Nick: Good morning. Today is the 5th of October. And we had a pretty exciting week after waiting around for nfp for quite a while So andy has everything changed after that very strong nfp number with strong revisions as well Something that really the market was not expecting. What do you think?

Andy: Yeah, I mean, I think the market changed without a doubt Two year yields rose 25 to 30 basis points over the last week most of it on friday And but has the Fed changed is the question.

And when I think about what the Fed has done, they were aggressive, cutting 50 basis points in September, and were very dovish in subsequent Discussions teeing the market up to the possibility of successive cuts of 50 for the next two meetings while at the same time cautious on their scp dot plots with 18 of the 19 members Penciling in only two cuts of 25 or less With nine saying we're only going to cut once between now and year end So And the SCP.

plot had a and that would only occur if inflation went to target or below, went to target, and the jobs number, unemployment rate went to 4. 4%. So, the market took that as saying there was a high probability of two 50 basis point cuts. And now we're basically saying, no, 25 is what's going to happen in both meetings.

And so for me, that just said that whatever happened just got the market's enthusiasm about extremely rapid cuts to a very low terminal rate. And positioning that fit that scenario. And reversed it on a essentially on a single number.

Nick: I think I agree that what the market is now going to have to come to terms with is that the terminal rate is unlikely to be where they were hoping it would be IE around the 3 percent area, or even slightly lower, and that it's likely to be in the range of three to three and a half percent, given what we know now.

Now that could easily change, but what we know now is. And unless inflation starts re accelerating as well, I think that there's very little likelihood that the terminal rate is going to be below 3. Very small likelihood that inflation stays anywhere but in the two to two and a half percent range.

And if that is the case, then the, the market is appropriately priced as it is for the time being with long bonds around the four and a quarter percent area and really. Equity market is not going to get a lot of help from the bond market going forward, but you know, inflation will decide. It's no longer.

I think a game of employment because I think the employment numbers are now. Let's let's just step back. We've been saying for a long time, where is this recession in the data? And the market was really beginning to price in some likelihood of a recession, certainly in the bond market. We can no longer do that because there absolutely is no recession around the corner.

That we can see in the data. I think anybody will agree with that now And if that is the case, then we need to revert to a normal Upwardly sloping yield curve with a terminal rate somewhere in the in in the middle threes And a 30 year bond trading around the four to four and a quarter area And normally positively sloped yield curve, which is a goldilocks scenario and the fed shouldn't really Objections to that kind of a scenario because the economy is still growing at two and a half to three percent real.

Inflation is still two to two and a half percent and everything is fine. It's still a scenario, which at in the end favors people. Equities over bonds. Is that what you think, Andy?

Andy: Well, I think we disagree, Nick. Frankly what I think is important when you look at the economy, and I, I think when we step back, our view has been 100 percent consistent, and we agree that there is no sign of recession.

That the economy is strong. Real GDP is strong. Employment is strong and there's no sign of a recession where I think we disagree is. On inflation. And when I look at the out the the path of inflation, it is clear that four months in the past, inflation has been the four month moving average of inflation data has, hit 2 percent has hit target possibly even a little below target. But when you look at the future of inflation, you have a global central bankers that are more dovish today than they were two weeks ago. You have China. Stimulating, whether that'll be enough and whether there'll be more is certainly important.

And you have a employment situation in which the Fed and consensus expected 4. 4 percent unemployment rate and we're at 4. 05 percent today. So, in my view, Consistent with our long term view, the economy is strong, and where Nick and I differ is the impact on inflation. And, he may be right, I may be right, but I'm more I think inflation will stay sticky.

Listen, I think 2. 6 is the likely print when it comes to the SEP next in, in December. So that's, hits their target. It's still well above target, but it hits their target. The UR rate could easily be 4. 1 or 4. 2, not the 4. 4 they penciled in. And the GDP is likely to be higher. So to me, that means that the 225 basis point cuts The market is now going to question them on whether there's going to be a pause.

