MACRO Voices

with hedge fund manager Erik Townsend

Harley Bassman: Hedging a High Interest Future

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Erik: Joining me now is Harley Bassman perhaps best known as the inventor of the MOVE index, which is basically the VIX for the bond market. Harley prepared a slide deck to accompany today's interview. Registered users will find the download link in your research roundup email, if you don't have a research roundup email, it means you're not yet registered at macrovoices.com. Just go to our homepage, macrovoices.com, click the red button that says "looking for the downloads". Harley, it's great to get you back on the program, sir, it's been way too long.

Harley: Thank you very much, great to be here.

Erik: I'm going to do this interview a little bit differently today. Because just to put my perspective on this one. For as long as I've known you, you've been a little bit different from most of our guests. You haven't had anything to sell because you basically retired from the finance industry several years ago after being very successful at an early age and are kind of enjoying life retired and continue writing about finance just because you enjoy it and find it rewarding. You've also been preoccupied for as long as I've known you with this obsession of what's going to happen someday if interest rates explode and nobody is protected.

And I know you and I have talked about this quite a bit over the years where you've expressed great frustration that the tools needed to hedge against what you think is the biggest risk and that anybody's ever, you know, seen coming in a lifetime. That may be coming in the next few years. The instruments are there, but they're only available to institutional investors. And the way I'm interpreting recent events is basically you kind of threw a tizzy fit and said, look, I'm not going to stand for this, I'm going to create a product to solve this problem. And you hooked up with our friend Mike Green. You guys both went to Simplify Asset Management in order to pull this all off. Is that right? Do I have the gist of it? And I guess we should probably dive into what is this problem that you're so worried about? That's possessed you to go off and create this new product.

Harley: You got this thing exactly right. There are options or other derivatives, other ways of getting either getting risk, or enhancing risk, reducing risk tends to be available on the listing form. And options on it are very short term one to three days, six months. There's an extraordinary risk profiles available in the longer dated option market or derivative market. And those are only available to professionals who have an ISDA contract. What we've tried to do

over here is to pierce the ISDA veil, and offer what I will call civilians, non-professionals access to these products. And these kinds of products can really offer incredible risk management. Especially options because a five, or ten, or seven year option will decay at a much slower pattern than a one to three month option will. And we've devised a way with the help of the team at simplify to offer these products and we have a new one out they got launched this week.

Erik: Okay, let's talk about what the risk is that we're hedging against what you're worried about is basically we've had a, I don't know, 35 to 38 year whatever it is, bond bull market. We're not quite positive that it's completely over, but it seems like it sure feels like it is and someday it's going to reverse and you're worried that a blowout in interest rates could basically destroy everybody who's not ready for it. That you'd have a whole bunch of people that have variable rate financing, that's gonna, you know, get adjustable rate financing that gets adjusted up and all of a sudden everybody's crushed. Is that the basic scenario that you think is coming? Or I should maybe I should ask, Is it something that you think is coming? Or is it just a risk you think people should be protected against?

Harley: I think we can go to the bar and kick around whether rates are going up or down in the path they're going to be in the next year, two, or three and have a fine discussion. But that actually is not what really worries me. The greater risk is not that rates go up or not. Although they can, and the single purpose of rates go up so bond prices go down or discount rates change. If we get interest rates above a certain level, the correlation of stocks to bonds will flip and that's been the biggest deal in the last 20 years. Is that you've seen stock and bond prices go in opposite directions. So stocks up, bonds down, and vice versa. So they kind of hedge each other. This not only has underpinned the 60/40 portfolio, right 60% stocks, 40% bonds, but it's actually grown this business called risk parrying. Bridgewater was the biggest user of this. Congratulations! It was a genius idea. And what they would do is, they wouldn't take 100 bucks and do 60/40. They take 100 bucks. Do 130 of bond and 70 of stock or some other ratio depending upon the correlation, and offered a levered return to people using this inverse correlation of stocks to bonds. And it turns out this correlation seems to be very much related to interest rates or inflation, or both.

