Nick: Good morning. Today is December the 9th and this is yet another episode of Two Gray Beards. The year is coming to a close and we probably have one of the most important weeks of the year coming next week. But first of all, I'd like to go over what happened last week and let's see how important that was.

There's nothing really in the economic data that is coming out, whether it's secondary or primary like NFP, which indicates that the economy is doing anything but fine. employment keeps on being created at a roughly the rate of 150 to 200, 000 jobs per month. The unemployment rate is constant between 3. 5 and 4 percent and keeps on going up and down within those parameters. And inflation is slowly falling towards target. There's absolutely nothing which suggests that we are getting a reacceleration of inflation at the moment because again last week Oil prices fell even more and they got to below 70 Although they did stabilize at 70 But what I did find interesting was that Wader japan's governor of the BOJ was Pushing back against the falling yields that they had there and basically hinting that they might go off the zirp-zero interest rate policy that they have Sooner than the market might expect.

So this is the background with which we are going into next week and next week we do have a lot of duration supply threes tens and thirties on monday and tuesday The CPI number followed then by the FOMC on Wednesday and the ECB on Thursday. I think the ECB is going to be just as important as the FOMC.

So Andy, let's discuss what you think is going to happen next week, primarily with the FOMC.

Andy: The last week, as Nick said, was pretty much a non event except some pushback on that was created by the NFP being a little warmer than expected on short term interest rates. But by and large, next week is all that matters.

And let's dig into the FOMC. And I'll post a graph of these things with this episode. But the important thing to understand is that this is a Fed meeting in which they pencil in their summary of economic projections. And the summary of economic projections is often called the dot plot. And it really is just that, a projection.

It's not a forecast. It's just what the Fed Each governor gets a dot and they sum them all up and we get to see what they're thinking for the economy. And so it helps to look at what they were thinking last September when we got the last dot plot. And so on that dot plot, Starting with the headline.

What does it all mean for markets? The federal funds rate was projected to end the year this year at 5. 6 percent and it ended the year effective fed funds rates ended the year or and are ending the year at 5. 35%. And so, and they're not going to hike in December. That's So the first thing that has to happen is that the dot plot for 2024 has to reflect the Idea that they did not hike.

So we'll come back to that. The next things for 2024 that we'll see on the dot plot are the various economic indicators, starting with GDP um, in on GDP, they had expected the. In September, they had expected the GDP to grow at 1. 5 percent for 2024. I suspect they'll probably reduce

that somewhat, maybe 1. 3 at the worst, but probably more like 1. 4 to reflect the slowing economy. The. Unemployment rate was projected to be 4. 1 as of September. And based on the unemployment rate we saw yes on Friday, yesterday, one might have thought, that number was likely to go up, but based on the report we saw on Friday, I'm not sure about that.

So, perhaps they keep the unemployment rate projection consistent with a soft landing and at 4. 1%. And then lastly, they project the core PCE, which is their inflation metric. They project the headline too, but that's less useful. And the core PCE was 2. 6 in September, and it's likely to be lower, maybe 2. 4%.

The question is, why am I saying all these numbers for you, and why does it all matter? And the answer is, that as of well, since, what, Nick? Oh, this summer. The Fed has been discussing the idea, and we have here, the idea that real Fed funds rates, what is the thing that expresses the tightening of financial conditions that they look at.

And real Fed funds rates, in a declining inflation environment, require the Fed to cut rates simply to address the nominal rate to maintain a risk the same real rate. And so here we are, inflation expectations are likely to be marked down on their projection, which implies a decline In the real rate, as does if they lower the GDP projection, which it's unclear that they will much, but maybe a little bit.

And those common things combined to something that's called the modified Taylor rule. And that's what the fed has been articulating as their reason for months now, even in the SCP plots of months ago, many months ago, they had. Penciled in rate cuts. So they're going to need to pencil in rate cuts again.

And so what the market's going to be looking at next week is what that dot says. And Wall Street research, et cetera, the pricing in markets is expecting a very low nominal Fed funds rate projection, lots of cuts. In 2024 and their own rule doesn't really support that. Remember I said mechanically they're going to have to lower the 2024 dot by 25 basis points taking it from 5 to 4. 85. How much

lower? Well, the Taylor rule says probably around 15 basis points. So their own math is saying 4. 7 percent on that 2024 dot. Market pricing. Is for, and that would reflect a little, they had two high cuts priced in 2024 in September, that would reflect two to three cuts priced in their SEP plot, the markets price for four to five cuts.

And so, if they stay on completely unbiased by any other monetary policy goal, completely unbiased and just follow the dots. The market will be disappointed.

Nick: Yeah, I think that is the balance of probabilities. And I think you've explained the modified Taylor rule and what they are trying to do is to keep real interest rates steady.

At a restrictive level. Now, what is a restrictive level? Real rates at the moment are just below 2%, and I think that is a reasonably restrictive level to keep them at or to try to keep them at for

the foreseeable future. But you're absolutely right, Andy, if the dot plots are anywhere around the 4. 65 area.

For 2024, the market, the very short end of the market has to be disappointed because it will have to price out at least one cut that they have already priced in, and that gives us a two year rate, about 15 to 20 basis points higher. And probably let's guess and say 10 basis points higher in the 30 year Certainly nothing that is going to destroy the market either in equities or in bonds just a modest backup What will be interesting is how he justifies this during the presser because you can justify it in hawkish terms or you can justify it in relatively benign terms.