Now, this will all swing. It swings all the time. And the swing will depend on this week. So, right, so where, Nick will be right? Is if the CPI comes in cold where I will be right is if the CPI comes in hot and in line, it'll still be undetermined and then we'll have PPI which is related we'll have The another non farm payrolls before the fed meets but right now the market has gone from a 50 50 chance, well even higher at one point, of 50 basis point cuts down to a virtual certainty of 25 basis points cuts in its pricing.

And in fact, it's actually now pricing in a tiny probability of no, no cut in November. So the inflation number will likely validate that pricing or throw it on its head.

Nick: Okay. So, because the only really important data next week is CPI from that, we'll be able to infer what PCE is. And apart from the auctions, we have threes, tens and thirties, but we have those, you know, every month.

So the market is now. Going to be prepared for these auctions and it's probably going to get them at a very good level. What do you think the the consequences of a hot CPI number are? Because I think they are going to be disastrous for the bond market because at the moment our pricing is, as I've said, is for a normal inflation target, hitting the target between two to two and a half percent.

and remaining there. If employment is strong and inflation accelerates, I think the bond market is completely mispriced. What, what are your thoughts?

Andy: Yeah, I mean, short term, a hot number above target, it's around 0. 2, say it rounds to 0. 3, to me would seriously question and possibly increase the probability to likely.

That the Fed won't cut it all in November. That'll raise a question on the whole curve about whether cuts are done. If there's a 50 basis point one and done. Now, obviously data subsequent will matter on that. But this week. November could come off the board as a likely outcome. December will come off the board as a likely outcome as well.

It won't just be November and the terminal rate will be instead of, you know, where it had been, which was sub 3%. Will be closer to the top end of the range that we are talking about, like three and a half or three and three quarters. So that's pretty disastrous for the bond market. And so ahead of this, we saw a big sell off last week.

I would expect further sell off in the next Monday, Tuesday and Wednesday. We haven't talked about Israel. They're likely to give a response that could have some impact on inflation expectations, particularly as it impacts oil or not. And the auctions, you know, the market makers will price these things so that the auctions go well.

And so that to me means short term pressure on the bond market. And then. The CPI and longer term pressure on the bond market would occur if the CPI is hot.

Nick: Well, yes, I completely agree with that. If the CPI is hot, the bond market is in a world of hurt. And we can discuss what the yield curve would look like, but I don't think that's appropriate at the moment.

But what do you think the effect is on equities? Because my own feeling is that if CPI is now If the economy is running hot, there is absolutely no way that the Fed is going to even allow talk of hikes again, right? So we know that there's absolutely no chance that at worst they pause and wait for another opportunity to cut.

But to me and to the bond market, I fear this is going to say that they are quite happy with an inflation target. With a new inflation target, which is above the 2 percent that they have set themselves. And really, then you are looking at a world in which. Inflation is going to remain hotter than target for probably many years, right?

When, when it's not something that's going to be transitory, it's something that's almost permanent. And then you really have to start questioning, especially after the election. And after the fact that every, you know, whichever candidate gets elected, they have absolutely zero plan. To reduce the deficit, then you have to really start asking yourself about a completely different asset allocation than the one that we have at the moment.

Andy: Yeah. You know, that's out there. In terms of expectations, what I care about is what the Fed actually does. And to me the asset allocation decision would depend on whether the Fed continues for whatever reason. Cutting into hot data if they do, I agree they are ignoring their inflation mandate.

And that's a certainly a possibility, but, you know, most of the rhetoric, except for possibly Chris Waller, most of the rhetoric from the Fed and the dot plot is concerned about the jobs mandate. And I don't know, this is just one number, and we've been saying one number shouldn't make much of a difference, but it clearly did.

