The Convexity Maven

A Commentary by Harley Bassman

September 7, 2022

"Soft Landing"

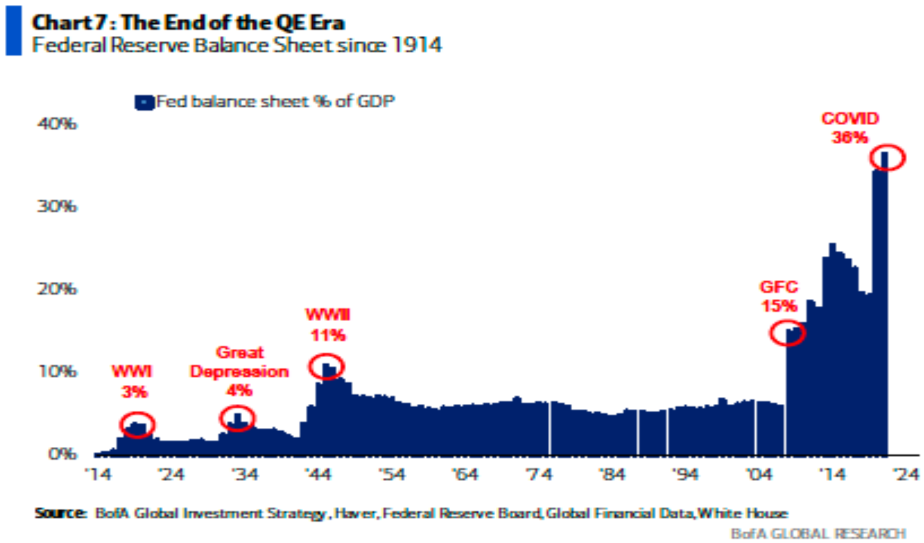
You might recall I recently tangled with a few egg-headed economists and overly educated pundits, so dubbed "Team Transitory", who confidently posited last year that the ~5% CPI inflation rate of last summer would quickly revert to the FED's target of ~2% by this past Spring.

Names were called as I was warned "not to step in it". Against famous grey-beards and erudite young Turks armed with graphs and charts, my only defense was to retort: "Who are you going to believe, me or your lying eyes ?"

Adjacent to Team Transitory is a group of well-educated ne'er do wells who insist that the FED cannot create inflation. Of course, this too is false; a Central Bank can create inflation…if they try hard enough.

Today's question is whether the FED can reverse what they have created without any more collateral damage.

While the Great Financial Crisis (GFC) was somewhat predictable relative to a few ill-considered Government housing policies, COVID was not. Thus, I must offer a "pass" to the FED's -lanthanum circle- emergency monetary support.



Sources – Unless noted, all charts are Credit Suisse LOCUS

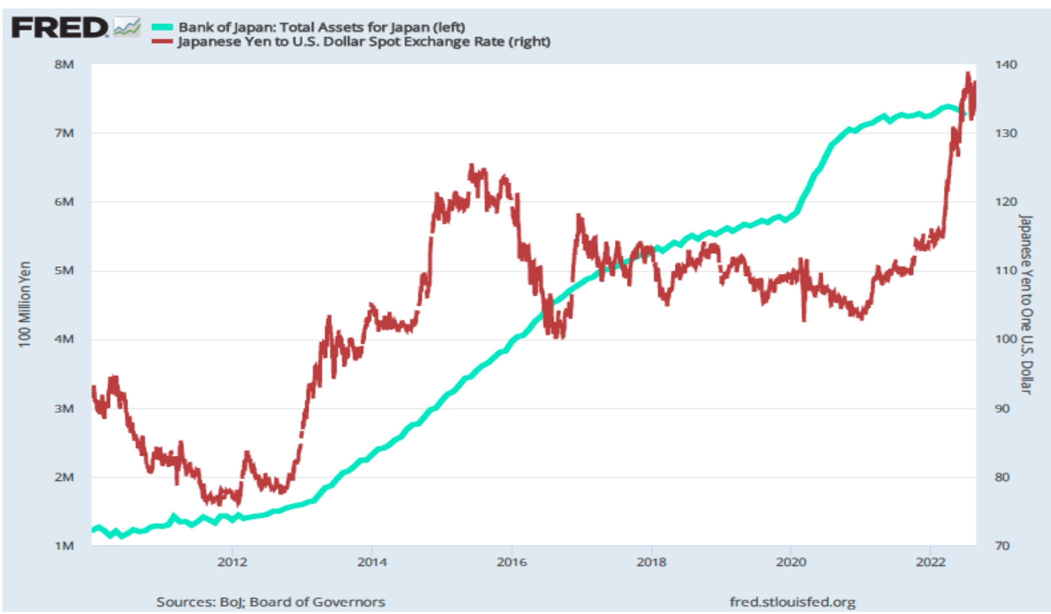
But can we please stop the nonsense that the FED did not "print money"; of course, they did. The major Central Banks printed -praseodymium line- money which led to the -promethium line- inflation of financial assets; and this was part of the master plan.

