2 Gray Beards Week 103

Andy: Hey there! Happy Holidays from 2 Gray Beards. Nick is on holiday, so he will not be with us today. You just have me with my Santa beard, Christmas tree, and it's actually snowing here. Pretty excited for the holidays. Let's start with last week. Last week was a significant week. The FOMC met and the outcome of that I think was extremely productive for the future of markets and for the economy.

And Nick and I agree on this by the way, we've spoken, but I will be the only one to provide you with the information today. What happened? Going into the FOMC meeting, the our assessment of asset markets was that let's step back. Our assessment of the economy was that the economy was strong that inflation was sticky above target, and that, The monetary policy, which had been essentially extremely easy for almost, about 13 months relative to the goals of the fed was too easy.

And so asset that was a great environment for stocks to outperform bonds and frankly, for bonds to do poorly. And for almost a year now, we've been. Fairly flat or short or have no position in longterm duration. And so going into the FOMC, we expected the Fed to try to be hawkish, try to use what is called a Cut, which was so widely expected that they had to deliver it, but then have a press conference and a dot plot that was suggested that they were back on the job of fighting inflation to bring it durably back down to target.

And The equity market and risky markets in general were not prepared for that outcome. Bond markets were already over prepared for that outcome, in that they had already priced only two cuts coming in 2025. And so then we got the outcome. And the outcome was what I described as as More hawkish, they out hawked the risky asset market and they couldn't and didn't out hawk the bond market.

So the bond market react, both markets reacted to that and the reaction that one would expect. When you expect dovishness and you get hawkishness, risky assets sold off and they sold off pretty hard, including on Friday morning down about 50 S& P points before the market opened on Friday, but it ended up rallying.

That may have a lot to do with the options expiration that occurred on Friday afternoon, which was, Friday all day, which was a huge expiration. But ended up down on the week. And the bond market also sold off and made lows that it

had not seen in a long time. And that was due to the fact that the Fed wasn't even hawkish enough, even though they were hawkish.

Now we can go into the dot plot and things like that, but that's not particularly relevant. The big picture is For 13 months, the Fed has been saying things like inflation is going toward our target. We have a lot of cutting to do. The market has front run that a lot by expecting a lot more cuts than are priced.

And that changed. That's the big picture stepping back. Now, did it change to extreme hawkishness? Did it, no, not at all. It just went from less easy to balanced. And that's where we ended the week with an environment in which policy now matches conditions. And while we have been favoring stocks over bonds and cautious on assets, I would say we now, we have shifted toward balance.

And so the big takeaway one should have from that is that we are no longer negative on duration, on long term assets. And so now it's possible that Bond markets will continue to sell off. In fact, it's fairly likely that over, the next few months bond markets, the economy is still strong.

Inflation is still too high. So it's possible that bond markets, long term bond markets could continue to steepen a little bit. But with the Fed on the job, a sort of uncontrolled steepening may have come off the board, which I think is great. On the other hand, a slow, a Fed that's on the job risks some of the inflated earnings expectations that are built into equity prices modestly, the economy is still strong.

And because bonds are now not destabilizingly going higher in yield, one might think that the PE multiple, the valuations of equities will Also be stable. The problem is they're just still high and they're too high relative to the new levels that the bond market are sitting at. So when you add all those things up for us, the economy, you take back the economy, start with the economy.

The economy is strong. Inflation is above target. And monetary conditions are sorry. Monetary policy has gone from dovish to balanced. That's an okay environment to own assets at a price. And so when we look at prices and we look at the action that we see, there's no reason to run into duration or into into stocks, but there is, are levels in which you're supposed to accumulate both.

And so I guess the first thing, the first takeaway is that. On a meaningful dip in equities, something around the SPY level of 5, 770 sorry, 577 or the S& P level of around 5, 800 or 5, 775, that's when we see value in equities. Given that

macro picture and monetary policy. backdrop. And I'll have more on that for each of our for Gray Beards Squared and Gray Beards Original.

What's the next week look like? Firstly, I hope everyone has a wonderful holiday period. The next five and a half days are of trading days between now and year end are rife with illiquidity and Year end flows by and large we see year end flows as being bullish bonds, bearish stocks because of the severe overweighting that has occurred in portfolios toward U. S. stocks in particular over the course of the last year. So we're not really seeing a meaningful Santa Claus rally and certainly wouldn't chase such a rally. But if we do get what we see, that might be an opportunity for us to buy some stocks. As rebalances push down stocks and maybe push up bonds. We do see some supply of bonds, and that is the auctions, which are heavy all week.

In a period of time where there is not much liquidity. So there are twos, fives, and sevens being offered. I think the number is like 143 billion. So there's plenty of bonds for sale on the front end, the back end, won't really feel that supply, but the front end will And there's very little economic news.

Now what there is a lot of news on, and this is something for a later episode, probably as things settle, but overnight the government didn't get closed down, which happened in the, the heat of the evening on Friday night a deficit spending package was sent to a stopgap spending bill, was sent to the president who signed it.

After lots of negotiation in the house, that went fairly smoothly the way up. And the negotiation was whether to lift what is now a constraining as of January 2nd. debt ceiling as part of the stopgap spending bill. What went to the president was only a stopgap spending bill, and that means that the debt ceiling remains in place, and that'll have implications for how the government finances itself, and markets.

Now, the government will remain open for another I think it's through March 14th, and at that point there'll either be another stopgap spending bill, or, hopefully, and I think it's likely when the president is inaugurated the new House and new Congress Senate is sworn in, and the Republicans have control of all of those separate areas that a Reconciliation bill for the budget will lift the debt ceiling.

Again, we don't know but for the time being the government stays open, the debt ceiling stays in place, and that'll have some implication on markets, which we'll discuss in future episodes. Hope everyone has a wonderful holiday, and I

think what the, we think what the central bank did is good but It does have implications on markets.

But at this stage we think the economy and the Fed are aligned in terms of policy and the Fed will have a much better chance of achieving its goals. Thanks for listening.