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Other side of the boat

James Robertson, Jr. writes:

"We are not in a business cycle," BlackRock, Inc.'s new 2025 Global Outlook report leads off. "AI has been a major market driver, inflation fell without a growth slowdown and typical recession signals failed. Volatility surged and narratives flip-flopped as markets kept viewing new data through a business cycle lens, not one of transformation."

So it's a new era? Doubting it, *Grant's* is committed to the familiar patterns of boom and bust, illusion and disillusion, bond-buying panics and bond-selling panics. And we are bullish, too, on the Simplify Downside Interest Rate Hedge Strategy ETF (RFIX on the Big Board), which launched two Mondays ago. In the words of its creator, Harley Bassman, bond quant, public benefactor and managing partner of Simplify Asset Management, Inc., RFIX is a "151-proof" bet on a steep slide in interest rates.

Bassman, like this publication, identifies as a higher-for-longer interest rate man. Even so, we can all agree there's nothing like a sweet option on an ostensibly improbable event. Markets, public ones at least, rarely take the shortest distance from point A to point B. Seven recessions attended the latest bear bond market, from 1946 to 1981, and they produced sharp retracements in the 10-year yield on its climb to the nearly 16% peak of September 1981 from the starting neighborhood of 2%.

Betting on a hard landing is surely no consensus trade these days. At that, neither is holding bonds. Kicking off the Dec. 5 CreditSights U.S. Outlook conference, moderators asked the gathered debt investors to name their top asset choice for 2025. "Stocks," they said, by a mile. When pressed to pick a credit strategy, the audience settled on a low-duration portfolio, one least exposed to rising interest rates.

If there's a message embedded in today's flyaway asset prices, it's that the imminent new administration will bring only profit and plenty. RFIX is built for an alternative set of outcomes, including the risks that tariffs, trade restrictions and deportations may present to economic growth. Besides, the president re-elect has nothing against volatility; this publication has identified him as the avatar of it. Why should we expect a serene administration? Only recall the first Trump term, around September 2019, when the former real estate promoter demanded that the Federal Reserve slash rates to zero or less.

Conceptually, RFIX is a 7-year call option on 10-year rates. A decline in the 10-year Treasury yield, to 3.25% or lower before March 2032, from today's 4.4%, would ring the register. Mechanically, at a $60 initial price, RFIX holds roughly $30 in T-bills and $30 on a 7-year option on the receive-fixed, pay-floating leg of a 10-year Treasury swap. The cost of exposure to that exotic swap option is 50 basis points a year. For the retail investors, it's the only way to participate.

If readers feel a sense of déjà vu, they would not be mistaken. RFIX is the bond-bullish twin of PFIX, the Simplify Interest Rate Hedge ETF (*Grant's*, May 14, 2021). The strategy is nearly identical, only the direction is different. PFIX paid off handsomely when the 20-year yield rose by 320 basis points, and its share price zoomed by 200%, between December 2021 and October 2023.

"There are two reasons why you buy RFIX," Bassman tells me. "No. 2, not No. 1, No. 2 is you just think that bad things are going to happen—a hard landing, an assassination, a nuclear bomb, whatever it might be—and rates are going to come down hard and fast, and you want an insurance policy against your portfolio."

What makes RFIX a high-octane stocking stuffer is its leverage to falling interest rates. Duration is the sensitivity of a bond's price to a change in yields, and RFIX is loaded with it. RFIX has a duration of 43 years by Bassman's modeling versus 16.7 years for a vanilla 30-year Treasury and 29.4 years for a zero-coupon one. That translates to RFIX returning 58.9% on a 100 basis-point plunge in rates versus 23.2% and 38.5% for the 30-year and its principal-only strip, respectively.

Like the Austria century bond (*Grant's*, Sept. 1, 2023), RFIX has convexity, as well as duration, in spades. A positively convex bond has more upside risk when rates fall than downside risk if rates rise. In other words, convexity is the good kind of asymmetry. And un-like the euro-denominated Republic of Austria 0.85s of 2120, RFIX does not expose you to currency risk and the policy choices of Christine Lagarde and the European Central Bank.

The No. 1 reason to buy RFIX, Bassman continues in his nonlinear way, "is capital efficiency. You only need to put down 15 bucks to get the duration of $100 of AGG [iShares Core U.S. Aggregate Bond ETF]. Instead of buying that, which is a big BlackRock fund, you can go and buy $900 of high-yield or $800 of the JAAA CLO fund and buy $100 of this product. You will get the same duration as the AGG, but you can pick up 100–200 basis points in yield."

After its first week of trading, RFIX is quoted at a 7% discount to its offering price. Constant readers will remember that PFIX fell 22% in its first two months when inflation, then rising, was waved away as something merely transitory. Given that the 30-day T-bill yields more than the value of the option decays, an RFIX holder is paid roughly 2% to wait. "You could wait a year or two before you're right," Bassman winds up, "and it will cost you nothing."

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