So, if you look at page three of the handout. Here's one version of the stock to bond correlation offered by our friend, Gerard Minack, he's been on your show. If you go to the next page, there's another story about the stock to bond correlation from a different vendor. And what the result is, is that if rates go somewhere above three and a half, four and a half, somewhere in there, you will see this stock to bond correlation flip. And you'll see stocks and bonds go up and down in unison. They'll no longer be any hedged value to your bond portfolio. And if you're a levered investor, we're used, where you have too much dollars of assets supported by $100 of money. Well, now this can get really scary.

If you go look at the last two times we've seen real market drawdowns last March, a year ago in March. And then before that 2018, you saw stocks and bonds go down together. And when that happens, things went really haywire. Because all of a sudden, all these various funds that were levered, would have to de-lever themselves. And of course, if people are not hedged properly,

that can get rather bothersome. And so what I see over here is, do I think rates are gonna go up? Yes. Why do I think that? We could talk about that in a few minutes. But the big idea is this, if we get rates above a certain level, let's call it four and a quarter percent, you're going to see this correlation, reverse. And if that happens, it's going to be a financial tsunami. I can't tell you how concerned people should be about this, because everything will go down. And many of your past guests have spoken out about margin, and leverage, and short of the all these various things about how we're levered up. The debt we have in the country overall, public and private. All this leverage is kind of based upon this correlation in the last 20 years. And if that reverses. That's the problem. And so I want to find a way to go and protect myself against that.

Erik: Okay, so we've got kind of a double whammy here. Because first of all, if interest rates back up, that causes a bunch of problems by itself. Money is getting more expensive. But on top of that, if it leads to this reversal in correlation, now I got the value of my bond portfolios going down, because interest rates are rising. And all of a sudden stocks are going down at the same time, because the correlation has flipped. And that's where I've really got and if that's not just happening to me, but happening to everyone else around me, all the other market participants are having that same experience. That's the financial tsunami, that you're talking about. How big of a tsunami, we're talking about bigger than the 2008 financial crisis? How big of a tsunami is it? And how much of a difference do you think you can really make by hedging against it?

Harley: I have not put pencil to paper on how big this could be. How much stocks can go down by. I just know that when you reverse that, people are going to lose the ability to go and ride their portfolios because all of a sudden, you're not going to have offsetting games to dampen the overall present value of what you own, they'll both be going down. And people are not gonna be used to that. People are pretty much used to there being you know, you see a bad headline, but they'll make money on one side of the portfolio and not make it on the other. So I haven't sized this yet. But the evidence says when we seen this correlation, reverse, so stocks and bonds move in unison. Those have been the biggest moves we've seen in the last number of years.

And I would say in particular, that the high value or high number of FAANG stocks would be especially susceptible. Because if you think about it, they're even proposed that your big tech stocks, the big growth stocks, they're gonna make a lot of money someday, someday being 10, 20, 30 years from now. Okay, that's fine. I mean, we've seen Amazon go from doing nothing to being gigantic. So that kind of worked. If you had these companies with very distant cash flows, and you're discounting those cash flows back 30 years at 1%. Well, that's worth a lot of money. If you discount it back at 4%. it's worth a lot less. And so if you have a situation where equities were going down, and the high value, long duration stocks went down, that would be a real problem to people which worries me. I mean, I kind of view these FAANg stocks as being like 70-year duration bonds. And they performed very well with that consideration, but if rates really go up, I suspect they will have a significant headwind.

Erik: Now you said in passing, you know, you wanted to protect yourself from this. You already knew how to protect yourself from this. You've got the institutional background to know how to put this trade on, and you have a personal ISDA account. So obviously, this has become something of a mission for you. You don't just want to protect yourself, you want to make this tool available to everybody so they can protect themselves to. What's driving that? I mean, was it just got bored with retirement? Or is this just a passion of yours that you want people to be able to protect themselves. So you see this as a really big risk? What's driving you to have kind of come out of retirement in order to do this project?

