Harley Bassman: The Long Slow Road to Inflation

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Erik: Joining me now is Harley Bassman, best known as the inventor of the MOVE Index, which is the essentially the VIX for the bond market and now known as Convexity Maven and publisher of convexitymaven.com.

Harley prepared a terrific slide deck to accompany today's interview. Listeners, I strongly encourage you to download it as we will be referring to those slides throughout the interview.

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Harley, I want to start with a call that you made way back in November of 2018, which you reiterated in May 2019. And you said, look, there is an economic recession coming at the beginning of 2020.

Now, obviously, you didn't know that the COVID-19 pandemic was coming.

Do you think that the recession is something that happened as a result of COVID-19? Or do you think that COVID-19 was just the catalyst that lit the fuse, so to speak, for something else that was already bound to happen? Because, of course, the president of the United States told us we had a perfect economy, right up until the virus hit.

Harley: Erik, thank you for inviting me back to your show, the best financial podcast on the market.

So I'll tell you, this kind of winds up with the two thoughts I always put up on the front of my website, which is, number one, it's always about character. Character matters and is paramount. And number two is it's never different this time.

And when we saw the yield curve start to begin to invert – on Slide 1, that's the Fed database showing the Fed funds versus the curve.

But more important, Slide 2, which was the funds rate was above the 5-year/5-year forward rate. The inversion was coming. And the yield curve has been the best predictor of a recession.

And what always happens – I'm not sure "always" is the right word, but what usually happens is they kind of come out of nowhere. You never see these things coming.

And people always say what is the next surprise going to be, which is kind of like jumbo shrimp. I mean, you can't see a surprise. It wouldn't be a surprise if that was the case.

So do I see this? Of course not. I think I wrote multiple times I have no idea how we're going to go into a recession.

But the curve is there. Somehow the market seems to anticipate this. And there we go.

So I suppose it was the – in general, this always seems to occur in some fashion where something finally pushes the market and the economy over.

Erik: Harley, we recently had Dr. Lacy Hunt on the show. And one of the things that he told us was that the population is declining. And that's one of the reasons that he thinks that, unless there was a major change to the Federal Reserve Act, we're probably looking at deflation for the foreseeable future.

I see on Slide 3 you're not really showing a declining labor force or population. What's going on here?

Harley: Well, Dr. Hunt is probably one of the best economists in the market. He's been dead right for my entire career from the bottom market to keep rallying. So I highly recommend reading him.

I think that what he's pointing to over here is the concept that GDP, at the end of the day, is labor force, number of people times hours worked times productivity. That's GDP in a nutshell.

Productivity really hasn't altered that much in the last decade, despite the introduction of better technology and hours worked. And we're kind of at the top of where we're going to be on that. So the real difference is going to be the labor force.

And many observers are right that Western democracies are having a declining population growth. What's happening in the US is the baby boomers are retiring right now.

But soon we will deplete them. We're about half-way through the boomer demographic. And the millennials are coming on in.

And what's happening is there is an inflection. And I've been writing about this for five to eight years now. There's an inflection coming 2023 to 2025, somewhere there, where the millennials are entering the workforce at a faster rate than the boomers are declining.

So if you look at this chart on Page 3, you can see that count is right. You do have a declining overall population growth rate. But the makeup of it is altering.

And so as these millennials come in, that's what's going to go and create demand for goods and services. And this kind of chart actually follows very closely – if you look at some of my past commentaries on my website you'll see I've noted that you should see this is labor force growth rate aligns very well with interest rates and inflation.

I also note that – which is a current topic – about immigrants. I think that immigration is going to be a gigantic impact. Immigration is probably the most worrisome aspect that I have, going forward, in the next five to ten years.

I thought it might be tax policy. I thought it might be buybacks. Maybe trade policy. But immigration is probably it because we've had very strong immigrant growth over the last forever.

And if we were to go choke that off as we try to come out of this recession, that could be very problematic because that will choke off your labor force growth rate. Which would not be pleasant.

Erik: Harley, our regular listeners know that one of the topics that I've been most concerned about in the last year or so is the possibility of the historical correlation between stocks and bonds changing in a way that might force the unwind of the entire risk-parity trade, which is probably the biggest trend in institutional finance.

