Convexity Maven

A Commentary by Harley Bassman

December 14, 2021

"A Model Portfolio - 2022"

(Holiday Stocking Stuffers)

Standing counter-clockwise from lower left: David Berns (CIO), Paul Kim (CEO), Brian Kelleher (Revenue), Shallesh Gupta (Head Trader), Michael Green (Chief Strategist), Harley Bassman (dinosaur), Peter Van Amson (CRO), John Ryu (CFO), Fiona Ho (COO). Seated: Ken Miller (PM)

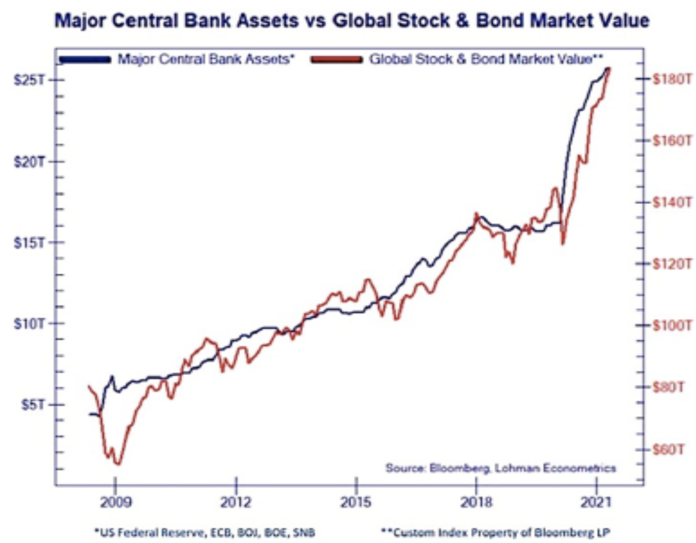
Come this time every year, I publish a list of "Investments" that I think will do well over the intermediate horizon – two to five years. These are NOT meant to be nips to blips RV trades, but rather longer-term notions that capitalize upon either my strongly held themes or the trembling hands of Sharpe Ratio focused portfolio managers.

As always, I will caution that my portfolio construction is not suitable for widows and orphans, despite the fact the last year's stocking stuffers were all winners. However, this success should be viewed with a gimlet eye as it was recently reported that a trading hamster named Mr. Goxx outperformed Warren Buffett.

Before I detail this year's Model Portfolio; let's consider the macro-landscape.

To repeat (ad nauseam), since the Great Financial Crisis (GFC) we have had the unresolved problem of too much debt, both public and private. The Federal Reserve Bank (FED) instituted a Zero Interest Rate Policy (ZIRP) for their overnight funding rate and combined it with Quantitative Easing (QE) in the hope of creating inflation to depreciate nominal debt.

Notwithstanding the bleating deflationist crowd, I suppose these policies were effective if one considers asset inflation instead of wage inflation a success. Notice the -mashua line- value of Stocks and Bonds has kept pace with the growth of -salsify line- Western Central Banks assets.



What has changed since COVID is the massive fiscal support from the Federal Government that stuffed cash into the hands of people with a propensity to spend, rather than into the wallets of investors.

Consumer Price inflation (CPI) has reached a near forty-year peak as post-COVID demand for goods and services cannot be satisfied. What is now unclear is whether this inflation is transitory and will resolve when the supply chain clears up; or is it more long-lasting as the growing Millennial demographic inflects against the accelerating retirement of the Boomers.

