# 2 Gray Beards Week 95

**Nick:** Hello, everyone. Today is the 26th of October. And what happened last week, Andy? Not a lot, really. Nothing that would tempt us to deviate from our view that the economy is still Pretty damn strong and that we have no weakness in sight that the data points to

**Andy:** yeah, for sure. All of the data, you know, there wasn't much data, but the data that there was was supportive of the economy.

The, auctions went okay, not great. And what I found interesting was the, you know, pretty meaningful reaction in some of the tech stocks that reported Netflix and Tesla in particular where, you know, those big stocks rallied. You know, 15, 20, 25 percent at some point on earnings that were okay.

And guidance that was okay. And it just tells you that there's not a lot of liquidity out there. There's not a lot of, you know, the big institutions aren't making a lot of bets. And so the markets are, you know, sort of on edge. And. You have to step back and say what's actually going on. And what's actually going on is ever since the Fed cut 50 basis points in September all the data, every bit of data that they've that they care about for cutting has been much better and bonds have sold off by 50 basis points.

And. Cuts that were priced to go as low as gosh, I think 2. 8 percent at trough are now priced at 3. 6 percent and for in terms of the trough of the cutting cycle. So markets have really Reacted to the strong economy.

**Nick:** Yeah, no, you're absolutely right. And even last week, the bank of Canada cut another 50 and that didn't really move the short end in the U S at all.

So we are getting a continuation of the steepening yield curve. We are well out of TLT and the long end. And the dangers are that it keeps on steepening. And that's about it. If you look at what happened last week, really, TLT was down 2%. Gold was up 1 percent and equities were down 1%. So really it's a continuation of this strong economy trade, which favors equities and gold ie.

Real assets over the nominal assets of bonds. And that just does not keep on, just does not change. And I think it's going to continue in the foreseeable future.

**Andy:** Yeah. I mean, I think we need to just cover briefly what happened last night in the Mideast, Middle East. There were the retaliation, the long expected

and retaliation by the IDF was done and it appears that it's a nothing burger in terms of it looks like a A meaningful response, but proportional and deescalating.

We've seen, you know, this is the fog of war. No one really knows, nor can predict what Iran's next move is, but it seems like we are At least deescalating.

**Nick:** Yeah, certainly the pricing that you get from the various betting sites for the weekend indicate absolutely no change to anything in terms of asset markets.

So we can disregard that. What about next week? Because next week, apart from the issuance, we get the QRA, but this time the QRA is likely to be not very important, right? But what are the

**Andy:** dangers here? Right. So it's a, it's a, I'll jump into QRA in a second, but it's a data packed next six days tomorrow you have the Japanese general election, which is likely to result in a relatively dovish outcome.

But if there's a surprise that could change things tomorrow on, on Monday, you get the amount of issuance in the QRA, you get 139 billion of auctions and then you start getting real data for the rest of the week with jolts on Tuesday. Again, a large auction, Google earnings, Wednesday, you've got the QRA consumption, composition and ADP and the GDP figure.

The first one, the first one for Q3 Microsoft and meta earnings. On Thursday, you get core PCE, which again is widely expected but you also get Apple and Amazon earnings. And then we end the week with the non farm payroll numbers. So, thankfully, the Fed's blacked out, so we won't get anything from that, but there is a lot to go over.

I'll briefly jump in on the QRA. So the QRA, the quarterly refunding announcement, says how much the budget deficit is projected to be for The first quarter of 2024 5, which, you know, should be pretty high. 1. 8 trillion annualized is the expectation is the estimate by the Congressional Budget Office.

Now, all that goes out the window after the election. And the Implementation of various policies could change that number radically, but they'll make an estimate based on that. And so you're going to get a certain amount of issuance necessary. And the higher that is, the more likely that the Treasury looks at its.

auction sizes and considers raising the auction sizes, but it really has to be a blowout high estimate for the budget deficit for the Treasury team. Even consider the idea of raising the auction site sizes for Q1. Now the auction sizes are important because they are how many new treasuries need to get bought by investors.

So that's how it matters. They have told us in past quarterly refunding announcements exactly what to expect in terms of auction sizes. So if they do what they say, which is what we would expect, they will keep the auction sizes the same. On Wednesday, after that Monday data, that is only interesting if the budget deficit is very, very high.

On Wednesday, we actually find out the coupon issuance. It's going to be. That is the highly likely outcome. And we see if they change the language for future auctions. Which again, has said that they expect to raise auctions, but not in the coming quarters. Now, this is the last Quarterly refunding announcement.

That is staffed by the Biden administration from treasury down to Jack frost, Josh, Josh frost is the guy who actually administers this issuance. And so it's, It's possible that they change the language, but not really sensible given that the next guy is going to actually be implementing that change.

