Convexity Maven

A Commentary by Harley Bassman

April 29, 2025

"Chekhov's Gun"

Anton Chekhov – 1860 - 1904

Anton Chekhov was a Russian playwright and short-story author widely considered to be one of the greatest writers of all time. His career as a playwright produced four classics, and his best short stories are held in high esteem. Chekhov, along with Henrik Ibsen and August Strindberg, is often referred to as one of the three seminal figures in the birth of early modernism in the theatre.

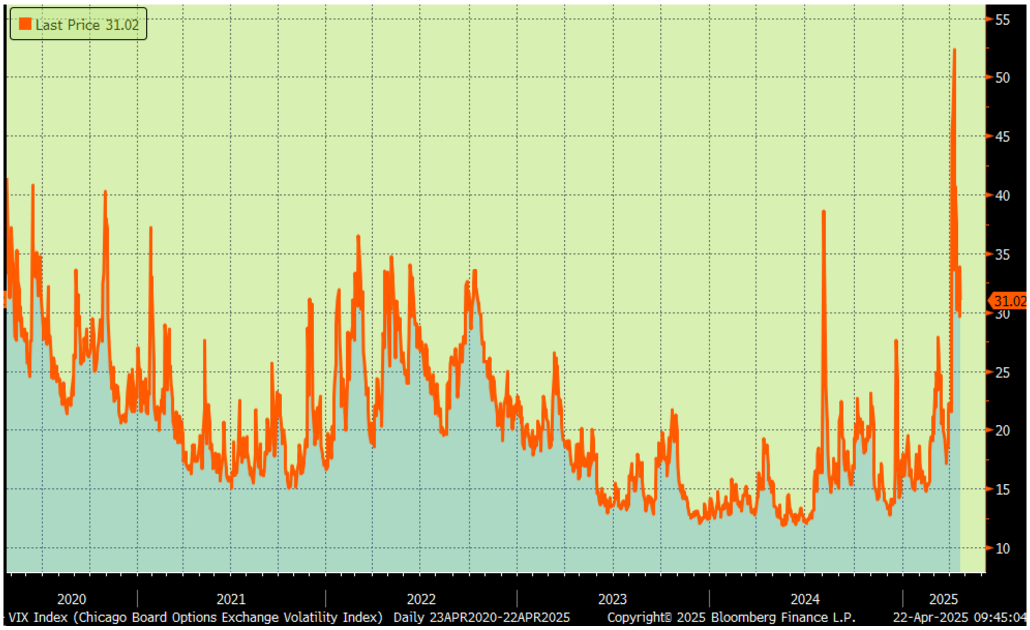
"Chekhov's Gun" is a storytelling principle that states <u>every element introduced in a story should be necessary and have a purpose</u>, not just a dangling detail. Chekhov famously advised writers to "not put a loaded rifle on the stage if no one is thinking of firing it," meaning everything introduced should eventually be used or have significance.

Here I offer the slight twist - once a "gun" (tariff) has been seen, it cannot be unseen. Similarly, once Global Tariff reform has been placed on stage, even if rescinded, <u>we cannot turn back the clock and unsee it</u>.

