

The FED's Master Plan

The FED recognized that there are only two ways out of a debt crisis –either default or inflate with the caveat that inflation is simply a slow-motion default.

$$\text{GDP} = \text{Money} * \text{Velocity} = \text{Price} * \text{Quantity}$$

$$\text{GDP} = \text{Workers} * \text{Hours} * \text{Productivity}$$



Boomers taking their inflated assets to retirement



Source: Federal Reserve Bank of St. Louis

The Three Risk Vectors

When making an investment decision in the bond market, there are only three risk vectors to consider:

- 1) Duration – When one receives their money back;
 - 2) Credit – If one receives their money back;
 - 3) Convexity – How one receives their money back.
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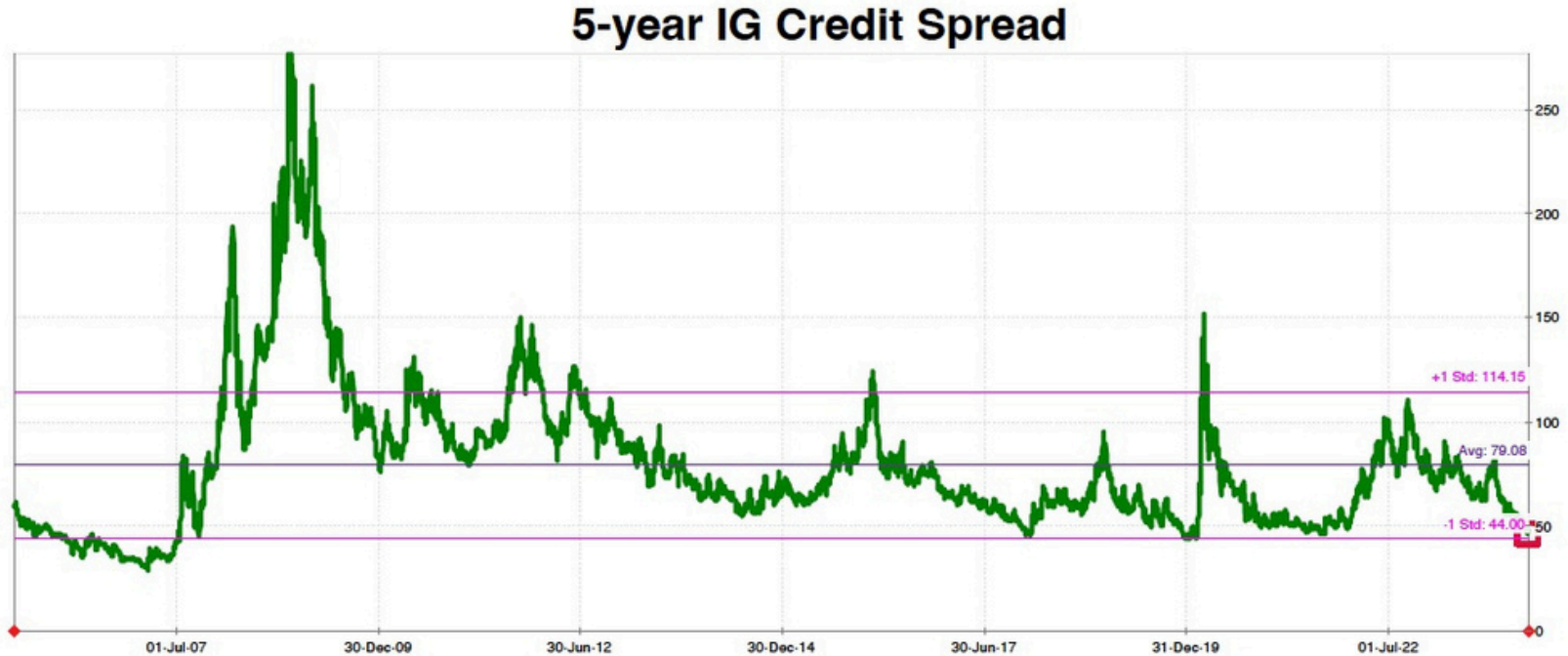


When a bond matures is often used as a proxy for **Duration risk**, but more precisely it measures the bond's price sensitivity to interest rate changes.

Credit risk is rather straight forward; it measures the chance of a default and the loss of one's investment.

Convexity risk is a bit tricky since it is mostly found embedded in callable bonds and can be challenging to measure; but the bottom line is that such bonds (mostly Mortgage and Municipal) presently offer the best relative value.