Harley: I will not be drawn into any kind of discussion of politics, that's a loser no matter what I say. But I do have a public policy vent where I do think that we should offer ways to help people optimize, or at least protect themselves against various outcomes that they're not prepared for. And this is a way to go and do that for lots of people. And these products are available in the market. And what's this actually, in some sense, is a market benefit, because these options are so very inexpensive, because there's no buyers of them. But there are sellers, why they're sellers is a different story. But there are sellers out there and made options extraordinarily cheap. And we might want to go through that and a little bit.

Erik: Harley, let's talk about what this product, this ETF that you and Mike Green are developing. Is it for people like me? Is it for investors? And how would I use it? Do I basically buy a proportion of, you know, a certain percentage of my net worth in order to hedge myself against future higher rates, how does it pay off, and who is this for?

Harley: I'll try to be careful over here seeing as our regulations say what I can and can't say. We have a new ETF that's come out there. It was launched this week. You could find it on the simplify website. And what it is, it's launched at $50 a share, it's $25 of a seven year option on the 20 year interest rate, it's kind of like buying a seven year option on a 20 year Treasury struck at four and a quarter percent. As current dollars of a seven year Treasury security, which is not gonna move all that much. And the idea is, is you buy this thing, it has roughly, let's say $1,000 of option per share. So if you bought 1000 shares, that would be equal to owning options on a million dollars of bonds. And it would perform as such.

And if you go look at my latest commentary, on page four, you'll see a model profile of this ETF relative to a futures contract. And it's rather, it's rather fancy in terms of what it does. The downside is about the same and the upside is, you know, triple what it can do. It's a very transparent, we're not hedging it, we're not managing it, you're just basically buying almost straight through processing to owning a seven year option. And what's fancy about this is the implied volatility for a seven year option is almost 10% below that, for a five year option, so the volatility actually goes up. So the decay of this is relatively small over time. So the idea is to buy this trade, put it in your book, hold it for, you know, a number of years, 2, 3, 4 years is the idea and as a giant insurance policy against a financial portfolio.

But you can also, if you are a contractor, a developer and you're building a mid size multifamily, and you get your construction loan, and you can't get permanent financing for three years until

the project's complete. The value of that project is very dependent upon where you get your permanent financing. And if rates went up by, you know, two points that might wipe out the entire profit of this thing. If you are a homeowner, and you have an adjustable rate mortgage, and it's going to go into reset in three years. You could buy this and and hedge your portfolio out. It solves all the problems of this business. There's nothing else out there that has this consistency, transparency, stability, and directness. The only thing close would be futures contracts. And that requires a lot of accounting, separate accounts to do it. And you have to roll the contract every quarter. It's very, very problematic. So this really solves so many problems for people.

Erik: So essentially, what you've done is you've done the analysis to look at where you think the macro risks are and you're saying that the instrument if people had access to institutional finance instruments that they ought to buy for their own portfolios. If they had access to that market is basically a put on treasuries at approximately a four and a quarter percent interest rate where it's paying off if, at the end of seven years. If interest rates have moved above four and a quarter percent, there's a big payoff there. It's a protective insurance policy, what you've done is just dialed in the parameters and turned it into an ETF so that anybody on Robin Hood can buy it in the Robin Hood account, if they want to. I would imagine the Robin Hood crowd probably doesn't understand what it is. But anybody who understands what it is can just buy it as an ETF. And they've got that protection, you've taken care of dialing in the right parameters to get the right instrument.

Harley: It is point and click right into a regular account. And yeah, it is piercing the ISDA veil and allowing civilian access to professional products.

Erik: Harley, let's talk then about why individuals would need to pierce that veil in the first place. Specifically, what could go wrong in terms of systemic risks in the market? if interest rates start to run away in the next few years and what do we need to be concerned with? What do we need to watch for in terms of why that might be coming?

