Nick: Hello and welcome to another episode of 2 Gray Beards. Today is the 28th of October 2023. Well, we had an exciting week with a lot of data out, a lot of data points, and a lot more to come next week. Next week is going to be absolutely chock a block. So let's have a look at what we Gleaned last week And was it importance I would actually say that gdp Was one of the highlights and that was very strong who would have thought that we'd have 4. 9 for q3 Anytime during even the beginning of Q3 nobody believed it and yet this is what we get. 4. 9 percent. I think that tells us all we need to know about the economy at the present moment and that is why the employment figures keep on being strong. I haven't seen a single piece of data for the last several months that's shown any doubt that the economy is strong or given us any indication.

That we are anywhere near a recession. What do you say Andy?

Andy: Yeah I think by the end of the day on friday the first GDP now cast which is created by the atlanta fed which had been ridiculed With its high readings for the entire q3 Printed its first estimate for q4 and that was 2. 3% So, it will get less ridiculed this time, I imagine.

Bonds sold off, stocks sold off. I don't know if that was the issue or if it was Gaza or if it was something else. But, the economy is strong and has yet to roll over.

Nick: Yes, absolutely. And the, sort of, the icing on the cake for me was the Core PCE number that we got on Friday as well, which annualized.

Shows that we are nowhere near a level that would make the Fed comfortable with with where we are on the inflation front. And yet we are discounting less than a 50 percent probability of a rate hike, not next week, because the probability for a rate hike next week is zero. But all the way out into the meeting on the 31st of January, it's sub 50%.

Is that justified? Can we justify no more rate hikes? For the next three months

Andy: I can't but at the same time, I don't think the rate hikes are Doing much and haven't been thinking the rate hikes have been doing and it's obvious with a 4. 9 percent gdp And a 5 percent annualized pce You're generating a 10 percent nominal growth rate just Now admittedly with a very short narrows and the averages are lower, but there's just no way to get to a view that the rate hikes are doing much.

They really aren't. And so does 25 basis points matter?

Nick: Yeah, but it's just another indicator that okay, they might not hike, but the idea that they're going to ease anytime soon is just ridiculous. It just makes no sense whatsoever, and therefore all the timings get pushed further and further out.

Will they ease? Yes, they will, because if they don't... And inflation keeps coming down at the rate that they are forecasting then real rates will be going up And there'll be a real tightening of financial conditions But I think the idea that they're going to Be able to cut rates during the first half of next year Is very fanciful unless the economy starts doing something That at the moment, it's certainly not doing and unless we get real time data, which shows that the a employment is moderating and be the real economy is really moderating at a much more significant pace than we have seen.

For the past, I don't know how long. So that is what we're waiting for. And really the idea that we can go ahead and buy nominal bonds at any price, especially with the QRA coming up next week is, to me, very fanciful.

Andy: Yeah, and I just look at the earnings. We had all the, we had, what, four out of the seven, magnificent seven earnings reports.

And. The rest of the earnings seasons from was broadly very strong and should be very strong with a 4. 9 percent GDP in Q3. And the forecasts were strong by and large. The thing is, and I think this is the important part. The 100 basis point rise in treasury yields, long term treasury yields, since the last QRA is starting to hit multiples.

And so, despite excellent earnings, and earnings that are forecast to remain excellent, which may or may not be true, Equities fell fairly substantially since the QRA. Russell's down 17%. NASDAQ and the S& P are both down 10%. And a lot of that sell off was this week. The last few percent was this week.

And so that is starting to take some of the fluff out of equity multiples. And the combination of bond prices falling and equities falling can actually have more impact on the real economy than these rate hikes. So that's what we're looking for is you get equities down to where we think they're going and you get bonds yields up to where we think they're headed.

And that's when the economy actually starts to weaken. And that's when you can buy bonds.

Nick: And equities probably, but later on, they're going

Andy: To have their earnings cut too, but

Nick: we'll see. As you said, it was a very significant to me how equities traded after the release of the earnings. As you said, earnings were excellent first move spike upwards, and then two days of drip, drip back to where they were before the earnings were released.

Or in the case of google that missed it got absolutely punished So that is the pattern you miss you get absolutely killed you beat What happens is a quick flip up and then you return to where you were trading before the earnings were released Which to me says the market is selling the story of a 25 growth in earnings over 2024 and 2025 We no longer believe that narrative or we are prepared to go against it because the forward look is one of worse earnings and lower multiples and that is why equities are coming down and that is why we're at minimum holding of equities and that's why we don't regret it.

Andy: Right. Absolutely. So, did we miss anything? No, we got everything from last week. Auctions were okay. ECB was unchanged with Lagarde being dovish at the margin. Yeah, I think that pretty much covers next, this last week. What do we think about next week? What's the data like? Well, we

Nick: have, naturally, we have NFP, we have ADP, we have ISM, we've got a lot of data, but I don't think that data is going to show us any weakness because it's backward looking.

