

Nick: Hello and we have a surprise for you. We are together in Miami, so we are not, no longer at opposite ends of the East Coast, but we are together to discuss what the Fed did and the implications going forward for our investing. So Andy, tell me what you think and then I'll tell you what I think.

Andy: Sure. So the big news of the week was the FOMC and other central banks, but mostly the FOMC.

And as we highlighted in our last episode, the dot plot was the important part, but it turns out that was less important than the way that Chairman Powell Coached his language for the future. And the way I describe the dot plot is simple. They decided to keep 3 cuts priced in for 2024. They.

Reduced the cuts in 2025, meaning they raised the interest rate they expected for 2025 and they increased the long term interest rate, which has been static for about 4 years. Modestly the. Economic drivers for those changes, which were tighter financial tighter rate rates were a significant increase, not unexpected, but significant increase for the real GDP for 2024.

The Fed was at 1.4 in December when the economy looked like it was turning down, but since then, the economy has performed well. And economic consensus has risen up amongst Wall Street professionals and analysts, et cetera, has risen to 2.1 and the Fed matched that. So they think the economy is going to continue to have a relatively strong growth.

They also increased surprisingly the core PCE number, perhaps, and that's the inflation number. Perhaps that's in response to the couple of months now we've seen. Core bottom, sorry, go up relative to where it had been in the 4th quarter. So, all in all, those are stronger economy, higher inflation dots and so.

You look at that and say the Fed expects the economy run hot for a while and then, and I think this is the key thing about the 2024 dot that I think caught people by surprise. Certainly caught me by surprise was that they didn't with all those things happening. They didn't take out cuts from 3 to 2. Now, when you look at the dot plot.

And you look at the 2024 cuts of the 19 members who voted 1 of them. It really mattered what the person with 3 cuts moving to 2 cuts did. And 1 of the moved 1 of them didn't move. And I think that's extremely important because that's probably chairman powell others across the board move to a higher rate.

By 2024 and so the average actually was moved up quite a bit where the median didn't move at all. So that brings us to Powell and Powell was. Very relaxed very somewhat dismissive of the idea of the 2 hotter inflation cycles we've had in January and February pushed back strongly about FCI, not really mattering much to the Fed and that he said that conditions were we're restrictive and also opened up what would it could only be perceived as a dovish view of quantitative tightening tapering fairly soon.

And so, when you add all those things up, the chair clearly wants to, cut, and. That just makes one think about what the implication is when you have the GDP rallying and, sorry, rising, GDP estimates rising, and inflation warmer. It appears that the chair wants to allow the economy to run hot in 2024.

Nick: Now that is my key takeaway. The Fed is going to do its utmost to keep the economy running hotter. For longer so it was higher for longer now. It's hotter for longer I my key takeaway is that two and a half percent inflation is probably the new two percent So they are tolerating a bit higher inflation I would have thought three to three and a half is too much for them But two and a half to three is close enough and therefore I just can't see You Who in their right mind is going to rush to buy nominal bonds at four and a quarter percent right now.

To me the odds are changing and that is why we made the changes in the portfolio that we did. If you now tolerate two and a half percent inflation and it's going to be sticky there, well odds are that the new range is going to be two and a half to three. In which case tips are going to perform much better and give you a better yield than nominal bonds And that is why we got out of all our nominal bonds and I spent the whole of thursday Looking through my portfolio and selling anything that was fixed income and nominal so I did a complete clear out of everything because I just then see the value Since I've been told by Powell that he's going to tolerate higher inflation.

Now, inflation could collapse, but the odds of it happening are very low indeed. And here we have to play the odds. The odds now favor hotter inflation, higher growth for longer, and therefore, A bigger allocation to risk and a smaller allocation to nominal bonds. Would you agree with that?

Andy: Absolutely.

The thing that, and this is for a loan only portfolio, that you want to own for a long time in an environment like that, that Nick just described. Nominal assets just do poorly. There's a lot of other reasons why we have not favored nominal

bonds and we haven't owned TLT for, almost, I don't remember how long it's been.

And that includes the very large supply of nominal bonds that's going to be issued over the next half of the year, or three quarters, for that matter, the next two years. And the extreme inversion of the curve, which means that The buyers that would normally buy a bond when it is trading with a positive yield, but spread to short term rates just aren't there to support the bond market.

So it doesn't appear that there's any reason to own the long term bond market, and I don't, we've said this a number of times, and it's certainly key to my thesis in at Damp Spring. Is I don't think the economy weakens until long term bonds have a much higher yield. We saw a modest slowing of the economy in the third, fourth quarter because nominal bond yields had risen over 5%.

At four and a quarter, they're not going to constrain the economy. So at some level, you look at the. At the Fed and say we're willing to raise allow the economy to run hot. Part of that actually is directed at the long term bond market to sell off so that the economy can then be impacted by that higher long term rate.

So I think you're fighting the Fed to buy long term bonds here.

Nick: I absolutely agree. I just can't see the attractiveness. I can't see the risk reward. You always have to play the odds, and the odds are in favor of tips versus nominal bonds. And let's mention why we changed allocations to equities. Because if the Fed is correct, and they're going to be able to run the economy hotter for longer, then this rally in equities should actually broaden to cyclical sectors.

And instead of just having one big leader, which is AI and tech in general, the QQQs, you get this broadening of the rally to the whole economy, and therefore you want to be as diversified as possible. In your choice of equities and that's why we chose VTI, which is an exposure to about 1600 stocks As opposed to the QQQs, which is a hundred and stuff like that So that is what we're trying to do.

