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Nick: Hello, today is the 11th of January. We've had an exciting week last week, with the economy showing just how hot it is. Andy what do we make of things right now? We've been saying for a long time that the economy is just fine. And I think that every single piece of data that's coming out is bearing out this fact.

What are your thoughts at the moment?

Andy: Yeah, I think we've been dead on the economy and on policy. The economy is strong, jobs are tight, inflation is sticky above targets and the Fed has for, around 13 months, 14 months now been accommodative, not restrictive, even though they constantly say they are.

And so we're getting the outcome when you have an economy that's healthy and the Fed is not restrictive. However, the market's starting to say, wait a second, you are going to have to become restrictive or we're going to see persistent higher inflation. And ever since they began cutting, the longterm bond market has been selling off in relatively, in a relative straight line.

And that's also picking up globally with the UK going out to new highs with Japan yields rising to new highs. Now, China's a different situation. China's yields are falling because their economy has is collapsing. But the Global economy X, China is strong and the central banks have began a cutting cycle into that.

And so the bond market has said, forget it. And the equity market, which is a beneficiary and has been a beneficiary of a strong economy. And has discounted continued ongoing strength now has to react to the bond market doing the work of the fed. And so they, it had, they have become begun. It has begun to occur ever since mid December, the equity market has been toppy.

And we are seeing sell offs that gets any bounces get sold. And at this stage, we're at a point where financial conditions are in fact. Becoming more tight and the big question for us is are they restrictive today?

Nick: I don't think they're restrictive. I think they're far more restrictive than they were.

Let's say three months ago but that does not make them restrictive. I think the fed has got it wrong Financial conditions are not restrictive Productivity is probably far higher than they measure it and as a result we are probably somewhere very close to neutral already You The Fed funds, right? So looking forward given the kind of NFP numbers that we're getting and possibly the kind of CPI numbers that we're going to get next week, there's very little likelihood of the Fed being able to cut any further.

And therefore the whole yield curve is going positive above fed funds, i. e. a normal yield curve. And that begs the question, where should the long end be? Well, who the hell knows, but it certainly shouldn't be much different from now. And where should reels be? Well, if reels are around 2. 5%, that becomes restrictive.

Where are we now, in the 2. 3's Andy? So we have another 20 30 basis points before we start becoming restrictive And then as the bond market always tries to spike a little bit and get a margin of comfort and safety We could easily get to the 270 275 real rate and that will be restricted And I think then the economy has Not a lot to look forward to unless the bond market helps it is that how you view things?

Andy: Yeah, remember the important I agree that a 275 real yield is both possible and restrictive That would also reflect a term premium that's in the normal range from the pre QE era But, and so that would be restrictive to a point that it would actually cause the real economy to slow meaningfully and risk.

I hate to use this word because people use it now as much as they used to use transitory, but an actual recession. I don't think that's the necessary outcome. What I'd like to see happen and what I think can happen is that this increasing restriction. Slows the economy. Enough to kill inflation, but not so much as to cause a recession.

And so, for instance, that would be something like, right now the projection for the combination of PCE and GDP for the next year is roughly at four point a half percent. A recession would look like something like 1.5%. So something. A two and three quarters real yield to me would look like an eventual recession and a significant fall in nominal GDP, but the markets are priced for continued ongoing strength.

And conditions have tightened. They may not be recessionary tight, but they have tightened enough so that I would expect some slowdown relative to current

expectations. And so perhaps we have a second quarter of 2025 or a third quarter of 2025 where we see nominal GDP in the threes. And The market is not prepared for that.

Nick: Yeah. No, I agree. And that's probably why you're seeing this and I would describe it as constant deleveraging by players. Every time the stock market rallies by a percent or two, there are sellers. We're definitely in a different type of stock market than we were until the fourth quarter of last year.

It's a market that's going sideways and has very brutal moves down of a couple of the percentage points when he hits an air pocket, then slowly comes back and that gets hit again. The problem I think here is the positioning of people. People are very long and therefore they're praying. They're praying all the time that bonds don't break certain levels and when they do, they have to do leverage.

They're almost forced. So, I'm not seeing a lot of hope for new highs any time soon in the stocks because I don't think the bonds will allow them. I think the bonds will slowly bleed the longs and make them sell at the wrong level. But, that's neither here nor there. What's important is what's going to happen next week.

And of course next week we have CPI and PPI as the most important numbers. We also have retail sales, which I wouldn't discount because the, CPI, unemployment and retail sales are the things that the Fed looks at. In most detail cpi Could easily be hot because commodities are giving us that signal recently What do you think andy happens if we get a hot cpi on top of everything that we've had this week?

Andy: right, so a hot cpi would suggest the fed has completely lost the the ball so to speak, lost the script and You We immediately begin talking about well, we're already beginning to talk about hikes, but every idea of a cut gets taken out of the market and we start talking about hikes, which should mean that twos do badly relative to the rest of the curve but bonds do badly.

And If the fed is going to be hiking the mark equity market is not going to like it. So that would be to me the knee jerk reaction of the Of a hot print.

Nick: I agree What do you think happens in case it's slightly cold because it's not going to be very cold the range of probabilities is from slightly cold To halt so what do you think happens that

Andy: right?

There's been a big backup We're at a point where no cuts are essentially no cuts are being priced in the yield curve and we're at neutral and that would be an a relief An outcome like that would be a relief you might get some bull steepening possibly bull, possibly just a rally across the curve I don't think you're going to get a flattening at this stage, but it's possible And so equities are going to also breathe a sigh of relief that this cutting hiking cycle isn't in front of us.