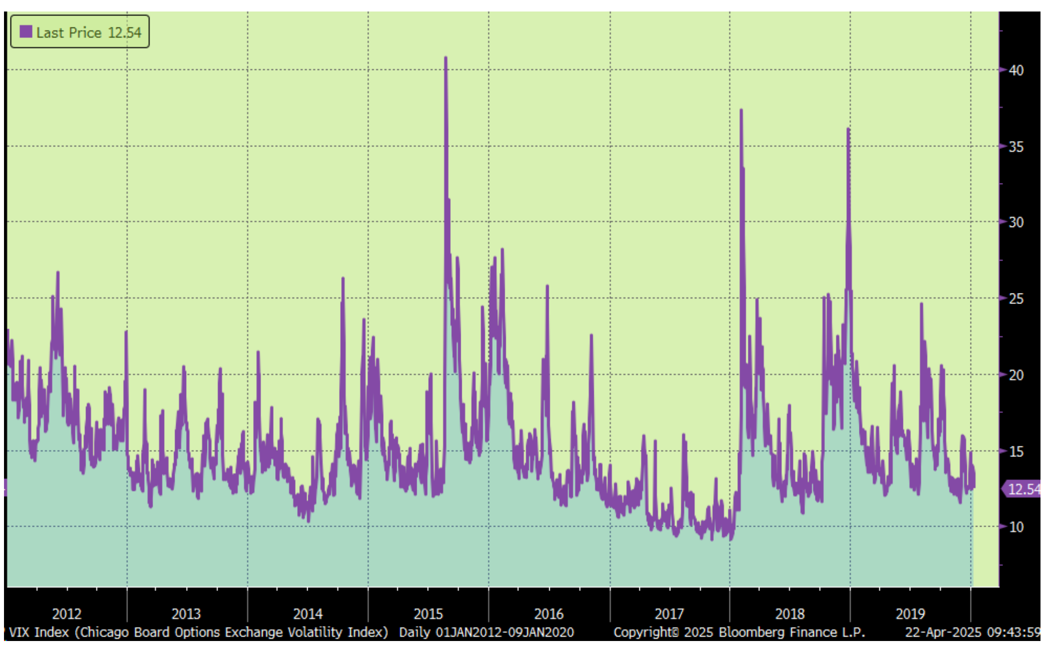
It has been said of President Trump to "take him seriously, but not literally".

Thus, the markets were supremely unsettled on "Liberation Day" (April 2nd) when he offered a Tariff profile that was significantly higher than anticipated.

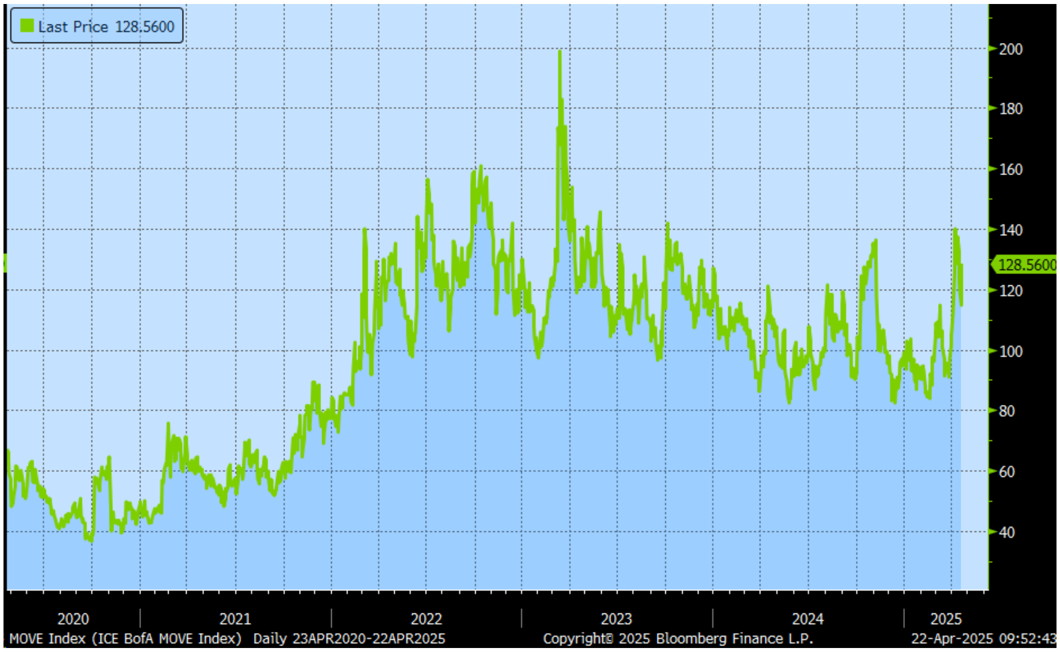
The -aranzavy line- VIX, the popular measure of Implied Volatility for one-month options on the S&P 500, screamed to well over 50, a post pandemic high.