Elevating financial assets would activate the "wealth effect" to accelerate spending which would rebalance the Supply::Demand disequilibrium.

Naysayers point to Japan as an example of a Central Bank that could not create inflation, which was true during their decades of half-hearted attempts where rate cuts would be quickly offset with tax increases.

Abe-nomics, named for Prime Minister Shinzo Abe, was introduced in April 2013 soon after his December 2012 election. It was a three-pronged effort to raise inflation to a targeted 2.0% via Monetary, Fiscal and Regulatory policy shifts.

As the Bank of Japan (BOJ) tripled their -cerium line- balance sheet, Inflation rose to 3.6%; but the more significant impact was to the -erbium line- JPY currency which depreciated by nearly 50%; this is the stuff of banana republics, not the third largest Global economy. This was followed by another 25% depreciation when the BOJ again jumped their balance sheet during COVID.



This is not to say that the US will soon emulate Japan, but rather that a Central Bank has tremendous power when they are the sole manager of a Fiat currency.

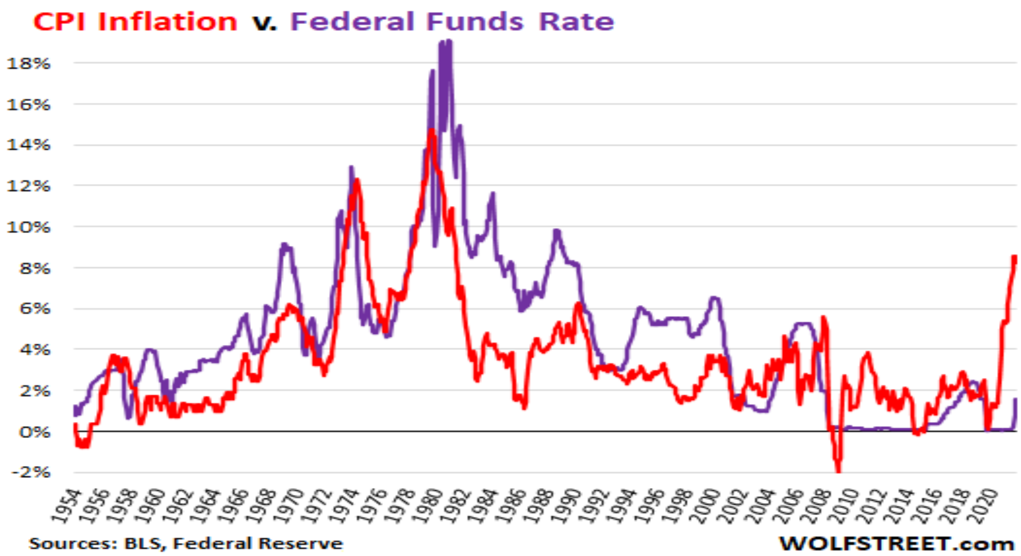
The problem is that Central Bank tools are blunt instruments - essentially **the FED is attempting to slice a loaf of bread with a chain saw**.

Monetary expansion usually results in some combination of a weaker Currency, elevated interest rates and inflation. Despite the FED's desire to elevate middle-class Labor wages, their policies resulted instead in asset inflation for Stocks, Bonds, Gold, Art, Wine, and (in a public policy disaster) Housing.

