Nick: Good morning. Today is the 13th of July and another episode of Two Gray Beards. So what do you think, Andy? What struck you from the price action last week and the data that we had? That's important at the moment.

Andy: Yeah. So I think the trend continues to have the Fed be able to achieve its mandate inflation data, both the CPI and the PPI when used to calculate what the PCE is going to come in at are on the right track.

Not necessarily any faster than. The Fed neat, the Fed has projected right in line. And so, the market reacted in a way that typically happens as you're in a slowdown, which is the markets ahead of the Fed's projections in terms of the number of cuts. It, July's off the table, but September is now firmly priced in.

And so the bond market rallied on that led by. The front end, you had a bull steepening. And the question is what, what's next now that two cuts are priced into 2024. The equity market it was choppy. We made new highs. And then sold off the biggest sell off we've had this year, practically, and led by a rotation out of Nasdaq stocks in the big Mag 7 in particular, and into Russell and the rest of the set of stocks that have underperformed.

And that was pretty sizable. And then the next day, yesterday that reversed, but also I think importantly by the end of the day, real sellers came in. And so we ended up soft on the end, at the end of Friday. But still very close to all time highs

Nick: Yeah, no, I agree with you. I think the the bond market is now finally starting to respect What i've been saying for a long time and that is that the curve is slowly Disinverting i.

e steepening and I think that trend has to continue there's probably four trillion dollars in bills at the moment in money markets in general and slowly, as people realize that there is going to be a cutting cycle, because as you said, the Fed is going to achieve its dual mandate and achieve the dot plots that they have put out, i.

e. two cuts this year and probably four cuts next year barring Data surprises. I think as that happens, people are going to put more and more money to work in something like two years or three years or four years just to make sure that they don't entirely miss on the drop when the bills finally start coming down.

And that has been the trend that we are positioned for and therefore it's no surprise to us and we are quite happy with it. As you say, what happens next?

Probably very little. And probably it's going to be all dependent on how people look at the probabilities of recession. And for that, next week's data of retail sales, I think, is going to be very important.

Because just as we had a whisper number that CPI was going to be lower, and it was, we have another whisper that the retail sales data next week might be negative. And that is probably going to be a bit of a shock to to equities, I think. And because this narrative that just because the MAG 5 or MAG 7 stopped going higher, everything else is going to start catching up with it, is not really consistent with a softer economy, is it?

So if we get that piece of missing data that the economy on the consumer side of things is beginning to soften that will give naturally the Fed even more reason to cut in September if they need any more reason than they already have. But it's going to make some people doubt how much further equities can go right at this moment.

I personally don't think that we're going to get a recession anytime soon, but I think that the pricing might come back and therefore increase the odds of a recession, which at the moment does. Almost zero. We need to have a little bit of a breather in the equities market. We have come So far so fast That really it would surprise me if we don't have at very at the very least a period of stability for the next month or so, what do you think of of that because we're just getting no confirmation from the weekly unemployment claims Or any unemployment number that we are accelerating.

Yes. Softening. Absolutely. As Powell has said many times, the labor market is in better balance. By no means are we seeing any kind of acceleration in unemployment, which would make us think that we are in anything but a growth slowdown as opposed to a slowdown.

Andy: Yeah. My basic view remains the same, which is bonds, particularly the long end, but recently, and this week, very much the short end as well, reflect fair, a fair degree of pessimism and a fair degree of hope that the Fed will, Be forced to cut, which depends on the economy delivering weaker numbers.

Now, if retail sales comes in negative, as Nick said, particularly the control group, the regular number is already expected to be negative. But if the control group comes in negative, bonds are going to rally and the front end is going to rally. But the data has been that way for a few months now. And the bonds have reacted in a fairly meaningful way in the front end.

And so My view is that there's going to be one of these sort of cathartic moves in the front end where everybody all of a sudden decides a recession is coming. And I don't know what data it will be. But at that point. There really won't be a recession. And that's the point that it may be time to change our allocation in terms of the front end, but we don't know that cathartic moment where everybody rushes to buy twos and threes hasn't happened yet.

And it's due and could happen at the same time. The data has only been surprising in one direction and eventually the market Adjusts and any positive surprise is where the big reaction happens. So it's an interesting point in time and we'll see how that plays out. But in terms of our investment philosophy, it's.

Fitting in well with us, we're long all the things that are most likely to get that cathartic spice spike on another week number, and we can adjust our portfolio into other things if we think that the economy really is not going to go in a recession, which I think is the common view that Nick and I share.