You've got a chart on Page 4 from Gerard Minack at Minack Advisors. What is this chart telling us? How do we interpret what's on this page in terms of giving us some insight as to whether or not that concern of mine may be well founded or not?

Harley: You're exactly right. As a macro concept, you've got to tie together the entire notion of labor force growth rate with interest rates and inflation, which then bleeds into this chart over here.

And the whole thing comes together in the next 2-3-5 years. And we're concerned about this. This is the big macro concept that I believe in.

And so the correlation between stocks and bonds generally has been inverse: One goes up; the other goes down. So risk parity has been the brilliant strategy for the last decade because a 60/40 portfolio will balance itself out. Stocks go up; bonds go down. And vice versa.

If we were to get inflation above 2.5% in the chart here on Page 4, or let's say 10-year rates above 3.5 or 4%, because you have real growth plus inflation, gives you the 10-year rate. You're probably going to see this correlation flip back to what it was in prior times where stocks and bonds go up and down together.

This will be very problematic because so many people have blended portfolios. But what's really going to be the issue is the risk parity types who use leverage, because stocks are more volatile than bonds.

So people will often say $100 of capital, of assets, of money. And then you buy $130 of bonds and $70 of stocks. So you have $200 total of investments supported by $100 of equity capital. If they both go down together, well now you've got a problem and you have to liquefy.

And that's what you saw in March when both stocks and bonds came together for a small amount of time. That's when you have the most volatility. Because they were not acting as a hedge but they're acting together.

So I kind of foresee this happening. But it's not happening until 2023 to 2025. That's what's going to happen because the labor force growth rate is going to turn up and you're going to get the inflation.

As a reminder, the last time we had this kind of a huge labor force growth rate was in the late '70s early '80s, when (ha-ha) that's when the boomers were turning 30, 35.

At that age what do you do? You get married. You have kids. You buy a house. You buy a car, a washing machine, and everything else.

And all this demand is greater than the supply available from the previous generation. The World War II generation was smaller.

That correlates very well with interest rates and inflation. So that's the cycle that I'm looking for. It all fits together.

So you're right but you're early. It's not happening until at least two more years from now.

Erik: Okay, Harley. Great.

Let's translate that characterization that you've just made of my being right but early, that we're headed toward a secular shift toward inflation and a different correlation between bonds and stocks.

What does that mean in terms of right now with respect to portfolio positioning? Do you stay long-duration risk and continue to wait for a little bit more of the deflation trend to bring bond yields down even more before you start figuring out how to reposition?

Or is this something where it's hard to gauge the timing? And, you know, boy, it's been 40 good years or almost 40 good years of bond bull market.

Is it time maybe to not worry about catching those last few percent and start to reposition a portfolio now just in case I turn out not to be as early as we hope?

Harley: I kind of think you're leading me like a horse to water here to the idea of negative rates, because that's kind of what you would require to get a lot more upside in interest rate products.

I'll say up front the answer is no to that. We're not having negative rates in the US. I guess in theory it's possible, but no.

The way we're structured – and, frankly, the idea hasn't worked even where it's been tried. Were a financial economy to disintermediate the banks in such a way it would be disastrous.

Do I think you should be selling rates here? No. I mean, I wouldn't be buying 30-year bonds at a buck and a half, but I think that we're not going to have a huge rise in rates. What I would recommend instead is into other risks such as convexity or credit, high-grade credit.

And the reason why I like that – if you go to Page 5 – this over here, one of my favorite charts, is the relationship between the yield curve – and the yield curve is the measure between the 2-year rate, the 10-year rate, the 3-month rate, and the 5-year rate – whatever it might be – some metric of the slope of the curve, which indicates people's concern about the market and inflation.

And the other line is going to be implied volatility. And what you see happening here is when the curve flattens, volatility comes down.

And I think with the Fed holding rates low and steady for a while – I mean, the Dot Plot said they're holding the funds rate at basically zero for the next 30 months. That kind of means that volatility should come down.

And we've already seen it in the bond market where you've seen the 10-yrear rates move about 20 basis points for the last few months. That's going to go and reduce volatility. Not risk *per se*, but actually realized volatility, which is more important.

