Convexity Maven

A Commentary by Harley Bassman

December 2, 2025

"2026 Stocking Stuffers"

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.

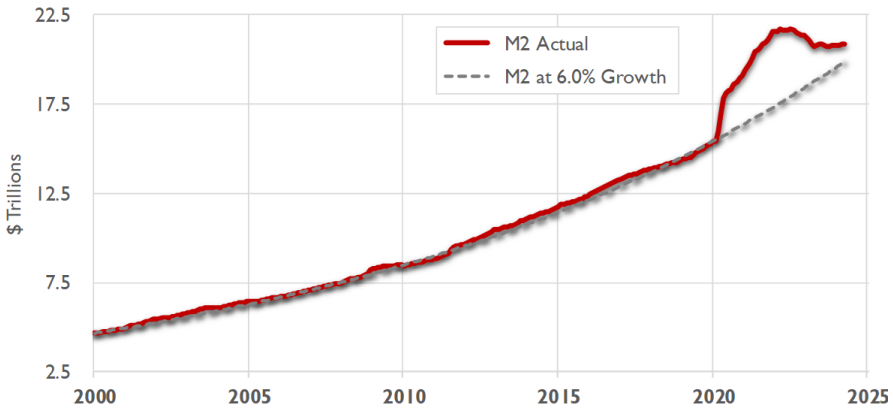
As many of you know, I am the Managing Partner at a firm I cannot mention, where I create and manage financial "strategies" whose tickers I cannot name.

Before I detail this year's Model Portfolio let's consider the macro-landscape; and repeat my mantra that **sizing is more important than entry level**.

The Macro View

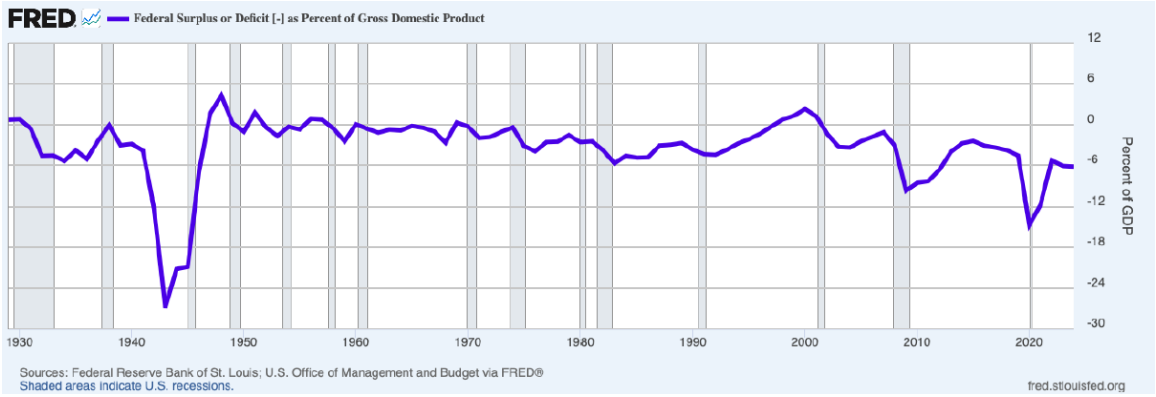
My interest rate view remains "higher for longer" as I push back on the notion that inflation is "Transitory". I am a UChicago trained monetarist who believes that excessive money printing eventually (and always) leads to inflation.

The FED re-opened the -rauour line- money spigot of ZIRP (zero interest rate policy) and Quantitative Easy (QE) when COVID spread, and soon after Fiscal spending picked up the slack when the FED tightened policy.

