in, the fracking business was built upon four years of oil at $95/barrel.

And while I am no fan of Modern Monetary Theory (MMT), this too is functionally supported by the notion that market prices would offer signals for policy makers to open or close the money spigot.

If the FED starts buying, instead of financing (lending), Municipal and less than Investment Grade (IG) bonds, <u>who will tame the bad actors</u> ? Markets presently deny credit to those with poor character or a weak financial structure, does the FED intend to take on that role ?

More urgently, how will these decision be made ? Will the FED read business plans, or more frightening, will Congress and the Executive branch be given such powers ? Would they have supported Amazon - a firm that did not make a profit over their first five years as a public company ? Would they support Tesla now ?

To quote Walter Bagehot, editor of The Economist in 1873 in reference to the Panic of 1866: *"…in a panic…the Central Bank should lend freely, at a penalty rate, against good collateral".* Special Credit to James Grant – "Bagehot: The Life and Times of the Greatest Victorian"

Lending is NOT buying; perhaps I am being a tad melodramatic, but once the toothpaste is out of the tube, it is nearly impossible to jam it back. (I'm starting to develop some empathy for Second Amendment advocates.)

A decade ago, we were told that the expansion of the FED's balance sheet was temporary, and that it would be reduced as conditions allowed. The FED has tried twice to pull in the reins, both attempts ended in tears.

To be clear, I fully appreciate the huge personal and financial harm the COVID-19 pandemic has wrought, and while perhaps a bit tardy, this full-throated Federal/State/Local government response is warranted.

But we need to keep our focus on the long-run effects of such policies and have a clear-eyed look at the costs; and I mean more than just financial. Our national nightmare of Opioid abuse was not cut from whole cloth by greedy pharmaceutical manufacturers, it was in part a concurrent reaction to decades of insufficient attention to pain management by the medical community.

Bluntly, <u>I do not have confidence the FED will be able to extricate itself from these policies</u>; no matter how well intentioned and seemingly urgent.
You already know my coda: **It is never different this time.**

Market update

Someday I will pen a full Commentary that pushes back on Robert Shiller's notion that his Cyclically Adjusted Price to Earnings (CAPE) ratio is independent of the level of interest rates. I will stipulate that a significant correlation has not been found, yet at some point common sense must be considered.

Why would the spread between the interest rate on a no/low risk bond not be a consideration relative to the discounting of future earnings ? Yes, CAPE adjusts for inflation and nominal rates are just that, nominal; but of course, this begs the question as to how one measures inflation.

Whatever. The US Treasury / Swaps Yield Curve will likely be managed by the FED for the intermediate future at some level near 1.00%. Pegging a 500bp risk premium for equities (+125bp to the decade average for Junk Bonds), that 6.0% earnings yield is the inverse of a Price to Earnings (P/E) of 16.67. This is about where the Dow-30 closed last week, which includes a dividend yield of 2.75% (before a few likely reductions).

Of course, these trailing earnings will be reduced, and it is unclear by how much and for how long. So, let's consider the S&P 500 with earnings of $152; knock it down by 10% to $137 for 2021 and slap on a 16.67 P/E. That is 2285, near the low close of 2237 on March 23.