And I think that's going to make a number of investment instruments interesting. Mortgage REITs, I happen to favor those. Not REITs where you're actually buying the properties. I'm talking about the levered REITs where they buy secured mortgages, usually Fannie and Freddie. But it can be Alt-A or non-agency.

I like those a lot because I think it's going to be not that hard to hedge them. And they yield an awful lot in a 1% environment.

And I think that – if you look at Page 6, what I'm showing here is the rate on mortgage bonds. So if you go buy a Fannie or a Freddie mortgage bond, there is no credit risk whatsoever to those – they're good by the government – and you look at that versus the 10-year swap rate, you can see that we're kind of about average right now.

You see the big jump we had – we're on Page 6 – the big jump we had when the financial crisis hit, but how quickly it came back once the Fed said, okay, we'll buy these bonds. We're kind of average there.

But if you look at Page 7, you can see how there is room for the spread to come in even further relative to volatility. And that's why I like that asset class.

I think the Fed's goal is multiple – which I think we will get into the inflation part soon – but they want to reduce volatility. They want to reduce risk. They want to bring risk taking into the market, the idea of starting a new business or expanding a business you already have. That's the idea of holding rates low and holding them steady.

Two different concepts.

One of them is your cost of capital and the other is the risk that you're going to be wrong. And by reducing volatility, they reduce the risk of uncertainty in the future. And, in theory, that should make you willing to take more risk in starting or expanding a business.

So they're not wrong in the macro sense. But, I mean, zero is kind of a tough number to use.

Erik: Here's where I get nervous about any kind of spread trade in fixed-income markets, Harley, is you know we've got what I'll call policy risk. Which is you could have made a really good argument a few months ago for, boy, look at what's going to happen economically. You know, the high yield spread above Treasuries has got to blow out.

Well, that would make sense if you were reading the Federal Reserve Act the way it's written, which is to say it's illegal for the Fed to buy junk bonds.

But, the Fed came up with its own interpretation of the Federal Reserve Act, that it actually is okay for them to buy junk bonds as long as they play some little game with the Treasury of supposedly being an intermediary, which in my opinion was designed intentionally to undermine the intention of the Federal Reserve Act.

So if you've got the government changing their own rules willy-nilly without warning, how do you bet on spreads between different interest rate products when you never know what kind of policy or legal interpretation might be coming next?

Harley: I think it depends upon if you're looking at the price of the assets or if you look at the underlying fundamentals of it.

I think that buying junk bonds is ill-considered for so many reasons. One of them being that it disrupts the signaling process.

That’s so important in a capitalist system is to have the free markets where prices signal what might happen and get people to prepare for risk, to hedge properly, to be prepared for what might happen, and not be over their skis and thus really hurt if things go south.

Usually, when a bond goes below a certain price, it will qualify as – I won’t say “junk bond” but something to be concerned about.

If we see a stock with a very high dividend yield that’s much higher than its peers, that’s usually a signal that there is a problem with the company. The Fed’s kind of covering that now, which I think is a bad idea.

On the other hand, high-grade corporate bonds, high-grade mortgages, those are basically probably fundamentally economically sound.

And then you’re looking at the concept of where does the Fed set the rate? And if they’ve set the risk-free market rate at zero and it’s set to be here for 2.5 years more or less, you could be more comfortable switching to debt. So maybe I’d rather buy a 5-year corporate bond than a 30-year Treasury bond.

So I’m saying you should be altering your portfolio to take advantage of the fact that the Fed is going to hold rates down for a while. And they’re going to reduce volatility.

Because a corporate bond or a mortgage bond, the extra yield, you’re getting is effectively an option. The price of an option is driven by its implied volatility. And if that’s going to come down, that asset should do better.

So that’s the concept there.

Erik: Harley, let’s tie all of these concepts together and relate them to a subject that I’ve discussed with quite a few of our guests. And I know you’re a regular listener to the show so you’re aware of all this.

Are we headed for a secular shift? Not just to a little bit of inflation but to secular inflation?

And, if so, how long does that take to play out? What does it look like? What’s the transition look like? How do we get from here to there?

Harley: Well, I’m not a gold bug, but I like the concept because we’re going to get inflation. The question is when.

