2 Gray Beards 104

Nick: Hello, everyone, and I hope you've had a wonderful Christmas. Another episode of Two Gray Beards. And what have we missed over the past week? Not a lot of data because it's a very light week that was, and also a very light week that's coming. But one thing which is very obvious is that term premia in the bond market are rising substantially, and they're dragging up real rates.

What does that mean long term or longer term for us beta investors? Andy, what's your take? What is making term premiums spike? And they are really as high as they've been since 2012. And what is dragging up real rates and what does that mean for us? I

Andy: think the first thing is that term premium is literally the compensation one gets for holding assets versus cash.

So higher term premium means lower asset prices, which means a better deal for beta investors. So the first thing is this is good because we're underinvested relative to most beta portfolios. And this is giving us an opportunity to scale into assets at a better deal. So the question is, why is term premium expanding?

I think you first have to step back and say, it's been really low for a really long time. Since COVID term premium has been Practically zero. And so bonds have been with very low term premiums, bonds have been actually a pretty terrible investment for the last four years stocks on the other hand, and this is why real rates are important.

So I just mentioned term premium, which applies to all assets, but real rates, which are also high relative to where they've been and are attractive for bond investors. And so we're interested in adding bonds as real rates continue to go up, has a signal about growth. Because a real term premium is only a component of the total yield one gets in bonds.

The other yield is for nominal bonds. The other part of the yield you get is compensation for inflation and compensation for growth. Real bonds tips compensate you on the side for inflation by paying you inflation over time, but they also have this composition of part of their yield is based on the expectation for future real growth.

And so if you see absent the term premium that we just mentioned, if you see real yields going up, that can actually signal that the economy is doing very well. And if the economy is doing very well, that favors equities over bonds. So if we think real yields are going higher, not term premiums, if real yields are going higher, it would say scale into equities.

If we thought real yields are going higher and term premiums are going higher, it would mean scale into a bond. broad portfolio of assets, a beta portfolio, so to speak. And if we thought the last thing is, if term premiums are rising and because term premiums rise, it makes it more expensive to borrow money relative to the conditions and makes cash As term premiums rise, assets fall, so cash becomes more attractive.

It makes cash attractive. That could tighten financial conditions, which would result in the economy slowing down. And so a combination of real yields rising, that slow and Term premiums rising that slow the economy down would favor scaling into bonds relative to stocks, but in all cases scaling into assets of some sort versus cash Is the big picture as these real as these compensation for holding assets increase,

Nick: right?

At the moment, we are having real yields being dragged up by term premium. The whole nearly the whole move and probably the whole move is actually term premium. So what does that indicate to you, Andy, that the market is telling us?

Andy: Yeah, it's not growth. If it's term premium, it's not growth. If real yields are going up and it's all term premium, which is what we think, that means that growth isn't accelerating.

There isn't a rising growth. And that would almost being equal, that would say you'd want to scale into a portfolio of a diversified portfolio and possibly favor bonds if, and this is the big if the level of term premiums are now tightening financial conditions so that the economy will slow down.

And it doesn't appear to me that we're quite there yet.

Nick: Yeah, no, it certainly isn't what equities are telling us because they're still quite buoyant. It will take quite a bit more rise in real rates for sure to get people to switch. Out of equities into bonds, and 2 55 has been the high for the past couple of years, and we are approaching that level.

We're about 20 basis points away, and we could easily get a spike through there, and that would probably be the signal that something is changing and that financial conditions are tightening enough that the. Stop market would start taking real notice of it and that bonds would start getting favored over equities for the time being.

That isn't the case for the time being. It's still which is over bonds, but above 250 to 60 real rates. I think there's a real danger that there's an avalanche of switching. Out of equities and into bonds. Would you agree with that?

Andy: Yeah. Particularly if that's driven by more term premium expansion.

If it's triggered by great economic data that surprises on the upside, nah, I wouldn't want to switch, but if it was triggered by it continued term premium expansion, which again is just happening because Positioning where investors are heavily levered long assets and supply and demand expectations that the Fed, the treasury is going to extend the duration of their portfolio and deficits, which so far there's nothing credible regarding deficit reduction.

All of those things are impacting term premium. And if they continue to do that, and That them and real yields are driven higher. You have to start switching it from equities to bonds.

Nick: Yes. Understood. And not that we're going to get any data next week, which is going to resolve this conundrum. Very light week holiday shortened, hardly any data at all, apart from the usual jobless claims and.

Some PMIs there will be some rebalancing between stocks and bonds on Monday and Tuesday and also we have the famous JPM collar that is going to cause 12 to 15 billion worth of selling in the stock market and also After that, we have probably some tax selling for in, into the new year, so he might get volatile next week, but still nothing really that we would want to take advantage of unless he got some significant levels, which I will talk about later in my piece for original.

And for squared what do you think is the smart move for next week? Is there anything that you think is smart for us to do now at year end?

Andy: Yeah, in equities, it's fairly, it would be fairly tactical. And I think there is very reasonable. A very reasonable possibility, and we saw some of this on Friday, that this rebalancing flows generate, I don't know, a 2 percent down move by the end of December, by Tuesday night.

And Then the question for me, and I would generally all else being equal when there's flows that are just being done for rebalancing purposes, they don't really contain any signals. So I generally would want to buy if everyone is selling just for year end. And so we'll have a level for that.

Presumably Nick will tell you that, but at the same time. The next few days, you're going to see stocks like Apple and Microsoft, the ones that have really performed well that people have delayed selling because they didn't want to realize capital gain taxes. And you're going to have a whole bunch of other stocks that have done poorly that people are going to say, gosh, I took my tax loss 31 days ago, and I think I want to back beat.

That stock is cheap. It's been beaten up. I want to buy that stock back. And they call that the January effect. And we'll, I think by using spy tactically on a rebalance sell off and then being thoughtful about how to do it. And I think Nick has some ideas using calls and then scaling out of our long stock positions, but he'll talk about that.

I think you can make a very tactical play into this into this week that can pay off. Bonds on the other hand bonds are cheap and you should be buying them. On the other hand, bonds are horrible and are being sold off like crazy. And though there should be some rebalance buying on Monday and Tuesday out of stocks into bonds.

We haven't seen a lift on bonds in a dog's age, as they say. And so Nick, do you think there's tactics there? Should we think about calling bonds or things like that?

Nick: Absolutely. There's tactics there. In my experience, the bond market is going to do some damage. And I don't know whether it's going to be.

Probably not, but into the first few days of next year, I expect the bond market to have a very volatile time to the downside and that would cause new highs in real rates, new highs. In the next couple of months, as you said, it takes a long time to turn this super tanker around, but if term premia significantly tighten financial conditions.

And real yields go above 260, 270, that to me will be the signal to start buying bonds heavily again because the likelihood of the economy then weakening after a month or so Are very much increased compared to what they're now And I know that everyone is very heavy into stops over bonds But that to me will be the signal that you need to start reversing that strategy.

It's not yet But the bond market first of all needs to do some real damage and get people's Expectations that real premia will continue to rise and of course They won't that will spike higher And then they'll come back and the bond market will do some sort of a V correction and we'll have some strategies to take advantage of that probability.

Great. I think all that remains for us is to say high level, keep on looking at term premia and keep on looking at real rates being dragged up by term premia. And we will set our compass according to them. Happy New Year to everyone. Happy New Year.