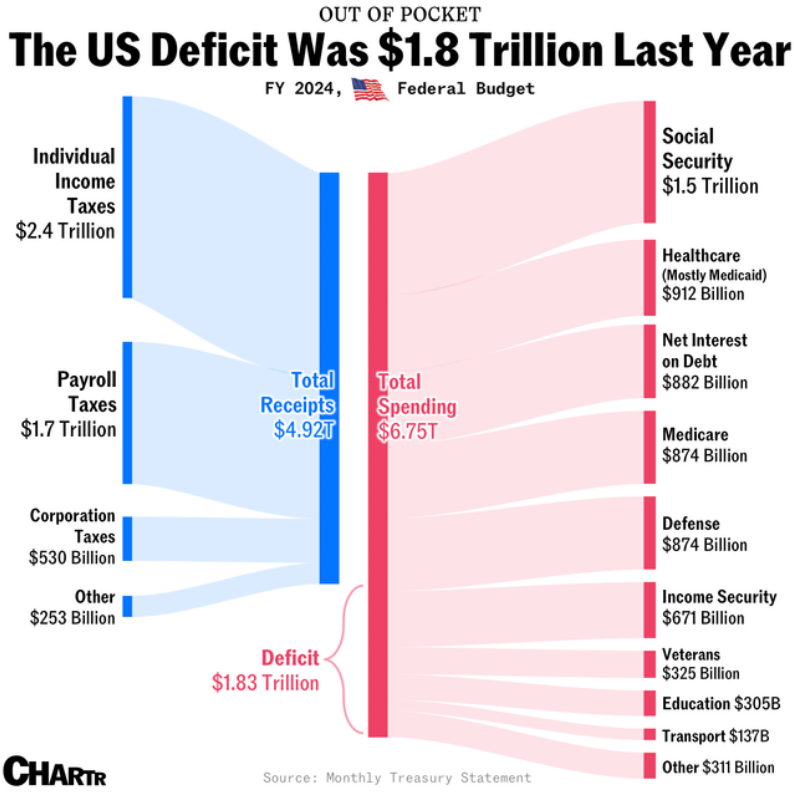


Remember those Modern Monetary Theory (MMT) alchemists spinning fool's Gold when they claimed the US Government had an unlimited wallet; so long as the Mandarins tightened the fiscal purse strings when inflation appeared. They were smoking their own supply if they thought elected officials could self-regulate.

Inflation touched 9% in 2022, after the Covid lockdowns loosened up, yet the US Government's fiscal deficit -fjolublar line- is still exceeding 6% of GDP, despite a respectable 3% economy and record high Stock Market. Such a gap has never occurred outside of a war or a recession.



Hindering a resolution is the "pig in the python" of an aging of the Baby Boomer generation as the -kirsuberja shading- mandatory fiscal spending for Social Security, Health Services and Interest inevitably overwhelms the -blar shade- total receipts.



These line items account for 62% of total spending, which I suppose could be manageable. The problem is that they absorb 85% of total Revenues at a time of peak economic (tax receipts) growth and a bubbly Stock market (Capital Gains collections). And revenues and expenses will diverge viciously in a recession.

Finally, and no trolling please, 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.

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 slower GDP**.

GDP ≡ NUMBER OF WORKERS * HOURS WORKED * PRODUCTIVITY

I do not know where the rubber meets the road on the nexus between immigration and the economy, but slower Labor growth will reduce GDP growth, and fewer workers will create upward pressure on wages, and then Inflation.

Passive Investing – Stocks will rally, until they don't

My good friend and partner, Michael Green (@Profplum99), is the Global expert on "Passive" investing. While not quite a "Ponzi Scheme", the Government-approved asset allocation strategy for retirement funds has the unintended consequence of pushing the Stock Market higher, until it doesn't.

In a nutshell, investing in "passive" is not passive, but rather an active investment decicion to buy an Index by allocating dollars to each individual stock in a weighted proportion to its size in the Index (market capitalization).

Unfortunately, the price sensitivity (liquidity and elasticity) of each stock is not proportional to its size in the Index.

Presently, a $10,000 "passive" allocation to the SPX Index would invest $3,000 in Nvidia, Apple, Microsoft, Amazon, and Google while only $5 would be used to purchase News, Mohawk, Solstice, LKQ and Mosaic.