It’s almost a religious belief in the sense that if you believe that you could print fiat currency at will, or at least at a rate that’s faster than the growth of the economy without inflation, I think, no. That can’t happen.

The thing is the timing. It could take many, many years for it to bleed on through.

So we're going to have inflation. The question is when will it occur? What will drive it? Once again, back to the idea of the match lighting a fire. When it is going to happen? 2023-2027. Somewhere in there.

Going back to Dr. Hunt and talking about money printing – and he's a deflationist, at least temporarily. He's right in the concept the Fed is printing money. I know guys say they're not printing money, they're doing something else.

But money is fungible, it goes into the system. It moves around. You can't hide it.

The money has been printed. We've had inflation. It's just not CPI inflation. It's asset inflation. The gold, the stocks, the bonds, with art, with jewelry. We've had huge inflation.

Now of course this is a massive problem we've had as a society is that the inflation went to the 1% who own assets, as opposed to the others.

The idea was to create inflation, which would eventually extinguish debt. I mean, the way you get out of a debt problem is you default or inflate. And inflation is just a slow-motion default.

So the notion 10 years ago that Bernanke had of creating inflation to reduce debt was right. It didn't work because the inflation went to the wrong place. We need to create inflation for wages, for the middle class.

And so Dr. Hunt is right in the idea that creating money will not create the inflation *per se* because that money is not being spent. It's not going into the economy. It's just sitting in bank accounts. When the 1% get money, they save so much more of it that the rest of society does.

So the question is how do you get that money to go into spending?

And so that's where you're going to need to have either fiscal spending to get the money into the hands of ordinary people. And I think that's going to happen hand in glove with this demographic change of the millennials becoming spenders.

And so that's where it's going to come. I think MMT it's preposterous. That's all I can say. It's a preposterous idea.

The thing is, it doesn't happen right away. It could take quite a while for this to change. And being a reserve currency where we have almost two-thirds of all global trade going through the US dollar, there is no Plan B. So, in that sense, we could have a Wile E. Coyote moment for quite a while.

But it's going to come.

As for your investing question, you don't short bonds today, but I think you have time to prepare yourself for what is going to come.

And inflation initially will be good. And then it won't be.

So that's kind of where I am on this thing. It's coming.

What's the best way to hedge it? Less clear, but I think real assets of some kind is what you want to own in a portfolio. I think owning gold, 5-10% is not irrational.

And, remember, gold is not an asset. It's not like a stock or a bond. And Warren Buffett dissed it a decade ago as a barbarous relic. You could buy so many Exxons and all the US farmland with it. He's right about that.

But it's not an asset. It's an alternate currency. And currencies, cash in your hand, yields zero. And gold yields zero.

So that's what it is. It's a currency that can't be printed by other governments. So that's why you want to own it as a diversification.

Erik: Let's talk a little bit more about inflation and the bond market, because there is an old adage that inflation is a bond market's worst enemy. But I want to go a little bit deeper into that.

Is it really true that inflation causes bond markets to sell off? Or is it the expected monetary policy response that the central banks are going to fight inflation by raising policy rates which really causes bond markets to sell off?

And the reason I ask that is it seems to me that when we get inflation that might cause you or me to think, boy, this could turn into a problem, policy makers ought to be fighting this. I think they're going to continue encouraging it for a while after you and I think that's a bad move.

So when do we worry about the bond market really selling off? Is it when the inflation starts? Or not until the central bank policy reaction is to try to fight it with raising policy rates?

Harley: Well, away from speculators, I would say you're wrong on both counts.

Erik: Okay.

Harley: All apologies, please.

What is money all about? Money is about delayed spending. You work, you make X dollars, and you don't spend it all today. You delay it and you spend it at a different point of your life. So you use savings for that. That's why you have cash. We're not in a barter economy anymore.

I think what's going to drive bond prices is people looking at this delayed spending power and saying how many loaves of bread can I buy with it. Oh my God, what if I could buy fewer loaves of bread in X number of years? That's a bad idea.

So you either spend now – and that gets velocity back up again – or you get out of things that are fixed coupon, like a bond, and go somewhere else.

So I think the dynamic of the investing class as a whole, all people, moving money around to other things that will protect their savings, protect their spending power, protect their purchasing power, protecting the number of loaves of bread they can buy in the future, I think that's what kind of drives it.