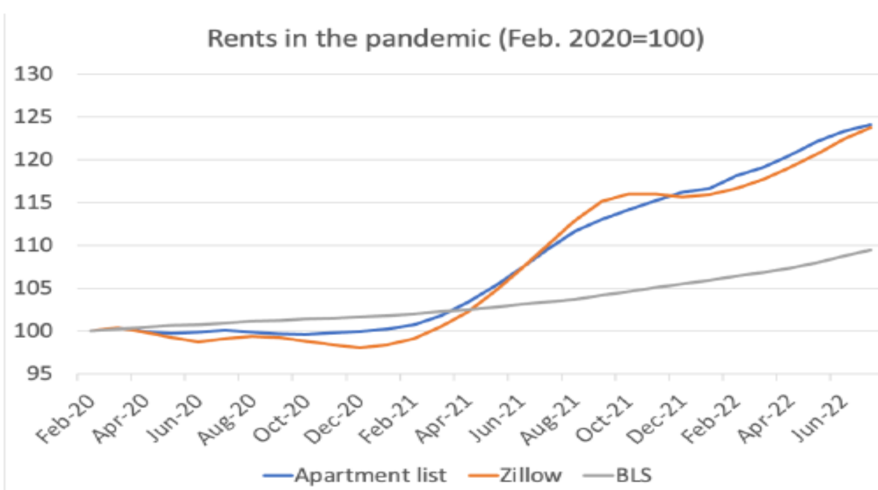
The unfortunate result has been a significant widening of the Wealth Gap.

As detailed in "*Nine Meals from Anarchy*"– July 12, 2022, the FED waited too long to "take away the punch bowl" and tighten Monetary policy, mostly because our tangled politics that delayed Jerome Powell's re-nomination.

Consequently, CPI inflation -ytterbium line- was kissing 8.0% before the FED acted to elevate their -thulium line- Funds rate from near zero in March 2022.



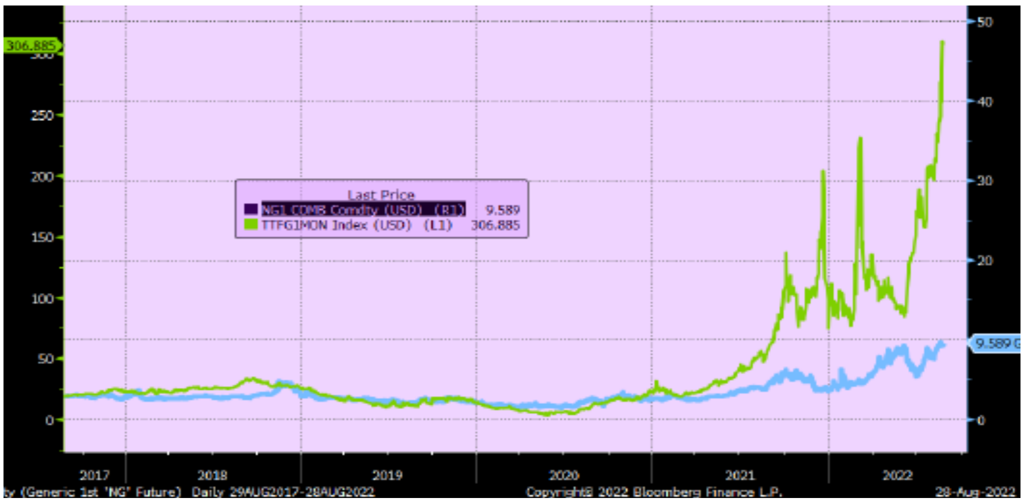
As an important reminder for the FED, "Hope is not a strategy". Despite many economic indicators signaling a potential slowdown in the economy, headline CPI will not be drawing down soon. The -astatine line- "shelter" component of CPI makes up almost one third of the index, and by construction, it tends to lag -osmium- market prices by six to nine months.



