Nick: Good morning. Today is Saturday, the 21st of October, and this is your regular update on Two Great Beards. We've had an exciting week, haven't we, Andy? Sure was. The news of the week really was all geopolitical, and the market reactions were mainly geopolitical, but you know, the, we've had a lot of things which still indicate that the economy is chugging along.

All the secondary data we had last week. Showed that the economy is not weak. Unemployment is still not going up the way the Fed would like it. And really, you know, the most important thing that we had was Powell during his speech in New York, basically, he said that, yes, we are happy with the way things are, more or less.

And we're unlikely to hike rates in the near future, or that's at least the way the market took it. And basically what the market did is took the probabilities down to zero that we're going to get a hike in November, and to something like 20 percent that we're even going to get one in December. Now. Is that right?

Would you think?

Andy: Yeah, I mean, I think we'll have to see the data. I think november's pretty baked in the no hike camp the thing I noticed about and I agree with the your Views about what happened last week. I think the interesting thing from pal from me It was two bits one is Reaffirming both the fact that higher long term rates, which is really the biggest thing we've seen since early, late July is a tightening, and they think that's desired.

Like, that's a good thing. And that was consistent with all of the rhetoric from the two other, well, all the Fed officials, but in particular, Williams and Waller who were talking about higher rates being. Tightening and Powell went even further and talked about things like bond stock correlation.

And he was very, he mentioned fiscal, but he was very careful about not saying anything about QRA supply or anything like there's a lot of bonds for sale. He was very careful to avoid that because that's Both a fact and something that they don't want to necessarily scare people about. But I think the other important thing that he said was he didn't say we're going to tighten a lot more, but he also did say we're not too tight.

Nick: Absolutely. I think the the odds of them cutting rates until the economy rolls over are almost zero. And that might take some time. Yeah, and

Andy: continuing to do QT, Waller supported that idea. And if Powell had disagreed, he would have said so. That, you know, their destination is two years at least worth of...

Quantitative tightening. And that is going to cause the. Issuance to transmit into wider term premiums and lower asset prices and a tightening which will ultimately cause the economy to feel some pain, which based on the GDP, which we're going to get on, I think Thursday, maybe Wednesday you know, it could be 5%.

Yeah, the economy is not rolling over.

Nick: Yes, it's going to take some time and really just as people have been Given giving up on this recession I think we're probably getting closer to it because we've had so much tightening Especially from the long end of the rates coming up and the yield curve actually getting to zero We're now flat in two's thirties To me, the signal for a coming recession has always been the dis inversion of the curve rather than the inversion of the curve.

The inversion of the curve just means that we are that the Fed is tightening because it wants to bring down. The speed of growth and the hotness of the economy, but it's when the yield curve disinverts that the market is saying that we're getting close to that

Andy: point. I mean,

Nick, you and I agree and have agreed for a while.

I think maybe it's part of our gray beards, but I think the bottom line is if you started your career in the last 25 years, it was the, Inversion that broke something in credit, which caused the recession toe to roll over. But that's not what we have here. Yeah. In classic business cycles. It's the disinversion that causes the economy to weaken, not a credit crisis.

And, you know, that's what we have.

Nick: And I think this is a very important point for our viewers to understand. That this is much more akin to a traditional business cycle, like we had between the 50s and the 80s. Rather than a credit event, which is what the G F C was or the long-term capital issue.

So we are not talking about a credit event. We are talking about a traditional business cycle where the economy is brought down by higher interest rates for longer. And the disinversion says that the market is seeing that it's beginning to work. So, that is where we are at the moment, and personally, I think that the odds of recession keep on going up, rather than keep on coming down.

Now, is it going to happen in the Q4 of this year? Probably not. But Q1 and Q2 of next year the odds, I think, are increasing rapidly. Right,

Andy: and the market perception, the thing that's keeping equities up in the face of very high yields is backward looking at a 5 percent GDP. And projecting that to 12 percent annualized earnings growth for 2024, which, you know, to me is optimistic and is keeping multiples elevated and earnings expectations elevated and less stock prices elevated.

So if we're right, you know, stocks will start. Catching up or catching down to bonds and then the question becomes What about bonds and that brings us to something that we've both been writing a lot of writing and talking a lot about which is the level of real interest rates.

Nick: I mean, I just said a look at tip 2.

