2 Gray Beards Week 108

Nick: Good morning. Today is the 25th of January, another episode of Two Grey Beards, and we're joined by Andy, who is in L. A. So, what happened last week, Andy? Not a lot, really. Well, you were traveling, so I'll go through it. Very little data, and the markets all did better. As soon as the bonds stabilize, And the bond stabilized really because there was no announcement of any tariffs from trump and therefore the dollar could weaken which it did by nearly a couple of percent and that supported the bond market because we all know that tariffs are inflationary.

What we don't know is if the tariffs have been just put off or if they are now on hold. We will find that out in the next few weeks, but I don't think there's anything imminent there. And as soon as the bonds stabilize, you get the bid inequities back, which pushes up all risk assets. And that is more or less what we had last week.

As I said, very little data, what there was was slightly weaker than expectations, but nothing to write home about. And therefore the markets didn't really move all that much. The BOJ hiked as expected, but the market did nothing because it was fully priced in and the press conference really did not give any hints that they were going to over tighten or tighten again at any time.

time soon, and therefore the market just took it in its stride. What do you think is, have I left anything out, Andy, or do you think that next week is far, far more important?

Andy: It sure is more important, but let's just wind back the clock a little bit. I think the big news happened right before the Fed went on blackout.

Besant was testifying. Kevin Warsh wrote an op ed, but more importantly, an influential member of the Federal Reserve was, the last statement before they went on blackout was very dovish. And really all of the market reaction, I could point toward that, which was the dollar weakened, Sensibly as a March cut began to get priced in equities rallied, bonds rallied, but have now since stabilized, as Nick said because there's relatively no data and, equities rallied in particular because, you know, also we saw earnings that were solid, solid earnings in tech related like Netflix and solid earnings across the board in banks as the less inverted yield curve is starting to help banks. And so. You know, we had that market reaction.

And so going into next week, we have to judge whether the outcomes of the FOMC and its press conference are going to be more dovish than what Waller already said. Equally dovish or less dovish, and I think there's very little now let's head into next week. We have, a series of auctions in the front end of the yield curves, twos, fives and sevens all Monday and Tuesday.

We have some data, but less important. We have lots of earnings data, which happens mostly at the close of business after the FOMC and we have the FOMC on Wednesday. So, looking at that, we have to judge whether again, whether the FOMC press conference will be. As dovish more dovish or less dovish than what the reaction has already been from a dovish influential fed member, Nick when you think about the earnings and when you think about the data Is there any real change in terms of our expectations for how the economic data plays out?

Nick: Not really. We, I think the market knows that the earnings are going to be good. The question is how good, and I think the market is also discounting that the data will continue to be very, very robust.

Andy: And we saw there's been a lot of speculation ahead of the president of the election since the election and last week regarding tariff policy lots of announcements, some what perceived as walking back to tariffs and simply because they didn't institute tariffs day 1.

And so that's by definition, a walk back if you expected broad tariffs across the board, but at the same time, I'm not getting any signal. That tariffs are off the board that somehow this is a tool that's being put away. I do think it was interesting that the. One of the, the, the, the main plan from Secretary Besant is called the, the, the three arrows plan or three, three, three, and there was quite a bit, and it impacted the market quite significantly of one of the three arrows, and that's the energy arrow in which The idea is for the administration to somehow by deregulation and working with OPEC reduce the price of oil while which would be disinflationary.

And that would be why bond yields could fall eventually. And oil really suffered on that after spiking In gen in the early part of the month and now coming back significantly. So when I think about, you know, the policy rollout we have, we know what they're trying to do, which is negotiate better trade deals through threatened, threatening and implementation of tariffs curb immigration, which we had some news on, but again, not a plan.

Reduce the deficit to 3 percent of GDP from the current 7 percent and we've seen literally no information about that because that's all hung up in the debt ceiling negotiation to relieve the debt ceiling. They're going to have to make some promises to the recalcitrant Republicans that are blocking the debt ceiling extension.

And We say nothing on that, but we know that's coming, that there's going to be a meaningful deficit reduction. I guess Vivek Ramaswamy leaving the Doge committee with leaving only Elon in it may have some signal, but probably not much. We just don't know what the deficit reduction is. And that's clearly anti growth and good for bonds.

So, We don't have any information. And then the last thing is the of the three arrows is the 3 percent real GDP target. And that's a very aggressive target when you are reducing the deficit. And so we've heard really nothing from that, except it is. Based on a significant thrust in deregulation and deregulation in in particular is likely to have the most immediate short term effect on the energy markets, which, as I said, cratered on last week and in the financials, which have already begin begun to expect significant banking deregulation.

So. You know, when I look at policy, really, there hasn't been any change. And I think a lot of the tariff news, so called news that we got last week really hid the fact that the dovishness of the influential fed member was the dominant thing. So when you think about that. We don't know much about the policy, the fiscal side, and we will certainly be on that as it happens.

And the first meaningful signal from the fiscal side will be on the QRA next week, not this coming week, the week after, which we'll talk about it the next episode. When you think about the FOMC, you know, how do, what's your expectation given all those things?

Nick: Well, I think there's very little upside to Powell taking the March meeting off the table.