This was over triple the -fijalietavy line- eight-year post-GFC average of 15.3.



This rhymes with the recent elevation of the -zialiony line- MOVE Index which measures the Implied Volatility of one-month options on US Treasuries.

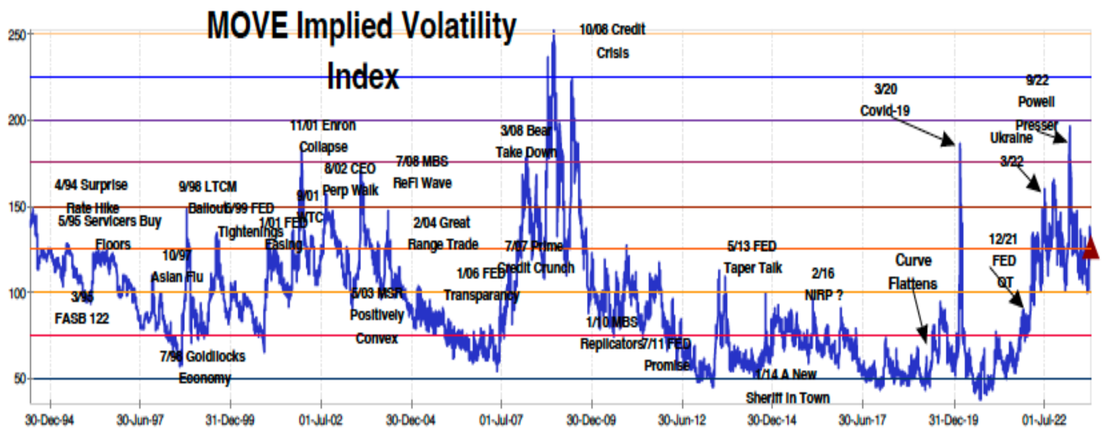


Since the Federal Reserve abandoned it policies of NIRP and QE and began a "data-driven" hiking cycle of interest rates in 2021, the MOVE has ranged from 100 to 140, well above its -blakitny line- eight-year post-GFC average of 65.9.

I would propose that **these jumps in the MOVE and the VIX are not short-term blips** that will quickly resolve; but rather **they may be permanent**, or at least until the end of the Trump Presidency in 2029.

Prior peaks of the -akijan line- MOVE (and VIX) included:

1) The 1994 LTCM hedge fund collapse;
2) The 2001 Enron incineration;
3) The 2008 Great Financial Crisis;
4) The 2020 COVID panic.



They all had a "mean reverting" nature where a return to normal was not only possible, but in fact it was even likely. These were exogenous, but not permanent, shocks to the financial system.

In contrast, or at least for the next four years, we cannot anticipate the final denouement of political shocks to the core functioning of Government.

I think both MAGA supporters and those suffering TDS can agree that with President Trump the uncertainty of his policies is a feature, not a bug.