So when you add all those things up, it's almost certainly going to be a short term Non event, and then we'll have to look at and each day, each month, each quarter, the market's getting more and more aware that there is a tremendous amount of increased auction sizes that are going to have to happen in order for the treasury to get its finances in order and stop increasing the amount of bills they use to finance the government.

Okay. And so at some point, probably not this week, particularly given all the other things going on at some point, the market's going to react. And that is a steepening bias.

**Nick:** Yeah, I mean just to remind people this time last year they surprised us all by actually cutting the amount of long term issuance and that actually sparked this year long rally in equities and certainly the first three months in bonds and bonds are now back to where they were more or less when they cut the amount of long term issuance.

So there has been zero change in net net in bonds, but there has been a very strong rally, about 20, 25 percent in equities. So that should moderate. And I just can't see how they can continue. With issuing more and more bills because

the percentages are now getting to be ridiculous, almost banana republic style you know, sort of percentages.

They're going to be issuing something like 35 percent in bills. Compared to equities. And of course, the longer they leave the current structure in place, the more bills they, they will be issuing. So in two or three quarters time, it's going to be nearly 40, 45 percent of bills. Should, you know, Trump win, for example, and increase the budget deficit.

So this has to change at some point. Well, we're saying it's not going to change now. But the market is definitely going to have it in the back of their mind that eventually it has to change and that continues to give the yield curve a steepener. Combine that with the fact that it's unlikely that the Fed stock plots will lead the short end as low as they think and 2.

9 is what the Fed thought in September and now the market's already saying 3. 5 plus. That gives us a very strong headwind in equities to be able to rally nearly as much as we rallied from November last year to. Now, which says that this is going to be a much more difficult 12 months going forward than the past 12 months.

Would you agree with that, Andy?

**Andy:** Absolutely. You know, they're, they're October 31st a year ago when they announced the coupons would not go up and projected that they wouldn't go up. Stocks were at 4, 200 on the S& P, the 30 year treasury was at five and a quarter percent, real rates in 10 years were at two and a half percent.

It was value. There was limited to no downside in owning assets. Today, that situation is completely reversed.

**Nick:** Absolutely. So one has to be careful. This is not the time as we've been saying for a couple of months, this is not the time to be leveraged at all. And it's actually the time to be extremely cautious. Whatever happens, it's probably a fade. So next week, you know, yeah, next week, we've got the the tech earnings, you know, everyone, Google, Microsoft, Meta, Apple, Amazon, they're likely to be good though, right?

So next week is probably not going to be the week that assets weaken. But you know, we, the only thing that we can do here is start thinking about where to add exposure to real assets. As opposed to add exposure to to bonds bonds, I think have very limited appeal from now on for the next several months.

And it's only a question of where do you buy long, you know real assets like equities, gold and so on, and even commodities. Is that something that we need to think about?

**Andy:** Yeah, I, you know, we've talked a little bit about this offline, but I think the only really difficult circumstance for those assets that you just described as a blue sweep.

In a blue sweep, corporate taxes go up. Realized capital gains for 2025 go up, which is likely to cause a 2024, where the capital gains tax is low, tax realization period, meaning selling, you know, And the economy is likely to get weaker more rapidly under a blue sweep than any other outline. And all of those things are good for bonds relative to all those other assets you mentioned.

So for me, it's what's the probability of a blue sweep? Honestly, I don't know. We know what the betting markets are doing. We know what the polls are doing, but they're They're not reliable. So anything is possible, but that just, again, says. Where do we find value in, in such an event? And as in terms of risk assets, I expect that with a blue sweep and a red sweep, we get the two extremes, either stocks outperform bonds in a red sweep or bonds outperform stocks in a blue sweep.

But let's say we get a blue sweep. Are stocks just going to crater? No. If they go down a little bit, we're not going to want to buy them, but if they go down a lot, remember the framework, which is it's going to take the people on top of that command, the battleship or the aircraft carrier and turn the wheel don't mean much, it's very hard to turn a battleship or an aircraft carrier.

And it's harder just to even to slow it down. Let alone turn it. And so this aircraft carrier is heading to above, is staying on the path of above trend growth and inflation. That's higher than we'd like, but, and sticky, but that's the direction. And what's that, that, and that continues to be good for equities.

Relative to bonds even in a blue sweep.

**Nick:** Absolutely. Just a question of where you buy them and how big the retracement will be But what do you think on a the most likely outcome according to the betting markets is a red sweep Or certainly you know at least the president and the senate I would have thought that Even if equities rallied under that scenario, and you're likely to see a very strong squeeze three, four, 5 percent in almost immediately.