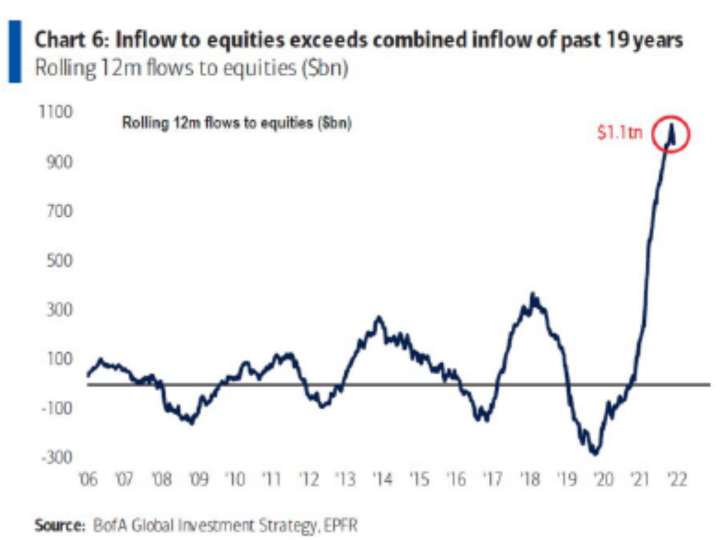
My view is that inflation will remain well above the FEDs 2.0% target for all of 2022, yet they will be reluctant to raise rates. I expect they will accelerate their taper of QE to facilitate a steeper Yield Curve, which as detailed in my "Open Letter to the FED" – July 26, 2021, is good public policy.

We can tally the hospitalization rate as COVID transforms from pandemic to endemic; what is unknown is how it may change our work vs life balance patterns such that those who have left the work force decline to return.

Switch into long-dated Equity call options

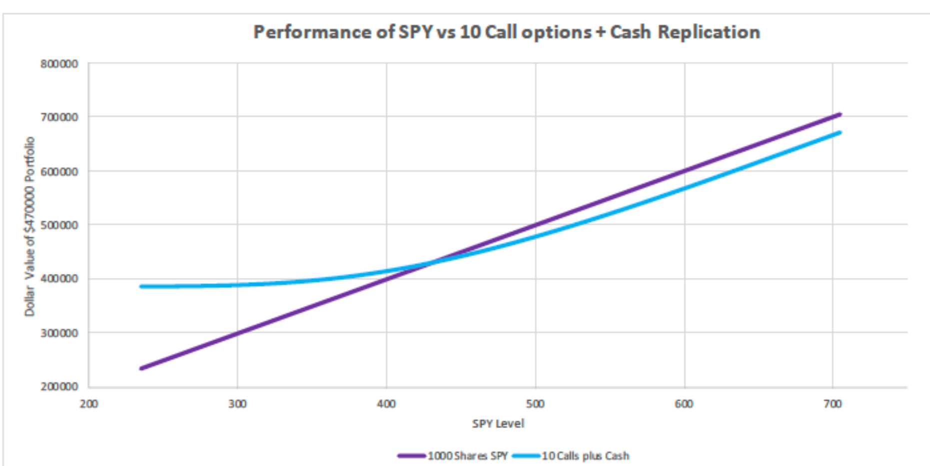
The logic of being a "contrarian" is that once everyone has bought, there is no one left to buy. This makes more sense than timing with a simple valuation metric since prices can continue to rise as long as more buyers lurk in the weeds.

Thus, the -romanesco line- may not be evidence of exhausted buyers, but it does explain why this year's rally is more about P/E expansion than earnings growth.



Sell SPY at $470 and swap into the Dec 2023 call option, K = 420 @ $85

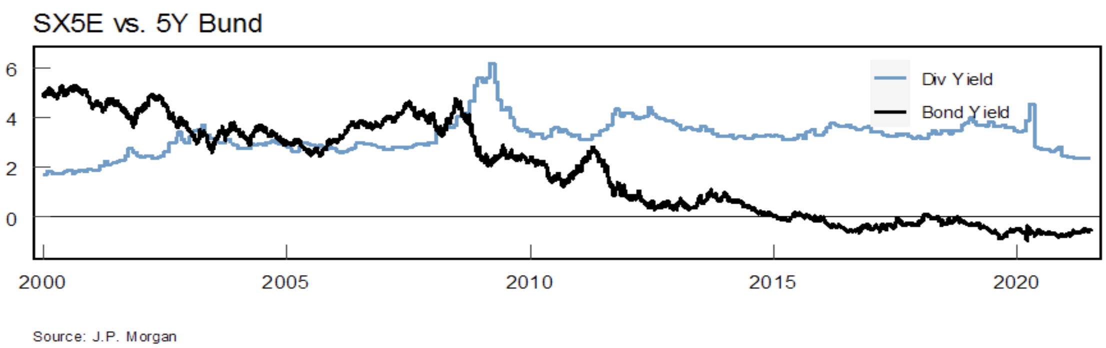
This sort of strategy allows one to capture most of a continued rally but offers a parachute if the FED actually pulls the trigger on their threats to tighten policy. Below the -kohlrabi line- is the linear performance of owing the SPY (S&P 500 Index ETF) versus the -damson line- cushioned performance, one year hence.



