Convexity Maven

A Commentary by Harley Bassman

May 5, 2020

"Where is the Folder ?"

Most people will remember the 1992 movie, "A Few Good Men", for the crescendo court scene where Colonel Nathan Jessup (Jack Nicholson) shouts at J.A.G. Lieutenant Kaffee (Tom Cruise): "You can't handle the truth"

Depending upon your politics, you were either inspired or offended as Jessup continued: "You have the luxury of not knowing what I know; And my existence, while grotesque and incomprehensible to you, saves lives. You don't want the truth because deep down in places you don't talk about at parties, you want me on that wall, you need me on that wall."

I was occasioned to think of this scene as I considered our rather haphazard response to this pandemic. It is a primary responsibility of DARPA (Defense Advanced Research Projects Agency), the NSA (National Security Agency), the CIA (Central Intelligence Agency), and likely a few more embedded in the "deep state" to game out any possible national security risk, from Martians to meteors.

So why does it seem there was not a secret folder in the file cabinet labeled: *Pandemic response*?

There have been over a dozen movies on this topic, so it's not like the idea of a global pandemic was totally alien (irony intended). And while some will surely blame this entirely on the President, too many people would have known this folder existed for it not to be leaked.

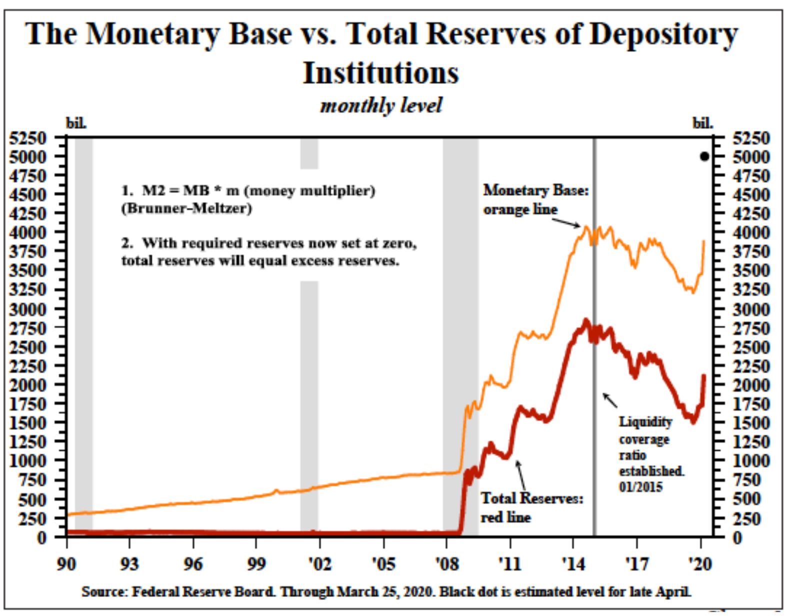
At a bare minimum, the Congressional and Senate intelligence committees would have had this folder delivered to their desks sometime in late December when (our spies at) the World Health Organization (WHO) first received reports from the Chinese about a cluster of 41 deaths from a mysterious pneumonia.

Surely the gears would have been grinding at a dozen Govt Agencies as early as late January when the President closed the airports to flights from China.

I suppose the alternative, of which I am incredulous, is that <u>there was no folder</u>.

Forced to consider the latter, let us not make the same mistake with our investments; perhaps it is time to take the long view and build our own folder.

Courtesy of the latest quarterly review from Hoisington Investment Management, the -oriole line- is the quickly expanding Monetary Base, which is projected to reach the -heron dot- of $5.0Tn at month's end.

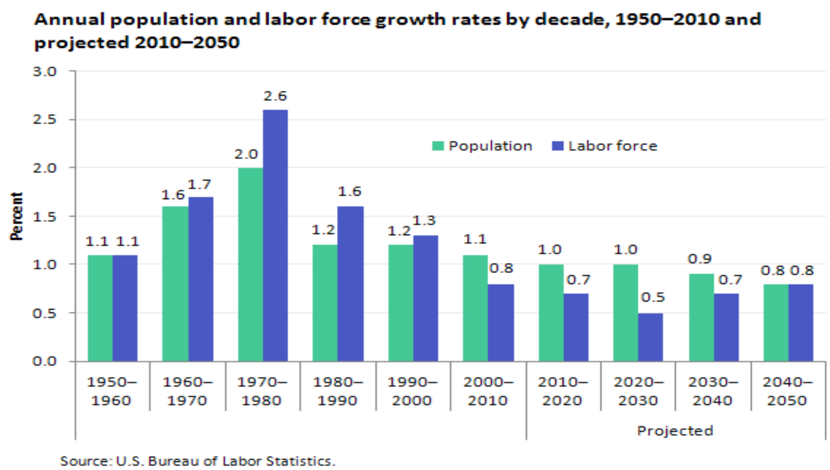


The Monetary Base vs. Total Reserves of Depository Institutions
monthly level
Source: Federal Reserve Board. Through March 25, 2020. Black dot is estimated level for late April.

