Week 100 2 Gray Beards

Nick: Hello. Today is November the 30th, month end of November. We've had everything we're going to have for November. And is it time for the Santa Rally? That's the big question. December is nearly always a time for higher asset prices. What do you think? What have we seen this week, which tells us which way next month is likely to go, Andy?

Andy: Yeah, I think it's still unclear. I think we had a a meaningful week in terms of bond market retracement higher, lower yields and equities followed suit but some of that may have been month end effect, so it's still hard to tell, but You know the odds are for a Santa rally and so the question is what would prevent a Santa?

What would I see that prevent a Santa rally and we'll talk about what's coming next week, but In terms of this week, we saw two year rates fall about 20 basis points to what I think is the middle of the range for expectations. And 10 year yields fell 25 basis points, which I think was a bit aggressive and had a lot to do with duration extension for month end flows.

And continued hawkish. Well, hawkish expectations building regarding budget deficits and at least the secretary of treasury not being a disaster for the administration, but being a reasonable choice. I think the ability for the next administration to meaningfully impact the deficit without simultaneously lowering growth is extremely low, but if they try to, and they, Succeed in reducing the budget deficit, you're going to see a growth hit and equities ignored that this week while bonds took that as a possibility.

And so you saw a bond market rally even though Inflation data and all the data for that matter continues to be strong. And you saw a equities follow suit. So we'll see about next week and the Santa rally, but my biggest concern about the Santa rally, just to put it. T on the cross the T on that is it usually is impacted by those who have capital gains, not selling and those who have who are underperforming chasing the things that are doing well and most of the capital gains this year, though it's broadening.

Most of the capital gains this year are coming from tech and I don't see any desire, need, rush to buy tech or to defer capital gains. Tech's acting pretty crappy. So if we don't have a Santa rally, it's because tech does not participate.

Nick: Yeah, no, that you're absolutely right that tech has been underperforming for Well, basically months now We are still at the level that we were in july We haven't made new highs on qqq or nq Ndx, so that's definitely an underperforming sector I'll give you my view as to what's happening in the bond market and it's slightly different from yours We've had a very big move up in yields as soon as the Fed cut rates.

And what we got was term premium going from basically zero up to 50, 60 basis points. And now they've come back 15, 20 basis points. Real yields went from, what, a low of about 153. All the way up to in the, into the two tens, two twenties. And now we've retraced to the sort of one nineties. I think the bond market is basically trading around a range of real yields.

It's telling us that anything over 2 percent is likely to be restrictive for this economy. And also that term premia are unlikely to go. I don't think we're going to be able to get the deficit rally to an exceedingly high until we see what the policies of the next administration are going to be. This is a bit of a relief rally I believe, simply because we have an adult in the room who is going to make a case for lower deficits or controlling the deficits.

Before that, we were fearing that we might get someone who is just a yes man. And could do just about any kind of harm to the to the, by increasing the deficits to balloon size. So we have, we've removed basically that fear. What is also going on, and our viewers should be aware of it, is that Europe, the economy there, is exceedingly weak.

We have political crises in both Germany And now in France Likely to exacerbate themselves. We will then probably have new elections Certainly in germany. We already know that but possibly in france as well And france and germany are naturally the largest economies in the eu and the drivers of the eu So the bond markets in europe are very strong And the differential between Europe and the U.

S. is going out and that is providing a flaw for U. S. rates as well. So we are having many cross currents and that those, all of them are supportive of bonds. At the moment we shall see if they continue to support bonds But what the market is basically saying at the moment to me is that the ecb is going to remain very dovish Jpn made a call that they will cut 50 basis points in december.

I doubt that they that is correct I still believe that they will cut 25 And then the us market is only looking at what the fed is going to do over the course of a period. I don't think that if the Fed does not cut in December, that means that

they've stopped. Cutting they will continue to cut. So whether it's December or January, I think it's almost immaterial to the market and what we are doing is we are continuing to debate what the right level for the terminal rate is.

Is it 350? Is it 375? Is it 4? What the debate no longer is it in the twos? And that was the debate that we were having only a few months ago And I think that debate has been settled with inflation up and sticky at the two and a half percent And with very little likelihood that it's going to go below Meaningfully below that two and a half percent I think the market is now arguing where in the threes Is the correct terminal rate and what the shape of the yield curve will be Once we've reached that terminal rate, and I don't think that we can tell that the yield curve could remain relatively flat if, and these are very big ifs, the next administration chooses the right policies, and we won't know that until probably February, even March, who knows how long it's going to take them to sit, get their feet under the desk.

They go in there what the 20th of January They get in there. They see what the books look like They run various scenario and then they decide to announce the policy That could easily be in march or even later and therefore until then I think the likelihood of having very large moves in the bond market Is low And therefore that lowered You Those lowered odds of the bond market making really sharp moves to me dampens the volatility in equities as well.

And I think that is the likely, the highest odd scenario that I can see at the moment for the next month or two. Anything that you want to add to that, Andy? Yeah,

Andy: I guess I'd like to just, so I agree with everything you said as in terms of the way it, the likely path. I'd just like to just put some perspective on the economic path.

