The Convexity Maven

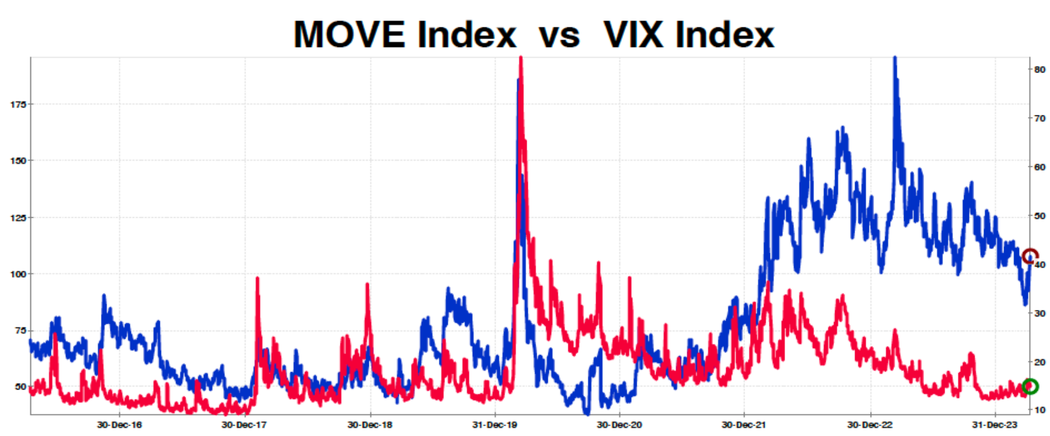
A Commentary by Harley Bassman

April 16, 2024

"Bedtime for Bonds"

Bedtime for Bonzo, Ronald Reagan and Diana Lynn - 1951

Soon after the Federal Reserve (FED) raised their interest rate target on March 16, 2022, the -kek line- MOVE Index (which measures the Implied Volatility for interest rate options) diverged from its typical relationship with the -piros line- VIX Index of Implied Volatility for equity options



Sources – Unless noted, all charts are Credit Suisse LOCUS

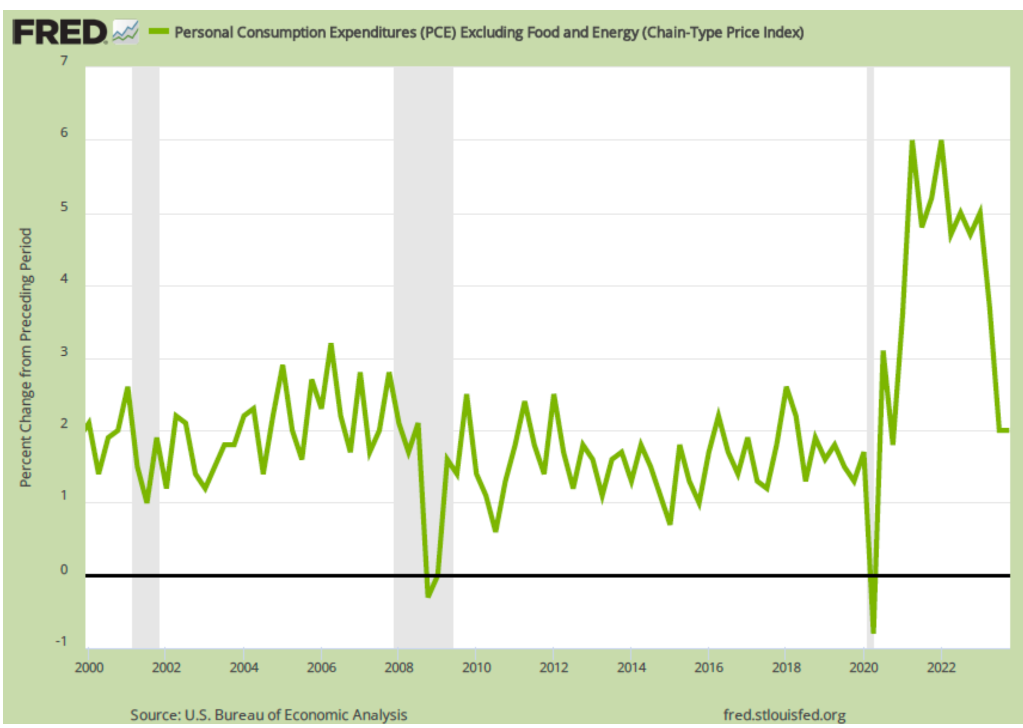
Since then, interest rates have moved dramatically, both up and down, reflecting confusing and uncertain FED policy. While rate policy is still uncertain, I would contend its path forward has considerably narrowed.