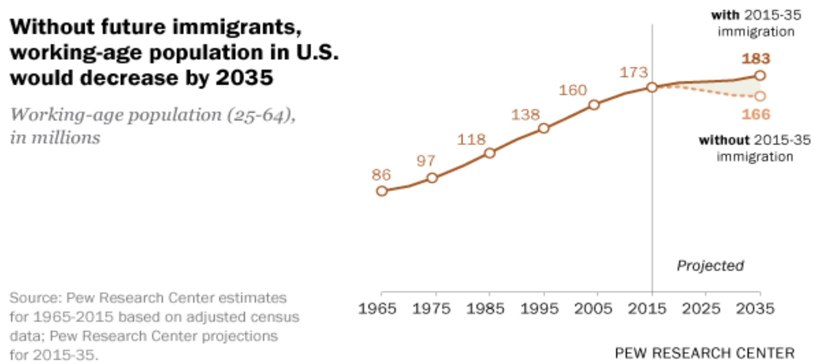
Front and center in this report is the equation: **GDP = Money * Velocity**

For reasons both demographic and economic, the Velocity of money has declined as quickly as the FED can print it; so the question is when will Velocity increase?

Despite a -warbler bar- of a declining Population growth rate, the -lazuli bar- Labor Force growth rate inflects up sometime between 2023 and 2027 as the increase in Millennials (1980 – 1996) overtakes the decline in Boomers (1946 – 1964).



The fly in the ointment, as I so often highlight, is the ill-founded policy of restricting -bittern line- immigration. <u>This is a greater risk to the US economy than poorly conceived tax or tariff legislation</u>.



At some point, Democrats who love fresh produce, Republicans who crave red meat, and Libertarians who value intellectual property will reach a compromise.

A final unknown is how this pandemic will reconfigure the Global supply chain as some production is brought back to US soil for a variety of reasons, including national security. This is surely inflationary, but likely a good outcome; not the least of which will be the expansion of middle-class jobs.

Ultimately, a combination of these forces will increase the demand for money; the result being <u>higher interest rates and inflation between 2023 - 2027</u>.

Bothersome as it may be, to quote Donald Rumsfeld, let's consider our "known-knowns" and our "known-unknowns"…

We are fairly confident that an increase in Government debt relative to GDP will hamper growth.

We know that a massively expanding the money supply will alter the relationship between real assets and fiat assets, but we do not know when or by how much.

We know that Modern Monetary Theory (MMT) posits that politicians must turn off the money spigot once potential is reached, we do not know if they can do it.

We know that residential real estate is a more secure asset than commercial real estate, and demographics favor the former over the latter.

We know that Gold is effectively an alternate currency, but we do not know to what degree it will be valued relative to fiat currency.

I know I am clueless as to where the SPX will close out the year; and that I can make a compelling case for a Fed-juiced 3400, or a COVID-related 2350.

One ticket I am not going to write is shorting the S&P 500 (SPX) vs single name assets. The primary reason is that the construction of this capitalization weighted index is no longer a measure of the value of the overall equity market, but rather of the top five stocks, who presently make up a -martin line- of 21%.

Source: BofA Global Investment Strategy, Bloomberg

For this reason, it seems unlikely the SPX can revisit the March low print of 2191. Holding the FAAMG at its current 7% decline, the other 495 constituents would need to decline by 45% to reach that level. More evidence of dispersion - last week the SPX was down 17% while the median stock was 28% below its peak.

