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Future shop

Fabiano Santin writes:

The more you come to terms with how little you know about the future, the more you're willing to pay for options on the kind of event that people who lack your becoming humility will make bold to judge improbable. Now in progress is a survey of the opportunities for self-insuring against the unexpected.

Our guide in this matter is none other than Harley Bassman, author in residence at CovexityMaven.com and father of the bond market's VIX-equivalent, the Merrill Lynch Option Volatility Estimate Index. Treasurys, gilts, stocks, gold and oil—and options and futures thereon—are the assets on the agenda.

If the recent run of economic data does not make you bearish, the 2018–19 plunge in interest rates just might. Benchmark German, Spanish, Greek and Portuguese government yields have just crossed all-time lows, fattening the portfolio of those who perhaps bought with little hope of ever making real returns. Thus, the fortunate investor who purchased 10-year Bunds issued last August with a ¼% coupon for 99 cents, has seen its price rally to 104⅞ to yield *minus* 0.23%, paradoxically anticipating 23½ years of income on a 10-year bond.

The world's largest bond market has yet to return to the 2016 lows, but who knows? "Well-heeled investment professionals are effectively willing to purchase five-year bonds to be issued in 2024 (five years hence) at a rate below today's risk-free overnight rate," Bassman writes in reference to the graph you see nearby. The former PIMCO strategist was pointing to forward rates that price five-year yields *in* five years at 2.4%, another type of curve-inversion signal that augurs recessions.

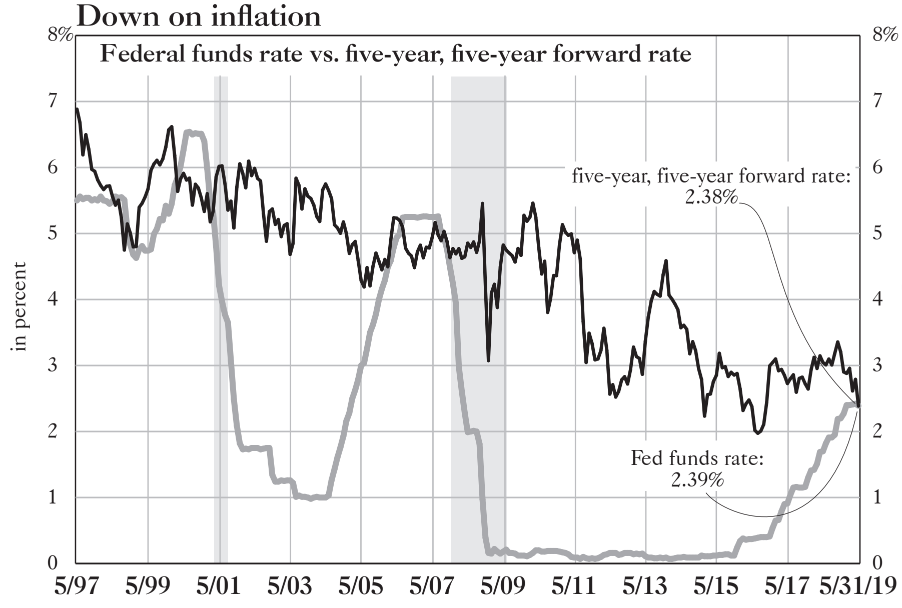
Will the curve steepen, as Bassman happens to believe? The recently launched IVOL fund affords the means to bet on higher volatility and a steepening of the yield curve (*Grant's*, May 17). The sophisticated retail trader may speculate in CME-listed options on Treasury futures, while over-the-counter options are the playthings of the pros.

The following example presupposes the reader's tolerance for perhaps mystifying and not necessarily important technicalities. "The possibility of gaining four times your money or losing every last dollar you put up" is the essential message.

The September maturity is the longest that one can trade on 10-year futures. The cheapest bonds for delivery on that date are the 2⅜s of 2026, not the on-the-run 10-year Treasurys. The yield on those 7-year bonds is what you're betting on, which is not exactly that of the 10-year bond.

Thus, the Aug. 23 call option on the September 10-year Treasury futures has a strike price of $127 (which represents a 1.97% yield on the bond). That Aug. 23 call last traded at $828.13, or 0.83% of the contract size ($100,000). If the 2⅜s of 2026 happen to change hands at

Down on inflation



shaded areas denote recession
source: The Bloomberg

a yield of 1.6% (price of $104.89) on the expiration date, the futures would trade at $129.95 (104.89 divided by a conversion factor of 0.8072) and the investor would earn 2.95 points (129.95 minus 127), or 3.6 times the cost of entering the trade. Of course, he loses 100% of the premium if the bond yield is trading above 1.97%.