And you'll probably see spending pulled forward. And, remember, GDP also equals money times velocity. If money has exploded with all the Western central banks, the velocity has collapsed in tandem.

So we've had very little change in GDP. Once we get that velocity of money picking up – linking back to what happens when the millennials come to the work force, start spending – that's when you get the inflation.

So I see that that's how it's going to occur.

And the Fed is pushing on a string in the sense that they're pushing money into the economy, into the fixed system. But it's not making people spend money. I think the spending is going to occur with the demographic as well as with the fear of inflation eroding their savings.

So that's kind of what you had in Weimar Germany, which we're not going to do. But people will try to spend the money as fast as they can get it.

And you saw it in Venezuela or Nigeria, the same kind of idea where people spent money as fast as they could get it because the value depreciates so quickly.

So that's kind of where it's going to happen. It kind of all comes together at a point. We're not there yet, but there is an inflection point coming. And that's what you want to be thinking about and watching for.

The Fed has been saying over and over again now, part of fiscal policy – what's interesting is both parties lined up to go and spend money directly to the population via various methods.

My preferred method would be infrastructure products because at least you get something out of the cash being spent. But, you know, direct funds to people, UBI or other tax rebates, either of those is basically the government borrowing money printed from the Fed.

Giving it to people whose propensity to save is very small. So I think we're definitely going to see rates start to rise, not because people are selling them *per se*, but they're not buying them while the government is continuing to borrow.

So it's clearly a question of how long can the Fed keep buying securities?

Looking at Japan, the answers not a long time. Of course, the difference is Japan has a very different demographic than we do. Theirs is declining in all aspects, whereas ours is not. So we are different than Japan in that respect.

Erik: Harley, what do we do in terms of portfolio allocation as this transition you're describing comes? You mentioned real assets and you mentioned gold.

What other real assets? Are we looking at real estate?

Things like Real Estate Investment Trusts were very popular decades ago. They've kind of been out of vogue for a few decades. Is that going to be the next big thing? Or where should people be thinking about starting to reposition their portfolios?

Harley: Mortgage rates where the entity is buying mortgages on assets, I kind of like that. Especially when their credit is solid.

Other kinds of property REITs I have no interest in. I have no idea what commercial real estate is going to be doing for the next decade. That's a blackhole I want to avoid.

Truth be told, I kind of like – I can't believe I'm saying this – I actually think I'm bullish on stocks right now. Stocks are actually a claim on a real asset, a company making a profit, doing business, making money.

And if you look at the current structure of the market – the Fed has said we're keeping rates at zero or 0.1 for the next 30 months, or at least as the Dot Plots say – they're probably going to keep the cash 10-year at below 1%. They kind of have to.

Is that yield curve control? Will they come out and say it explicitly? Or will they just go and buy the bonds to make it happen? Unclear, but it probably does that also.

If you look at the S&P, the trailing dividend yield of the S&P is about 2%. If you use the dividend futures market, which is a better idea – let's go to Slide 9 – this is on Bloomberg – and they trade futures on dividends, they trade on S&P, on the European SX5E, on the Japanese Nikkei.

It's not the most liquid instrument in the world, but they exist. You can see over here that the futures on the S&P indicate an annual dividend of about $50, going up to 2025.

And if you look at Slide 10, that's the contract and you can see that it was trading in the 60s and then it dropped down to 40 and now it's about 52. And these contracts were trading in the 60s at the beginning of the year.

If you look at that $51-52 dividend divided by a percent and a half, you get the DOW – is owning a claim on the top companies in the country.
I'm not talking small businesses that are definitely going to get hurt right now. I'm talking the largest companies in the country, owning a claim on their business. And you could earn a yield of 1.5% – 1.65% right now, with 51 bucks of dividends.

You could earn that and you have upside. Your stocks can go up. 30-year Treasuries go to par, right. 10-year Treasuries have yields of 0.6-0.65. It's going to par.

So you could actually own claim on a real asset. You get a higher yield, cash-flow yield, than owning Treasures. And you have upside.

As a matter of fact, it's better than that. It's actually a convex upside because stocks only go down to zero. But they can go up 1, 2, 3, 4 times.