Long-dated options on SX5E (Dow 50 Index of Europe)

As detailed in "Unbalanced Leverage" – November 30, 2021, one of the key features of options is access to non-recourse borrowing at the institutional interest rate. When based in the Euro currency, one is effectively borrowing money at a negative interest rate compounded over the life of the option.

Moreover, since the -daikon line- borrowing rate is substantially below the -delicata line- dividend rate, the cost of a call option is significantly reduced.



Buy SX5E December 2025 expiry call, K = 4200 (at-the-money) @ 375

This option is listed on the EUX exchanged, so it is relatively liquid and transparent. The price of 375 for an at-the-money option is only 8.9% of the value, so the Index need only rise by that amount over four years to breakeven.

As a geeky side comment, this option effectively creates a "short" in the four-year European interest rate. If the ECB increased rates with other western Central Banks, there would be an immediate mark-to-market gain. For example, a 100bp rate increase would jump the call price from 375 to 431, all else equal.

This is the best ticket on the list. A similar option on the S&P 500 would cost 775 points, or 16.5% of the Index. I can gain exposure to the best companies in Europe, which have massively lagged the US market. This leaves 91.1% of my cash for other interesting financial ventures.

Buy SX5E call, K = 4200 vs Sell SX5E put, K = 3300 (21.5% OTM); Zero cost

This construction is not for those who tremble at mark-to-market risk and should only be considered if willing to own the SX5E at 3300, down 21.5% from the current level.

One is now borrowing the entire investment at a compounded negative rate, as well as monetizing the "skew" where the Implied Volatility of puts trades higher than calls.

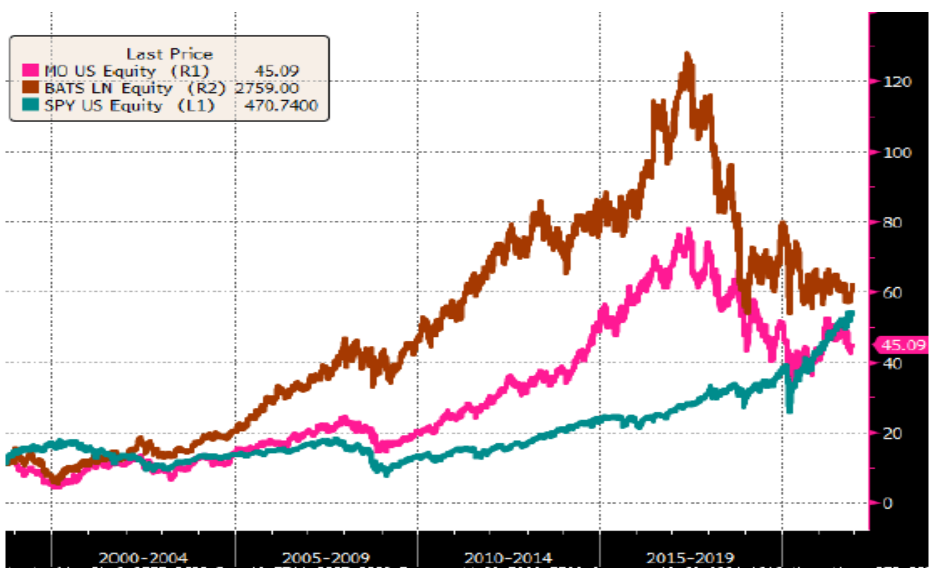
Buy Big Oil

Presently the "skunk at the garden party" is Big Oil whose residue has been linked to greenhouse gases that contribute to Global warming. Worse still is the accusation of deceitfulness as it has been reported that Exxon was well-aware of the risks of climate change from their own studies as early as 1977.