The problem is that these top five stocks are not 600 times more liquid (elastic) than the bottom five. As such, this "passive" allocation has a much greater percentage price impact on the larger names than the smaller names.

Lather, Rinse, Repeat: This is why the top names become more concentrated; each dollar into the Index elevates the top names more than the bottom names.

Employed Millennials, on the good advice from their Boomer parents, likely allocate the maximum allowed into their 401k accounts. Aside from the benefit of long-term retirement planning, they also take advantage of an Employer matching program (free money), frequently with a quick vesting schedule.

Often these funds go into a corporate sponsored Fidelity or Vanguard account, which usually defaults to a selection of Index funds.

This process will continue as long as retirement dollars are allocated, **in a price insensitive manner**, to Index funds. Value is meaningless since the investing decision is done by process, not by old fashioned bottoms up analysis.

This only ends when retirement dollars stop flowing to Index funds. And that occurs when people lose their jobs and stop funding their retirement accounts.

I predict this can occur when the unemployment rate breaches 5%.

I urge you to click here for Michael Green's excellent summary of "Passive":
https://x.com/philrosenn/status/1986073846240121024?s=20

Buy newly-issued Mortgage-backed Securities (MBS)

As a reminder, Mortgage-backed Securities issued by Fannie Mae are for all intents and purposes guaranteed by the US Government. If you think otherwise, I urge you to buy a gun, cans of tuna, and small denomination Gold coins as those would be necessities if Fannie (or Freddie and Ginnie) defaulted.

To be clear, you will not become "rich" buying MBS, but rather everyone should have an allocation to "safe" money that can be retrieved on a day's notice.

As detailed below, newly-issued MBS have a high -purple line- distribution (dividend) and -blooi line- Yield to Maturity relative to other "strategies".

But the key insight is the -bleikur line- **much lower risk** (Volatility) exhibited over 2025, despite the uncertainty of Tariffs and FED Policies.

There are many ways to measure the balance between risk and return. Common among Hedge Funds is the -appelsinugult line- Sharpe ratio of -vinviour line- historic return divided by Volatility. But this fails to adjust for the differences in Duration -bleikja line- (price sensitivity to interest rates).

As such, the better prospective measure would be the -himinn line- ratio of its Yield to Maturity divided by its Duration.

11/28/25 Strategy	Newly-Issued MBS	MBS Index	Bond Aggregate	3-7yr UST	IG Bond	+20yr UST
Price	$50.49	$95.77	$100.82	$120.26	$111.86	$90.21
Monthly Coupon	$0.250	$0.336	$0.327	$0.366	$0.402	$0.325
Distibution Yield	5.94%	4.21%	3.89%	3.65%	4.31%	4.32%
Yield to Maturity	5.12%	4.62%	4.59%	3.56%	5.16%	4.70%
Duration	3.50	5.47	6.11	4.33	8.55	16.09
YTD Total Return (ann)	8.09%	9.09%	8.27%	7.87%	9.60%	7.82%
YTD Volatility	3.65%	5.42%	4.83%	3.80%	6.98%	12.47%
Sharpe (Return/Volatility)	*2.22*	*1.68*	*1.71*	*2.07*	*1.38*	*0.63*
Yield / Duration	1.46	0.84	0.75	0.82	0.60	0.29

The spread of MBS over the UST 10yr has tightened to about 105bps as Implied Volatility has declined and the Yield Curve has steepened; but this is still well above its long-term average of +75bp.

Also, above the 53bps spread of Investment Grade (IG) Corporate bonds.

Nobody brags about owing MBS at the holiday party, but you will rest easy as the hangover subsides the next morning.

Buy ultra long-dated bond options for Capital Efficiency

For reasons beyond the scope of this Commentary to detail, there is an active and liquid market for options on Interest Rates that expire from five-to-ten years; well beyond the one-to-six-month options traded on the exchange that quickly melt (decay). Such options are usually ONLY available to professionals.