Harley: I mean, the case for why rates may go up in the next two or three years has been explained over and over again, on this show. So there's no reason to repeat that. But I will say is this, the people who push back and say the Fed doesn't want that, I disagree. If the Fed actually does want a steeper curve, and they do want higher long term rates, not the front end, but I do not think you're gonna have yield curve control on 1950s, where they hold the back end of the curve down. And there's so many good public policy reasons for this. It is steepen the curve, you help the banking system. Now the bank, I'm not going to call the major banks, the good guys here but the financial system will improve in a steeper curve. You will increase profits, you will expand their capital cushion, that is a public policy good. And so that is supportive. And we are a financial economy, where it levered financial economy and making sure the plumbing works is very important. It'll improve the pension systems that we have, right? Pension and insurance, our long liability people, they owe their money out way in the future. Higher rates, higher long term rates will reduce the funding gap in pensions and insurance companies. So that's good. To the extent that we have a huge cohort of people who are retiring

soon, by taking rates down as they have for the last decade. You kind of robbed Peter to pay Paul. People who are savers have had their savings, their income get reduced and that benefits gone to borrowers.

A steeper curve, higher rates in the back end, would be helpful to people who are retiring, because they'd earn more interest, and that in turn would perhaps reduce the government cost of public assistance, people who are retiring. Finally, most important for, I think the people on this show, we're probably all in pretty good shape is a steeper curve, we'll pass along information about the market. The yield curve has been historically the best predictor of the economy. You might recall that I predicted a recession for the first quarter of 2020 at the end of 2018, when the curve inverted, first inverted, and lo behold, 18 months later, it happened. Now, did it count that a virus occurred? Maybe not, but it did happen. And this has been the best prediction is the yield curve. And so therefore, allowing the curve to move via market conditions will cue people into risks coming or not. It'll improve, it'll make them more cautious, and they'll hedge, they won't be as exposed. And so that's a public policy good also.

Erik: Tell me about the pricing of this. Presumably, if you're using institutional traded products, there's some efficient price discovery. So I would imagine there's reasonably efficient pricing for this protection that this ETF offers.

Harley: Well, I guess there might be if the Fed didn't have their big finger on the scale. In the same manner that the yield curve has been the best predictor correlation to the economy. So has the yield curve been very well correlated with implied volatility, the cost of risk, the cost of insurance, the cost of options is driven by implied volatility. And if you look at page seven, one of my favorite charts, you can see that the yield curve has steepened a lot. That's the orange line, but implied volatility, the purple line has not gone up. I think this is because the Fed has basically one been you know, supporting the market, but they're supporting it with both words and deeds.

But I don't think this is actually long term viable. I think implied vols have to rise as people become more and more concerned. And what's really strange is this. Going to page eight, this is the term surface, the implied volatility level for a three month option, a one year, five year, ten year option. Look at that green line, at the slope of the green line, and how it goes up. Because as you go more in the future, it's further away, you can't see as well and you have more uncertainty. And therefore, the price of insurance, the price of uncertainty should also rise and it did.

But look at the most recent snapshot, see how this balls flattened out, You'll see long dated options, ten year options come down. This is totally anomalous considering that we've gone through massive increase in the Fed balance sheet with this double barreled fiscal program soon to be maybe one or two more of them. It is greatly uncertain what's going to happen. We've never seen us grow the balance sheet and spend this much money, grow this much debt before, Will be higher or lower rates. We can argue about that but the uncertainty has gotten

greater right now and therefore it's totally anomalous that vols come down for long dated options.

Next page, this is options on the European SX5E , the Dow 50. See how much that vol come down. In Japan, currency options, same thing, they've come down very hard. And then finally, page 11. This is where the real value proposition is. This is the implied volatility of interest rates, implied volatility of the 20 year interest rate going from one month option out to a 10 year option. And notice how it's actually inverted. It's a longer story about why this is the case, market conditions and this and that. All you have to know is it's pointing south. As far as I'm concerned, it should be going north. And when you get this inverted volatility term surface, it becomes very inexpensive to buy this insurance against a great uncertainty. So it's really not a matter of predicting that rates are going to go higher, that things are going to go get crazy. It's a matter of the insurance is so cheap, relative to a very costly risk outcome, you should buy it.