While I will not opine on the veracity of either of the above, the general zeitgeist well-echoes the fight over Big Tobacco thirty years ago. Somewhat similarly, it was revealed that tobacco producers had significant internal research that linked smoking to lung and heart disease yet continued to profit from their business.

The tobacco litigation all came to a head in November 1998 with the Master Settlement Agreement where the "big four" tobacco firms were released from liability in exchange for $206 billion dollars to be paid over the next 25 years.

One might have thought this was the time to "short" Big Tobacco, but on the contrary, this started their great ascent. Notice the -rutabaga line- Altria (the old Philip Morris) and the -cassava line- British American Tobacco significantly outpaced the -celeriac line- SPX until the recent tech boom launched the FAANG stocks into orbit. (The remaining "big four" were merged.)



Source: Unless otherwise marked - The Bloomberg

The Stone Age did not end because we ran out of stones; rather the creation of superior products closed the quarries. Similarly, regulations that restrict oil and gas exploration may serve as good public policy over the long-term, but over the next decade I suspect Big Oil's earnings will cover their above market dividend and may well have price appreciation via P/E expansion. The big five Western Integrated oil/gas firms have an unweighted P/E of 12 with a dividend of 4.9%.

Buy December Fed Funds or Eurodollar futures / options

The FED (sort of) promised not to raise short-term interest rates until at least January 2023, and I still believe this to be the case.

The FED has been trying to ignite inflation since the GFC, using every arrow in their quiver, and then begging for more accommodative Federal fiscal policies.

With their -perilla line- wish finally fulfilled, why would the FED snuff out the flame of inflation as soon as it flickers ? They have said they want the economy to run "hot", and the two-year running core CPI is only 2.37%, close to their target.

Most important, their ultimate goal was never asset or consumer inflation, but rather wage inflation which is finally occurring as a COVID reduced Labor Participation rate offers hourly workers a cudgel with which to bargain.

Buy the December 2022 FED Funds future (FFZ2) at 99.315 --or--
Buy the December 2022 Eurodollar future (EDZ2) at 99.00 --or—
Buy the December 2022 EDZ2 call option, K = 99.00, at 28.5

The option strategy is my preferred execution as it is signaled by my (famous) Three to One rule, detailed in "Your Ace in the Hole" – July 16, 2014.

In a nutshell, if the FED does nothing all year, the EDZ2 contract will rise to the December 2021 level of 99.795; so, an increase of 79.5bp. The option costs 28.5bp, so the ratio is 2.79x. A "buy signal" usually occurs somewhere near 2.75x. (I allow some wiggle room so 2.6x can be fine at times).

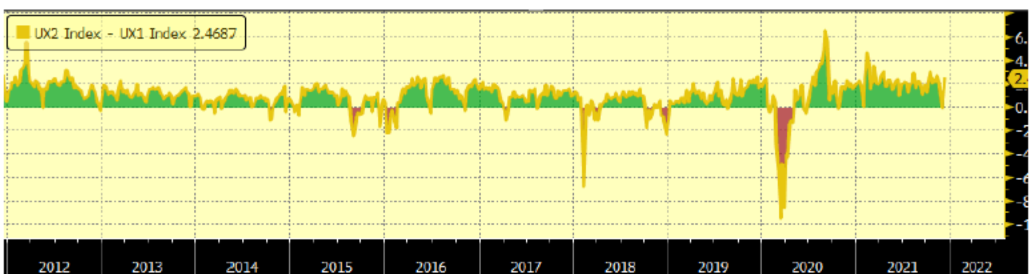
Capture the VIX Term Surface Anomaly

This ticket is a bit tricky, but fortunately there are products available to do most of the heavy lifting, albeit still with the risk of a substantial drawdown.

As discussed in prior Commentaries, one-month options on liquid assets (stocks, bonds, commodities, etc.) tend to trade with an Implied Volatility of 8% to 12% above the realized (actual) Volatility. As such, there are Hedge Fund managers who sell one-month options systematically to capture that excess premium.

