

2 Gray Beards Week 96

Nick: Hello, good morning. Today is November the 2nd, and we have an exciting week in front of us with the U. S. elections. Should we go very, very quickly through what actually happened last week, Andy? The QRA was absolutely a non event. Everything was completely as we expected, completely unchanged, and therefore no signal For us to do anything at all from that and the little data that we had like PCE was as expected.

The the non farm payrolls were slightly weaker, but as we foretold, completely explained by the Boeing strike and also by the hurricane effects, so really no macro signal at all. And the market completely ignored them. The one thing that's puzzling slightly is that the long end of the yield curve keeps on selling off.

And in fact, the whole bond. Complex keeps on selling off and we are well out of it as it were. We've taken our loss like good boys. We realized that we were wrong and that's it. Risk assets also got sold, but that to me is completely explainable by people just lowering the the price. The leverage ahead of big events like the U.

S. Election. So I think that's more or less what happened last week. Did you notice anything particular Andy that I haven't mentioned?

Andy: Yeah, I guess, coming from where I come from, which is, I think the supply matters. I would rephrase the Q. R. A. X. Expectation. It also it. While I agree completely that this is a deleveraging event ahead of an election, I'd also like to point out that we've been saying for many, many months that the supply of treasury bonds that is necessary to be financed over the next couple of years is immense and should keep pressure on assets.

And so it doesn't surprise me entirely that Long and bonds and stocks and even gold sold off after the Q. R. A. Even though the Q. R. A. was neutral because there is also this pressure this headwind on assets that just isn't going away. Anyway, I agree ultimately that it's was all about pre election positioning and a relatively strong economy, but let's talk about that.

Nick: Right? So next week, then, right? We've prepared a a presentation for you. What we individually think is going to happen after the election, depending on the result. And. We'll put that up now and you can also download it. Well, let's let's go through it andy you know There are really four scenarios.

There's the red sweep the trump, but a split congress The harris but a split congress and then finally the blue wave Which the markets really are not prepared for and that's because the odds of it are very very low indeed so Let's see what we think Equities If it's a red wave, we both think that the market is going to go higher by between three and 6 percent to price in the Corporate tax cuts which are definitely going to come and also there could even be Income tax cuts you never know with trump And that could you know?

Anything's possible And that could actually even you know supercharge consumption. So we agree that the big beneficiary In terms of assets of a red sweep are equities, right, Andy?

Andy: Yeah, I think the key differential between the key thing on policy is that trump has the ability regardless of whether he sweeps Or doesn't sweep congress to affect immigration Which we expect to be, fairly severe with deportations, etc and tariffs but the Thing that gets unlocked that supports equities and likely to cause a meaningful immediate equity move is the lowering of corporate taxes back to the Trump level were in place when he was in office and.

Almost definitely any concern regarding capital gains tax increases will go away. And that's good for a, a big differential between Red sweep and not red sweep but red split. So yeah, I think that's the dominant factor in a red sweep is the impact on taxes because we get the immigration and um, and tariffs regardless.

Nick: So why do we think, and we agree on this, why do we think the blue wave is actually the worst outcome possible for equities?

Andy: Right, because Just for that reason corporate taxes will almost definitely be at least what they are and more than likely raised. And there's going to be some pressure to, well, immediate pressure to tax the billionaires and do it via increasing capital gains tax, realized capital gains tax.

There's a lot of noise on this unrealized capital gain tax, but even that's possible. And that's Immediately very bad for 2024 equities in particular, because those tax cuts and those tax raises on corporations and tax raises on capital gains would probably be in 2025. And so there'd be a reason to sell.

Nick: Yeah, so immediately you would get, a move down, but it's not going to bounce simply because there's going to be pressure from people taking profits and realizing their capital gains whenever there is a bounce and therefore. No

bounce could be sustained. And if no bounce is sustained, then really you want to keep away from equities and go to a minimum and that's it.

You wait until the situation settles down and basically you can forget about a Santa rally. I think we agree on that. So bonds, it's tough to see. Anything but a continued steepening, whatever the outcome and different levels of panic. And I just think that the long end of the, of the bond market, as you were saying, is going to become more and more susceptible every time there is supply.

And really, there are just no natural buyers until and unless. We get a positive yield curve and I think that that is the thing to stress that the yield curve has to become positive And for the leverage buyers to come in and buy 30 year bonds or mortgages They need to see a very nice cushion where they can fund it positively.