Are they a buy or are they a sell? Because I'm really beginning to think that it's a sell.

**Andy:** Yeah. My view on that is simple. Well, not that simple. Trump will Regardless of whether he has the Congress with him or without or against him, we'll institute higher tariffs, because that's his right, and restrict immigration.

Both of those things are inflationary and anti growth short term. And that means the Fed will have to be more hawkish and partly because even though it's anti growth, which you would think would allow the Fed some ease, allow them to be easy, it tightens the labor market. It doesn't cause unemployment.

It means there are fewer workers for the same number of jobs. So the fed will be, have the ability. Now they'll get yelled at by Trump, but you know, they'll have the ability to be tighter. That's just not good for equities longterm. The only thing that is good for equities longterm is in a red sweep. He undoubtedly lowers corporate taxes, and any fear of lowering capital gains taxes is eliminated, and those air bullish things and low lowering corporate taxes.

You know that's worth something if they if he lowers corporate taxes such that the effective tax rate of the corporations that make up whatever index you're looking at drops by 5%. That should be an immediate Instant an instantaneous increase in the fair value of stocks by five percent in perpetuity.

So that's The red sweep case you have the red regardless case of being of restricting immigration and adding tariffs. In the red sweep case, you should get a rally because of the tax issue. In a red split case, there's really nothing good that comes for equities out of that. And so, the question is how far, and if you get 5 percent day one, That's a fade because then all the news of the Trump administration is built in and he's still the guy that's piloting this aircraft carrier.

The good news is, is it going to fade? Is, are we going to crash? No, because the economy is still strong. So from an election standpoint, it's a fade on a pop, but from a, you know, do bonds outperform stocks or stocks outperform bonds. The big nonpolitical pressure is for stocks to continue to outperform bonds.

**Nick:** Yes, I absolutely agree. I think the next 12 months are going to be far harder than the previous 12 months because the the pull of the higher yields at the long end Is going to mitigate how much stocks can go up. So I think 20 25 Is really out of the question. I think it's probably going to be single digits that You know, stocks can go up by Because they the multiplier is going to be pulled back all the time by the rise in long term yields And long term yields I i'm I I

think can only rise over the course of the next 12 months Unless we get a recession And I think that that is very unlikely,

**Andy:** which raises the question about when do you step in and just buy two year notes, we're almost at four and a quarter four 15 or so there's going to be a level where.

It may it just pays to move out of equities into two year notes on the margin and Out of and we already think it makes sense out of duration. When does what do you think that level is?

**Nick:** Yeah, I know. I I think four four and a quarter is that kind of level? And i'm waiting for that to invest. I mean as you know, we are in usfr mostly simply because we thought at the time that that the likelihood that the Fed could cut to the level that is in the SEP and is discounted by the two year note, the terminal rate is unlikely to be that.

But now that we're getting to 350 to 375 of the terminal rate, that is where you want to then put your money in the two year, the three year That is the kind of value area. And that's around the four and a quarter percent. We are not quite there yet, but very, very soon it'll pay to invest in the, in the two year, because it's very unlikely that we, that even equities can beat the cash rate by very much over the next 12 months.

So you will have probably seen a a Goldman Sachs report that is predicting 3 percent return for equities for the next several years. I don't think it's going to be nearly as bad as that, but sector investing is going to become much more of a, of a, of a theme and also you know, investing much more in short duration.

For longer periods, I think it's going to be become more of a theme for the rest of this year and probably most of next year.

**Andy:** One, one last thing before we leave we have a lot of employment data that also is important to the Fed, to markets, et cetera because of. Hurricanes and strikes, the odds are that the, the various employment numbers, including the nonfarm payroll on Friday, which is the biggie are soft.

It's pretty unlikely that. They're hot. And so the market's going to principally look through soft payroll, but the fed may and is light is expected. And we'll talk about this next week to cut 25 basis points in November at their next meeting in two weeks. And the inflate only if a, if all those pressures of the hurricane and the strikes get overwhelmed by.

real strong labor demand, will you see a market reaction? More than likely you get soft data and no market reaction.

**Nick:** No, absolutely. The, the market is going to find a thousand excuses for the soft numbers because as you said, strikes, hurricanes, Pestilence. So the that is not going to move the fed.

What could move the fed, but I think almost nothing is going to move. The November cut is a very strong number because then you're getting. Sticky inflation, accelerating growth to three and a half percent GDP and very strong labor numbers. I think that that actually puts the kibosh on a December cut.

And then you could, we could see the two year at four and a quarter or so, and that will be the time to buy it. Thank you very much indeed. I'll speak to you next week.