Nick: Hello, and today is the 10th of August and we've had quite an exciting week. Andy, do you want to tell us what you think happened last week and why?

Andy: Sure. I mean, I think the, so I think we should step back briefly and say the big catalyst for Last week was the action on last Friday, the Friday before last, and that was the non farm payroll, which came in light and which concert created a fairly large concern that we're heading into a recession.

And. The next phase of this was last week, in which there was essentially a panic. And what we saw when you step back is that the S& P is unchanged since last Friday. So, essentially nothing happened this week, but a lot did, and so it takes some explaining. And I guess the first thing is this is a broad, Situation there isn't a silver bullet that explains what happened despite significant focus on something called the yen carry trade.

We think that broadly, this is consistent with a risk asset deleveraging broadly. Now that can, that can, that, that asset deleveraging can pause can Return in a, you know, a meaningful way, or it can go the other way for periods of time. And so with that background, which you should have been hearing from us for a long time, and why we're not long, long term duration it's, let's drop into what happened on last week, which was a very rapid decline in the Japanese market.

The Nikkei went from a high of 42, 000 a few months ago to 30, 000, a 26 percent drop in, and most of that was in two days. And, At the same time, a very rapid increase in the value of the yen. And so a combination of risky assets falling in price and yen strengthening caused a deleveraging of a trade.

That has been very popular and very successful for the last four years in which investors buy risky assets, non Japanese risky assets, and borrow the money in yen. And if you look back since 2021, if you did that way, if you invested in the S& P 500 in that way, you benefited from a massive post COVID rally in the S& P, a Massive depreciation in the yen and frankly, during the 2022 drawdown, you had no pain at all.

Your savings were the same. So it was very popular and very large. And so there's. Speculation that the people in that trade with everything going the opposite direction, strengthening yen, higher yen interest rates and falling global asset prices that people were forced out of that trade. And I'm sure that happened.

Nick: Absolutely. Personally, what I think is that the root cause of the panic was the steepening of the yield curve because the market somehow seems to have convinced itself, not with a lot of evidence, but very partial evidence, I would say at best, that we are somehow currently on recession watch. What do I mean by that?

The yield curve steepened considerably. If you look at the 2's 10's or the 2's 30's, a lot of people starting, started putting their money into the safe asset, i. e. the short end of the yield curve into treasuries. And that caused A significant part of the risk of the fact that U. S. rates at the short end were coming down while Japanese rates were in fact going higher cause the yen move, which then caused the D.

Leveraging and other risks. All the cascading effect. Now the cascading effect was made larger simply by the fact that so many people were into this trade and therefore the positioning was probably very extreme and the fact that a couple of weeks before that, the the Ministry of Finance in Japan had intervened to stem the rise of the dollar against the yen and a whole load of Factors, which basically hit the market all at once.

So, it was not surprising to us that we saw what we saw. The extent was You know, I was quite surprised by the extent and I was quite surprised by the fact that people needed to buy so much volatility because they were obviously very very short of volatility But let's talk about volatility for a second because we sold it as you know first thing on monday morning We sold volatility and you know, we're out of it We should have sold more and we should have sold for longer and I think But you know, you are never perfect.

We had a situation in which VIX apparently spiked to 60 percent and people got very panicked by that. No, VIX never traded in the 60s. That was a mispricing caused by one single put option which nobody wanted to price correctly at the time. The market was not open. We also had glitches on the open and people couldn't trade.

In the options pit, and therefore that never really happened. Volatility never really went up beyond the mid 30s, which is not a sign of, how shall I put it, of extreme stress. Volatility can go into the mid 30s for a variety of garden variety reasons, as opposed to real, real stress. So, we have not seen the real stress, but what I think that we will continue to see, and this is actually evidenced by what happened on Thursday after nonfarm payroll came out, which showed that maybe NFP is a one off.

Maybe it's the situation is not as bad as we thought it would be. It could possibly be. The market rallied 100 points in the SPY in, in no time at all. So we are still on recession watch. I don't think the market is going to go off recession watch for a while. So every retail sales, every non farm every non farm payroll, every weekly claims, any data current data about the economy that shows where we are, are we going towards recession or are we just Doing what is would be normal i slowing down the rate of growth and Make no mistake an expansion a slower expansion is actually what the fed wants So we should not be panicking here at all We should have a normal Lower allocation to equities in case we are wrong and we do go into recession so we don't lose too much, but we certainly shouldn't panic and abandon all risk assets because the proof that we've had so far that indeed we're heading into recession.

Is very scant indeed. Okay, so a lot of people actually concentrate on the SAM rule. You know, it's another indicator. The the disinversion of the yield curve is another indicator, but these are not indicators that per se, any single one. Can absolutely tell you with any certainty that we are in recession that we absolutely refute the balance of evidence is still that we are in slower growth rather than contraction.