As late as September 2021, the FED's "DOTs" projected a FED funds rate that would remain near zero for all of 2022 and reach just 1.8% by the end of 2024. Moreover, their "long run" policy rate was targeted at 2.5%.

As such, I do have a morsel of sympathy for the top dogs at the banks who bet the ranch on FED Chairman Jerome Powell's "promises". That said, I will show absolutely no pity for the risk managers. Situations such as these are the sole reason you have that job: "You are the designated driver".

I cautioned in ["Moral Hazard"]() – May 23, 2023, about the inherent risks embedded in policies such as the DOTs (Summary of Economic Projects) as they offer a false sense of certainty – a notion orthogonal to risk management.

This notwithstanding, at the time the FED had good reason to anticipate inflation stability near their professed target of 2.0%. This confidence was not pulled from their nether regions since their preferred inflation measure of -olajbogyo line- Core Personal Consumption Expenditures (PCE) had been bouncing around that level for the better part of two decades. [The "core" rate excludes the more volatile "food and energy" components are discarded.]



Politics and Policy

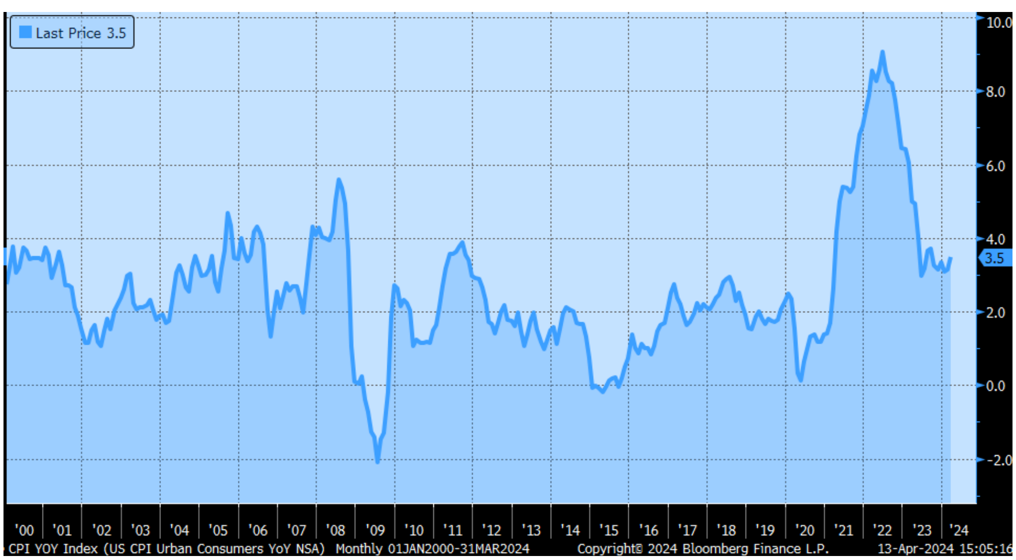
Up until the Great Depression, the Panic of 1907 was the nation's greatest financial crisis. Order was only restored when J.P. Morgan (the citizen not the bank) cobbled together a phalanx of wealthy New York executives to pledge funding to banks that could not meet a frenzy of withdrawals; thus, saving the country from a more severe financial crisis.

Clearly, it is bad public policy for a nation's financial system to rely upon a few private individuals. The Federal Reserve Act of 1913 established the Federal Reserve System as the central bank of the United States to provide the nation with a safer, more flexible, and more stable monetary and financial system.

So as much as the FED frequently asserts that they "value their independence", they are in fact a direct arm of the Government, obligated to also consider the political implications of their actions.

As such, I would propose that politics, as much as economics, has driven FED policy since inflation meaningfully increased.

Mr. Powell first discussed the concept of "transitory" in his June 22, 2021, testimony to a Congressional Oversight panel. Here, he was responding to the recently reported 5.0% year-over-year (YOY) increase in -felho line- Consumer Price Inflation (CPI).



Source – The Bloomberg

While this may have been a sincere belief after the Covid tumult, I suspect it was also shaded by his desire to be nominated for another term as Chairman.

The FED Chair serves a four-year term at the pleasure of the President. Mr. Powell's first term started on February 5, 2018, and was set to expire in February 2022. To maintain continuity at the World's most important financial institution, a nomination (or re-nomination) often occurs in the late summer of the year prior to let the machinery of Government grind efficiently.