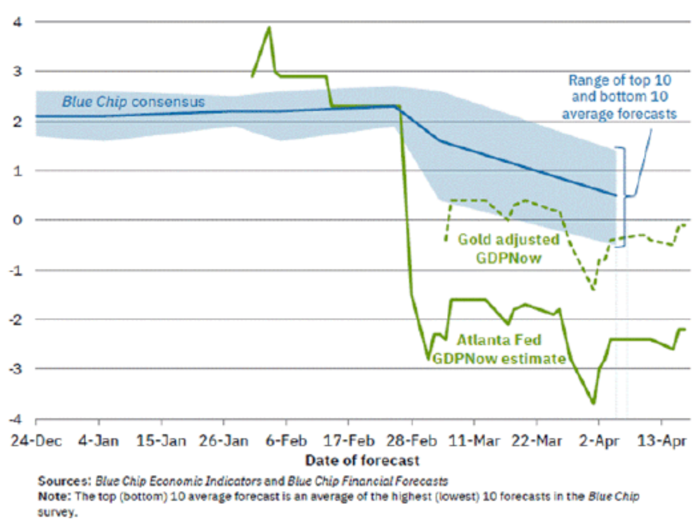
It is often the case that those engaging in *realpolitik* may want to appear somewhat "crazy" as a strategy to gain a tactical advantage in negotiations by leveraging the other party's emotional responses and potentially creating a sense of uncertainty or unpredictability.

And this is not some untested concept. It is known that President Richard Nixon instructed Henry Kissinger to tell his counterparts from North Vietnam at the Paris Peace Talks that the President was a "bit crazy".

In support of this notion of <u>longer-term uncertainty</u>, I would point to the recent price action in -zolata line- Gold which has a history (and reputation) as a stable "store of value" for the length of human history.

Gold has risen nearly $1,000/oz since Trump's election in November with a realized Volatility of over 35% since our new Tariff policies were announced.

So great has been the demand for physical Gold in the US that the Atlanta FED has pulled the -dotted vapna line- import of Gold Ingots from its real time GDP estimates (since imports are a negative constituent of the GDP calculation).



Source: Federal Reserve Bank of Atlanta

Screening out the "margin call funding" liquidations, the price of Gold was basically unchanged from July to November 1998 as the markets recognized this as a financial issue, not a potential change in the Global World Order.

I would also point to the recent sharp drop in the -irza line- US Dollar Index.

This Index tends to rise during times of stress and is well-correlated to the level of -carnica line- US interest rates as one prefers to own the USD when it offers a higher return. Thus, it is anomalous that the USD Index cratered as rates rose.

The popular press has trouble deciding if the President wants to turn back the clock to the post-war US domination of the 1950s of his childhood, or the Gilded Age 1890s, but I might suggest we are **reviving the policy uncertainty of the early 1980s Volcker era**.

Most of you are too young to recall that in those days there were no rate policy announcements, no 2:15pm press conferences, and definitely no DOTs.

The only way to know if the FED had altered its policies was to wait until 11:15am the next day to see if the FED executed "System Repo" trades to push or pull their overnight funding rate.

The End of Moral Hazard

While I try to avoid partisan politics in my Commentaries, those who read between the lines (and know that I split my time between the two largest Blue Bubbles) can likely make a guess as to my views.

That said, injecting uncertainty into the financial system is a public policy good.

I have long argued that Greenspan's stated policy of raising rates at a **"measured pace"** was ground zero for the Great Financial Crisis (GFC).

By signaling to investors that he was going to raise rates by 25bps every six weeks (the time between FED meetings), he effectively blessed the selling five-week expiry 26bps out-of-the-money put options in unlimited size.

