Nick: Good morning. Today is July the 27th, and we've had a very exciting week last week with a lot of degrossing, haven't we, Andy? I actually wrote a piece on degrossing and why it happens and how it happens. And it's in the research folder for the 25th. So if you'd like to go and read it, I think that will shorten the conversation that we are going to have today.

So Andy, we're going to have a very exciting week, but let's go very briefly over what happened last week. What struck you?

Andy: Yeah, so I think you're right. What you saw was the after the earnings of Google and Tesla, and with a extremely strong Japanese yen on the back of intervention. Prior intervention and hawkish expectations for the BOJ broadly those trades that levered investors had, which includes anything from owning assets financed in yen, which creates a short yen position.

Or long tech short value for sake of a better word. Manifested principally by Russell and the like you saw that on begin to unwind and you saw that in equity market action and currency markets. Primarily, not really much in the bond market, which was fairly quiet last week.

Nick: Well, yes and no, we had a quite a steep disinversion steepening of the yield curve.

And, you know, do go and read that piece I just mentioned, so I don't have to. Go over it right now, but they all the curves, you know All the way from two years out to 30 years are now looking to disinvert so that is normally a signal that something is changing in the The way the market is looking at the valuation of assets and it Normally happens because they are beginning to think that the odds of recession are going higher.

I'm not saying that the odds of recession are very high, but that the odds of recession are going higher. When that happens, people buy volatility. And therefore, degrossing follows because the VAR function, but it's all in that piece and you can read it. So that is what happened last week. The data was minimal, right?

And there's nothing that we can just say, Oh, look at that piece of data that changes our macro view. Or changes the probabilities that of our macro view So it's really all about degrossing getting rid of stuff the yield curve steepened, but it's still not Disinverted which would be a big signal to me So what are we what are we to make of things pce was exactly as expected?

People looked at the second decimal the third decimal the fourth decimal And inflation at the moment is just not the problem. It's not what the market is focusing on. The market is now going to focus on the second part of the Fed's mandate, which is the unemployment, and we get a whole slew of unemployment data next week.

So we might as well look at what's going to happen rather than what happened last week, right?

Andy: Yeah, I mean, I think the important thing you said there was that we don't know that the battle to fight inflation is over, but the noise around the battle to fight inflation is clearly over. We may not ever reach their target, or we may reach it soon.

There's a recession, you know, when you're starting to look at the second decimal place and all the revisions back to May to April to make sense of the inflation data that, that game's over. So I agree, it's entirely on the employment side and whether employment stays tight, which it is. Or starts to roll over, which it really hasn't.

So we'll see whether there's any trend in the data. But you know, next week is got not only jobs data, it'll have jolts and EDP and NFP and jobless claims, basically a data point every day starting Tuesday. But it'll also have important policymaker and. Equity earnings data the policymaker data will be the treasury announcements on both Monday and Wednesday on the QRA and the FOMC meets and will have its press conference on Wednesday afternoon.

And along the way, we get Microsoft, Amazon, Apple and Meta. Which are the big earnings before NVIDIA at the end of the month. So what I was thinking we do here is let's just go through the calendar in terms of the policymaker data and start with Monday's data. On Monday we get the financing estimate which will tell us how much new debt is needed to be issued, whether it's bills or bonds will be a later discussion, but we expect that to be higher than, than it was the last time they estimated it, because of increasing budget deficit.

And then the moving part that is relevant to markets is whether the Treasury Department will maintain A large checking account, their treasury general account in case of a to make sure that the government doesn't default in the case of a market disruption event that prevents them from issuing or will they likely in a political sense, spend down that TGA to reduce the amount of issuance during the election.

I think there's no chance they do the latter.

Nick: Yeah, I I think the odds are very low that they do that it would be a seen as a very political move But asset prices would respond wouldn't they and that's the thing that we are always mindful of Why politicians do what they do is really immaterial at the end of the day.

It's the effect that matters But on the you know, I completely agree with you. I think the signal from a tga spend would be very obvious You They want to decrease on Wednesday the or or limit the amount of coupon issuance Now what they have said is that the amount of coupon issues would remain fixed for the next several quarters So I don't see how or why they would reduce the tga When they've already said that they're going to keep the the issuance of coupons constant I don't see what benefit it gives them.