However, there are two NYSE-listed "strategies" that offer such exposure:

The **Interest Rate Hedge**, which effectively owns a put option on the UST 30yr that expires in June 2032, with a strike level near 5.45%.

If you want disaster protection from an explosive rise in rates, there is no better product. While I am not predicting such, recall Liz Truss's "head of lettuce" panic in August 2022 when the UKT 30yr bond collapsed from a price of 142 (2.35%) to 86 (5.05%) in a mere five weeks. Yes, this can happen in the "developed world".

	UST 30yr Rate Shift								
	6.65%	6.15%	5.65%	5.15%	4.65%	4.15%	3.65%	3.15%	2.65%
	200	*150*	*100*	*50*	*0*	*-50*	*-100*	*-150*	*-200*
Interest Rate Hedge [instant]	$91.61	$79.89	$68.24	$57.10	$46.90	$37.97	$30.52	$24.59	$20.13
% Return	95.3%	70.3%	45.5%	21.8%	0.0%	-19.0%	-34.9%	-47.6%	-57.1%
Duration		*-29.3*	*-33.4*	*-37.4*	*-40.8*	*-43.1*	*-43.9*	*-42.2*	*-38.0*

But perhaps the more interesting trade is the **Bond Bull**, which effectively owns calls on the UST 10yr that expires in March 2032, with a strike level near 3.40%

	UST 10yr Rate Shift								
	6.00%	5.50%	5.00%	4.50%	4.00%	3.50%	3.00%	2.50%	2.00%
	200	*150*	*100*	*50*	*0*	*-50*	*-100*	*-150*	*-200*
Bond Bull [instant]	$22.56	$24.49	$27.74	$33.02	$41.19	$53.30	$70.43	$93.64	$123.88
% Return	-45.2%	-40.5%	-32.6%	-19.8%	0.0%	29.4%	71.0%	127.3%	200.8%
Duration		*21.2*	*30.7*	*40.7*	*49.2*	*54.9*	*57.3*	*57.1*	*55.1*
UST 30yr [instant shift]	$30.53	$32.76	$35.27	$38.06	$41.19	$44.71	$48.67	$53.14	$58.19
% Return	-25.9%	-20.5%	-14.4%	-7.6%	0.0%	8.6%	18.2%	29.0%	41.3%
Duration		*14.5*	*15.0*	*15.6*	*16.2*	*16.7*	*17.3*	*17.9*	*18.5*
Bond Bull vs UST 30yr	*-19.3%*	*-20.1%*	*-18.3%*	*-12.2%*	*0.0%*	*20.8%*	*52.8%*	*98.3%*	*159.5%*
Zero coupon [instant shift]	$23.12	$26.71	$30.83	$35.62	$41.19	$47.63	$55.10	$63.75	$73.83
% Return	-43.9%	-35.2%	-25.2%	-13.5%	0.0%	15.6%	33.8%	54.8%	79.2%
Duration		*28.9*	*28.9*	*29.1*	*29.2*	*29.2*	*29.2*	*29.4*	*29.4*
Bond Bull vs Zero coupon	*-1.4%*	*-5.4%*	*-7.5%*	*-6.3%*	*0.0%*	*13.8%*	*37.2%*	*72.6%*	*121.5%*

The Bond Bull is the **"151 proof" of duration assets** where a <u>15%-dollar allocation will match the duration of the Aggregate Bond Index</u>. This creates **Capital Efficiency** since the conserved 85% of your bond allocation can go to higher yielding assets that will not perform as well in a stress-induced rate rally.

The Bond Bull's Capital Efficiency uses are myriad but consider a few simple two-security combinations versus the vanilla Bond Aggregate Index.

The -graenblar set- pairs the Bond Bull with the popular Triple-AAA CLO product, while the -tyggjo set- pairs it with the large High Yield (junk) product. Both pairings offer a superior yield.