Erik: So how do you envision this product being used? Is it primarily individual investors putting it in their portfolios? Or is it institutional portfolio managers saying okay, I need you know x number of shares of Harley's ETF in order to hedge this particular risk in some other fund that they're managing, for example.

Harley: The two largest buyers I expect are going to be family office or high net worth individuals who have significant exposure to higher rates. When people don't have large bank accounts or large investment accounts. I suppose they can get hurt by higher rates. But that's very indirectly, it's when people have assets, insurance and pension companies are not going to buy this because they actually want higher rates, right? Because they discount their liabilities and collapses that asset liability gap for them. Hedge Funds tend not to be buyers, because they're very short-term oriented. They don't have a macro thought when they're looking out to the future. Some of them do but most are very short term dips to blips. So you're going after people who have assets, who have risk, and have the capability to go and appreciate the risks of doing this. Now, that's probably the target audience here. And the sizing is fairly simple. 1000 shares is roughly an option on a million dollars of options. So it kind of in your head it kind of works pretty easily.

Erik: So is the prescription then that you base it on your net worth? If your net worth is $5 million, then you need 5000 shares? Or how does that work?

Harley: Well, I'd love that. But no, I think you would base it on, you'd look at the asset portfolio, you have an and how many of those assets would be at risk if rates went up by two or 300 basis points. I think most people who have reasonable assets kind of have an idea of what's going to move and what's not going to move relatively. So if you own, if you have a lot of commercial real estate things that trad Class A buildings which is a different animal entirely, but people who have any kind of rental property, they could be seriously harmed with higher rates, if they ever want to sell. If they're going to hold it to maturity forever for the family. Forget it. But if you might want to sell this asset someday, the cap rate is going to change. And these are very long duration assets. And they will go down in price pretty hard. If rates go up a lot. And you have to

go and try and sell them. I mean ultimately, this strategy is not for someone who certain rates are going to go up. Those people have already sold the market. These are people if insurance against an outcome that is not, you know, a certainty, but is a very expensive outcome. I mean, you, you don't buy home insurance because you think your house is gonna burn down. You buy it because you if it did, you'd be very sad.

Erik: Okay, Harley. So this is not designed to speculate on the direction of interest rates. We use futures for that. This is a hedge designed to protect my portfolio against an unexpected move if it happens.

Harley: The word speculative or speculate has weird connotations to it, most of them negative. If you want to use the word speculate, the term of a two year horizon, this is fine. This s a longer term, macro exposure to higher interest rates. So if you want to go and bet that rates are going to be higher, a year, or two or three from now. This is almost the only way you can do it. If you want to go and trade Friday's payroll number, don't call me on this, go and trade futures. So it's more of a horizon concept than it is something else.

Erik: Harley we haven't talked about inflation. yet. That seems like a big part of this equation, because an expectation of inflation is certainly a reason to expect increasing interest rates.

Harley: You know, this whole idea of inflation and interest rates kind of gets, you know conflated with each other. They're kind of two different things, it is possible to have inflation and not have higher rates, the Fed can control interest rates by buying them. It's what they've been doing. Right now we have a negative interest, negative real interest rate here, as well as in Europe and Japan. So they'll go hand in hand. But and in this particular product that we're talking about, it pays off as interest rates go up, not as inflation goes up. So there is the scenario where if the Fed really, you know, bought every bond available, that you could have inflation go up and rates not move. So that is something to be careful about.

I do want to make one more comment here. That I'm greatly disturbed by this idea of people saying, there has not been inflation. We've had people who, you know, 10 years ago talking about, if the Fed prints as much money, we're going to get inflation, and I'm a huge Chicago graduate man, I believe in monetary theory, MV = PQ equals GDP. And we have taken M's way up here. And the idea that we have not have inflation is totally completely false. I can't be more clear about that. It is totally bogus. We've had inflation just not in CPI, fed inflation and housing. And you can see that on page one. Look at this over here, you've seen housing prices explode higher. They're well over where they were at the peak in 06'. Yet, the owners equivalent rent that they use for CPI that hasn't gone anywhere. We've had inflation in stocks, in bonds, in gold, in art, in jewelry, everything. I mean, there's been massive inflation.