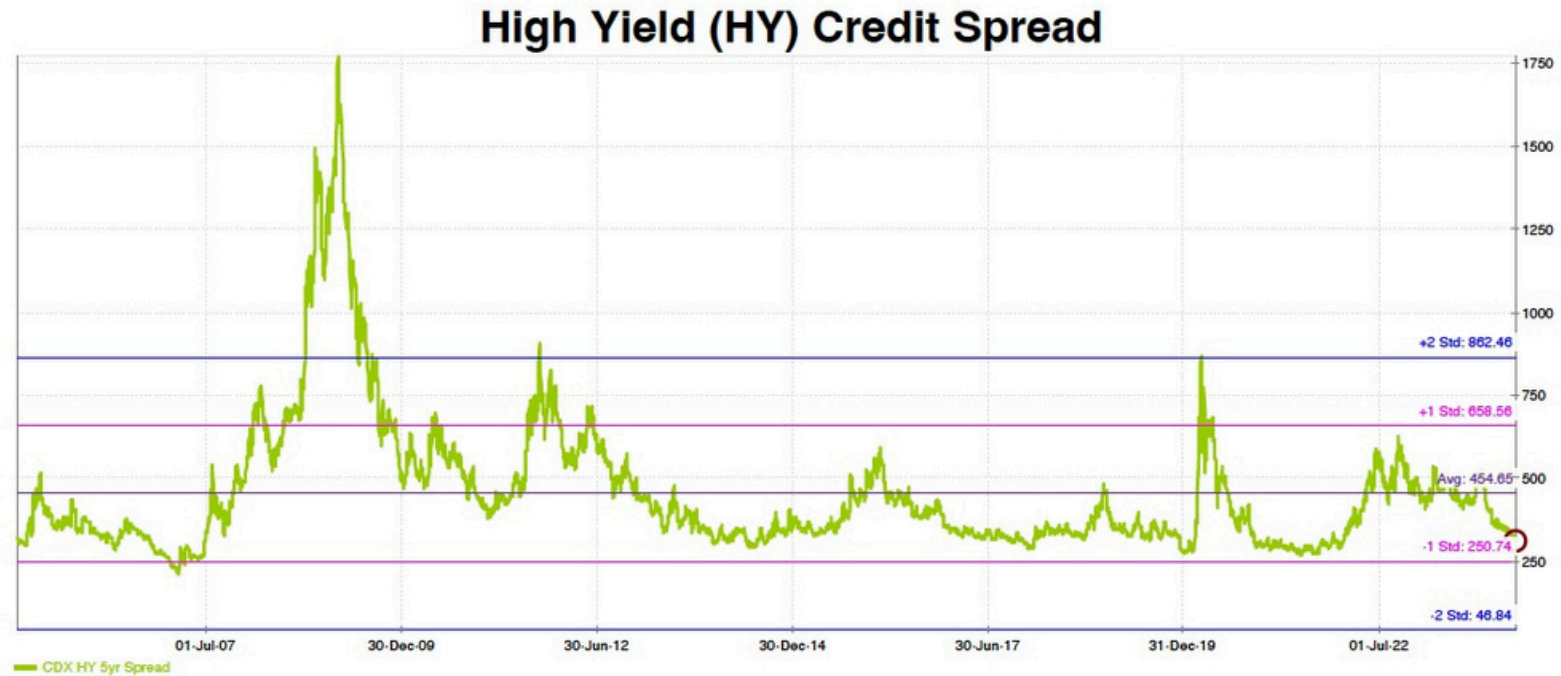
5-Year Investment Grade (IG) Credit Spread