Therefore. I think it's low odds But we will send you an email immediately should it happen,

Andy: right? The point is we we're not going to guess we think it's extremely low odds But we're not going to guess if they spend down the tga we're buying assets and we'll let you know So that's three o'clock on wednesday on monday and then 8 30 on You On Wednesday, the day of the Fed meeting, we'll get the QRA composition, which is how many bonds coupon bond auctions at what size they will be.

As Nick said, well, let's just say the the outcomes. One possibility is they reduce the coupon issuance in some way. Now, that is not, hasn't happened in five quarters. They've told us they're not going to change the coupon issuance. There's no, the deficit is rising. The political climate would be unfavorable if they were to do such a thing.

I think there's zero odds of that. Now it could happen even at zero odds. It could happen, but that's option one option two, and this is getting into the nitty gritty option two is they do what they said, which is they maintain coupon issuance at 1 trillion 80 billion roughly, and about 500 billion net new issuance of coupon bonds, and they don't Change the language that said, that Nick quoted, which said that in the next few quarters, they expect, we expect the auctions to remain the same.

That's option two. Option three is they issue the same amount of coupons again, as they said they would, and change the language saying that they do expect to step up the auction sizes in coming quarters or next quarter or something of that nature. That's a language change. Fix coupons, language change.

Option three. Option four is they said they do something that, you know, they can do. Larger deficit, good time to issue coupon bonds given how low the term premium is. It's negative. They increase coupon issuance. At that point, the language doesn't matter much because they've decided to increase. So those are the four options.

And I think Nick and I agree that option two and option three are The most of the probability with option one being zero and option four being Something not zero, but not high.

Nick: Yeah completely agree with you and the effect would basically be a steepener, wouldn't it? I mean the people would be selling longer coupon bonds If they increase or whether they promise to increase or hint that they will increase in either case It's a question of degree, of course, but the move is a steepener people will be selling coupons, especially long duration and as a result You will also have an impact on equities and the impact will be lower.

Not as much probably as in as in the bonds, but certainly you will have selling of equities and especially probably of. high beta equities like, you know, the QQQs or the NASDAQ, especially if the earnings are not very supportive. We already know that these companies are going to beat their estimates, but we saw what happened to Google when it beat by a little, it got absolutely slaughtered.

So I think there are a lot of people on the sidelines who saw what happened last week saw that the curve disinversion tends to create volatility and therefore the degrossing and are waiting and hoping that the QRA and the FOMC are going to save their bacon and they're going to be able to degross at better prices.

Now, should the QRA disappoint, those people are going to be in a panic. The, the selling in the NASDAQ is going to be ferocious. So, let's see we are well positioned for either outcome, and we will decide what to do when we've seen the facts as opposed to the probabilities. That's all we can say.

Andy: Right, so we have these two zero probabilities for Monday and Wednesday that would be extraordinarily bullish. We have the Wednesday event being the way I would describe it is option two, which is Fixed the coupons don't change and they don't change the language is about as good as the market can expect And if it does all it just says is that there's still 500 billion dollars of new issuance to come next month next quarter and for And so it continues to be this idea that they're just going to continue to lay on coupon bonds with more supply forever.

And so it's not bullish bonds, but you know, the market could rally on that in any way. It's just a small, it would be a small factor. And then. The other two outcomes are steepeners. And that's what we've been saying is the risk to markets and equities since then. So let's go to the Fed. Nick, what do you think?

So there's a couple of moving parts as far as I can tell. There's will they cut in July? And what is the guidance for September? What's your outlook on that? Well, I,

Nick: I would be very, very surprised if they did cut. In fact, I think the odds of them cutting are reflected in the futures prices and the odds are zero.

So the the market would be very surprised. And we know that the fed does not like to surprise the market. It would be an enormous signal. If they did it would the market would be shocked the short ends would rally like mad and actually the curve would again steeper. So it really is They have no incentive to do so.

It just makes no sense for them to surprise the market in this way. It would be seen as a bit of a panic move and the everybody would be asking themselves, what do they know that we don't know. So I would put the odds in precisely where the market is putting them and that is at zero. However, the language could be slightly dovish.

But I just don't see that the Fed is in a bad place at all. They have moderating inflation, certainly not re accelerating, and therefore they can say that they have increased confidence that the inflation numbers are going in the right direction. And they are, in fact, meeting their SAP SEP projections, so I don't see why they wouldn't say that, and they can emphasize that they are now beginning to concentrate more on the employment picture.