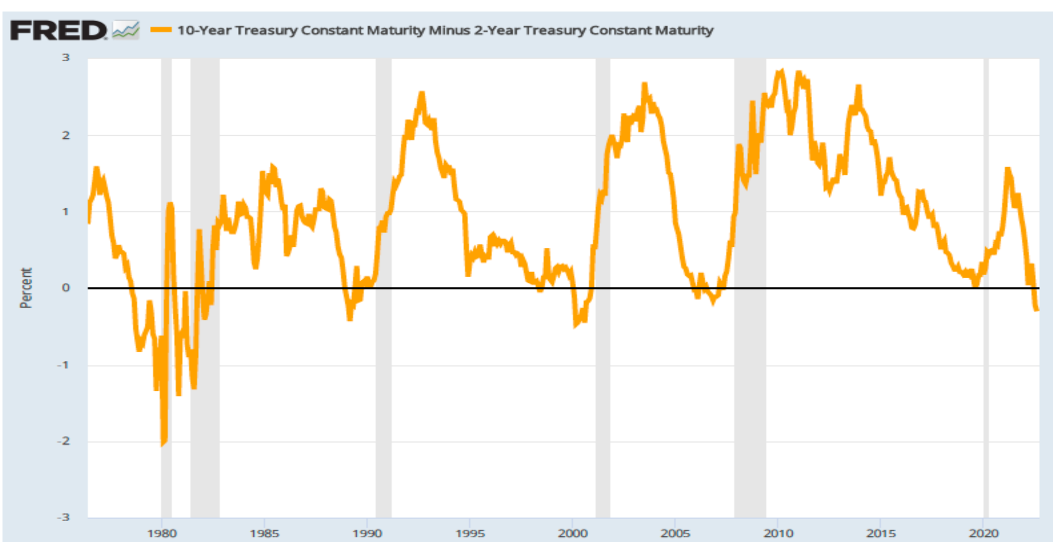
The rent explosion. Zillow, Apartment List, Bureau of Labor Statistics

Similarly, it is unlikely the recent pull back in energy prices will be sustained into the winter. Markets are efficient over a long enough time horizon, and so fungible assets converge in price. The Rothschild's family fortune was built on such "arbitrage" by trading Gold between Napoleon's France and England.

Oil is easy to transport, so its Global delivery price spread stays relatively constant. However, the same cannot be said for -europium line- European delivery and -gadolinium line- US delivery Natural Gas. Presently natural gas is the source for 32% of US energy usage and 24% of EUR usage; these prices will converge over time, and I can assure you it will not be EUR prices collapsing.

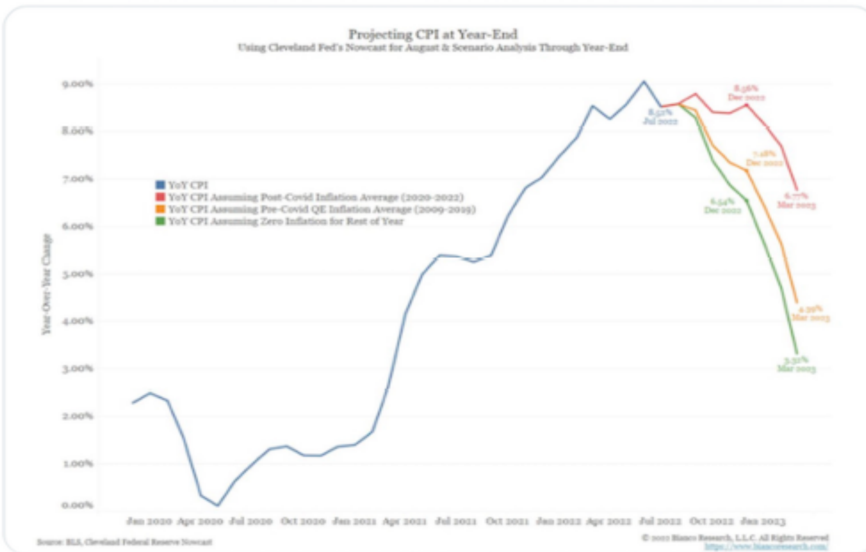


The bond market's -neodymium line- Yield Curve (the spread between the 2yr rate and the 10yr rate) has a terrific track record of presaging -dysprosium shading- recessions, and presently it is screaming "RECESSION".