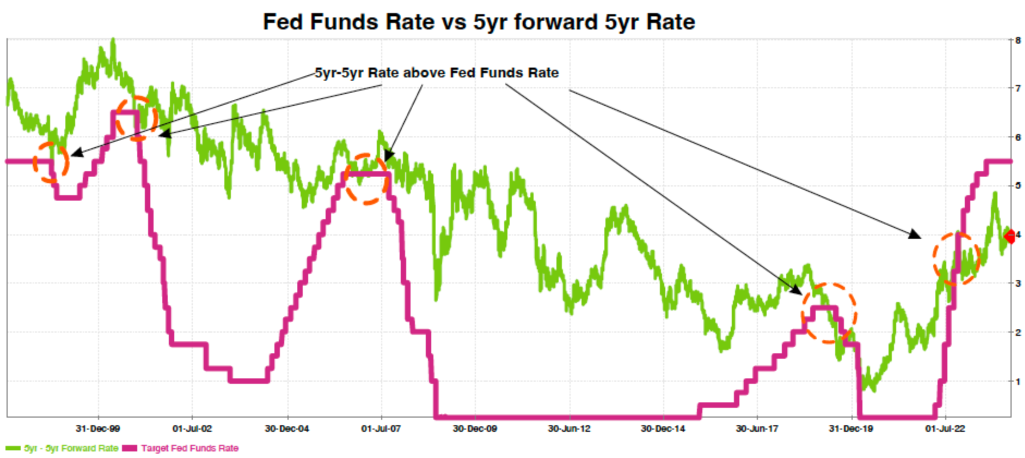
At the time, it was not a certainty that Mr. Powell, a Republican chosen by Trump, would be re-nominated as rumors swirled that Lael Brainard, an Obama administration Treasury official wanted the job.

Mr. Powell's was eventually re-nominated in November 2021, but not confirmed until May 12, 2022, a full three months AFTER his term had officially ended.

Call me cynical, but I suspect Mr. Powell was worried that he might lose Congressional support if he abruptly hiked interest rates and curtailed QE before his confirmation.

Behind the curve, the FED "released the Kraken" by hiking their -biborvoros line- policy rate at the quickest pace since Paul Volcker's chairmanship.

Contrary to prior cycles, the FED has pushed rates well above the -szolo line- five year forward five-year rate, a market implied level of rate equilibrium.



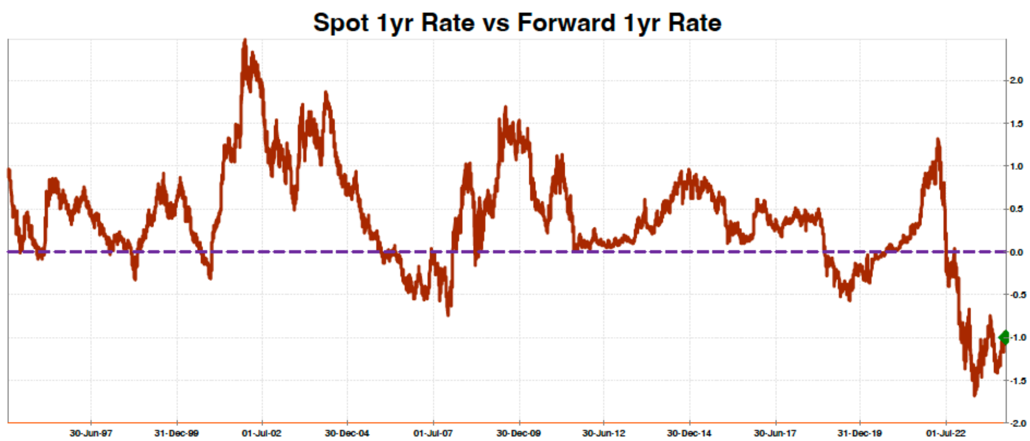
I would (again cynically) suggest the series of rate hikes had more to do with Mr. Powell's legacy than economics as foremost on his mind is the epitaph that will be chiseled onto his tombstone.

Will he be remembered as an Arthur Burns redux whose name conjures the ruinous inflation of the 1970s, or a slayer of inflation alongside the sainted Paul Volcker ?

Going nowhere fast....

Unless inflation re-accelerates to well over 5% and the unemployment rate dips below its cycle low of 3.4%, **this hiking cycle is done**. The FED confirmed as much in December when not a single DOT was above the current rate level.

Taking their cue from Chairman Powell's forward guidance of up to three 25bp rate cuts in 2024, bond traders have priced the -barna line- one-year rate 75bp to 100bp lower than its current level one year hence.