Now unfortunately, as a public policy concept, inflation has gone towards assets that 1% owns. So that really hasn't worked. The feds idea was to create inflation, for middle class wages. And that has so far has not occurred. But to say we haven't had inflation is false, it just wasn't in CPI. What I think's going to happen is the Fed working with the fiscal policy, this time it's going to go

and work. When they increase assets before it stayed in the pension system, and inflated stocks and bonds and other assets like that. The money did not go to the people who spend, it went to people who have money, who is prepared to spend the extra dollar for the thin. These fiscal policies are going to go to people who have to spend money and will spend it. A Fed study from a few years ago showed that 40% of the population could not conjure up $400 for an emergency. That's that is a test terrible, that is really terrible. But nonetheless, is the fact that if these people go and get money from the fiscal policy government, it will get spent. And I think that's what's gonna go and finally drive inflation, CPI inflation higher, and interest rates higher. So that's my core thought on this. And there are others who disagree, but you know, that's why we have bars to go drink at.

Erik: Harley, tell me a little bit more about how you and our friend Mike Green got together because frankly, last I knew you mean you've been retired officially from finance, enjoying your retirement and talking as long as I've known you about how badly this product is needed. Is this just something you had to do? I mean, is this about making a buck for you? Or is this about really wanting to see this product come to realization?

Harley: Oh, the latter. I want this product to exist, I'm making money but I mean, I would like this to exist because as a public policy good, it is helpful to people. I also like the idea. If you really look at what an ETF is, the original idea is you're taking some kind of open-end fund, which you can only trade at four o'clock every day, and putting it on an exchange so you could trade it whenever you want all day long. That's the first generation. The next generation was people like buying puts or selling calls on these embedded ETFs as a very static strategy. there was a little help, kind of bent the edges of the profile of ETF.

Simplify why I joined them and I can show you why Mike Green joined also with me, and we are personal friends by the way, for quite a while. Is that you're taking this next level of actually really moving dynamically, the profile of an asset by looking at the options and managing the options that you have in them, or by offering these long dated options via piercing the ISDA veil. This is entirely new. This is a brand new area that suits both of us very well because we both really appreciate the dynamic of unbalanced leverage, right? When you buy an option, you have limited loss, unlimited gain, and we're both pretty good at locating where value is, and then sizing it appropriately.

So um, I think the Simplify Asset Management, this could be a real deal, man. And I mean, was I retired? I wasn't earning a W-2, I'll give you that. Retired, not quite, I was publishing. But I did, you know, I'll say get back to a real job. Because it's just so interesting. This is a startup operation. I'm employee number 10. Mike's employee number 12. It's really exciting to go get involved in this and really create new products that are actually interesting and viable. And by the way, our fee structure, if you go look at that is very low compared to other products out there. That even tried to replicate what we're doing.

Erik: Well, Harley, my hat is off to you and Mike. So the gist of it is basically, it's a 1000 shares per million of principle that you want to protect against the risk of higher future interest rates. And it's a seven year embedded option that's behind that ETF. Harley, I can't thank you enough for a terrific interview for our listeners who want to find out more about the ETF or more about what you and Mike are doing, where can they contact you.

Harley: Well, you can find us at simplify.us. That's our company website, you can find my commentaries, still published independently, at a convexitymaven.com. If you want to get on my list, just send me an email, I am glad to do it. And I'll tell you that, you should keep your eyes open because you know, Mike and I and the team there, we have some very clever ideas about how to offer some products that will have much better path dependency outcomes as well as offering some new ISDA type products for, you know, foreign currencies or other things where we get access to long dated options, long dated investment profiles. So these are all coming up very soon. Keep your eyes open, and I think you'll be very pleased.

Erik: Well, Harley, we look forward to getting you back on the show in a few months for another update. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.