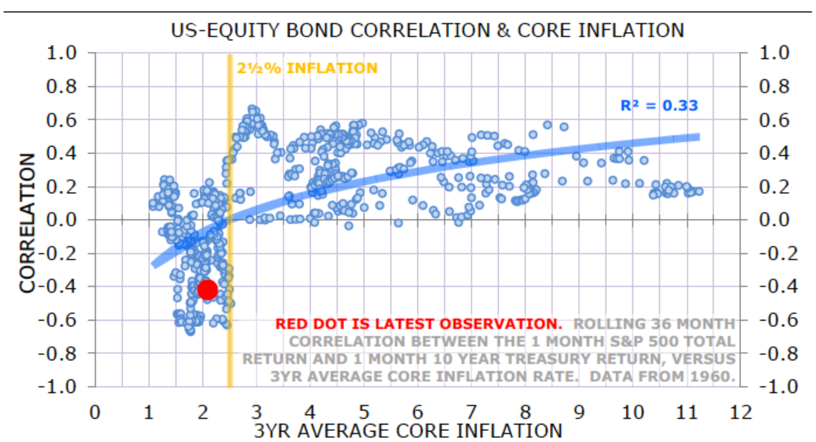
This is the third time the "Fed put" has been exercised in the past 15 months. First in December 2018 as the market just averted a clock stopping 20% draw down. Again, in September 2019 as the Treasury Repo market jammed which was occasioned by a 60bp drop in the T10yr rate in a month. And finally, last month after a Global "margin call" prompted even the safe haven of Gold to plunge by $250 (~15%) in six days.

With respect to the current recovery in financial assets, if ever there was a time to invoke "don't fight the Feds" (including fiscal policy), it would be now.

Notwithstanding a "V"-shape recovery is absurd, and a "U"-shape may be wishful thinking, the FED has promised to do "whatever it takes". As such, the market may fail to notice that the service sector has been hit with an economic tsunami.

Thus, if we are going to 'game out' a worst-case scenario, it has to include a situation where <u>the FED can no longer hold back the tides</u>; and I will volunteer this occurs if interest rates significantly increase, perhaps above 4.5%.

The massive leverage built up in the financial markets has been supported by the -kingfisher dot- correlation between stocks and bonds. Since the start of the Great Financial Crisis (GFC), the prices of these two asset classes have generally moved in opposite directions, offering "hedge value" for a diversified portfolio.



Source: S&P, Bloomberg-Barclays, GFD, BLS; Minack Advisors

Employing a strategy of Risk Parity, managers might use $100 of capital to buy $70 of equities and $130 of debt instruments. As long as this correlation holds, losses on one asset will be offset by gains in the other. If this relationship flips, risk manager MUST reduce leverage and sell both; which is precisely what occurred in March and prompted the FED execute an inter-meeting surprise.

The correlation seems to reverse with a -canary line- inflation rate above 2.5%.

The old rule is that the T10yr rate should tend toward nominal GDP. As such, a real GDP at 2.0% plus an inflation of 2.5% should lead to a T10yr rate of 4.5%.

While a 400bps increase in rates presently seems unlikely, I can assure you that, at the time, a 400bps decline from 2007's average yield of 4.63% would have been thought even more absurd.

I have stated previously that demographics would keep rates under 3.5% until 2023, and that MMT policies might not be fully engaged until after the election in 2028 when the entire Boomer generation reaches the age of 65. But this pandemic has accelerated the clock as (direct) fiscal Helicopter money has been added to (indirect) monetary expansion (QE).

Packing the Bug-out Bag

For an investment horizon greater than two years, one should have exposure to large cap equities. They have the resources to survive the shut-down and will gain market share as the economy recovers.

Buy quality intermediate term (4yr to 7yr) fixed income assets. As pandemic fears recede, the Boomer demographic will reach for yield to fund retirement; and they will continue to transition out of Equities and into Bonds as mandatory IRA withdrawals escalate.

Own positive Convexity (assets with much more upside than downside):

1) Buy 7yr into 20yr payers (put options), K = 3.00% @ 225bps;
2) Buy USD / JPY calls, 7-year expiry, K = 120 @ 1.75%;
3) Own Gold, perhaps 5% of assets;
4) Refinance your mortgage - you own the prepayment option;
5) Be cautious of embedded leverage (this is why mREITs imploded).

Prior to the pandemic, nattering financial pundits insisted the FED's toolbox was depleted, this was clearly not the case. What was vacant was the imagination of the chattering class. For while the FED may be somewhat bothered by deflation, let me promise there is a tanager folder marked "secret", locked in a glass box with a hammer, that contains the plan for how to manage the inflation on the horizon; **this is the real 'lights out' scenario they fear**.

Harley S. Bassman
May 5, 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

If you are an institutional investor, I can highly recommend:
Hunter Davis at BNP and Jordan Brink at Morgan Stanley

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