Source: Credit Suisse LOCUS



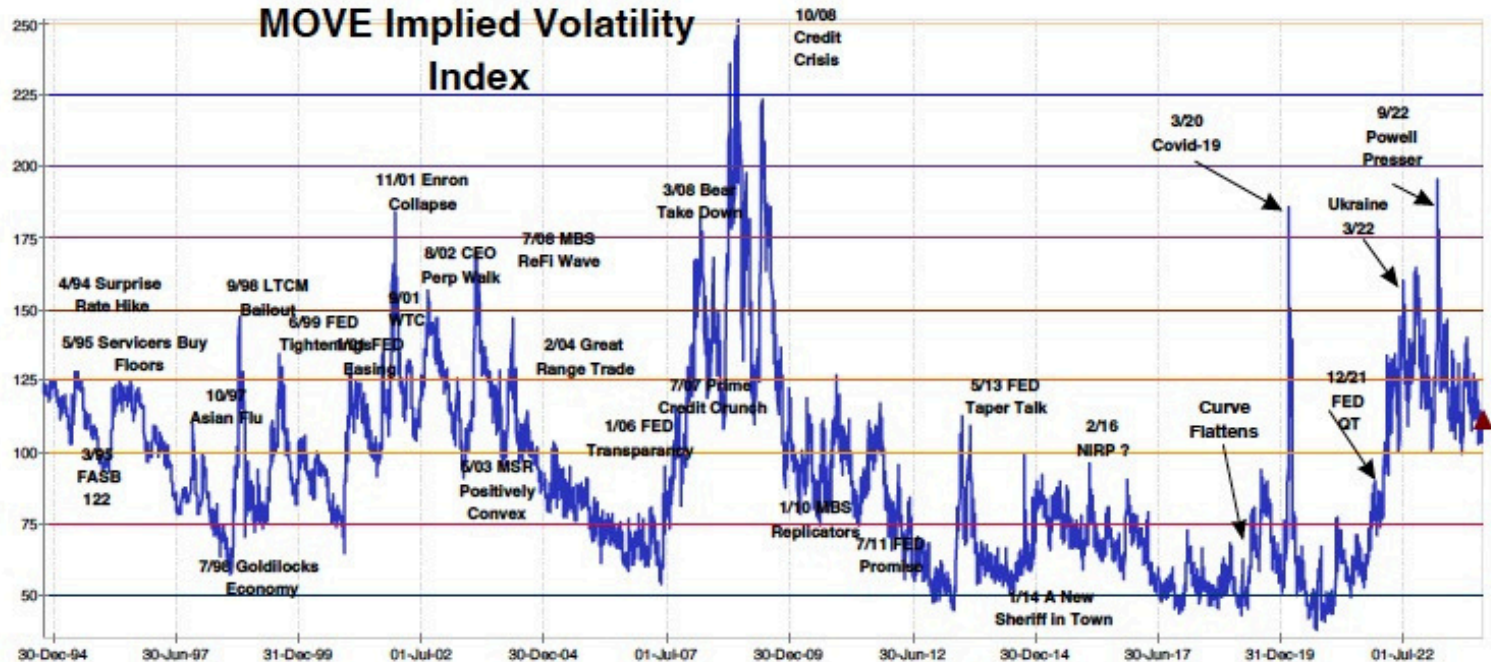
High Yield (HY) Credit Spread



Source: Credit Suisse LOCUS



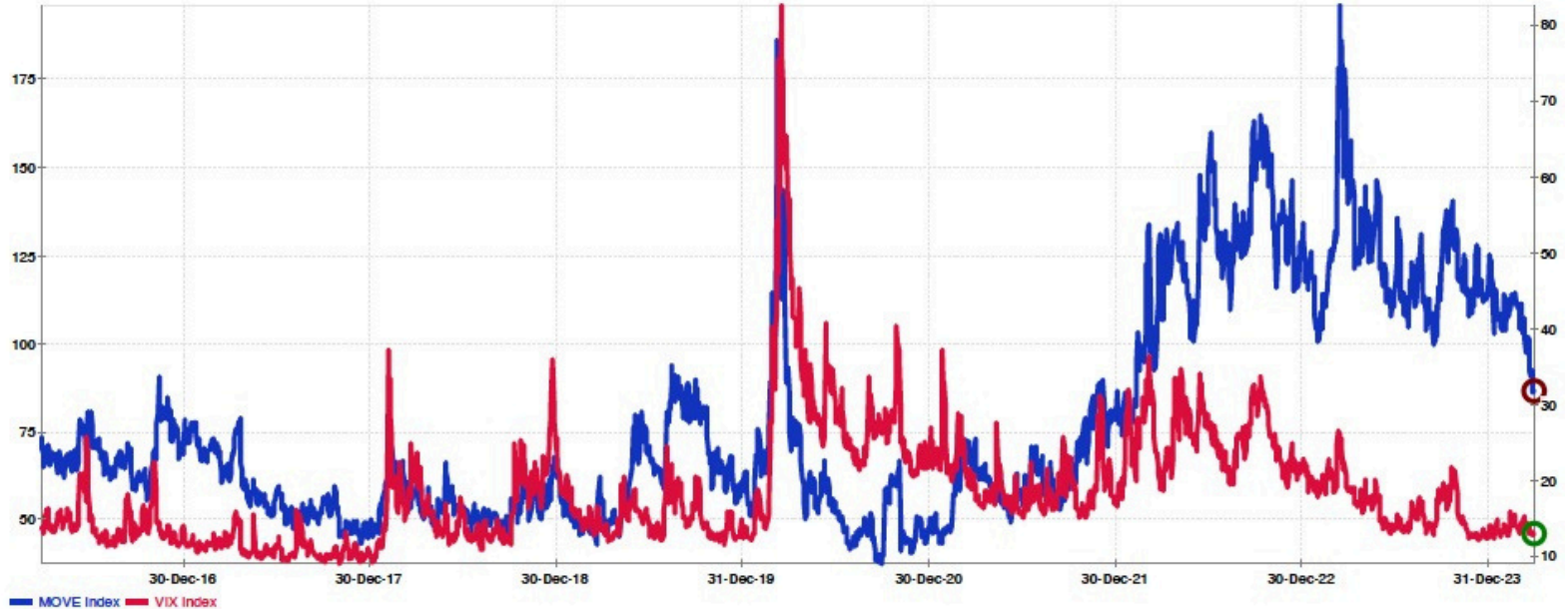
MOVE Implied Volatility Index



Source: Credit Suisse LOCUS



Move Index vs. VIX Index



Source: Credit Suisse LOCUS



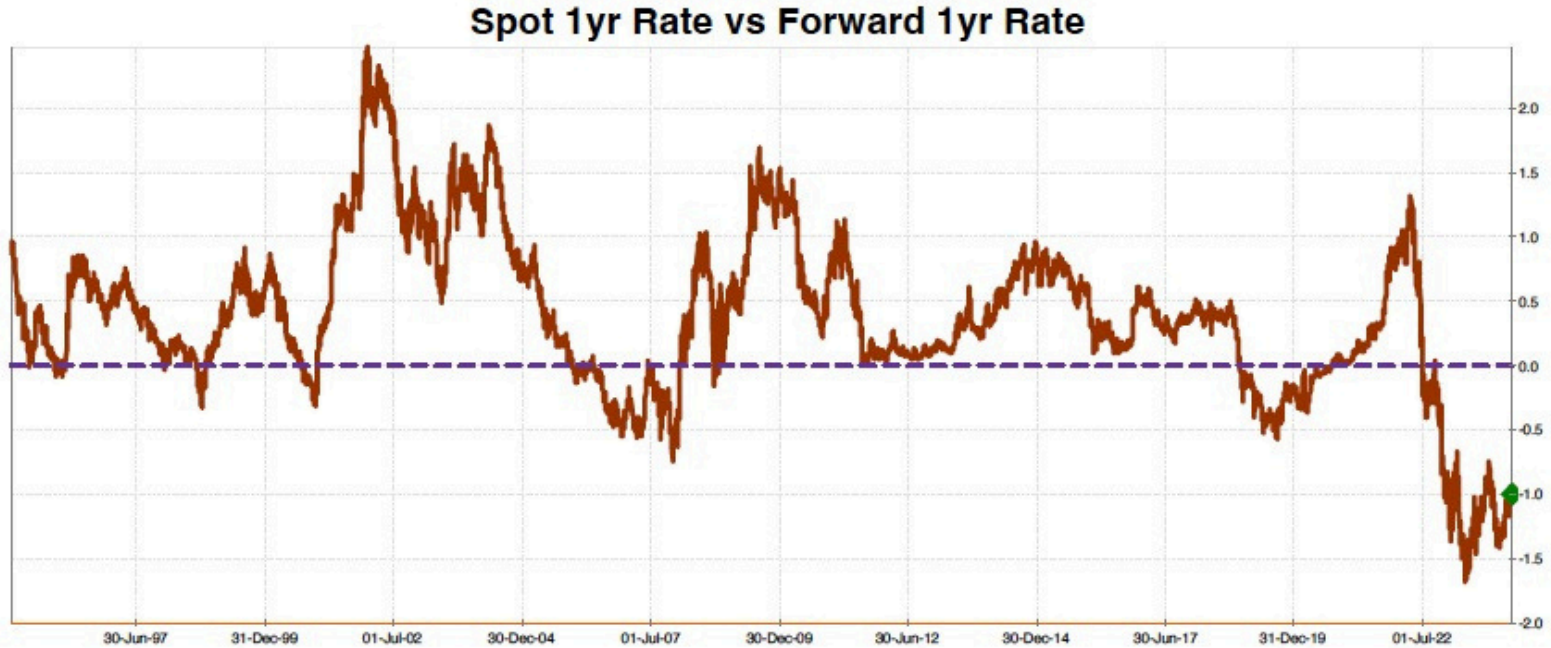
What Is a Forward Rate?

As detailed in [“Dangerous Curves”](#) –February 15, 2022: “Forwards are NOT a prediction, rather they are the simple mathematical discounting of the Spot Curve to produce an “arbitrage-free” price, no more, no less.”

In a nutshell, if Grandma can buy a one-year CD at 2% or a two-year CD at 3%, she would only buy the one-year CD if she thought she could buy another one-year CD next year at 4% or higher. We would call this 4% rate the one-year rate one year forward (or the break-even rate).