We're trying to listen to the Fed Agree with the Fed And invest according to what they're telling us that they're seeing happening to the economy or what they want to see happen to the economy. In which case, I think we have the correct allocations now

Andy: for a while. Yeah, it's certainly the case that a stronger economy with higher inflation.

Is good for broad equities. And so the, that has been what we've been having though. So the question is why now relative to 2 months ago, and I think the important part is, this is an endorsement by the Fed. That they will, in fact, let this happen. The fact that it has been happening is a little different than the fact that they now endorse it happening by cutting when it's unclear why so, yeah, I think it's, I think that's the play for the next three months.

We're what, about 40 percent ish long equities and that hasn't really changed. It's really about the allocation and that's the right play until the Fed decides to, Slow the economy and or long term bond market decides to slow the economy. I don't know which or if either will happen.

Right? But if both of those happen or 1 or the other of those happen that's when you want to get defensive inequities and when you want to get more concentrated in things that perform well, when the economy is slowing. I

Nick: think you said it correctly. The only thing that's going to kill this equity rally is going to be bonds, and that is nowhere near on the horizon at the moment, and Until it happens, you have to stay long, longer of equities because equities will outperform bonds.

That's all there is to it. And I think we have the correct allocation now and we don't need to change it for a bit. What I think we need to do in the weeks and months ahead is think about the rest of the world. It's a big world out there and a lot of countries and sectors could be doing a lot of catch up.

To what has happened in the U. S. as well, because it's because what is going to happen is that the rest of the world might start catching up with the U. S. But that is something that we need to think about for the next over the course of the next couple of weeks. There's no rush because Equities in the U.

S. are very expensive relative to equities in the rest of the world, and therefore if the whole of the world economy is supported by the Fed cutting first in June, followed by the ECB, followed by, and the Swiss National Bank did it this week, then the Bank of England, so it'll be a cascade of rate cuts around the world, and that should support asset prices.

Throughout the world, and therefore we should think about reallocating some from U. S. exposure to rest of the world exposure because the rest of the world is trading at much cheaper valuations. That could catch up.

Andy: Right. And the question that any equity investor has been thinking about, we've been fairly defensively positioned and any equity investor should be thinking about with crypto near its highs with Nasdaq, S& P, Dow, all at their highs is whether to rush and, I still think there's no need and perhaps we are under allocated equities, but I don't think so.

I think we're solidly invested. So the question becomes, is this the time to lever up? Is this the time to replace with call spreads? And I don't think so at this stage. I think it's just a time to patiently. look at what the data is providing us and make moves based on that.

Nick: Absolutely. I think you've got the message.

We think that nominal bonds are really going to underperform, certainly tips, hopefully, but. In a normal portfolio, I think nominal bonds are now going to be the worst performer. In any case, what's going to happen next week? Very light calendar. All we have is some auctions, those fives and sevens, and some very secondary data, GDP from before.

For the fourth quarter. So we are not really all that interested. Well, we'll get that

Andy: PCE figure on Thursday, right? It's a short week. Good Friday. On Friday. But we know what that is, but we know what the PCE is, so it is, I agree with your synthesis. It's a lot of short-term bonds. Twos, fives and sevens.

I think the number was 172 billion bonds. Yeah, it's a lot. So. For my own prop positions at Damp Spring, I'm looking at selling 10 year bonds as we just described short selling 10 year bonds, but I'm also looking to acquire some two year bonds because at this stage, what is priced in on the short end of the yield curve is what?

The fed has said they're planning on doing which to be honest is the first time that's happened. Yeah for a long time So jimmy,

Jimmy: I have a question for you guys. Yeah,

Andy: look who's here jimmy jude

Jimmy: What do you guys think about commodities and energy in this?

Andy: Well, you know the growth should indicate strong demand for both of these commodities and the easy the willingness to allow inflation to You Stay the economy to stay hot should bode well for both commodities oil and the metals But they've run a long way and seem to be flagging to me.

Jimmy: Absolutely do you think so? There's basically what you it's going to be a muted reaction across the board until we see the long end Bonds take out their february lows and really start Getting the market's attention until then It is it's probably by the dip in equities. Or maybe by a big dip not a little dip in equities.

And Like you said they're gonna let they're gonna let the environment run a little bit hot. Yep Okay,

Nick: that seems to be the consensus now, right? Anyway that's all we have for you this week and We're not going to be with you next week because it's good friday and easter So we wish you a very happy easter and we'll see you in two weeks time.

Sounds great We already posted this file on Thursday after all the changes were made. But once again, this is as of Friday, we are 40 percent invested in equities and mainly in VTI, so we have a broad dispersion. We are 20 percent in long tips and another 20 percent in short. tips with 5 percent in cash in the USFR FRN and we have 10 percent in gold and 5 percent in GSG commodities.

We feel that this is now broadly balanced and we would like to stay with it for a while. We might want in the weeks ahead to start buying some foreign diversification because There will be a catch up trade from those should the world economy be doing better as the Fed implies then probably a little bit of foreign equities more of an add to foreign equities as to just the EUFN is warranted and we will be thinking about that in the weeks ahead otherwise The broker statements are updated.

The order entry, as you can see, there is none for next week. And if you want to read the summary of economic projections by the Fed, all you have to do is click there. The monthly performance is also updated. And that is all we have for you now. Have a wonderful Easter holiday. And we will return in two weeks.