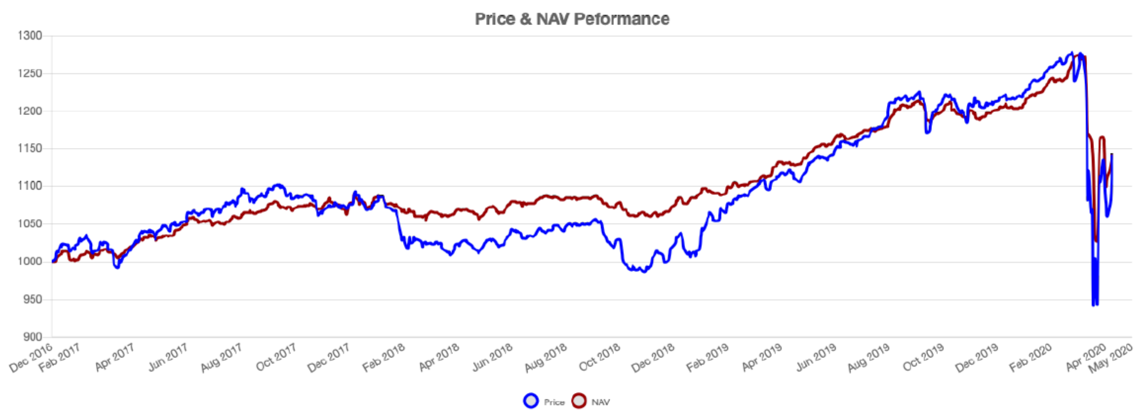
In my last Commentary, I suggested the S&P 500 would kiss the November 2016 election day close of 2139, barely 6% below my "fair value" estimate. But with the FED buying almost all debt assets, and the possibility suggested by Janet Yellen last week that the FED should be allowed to buy equities, all I can say is that **fundamental analysis is out the window**. I have no idea how to value equities, except to suggest it is a challenge to fight the FED and win.

What is the Wrong Price: Municipal Bonds

Notwithstanding my ignorance of Equities, I do feel a bit more comfortable opining about interest rates.

On the following page is a -titanyl line- of NAV and -vanadyl line- of Price for a National Municipal Bond Closed-end Fund Index. Both the Price and NAV of this Index are down about 6.5% (YTD) to offer a Federal tax-free yield of 4.77%.

As a macro observation, the yield on this Index is about 35bps higher, year-to-date, while the T10yr yield is about 100bp lower and IG corporate bonds are about 65bp lower.



Source: Closed-End Fund Advisors

Now, there are a few large caveats to consider:

1) This index is weighted 10.8% - Illinois, 9.7% - Texas, 9.3% - New York, 8.3% - California, and 6.0% - New Jersey. Except for Texas, each of these states has some bothersome issues.
2) This fund is leveraged at about 36%; and leverage has been the wooden stake during this financial crisis.
3) Closed-end Funds, in general, are illiquid and volatile around their NAV.

The safer trade, for those willing to do a bit of homework, is to buy single name Municipal bonds in States that are not fiscal basket cases.

In the prelude to my last Commentary, I noted that I purchased a 4.0% coupon, 24 year, California GO, rated AA, near 100 to yield 3.95%; a bond that traded at 121.86 on March 6th. This bond closed last Friday at 113.63 to yield 2.38% to call in 2029; or +100bps to the T30yr. As a caution, California derives one third of its revenues from the Top 1% of income households; and these taxes are often associated with capital gains, which could be impaired.

I have little interest in Municipal bonds in states with Pension concerns, with New Jersey, Illinois, and Connecticut ranked within the bottom decile. But I am willing to take a flyer on the solvency of the New York Metropolitan Transit Authority (MTA). While ridership is down perhaps 90%, it seems unlikely the Government will allow the agency that manages the Subway, Buses, and Trains for our largest city to default.

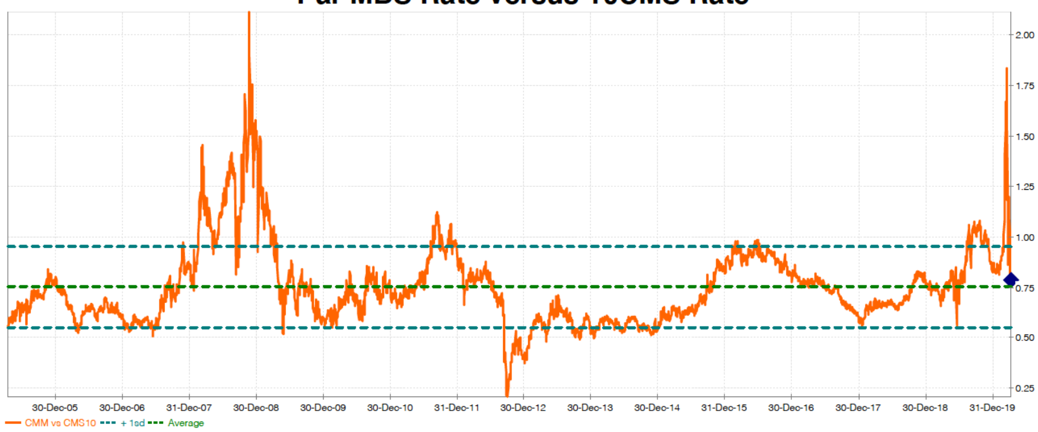
MTA Revenue bonds have also retraced much of the March decline, but recently there were many bonds offered at 4.0% to 4.5%, triple tax free to NY residents.