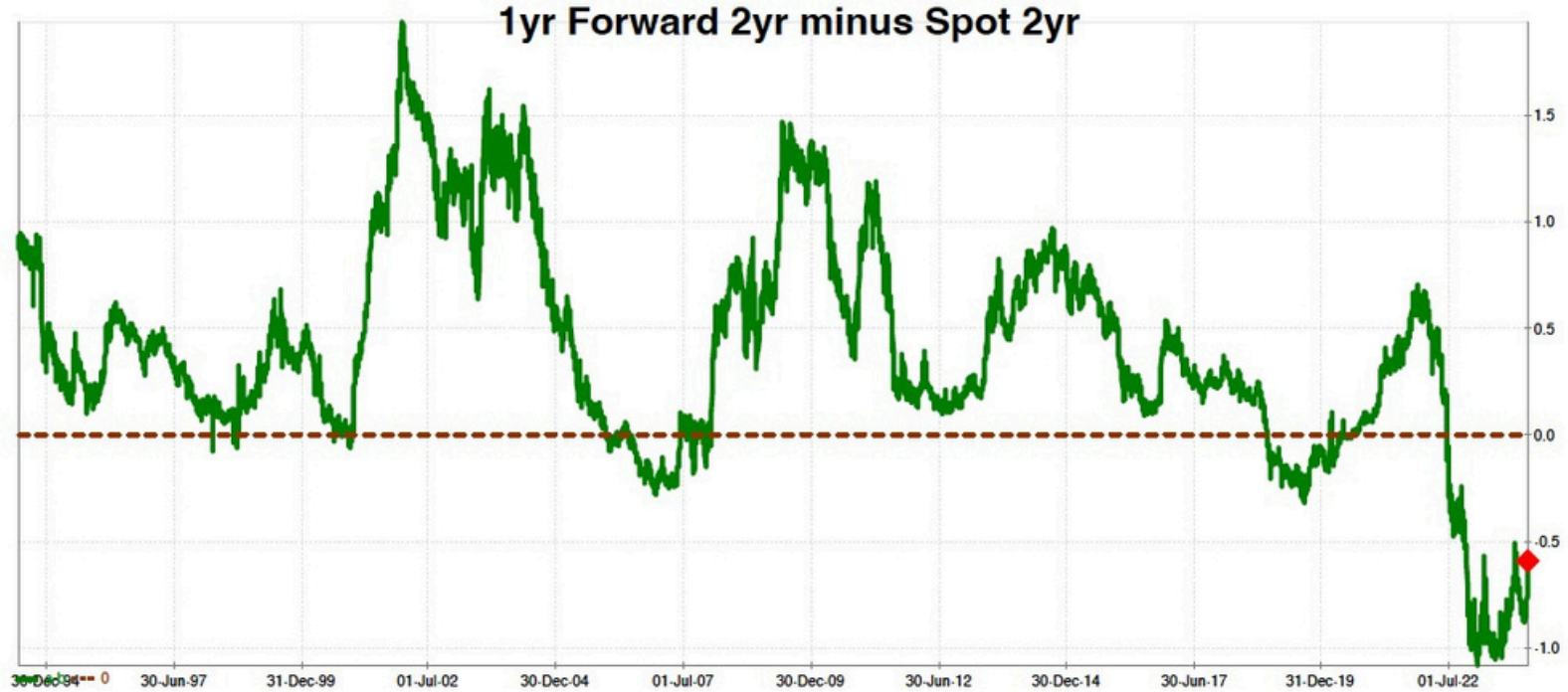
Spot 1-Year Rate vs. Forward 1-year Rate