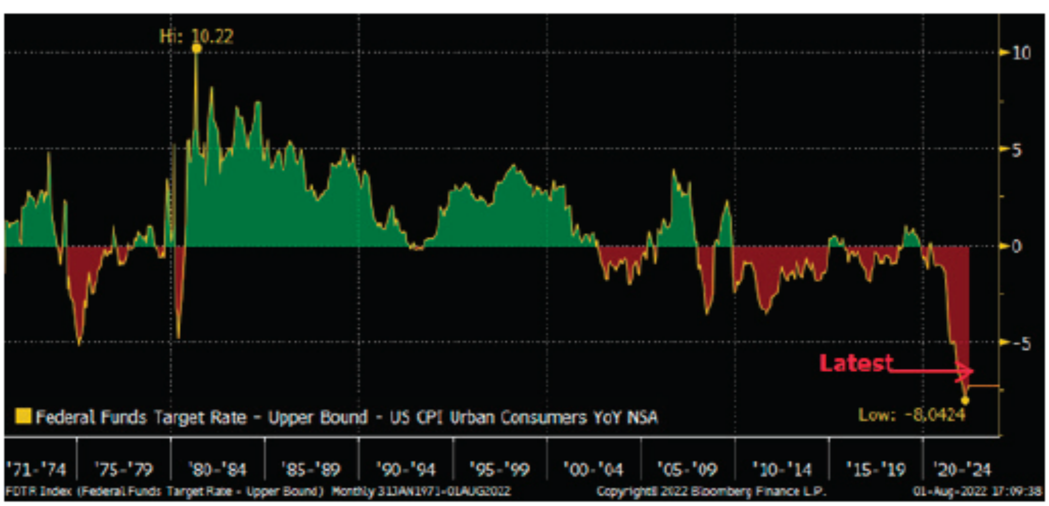
The FED would love to let an approaching recession do the heavy lifting of trimming inflation, but they burned their credibility when they offered the notion of "Transitory" last year, and now they must do the dirty work themselves.

But even if one counts the current "technical recession" of back-to-back negative "real" GDP quarters, it is still an almost certainty that -rhodium line- inflation will print at least a 5%-handle in December.



Unless we are already in a recession, and headed into a full-on depression, a deeply negative -samarium shading- Real Fed Funds rate is still quite stimulative and **even a 4% FED Funds rate will not reduce inflationary pressures**.

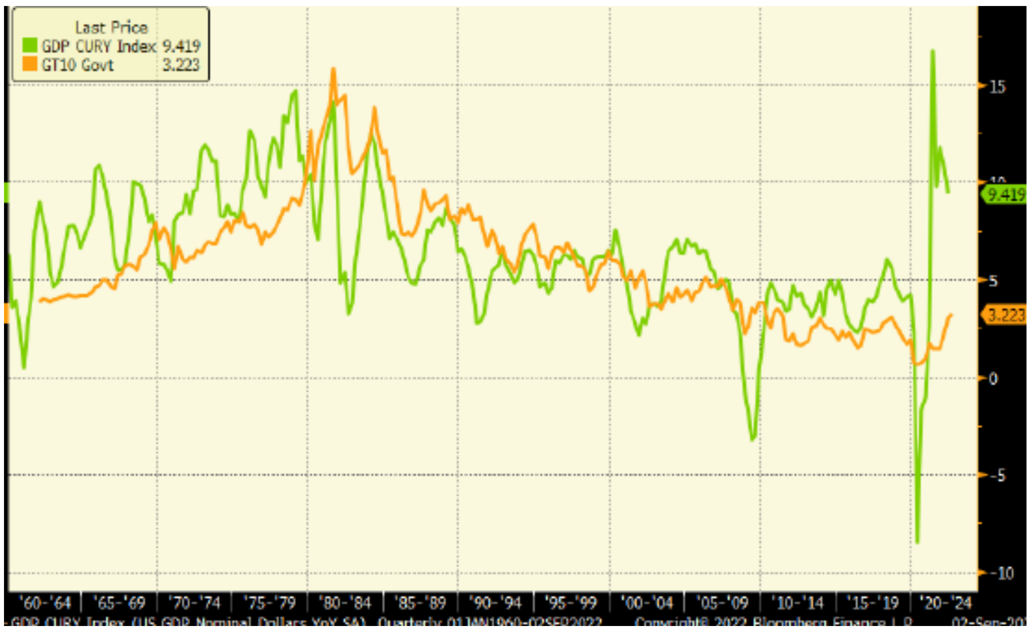
Real Fed Funds Rate
(Jan. 1971 – Jul. 2022)



Source: Bloomberg Finance L.P.

The FED must consider the possibility that the Yield Curve has inverted because of its heavy-handed use of ZIRP (Zero Interest Rate Policy) and QE (Quantitative Easing); and thus, they cannot rely upon its history of economic clairvoyance.

The cold truth is that only a robed monastic economist on a cliff in Tibet would refer to a -terbium line- nominal GDP of 9.4% as "recession" and a concurrent ten-year -holmium line- rate of 3.25% as restrictive to the economy.