Many of the online brokerage sites offer sorting and analytics to buy single name bonds with almost no mark up. That said, please be careful as you may need the help of a full-service broker to sell single name bonds before maturity.

mREITs

One of the more common dangers for visitors to England is to look left, despite the flow of traffic coming from the right. This is how I might sum up my feelings about Mortgage REITs. Despite my view that long rates would be not rise too much, the Yield Curve that would steepen from the front end, and a near decade wide -dichromate line- MBS spread, most mREITs were crushed in March. Ultimately, it was the classic risk of too much leverage in a volatile market.

Par MBS Rate versus 10CMS Rate



Source: Credit Suisse LOCUS

I suggested this asset class when the MBS spread to Swaps was at 104bps, near its post Great Financial Crisis (GFC) wide. How clever I might have been since it has now tightened to 78bps, near its long-term average. Such a pity it clipped 170bps before the FED rolled out its QE~ program.

The widening created a "margin call" liquidation, and the associated losses will be a permanent impairment. As such, most mREITs have seen their book values (BV) decreased by over 25%.

While the pure Agency mREITs were damaged by leverage, the non-agency mREITs were forced to liquidate at whatever price their lender determined.

The only real risk left is how the non-bank mortgage firms manage the advances for Mortgage Servicing Rights (MSR). Recall the servicer must advance the principal and interest (P&I) to the bond holder, even if the borrower is late. This is usually a small number, but if the Government allows a 90-day grace period, it is unclear who will stand in the middle if the servicer does not have the funds.

The pure agency mREITs are now safe to buy, likely trading at 85% of BV. The mREITs with MSR are a bit trickier; and <u>must be considered speculative</u> until the Government opines on managing delinquent P&I advances.

At the end of my 26-year career at Merrill Lynch, what angered me most was our ex-CEO bleating that it was not his fault that the GFC washed away the firm he was supposed to protect. For G-d's sake, of course it's your fault, why do you think they paid you $25mm a year. When was it ever a reasonable notion for a firm with $50bn of equity capital to own $45bn of sub-prime CDOs ?

I am not too concerned about being struck by lightning, but I also do not play golf in a thunderstorm.

Risk management is part and parcel of life, in all aspects; but so many allocate their risk budget improperly. Those same people who worry about a shark attack in the ocean likely fail to buckle their seat belt in a taxi.

In hindsight, clearly all levels of Government should have been better prepared and acted sooner; but really, who am I to point a finger. Over the past two decades SARS, Swine, and MERS all could have become pandemics; so, it is not a huge stretch to see why the markets (and policy makers) mostly ignored its early signs.

Before Bear Stearns went rogue, a trader walked into then CEO Ace Greenberg's office. The trader asked to buy more of a certain security than his risk limit would permit. The trader detailed the value and how great a profit could be earned. Ace simply replied: "No…this is why we have risk limits."

There are lines that should not be crossed because sometimes one cannot revert. As such, let me be clear I think direct purchases by the FED of risky assets is problematic; lending against collateral is fine, but buying is not.

This is quite different from what happened with AIG; there, the Government crammed down the equity holders by 80% before they backstopped the firm. That is not the same as buying at the market price to support the stock.

In addition to introducing Moral Hazard to the financial markets**, a Central Bank buying risky assets creates the potential to erode the basic foundation of Capitalism.**

It is never different this time.

Harley S. Bassman
April 14, 2020

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

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