But the kicker is the **massive Positive Convexity** of the Bond Bull that offsets the negative convexity of the other investments (including the Aggregate Index itself). This will improve your investment profile if markets become violently dislocated and the FED slashes interest rates.

	Price	Investment	Yield	Duration
Aggregate Bond ETF	$100.82	$1,000	4.60%	6.1
AAA CLO ETF	$50.73	$875	5.48%	1.0
Bond Bull	$41.19	$125	2.00%	43.0
Synthetic Portfolio		$1,000	5.05%	6.3

		Investment	Yield	Duration
Aggregate Bond ETF	$100.82	$1,000	4.60%	6.1
High Yield (Junk) ETF	$80.99	$900	6.67%	2.9
Bond Bull	$41.19	$100	2.00%	43.0
Synthetic Portfolio		$1,000	6.20%	6.9

Both pay a dividend since long-dated options decay slowly.

While I am somewhat loath to predict the next short-term move in rates, both have **excellent entry timing** since the level of -spergilkal line- Implied Volatility for long-dated options has declined significantly this year.

High Quality Front-end Leveraged Funds (BDC, CEF & ETF)

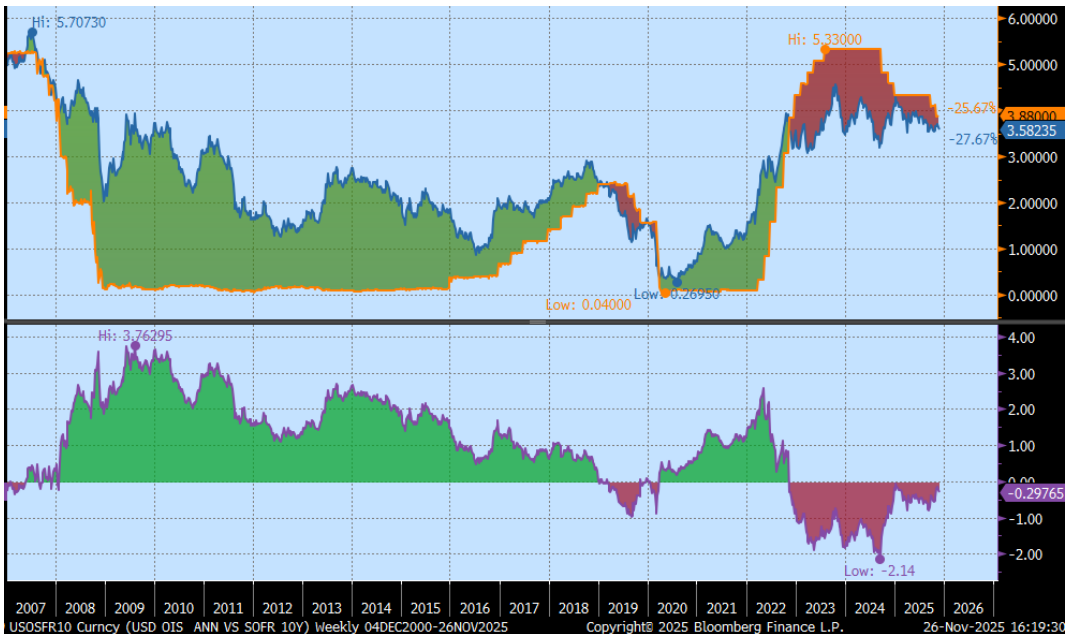
This will require a bit of selection homework since I want to minimize Credit Risk and profit from the FED cutting its overnight interest rate.

This can include top-of-the-capital-structure Business Development Companies (BDCs), Mortgage Real Estate Investment Trusts (mREITs), Closed-end Funds (CEFs) and certain Exchange Traded Funds (ETFs).

These asset managers use "leverage" where they borrow money inside the investment vehicle. For example, high-quality mREITs may take $100 from an investor, borrow $600 and then buy $700 of assets. This strategy works best when the Yield Curve "steepens" such that the short-term interest rate (cost to borrow) is significantly less than the longer-term rate (income earned).

