2 Gray Beards Week 101

Nick: Hello everyone. Today is the 7th of December and today we're going to game what the Fed might do and why and what the market reaction might be. I know it's not next week, but next week we do have CPI and PPI and those are really the only two. Missing pieces of the puzzle before the FMC sits down and decides what they're going to do in December, and we're going to try and get there and see what the compromise at the FMC might be and what the market reaction might be.

First of all, what happened last week, Andy? Nothing really that would tell us that the economy is doing anything, but what it has been doing for months. i. e. chugging along at a very high pace without any real signs that it's going to moderate any time soon.

Andy: GDP now printed 3. 3 percent this, this by the end of the week the jobs number, you know, there's always something to look at that's negative.

And, you know, we're starting to get a little bit concerned about things like the. absolute size of the labor force, not basically flatlining which, you know, is new ish, but not unexpected given how how the economy's progressing. And That gave the bond market a bit of a bid. That's been Basically a bit of a bid since the treasury secretary was announced and that continued this week But you know when you step back and look at the macro economy It just doesn't look like it's about to roll over

Nick: certainly and really the the inflation picture is Muted, right?

I mean, it's neither accelerating nor decelerating. It just seems to be at this two and a half to three percent, basically above where the Fed would like it. But I don't think it's, I mean, do you see any signs that it's accelerating? Because I certainly don't see any signs that it's decelerating,

Andy: right? I, you know, again my view, I think our view has been pretty consistent that the inflation, inflation is not going back to target.

And it's staying sticky at a level that is too high for the fed. And you know, each data point we're going to get is going to be an inflation That is between 0. 2, which is too high for the fed and 0. 3, which is what the expectations are for this particular print, which is well too high to the print the fed, because if you annualize 0.

2, you get. 2. 4 ish, you have to compound it. And if you analyze 0. 3, you get 3. 6 ish, and those are above target. And so for us to get inflation back down to target requires just consist, consistent 0. 1 and 0. 2 inflation months, and there's no sign of that.

Nick: Yeah, so what would you do? I mean, I know what you would do, but what do you think is reasonable to expect that the Fed does?

Andy: Right. So let's start first with pricing. And the market is the last I looked, it was 87 percent chance that they're going to cut in two weeks. And so one would have to say, well, why wouldn't that be right? The market's pricing that. Yeah. My view is that the employment number gave them the wasn't so hot that it, it was warm, wasn't so hot that it would mean a pause immediately.

And Since then and all week, the Fed speakers have said, yeah, we're leaning toward cuts or we're likely to cut, but not likely we're leaning toward cuts. There's more work to be done. Both rates are still restrictive. So we do want to bring policy rates down, but you know, a larger group is beginning reemphasize how they are very patient.

And so there are enough people out there that are saying enough voters at the Fed saying, pause, that, I don't know, to me, if I, if, you know, as a betting man, if I were to say 87 percent is priced as the odds, I think it's less than 87%, but not greater than 50%, but greater than 50%. The odds are they're going to cut.

And so. The question becomes next week as we look at the CPI and PPI, which are the big data points of next week will they be hot enough to cause the market to price out all of the cut? And it's unlikely that it'd be hot enough, but obviously that'd be relevant if it were. So I think going into the FOMC, you're going to be at greater than 50 percent chance of cut.

And that means that they are going to likely cut.

Nick: Right. I mean, you, there are so many excuses for a cut. You could point to oil prices down at the lowest for the year. You can point to commodity prices having gone up not at all this year. On, on index basis as it were, whether you look at The, the Goldman Sachs index or the Bloomberg index for commodities, they are basically unchanged for the year.

So you can start saying that where is the inflationary pressure coming from? Well, you know, it's coming from retail sales, isn't it? It's coming from people being flush with cash and buying lots of stuff. So maybe commodities don't

matter that much, but they're a useful excuse for the doves. They can point to that.

So let's try and game what the market reactions would be on on, on a cut or no cut. And really, I feel, and I dunno how you feel that it's all going to be in the presser afterwards rather than the announcement of a cut or a pause. It all depends what they want to do afterwards. I, I think the market really much cares.

Whether the cut is in December or in January, what it cares about is what the dot plots are going to say about what they feel comes next. Right.

Andy: And the dot plots are a I think very useful set of information if you look more deeply into that regarding the consensus versus the extremes and what you're, what you notice if you look at the paths of the dot plot for the last few months, sorry, last year, and also corroborate it with the statements of each of the members, there's a pretty meaningful divide on the committee, in which there are roughly seven, maybe six, hawks who think that rates should not be cut.

And there are six lifelong dovish of dovish, never gonna be anything but dovish doves out there who think that, you know, rates are way too high. And then there are the people that make the decisions that sit in the middle of that. Maybe it's five of or four of them. And so when you look at a dot plot, you're just getting the median of that thing.

And so that does influence those people. And so the dot plot is likely to move a little bit more hawkish, but not as hawkish as the current market. And so to me. While I'm going to pay a lot of attention to the dot plot, it's really the way Powell decides to frame the dot plot, like, and I'd like to know what you think the possibilities are in a cut scenario with the dot plots, you know, rising like you might expect, and in a cut scenario, it's the unlikely event of a Pause scenario.

Nick: Okay well Let's first analyze what might be a decent compromise between the people you call the hawks and the doves How about? The market is already pricing in as you said 87 Probability of a cut the fed hates to disappoint the market It only does it when he wants to really send a message And Okay, so the compromise might be fine, let's cut, but also during the presser and via the SEP dot plots, tell them that that's it.