Why not? You know, we, we haven't had any employment numbers that have been bad, but we could easily get one, and that would be a reason to ease, and September seems to be a very reasonable time to ease in any case, even if employment does not. You know, roll over. So I really don't see what they have to gain by cutting now.

They certainly can maintain the optionality of the language, why would they absolutely indicate that they must cut in September? If I were Powell, I would say the numbers are going our way. We're very happy. Our confidence is increasing and we are maintaining flexibility and data dependency, but we are aware that the second part of our mandate is Now, in a little bit of danger, and we are focusing on it and the story.

Thank you. Which

Andy: is basically what he said last meeting.

Nick: And the data hasn't really done much of your language. Yeah, you have a lot of optionality in what I've just said. Why lose it? Why waste it? Well, the way I like to

Andy: think about that is you waste it when you need to Correct when the pricing if the pricing were for no cuts in september Then you'd be then you're dovish because you want to move the pricing to a cut right now A cut is 100 percent likely in September.

So you don't need to move the market in your way, in your favor. So there's no reason to take away optionality. We have, we have the jobs data this week and we have, which they won't get much of, they won't get the NFP. And you have another inflation cycle and then another of both before they meet.

There's no reason for them and, and the market's already priced to where they want it to be. There's just no reason for them to give up that optionality. And you mentioned something in our prep call, which is the there's a fairly big divide in the, within the FOMC with about half Doves who want to cut and about half who are, you know, the higher R star, higher long term interest rates don't cut at all type crowd.

And many of them are voters. And I don't think, maybe I'm wrong, but I don't think Powell wants to have the first cut as a, with a lot of dissension with people voting against it.

Nick: Absolutely, it would be seen as political and, you know, it's very difficult to make the argument even to people who are not outright hawks, that the data that we've had so far should convince you to cut now, that there isn't a single piece of data which has come out as a real surprise, showing that the economy is in any way weakening.

You can point to what the SMPs have done in the past couple of weeks, you know, they touched 5 percent off the all time highs, but 5 percent off the all time highs is a run of the mill nothing correction. That we get several times per year. It's not an economic signal and it will convince no one on the FOMC that this is something significant.

Andy: So with that, you have our view on the FOMC. How do you think the market reacts to our view? And, you know, what, what, what is there anything we should be doing?

Nick: Not right now. I think the FOMC is actually the least important of next week's data, as it were. I think the QRA potentially can be important. I don't think it will be, but it would have much more of an effect.

Then an FOMC presser that is judged by some people as slightly one way or slightly the other you know ken powell surprise, of course he can but I just don't see why he would as we've just said It loses optionality and he gains you nothing because the markets are already pricing 100 percent the cut in september.

So he's just wasting capital for For no reason. So I, I don't think that those two factors are going to be the decisive ones. What could happen is that one of these days you get a really weak unemployment report and that would have a major impact on markets, because if the FMC is shifting attention from the first inflation mandate to the second unemployment mandate, that would definitely move markets.

Andy: Right. So we don't anticipate that, but it could happen. We don't anticipate that, but I think our portfolio is positioned appropriately, which is by and large long cash like and short term, medium term, you know, twos, threes, and fours on in treasuries, small gold, small commodities allocations and equities with.

Optionality.

Nick: Absolutely. And, you know, a lot of things could happen next week. And if they do, we will email you immediately, probably starting Wednesday, because that's the most likely day for something to happen, but it could be Monday as, as we've discussed, whenever it happens, you'll have an email immediately.

Thank you very much for listening. Bye. So let's have a look at the portfolio. And naturally we didn't do anything last week. Otherwise we would have told you we lost about 600 bucks. I mean, nothing at all. We have very nice optionality. All we can lose is another 0. 58 on the option, and that would reduce our equity allocation to below 20%.

So we are in a very good position and we are very happy with The way things are going order entry. you know, email only. You will most probably get several from us starting from Wednesday, because that's when the odds are that something does change in the QRA and the FOMC. But you might get one already on Monday from the first part of the QRA.

But as we discussed in the video, that is unlikely, and we think the odds are low. But Please be prepared to get emails throughout the week and especially on NFP because that could be a significant mover as well. Otherwise, everything is standard. I've updated the broker statements. You can download them and the monthly performance.

We are where we should be and we're very happy and doing nothing apart from sending you emails when we want to change the allocations, when we've seen the facts and those have changed our mind. Thank you very much indeed and have a lovely weekend.