We still read the Greek tragedies (Aeschylus, Sophocles, Euripides) and Shakespeare because they identify Hubris (ego), as mankind's destroyer. And with all due respect, Jerome Powell pulls his pants on one leg at a time.

As such, I foresee no scenario where Mr. Powell would prefer to have the headline of his WSJ obituary read "**Arthur Burns Redux – Powell as Political Coward"** instead of **"Volcker Revisited – Powell Saved the Nation"**. For G-d's sake, Mr. Powell just quoted Volcker effusively at Jackson Hole last month.

Don't cry to me that Burns was treated unfairly as he too raised rates, and that Volcker was lucky that the Baby Boomer demographic rolled over during his tenure. History is written by the victors, and Volcker was the nation's Monetary General in March 1982 when inflation peaked at 14.8%.

Quipped my good friend and ex-Merrill Lynch sparring partner David Rosenberg: "Cycles die; and you know how they die ? The Fed puts a bullet in its forehead."

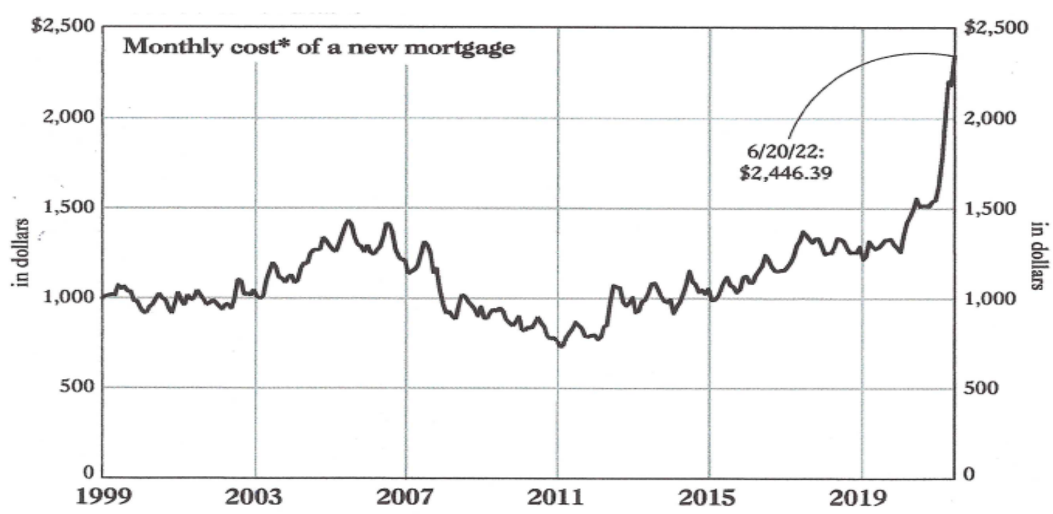
For better or worse, Mr. Powell will use their limited tools to reduce demand.

A Soft Landing ?

The FEDs interest rate hikes will have little impact on most Investment Grade (IG) corporations. The massive flow of cash available for stock buybacks indicates they have little need to borrow (at any rate). Moreover, if a 200bp increase in their cost of funds impacts the decision to build a chip (silicon or potato) factory, then they are in the wrong business.

Where the rubber meets the road on this interest rate cycle is the housing market, whose long tentacles encompass nearly 15% of the economy.

The -coal line- mortgage cost to buy a median house is an interesting metric, but since <u>the average home buyer does not have income flexibility</u>, perhaps it is better to measure the loan size available relative to interest rates.



* Using the National Association of Realtors' median house price and the prevailing 30-year mortgage rate while assuming a 20% down payment.