We already know most of the components of these of these numbers that we are going to get next week. So I think it's too early for those to start showing weakness in the economy and that the tightening that we've had over the past three months is beginning to really impact the real economy, probably too early.

The important stuff. Is not going to be the FOMC or the BOE. It might be the BOJ. We don't know. We, you know, we'll see what the BOJ does, but the FOMC and the BOE, we already know what they're going to do because the market is discounting a 0 percent probability of them moving. Will, you know, Powell tell us anything that we don't know during the press up?

Who knows? Unlikely though, it's low odds. The real data to me next week is going to be the QRA which is going to be released on November the 1st.

Andy: So let me go through that. The quarterly refunding announcement is a report from the U. S. Treasury that's been coming out forever. A report that Nick and I have looked at forever.

And all of a sudden and also pointed out how important it is in this new environment to pay attention to that. And that was the genesis of our call this August to be very cautious on assets. And that's played out. So now all of a sudden this report is getting a tremendous amount of attention from people because they saw the 17 percent sell off in TLT and the 10 percent minimum sell off and all the major equities and know that it happened when that report was announced, since that report was announced pretty much in a straight line.

And so we have a new report coming. And why is this report important? It tells us a couple of things. First, on Monday at 3 o'clock p. m. we will find out what the situation is with the budget deficit and how, what that means in terms of the amount of money. The or bonds and the bills obligations that the treasury will have to issue in order to pay off its debts and then spend the deficit that it creates.

And so the first thing to know is the deficits are rising rapidly and are near 1. 6 trillion. I think there were 1. 7 last year look like minimum 1. 6 trillion. And, you know, that doesn't include a hundred billion, which is a lot for the most recent spending idea that the Biden administration has put forward to deal with the various wars.

And it doesn't address any. Things we need to spend to fund a war. So it's pretty likely it's going to stay very high. So that's a lot of issuance. And on top of that, and this is the more impactful issuance because it represents a new bond that the private sector has to fund. And that is the runoff of the Fed balance sheet at 180 billion per. quarter. And so the government's going to have to issue a lot of obligations to pay off the deficit. And so we'll learn two things. We'll learn on Monday, we'll learn what the Q4 deficit projection is. We've already gotten an estimate of it last August, we'll get a new one for the balance of the quarter, and we expect it to go higher, and thus need more obligations for sale.

And then Q1 estimate, which will be forward looking, will be an estimate of how many bonds and bills and so on needs to be sold. So then, we have the quantity. And so then at 8. 30 on Wednesday this is the day the Fed meets and you know, it's a pretty impactful day. At 8. 30 that morning, we'll get the composition of the funding.

And that is how many bonds versus how many bills and so bills are easy to finance The government can issue a ton of bills fairly easily but they don't want to issue only bills to fund the government That's like borrowing overnight to fund your long term Investments. It's a bad idea. And so They hesitate to issue more than 20 bills each In aggregate for the years, you know, in terms of the total national debt.

So that is a constraint, but what we'll find out is what is, it doesn't really matter how, you know, what to guess at this stage, what you should do is just say. What did the report say? And that is where we come into bond issuance. Bond issuance is harder to fund. Buyers have been lacking for a long time now.

Banks, which are traditional buyers, have been selling. Foreign central banks have been selling. The bond markets for private investors in foreign locations Are more attractive than they've been and so people are Selling their u. s. Bonds and buying their domestic bonds and so there really hasn't been a big buyer that's stepped in so The important thing is these bonds for sale and the larger they are the more impactful they are in assets In August the government said that Q4 would increase bond issuance almost double from 178 billion to 100 to 338 billion.

And that had a huge impact. 160 billion new bonds, net new bonds in the quarter really moved markets 50 to 100, you know, 100 basis points in 10 year notes is what occurred. So, What we thought we'd do is we'd give you a chart and we can put that chart up on the screen and help you think about how this issuance can be looked at and what it means.

And so. Because we care about both the amount of bonds to be issued in the remaining, in Q4, the remaining two months of this quarter, and in Q1, what we'd like you to do is sum the combination of new bond issuance. And so we've given you this table. And as you can see, the table starts with basically, The same bond issuance

338 billion for q one q4 and then Once again that amount to get a total of 676 billion Which would mean no change in the amount of coupon issuance. We think that probability is extremely low But if we saw it we'd be a buyer of assets Because the market would be very surprised with that low in issuance amount.

And it would mean there are fewer assets around to buy, which would be a buy signal. A more realistic low is around 690 billion. I have 688 penciled in here. This assumes that the increase, a small increase in total issuance. And that would still be a buy. More likely, we have these scenarios of 730 to 780 billion of total issuance and the reaction that we would expect.

Those are all medium to medium high to high probabilities. High is my central case estimate. And notice that the bigger it gets, the more aggressively we'd want to go from buying assets to selling assets. Now, it is a remote possibility. That the government's deficit increases a lot, and the government decides to use mostly bonds instead.