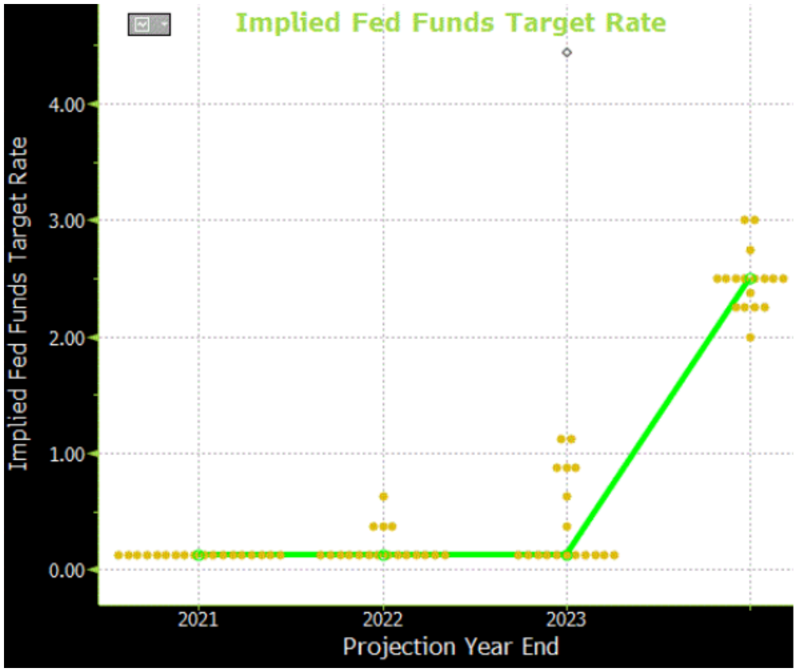
On a more macro scale, Greenspan implicitly blessed a massive increase in financial leverage - which is why Merrill Lynch CEO Stan O'Neal felt comfortable owning $45bn sub-prime CDOs on barely $40bn of firm Capital.

So too do the **FED's quarterly DOTs** (summary of economic projections) **encourage excess risk** via Moral Hazard.

On the next page, the -zouty dots- are the projections released after the March 2021 FED meeting and the -trava line- is the median single point number.

At the coincident press conference, Chairman Powell's comments indicated the FED expected their Funds rate to hug near zero (0.125%) until March 2023.

Is it any wonder that Silicon Valley Bank, Signature Bank and First Republic thought it was a fine idea to buy FN 2.0% MBS at Par and not hedge them ?



Source – The Bloomberg

While the top brass at these institutions cannot be frog-marched to jail (greed is not yet illegal), they are certainly guilty of gross mismanagement of their balance sheets – **which the FED implicitly encouraged**.

As such, let's give the President credit since a policy of "uncertainty" while bothersome to many investors is a public policy good as it will reduce the Moral Hazard that leads to excess leverage, unhedged balance sheets, and worst of all, a more Negatively Convex risk profile.

The Macro View and Concluding Comments

Presidents Trump's policies on Tariffs have been revealed, and his tax policies are in the works, but I am still waiting for him to flip the Immigration card over.

What I know for sure is that if the US Government tries to deport more than the estimated 75,000 illegal immigrants who have been convicted of a crime since 2017, we will have a hard landing, period.

GDP ≡ NUMBER OF WORKERS * HOURS WORKED * PRODUCTIVITY

No matter your politics, we should all agree that there is a strong link between the number of workers and GDP; **and fewer workers means lower GDP**.

Since this is presently an uncertainty, I have no opinion on the Stock market.

As per Interest Rates, I think "fair value" on the T10yr is 4.35%. That is the calculation of taking the FEDs 2028 Funds Rate projection of 2.88% and adding the 35-year average T10yr spread of 147bps.

Sans a hard landing that prompts a "power windows down" series of FED rate cuts, I think this is the Zip Code for long-term rates. I believe we are still "higher for longer", and thus the two-year rate is likely a bit ahead of itself.

For those who think I am violating my cardinal rule of "It is never different this time", let me push back.

It was the past decade of massive Government intervention into the financial markets via NIRP and QE that was the unexpected difference; <u>what is happening now is a return to normal risk management</u>.

An unhindered open market creates a feedback loop between those who need capital, those who have capital, and the Government that acts as referee. Government intervention disrupts the flow of information, and bad information leads to bad policies.

[*Can you tell I am a UChicago Monetarist ?]*

Circling back to the top, President Trump has placed the "Tariff gun" on the table; we cannot unsee it. And as Chekhov has suggested, it was put there for a reason…..**and now all eyes are on the gun**.

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

Harley S. Bassman
April 29, 2025

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.
Also, a fond farewell to Jordan Brink – one of the best on the "sell side".
Now I only have Hunter Davis at BNP to call and complain.