The problem is that a self-described "data dependent" FED does not have the **coincident data** to support significant rate reductions consistent with their long-run 2.0% inflation target.

The BLS reported that 303,000 jobs were created in March, exceeding Street expectations of only 214,000. This was followed by a year-over-year "headline" inflation (CPI) survey of 3.5%, above the previous month's reading of 3.2%.

It is a certainty that my partner @profplum99 is correct that the internal dynamics of these numbers were driven by **lagging vectors**; but the FED's prior comments of "transitory inflation" have burned their forecasting credibility.

At his most recent post-FOMC meeting press conference, Chairman Powell confirmed that he wants to be certain that inflation has been checked before he significantly reduces the policy rate. Clipping a page from the American Revolution he is mimicking the orders of William Prescott at the Battle of Bunker Hill: "Don't shoot until you see the whites of their eyes."

To secure his legacy, he wants to jam a wooden stake in the heart of inflation.

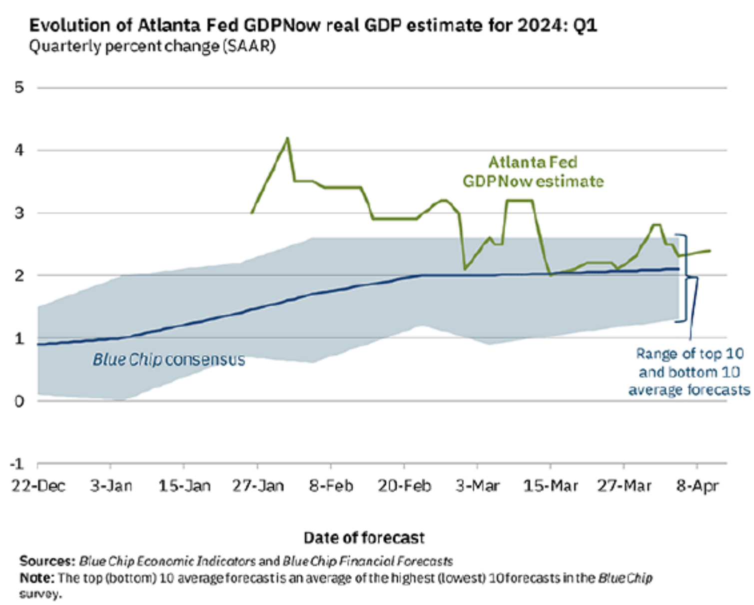
An unhelpful calendar… *(hat-tip to Jim Bianco)*

May 1 – FOMC meeting
June 12 – FOMC meeting
July 15–18 – Republican Convention
July 31 – FOMC meeting
August 19-22 – Democratic Convention
September 18 – FOMC meeting
November 5 - Election
November 7 – FOMC meeting
December 18 – FOMC meeting

While the FED is certainly an institution woven into the fabric of the Government, it is still a useful chimera to coyly assert their independence.

Mirroring the Department of Justice's "sixty-day rule" to not take prosecutorial steps that could influence an upcoming election, I suspect the FED will be loath to make any policy adjustments at their July and September meetings.

The simple fact is a "data dependent" FED is running out of runway to significantly reduce their policy rate this year. The -novenyen line- Atlanta FED's GDP model estimates real growth of 2.4% for the Q1-2024, not at all indicative of a "hard landing".



Consequently, one can **"Stick a fork" into interest rate Volatility, it is done.** You can put bonds to bed for the next six months and quietly clip your coupons; the FED may squeeze out one cut in June, but that's it until the election is over.

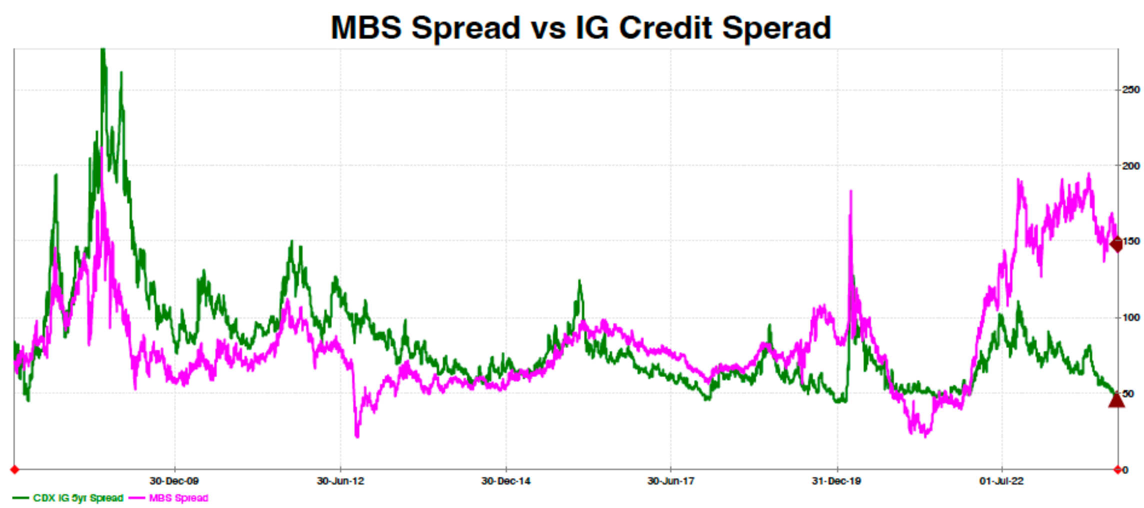
Newly issued MBS: Still the Best Bonds in Town

