Nick: Hello, good morning. And today is the 9th of March, Saturday. Another episode of Two Gray Beards. And what happened last week? Well, the big news, I guess, was NFP because nothing else really moved the market very much. And the NFP number was a bit cold. The revisions for January made it look a lot stronger than it was in reality because we had a complete reversal of what we thought was the case in January, i.

e. the figures were not really at all strong in January. And that gives some people confidence that the CPI figures for January We're also an aberration which will be revised in future and that the Fed is pretty much on track to deliver the terminal rate they, they say they will deliver by the end of 2025.

What do you think, Andy?

Andy: Yeah, I mean, it was 150, 000 roughly jobs revision down now that February was 75, 000 more than expected. So when you add those two things up, it's 75, 000 less than what was predicted over those last two months. And that created enough

weakness for the market to respond favorably. And one, the initial reaction was quite favorable with global equities up dollar down bonds very strong. And that all reversed by the end of the end of the day. Largely the bond market faded, but didn't really sell off. And the equity market. And that makes sense because the numbers were weak.

The equity market really reversed, but I think that was pretty narrow.

Nick: Yeah, very narrow. If you look at the Dow, it has basically done nothing at all over the course of five weeks, the close closes of the week for the past five weeks have been nearly identical within half a percentage point of each other.

So it's not equities, it's Nvidia and. All the other mean stocks which go up and down 10 percent per day. That is the only thing that reversed. Will that continue? Who knows? But it's certainly not stocks which are strong. It's individual shares within the company. All individual sectors like semiconductors within those indices.

Andy: Yeah. I tweeted that a damped spring on Friday. If you want to scroll back on my Twitter feed and show how narrow both. The whole 2023 till today and most recently 2024, it's really four or five stocks and largely it's one stock and that stock went down for the first time. It's basically been one direction for almost a year now, over a year now.

And that stock went down for the first time basically. And who knows what, what it'll do next.

Nick: Correct. Now, one thing that we should comment on is what Biden said during his election rally on Friday evening late. And you can see that here now, Andy, I don't think this is significant in the slightest.

I think that the market probably on Sunday evening and Monday morning will take it as very bullish news and take the excuse to go higher. But it's something that longer term investors should completely look through. What do you think?

Andy: Yeah, I mean, I think it, it, it fits well with his state of the union address on Thursday and his proposal to provide a tax credit for homeowner Pete for first time homebuyers.

And His design, the big issue for him is housing affordability. And you know, he's his goal is to make houses more affordable. And so we proposed something that, you know, gives money to people who buy homes. Of course, it won't pass, but, it's a proposal. And on the back of that, he also wants interest rates to be, he thinks the Fed will cut interest rates.

While that's great speaking as the president of the United States and people may perceive on Sunday night that he has influence on the Fed to cut interest rates. Anybody who's been listening to two gray beards or. Basically has been alive in the real world knows the Fed is going to cut interest rates in the next few in 2024.

And that's not unexpected. Nonetheless, who knows how markets can react. And so it's possible you get a rally on Sunday night.

Nick: Yeah. Sunday night, Monday morning, you certainly get a rally out of it, but it's something that we should not chase or anyone should chase in any shape or form. This is.

Politicking this is something that the fed will look completely through and really the big news Will not be biden by tuesday, but it's going to be cpi

Andy: indeed you know, we have a a couple of things happening we have cpi and ppi and Those are going to be the the key data, but we also at the same time and it Is important.

We also have 117 billion of threes, tens and 30 year notes being auctioned while the market is digesting the news. And so, you know, what we're trying to figure out is what to do, depending on various CPI cases.

Nick: Yeah, if CPI is a cold number, I think that it's very predictable that the FOMC will be content to keep the current dot plots, which does not mean that the market will not rally because don't forget the market rallied to seven cuts.

When the FMC was showing three, I don't think it's going to go that extreme, but it'll go in that direction. Certainly, the market will like the fact that the Fed is on track and don't forget that many, many Fed governors have said that they don't need better data. than the ones we've been getting.