79 Once you've taken away fees and this and that, you're probably around the 250 255 area. And what's interesting to me is that in the past two weeks, you've seen the long part of the curve, so 30s, 20s, 10s, and even 5s, break the previous lows, but tips have not. They are maintaining this 2. 5 percent yield.

And I think two and a half percent yield is the highest we've seen since 2004, really. So it really is an attractive yield to invest money at.

Andy: Yeah. I wrote so, I filmed a, an explainer, which is available on two gray beards, YouTube channel about tips and also about how that impacts gold.

And I, I recommend and I that you take a look at that to understand what we're thinking about. I'm a little bit more cautious about real yields rising further because of what. We may see on the issuance announcement the week, not this coming week, but the following week during Halloween and the Fed meeting.

And so, but that doesn't mean I'm not a buyer here. It means I'm just cautiously adding to real yield positions. Into weakness, because the value is there and I explain why in that explainer and I recommend you looking at that,

Nick: but absolutely

Andy: What are we looking at for next week nick?

Nick: Well, we don't have a lot.

We've got gdp For q3 which is backward looking and that's going to be very hot and we have the auctions twos fives tens sevens yeah, sorry and we have the ecb in europe which I think Is going to be a non event they're going to basically say that we're doing nothing and that's going to cement The the fomc the week after so basically all the central banks are now at a whole steady Level or beginning to cut for the ones like in emerging markets, which started the hiking cycle Much earlier and on friday we have the core PCE, which is Powell's favorite and that's the last bit of data that could possibly change his mind about november or More probably december and the market will certainly react to it But it'll be a pretty mute reaction because we already think that 99 percent we get nothing in november So all the action will be in the back part of the curve So that is all we have for next week.

And after that, naturally we have the QRA, which is going to be the important event and that we're going to talk about next week.

Andy: Yeah. So, the other thing that's not macro is the earnings will be, it's the heart of earnings season. You'll have. Google and Microsoft lead off and then Meta on Wednesday and Amazon on Thursday.

And, you know, those earnings are going to be fantastic. There's just no way with a 5 percent trailing GDP that these companies aren't going to... Mint money, but what will be important now, Tesla was a little bit of a different story and it's probably by, well, it's by far the most interest rate sensitive portion of the mag seven earnings.

And so it disappointed and the stock was punished. But I look at American express, which is right in the heart of wealthy Consumption and their earnings were fantastic and their outlook was good, not bad, good. The stock rallied 3 percent ish on the news and ended up down 11 percent from the peak, down 8 percent for the day.

That is what I'm concerned about for the

Nick: Yes, I think the market reaction to the earnings is going to be far more interesting than the earnings themselves. I think if they sell them, they are beginning to acknowledge that 12 percent growth for 2024 is fanciful and therefore they're going to bring down the multiples and the earnings forecasts so we could get, you know, a real catch down in equity valuations, as you mentioned, especially relative to bonds.

And that is why I think that our portfolio at the moment is very well structured and really exactly where we Want to be at this stage.

Andy: Yeah, so let's talk about that We the portfolio is about 50 percent bonds about 50 50 And very nicely yielding bonds in particular And nick will talk more about that but also 50 50 inflation protected versus nominal and Equities are at their minimum.

We did make a big move. Well, big. We made a move in gold and flattened our exposure to zero in gold because of a lot of the things I talked about in the video that Nick strongly agrees about in terms of its relative competitiveness to real rates. But the other thing I'm thinking about is why has gold rallied?

Why do you think that is Nick? And what does it mean for the. You know, the broader available ways of playing that well,

Nick: the I would have thought that the main reason is naturally the geopolitical tensions which people feel are or fear might get out of hand, then that is always a possibility, but the other probably more rational explanation.

Is that they fear some kind of a fiscal dominance argument that the U. S. is going to have to issue so much more paper because the fiscal deficit is going to be so much higher, simply because the U. S. is going to have to produce. So much armament in the next X years, that argument makes some sense, but if one believes that argument, then stocks like the ITA ETF would be surging or XLI which have a lot of the same components within them. But that is just not the case. We're just not seeing that so to me that is not a very good argument and if you believe that argument then those are the stocks that you want to buy Rather than hold gold which yields you zero percent Now if you are living in Bahrain.