The 10-year/3-month yield curve inverted on May 23, which may or may not presage a recession-driven collapse in interest rates. Timing and endurance are the problems. It would likely take a bit longer than the 2½ months until Aug. 23 for the hypothetical recession to materialize. If this is a concern, you'd perhaps be better off in Treasury futures contracts, not forgetting, however, such essential impedimenta as margin calls, roll dates, etc.

Perhaps we are seeing history repeat itself. The 1946–81 bond bear market had ended with a 15% long yield in the fall of 1981. Or did it? In 1983–84, yields shot right back up again, leading many to conjecture that the bear market was back. It was no such thing. If Treasury yields indeed bottomed in July 2016 and the recent bond rally is just a short-term correction at the start of a secular trend in rising interest rates, it's the bond bears that will soon enough be proven right.

Those bears may consider the Aug. 23 put at a strike of $127, which last traded at $1,031 per contract, or 1.03% of the contract size. Thus, if the 2⅜s of 2026 are trading at a yield of 2.4% (price of $99.84) on the expiration date, the 10-year Treasury futures would be trading at $123.69 (99.84 divided by the conversion factor of 0.8072) and the investor would get paid $3,310, or 3.31 points per contract (127 minus 123.69), for a 3.2:1 payoff. The yield on the bond would have to be at 2.10% for the investor to break even.

In this world of strange yields, one of the most curious is the 0.86% on 10-year gilts. In Britain, inflation is running above 2%, and a hard Brexit looms. It's a strange enough yield that Warren Buffett noticed and plans to issue sterling-denominated Berkshire Hathaway, Inc. bonds with up to 40 years maturity, according to Bloomberg. Because options on gilt futures are illiquid, the way to bet with Buffett is through the futures market (Interactive Brokers platform welcomes retail punters).

Gilt bears may short the Sept. 26 10-year futures contract, trading at $130.22, of which the cheapest-to-deliver bonds are the 1⅝s of 2028 (trading at £106.89 for a 0.86% yield and with a conversion factor of 0.8196). A speculator shorting one £100,000 contract would require a £1,980 margin and would make £1,000 for each point down on the futures contract (or lose £1,000 for each point up).

Thus, if the path of British interest rates were indeed up and the yield on 10-year Gilts reverted to 1.5% by Sept. 26, the 1⅝s of 2028 would trade at £101.05 and the futures at £123.28 (101.05 divided by the conversion factor of 0.8196). The profit would be £6,940, or 3.5 times the initial margin.

What would happen if the 10-year went back to the all-time low at 0.5% on Aug. 15, 2016? The futures would trade at £134.15 and the speculator would lose approximately £3,938. For whatever it might augur about the next 90 or so years, the 10-year Gilt has traded at 1.5% or higher in every year since 1929.

Conceivably, one may not want to get into the technical details of bond futures and options contracts. Some may still be slightly bullish on the stock market despite the threatening rates scenario. That investor could consider purchasing a Sept. 30 SPDR S&P 500 ETF (SPY on NYSE Arca, which represents a tenth of the S&P value and last traded at $289) call option at a strike price of $295 for $5.76, or 2% of the stock value. The break-even on that call is an index reading of 3,008, perhaps in a scenario that Trump backs away from the trade war, or disavows tariffs or Twitter, and the S&P makes a new all-time high (the zenith was 2,954 on May 1). A 10% rise in the S&P would deliver a 4.1:1 payoff to the option buyer.

One appealing feature of SPY options is that you can buy maturities as distant as Dec. 17, 2021. Thus, a call with a strike of $290 expiring on that date may be purchased for $28.87, which means that the investor has more than two years to wait for the S&P to rise by 10% and the option to reach break-even at $317.87.

Fortunately, metal bulls have decent alternatives such as longer-dated calls for the SPDR Gold Trust (GLD on NYSE Arca, last traded at $125.18). A Jan. 15, 2021 call at $125 on the GLD costs $9.40. If the end of the reign of the world's central bankers is nigh and the metal climbs by 25% in two-and-a-half years to trade at the 2012 average of $1,668 an ounce (roughly $157 for GLD), the call buyer would earn $32 for a 3.4:1 payoff.

The start of the summer driving season has not been promising for oil, and a recession may be just around the bend. But bulls, undaunted, may consider the Jan. 15, 2021 calls on the SPDR Energy Select Sector ETF (XLE on the NYSE Arca; last traded at $61.57) at a strike of $65 for $3.91. If the XLE were to climb towards the $76 mark registered every year since 2007 (except in 2009–10), the investor would make $11 for a 2.8:1 payout.

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