They just need it to be consistent. And that will be another sign of consistent data with their dot plots. And therefore, we think that the chances of them changing their dot plots or the median dot plot to something higher, which really has been a probability up to up to now, those probabilities will disappear and go back towards zero.

I think that the odds of them actually lowering the median dot plot are also very close to zero. I. e. they will keep exactly the dot plots they showed us in December and they won't change them at all. But that will be enough for the bond market to quite like it.

Andy: Yeah, absolutely. You know, as we kick around that, we start with how many cuts are priced in.

The dot plot is currently at, which is their projection is currently at three. It's cuspy on whether it'll be two. And as Nick said, data would have to push it to two cuts and data would confirm it at three cuts. And so the market will react. So let's assume it's cold. CPI is cold. You're going to get the dot plot.

Okay. Without a doubt, the following when Thursday, Wednesday or Thursday, when the FOMC speaks will confirm three cuts in 2024. And then the market will price five. Maybe they'll price six, but they're not going to price three. So that means the front end is going to rally on a cold number. What about the rest of the curve?

Nick: The rest of the curve will probably do not a lot simply because we have the 10 year auction and the 30 year auction. The curve itself will steepen, but Probably not a lot. So I, I, I certainly am still of the view that the risk reward is to be positioned exactly as we are positioned in the belly of the curve, because that will be the area that responds most to the terminal rate.

Or when we get to the terminal rate. So, let's say that today is December of 2025, and the Fed has delivered everything that it had, it promised in its stock plots. Where are two year notes? Well, two year notes are somewhere around 3. 5%. Where are three year notes? Well, they are somewhere around 360, 370.

Where are five year notes? Around 380. And where, where are bonds? Where are long bonds? Well, probably this side of 4%, i. e. not very far from where they are now, in which case the risk reward is to be long of threes and fours. And just ride the curve down for appreciation and positive carry.

Andy: Right. That's the whole, that's the whole reason we're where we're at, why we don't like the long end, why the short end, you know, is, is again, just pricing the cuts.

So we like the belly. And the only risk to that is that for some reason the Fed decides to increase the terminal rate because then the fives won't, the fours and fives won't rally. They're not a bad investment in that case, and hence the risk reward is, is strong because other things will do the same.

Do worse, but that's the risk of the belly is whether the Fed decides to keep interest, the terminal rate, the final rate that is neither accommodative nor stimulative two and a half percent. If they increase it, that's where the belly does worse. But on a cold number, there's no chance of that. There's no very little chance of it on a hot number, but there's certainly no chance on a cold number.

So we like the risk reward of the belly still.

Nick: Absolutely. And I think our portfolio is fairly ideally positioned at the moment for the information that we currently have. The one thing that we should probably mention is gold, which rallied very strongly last week. Myself, I don't have a very good explanation for it.

I have several. Marginal explanations, but anything that you see, Andy, that makes you believe that this moving gold has been reasonable in, in terms of size, because it's rallied a hell of a lot compared to what I thought it would rally. I thought it would rally, but this has been quite a bit more.

Andy: Yeah, I mean, it's outperformed real rates, real rates have rallied, but gold has rallied more that happens on occasion, just for no reason at all.

I think there's some narratives out there like crypto's rallying. So gold should rally because crypto is. Gold is digital gold. I guess that's possible. The driver of the common driver would to me be overly easy central banks and and banks losing and central banks losing credibility. I don't see either evidence of either of those things, but markets seem to be heading in that direction.

Nick: Yeah, I, I think my own explanation, which I'm not 100 percent sure is completely accurate is that we had a lot of people expecting that the dollar would do better. And the dollar reversed, which made sense bonds also rallied. And therefore you got the double whammy or both the dollar going down and the bonds going up in price down in yield and gold got squeezed because it's a much smaller market and a small amount of money tends to move it quite a bit, but just as it moves very quickly up, it also moves very quickly down.

We don't think it's the time to get rid of our allocation in gold and we went from zero to seven percent So this actually does suit us We will probably decide what to do with it after cpi and in fact after cpi is the time To reallocate not before it simply because it's going to be such a crucial piece of data

Andy: Yeah, so let's talk about a hot number.