At the same time, there are managers who are required to buy longer-dated options as part of a defined risk management program.

This creates an artificially steep slope between one-month and two-month expiry options on the SPX, which can be measured as the -purslane line- spread between the one-month and two-month VIX futures contracts.



This spread is much wider than its fundamental risk value but is kept wide by the exogenous supply demand imbalance between buyers and sellers.

An interesting income strategy is to sell the two-month VIX future, and then buy it back when it becomes a one-month future and roll it back out to the new two-month date. The problem is that on those rare occurrences when the stock market flushes down, the VIX rises and inverts to the -chayote patch- spread.

Looking down from 30,000 feet, this is an insurance strategy where over the long course of time it wins, but there are sporadic earthquakes that cause a drawdown. So, the key is to size it properly so one can ride out the volatility and earn the long term expected profit.

Professionals hedge out some of the risk by selling SPX futures (or SPY ETF) in some ratio, but that is too complicated for civilians. So, another method is to buy some portion of deep OTM call options on a VIX product as a catastrophic hedge.

Funny you should ask but Simplify offers such a strategy; go to our website.

Buy Ethereum

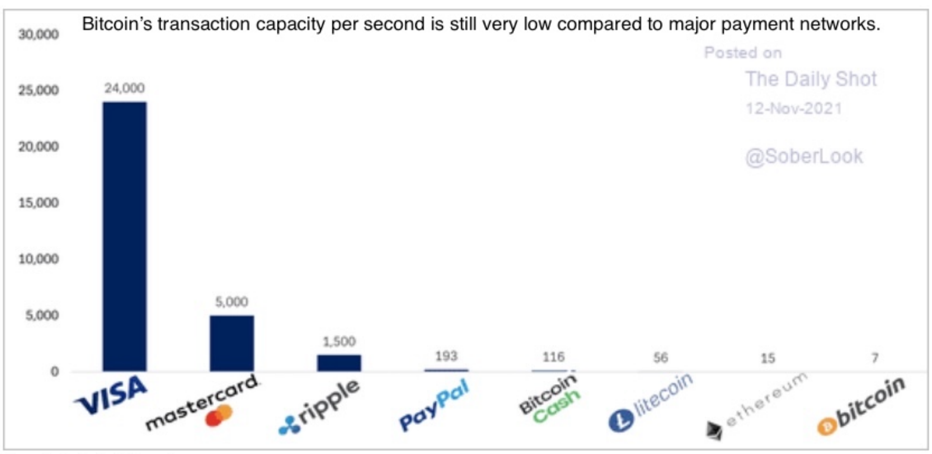
Ugh….must I bend a knee ?

In "Tulips for the Masses" – December 5, 2017, I opined that BitCoin was an "…an act of war against a sovereign state"; I have not changed my opinion too much.

Think about it, what defines a country: Race ? Language ? Religion ?
Or perhaps its currency. Thus, it is inconceivable that a country would give away control of its finances to a non-aligned independent manager.

Moreover, Crypto-currencies are presently <u>not a store of value</u> since their volatility is 12x the EUR and JPY, 6x of the Russian Ruble, and even twice that of the Turkish Lira, which is presently in a near melt down.

Moreover, they are (presently) <u>not functional as a means of commerce</u>. As detailed below, there is no scale to compare BitCoin to the main bank platforms.



Source: Deutsche Bank Research

In 1977, Ken Olsen, founder of Digital Equipment (DEC), the Apple of its day, said: "There is no reason for any individual to have a computer in his home."

