

Nick: Good morning, ladies and gentlemen. Today is May the 11th and another update from your favorite two grey beards. We had a very quiet week last week, which was not pivotal and, but that can't be said about next week. Next week is likely to be extremely important. Isn't it Andy?

Andy: Yeah, just to cover last week.

We had no data essentially except a weak jobless claims number which caused some moves a little bit in the front end of the yield curve which then reversed. But what was notable, if anything, was the three auctions, 125 billion of three year, 10 year, and 30 year bonds. And all of the auctions went fine in the moment.

However, all of them ended the week fairly underwater, meaning everybody who bought a bond during those auctions is at a loss today.

Nick: Yeah.

Andy: But next week's a big deal.

Nick: Yes. No and this is what keeps on happening in the bond market. We rally on some. Data, which some people perceive as slightly bullish, people have been looking for unemployment claims to start rising for about a year and finally they get a week in which they rise by about 10, 000 more than expected.

They get all excited. And it reverses within 24 hours. So, that is, just keeps on happening. And I don't, but I do think that whatever happens next week is going to stick. So, let's try and cover what the data that we have next week is, and how it's likely to influence markets. Because we not only have inflation data, with ppi and cpi, but we also have Retail sales and another set of unemployment claims which might or might not confirm Last week's because last week's was really skewed towards one state and that's new york So that could be a complete outlier which could easily be reversed this week So let's have a look at the mood music behind everything that's happening Last week, we also had the Bank of England, which wants to cut just like the Fed wants to cut the Bank of England would like to start cutting rates at some stage soon because they say they are restrictive and they can see their economy slightly weakening and their inflation rates slightly weakening.

Then we had the the Swedish Central Bank, the Riksbank actually cutting rates. For the first time in something like eight eight or nine years So there is this mood music behind Everything where the central banks are afraid that they

might be starting to hurt the economy The real economy and as soon as the inflation data allows them they would like to start cutting rates So let's have a look andy.

What do you think happens? in the various scenarios, let's start with The one which is most probable and that is that the inflation data is in line Or slightly higher than expected.

Andy: Yeah. I'd like to step back and say that basically the set of data is prices CPI and sales, which is a measure of.

Demand how much the consumer is buying which isn't a measure of supply So may not necessarily be perfectly aligned with inflation But is a measure of demand and then lastly jobs which are is the ability to continue to demand And so when you put those in context, we're looking at Is inflation slowing?

Sorry, is the is the disinflation that the Fed expects going in a good direction, which is toward target, or going or staying sticky? And when we look at retail sales, we're looking at whether the economy still has demand or there is demand destruction, which would align with future falling prices and then jobs obviously is important to determine whether the real economy is weakening.

So when you add those things up, I think you start with what happens if everything's in line. And so meaning meets expectations. And so with those levels, the, what we have seen what is priced is June being fairly off the table as a rate cut. One to two cuts happening in 2024 and four to five cuts happening between now and December, 2025 over the 13 meetings.

And so we would expect that to stick about the same. And if then What does that mean for the longer term bonds? We continue to think that longer term bonds offer very little value. Because of their term premium and their high inversion. So, I would expect those to continue to drift farther out.

And that would put modest pressure on equities, but, nothing big. So, we're going to go back to whether the, then you're in the nuances. Was the retail sales good? Was, In those sort of little nuances relative you could see equities be soft or not

Nick: certainly, I think that if the the cpi number is On the soft side.

We know the reaction. The fed is chomping at the bit to cut given the right excuse and a soft ppi And cpi would certainly give it that excuse So we would

be very big buyers of the short end, something like two year notes, because once the process starts, I think the market will immediately price at least the 50 percent probability that they start cutting in June already.

So we know what we want to do in that case, soft numbers, especially if everything aligns. If we have a lower rate of inflation through a cold cpi and ppi Then retail sales miss and they're weaker and then unemployment is also higher Then we know what is going to happen people are going to start switching Massively into the very short end of the yield curve in bonds And they might start having doubts about equities because equities will not like You The fact that the fed has to cut to support the economy.