We are now going to pause until the data tells us that we need to move one way or the other, and we won't move without the data. I, we think that we are close enough to neutral. That we don't have to do very much more until the data says that we are, that we need to jump one way or another.

Andy: Right, so what that means is, the way I think about that is that sort of, I like the idea of the compromise, that sort of takes what had been when this cutting cycle started, Or, you know, began to be thought about even before it actually happened, that the cutting cycle would be 225 basis points fairly rapidly to the cutting cycle may be over,

Nick: right?

Andy: Yeah. Data

Nick: dependent, of course. Right? But they really need to stress this data dependency because they've used that word. And it's become meaningless now because they keep on cutting even though the data does not tell them to cut.

Andy: Right, I think that's important to say as it relates to the SEP. You know, the September SEP that validated 100 basis points of cuts, which they, for them to deliver, would be another cut.

25 cut in December had GDP at 2%. It's running at three had PC inflation, core PC inflation at 2. 6. It's running at three had unemployment rate at 4. 4. It's running at 4. 25. And yet they're still cutting. It means the whole data dependency is being co opted by an agenda to get rates down quickly.

Nick: Right.

They would really need to convince the market that, you know, they are truly data dependent from now on. And that can only be done through the dot plots, but also through a very, very hawkish presser. You know, Powell would really have to stress. Certain words and repeat them very often for the market to get the message.

Right, so

Andy: ironically, right, the, the natural thing is if, for the market to believe is if they cut in December, no matter what they say, they're cutting in January. That would be the natural reaction that

Nick: And that is what he would have to push back very, very hard against.

Andy: Right. So the question I have about that, which I agree anything that is a cut is going to, to create, um, extrapolate to further cuts and he would have to push back hard at the same time for the first time we're going into an FOMC meeting in which the dot plot and even this pushback that we're describing is already in the two year note.

Yeah.

Nick: Well, some of it is let's let's have a look at what the market reaction would be from the bond side and try to then Have a look at what would happen to equities You would for the first time in a long long time You would actually have positive carry at the long end Because rates would now average fed funds would now average at 4 30 and assuming that general repo is somewhere around there You are getting positive carry at the long end, but two year notes are at 410, and they've just been told that we are not cutting again until the data tells us to.

So what do two year notes do? Well, they don't rally very much, if at all. In fact, they're more likely to back up a few basis points just for the sake of safety and because you have no carry, while the long end should really you. Quite like it and it's got positive carry So the odds of some sort of a flattener are become very high That actually is supposed to, how shall we say, support equities because the multiple would be unchanged to slightly better because everything is priced off the very long end of the curve rather than the short end.

But I have the feel that for the first time in a long time, people would start preferring bonds to equities. That is my feeling. It's, I cannot truly justify it, but maybe you have a different view.

Andy: Yeah. So I think the idea of a extremely hawkish, whether it's a cut, well, it would have to be a cut with an extreme hawkishness, a pause will actually delay this whole thing, which wouldn't be great for bonds, but a, Really hawkish move in December is good for bonds.

There's just no way to really suggest that the Fed tightening monetary policy or slowing the easing is anything but good for the long end of the bond market. Especially with real rates

Nick: around 2%. Right, and

Andy: so the question becomes, you know, what's the knee jerk reaction? Listen, if they're really, really hawkish, bonds are going to, led by twos, are going to sell off a little bit.

But that's when they're a buy. And, At that point, I think you just have to look at bonds as a, as more attractive than stocks. And so equities, what would happen in a real hawkish equity press press conference? Well, I think your gut is about right. I think we sell off as, you know, is it a 1 percent sell off or more?

It's not going to be much more than that, because as you said, bonds are going to be okay. So to me at that point, what do you do? You have bonds down, maybe down a little bit and you buy them, but you have stocks down 1%. Do you sell them? I think you do.

Nick: Yeah, well, the way I'm thinking about it is this, if they are truly data dependent, and they do convince the market that they are through, I don't know, whatever it is they need to do to, to really convince us, then what happens, then all you're looking for is weakness in the economy, aren't you, that you are hoping to get weakness in the economy, right?

So that you get cuts. Well, why would equities like that for the first time in just about two years, you'd have to start preferring bonds to equity. Yeah. Yeah. I think that's right. So you want to increase your allocation to bonds and decrease your allocation to equities for the first time in two years.

Andy: Reckon realizing what we're saying is the fed pivots,

Nick: right? What are the odds of that happening? Who the hell knows? But we just have to be ready for that behavior because it's logical to me. That's the logical compromise,

Andy: right? It

Nick: might not happen. The odds are not huge, but we have to, you know, be ready for that.

And next episode, we can talk about the more likely scenario. I, they just keep on cutting and they don't do anything, but that is easy. That's bullish for equity.

Andy: Right. In that case, a portfolio that has a little gold, a little bit of, of equities and a, a good allocation of equities and no duration soldiers on.

Nick: Right. So there's nothing that needs to be done if they just cut and don't say very much. And they just have more or less the same dot plots, maybe one cut taken out of the terminal rate. I mean, that's easy. I you do nothing you might even need to increase your allocation to equities The tough one is what what to do if they're really really hawkish and I think we have our you know our playbook for In case that happens the odds might not be great, but we have to be ready for agreed I think that's about it.

I'll mention that and what we need to do in my segments, but until next week, I think that's about all we need to cover.

Andy: Yep.

Nick: Thanks for being here. Thank you. Bye bye.