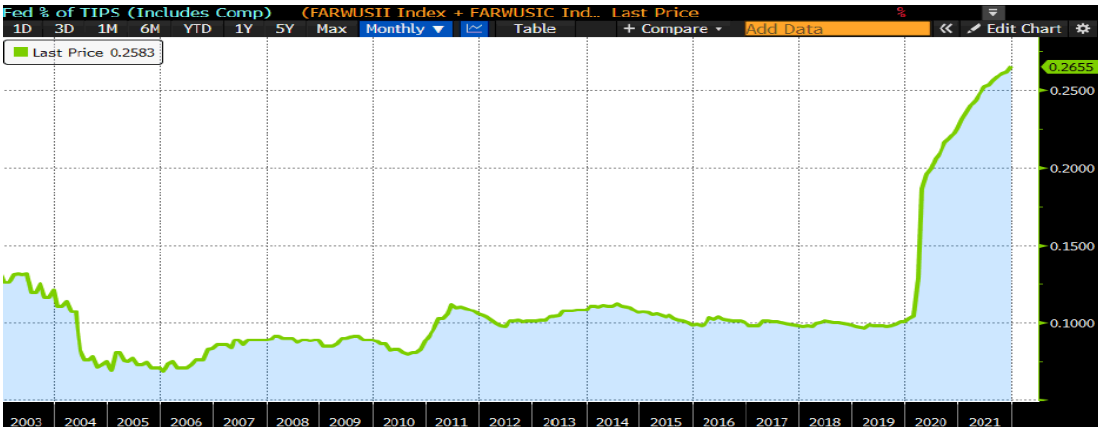
As much as it bothers me to quote Donald Rumsfeld, I must confess it is possible that Crypto-currencies offer the flavor of an "unknown unknown".

I bought Ethereum on last summer's pull back since those who know seem to believe that Ethereum has the best underlying code. Perhaps money down a rat hole, but my four kids all own it, and they have kicked my a$$ trading this year.

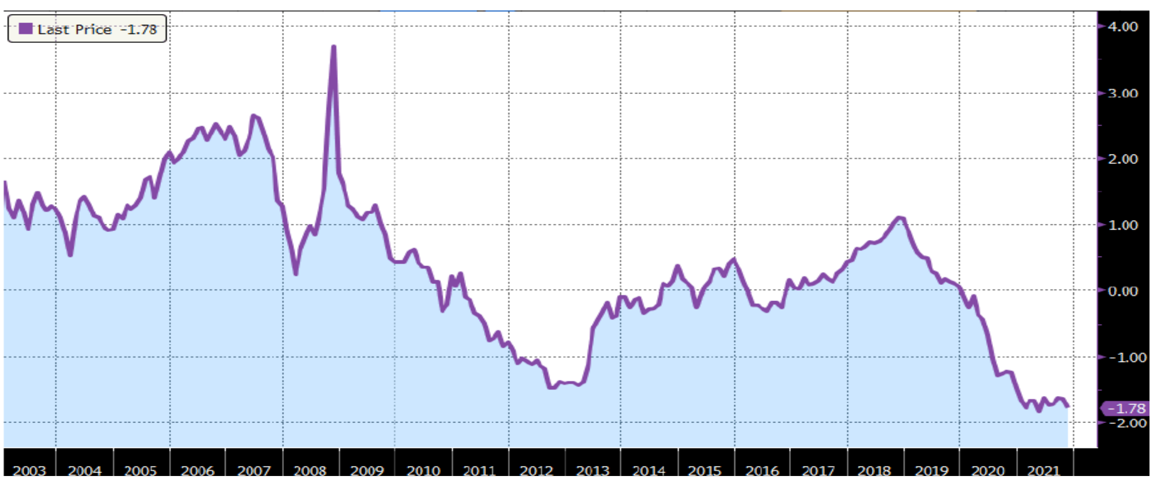
I was also talked into buying GarliCoin by my techie son, but that's another story.

I Hate TIPs

Various pundits sourced the bond market as a font of wisdom, which I tend to subscribe to, with certain exceptions. Here the -fiddlehead line- is the percent ownership of Treasury Inflation Protected Securities (TIPs) by the FED, which jumped from 10% to 26% when they re-started their QE program for COVID.



In fact, the FED has purchased more TIPs than the net supply at auction, thus driving the -salsify line- yield on five-year TIPs to a real rate (nominal minus inflation) of <u>negative</u> 1.78%. This cannot be informative of expected inflation.



There is a case to be made that the FED will let inflation "run hot" while at the same time it conducts some sort of Yield Curve Control (YCC) to keep nominal rates low, that is a big assumption for not a lot of return. TIPs will crash and burn if the FED tapers their bond purchases and nominal rates rise, thus quickly returning "real rates" to a positive number.

