Nick: Good morning and today is the 19th of October. We had a very quiet week last week really because the data side was very light. All we had was a little bit of retail sales and weekly claims and the numbers keep on coming in. Slightly stronger than expectations, which basically means the index of economic surprises keeps on rising rather than falling.

And that's really what we've been saying for quite some time, that the economy continues strong and there is absolutely no reason to expect. That nominal GDP is going to fall at any time soon. And that's reflected by the data that's coming out of the Atlanta Fed, where they're looking for very, very solid GDP growth in the next quarter.

What else happened? Well, we had a, another cut from the ECB, which is significant because Lagarde justified it by saying that they were restrictive and they are continuing to be restrictive even after this rate cut and therefore that the expectation should be that the restriction will continue to be lowered via rate cuts in the future.

So she's on the same page really as the FOMC and especially J Powell. China keeps on continuing to support its equity market or keeps on Attempting to do that and all these factors are making it so that hard assets and we are talking about equities and gold continue to outperform nominal assets like bonds and really the only thing that's a hard asset and is weak is oil but that's that's that commodities really are not in that cycle as yet.

What's going to happen next week, Andy? Very little, really. We have very little data to give us any kind of contraindication. Yeah, I mean,

Andy: I think this week is about, and next week will be about the same thing we've been talking about for a while now, which is very easy financial conditions, despite what the central banks say is supportive of assets and more, much more importantly, supported by the central banks.

Supportive of an economy. And so the U. S. Economy continues to roar with and every bit of data that we've seen suggests that and, you know, it's just one of those things where the Equity market is going to outperform the nominal bond market But what I would also say about last week and the week before and the week before besides this strong economy powering equities over bonds there's also becoming a interesting dynamic regarding Expectations for the election and we're going to cover that.

Next week, it's going to be more of the same. We're going to get earnings, some earnings but it's a relatively quiet week. And then the following week is where things start getting hot and we'll deal with the QRA, which comes out quarterly refunding announcement, which comes out on a week from Monday and a week from Wednesday.

Andy: In the next episode, but we don't expect anything particular to be a macroeconomic driver besides geopolitics Mentioning china at one point they continue to do all they can to prop the real estate market up prop the stock market up And are not doing anywhere near enough to prop the consumer consumption economy from replacing the heavily levered investment economy that has resulted in the very poor performance of China.

So we don't think that that's necessarily enough yet but we'll see. So, Nick, what do you think about the election?

Nick: Well, of course I have no more idea than anyone else about what the result will be. I just know the way the money is flowing is that the market is beginning to bet on a red sweep. And Really what concerns me more than anything else is the dangers that that would present to anyone's portfolio and that people need to hedge.

In my view, a red sweep by which I mean Trump wins the presidency and both houses are controlled by the Republicans That really takes the brakes off what he can do and what economic policies he can enact. Let's, let's go through them. There will certainly be deregulation, which is positive for equities.

There will certainly be an increase in the budget deficit, which is very dangerous for the long end of the bond market. And really, this trend of equities over bonds might go into hyperdrive. If I were long, and as you know, we got rid of our TLT and IEF this week, not so much because of the price action, but because of the future dangers to those positions.

I just cannot justify to myself holding long duration bonds. At these prices With the danger ahead of a red sweep. What do you think andy?

Andy: Yeah, I mean the red sweep to me is Again, as you said, pro equities over bonds and very negative bonds. And so the question will be what's discounted already in both markets?

Not much. We're probably, you know, in a train trip from New York State Grants Penn Station to the West Coast. We're still on in the Northeast corridor

heading West on both pricing. So equities will likely spike. Bonds will likely sell off and the question is to what extent and to how how persistent will that be?

And what we know is that corporate taxes are likely to come down Which is positive for earnings and positive for stocks Any wealth tax associated with capital gains or Investment income will probably not occur which is positive for stocks But on the budget deficit side and the inflation side, it's extremely negative.

And so a red sweep to me looks like a very, very aggressive bear steepener where the Fed will have no choice, but to slow, even with the intense pressure from the red sweep to pause cuts, which will hurt the short end. And all of the other factors that we just mentioned are bearish the long end. So that seems to be a no brainer that you'd have to stay out of bonds.

The question is can equities sustain the rally that they will invariably have? Due to the positives with the bond market cutting out the valuation needs. What do you think about that?

Nick: I think All I know is that there are very few natural buyers of bonds when the long duration asset is Has no positive carry now, that is a real problem When will the levered players buy?

You long duration with both hands, when will the banks step in? Well, only when they have positive carry and we are a very long way away from the bond the long bond having positive carry. So, if the long bond now goes towards five percent where it would start having positive carrying and even 25 basis points might not be enough, Of positive carry that is a very big move.

What is that about 15 to 20 percent? fall in the price of long bonds That would really suggest that equity valuations rather than equity multiples should fall by just about the same kind of percentage point. Naturally, most of that will be taken care of via earnings, increased earnings expectations as you suggested.

The danger is on the bond side, not on the equity side, in, any kind of red sweep. Even if one of the houses is not Controlled by the republicans that would naturally mitigate it But still I just can't see much hope for bonds here And that is what worries me. I if I were long of long duration, I would have to hedge it

Andy: Absolutely.