I can understand why you want a bar of gold so you can put it in your suitcase and get the hell out of there or Swiss francs. Yeah. But if you're living in the U. S. I really can't see the argument for it over something like ITA or XLI or especially real yields. Right. I just can't see that argument because you're not afraid for your life.

If you're afraid for your life, it's a different argument, but here I just can't see what the rational argument would be that fiscal dominance, if it comes about. Is not going to produce great profits for something like tip because the real yield is going to be so good. But also for companies that produce these armaments that everyone's afraid of.

So I, I really can't see the argument. Can you?

Andy: No, I, I agree. I think it's you know, I look at flows of all assets and one reliable flow is when there is concern about being an enemy of the West, that the natural thing is to divest of Western assets, Western currency exposures, and invest in. Swiss franc, which has done very well, and by depositing your money in a Swiss bank and gold.

And so, the flow driver that took gold to this, that rallied gold without anything other than oil rallying, makes sense. The question is, what's next? After those flows have occurred, sure, there could be somebody that's just late to the party and hasn't yet sheltered their U. S. dollar or euro or even yen assets and moved to these other assets, but you're running on fumes on that trade.

So it really depends on whether there's going to be this Fiscal dominance argument, and if it is the case that fiscal spends a ton of money, firstly, that's going to be inflationary. So you want tips versus nominals. That's going to be pro growth. That's not great for Tips, but you know that not everything is perfect.

And the way to protect that versus gold Is these things we've just talked about like pro growth pro inflation go where the money's being spent Yes, so that's the thesis. I think it makes a lot of sense now We're not suggesting going out and buying these things. What we're suggesting is sell gold and buy real.

If it comes to pass we will be looking to buy some of these industrial sensitive Stocks, but we don't feel that's necessary at this stage.

Nick: No, certainly not this week we'll look how things progress and I think the qra is going to be one of those times when we decide if fiscal dominance will come at some stage.

Today we have not enough information to decide and therefore we should wait on pulling the trigger on something like ITA or XLI.

Andy: Yep. And we'll be we'll have a fairly extensive commentary on the QRA in our next episode. Something to look forward to for next Saturday. And with that, I'll turn it over to Nick for his portion of the segment.

Nick: Thanks, Andy. And let's have a look at the portfolio. What I've done is I've put here links to all the ETFs we own so you can have a look. And let's talk about the melded rate of interest that we're going to have to maturity on this portion of the portfolio, which is the bonds, where we are at nearly 50%.

So, all you have to do is basically press the link and you will come up with these figures. If you have a look at the yield to maturity, that is going to give you an indication of what we are expected to earn over the lifetime of the, of our holding. So with, for VWOB, that is 7. 9%. For TLT, that's five and a quarter.

For CHI, that is 521. And even for TIP, and this is the amazing thing, we are getting 5%. But 2. 79 real, which will go down after fees and so on, but it's not going to be much lower than 2. 5. So if inflation is 3%, you're going to get 5. 5%. And that really is a very good melded rate for everything. Our melded rate is now above 6 percent for all our holdings.

So either we're going to be getting 6 percent a year, or we're going to see significant appreciation from this part of our portfolio. As we mentioned, we think that equities are very likely to catch down at some stage, and that is why we still have 28 percent in cash that we can deploy to equities at any time.

If we decide that fiscal dominance will become a part of the Argument then we will go into ITA. We will go into xli We might even go into eww a little bit and we will probably Reduce some of the nominal bonds and allocate to gold again But as you can see we so sold our gold. We are happy to have done So have a look at andy's explainer, which is on the youtube channel and you will see why At these levels, it makes perfect sense to be out of something yielding zero and being in something which yields two and a half percent real.

We naturally switch some of that gold into gsg and that is another hedge against inflation Because if we get a you know gold taking off because of inflation that will be good for tip But also it's going to be very good for oil which is a major component of the GSG. And we are really not afraid to be out of gold and into GSG and into TIP, because we think that is a much better longer term allocation.

As far as everything else is concerned, there are no orders for next week because we're very happy with our current allocation. And we want to wait for the QRA and we will discuss that next week. Naturally, all the broker statements are uploaded so you can have a look exactly what we did and what levels we did them at.

The chart pack is also updated and you can see all the holdings that we have and even the crosses and why we like our positions so much. Again, nothing to be done this week, no orders. If there is anything that we see which merits your immediate attention, we will naturally send you an email. Thank you very much indeed and have a lovely weekend.