Andy: Yeah, I look at the, I scan across the the various outcomes in our, in our work here. And I don't see anything that says you got to be long the 30 year because, and even, as you come closer, we may differ, but certainly, I think. 30s at what 30 ish basis points is nowhere near where people need to buy 30 year bonds in an economy in which the Fed isn't aggressively cutting, meaning a recession.

And we don't see that happening. As you get closer, 10 year bonds, Are starting to look buyable, but they are still not anywhere near the level that would create significant demand by banks who are leveraged buyers in particular, because the 10 year references, the mortgage rate a lot.

And that's a lot of the things they buy. So it's getting, if it's, we, I think we agree that the, if there is any value in the bond market, it's as you approach the front.

Nick: Yes. And also tips, should they go above 2 percent in the short end, like two, five year tips at over 2%, you're not going to go far wrong.

You're not going to make a lot of money, but you're not going to go far wrong. And it's good diversification. So it should certainly be a part of the portfolio, gold and commodities. We actually disagree, don't

Andy: we? Yeah, I think so. Well, not commodities so much. I don't really do the things you do in commodities.

I do have a different view on those things, but really my expertise is in oil. And I think we mostly agree on oil. Right.

Nick: Yes, we both think that under a red wave oil is likely to go down. Well, more than in other, in other scenario, but the commodities, because all the commodity ETFs are so oil heavy, 50 percent or higher, that would mean that those would not go up.

That's why I put down, on a red wave, you go and you try to get some industrial commodities. My thinking is that a red wave. Is inflation and you do get higher rates which moderate the economy, but I still think that Industrial commodities are going to be Support it over time. Yeah,

Andy: I think that's I think the where we disagree is, well, we agree on that point as it relates to inflation.

The red sweep is probably the most inflationary outcome. And so you have to think about a commodity allocation as inflation. But you also have to think of it as growth. And I think that the value of the red sweep is mostly handed to shareholders and corporations in lower taxes and higher budget deficit, which concerns can creates potential inflation and immigration reform, which reduces worker supply.

And tariffs, which is inflationary. All of those things say inflationary, good for commodities. You want to own commodities because they're a physical real asset. My problem is I think they're also really anti growth because all of the value is going to corporations and not to the real economy. And so, for me, the anti growth impact of fewer workers making stuff and tariffs slowing free trade to me is anti growth enough that I can't get it.

Excited about industrial commodity.

Nick: Okay We do disagree about gold really you are a seller and i'd be a buyer of dips in almost all scenario you know because if the if the price of gold now were to fall five percent I would be Buying them, I would be buying it with both hands kind of thing.

Definitely doubling or tripling the allocation. So what's your argument for not liking gold wherever it goes basically?

Andy: Well, I like gold on a dip in a red wave for some of the same reasons. I think the monetary inflation issue is good. I think the question I have on that is if we get a Inflationary environment and nominals continue to move out.

Do you get this run to this complete continued sell off in, in, in nominal rates and even real rates are pulled up by that, you could get a dip and that's a buy because real rates are gonna come down. So I like gold in the blue sweep in the red sweep. After that,

I think the Fed is going to be able to be tighter in most scenarios. And I think that real rates are in, in certainly in the, in the Harris style wins are going to be coming down. And so as I favor tips, I'd prefer tips over gold. And for that reason, I think gold has. Broken away from tips in such a meaningful way that I just can't get excited about gold.

At the same time, looking at the charts and looking at, the, the flows of that asset, mostly I'm not saying be short this thing. I'm saying we've had a huge run. Take some profits, sell some, sell, sell rallies versus buy dips. And so, I'm, I'm not, I'm more neutral than aggressive on, on gold.

I guess I would say.

Nick: No, I, I would I would agree that if we see another big move in the tips versus gold, it's probably time to add to tips and take away from gold.

Andy: But in the

Nick: meantime, I think that the likelihood of gold having a sizable move lower is very, very low. In any case the one thing that we haven't mentioned is probably the one that we would have mentioned first had it been any other week, and that is the FOMC.

We have FOMC on Thursday, and no one is really even talking about it, and that's because we more or less know that a 25 basis point cut is a lock. What do you think about that? I

Andy: think a 25 basis point cut is a lock, and I think that based on the economic data that we've seen, including this noisy and NFP print they shouldn't cut, but they will. And the real question, and it's a major issue for particularly ignoring all the election stuff. If it were just the FOMC happening I would need to be even thinking about taking advantage of this Bond sell off.