Source: Credit Suisse LOCUS



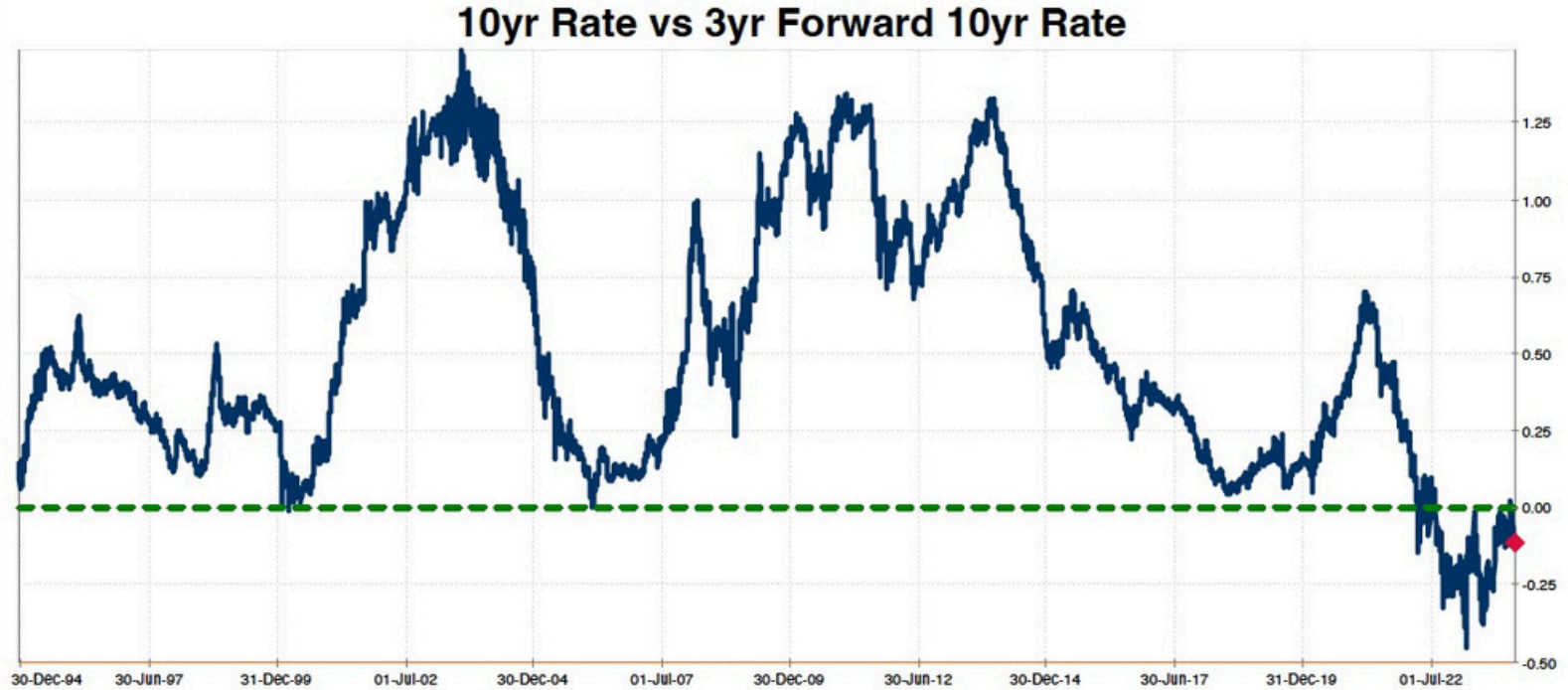
Spot 2-Year Rate vs. 1yr Forward 2-year Rate



Source: Credit Suisse LOCUS



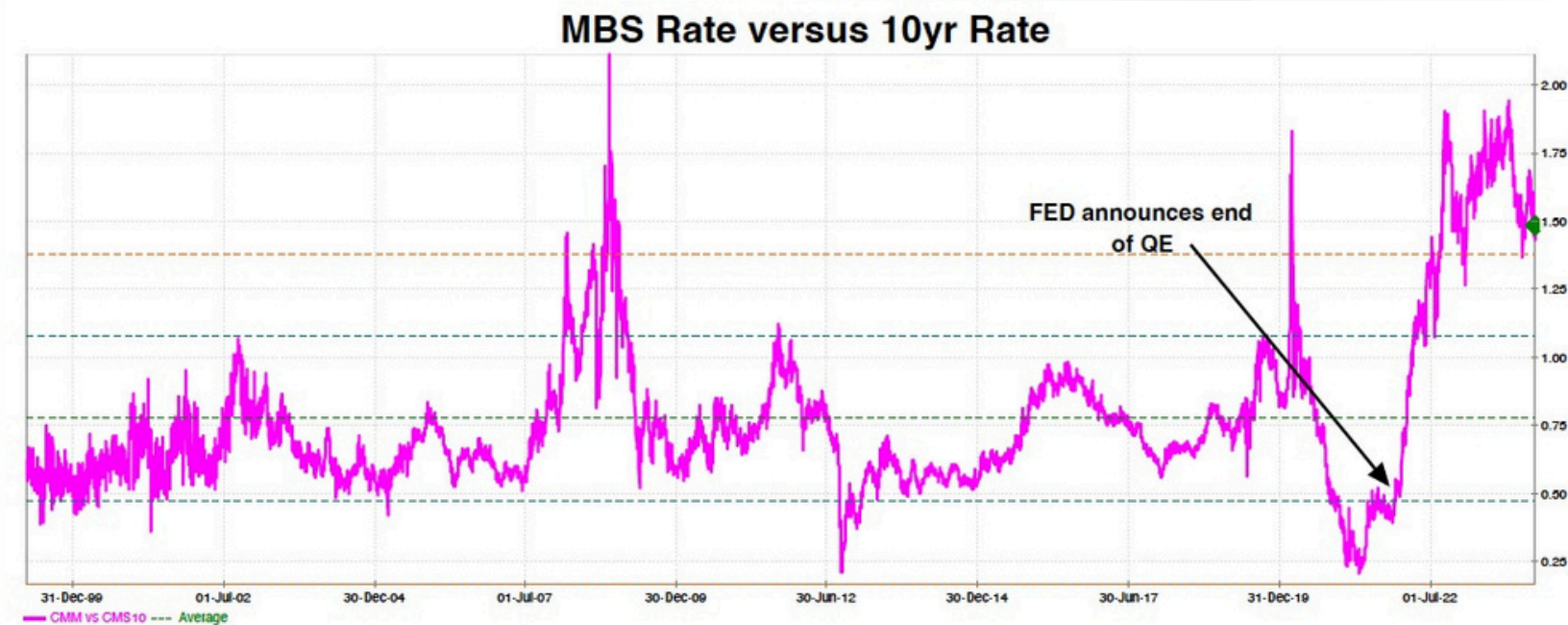
10-Year Rate vs. 3-Year Forward 10-Year Rate