I mean, look at from the '09 crash. We had spooz at 650, 660. Now it's 3,000.

So you can make a lot more than you can lose. I'm not saying it's going to happen, but there is the potential for it. So you can get the same yield as a Treasury and you have more upside.

It seems to me that over the course of time insurance companies and other kinds of long-term liability managers are going to have to equity. They give up nothing in the cash-flow coupon and they have more upside. And, you know, most insurance companies, their cost of business is a lot more than 1.5%.

So I kind of see this underlying support over time bleeding into the equity market, which seems incredible to me. But I'm actually – I'd rather be long than short, that's for sure. And there are some very interesting trades you could do to take advantage of that.

Erik: Let's do exactly that, Harley. And for our listeners' benefit, if you look here, we've been talking about the graphs on Page 9 and 10.

But 11, 12, and 13 provide some more charts showing the other dividend markets, not just the S&P but also the SX5E and so forth.

Let's move on to Page 14. You've got a specific trade idea here. Talk us through it.

Harley: I'm a macro investor. My concepts are 2-3-5 years in the future. I don't day trade. I really pick specific names. I like macro thoughts and what's going to happen in the big picture. And I size it appropriately to go and manage that risk.

What’s the wrong price right now? What’s the wrong price right now is interest rates are zero. It’s clearly the wrong price. And if the Fed was not buying everything and holding rates down there, they’d be higher.

If that’s the wrong price, then what happens is if you look in the forward space, out 2-3-5 years in the future, since all derivative instruments price off of forward pricing, where an asset will be cash-flow adjusted in the future, what’s happening right now, the S&P, the Nikkei, the SX5E, their forward, their future price is actually below the current price.

Which means if you do an option trade based upon these instruments, the market will look at the forward and not the spot price.

And so if you look at Slide 13, you can see how the forward SPX price is actually below its current price.

And then, going back to Slide 11, you see how this relationship has changed over time with Fed action and ECB action.

So looking at a listed trade – and this is when the S&P was at 3,000 so the SPY ETF was at 300 – the forward price – now I’m on Page 14 – the forward price was 285 roughly.

I could buy a call struck at 340, which is the old high, sell a put struck at 230, actually taking a small credit. Let’s call it flat, once you put in the bid offers.

So I own the upside above the all-time high and I own the stock market at 230 1-2 years forward. This trade expires in December 2022. I find it hard to believe that we’re going to get below 230.

I guess it’s possible. We did before, a little bit.

But if you think about that, if you put a P/E of 1,675 – so the inverse of that means that the earnings coming out of the S&P would yield 6% (1 divided by 16.75) – if I compare that to the 10-year, the 30-year, that’s like 500 basis points over a Treasury. So I’m getting a pretty good yield from the earnings.

And then my dividend is above what they’re ticking out. So it seems to me that that low is probably pretty good. Unless you are a super-bear, you think we’re going to into a massive recession/depression and earnings are going to absolutely collapse. Because earnings last year was 163 and dividends paid last year was 58.

And if you go put any kind of number on these things, I mean, you could – I could see 4,000 on the spooz in two years, which is utterly crazy. I can’t even believe I’m saying this.

But the Fed was going to hold rates at zero and 1% in the belly. I just don't see how money does not migrate there.

If you really think about it, this is a very sexy idea because an equity, a stock, is actually a call option on the company where the strike price is the value of the bonds.

Because if you're the company, you pay the bondholders first. What's left goes to the stockholder. So you have that kind of leveraged upside on equity versus a bond in which all you get back is your principle.

So if an equity of a stock is a call option on a company, a real asset, a real company, and you're buying a call option via the structure, you're buying a call on a call. It's a very levered way to express a thought. A lot of convexity, a lot of positive leverage in your pocket.

So this is an idea that I like a lot as a way to go take advantage of the Fed forcing the forward price down because of that zero percent interest rate.

So it's risky. Let's be clear. If we go below 230, you have a lot of downside.

But as a profile, I kind of like having this trade. And then supporting that with mid-grade, mid-expiry, fixed-income products, 5-year high-grade. Maybe some munis, some mortgage REITs. So you kind of balance it out that way. That's kind of my preferred portfolio.

And then you toss in some gold.