While not without risk, selling volatility via a "covered-call" strategy is a perfectly fine way to add value to a portfolio. As such, newly issued mortgage-backed securities (MBS) can be a terrific strategy for the bond portion of your portfolio.

Differing from the common equity strategy of selling short-dated (one to three month) call options, MBS can be modeled as buying a UST 10yr and selling a three-year expiry call option. Such a long-dated option is less negatively convex and requires much less management than a short-dated options strategy.

The more important value-add is that selling a long-dated option captures the currently elevated Implied Volatility, which will bleed off with a static FED.

Newly issued -rozsaszin line- MBS offer tremendous value with a yield of nearly 90bps more than -hanyas line- Investment Grade (IG) Credit bonds. All MBS have zero credit risk, and newly issued MBS have a similar 4.3-year duration.



Be careful though, do not buy MBS products (mutual funds or ETFs) whose goal is to replicate the MBS Index. The MBS Index is overwhelmingly comprised of mortgages issued from 2020 to 2022 with coupons of about 3.0%. As such, the MBS Index (and related products) has lower yield and longer duration (7-years).

Most financial institutions will not allow civilians to directly buy single pool MBS; and even if available, I would advise against their purchase. To resolve this problem, I created a **listed ETF strategy** that only invests in newly issued MBS bonds. Presently this strategy offers a dividend and yield of about 5.95%, the only high-grade credit product that yields more than three-month T-bills.

For more, see "A New Issue MBS Strategy" – November 6, 2023

Concluding Thoughts

Pundits often say the "easy money has already been made"; such a pity they could not reveal these great investments ex-ante.

While never totally transparent, the medium-term path forward is well lit. Via a combination of Politics, the Data, the Calendar, and Hubris (human ego) the FED is boxed in, and the most likely scenario is **"one and done"** until the election.

The US Treasury Yield Curve is inverted but fairly priced. Credit Spreads are near their pre-Covid narrows, yet Implied Volatility has nearly doubled since 2020.

Newly issued MBS are the only "safe bonds" that yield more than the FED Funds rate. While I usually caution against negative convexity, I also note that there are **no bad bonds, just bad prices**. Presently, selling interest rate Convexity via MBS offers a better risk::return than taking Duration or Credit risk.

	Coupon Yield	Yield to Maturity	$ Duration
FN 6s	6.01%	6.03%	3.43
FN 5.5s	5.61%	5.83%	4.46
3m T-Bills	5.35%	5.35%	0.25
MBS Index	3.75%	5.21%	5.79
FN 3.5s	4.00%	5.11%	7.08
IG 5yr	5.10%	5.10%	4.37
FN 3s	3.57%	5.07%	7.75
2yr UST		4.90%	1.85
30yr UST		4.63%	16.26
5yr UST		4.55%	4.42
10yr UST		4.52%	7.95

One final note: Be careful of leverage. The cost to borrow money for financial leverage at the FED Funds rate of 5.33% (plus a spread) is greater than the yield of most assets (SPX, Gold, Oil, IG bonds, etc.). This will be a drag on your return profile. Unless you are certain of near-term direction or can borrow at an advantageous rate (via derivatives), don't lean too far over your skis.

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

Harley S. Bassman
April 16, 2024

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.

To become better educated on macro-economic fundamentals and policy, I urge you to connect with my partner, Michael Green, better known as @profplum99.

Special Coda: *Some of the ideas I suggest can be particularly complex via the use of futures contracts and options embedded into Strategies for leverage and/or convexity that is both clever and tricky. I urge you to ping my associates who are waiting for your call to detail these strategies more fully.*

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.