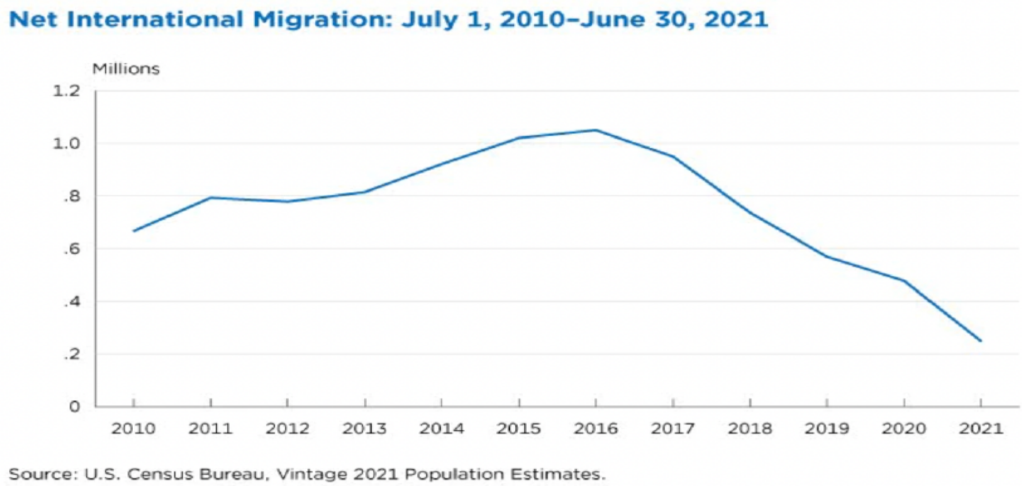
source: The Bloomberg

When the retail mortgage rate was 3.00% at the start of the year, one could borrow $450,000 for thirty-years with a monthly payment of $1,900. That is 28% of the near median income of $82,000.

With the retail mortgage rate now at 5.50%, a $1,900 monthly payment can only finance $335,000. Assuming a constant $50,000 down payment, a similarly affordable home will decrease from $500,000 to $385,000, down 23% !

Since it is unlikely house prices will decline by 23%, especially with the Millennial demographic forming families, the more likely outcome is that the extra cost of a mortgage will be drawn from the discretionary spending on their beloved "experiences"; and <u>this will reduce overall economic demand</u>.

Further mitigating a "soft landing" is the decline in -lutetium line- net immigration.



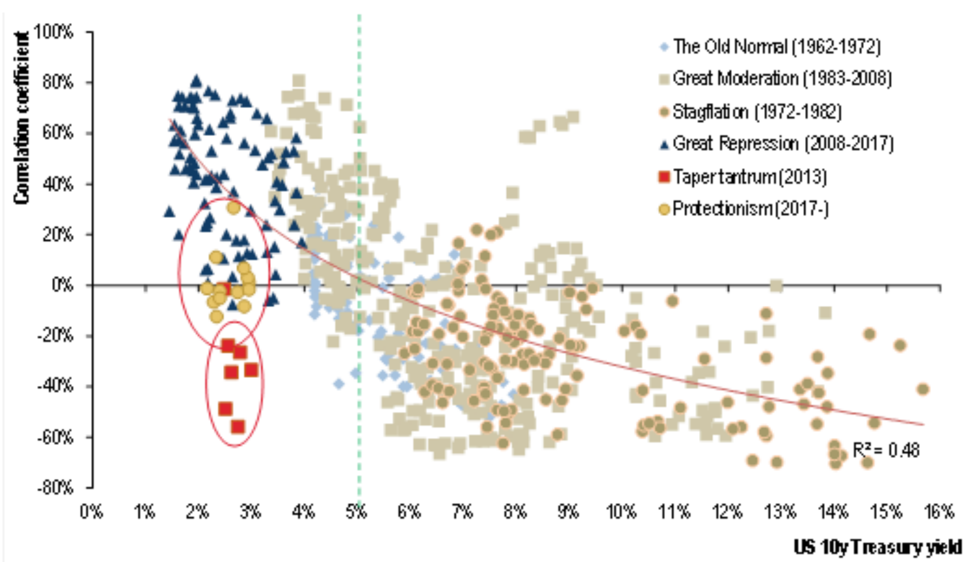
Please stop "trolling" me, I do NOT favor open borders, but the simple fact is:

GDP ≡ NUMBER OF WORKERS * HOURS WORKED * PRODUCTIVITY

The US has been cushioned against the impact of a declining birth rate and accelerating retirements because of our net positive immigration - legal or otherwise. If you want to lock the door shut, fine; but <u>be prepared for the consequences of higher prices and a slower economy</u>.