Andy: Yeah, I think it's important for us to say what our view is. Our view is that is that what Nick just said, which is based on evidence, the economy is slowing. Thank you Inflation is returning to target, but may be sticky along the way, and we'll get CPI and PPI numbers this week. And that is the Fed's objective.

Now, the thing that Nick also mentioned, In mentioning the stress indicators another stress indicator that we focus on is really responsible for the disinversion of the yield curve. And that is that gosh, in the, on the morning of Monday, when. Things looked panicky for most, and we were selling puts.

We weren't panicking. The cuts priced in suggested a greater than 50 percent odds that the fed would do an emergency cut. before September, before their next meeting. And when the market actually opened and things got a little more sane, the market had priced in almost 150 basis points of cuts.

In other words, 50 basis points of cuts in every meeting through the end of the year. And that's resolved a little bit, but there's still this strong demand for recession protection, which is the two year note and shorter term interest rates. And even today, 110 basis, 106 basis points is priced in of cuts in the next three meetings, which means 50 basis points in one and 25 in each.

Now, we see no, I see no reason whatsoever based on the data for such a cutting cycle to begin. And that to me shows there is an underlying problem. Recession trade being priced and the question will come and we'll see. It'll really depend on the data this week. Both the inflation data to me has that story is old.

Unless inflation data comes in hot, if it comes in cold, that's an old story and it all becomes retail sales, jobless claims, and then eventually the NFP in terms of plotting the Fed's direction. But the market price of The cuts priced in indicates there's still a significant recession watch. And so the question will be, if that data comes in, like the jobless claims on Thursday, a little on the warmer side versus expectations and retail sales comes in warmer and another jobless claims comes in warmer, what does that mean for.

Markets. And what do you think that means, Nick?

Nick: It means that the short end returns to pricing in something like 50 basis points, as opposed to over a hundred for 2024. And we get again, a flattening of the yield curve because long term bonds will go down as well, but nowhere near as as the short end will, and that will Lend a supporting aspect to risk assets people will, you know, basically go back out from of the safety of short term treasuries into Either longer duration or they will be buying risk assets like equities I have absolutely no doubt about that.

The yield curve will re steepen. Oh, sorry re insert. Yeah, so what Was very evident to me through that I and I watched the price action all day every day Is that equities traded with the yield curve steeper yield curve i. e two year notes trading better than 10s and 30s risk off equities selling off reverse Vice versa.

We get a rally in risk. So that is the way the market is positioned at the moment and the psychology of the market. The market is on recession. Watch whenever it feels that, oh, my God, we are fearing that we're going to go into recession. The yield curve steepens and risk assets come off. It's like trading the same thing.

They're equivalent at the moment. And that proves that we, that we are on recession watch. So stronger than expected data or even inline data for retail sales and weekly claims next week is going to really stabilize the market. It's going to make volatility come off. And as soon as volatility comes off.

Which is one of the fear gauges, you get the bid inequities. So that is what we are looking at. And. While the market is on recession watch it probably pays to fade that it's never when you expect it It's probably always when you least expect it that some piece of unexpected data comes out And our view I think I can talk for andy here is that the evidence for recession Is extremely scant still We are in a period of lower growth and lower inflation Not in a period of contraction.

Could we be wrong? Absolutely. But data would have to come out and prove it to us,

Andy: right? So I was thinking as we were talking about this, what Nick is basically saying is that calming markets is going to be relatively bullish equities, relatively bearish 2 years and meaning medium bearish Okay.

Long term bonds. And so that's fine. That seems like to me, I agree with that. It's hard to disagree with that. The question is, what is the upside on equities, given their pricing and given the, you know, the economy is slowing and one at one point in the future, we may drop into a recession. And so when you look at equities, are they going to be?

Oh, a pound table, table pounding by here. Certainly not. Are they likely to drift higher on calming fears without a doubt? And so the question that I was thinking about is, and our portfolio is conservative on its equity exposure. We're actually selling the calls as Nick mentioned. At high implied volatility, and those are the sort of leveraged upside with limited downside that we have and replacing it with less.

Notional equities. So we're being conservative, though optimistic, given our macro view and given pricing that we drift higher in equities. On the other hand, what do you think happens if the retail sales and jobless claims, CPI, retail sales, jobless claims, and PPI all come in on the cool side? Coolside, as

Nick: you mean, they're weak.

Yeah, weak. The weak retail sales. Meaning

Andy: we're not, you know, we expect them to be in line to warm, and they come in weak.