Why get rid of optionality for no reason at all and disappoint or annoy Trump? Because Trump did say that his plan is for Drill baby drill, bring down the price of oil, which is deflationary, that would permeate across all sectors, reduce inflation, and then the Fed could cut rates significantly. So why annoy him by taking a March cut off the table?

As you said, Waller was His usual very dovish self. He repeated that as far as the, as far as he's concerned, and he probably speaks for a vast chunk of the

FOMC, rates are still restrictive. And that they can afford to bring them down three or four times over the course of the year, data dependent. And he did stress data dependent.

The market didn't really listen to him because the market never does. They just hear lower rates and they go for it. So what are the odds of the moment that they cut in March? Around 27%. We all know that the FOMC is going to do nothing. So it will all depend on how the press is perceived and what language Powell uses during it.

And we also all know that Powell is a very dovish speaker. And every time he speaks, the markets rally. I am. I'm probably convinced that the, those odds of 27 percent that they will cut in March will increase to 50, 60, 65, 70 percent after Powell has spoken. He is. He's likely to do a wall of light. I think he's likely to say that, yes, he thinks rates are still restrictive.

He is probably likely to point to the data about new rents being lower than last year or a 2. 5 percent lower than they were last year and say, yes, this is the component that we've been looking at. as a signal that it's likely that inflation will come down to target. And that kind of language, if he uses it, will, will cause the yield curve to steepen.

There'll be a, a rally of around 10 basis points in twos. And really, whenever he speaks after an FOMC, you always get a decent rally in twos. So that is almost guaranteed. So you get this rally in twos the tens and thirties do a little bit better But over the course of one or two or three days They give up most of those gains the yield curve steepens But in the meantime the equity genie is released out of the bottle again We make new highs and then we settle back.

Those are the odds for what happens at the FOMC. I really don't see that he's likely to be Hawkish, I think the most hawkish thing he's going to say is that they are data dependent. And we know that the data is really not favoring them because you have inflation expectations through swaps or any, which way you'd like to look at them going out, making new all time highs.

And therefore the market is saying that it does not believe. that we are going to have anything but sticky inflation over the course of this year. So that is why, if he's dovish, all that really happens with the bond market is that the yield curve steepens. And that, for a brief period of time, allows equities to rally a little bit.

But, as you said, he probably sits down at 3. 30 and what happens at 4 o'clock? We have a slew of the three big techs reporting earnings, and that will be the real test for how the market is taking the whole of the economy and whether it's really bullish enough. Because we have taken the multiples on equities.

Up a lot and we have a, we're, we've been making new highs on the S-B-Y-T-L-T or IO, so the totality of the bo of the bond market against the totality of the government bond market. It's been going up and up and up. Multiples are at record levels and unless we believe that earnings are going to increase, at least at the pace.

That we're expecting them at the moment equities have to take a breather or even correct slightly What do you think of that Andy?

Andy: Yeah, I mean, I agree. I, I guess I am I guess the word is unrealistically hopeful that given the inflation expectations, making new highs. And given the still uncertainty regarding the policy and given the labor conditions vastly improved from when Powell became dovish that the inflation data.

doesn't need to be responded to. Remember the reason why they cut isn't because inflation is going down. It's because labor is getting worse and that was why they initiated the cuts. They continued the cuts and since then labor has strengthened. So when you think about their dual mandate, inflation may be coming down, but that's not a reason to cut.

If, Labor is still strong. It is a reason to cut if labor starts to weaken. And so I'd like to say that I hope they can be patient and being patient to me means being less, you talked about, I framed it by more dovish than, than Waller. I don't think there's any chance of that as dovish as Waller. You're sort of in the yeah.

Okay. Dovish light and light. Yeah. Yeah. I get that. And then less dovish than Waller is what I would hope, but hoping like that has been a fool's errand. So I think we're, when you think about that and say, well, very little chance that they're more dovish, probable that they are equally dovish, thus twos rally, curve steepens equities do fine.

To me, When I look at our positioning and see how we're protected and how are we're diversified and what our upsides are We're probably reasonably positioned for any of those outcomes and quite well positioned in the event that There is quite a bit more hawkish He falls on the hawkish side where I'd be worried and think we might be Want to have more exposure of is if I really expected to equities is if I really expected them to out of waller and I just don't see any probability.

Nick: Yes, I think that is a very low probability at the moment. I think there will certainly like to see the NFP, which is the week after, isn't it? And because they're going to have very large revisions, so they would like to see those. And after that, you get the CPI. So I, I don't think there's any chance that these markets are going to do significantly better before we've seen another set of NFP with the revisions and then another set of CPIs.

So I think that the upside is going to be capped for the next couple of weeks. Really if the markets do significantly better, it's probably an opportunity to take down risk and raise cash levels.

Andy: Right. Exactly. I, I said on my Twitter handle that I think it's a great time to raise cash. I think we're already in a good position at two gray beards and an opportunity to raise additional cash.

If it shows up also makes sense. It's time to be relatively defensive for now.

Nick: Great. I will go through the portfolio and what we intend to do on the various outcomes And we'll speak next week. Absolutely. See you next year again. Bye