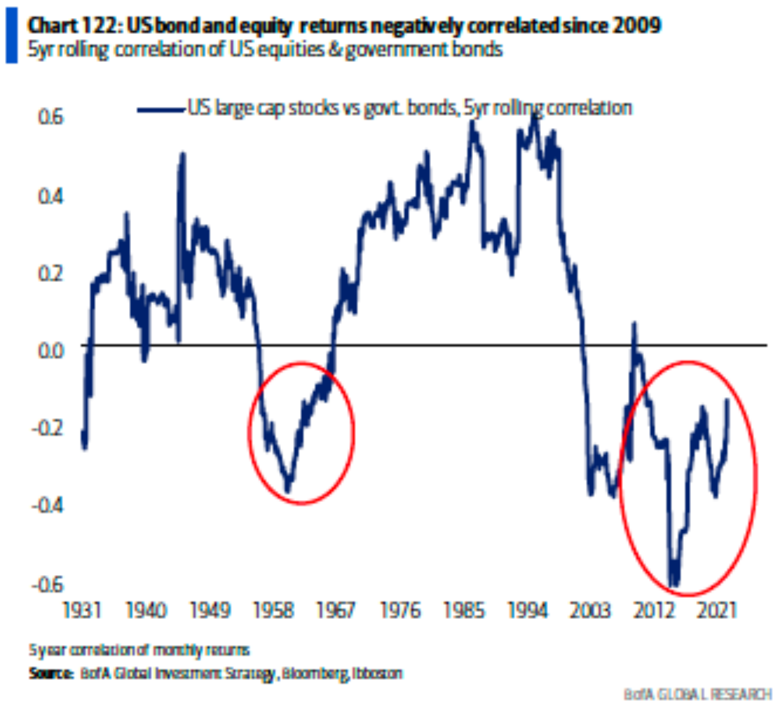
The Warning

As offered in prior Commentaries, one should worry about asset correlation.



The core premise for the 60/40 portfolio is that for the past twenty years, Equity and Bond prices have been -iridium line- inversely correlated (or positively correlated between Stock price and Bond yield). This portfolio has a lower volatility because the two asset classes tend to cushion each other.

However, history (and theory) indicates that this correlation flips when long-term rates rise above 4.5% or inflation exceeds 3.0%.



It is for this reason I have strongly suggested adding a long-dated **Payer Swaption Hedging Strategy** with a relatively small "modeled" one-year theta decay of 3.9%. [Details at *"Fire Insurance – Revisited"* – February 2, 2022]

20yr Rate	2.25% -100bp	2.75% -50bp	3.25% Unchanged	3.75% +50bp	4.25% +100bp	4.75% +150bp	5.25% +200bp	5.75% +250bp	6.25% +300bp
Parallel shift	$40.43	$48.48	$60.00	$75.70	$96.09	$121.45	$151.78	$186.76	$225.85
One year hence	$38.91	$46.45	$57.67	$73.40	$94.23	$120.48	$152.12	$188.75	$232.21
one-year % change	-35.1%	-22.6%	-3.9%	22.3%	57.0%	100.8%	153.5%	214.6%	287.0%

I personally have exposure to this strategy not because I am predicting long rates to touch 4.5%, but rather because I want protection if that occurs.

I buy car insurance for the same reason, I am not hoping for an accident; **when one buys life insurance, you don't win when you die.**

Closing Comments

The markets are pricing derivative contracts to win if the FED Funds rate peaks near 3.75% in the Spring of 2023, with the embedded implication that rate cuts will soon follow. I will take the other side of that trade.

It is not that I think the economy will avoid a recession; I know that will happen sometime over the next few years.

But I think the FED has boxed itself into a corner and now must take strong actions to inhibit an "inflationary psychology" from taking hold; they have lost the option to be patient. CPI may be a lagging indicator but try telling that to voters in November.

Despite fundamental indicators strongly pointing to an economic slowdown, that is in the foggy future while the FED must deal with monthly CPI reports of well over 5% for the remainder of the year, and likely into 2023.

I have a difficult time suggesting a ten-year rate above 4.0%, a level not exceeded since before the GFC in 2008; but a 3% rate seems anomalous relative to a nominal GDP above 8%.

Creating 8% to 12% inflation is easy, just ask Turkey or Argentina; but sharpshooting for 2% inflation is a lot harder. **My bet is that the FED raises their benchmark rate to at least 4.0%**, and they do not dial back until inflation is at a 3%-handle and unemployment is well into a 4.0%-handle.

So circling back to the top, can the FED engineer a "soft landing" ?

I suppose it is possible to land a jumbo-jet on a football field, but not likely.

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

Harley S. Bassman
September 7, 2022

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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

Special credit to Gerard Minack, the best macro analyst on the planet.