And so, I'm a little surprised. It may take another number to convince people, but certainly an NFP that doesn't show any signs of weakening by November 1st, and we'll know whether the Fed is intending to ignore its inflation mandate. Even if inflation comes in at target because when you roll ahead to the SCP in December and the the unemployment rate doesn't even come close to hitting the unemployment rate they were concerned about and inflation hits target and GDP is hotter.

Why are they cutting

Nick: and the bond market in that case will be a lot worse than it is at the moment. But that will have a repercussion on equities as well. I

Andy: was thinking about equities and, you know, there's a, there's two things that drive equities, multiple expansion, which comes from those that comes from whether the Fed is too easy relative to conditions or too tight relative to conditions which sort of is a valuation dynamic.

And. Earnings. And earnings are dependent on the level of nominal GDP, which is a combination of real GDP, which we said is strong two and a half, 3 percent and inflation. And so the dynamics for equities are likely to in a fed that sort of sticks with the normalization that they have in the penciled in SEP and maybe tweaks it a little bit because of the incoming data, multiples are not likely to expand.

They had expanded when the market had expected the Fed to be very aggressive easing. And so to me, the multiple should have contracted a little bit on the data last week and the earnings expectations should have improved based on the data last week, those two things offset each other. And not surprisingly, The equity market closed where it opened.

So I expect further things like that, which is good data, meaning strong, real data like employment and GDP is good for equities. Inflation is not good for equities and the way the central bank responds to those things, either by. Cutting into strength, which is fantastic for equities or not cutting into strength, which is neutral to equities or the economy weakens, which is bad for equities is the way to trade equities right now.

And ahead of the election, I don't think there's much to do.

Nick: Yeah. So we are basically saying that something big could change. Over the course of the next month or so, and really, it's still a period that is so uncertain that one should have a lot of cash at hand and not take any big risks right now, because whatever happens over the course of the next month or so is going to have very important reallocation potential.

So either we're going to go heavier in equities, heavier in gold and heavier in commodities. And really basically abandon bonds altogether or just go into reels again in into tips As you know sort of stip tip that kind of etf All we all we are at a at a place where investing in long term Bonds and duration is actually quite good, but we'll only know that You know over the course of the next month.

Is that what we think Andy?

Andy: So I think that I think we're getting bogged down a little bit. So let's just sort of simplify things the economy is strong inflation nick and I disagree, but who knows we'll see what the outcome is and The fed is on a path to cut rates. We think it's probably Less aggressive and more and to a higher rate What does it matter for assets?

If we have a hot inflation print everything's going down. Stocks, bonds, probably not gold, but, and probably not commodities, but everything's going down. If we have a cold inflation print, Bonds are like that. And stocks will too.

Nick: Yeah, I absolutely agree. I think this inflation print is going to set the tone for the next several weeks.

As you said, if it's called the long end, we'll like it. And I don't think the short end is, is going to be too upset by, by any stretch of the imagination. But I think the, the equities will certainly like that because they'll have. A reassurance that the Fed is still on track to ease. The long bond is helping them with the, the multiplier.

And therefore I think equities will probably really like it, and they'll probably be up by a couple of percent. The bond market, I fear is not going to like it as much as equities. Although they will like it simply because. The likelihood of a terminal rate below three or three and a quarter percent to me now is very, very low.

Inflation would have to be at target or below target. And before year end, I think there's very little likelihood of that happening. Therefore, the short end really is stuck within 10 or 15 basis points of here. And the long end is also stuck within 15 and 20 basis points of here. So the bond market is more or less stuck within 3 or 4 percent moves on the ETFs.

But really equities and commodities as well. Could start performing better going into year end naturally depending on the election So we will reallocate it's just that we feel it's the wrong time to reallocate right now

That's that. Okay. Okay. So that's really all we have at the moment and the overarching message is stay small on risk at the moment because over the course of next month, big things will happen and we'll have so much more clarity. And we'll be able to really position the ship in the direction that the market will go at the moment.

It's also uncertain. We really have to wait and this is the worst time to add on too much risk. Absolutely. Thank you very much.