2 Gray Beards Week 98

Nick: Hi, good morning, and today is the 16th of November and another episode of Two Great Beards. Last week we had a bit of a bloodbath in the markets. Certainly compared to what people were expecting. What do you think Andy, where are we in terms of what the Fed is likely to do and what to look for next week?

Andy: Yeah, I mean I think the first thing to do is look at what happened last week. And what happened last week is every bit of data was warm. And probably, and many, many, many Fed speakers spoke. And all of them were including Powell, who can't help himself but be dovish,

The possibility of a pause on the table. But when you look at the actual data and in particular, their, their measure for inflation is something called core PCE, and we don't know what that data is until I believe November 27th and that data has. A significant amount, almost all, not every bit, but almost all of the data that that report has comes from components of data that we received this week, including CPI, PPI, and import prices.

And over the course of that, those, that data release, the estimates for our estimate and street estimates for core PCE, all. Rose on every data point. So for instance the market had expected core PCE for November 27th to be 0.2%. And on a rounded basis, on an unrounded basis, it was between 0.19 and 0.23.

The CPI raised that estimate by 004, the PPI raised it again, and the import prices raised it again. So, right now, A core PCE of 0. 3 rounded or higher. It won't be higher. It won't be 0. 4, but it'll be at least 0. 3 is a certainty. And that's a huge change in inflation, which to our mind says. Though the market is only at 50 50 right now, December will absolutely be a pause.

Nick: I completely agree with you. The way the bond market traded to me says we are going to have a pause. Monetary stimulus is going to be less than the market expects. And that I guess is why we had the reaction in equities on friday that we did And also why gold has been falling basically all week. What do you know?

Andy: The equity sell off, you know, you never know what it is Equities have been very strong post election. We mentioned the improving The, the very likely odds of a corporate tax cut, which caused the equity market to jump but the bond market has sold off around 20 basis points and the long term bond market.

And, you know, it didn't, it didn't close on its lows, but closed fairly weekly and the short term bond market two year notes actually was unchanged. So, and that's because the two year and shorter has already adjusted. over the course of the last, since the, since they cut 50 basis points to the terminal rate, being the, the sort of trough interest rate during this cutting cycle to be close to 4%.

And so there's not much room for the front end of the yield curve to move. And so it's all been the back riskier assets like long term treasuries and riskier Assets like equities that are feeling this tightening despite the Trump bump on taxes.

Nick: Yeah, I absolutely agree the the front end of the bond market is where to be because quite soon with the next fed rate cut which We don't think is going to come Coming December, I am absolutely 100 percent sure that the market is still slightly mispriced for December.

As you said, the odds are still 50 50 and I think those odds are going to go towards zero. But that does not mean that they will not cut going forward. So the cut will be postponed. It'll be postponed to December. January or maybe March because real rates are still significantly higher than where they would like or where they estimate neutral should be and therefore the cuts will come and the next cut actually gives the Front end the two year note, especially positive carry and once that happens I think the two year note has only got one way to go.

So the shorter end Zero to five years is where you want to be positioned in the bond market and that's where we are with the corporates and we have positive carry and that is perfectly good enough as far as I'm concerned. Can the two year note go up another five basis points, ten basis points on warm numbers?

Absolutely. But it's getting to buy levels where there's value and where there's value the bond market will respond. If not the same day, then over time. So that part of the yield curve does not worry me in the slightest. The long end does worry me, although they will like. If the Fed does not high does not cut that will support the long end of the bond market, which will in turn eventually support equities.

But in the meantime, equities are being sold off and I have a bad feeling about next week as well, but it's just the feeling that I can't quantify or explain rationally that equities are also feeling this. Lack of monetary stimulus and we'll continue to feel it for the Short term, especially if Nvidia earnings are nothing stellar and the market decides that we are priced enough.

The one thing that we haven't discussed and we really need to discuss is the U. S. dollar. Because the U. S. dollar is being a bit of a wrecking ball at the moment. 50 percent of the earnings for the S& P 500 companies come from abroad, i. e. they're then translated into dollars. And at the moment we have the situation where the dollar is rapidly appreciating against every currency just about.

And therefore the earnings that the, That the S and P 500 companies are going to have unless they're hedged and no way do they hedge 100 percent of their forward earnings are going to be lower. So you have both the situation that earnings are being revised down in dollar terms and also the fact that the long end of the yield curve is not coming down, but is actually stable at high levels is hitting.