Caution on Mortgage REITs, but love for quality BDCs…

I have been selling covered calls on my Mortgage Real Estate Investment Trusts.

Recall that a Mortgage REIT is different from the more common Equity REIT as they do not own real estate assets (offices, hotels, shopping centers, apartments, etc.), but rather mortgages supported by residential property.

As such, the main risks they face are: 1) The ability and the cost to borrow (short-term rates); and 2) asset market (long-term rates) Volatility.

While I am not too concerned that interest rates will become substantially more volatile, this asset class is under pressure as forward short-term rates rise in anticipation of (hinted) FED rate hikes.

Noted prior, I do not think the FED raises rates as much or as soon as feared, but I see no reason to fight too hard, so I am selling calls to either dispose of the asset, or at least increase the income to soften the risk.

That said, if you think the FED will aggressively raise rates, then sell now as a sharp rise in their borrowing cost could presage a dividend cut.

I still like the Hybrid REITs that have less leverage and use Mortgage Servicing Rights (MSRs) as a hedge; but they are name specific to their management.

I have not sold any of my Business Development Companies (BDCs) as the better firms rely more on their credit skills than pure leverage. (See Mark Grant)

Refinance your mortgage

For G-s's sake, please refinance your mortgage. I am in the process of refinancing my mortgage in Laguna Beach where JPMorgan is offering an Adjustable-Rate Mortgage (ARM) with the first five years locked at 2.00%.

And while I would not advise this to widows and orphans, I do confess that I am increasing the principal amount to create optionality for myself in case an interesting investment opportunity arises in the near term. I can always pay the funds back early if so desired, but I suspect I can find a solid investment with a low hurdle rate of only 2.00%.

The Simplify Interest Rate Hedge

This is my creation; and was detailed in "Fire Insurance" – June 8, 2021, so I will not repeat it here. Below is a somewhat recent "modeled profile".

	-50bp	Unchanged	+50bp	+100bp	+150bp	+200bp	+250bp	+300bp
20yr Swap Rate	1.35%	1.85%	2.35%	2.85%	3.35%	3.85%	4.35%	4.85%
Stretegy Value Today	$36.59	$42.00	$49.75	$60.11	$73.15	$88.64	$106.10	$124.84
1x listed Future Value	$39.40	$42.00	$44.42	$46.67	$48.76	$50.71	$52.52	$54.22
Px Difference	-$2.81	$0.00	$5.33	$13.44	$24.39	$37.93	$53.58	$70.62
Two year hence Strategy Value	$33.45	$38.23	$45.63	$56.21	$70.29	$87.82	$108.34	$131.01
3x Listed Future two years hence	$29.82	$37.63	$44.88	$51.63	$57.91	$63.76	$69.20	$74.28
Px Difference	$3.63	$0.60	$0.75	$4.58	$12.38	$24.06	$39.14	$56.73

Concluding Comments

It is likely the FED has broken the correlation between interest rates and inflation. Thus, Implied Volatility on long-dated options is way too low since the range of possible outcomes is now much wider.

If the FED let's inflation run hot, yet interest rates remain suppressed, stocks will continue to climb. However, if short-term rates rise above 2.5% or long-term rates above 3.5%, there will be a lot of wet eyes. This is why I own an interest rate hedge, not because I am super bearish on rates, but rather because it is unclear our leveraged financial economy can handle such a cost.

Finally, **the cheapest option available in the market today is CASH**.

Short-term rates near zero create a low opportunity cost, and this offers you plenty of "dry powder" if the FED makes a policy mistake that tanks the economy (and the market) like the current flattening of the Yield Curve seems to indicate.

Remember: For most investments, sizing is more important than entry level.

Harley S. Bassman
December 14, 2021

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Follow me on Twitter: **@ConvexityMaven**

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

As a reminder, I am not an investment advisor, nor is this a solicitation. You should not rely upon this Commentary for accuracy, and you should seek advice from a professional. Finally, I personally own a variation of these investments.