Source: Credit Suisse LOCUS



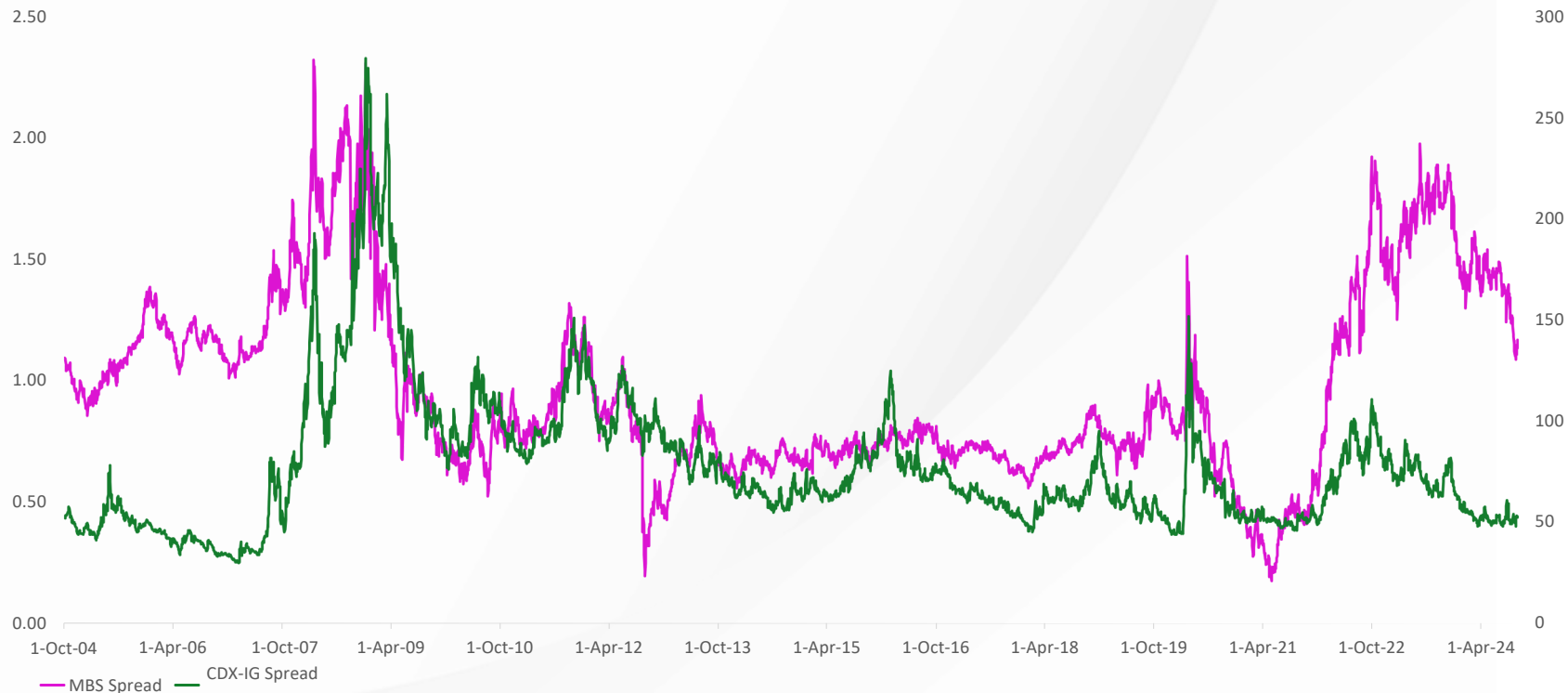
MBS Rate vs. 10-Year Rate



Source: Credit Suisse LOCUS



MBS Spread vs. IG Credit Spread



Source: FRED, Bloomberg



UST 10 Year vs. Fed Fund Rate



— UST 10Y vs FFR

Source: FRED, Bloomberg



How a steeper Yield Curve richens callable bonds

| | <u>~Recent Curve</u> | <u>Steeper Curve</u> | <u>Change</u> |
|---|----------------------|----------------------|---------------|
| Fed Funds | <u>Rate</u> 5.40% | <u>Rate</u> 2.50% | -2.90% |
| 1m | 5.40% | 2.50% | -2.90% |
| 3m | 5.40% | 2.50% | -2.90% |
| 1yr | 5.25% | 2.75% | -2.50% |
| 2yr | 5.00% | 3.00% | -2.00% |
| 3yr | 4.75% | 3.20% | -1.55% |
| 5yr | 4.25% | 3.50% | -0.75% |
| 7yr | 4.10% | 3.75% | -0.35% |
| 10r | 4.00% | 4.00% | 0.00% |
| 20yr | 4.00% | 4.00% | 0.00% |
| 25r | 3.75% | 4.00% | 0.25% |
| 30yr | 3.75% | 4.00% | 0.25% |
| 40yr | 3.50% | 4.00% | 0.50% |
| 3yr - 10yr Forward Rate | 3.71% | 4.35% | 0.64% |
| 3y - 10yr Call Option K = 4.00%; lvol = 100 | PX = 6.13 | PX = 3.89 | 2.24 |

Source: Bloomberg

MBS Index vs Newly Issued MBS Cheapest

3-year call option on 10-year rate

Strike = 4.00% Price = 6.13

Strike = 2.00% Price = 1.07



Profile of MBS Index

| | <u>Coupon</u> | <u>\$MM Issued</u> | <u>\$ Price</u> | <u>Effective Duration</u> | <u>Distributon Yield</u> | <u>Yield to Maturity</u> | <u>CPR</u> | |
|-------------|---------------|--------------------|-----------------|---------------------------|--------------------------|--------------------------|-------------|-------------|
| 4cpr | 2.00% | \$1,754 | 81.55 | 8.76 | 2.45% | 4.34% | 4cpr | 24.2% |
| 4cpr | 2.50% | \$1,469 | 85.11 | 8.19 | 2.94% | 4.39% | 4cpr | 20.2% |
| 4cpr | 3.00% | \$881 | 88.52 | 7.72 | 3.39% | 4.45% | 4cpr | 12.1% |
| 4cpr | 3.50% | \$623 | 91.94 | 6.87 | 3.81% | 4.51% | 4cpr | 8.6% |
| 5cpr | 4.00% | \$471 | 94.84 | 5.63 | 4.22% | 4.69% | 5cpr | 6.5% |
| 6cpr | 4.50% | \$367 | 97.28 | 4.44 | 4.63% | 4.88% | 6cpr | 5.1% |
| 7cpr | 5.00% | \$393 | 99.16 | 3.28 | 5.04% | 5.16% | 7cpr | 5.4% |
| 8cpr | 5.50% | \$481 | 100.53 | 2.52 | 5.47% | 5.42% | 8cpr | 6.6% |