They might not go down as much as they should But they certainly Will not be the preferred risk instrument will they

Andy: right you describe the? Inflation coming down enabling fed cuts and weak economy enabling fed cuts that's the worst case for longer term assets and the best case for twos but you know as the question is You know, we know what we'd want to do in that case, but as we don't know what the data will be.

So when we look at the market and say, okay, here we are what's going to happen in a cold CPI case, PPI case, which is the first piece of data in a cold PPI case, twos are going to rally a lot. How much will be the determining factor? Because then we have CPI and then we have the other things.

If you told me today that we've had all of those numbers come in worse for the economy, higher unemployment, lower inflation, lower PPI, lower retail sales, I'd say I want to own twos, but now the question will be where will they be? And I expect them to be much, much lower on yield, much, much higher in price by Friday.

And so it's possible I'd want to sell them.

Nick: Yeah, well, the, it's it's very unlike once the short end gets going, it just keeps on going with, with a little bit of consolidation in between. So it's not something we have to worry about. We just have to assign a probability to that scenario.

And I think that scenario of all these numbers being weak. Is fairly low. I just don't think it's likely The one which is more likely is that they're all in line to slightly higher, especially the inflation prints and therefore that inflation is still

sticky and that the fed can't move And that is the one in which I believe and i'd be interested to know what you think Is that twos go back to five points?

0. 05 percent But they never start pricing in hikes Because the fed bar for hikes is incredibly high at the moment And that is our opportunity to buy the twos around the five to five point oh five percent area But what do you think happens to equities in that case? I think they don't react too badly.

Andy: Yeah, you know the if we end up the week with all of the data being warm Not allowing the fed to cut and Jobs and retail sales indicating strong demand. Equity should like that. The only thing that they won't like is the higher short term interest rates and potentially the higher longer term interest rates that will follow those shorter term interest rates in what's called bare flattening.

And the equity Shouldn't mind that. Now, knee jerk, I think, a, high inflation numbers, which lead us to the future numbers of retail, well, retail sales comes out at the same time as CPI, but higher inflation numbers, knee jerk, are likely to take equities down, but not much.

Nick: Yes, I would agree with you. Certainly people will continue preferring equities to bonds in that scenario If inflation is sticky equities are a much better hedge against inflation than bonds will ever be so It's more of the same, rotation out of bonds, certainly out of the three to five year area that even the 10 year area and back into equities.

That seems to be the the most likely scenario for what we will see next week. But of course, we're prepared for all of these scenarios and we'll naturally send you an email immediately once we've seen the numbers. What do you think is prudent to do given the current level of volatility before the numbers?

Andy: Right. I think the prudent thing to do is to step back and say, what is the, we can trade the week and we'll give you indications of what we'd like to do to trade the week, but we can position our portfolio. And the high level macro view that we continue to share is the economy's doing fine. And it will take higher rates higher long term rates in particular To ever take the legs out of equities And as long as equities are strong the economy is going to be strong and we've also said the fed is unlikely to hike And so when you add all those things up, the question become you know in that environment How do you want your portfolio?

And what we'd like our portfolio to be is the way it is, which is out of duration and long equities and long, some commodities and gold, but also mostly in short

term interest rates stuff. And so I'd like to continue to have that general portfolio until we see a reason to buy duration or sell equities if the economy starts rolling over, which we don't think is likely at this coming week, but who knows?

And so what I'd like is some optionality and Volatility is now the VIX is below 13 which is pretty low. It's not as low as it was in 2017, but this, my friends is not 2017. So I think we should buy some calls and sell some equities.

Nick: Yeah, because with volatility at this kind of level, you can buy very long term calls, something like going into September or something like that for a very modest premium, which really impinges on your portfolio very little.