Instead of mostly bills to finance the debt. And in that case, an 820 number would a aggressive cell. And so that's what we're looking at. We have an estimate, and that estimate is the one in the highly column. And we think that will be a cell of assets, but what we're going to do is we're going to look at the numbers, see what they say, and act accordingly.

Nick: Absolutely. The one thing to explain is how... And why equities are going to get dragged down with bonds, and why bonds will respond to the supply, and that has to do with the term premium. The term premium at the moment in bonds is not that high. It's much higher than it was, say, three months ago.

But historically looking, it's actually not very high, and can go up quite a bit more. And this issuance... If it's very high, we don't know we will look at the numbers as andy says there's no point in anticipating this Because you're going to have a very big move that is going to last a very long time if issuance of coupons Combined q4 and q1 really is 820 plus billion You're going to have a prolonged move during which term premia in bonds Expand, they probably expand another 20 30 basis points, at least, in which case that is going to Compress multiples inequities absolutely no doubt about it.

It's going to take time, but it's going to be much The same kind of continuation move as we had after the qra in on the 2nd of august Where it started slowly and then people finally realized how bad it was And then it accelerated I expect much the same kind of move over the course of the next couple of months In which case you can forget about the santa rally that everyone is talking about and you just get a Continuation of expansion of term premia in bonds which hits the multiples in equity,

Andy: right?

Completely agree with all those things one other point. You know, we said this big bond supply that came in August was going to cause assets to fall a lot and we were dead on right and we think that another big issuance will do that. If you put yourself in the position of people that haven't believed that thesis They're probably coming around to believing that thesis and are going to, you know, anticipate, not anticipate, but react in a way that is a little bit more cautious in terms of being aggressive buyers of assets in the face of additional supply.

But I think they're still a little bit behind the game. Q1.

We're looking to 2024 and 2025, and the dynamics of a 720 billion of QT Fed balance sheet runoff isn't going away. There's a trillion and a half to come of QT. And that trillion and a half bonds, forget about the deficit, you know, the deficit is one thing. That trillion and a half Bond issuance which the private sector will have to buy is coming and we don't think the market's ready for it yet And they're just catching up to it being a sort of quarter by quarter thing and haven't yet fully discounted the full extent of the impact and so We'll see how the market front runs that, but a trillion and a half is very hard for people to price in immediately.

Sometimes it's just the supply that pushes things down. And so, you know, that's the framework we're now looking at the QRA. We said an instantaneous piece of news would move the market. Now we're saying it's sort of really two month, two quarters that's going to move the market. At some point, it's going to be the whole ball of wax that people are going to appreciate.

And we don't think we're there yet.

Nick: Yes, it's going to take time. And I think the first reaction, especially if Janet does some magic trick and shifts issuance into bonds, into bills rather, the market is probably going to have the wrong reaction, i. e. the right reaction as we've said, but the wrong Long term reaction and we will you know, we will basically played by ear And we know that the market is going to squeeze both bonds and equities if the issuance is lower than they feared But that is going to be yet another opportunity for long term players And we will play that one week at a time.

There is absolutely no need to rush Anything that happens on the on November the 1st, we will immediately send you an email. We'll tell you what our immediate reaction is. If we want to change the composition of our immediate portfolio, we will do so in that email. And if we don't, we will tell you that as well.

Just know that longer term, we think that things are not good, but we will play them in the short term as well as in the long term.

Andy: Thanks for having us again in your living room or wherever and Nick will do his bit on Review of the portfolio.

Nick: Thank you very much indeed. Bye. Bye

This was a long episode so i'll keep it very brief as you know, we have done nothing We have kept the allocations as they were the week before. Just a quick word. We are down 8, 000 since the beginning of the QRA episode. And that is the price we pay for having an allocation, a minimum allocation of 20 percent in in equities.

We are very happy with the allocations that we have now. We are very happy with the yields. As I mentioned last week, the melded rate that we have. In our bond portfolio, we think that's going to be great next year. Absolutely brilliant. And we're looking in fact, to add when it's appropriate, we prefer commodities to gold simply because the real yield at two 50 we just don't think gold can keep up.

And I think gold is going to collapse once the Gaza episode is out of the way. What I have done is updated the chart pack, but also what I've done is updated naturally the broker statements. But one thing that I've added here is the QuickStrike FedWatch tool. So you can watch the probabilities of changes of Fed action at various meetings.

It's a very interesting tool and I encourage you to use it. Anything that we want to do, naturally we are no orders for next week, no active orders, but we will immediately send you out an email on the 1st of November as soon as we've calculated all the numbers and then we can tell you whether we think it's an aggressive sell or whether we think that actually it Assets are a short term buy because it's only going to be a short term thing And we will act accordingly though, and this is a long term process One week at a time.

Have a wonderful weekend