Despite all the blather of a steeper Yield Curve, the reality is that the -apriko line- FED Funds rate is still above the -kobalf line- ten-year swap rate.

Notice the -gulbrun shaded area- that highlights this "inversion".



This inversion has created a head wind to levered investments as the cost of capital sometimes exceeds the interest earned. FED rate reductions will flip the profile, and these assets should see their **prices rise** as well as their **distributions increase**. Just make sure your credit risk is under control to isolate the trade to pure interest rate exposure.

Big Oil and Best in Class MLPs

I am not going to compete with the research specialists in this sector, I will simply say I do not think Fossil Fuels are going away anytime soon; no matter how many times Greta Thunberg is nominated for a Nobel Prize.

Current politics may discourage investing in dinosaur residue; but this is an investment Commentary, not a religious hymnal.

You might recall the opprobrium heaped on Big Tobacco in the late 1990s, but since Altria spun off Phillip Morris in 2008, its total return has exceeded that of the Tech heavy SPX.

Similarly, Big Oil is still under-owned despite beating the SPX over the past five years. The soft underbelly of these **AI Gigafarms** is the energy required to power them, and only Fossil (and Nuclear) can provide a reliable "base load". (Did you notice Microsoft is restarting Three Mile Island ?)
While no longer "cheap", Big Oil pays a safe dividend close to the UST 10yr.

If you have the stomach for those bothersome K-1's, the best-in-class energy-focused Master Limited Partnerships (MLPs) pay a **tax-advantaged** 7% to 8% distribution. I have over-owned MLPs since I penned my October 19, 2019, Commentary "Fail Better", earning an 11% annual total return.

Gold

The most popular Commentary I ever scribed was my April 16, 2016 release of "Rumpelstiltskin at the FED". Here I advocated for a redux the April 1933 Executive Order 6102 where the US Government jumped the official price of Gold from $20.67 to $35.

With the price of Gold then at $1,234/ounce, I urged the FED to set a $5,000 floor and buy as much as needed to support that level. My advice was not heeded by our ruling class; however, it seems the Russians and Chinese were listening as Gold may soon exceed its high print of $4,378 set this past October.

John Maynard Keynes called Gold a "barbarous relic"; and with all due respect, Warren Buffett is dead wrong that Gold is an "unproductive asset".

It is neither - **Gold is an Alternate Currency** !!

I have owned Gold since that publication, and I will not be selling any time soon. **Western civilization will only avoid bankruptcy by inflating its Fiat currency….and so it shall be done**.

Concluding Comments

We have too much debt, and the only way to reduce it is to either default or inflate, where inflation is a slow-motion default. There is also the post-WW2 path of GDP growing faster than debt, but that presently seems unlikely.

The Democrats are veering towards Socialism (Mayor Mamdani) and the Republicans are resurrecting Huey Long populism. As such, the only solution that threads this fiscal needle is "means-testing" for the larger mandatory benefit programs, which is effectively both a tax increase and a spending cut.

[It would be sweet irony if the means-tested level was $140,000 !]

While I will not predict a Stock market crash, I do think the best parallel for our current AI stampede is the late 1990s capital spending boom of laying fiber optic cable that came a cropper when revenues failed to cover these investments.

Herbert Stein noted that "If something cannot go on forever, it will stop"; and this is what will happen. As I have said: "Pigs can fly if shot out of a large enough canon, but they eventually they return to Earth as bacon".

My investments for 2026 circle around the notion that **"Fair Value" for the UST 10yr rate is 4.35%.** That is 147bps (the 35-year average) over a long-term Fed Funds rate of 2.88%. T2yrs will head to 3.35% and T30s to 4.85%.

And do not forget: **Sizing is more important the entry level.**

Harley S. Bassman
December 2, 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:

https://www.convexitymaven.com/classroom/

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.