What it does offer is the possibility that if equities do swoon, then you can buy them at much better levels and get rid of the optionality if you so wish. But it gives you a very long timeframe in which numbers, data will come out and the situation, the macro situation will change, and then you can very cheaply reposition your portfolio for what you think are the more high probability events that will start coming up.

Andy: Right. And what we describe this as is what. Typically is called stock replacement. And I have a video that we recorded for Two Greybeards that we'll attach to this episode about what stock replacement is. One thing to mention on that is there's tax implications for selling equities and buying calls.

In an account that is larger than ours, because we have a certain amount of capital that allows us to buy and sell a certain number of calls or puts. One option would be instead of selling equities and buying calls, as Nick will go into, is just buying puts on your long equity position. If you're able to do that may be more tax efficient if you're operating we don't offer tax advice.

For any reason under any circumstances, but in the event that you have and you're in a taxable account. That's something you may want to consider

Nick: Absolutely So I think we are we have a fairly good idea of what we want to do next week and why? We will, I will now go through what I think is prudent to do before the numbers.

And then as the numbers come out, we will be sending you out emails telling you how our opinions are changing and why they're changing, which is the most important thing and repositioning Thank you very much indeed. Thanks

everyone. There was no activity in the account last week. We didn't get anything done.

So these are the current positions and the current allocations, you can see we're about 26 percent in equities and we are very heavy in cash. Now, let's talk about something to do before the numbers. We have cancelled the bid in SLQD because we didn't get hit and also the risk reward in keeping it at that level is not great.

Either it's pointless because the numbers come out as we talked about weak, in which case we'll never get filled, or the numbers come in hot, in which case we will, we could have got filled at a much better level. And therefore what we like to do is cancel that bid and then reposition it after the numbers because we'll have plenty of time to send you an email.

and buy it at much better levels. But this is what we would really like to do before the numbers. And that is sell all our equity positions or cash equity positions and buy two of the SPY September 20th, 520 calls. Naturally you do all that at the same time. The money that you raise by doing that, the 70 odd thousand dollars and let's have a look exactly.

It's about \$78,500. You put in a money market account, USFR or T bills or whatever you prefer, and that actually gives you a net cost for the option of approximately 12.6. Times two, that comes out at 2, 520 or about 84 of the account value or 3. 21 percent of the current equity allocation. And that gives you a long of about 104, 000.

as opposed to the 78, 500 that we currently have. So we will be slightly longer if this goes in the money. 520s are at the money. But it will only cost us 0. 84 of the account value. And we prefer to have that position ahead of CPI because as we talked about, it gives us a lot of optionality. And we can add to these calls.

We can sell the calls and buy more equities. We just have a lot of optionality. And as Andy mentioned, for anyone that's concerned about tax implication, buying two puts and not selling the equities gives you exactly the same result. Otherwise, Everything is updated. The broker statements are updated. The monthly performance are updated and the weekly charts with the volatility are updated.

We are at a new high in the NAV and let's hope it continues that way. Just one more thing to mention, and this is a bit of a cautionary tale, I actually made a little boo and instead of hitting a the bid button for SLQD, I hit it for SWIG.

And of course, I got immediately filled at that level because it was before the market had opened and it resulted in a net loss of 540, which I wired back into the account.

And this is more to tell you that this happened. And this tends to happen to everyone including myself who's been doing this for many decades? Sometimes mistakes happen when they happen just own up to them get rid of them Compensate the account and get on with it. It's just not worth thinking about 540 So that is all I have for you by tuesday We will be at zero here as we described And It, we will be long approximately 105, 000 worth of equities, giving us optionality to do.

a lot and change our portfolio allocation by a lot should the numbers in this next seminal week be different from what market expectations are and also from our expectations because if they are I think we have to start changing our macro outlook for the medium term and therefore all our account allocations Thank you very much indeed and you will definitely get more than one email from us next week

