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Nick: Hello, good morning, and today is the 4th of January. Happy New Year to everyone. Well, we shouldn't really take too much time about what happened last week, but we've got time to discuss what the possibilities for the first quarter are. So, Andy, do you want to kick us off and tell us what you saw last week, if anything?

And we'll very quickly go to what is probably going to happen in the first quarter.

Andy: Sure. When you look back over the course of the last Three months equities, except for the mag 10 perform pretty badly. Really making no return on the S and P 500 overall. There was a little election bump, but really not much.

Stocks outperform underperformed cash. So what was notable over the last quarter and it, and. Friday ended about where at the worst was the continued sell off in interest rates where interest rates on the two year are near their highs and interest rates on 30 year bonds are at their highs since for 2024.

So, I think the story still remains that the fixed income market is vulnerable because we got warm data. And data has been warm and continues to be warm and the economy shows no sign of weakening and that's and we also know that there's continued budget deficits with tremendous issuance and there's just been no lift to the bond market.

Nick: I think the market is beginning to discount that we are at or very close to The neutral rate that famous thing that nobody knows where it is, but everybody thinks it exists And if that is the case, what is the market doing? Well, it's pricing in A higher real interest rate via higher term premium because if the economy is not going to buckle Well, the only thing that can happen is that the curve goes steeper.

And if we say that Fed funds are at, 435 and general collateral is around 435, that means that the two year note is slightly higher than that. The five year note slightly higher than the two year note, the 10 slightly higher than the fives, and the third is the highest of all. And we have basically a normal yield curve.

Which is a good thing longer term because you earn money by just being patient, but in the meantime, you get these adjustments whereby equities just

can't go any higher because duration and equities are the longest duration asset keeps on getting sold and therefore equities just spin their wheels overall.

Which is what we've seen for the past quarter. Yeah,

Andy: I want to No

Nick: change. Yeah, I

Andy: want to highlight what nick said about that in terms of the yield curve a lot of people try to guess try to and for good reason, try to Look at the yield curve as an indication of what the fed will do and when it's inverted Like it has been for most of the post COVID post inflation period.

There's an expectation that the fed is going to cut rates aggressively. Now, Nick said, the curve is going to go positive across the entire curve. If the neutral rate has been achieved, that doesn't say that. You can't take a positive curve and say that means the fed is going to hike. That's just normal.

It means the fed could hike. Or it may not or it may cut And so it's and that's neutral And so the insight that nick mentioned is that as long if we are at the and again This is market pricing not anything else if we are at the neutral rate We should expect a curve to be positive across the entire curve.

And so two should trade at a positive yield Relative to funds

Nick: and that's what premier basically is, the higher it goes The more positive the curve really and At the moment we are taking out the highs of the previous couple of years and in real rates, we are approaching the 250 level in the 10s and If we go through there and we go to 275 280 See That should be enough to slow down any economy, let alone one which is as highly leveraged as the U.

S. economy. So we shall see. Those are the possibilities for the for the next quarter, for this quarter that we are in. Either we get higher real rates to around 275, and don't forget that the highest we've seen, the was October of 2023 when we achieved 255. If we surpass that Which would mean that bonds take another leg lower in price That is not going to be good for equities at best They're going to spin their wheels like they've done for the past quarter at worst They're going to have a pretty significant repricing and we will have strategies in place for either possibility But what we're basically saying is that no one knows and You Next week we get a piece of data which is going to be important in the puzzle.

Which is nfp? What is going to happen for nfp? Well again Every single piece of weekly claims has been pretty neutral as expected So we would be a surprise if this nfp Was a big surprise i. e. very cold or very hot So probably this is not going to tell us very much about the economy and we'd have to wait then for cpi Later on in january and possibly the politics Of, the Trump administration inauguration and the first 100 days and the the tariffs because the market could have anticipated quite a bit of inflation through tariffs.

This is something that we will have to discuss. On a weekly basis going forward because we just don't know at the moment.

Andy: Yeah, I agree with all that. We also have the refunding of threes, tens and thirties next week. Monday, Tuesday, Wednesday, Thursday is a weird day with the stock market closed.

There's not a lot of information, but there's some, and certainly on Friday, important information that the market may react to. I'm interested in. Your outlook on the risk to the bond market. You've been a bond trader your whole life. We're at a point where everything's pretty, what looks like pretty cheap, but on the other hand, do you think it's, we're vulnerable to a sudden repricing?

Nick: Yeah the bond market loves to spike and and then retrace. I think the highest odds, and this is just me speculating, is that we have a spike in in term premia of about 30, 40 basis points, which drives the tens reels to new highs, i. e. 265, 270, 275. And then that should be enough because then people will get really bearish of everything of all assets.

Mostly bonds, but equities as a result of of the bond spike and you might get a very quick drawdown in equities, which probably is a buy. And certainly I would buy the the bond spike because it's just too attractive at 275 real rates. I think it's very attractive and I don't see what we have to fear unless we have a resurgence of inflation.

And I think that is very unlikely at the moment, simply because I don't think the Fed has cut too deep to reignite it. And all the policies that the next administration is going to have in place, and I have a lot of faith in Bessant as a market. Participant and someone who knows very well what the market is going to respond to and how it's going to respond to his policies I have a lot of faith that he's not going to put in place policies which the market isn't going to like Longer term,

Andy: right?

I'm more interested in the sort of spider sense that you have that A drift it that whether this will be a drift to 275 or a spike and why and it sounds like you're leaning toward a sudden violent. Drawdown in bond prices.

Nick: Yeah, I think the likelihood is more towards that the bond market tends to do little crawl and then a big spike and that is what I think is more likely and When could it happen it could happen on any really hot unemployment number Nfp or it could happen on a surprisingly high Inflation number either of those would be enough to have a real panic.

And I'm, when I say panic, I'm talking about a 20 to 30 basis point readjustment in a day. That kind of move. And that, I think, would be enough. That should mark the high, or very close to the high. We will see, it's something that, just as you mentioned, my spidery sense, and that's why I like to be hedged.

For that possibility but i'll talk more about it in in my piece later on

Andy: sounds great. So, We're leading into this week. We do see bond supply. We do see potential market moving data Obviously equities continue to be dominated by strong AI but broadly equities are not doing that great.

Is there, when you think about our equity allocation, I still want to be long equities given there is a, well, we always want to be long equities, but given that there is a very strong economy and What we're saying is until there's a bite where the real rates actually start to affect the economy, and that'll take a lag, equities remain okay to own.

I'm only thinking about risk, and so I could imagine at some point we think about using the technique we've described in stock replacement, where you can either sell your stocks and conceptually what we're trying to achieve, or By puts and hold your stocks and that gives you a call like payoff What do you think about that at this stage?

Is that is it time? It feels early to me

Nick: It's a little bit early. I think I think if next week we have a bit of a rally, it might look attractive in the VIX and the structure of the VIX says there is no panic at the moment and that we have time. I'd rather wait for either a decent rally next week.

Or I would like to see what NFP is and decide afterwards. But in any case we have we can send out a very quick message Because I think the big risk is that

we break the support in the equities on the back of bonds I don't think that equities are going to do it by themselves I think they have to be driven into a sell off by a bond sell off So we will have probably plenty of time to advise our clients of what we want to do.

Andy: Sounds great Have a happy new year everyone.

Nick: Happy new year. Speak to you next week