I would need the Fed to be hawkish and right it's unquest. It's unclear whether they will be

Nick: And just a a naughty little question. If you were worried, if you were a J PAL, and if you were worried about what the long end of the market is telling you, what would you actually do at this FOMC?

Andy: That's an excellent question.

To me, it's very clear that their policy mistake. Has already been made. It wasn't the 50 basis points cuts. It was the failure to manage their balance sheet well. And so what I would do if I actually, so the question is, does he care? Does he care about this incredible sell off in the long end? He has many times.

He should. He should, and he has he starts mentioning the tightening impact of the long end of the curve and doing some of the feds work for them at, in October and took pretty dovish steps to try to protect the bond market. But his policy mistake has always been QT. Runoff versus outright sales.

So if he is concerned, which I don't know if he is, I honestly don't. He should be. We both agree on that because you lose the bond market. You lose the markets your inflation expectations blow out everything you think about sticky about anchored inflation goes out the door if you lose the long end of the bond market.

And so he should be, but he hasn't been lately. And so to answer your question, if he is concerned about the bond market, he is going to talk about balance sheet reform and the, the time that it takes and their path to, to on of QT being much longer than people expect. Will he? I doubt it, but if he does, that's what you're looking for.

And

Nick: what happens if he actually starts saying that we are approaching the end of QT? Which could easily happen, right? It sure

Andy: could. The RRP is coming down and lots of liquidity measures are for trash. Uh, the market's going to love it. Stocks are going to rally. Bonds are going to rally. And you got to sell them both.

Nick: Exactly. And that's the message, because if you get a rally on the back of that, that's actually the last thing belonging of the bond market needs, in terms of going forward, yes, the rally will be great, but then you've got to sell it because right. It's another steepener.

Andy: I think the important thing about QT is.

And I tried to reference it in the last few minutes. QT was handed to the treasury. When you let your balance sheet run off, instead of making outright sales, it doesn't matter. What matters is what the treasury does. And what the treasury has done is finance that with bills. And they financed it to a point where there, there is no actual limit, but if they continue to do that, there's risk.

And so, If the treasury extends their duration as we expect, it doesn't matter whether QT is happening or not. And so that's the risk. And to me, this is why the QRA is always more important than the QT.

Nick: Yeah, I completely agree with you. So anything that we're going to do before the election, no, is the answer because we Don't take, bets outright bets with a portfolio.

We actually react to data and to events that have happened and we know what we're dealing with. So the only thing that we can do, and let's just mention very quickly why we haven't done an options play for this event, because as you can see from the presentation of the, what we think the outcome of the different events is the biggest danger that I personally see is that volatility collapses immediately on the event, and that actually whatever you've done in options.

And whatever the outcome, you've actually made almost nothing outside of a red sweep. Sorry, outside of a blue sweep, I would say. The blue sweep in no way is priced in. Every other outcome is more or less priced in given the level of vol that we have and our own personal expectations of how the market would react and how far it would go.

So, unless you believe there's going to be a blue sweep. Options at the moment to me are just too expensive. The risk that you're taking is not being compensated by the too high a price that you're paying for those options. But we will see and we will definitely be in touch as soon as we know the result and changing.

The portfolio allocations, because if it's a red sweep, we definitely need more equities. If it's a blue sweep, we need to get the hell out of them as quickly as we can.

Andy: Yeah. I just want to mention that 2016, I was up all night. I'll be up all night in 2024. And if you traded the markets during that period of time, when Hillary looked like she was going to win.

The market rallied when Trump looked like he was going to win. The market went limit down those things. I bought it. Those. Yeah, me too. Those things didn't make logical sense.

Nick: Right?

Andy: Remember over on Tuesday night, Wednesday morning, and however long it takes that there will be positioning related margin calls and unwinds that are, that may look like trading opportunities, but may not be.

So try to ignore the chop and focus on the things we described on the right side on this presentation about the future path, not what's happening short term. We'll try to. Give guide you through that.

Nick: And certainly I will be sending you messages throughout the night on the website about any portfolio changes and also any views that are, that we might hold for the longer term and how they're evolving.

Thank you very much. Have a good week. Bye.