Nick: Yeah, it's very difficult to see that the market would price in more than it priced in last week. On monday in terms of cuts I I find that very very difficult to see to me The the risk reward is to sell would be to sell that kind of a spike Because one piece of data is not proof of the pudding.

You would need to have Two or three pieces of data that come out now, if you tell me that both retail sales will be weak and jobless claims would be very strong. I a lot more jobless then I might change my mind and say, Oh, yeah, let's,

Andy: let's, let's take that though. I think the point you're making is if the.

Data confirms low falling inflation and rising joblessness and weak retail sales. One would think that the recession watch beat would get louder. And I'm just trying to think of, you know, what the right thing is. And to me, I think you said it right, which is What's the, you know, at the lows of last week, 150 basis points of cuts was priced in.

I would think the numbers would have to be substantially worse again and again and again for 150 basis points of cuts to occur. What, what, but I agree there, so there's limited upside in two year notes. I assume duration would trade well given that. So you would get a bull flattening.

Nick: Yeah, I, I don't think it really matters which way the, the curve goes in, in, in that case, but you, you certainly would start getting the drum beats of, wow, we are going into recession and therefore real rates by and against fed funds would have to go towards zero.

A lot of people start talking about zero real rates. Fed funds being on top of CPI. That would be what people would start talking about. 8 and cooling, then people will start, we'll start talking about a 3 percent fed funds rate. And

Andy: what do you think happens to equities? Well, they don't trade very

Nick: well.

They don't trade very well. You know, they, they certainly cheapen up. But that is the risk one runs. It's you know, it's risk reward before the numbers. So we might do something before the numbers that we regret, but then we don't know what the numbers are, nor does anyone else. And therefore you can react after you've seen the numbers with a very cool head.

There's no need to anticipate. I don't think I think what the need is, is to weigh the balance of probabilities at any one time, the information that we have at the moment is one set, a different set might emerge, but from everything that we are seeing so far, it's premature to say that we are on recession watch, but the markets always, always.

You know, and how many times that we've seen this throughout our career, a dozen times, the markets always overshoot.

Excellent. I'll do my bit now and thank you very much indeed. See you next week. See you next week. So let's have a look at what happened to our portfolio last week. almost absolutely unchanged in value. These are the positions. Really, the only thing that we did is we sold the put, which expired worthless, and that helped us really remain unchanged on our valuation.

We still have this one 540 SPY call, and this is what we, on the balance of probabilities, is. We'll do next week. We will sell that call because now Theta will really start kicking in with a month to go to expiry and we will buy 80 shares of SPY to take us somewhere close to 25 percent of AUM. The convenient thing is that to achieve that we need to sell just about the whole of our SHY and we will therefore sell however many SHY we need to, to completely fund ourselves on this purchase without being leveraged.

So we will raise some money from the sale of the core. We'll spend. about 30 odd thousand on the purchase of the SPYs to take us some around 23 to 25 percent in total allocation to equities and to fund whatever we need to fund so we're not below zero in cash we will sell however many shares of SPY we need to achieve that very simple What will we have achieved by that?

As we said, the preponderance of the evidence still shows that we are in a slowdown and not in a recession. Therefore we need to be at about 25 percent here and SHY we think has done the job we wanted it to do. Now remember this is a non leverage portfolio. Yes, we could have bought and done a lot better but Tua is a leveraged product.

If we say that we are not leveraged and then we go and buy a leveraged product, then we are lying to you. We have done exactly what we said we would do and we've remained absolutely true to the investing rules and objectives of this account which are laid out here. Now, it will be completely different in Two Grey Beards Squared, and I will address that next, but just to tell you that the broker statements are all updated, the monthly performance and the weekly performance chart, everything is updated for you.

That is everything I need to tell you about the Two Grey Beards original. Now just a couple of words about Two Grey Beards Squared because a lot of people have asked. It will be launched, the new website containing it, will be launched on the 15th of June. of August. Why the 15th of August when we are starting on the 31st of August when we will be recording the first episode?

Well, to give a couple of weeks to people to switch. The new website will contain a page where you can easily and quickly switch your subscription from the original to the squared. These are the differences between The programs apart from the size, this product will tolerate some leverage. So instead of buying shy, when we're very bullish of the short end, we'll be able to buy tour and get some leverage.

When we are very bullish of equities, we'll be able to buy more calls and get some leverage that way. It just gives us much, much more Flexibility to do what it is that we really want to do. And it will also offer us the possibility to do some inter week trading. I wouldn't say we're going to have a hell of a lot of it, but we're going to have some more.

Potentially profitable trading like for example at the beginning of last week instead of selling one SPY we could have sold three SPY or three times rather as many because this account will tolerate some leverage. So we hope that it will be much more profitable. Although we will try to retain the same kind of risk profile.

Thank you very much indeed and speak to you next week.