We discussed, I agree on gold. Let's talk about what happens in the event of a hot number.

Nick: I think because we have the 10 year auction a few hours after the CPI and the 30 year the next day. They're going to take bonds down quite a bit you know, because they will want to get them as cheap as possible.

And they'll have to price in the fact that the odds will increase that the fed will go to two cuts median. I don't think the curve will do very much. It will definitely flatten a little bit simply because on Monday, don't forget a lot of people are going to be buying the short end of the back of Biden.

Which I think is completely the wrong thing to do, but I don't think equities will go up for sure that, but I think they will come down less than bonds. Bonds are going to be nobody's friends. If the CPI is hot.

Andy: Yeah. I, you know, as, as we said the odds would favor significantly that the dot plot on the following week would then have two cuts instead of three And so the front end will sell off, but it won't sell off to two cuts, and it certainly won't sell off to something like, Oh my gosh, there's going to be hikes now.

Now, anything can happen, and the market can go too far. But, you know, down at three hikes priced in, cuts priced in, I think you'll probably see some support for the front end. And, Because of the, and so that'll be a call it 25 basis point sell off in the front end, but the supply might cause the long end to not to sell off quite as much as that, but, and thus flatten, but move at least 20 basis points, 15 basis points.

And so that should take some of the legs out from equities as well. But as Nick said. Equities should like warm economy, warm nominal, nominal GDP and inflation is, is not as bad for equities as it is for bonds. So in the event of a hot number, you know, I would expect equities to outperform bonds. Yeah, for sure.

But both likely go down.

Nick: Yeah. Volatility has been very low, hasn't it, Andy? I mean, I keep on looking at the returns of the portfolio and they're so steady, nice little upward path. This is something that we don't see very often, this kind of very low volatility of returns.

Andy: Yeah, it only the year that it reminds me of is 2017, where you had a basically an entire year without an, without an asset drawdown of any sort, not even an equity drawdown of any sort, you know, less than 5 percent less, I think it was less than 3 percent the whole time and realized volatility was single digits.

And, you know, that reflects low economic risk, low. stress in the financial system, low changes in policy, low global geopolitical conflict, all of those things. And, and in 2017, we had tax relief for corporations, all of those things that we experienced in 2017 that led to low volatility. Not one of them seems to be true today.

Like all the things I just said, I would think that would volatility would be high, but it's not. And so, you know, it, it is to me, something to be cautious about for portfolios that, that it can happen. We can have a whole year of low volatility. And if so, we're going to have these continued grinding returns in portfolios.

Nick: Yeah, but in any case, we will see the CPI and we will decide what to do after it. We really are extremely well positioned, I think, and nothing that we need to change before it. If the narrative changes after it, we will email you straight away. And i'll do that in my next second. Sounds great. See you next week much indeed.

See you soon Let's have a look at the portfolio allocation Since the qqq options are expiring on the 15th And they are now out of the money i've made return this to 159 shares of QQQ, but don't forget that we do still have this short the 442 call again to the 15th of March. So that could become 59 and we get the cash instead.

But this is the situation at the moment. We've added the XLI, the ETA, the XLE, the EUFN, and the EWW. So we're now at the moment around 43 percent in equities, 40 percent in bonds, and as we discussed, we think that we are right at the moment. where the risk reward is. We will probably decide to sell into a big rally, probably something like tip.

This is not something that we really need to discuss now because we will send you an email after CPI. Because that is the right time to actually make decisions, not before we have seen what the CPI is. It will be seminal because it really will affect how the path forward looks and what the Fed decides.

I believe that if they have to change their dot plots, there is a chance that they might even have to change the 2025 terminal rate, but this is something that we will discuss and we will send you an email with any allocations. Please make sure that you are registered on this link and that you check your email so that you receive a notification.

Punctually the email we expect it to be out by 9 a. m Because the cpi is out by 5 30 In any case all the broker statements are updated even the monthly so you can have a look at those And the performance is here Everything is updated for your convenience Thank you very much indeed and expect an email on tuesday before 9 a.

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