If he were to be asked, well, financial conditions have eased a lot. Would you endorse that easing of financial conditions over the course of the past month? And he could waffle and say, not a lot, in which case we know what equity is going to do. Equities are going to like it. Equities are going to say, okay, they have.

Hawkish dot plots, but the rhetoric that they are accompanying that with is not hawkish. And then, the animal spirits and the Santa rally will get going again. And that is why We would Ideally like to buy a backup in yields in bonds, but we don't know until he sits down on Wednesday how the market reaction is going to play out because he could say almost anything during the presser and validate those dark plots or almost negate them.

Right?

Andy: Yeah, so I think we're coming in expecting the dot plots to be hot, more hot, and we said, as it relates to the two year rate, more hawkish than market expectations, supported by a decent NFP number and also just their own math, like forget the data. Their own math suggests a dot plot that isn't going to come down anywhere near as low at more, the amount of cuts as markets expect.

So that should have a negative impact. And then, gosh, I lean toward the idea that the Fed And all of its rhetoric was aggressively describing the long term interest rates at 5 percent as helping the Fed do its job. For sure. Even at the presser a little over a month ago, that's what Powell said.

And other said as well. And since then, 10 year yields have rallied 80 basis points. And so the Everything they said about long term interest rates not doing their doing the job of the Fed for them has reversed. And that acts as if there was a rate cut. Since then. Now, who knows what the reporters will ask or whether Powell will address it face on in the the pre question and answer testimony, and certainly it's unlikely it'll be addressed in the statement itself.

But that's a wild card. It clearly has been an easing of financial conditions that the Fed themselves said they depended on the tightening effect. So it'll be an interesting issue on whether how they come back, how they walk that back, or more relevantly, if a bold question reporter asks a question, but Powell could dodge it.

Yeah. And so we don't know. So we're going to have to literally listen to what the question and answers are and how they're responded to. But

I would say that the market, given current pricing of term premium and level of equity markets and level of rates is exposed to a hawkish surprise more than it is a dovish surprise on that

Nick: particular topic. Yeah, I would agree with you. The balance of probabilities is certainly that the market will be disappointed.

Powell could make it very disappointed or only moderately disappointed, but the balance of probabilities is the one where rates back up, especially at the short end. And he's basically going to say, wow, boys. We agree with you that nominal rates need to come down as real rates remain steady around 2 percent as inflation falls, but that is going to take a long time and we want to be absolutely sure.

That the second wave, the potential second wave of inflation does not materialize and that we will be able to maintain it at 2 percent in the long term.

So the balance of probabilities is certainly that the market backs up a little bit. How far impossible to tell depends on a such a multitude of factors, what he says, what word he uses, et cetera, et cetera.

All we can do is expect that outcome. But we will know, when we see it, what the right thing to do is. And that is why, what we have done is we've sold our TLT. We didn't manage to sell our shy, but we have 25 percent in cash. So we are very well positioned to take advantage of the market disappointment should it come

Andy: Yeah and I think that also has to be put in context with 110 billion dollars of threes tens and thirties and how those are absorbed going ahead as the fed meeting, begins before but before any announcement is made and also how Inflation data comes in which is likely to continue to be On trend particularly headline given the price of oil And, those features are all going to make it a pretty robust set of news and information.

And so I guess it's possible that something happens before the fed and we'll mention if it does, but look for the fed and expect. If there is a backup in the part of the curve that we're most interested in and you've seen the videos about buying Individual bonds look for an email from

Nick: us. Yes, absolutely You'll get an email within 15 minutes of pal having sat down So expect one around 3 30 3 45 and we will make portfolio changes accordingly Thank you very much indeed.

See you next week. See you next week So in pictorial terms, what we were talking about is a backup in yields. And this is the five year note to somewhere around here, the 440 level, which we would like to see. To buy it and that is still our intention, but since we don't know how hawkish she can possibly be as we said the best thing to do is to send you an email With the

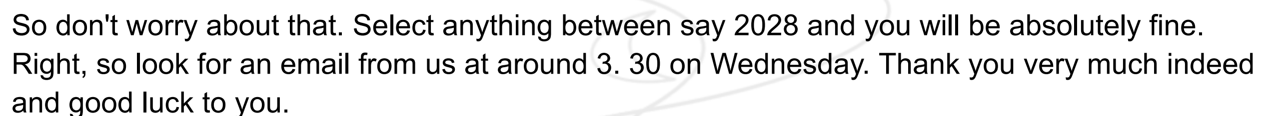
precise details of what orders we are putting in just as soon as he has sat down On wednesday as far as the account is concerned as I mentioned we sold All our position in TLT.

We didn't sell anything in SHY. We didn't get our price. So this is where we are at the moment. We've got 32 percent in equities, 36 percent in really short bonds, because mainly we have VWOB and TIP. So we really are not all that exposed to a backup in rates. And we do want to buy the backup in rates via.

buying individual shares. We have 25 percent in cash, therefore we will be able to deploy that in whatever manner we think is best after Powell has spoken. I've updated the broker statements, you will find them all in here this is including

the monthly, so every single broker statement is here and you can just download them at your leisure.

For the orders, as you can see, we intend to buy the belly. These are the bonds that I selected, but really if you select different ones, it's not going to make any difference. The, it's going to be one basis point different or something like that. And unless you are trading in the tens of millions, the liquidity is really not a problem.



So don't worry about that. Select anything between say 2028 and you will be absolutely fine. Right, so look for an email from us at around 3. 30 on Wednesday. Thank you very much indeed and good luck to you.