And so they should rally as well.

Nick: Yeah. Now the the bond market would certainly take some comfort from the fact that no hikes are necessary and that we are probably going to stand pat for a while until things become much clearer. And The possibility that the current conditions, which are starting to become restrictive slowly temper the economy and therefore inflation.

We also have, Trump being inaugurated. So if, unless he starts coming out of the gate with some very radical proposals, which is always possible, the stock market should again, Feel a little bit better about things and stabilize. I don't think that we rally over the course of the next several several weeks, not substantially.

I think we are now in a range waiting to see what the proposals of the Trump administration are and how they play out. Do you have any other suggestions, Andy?

Andy: Yeah, I think the big question that we've seen in October of 2022 and October of 2023 is a V bottom in assets. In both cases bonds had sold off, conditions had gotten aggressively more restrictive.

And so that's, those things are common with what we're seeing today. And equities, but in, in. What was is uncommon is equities didn't sell off this time where they did in the past and so I think it's different and what I'm basically my outlook is there in both of those cases, the policy makers had significant levers that would work and they used in October of 2022 aggressive dovishness from the Fed was a positive and the Treasury started spending its Treasury general accounts, stimulating the economy in October of 2023, the Fed got extremely dovish again, really November, and the Treasury decided to not increase its coupons.

Those are real life levers that affect the market. So they have those levers still, they could adjust treasury funding. They could spend the TGA. They could in a

stimulant in both cases in a stimulative way, and the fed could project easing. But in this case, none of those things would likely work.

In fact, they might actually backfire in a meaningful way, given where the bond market is. And so that really leaves fiscal. As having the potential for something that would V bottom the bond market. And to me, so that, so what could they do and why would they do it? What they could do is be extremely hawkish on spending significantly decreased the deficit.

If they were to do such a thing like that would be great for the long end, but terrible for stocks. So you wouldn't get your V bottom in stocks. You just get a. Sloping up more like an L for bonds than a V. And the question then becomes why would the administration do anything that would save the bond market to save the bond market?

They'd have to kill the stock market. So then the question is, can they do anything to save the stock market? And would they? And what do you think about the timing of something from the Trump administration that would be good for risky assets?

Nick: I just don't see what the problem is and why they would need to do anything at the moment.

They have a very strong economy, which is the envy of the world. They have a political situation in which no further elections are going to take place until 2026. Thank you. For the house. So if they need to fire a bazooka at the market to make everyone feel better and go out and vote Republican, they don't need to do that until very late on this year or the beginning of next year.

So for the time being, I would have thought that Trump is going to concentrate on getting his agenda through. The border wall, the immigration, tariffs, and see how the market responds. And if the market doesn't respond favorably, He's got plenty of levers as you've just said and plenty of time to activate those levers I'm sure that besant can come up with 10 ways to improve the bond market and also make it You know make the stock market like it but from a lower level from a level where everyone has Given up on the good news and that is the problem that I have at the moment.

People are positioned long. The positions are very long and everyone I feel is praying and the price action in both bonds and equities suggests to me. In bonds, it suggests to me that the dealers are taking every opportunity they're

given to lighten up or hedge their books, because they know that in two weeks time, they're going to have another 50 billion, 80 billion, 130 billion to swallow.

So why run the positions long in the meantime, while the data keeps on being hot, and hot? I can't remember the last time that we had a number. That made me want to buy bonds I just can't remember it. It's been such a long time and therefore You are getting this situation that the bond market is just drip making the situation worse People are very long of stocks for good reasons i.

e. The economy is doing great Productivity is doing great technology is Advancing at a very rapid pace, but again, we are very expensively priced and real yields really matter. So as real yields go up and nominal yields go up and everything gets dragged up by the term premium, you are getting the situation that People long of equities are becoming uncomfortable.

How long can the miss magnificent 10 hold up the whole edifice? Because that is what they're doing. You're seeing various sectors of the stock market doing significantly worse than the averages that is the current problem. If I were Trump and the Trump administration. I would let the stock market slowly deflate over the course of the next two or three months.

And then we will be in a much better position to rally when they want a rally I towards. You know the latter part of this year But I think that we just go sideways for now because the bond market I don't think is going to allow for any better than that

Andy: Yeah, just back to the policies, the trump agenda needs to get the debt ceiling resolved Which I suspect they do well earlier than expectations Which takes stimulus via the tga spend down off the table and the rest of the agenda tariffs Immigration Um, deficit reduction or anti growth.

The one thing that's pro growth is deregulation. And that to the extent they use that lever more so than others, that would be the most healthy lever for the current economy, but again, the question is, they have a big agenda to get through and each of those things are going to be part of it. And so when I look at that, I just don't see the.

the need or the desire or frankly the ability with these current levers if you use all of them to create the sort of pro disinflationary growth that is great for assets and so we'll see and certainly the you know I think the most important thing to recognize is policymakers matter and policymakers can do a lot of different things and if they do something that is widely unexpected.

That's a time to tilt your portfolio, but based on our thinking, we cannot come up with a reason or a thing, a reason or a lever, that needs to be used at this stage.

Nick: Which basically means sideways, right? And reacting to numbers. And that's about it. That's all we can do at the moment.

Andy: Yep. And favors to me, portfolios that are balanced and light.

Nick: Excellent. We will contact you if anything happens, significantly happens with CPI numbers. Otherwise I'll just go through the portfolio and explain where we are and what we want to do in future should real rates spike. Thanks everyone. Thank you. Bye bye.