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PFIX-er upper

Rising interest rates disturb the peace. They plague the holders of bonds and stocks, commodities and real estate. They could tarnish even so fetching an investment narrative as the one in which JBG Smith Properties becomes the northern Virginia landlord of Amazon.com, Inc. (see page 4).

True, interest rates are not now rising. But because (a) they are very, very low and (b) they were once very, very high, we return to Simplicity Interest Rate Hedge ETF (PFIX on the NYSE Arca). In preview, we like this $39-plus stock even more than the $50 version about which we wrote in the May 14 issue of *Grant's*.

PFIX is a way for the individual investor, not possessing a license to deal in derivatives (count your blessings), to hedge interest-rate risk. At the May 11 offering price, PFIX consisted of, in equal parts, a 7-year Treasury note and a 7-year forward 20-year payer swaption with a strike price of 4.25%. If the second segment sounds arcane, remember the name "Simplicity." Pure and simple, the swaption is a kind of put on the 20-year Treasury. It would pay off at maturity in 2028 if the 20-year bond yielded more than 4.25%, up from 1.9% today.

The swaption would reciprocally expire worthless if the 20-year bond yielded less than 4.25% in 2028, which loss would leave the holder still clinging to his maturing 7-year note. At the $50 issue price, one's maximum loss would therefore be $25. Mr. Market, his eyes fixed on the dwindling 20-year yield rather than the 5% year-over-year jump in the May consumer price index, has subsequently reduced the downside risk to $14 (i.e., $39 minus $25).

Perhaps, as Hoisington Investment Management lays out in its first-quarter letter, investors are looking through the hot inflation prints to the twin disinflationary powers of over-borrowing and under-procreating. The ratio of nonfinancial debt to GDP rose by 31 percentage points, to 281%, between year-end 2019 and the first quarter of 2021. "While this debt may be politically popular and socially necessary," Hoisington posits, "it will weaken growth and inflation after a transitory spurt."

Not so transitory, they contend, are the declining fertility trends; last year, the fewest American babies were delivered since 1979. Ergo, the famous bulls conclude, as they have for so long and successfully done, "[T]he trend in long bond yields remains downward."

The bond market, like the investors who populate it, has its moments. The novel coronavirus made its first appearance in *The New York Times* on Jan. 8, yet the 10- to 2-year segment of the Treasury yield curve inverted in the last week of August 2020. An inverted yield curve typically precedes an economic slump, which could almost imply that bond traders had a spy in Wuhan. But no such prescience was in evidence from early 1980 through the autumn of 1981 when long-dated yields pushed to 15% from 10% even as Paul Volcker was crushing the inflation rate.

What is the message of today's ultralow yields? Perhaps, chiefly, that the Fed continues to buy $120 billion's worth, every month, of bonds and mortgages, increasing bank reserves by a like amount. Meanwhile, the U.S. Treasury has drawn down its general account at the Fed by $761.6 billion this year, a process that also releases cash into the banking system. In consequence, commercial bank reserves have piled up and money-market mutual funds could find nothing better to do with their $991.9 billion on June 30 than to dump it into the lap of the Fed's reverse repo facility for the grand total remuneration of five basis points per annum. All these redundant dollars drive down interest rates as everyone hunts for yield.

Interest-rate puts are cheap because bond bullishness is entrenched. But if the 20-year yield were to rise by 100 basis points in the next two years, PFIX's price would increase to $54.86; if by 200 basis points, to $87.29; and if by 300 basis points, to $127.54.

That analysis comes courtesy of Harley Bassman, a managing partner at Simplify Asset Management and one of the PFIX managers and inventors. Importantly in those calculations, Bassman assumes only small upticks in interest-rate volatility. If rates really were to jump by 100 or more basis points, he observes, interest-rate volatility probably would lurch higher, too. A leap in vol would make the options more valuable, which would further lift the PFIX share price.

"As such, PFIX will be explosive to the upside in a significant rate move," Bassman emails colleague Evan Lorenz. "This product is a coiled spring on almost every risk vector. Now, that does not mean that rates will rise in our lifetimes, but as a hedge product, this is quite powerful."

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