The U. S. economy and to some extent the European economy, well, every major economy is a massive supertanker. The U. S. being the biggest, but every economy is a massive supertanker. And all this, Wiggles and waves and little corrections that the is just very little has very little impact on what the major economy is doing.

What? And so when I look at the United States, I look at an economy that is, as Nick said, not going to super accelerate in inflation, but also not going to achieve target. And growth is pretty darn good. And jobs are pretty tight. And that's the sort of thing where and now that we've seen this sort of expansion of

term premium out to 60 basis points, which is, principally why we've been out of the bond market, long term bond market and A retracement.

You look at the returns that assets can provide and a 40 basis point term premium is not attractive real rates below 2%. Aren't that attractive? And so it's still the big picture still is, and I look at our inventory. Now we made a few mistakes over the last couple of weeks. I look at our inventory after we address it this week and we're long stocks and not in bonds.

And that's the way I'd want to be in an economy that is moving forward in the direction it's going. Now, would I want to be super aggressive in equities? No, because bonds are not attractive. They're okay. They're not attractive. And there's more economic upside that could cause a bond market to sell off more than it will rally.

And that would take some negative impact on equities. I don't yet see a clear case for flow driven. Santa rally because of the weakness in the leadership that's been weak for a while But the odds are we continue to go forward in equities, but they're still Extremely bid and have been since the election and there's a lot of policy that specifically will address equities that needs to get litigated To get negotiated.

So when I look at our book and I look at my the economic path I don't want to own bonds and I do want to own, a market weight of equities and that's where we're

Nick: at Makes perfect sense. Let me ask you a question. What would make you bullish or bonds?

Andy: Bullish of bonds.

Nick: And if you're bullish of bonds, you could be bearish of equities.

Of course, if it's an economic thing, if it's a recession call. But that is unlikely, right?

Andy: Right. So bullish of bonds to me is about starting with the economy. And I can't be bullish of bonds with inflation above target break evens where they are, which are not. Term premium, where it is, which is not elevated, but higher than it was and real rates that are in the, that are below to so price would be the number one reason to be bullish bonds and it's not, and it's not there.

Obviously, the most, for me, the most important thing that the new administration is faced with is the old administration's extensive use of bills to finance the deficit. And so, if I were to see signs that the new administration is going to continue that easy policy. That would make me more bullish of bonds than I've been, but, and so yes, I would, I could imagine being bullish of bonds if they decided to address the budget deficit in a similar way to the past administration.

On the other hand the budget and, but this is, US did not have an economic weakness. I guess if they really succeeded In reducing the budget deficit having all those work government workers that are getting fired and eliminated by doge, start picking our crops and doing the menial labor that the that the immigrants that are getting deported are doing we're doing and have a perfectly Efficient productivity enhancing budget deficit.

At that point, you'd have to say real rates belong at 1 percent and off we go. So if there is this miracle of productivity I could imagine bonds rallying quite a bit, we're talking about very unlikely events. The most important one, we won't even know till May because the decision to extend the duration of the treasury depends entirely on the QRA, which The first one will happen at the end of January when these guys are not, the seats aren't even warm from them sitting in them.

And then we won't know till May. So I think that is, and they have, the rhetoric is that they will not do what I say. The prior administration does. So I have a, I struggle finding a non economic reason. Obviously if inflation crashes and growth crashes, that's bad for equities, but things that are not bad for equities and yet are Good for bonds.

Are the things I just mentioned and they're fairly low odds.

Nick: Yeah, and I agree with you. So basically what we're saying is that the odds of the bond market doing substantially better from here, certainly all the way out to May. The next quarterly refunding announcement are not all that great. So we are really not seeing a lot of opportunities in bonds.

And as a result, we are probably not seeing a huge return from equities either. And that is really what we can foresee now for the next three, four months, which is not fantastic. economies,

Andy: the battleship is for, the battleship, the big trend is for better equity returns over bond returns. But also decent returns in two year notes in cash at the right level.

And that's the way we're positioned.

Nick: I completely agree with you. Anything else that we'd like to tell our viewers about next week? I think we've just about covered Everything that we're likely to get

Andy: yeah until we see

Nick: nfp. We can't really tell

Andy: it's jobs and the I think it's important to mention that hot data may take, right now, there's a 65 percent chance that the Fed cuts rates 25 basis points at the next FOMC.

Hot data reduces that, probably pushes it into January when they're going to cut. Cold data enhances that probably takes some out of January. So, the front, front. Part of the yield curve, the very short term interest rates are about where they should be, and it's going to be data dependent.

Nick: Yeah, no, and really all we are arguing about, as we said earlier, is the terminal rate and how high that needs to be. And we won't know that without data. So nfp, of course is important But whatever this nfp is and it's the last one before the fomc It's only a question whether there is in december or there is in january And that's the way the market is probably going to take it probably.

Yeah, great. Thank you very much. Andy. See you next week See you nick