That seems clear in both the red sweep and the red split. Let's talk a little bit more about the red split. I agree. It's probably mitigates that somewhat. At the, you know, in a red split sweep, the actions of the central bank to offset that stimulus. Would be you know pretty clear. They wouldn't really have to deal with the politics in a red split I imagine the fed will be more cautious in terms of You know offsetting any spike in the economy and maybe just pause versus acting which to me mitigates the pain on the short end which supports the long end but As you said, the long end is still unlikely to see bids from already levered banks that are already long a bunch of treasuries from much lower yields before they start bidding, so the long end still looks vulnerable, but a hundred basis points, which, by the way, that's what happened in 20, in 2016, the moment Trump was elected a hundred basis points of, of yield got, increases happened almost instantly. Now, stocks also rallied, and that's the point. Stocks will rally on Good news on taxes, good news on corporates and bonds will sell off hard. So the risk is in the bonds.

Nick: Absolutely. But another risk, which is probably underpriced by the market.

And that is why instead of going into the short end, I actually chose to go to USFR. is that the Fed could become significantly more hawkish. Because if now you start getting an acceleration in GDP, and Animal spirits in released in the equity market. I really don't see why the fed would not pause After this cut in november because let's face it if trump wins and they pause in november that will be seen as Very partisan.

So I think the november cut is pretty much baked in But after that, I can really see the Fed turning much more hawkish than the current dot plot suggests. And we could easily have a situation in which they start thinking about having to hike rather than having to ease throughout 2025. And we're not counting the number of cuts in 2025, we're actually arguing whether they need to hike.

And the yield curve actually goes Quite positive so that is to me the big danger on a red sweep Do you have anything to add to that andy?

Andy: No, I mean, I think it's what we're saying is that the red sweep is very bearish bonds that will require a fed action and is good for equities, but maybe will be constrained by this very significant drop in bond prices and the red split is more neutral to both of those things, but in the same direction What do we think about so, and one, I think, I think it's important to say.

The election will happen and no one can predict it, but it's important to say that as Nick mentioned, the markets are already moving in a direction that indicates a red victory in the presidency. So part of this is already being discounted. Not enough, not anywhere near enough, but part of it. Are they right?

I doubt it. They don't know. They're just, it's just the way the money's moving. If you saw what happened during any of the most recent elections, you know that markets are caught off guard completely by the election results. And so we expect the same. So that's why it's a matter of risk. Now the question on bonds, if we are so bearish bonds in a red sweep, are we bullish in a blue a blue split or a blue sweep?

Nick: I'm not, because I just don't see that any outcome reduces the budget deficit. And I just can't see that this kind of yield curve is sustainable With an increase in the budget deficit because everyone whoever wins the budget deficit will continue to increase What are your views?

Andy: Yeah, I don't so I step back and say Does it even matter?

The election is going to matter it's going to matter and don't don't don't misunderstand I'm saying is that The economy is this battleship that's hurling along at 3. 4 percent GDP growth and 2. 6, 2. 6 to 3 percent core PCE year over year. That's A battleship moving forward and who's pulling the tiller may affect markets But it's hard to see that it affecting the real economy in my view bonds are have modest upside because of all the All the more the the more likely blue victory is a blue split which will constrain budget increases and constrain some of the Spending tendencies of the Democrats and will, but will allow the Fed potentially to maintain its path and that'll be supportive short term of the bonds, but the economy's going to soldier on in, in that environment.

What I'd be more concerned about regarding a blue sweep, which again, markets are pricing it as the least likely outcome, but you never know is the stock market. Because in a blue sweep, the odds of a, it's important to distinguish because there's a lot of noise around unrealized capital gain tax policies, which I don't think are actionable versus realized investment income, capital gains, tax increases, particularly on the wealthy, that'll be instituted.

And 2024 will be the opportunity of a lifetime to sell your equities, even though the economy continues to be strong. Capital gains realization before the rate goes up. So in a blue sweep, which again we think is unlikely Or the markets think is unlikely Stocks are going to get hammered.

Nick: Yeah, and bonds will do. Okay, but on the other hand Yes, the bonds will do. Okay, because there'll be all this money which is exiting equities and going into bonds but they won't go that far so the odds really are that You Because the economy is so strong so really the odds are on a red sweep Long bonds can go 75 to 100 basis points up in yield quite easily And on a blue sweep they can go 25 basis points lower, maybe 30 basis points lower But then they come back on a red sweep.

I don't see them coming back at all Probably even continuing so the danger is all in bonds The equities even on a blue sweep will come back because the economy is so strong And we then work out an appropriate valuation and we actually buy the equities levered So that is not the big problem the danger for anyone's portfolio Who is heavily?

Into duration is what happens to long duration? Whatever the outcome of the economy because if it's a red sweep, it's an immediate effect If it's a blue sweep, it's a delayed effect. So, those are really the dangers, and we will try to position ourselves to take advantage of them. Either of the outcomes.

Andy: Yep. I I think just to review on equities equities do the best in a red sweep instantaneously, but the bond market can sell off constrains them by because it's so aggressive in a red, split both of those influences are less and so But initially less and eventually bond sell off In a blue split equities are, you know, fine because the economy is strong.

In a blue sweep, you buy the dip in equities and you sell the rally in bonds.

Nick: Yeah, absolutely. And I'll go through those alternatives in my piece next. Sounds great. Bye. See you next week.