And, I mean, if you have yields on some of these high-grade corporate bonds at 3 and change, some of the mortgage REITs are at 8, 9, 10, munis they yield 2 and change, but if you're in a good tax bracket then you're talking 4-4.5 – that's not that bad for a portfolio structure.

Erik: I'm actually surprised, Harley, to hear you say 4,000 by the end of '22 is a crazy high number. I wouldn't have said that at all.

Now, I certainly don't think that economic fundamentals are going to get us to those levels. But I have confidence in central bankers to get us to those levels as long as nothing blows up first. So I think the upside is very clear.

But let's talk about the risk side of it. What if things do blow up and you do have to start thinking about below 2,300 on the S&P?

How do you run the risk management on this trade? At what point do you start to bail out and eat a loss before you ride this all the way down?

Harley: I'm making the assumption that if you're a hedge fund manager running a levered portfolio – I'm not saying this is the best trade in the world, because this is a beta trade. It's not an alpha trade.

It’s an alpha trade in the sense that it’s a better way to gain exposure to equities than just straight buying them outright. I’d rather have this than owning the straight-up futures with the ETF SPY. But if you’re not willing to own equity risk outright as a proportion of your portfolio, this is the wrong ticket for you.

But I suspect everyone is going to have some kind of spooz exposure in some fashion or form. So you basically substitute owning this ETF or some other portfolio and you put this instead in there.

And if you own equities outright, you already have some kind of stop loss or thought in mind that you’re running.

But usually you have no stop loss. You’ve a certain amount of your portfolio allocated to the secular market. That’s what it is.

So that’s kind of my thought on this. You buy enough of this so it’s impactful if you’re right and you can survive the drawdowns if you’re wrong.

But the Fed’s already kind of said “whatever it takes.” Are they going to buy equities? I sure hope not. But we’ve already seen Europe and Japan go down this path. So if push came to shove the Fed will do whatever it takes to go and do this.

I kind of think – I’m not saying it’s a Fed put *per se*, but it sure looks like there is something there.

And, once again, you’re not buying the whole economy. You’re buying the top 500 companies. And, frankly, if you look at the top 100 companies I think they’re going to do okay. Because they have a population that is going to buy their products.

And let’s add something else. Right now, the top five companies, six companies are 25% of the S&P 500. So, I mean, you’re kind of buying the best companies out there right now, or at least the most valuable.

So I view this trade not as pure speculation but as a better way to gain exposure to an asset class you would already own. And then, going back away from mom-and-pop investors.

I just don’t see how insurance companies or pensions, I don’t see how they have this cash flow coming in, how it keeps going into only bonds. The cost of – most pension funds, state pensions run 6.5 to 7.5 as their bogie.

Buying Treasuries at 1-1.5% they’re kind of locking in a loss at that stage of the game. So I kind of think you have to see a migration into those assets over time. And if you put a – I mean the dividend futures were trading at 65 last year. The actual dividends were 58 last year. Let's call it 60 is where it's going to be three years from now.

You put in a 60 div, you put in a 1.5% yield on that 60, that's 4,000 on the S&P.

Will dividends be cut dramatically from here? Well, perhaps. But I think the best companies, they're not going to be. What you might well see is money that was going to buybacks or other forms of spending might go to support their dividends. So there is plenty of room to go and support them, for the best companies out there.

Erik: Harley, I can't thank you enough for a terrific interview.

Now, you are one of the few guys that we have on the show who's not selling anything. So we have no product for you to promote. But please do tell our listeners, you have a completely free website convexitymaven.com. it's also possible to subscribe to a newsletter there that you put out from time to time.

What is that about? What can people expect and where can they sign up?

Harley: The website is convexitymaven.com. If you want to get added to it, you can send me an email to harley@bassman.net. Happy to respond to your comments. I always learn a lot from people who know more than I do.

And I write episodically. I think the key thing to note is that I'm a macro thinker, I'm a long term investor, I'm not a day trader.

And that sizing is more important than entry level. You're talking about top to the bottom. You've got to allocate your portfolio accordingly so that you can ride out the risk. Because surprises always happen. That's why they're called surprises.

Erik: Size matters. And you heard it first from Harley Bassman.

Patrick Ceresna and I will be back as MacroVoices continues, right here at macrovoices.com.