| 12cpr | 6.00% | \$462 | 101.69 | 2.12 | 5.90% | 5.65% | 12cpr | 6.4% |
| 16cor | 6.50% | \$95 | 102.69 | 1.93 | 6.33% | 5.81% | 16cor | 1.3% |

| <u>30yr MBS Coupon</u> | <u>\$MM Issued</u> | <u>Index Price</u> | <u>30yr MBS Efftv Dur</u> | <u>30yr MBS Distribution</u> | <u>30yr MBS YTM</u> |
|------------------------|--------------------|--------------------|---------------------------|------------------------------|---------------------|
| 3.36% | \$7,260 | 89.58 | 6.09 | 3.75% | 4.53% |

| <u>UST 10yr Coupon</u> | <u>UST 10yr Price</u> | <u>UST Dur</u> | <u>UST 10yr Distribution</u> | <u>UST 10yr YTM</u> |
|------------------------|-----------------------|----------------|------------------------------|---------------------|
| 3.875% | 99.25 | 8.08 | 3.90% | 3.97% |

Source: Bloomberg



Newly-Issued MBS vs. MBS Index

Newly-Issued MBS Strategy:

Price ~ **51.06**

Coupon ~ **6.00%**

Distribution ~ **5.88%**

Effective Duration **3.65**

Yield to Maturity ~ **5.12%**

MBS Index Strategy:

Price ~ **94.51**

Coupon ~ **3.74%**

Distribution ~ **3.95%**

Effective Duration ~ **5.55**

Yield to Maturity ~ **4.54%**

Source: Bloomberg



Public Policy Benefits of a Steeper Yield Curve

- A steeper Yield Curve supports the plumbing of our financial system.
 - Higher long-term interest rates improve the health of our pension and insurance systems.
 - Higher long-term rates make private long-term health care policies more affordable and thus reduce the reliance upon Medicare.
 - It is a public policy benefit for corporate borrowers to enhance retirement income via higher interest rates, and thus reduce the need for Government assistance.
 - Yield Curve Control conceals market information and encourages Moral Hazard, to the detriment of both policy makers and investors.
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Sizing Is More Important Than Entry Level



Contact Information



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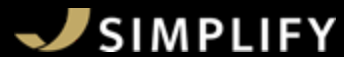
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"I'm looking for a hedge against my hedge funds."

THANK YOU!



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