And so that's good. And the question then is what do we do with our equity position?

Nick: Yeah. Well, The price action on Friday told me what all I need to see, and that is that we are at the top of a range. As I said earlier, we've come a hell of a long way in a very brief period of time and markets probably need a Period of sideway consolidation at best, or a period of, 2, 3, 4 percent retracement.

I think the the US dollar is beginning to weaken. That gives me a added comfort that we are likely to see weak economic numbers, which makes some people believe that we might be going into a recession and that shouldn't be good for equities relative to bonds. I think a period of people out of people buying the short end of the bond market and lightening up on equities should be coming And in any case, the risk reward to me is very much one of equities, possibly at best doing not very much for the next month or so, in which case I think that we should lighten up on an equity position.

We have only calls, but there is no reason not to sell, let's say half of the calls that we have, and then look to reset at lower levels because there's no point in selling calls. Above the market because volatility is so cheap and we really when if we are right We make nothing out of it So I think selling what we have makes far more sense Than doing a cool spread as it were what do you think we've

Andy: done in the past?

Yeah, I agree If we get a spike that allows us to reallocate our two years because of you know a major rally in that area Equities are going to fall and so to take I don't know. I think it's about 90 basis points of premium off the table in equities makes sense to me

Nick: So I'll discuss that and the various alternatives that people can do in in my segment, but otherwise we really don't see very much upside inequities.

I think we agree on that. The bond market is more than fairly priced for what we have seen now. We are just waiting for that cathartic moment to get out of a very short end. But otherwise, we're happy with our locations, right? We don't see anything much that we should be doing on a beta side of things, and really not even on an alpha side of things.

Andy: Yeah, what's the downside in our unlevered twos and threes? Not a lot. What's the upside on a cathartic spice spike, it might be time to reallocate. But so, holding twos and threes still seems to be the smart place to be. I have no bid for duration. It's already well, it's priced down as yields have fallen.

No bid for that relative to twos and threes in the cathartic spike, you're going to do much better in twos and threes. So. Yeah, I think that's about right. There's going to be a time to sell the front end, but at this level, I'd wait for that bad piece of data. Absolutely.

Nick: Okay. That's about it. We'll see you next week.

Thank you very much. See you next week. So let's have a look where we are while the portfolio continues to perform remarkably well, and it's really driven by the fact that the very short end in which we are very heavily positioned is doing extremely well. Equities, of course, are not hurting, that's the main part.

I've updated the performance and I've also updated the weekly performance. Now, as far as order entry, what we are doing is we are selling one of the two 540 SPY calls to the 20th of September that we own. So we will be Less long here will be long of a hundred and thirty shares as opposed to two hundred and thirty shares and Really, that is what we want to do and we've explained why we want to do it because we feel That at some stage we get a cathartic move in the twos and threes when everybody is convinced that we are on the cusp of recession Which I think is going to be or rather prove to be complete nonsense.

But that is what we're waiting for to lighten up there as well. We're selling the one call because volatility, as we said, is far too low to sell calls above and turn

this into some kind of a call spread. If you prefer, you can do that, or you can sell a call spread. It's slightly in the money.

Cool. We are trading at five 59, let's call it five 60. You could sell something like a five 50 call to hedge yourself, or you could just, lower the amount of shares that you have. We would be comfortable with something like a 25 percent allocation at the moment. That is what I think is reasonable.

And it's reasonable for a Couple of technical reasons because we are right up against the monthly and weekly Bollinger Bands of the of everything in the stock market. Whether you look at the SPY or the QQQs Or whatever else you look at, we are very stretched and any kind of weak number like we mentioned retail sales could have an outsized reverberation through the market and get people willy nilly to switch into shy and IEI and tip and SLQD and even TLT for that matter.

We don't think that will be warranted and therefore we want to step ahead of it. And also we feel that the upside in equities at this price is so limited that even if we cut our allocation, we are really going to be doing no longterm damage to ourselves. Whatever happens in the next week or two weeks or even month, we think that SPY will continue to Trade up and down, and this gives us added possibilities of buying some more calls should the price fall, and we're hoping for stability at best and a bit of a hiccup in the stock market at worst to be able to trade.

Go back in and buy more calls because we don't think that there's much of a chance of a recession We will keep these positions Just as I wrote here We're waiting for that cathartic move up and when we get it, we'll sell it and buy equities again