The hitting the multiplier. And on top of that, we have a situation that we have instability because Nvidia is such a part, such a large part of every single index. And on top of that, we have positioning because I think positioning is probably still extended. So I think the odds of a couple of nasty weeks in the bond market are far greater than the odds of.

You know, it's blue skies after NVIDIA. What's your feeling, Andy?

Andy: Do you meant the equity market, right? The couple of the equity market, you said the bond market. I'm just, I'm sorry. So I guess the question that's on my mind, so. Nick has this feeling that he said he couldn't articulate and then perfectly articulated which with the combination of No,

Nick: it's, it's a feeling that that something nasty is around the corner.

You know, I, I just get that feeling sometimes and this is one of those times. By no means is it always correct, but more often than not. You know, I regret when I don't listen to my feelings,

Andy: right? And we try to minimize that in our lives. And but when you get that feeling it's it's often a call to action so as it relates to my outlook on on on the bond market first I think it's important to recognize that There will be a natural response if we're right and equities have a couple of nasty weeks for Short term bonds to rally.

And so we're positioned in short term bonds, and I think that's a useful Way to hedge a long equity exposure. Long term bonds, on the other hand, just continue to not perform. And that's also taking some of the legs out on equity multiples and some of the legs out on of gold. And so. So, the bull case for bonds is still hard for us to paint.

And so, you look at what's coming next week. And what's coming next week is a couple of bond auctions for bonds that are generally not particularly loved, the 20 year and the 10, the 20 year nominal and the 10 year tips. But it's not a lot of supply. And you don't have a lot of, of economic news. You have the regular jobless claims and some secondary data.

And then you have Nvidia earnings. And so basically everything's rest. The upside case for equities is resting, resting on Nvidia. And there really is no. Significant news in bonds. So what's more likely to happen over the next couple of days is bonds continue to drift higher in yield, lower in price, unless there's a significant equity sell off.

And in that case, two years do well, long term bonds probably don't do that well. So it's still a pretty bearish climate for long term interest rates. And. Equities really are going to depend on NVIDIA, and if it's disappointing, I agree with Nick, we're, we're destined to have a very difficult week next week.

Nick: Yeah, I, I think of it this way. Even if NVIDIA earnings are better than expected, what are the odds of a significant rally in NVIDIA? And I think those odds are slight. I think there might be a small bounce, two, three, four, five percent in NVIDIA itself, Which might take the indices up a percent, but after that, I think they fade.

I think everything fades.

Andy: And we're also in this interesting period where NVIDIA's customers have been getting a big boost from AI, but they are the ones that are paying NVIDIA. So at some level, and this is, has not been the way it's been for, But at some level, what's good for NVIDIA is bad for the rest of Mag7, as they are the spenders and NVIDIA is the earner.

And we have this very unusual circumstance where one of its major customers is in the midst of not being able to, has fallen 80 percent in a, in a few months since it was added to the S& P 500. And is in still has not yet been able to release its quarterly report and has had to fire its auditors and that's super micro.

And so one of its large buyers is now in diff in difficult times, not to say that Nvidia earnings in particular will suffer because of some fraud associated with SMCI, but simply because they're one of their big buyers. So it's an interesting dilemma. A great for NVIDIA may lift markets, but even if NVIDIA holds, it's hard to see that really helping the rest of mag seven.

And so,

Nick: so what we're saying is that it's the risks are all skewed to the downside at the moment. Absolutely. Okay, so basically what we've got to do is we've got to take advantage of these feelings that we have and these odds as we see them for next week. And therefore hedge some equity exposure and and see how that works out,

Andy: right?

Yeah. The good news is volatility is relatively well bid. Now we're not calling for some sort of, you know, big move in equities. Could they fall 5%? Sure. Could they fall 10%? Anything is possible. But what really, what we're saying is they don't have a lot of upside. So. Puts are expensive, so we can use call selling to take some premium in and protect ourselves, given that we don't have a lot of upside expectations for equities in the near term.

Nick: Okay, and I'll cover that in my section next.

Andy: Great. One thing that we did dance around a little bit is gold. I think it's important to recognize that, and you've certainly seen this as part of the Two Greybeards portfolio, one of our star performing assets has been our allocation to gold. And yes, it's given back a little bit in the last, if you owned it in the original portfolio, it has given back a little bit in the last few years.

We in the last week or two but it's an important core holding. So we're always going to be on the lookout to manage that holding and buy a dip for diversification purposes.

Nick: Yup. And we'll, I'll certainly be discussing that as well. And I'll be adding to the I'll be adding gold to the squared portfolio.

Sounds great. See you next week.