2 Gray Beards Week 110

Nick: Hello ladies and gentlemen, today is the 8th of February. Last week started exciting with the Trump tariffs and really ended up with a bit of a whimper week on week we had bonds slightly up and equities slightly down and really nothing to write home about and we think that this is Something that is likely to persist in the medium term But let's have a look at really what happened last week.

The data was Okay. Although the NFP headline was a slight miss, everything else was very strong inside the data release. So the bonds actually went down on Friday. What can we expect really going forward, but more economic strength? We've been telling you for quite some time that the economy is strong and continues to be strong, and the data continues to validate our point of view that the economy currently is very strong.

We also had the QRA, which was a damp squid. Nothing changed in the QRA. In fact, even the language didn't change. It was literally a copy paste job. Most of the people who are going to be working with the QRA have not even been confirmed and therefore that is not surprising, but Besson did say, right, Andy, that he would, does not anticipate having to increase coupons.

Even going forward. So, shall we discuss what Besant is trying to do? Because that is important for our positioning and for our overall macro views. He has this famous 3 3 3. ambition, which basically means he wants to increase production of oil by 3 million barrels. He would like to have 3 percent real GDP, and he would also like to have the budget deficit at 3%.

How realistic is that ambition of his, and what does it mean for our positioning?

Andy: Yeah, so I think it's important to note So Bessant is, had made two statements, one that confirmed the language in the QRA, suggesting that there's no need for the coupon issuance to rise and the other is that he wants to target may be the wrong word, but he wants to pay attention most to what 10 year bond yields are yielding and saying about the economy and more relevantly as a scorecard.

And this is my interpretation, a scorecard for the success of the government's policy actions. It shouldn't be a surprise to hear that because if you look at his 3 3 3 plan he To getting 3 million barrels equivalent of energy production in the United States is disinflationary and pro real growth.

Getting pro real growth at 3%, while also reducing the deficit to 3 percent is a very ambitious goal and would be excellent for Three year bond 10 year bond yields. Because you would have real growth at 3%. Markets wouldn't discount real growth at 3% in perpetuity because it's so far above trend growth, which is closer to one and a half.

But, and so they would likely have real rates at two-ish. In such a, in such an environment, but also the disinflation that would come from lower government spending and that's the deficit bit and lower energy prices should make inflation expectations stay anchored at 2 percent or maybe even lower.

And so, if I were in his shoes and I was trying to guide. The markets, the economy, and very importantly, the president, who is one of his is his only real important constituent. I would have him focus on that to grade my success and my admin and the overall administration's success. And so it's a totally reasonable benchmark.

It should be noted. That it isn't necessarily great for stocks now that it could be great for stocks, but it isn't The thing he wants to be measured against

Nick: right having said that how realistic? And how does he get to the three percent real growth and three percent deficit more importantly? That's the bit I don't get how do we get to a three percent deficit?

In the united states, right? What are your views about that?

Andy: I think it's important to start with where we are Which is around six and a half percent, debt to gdp, deficit to gdp And then talk about the levers and the levers are fairly straightforward. We can raise revenues. That's taxes or tariff revenues or we could cut spending and Let's get in a bit into the weeds on that the tariff revenues, we have 2 trillion of trade done with our major trading partners and 4 trillion of trade done with everybody on earth.

And so we know our major trade, one of our major trading partners, China is about 500 billion of trade. We know that they've increased tariffs from 10 percent to 20%. And so that's an extra 50 billion. Maybe they'd get another 10 percent and we're at 30 and that's. 100 billion dollars. China Europe, it's unclear whether we're going to have a net tariff.

So let's assume that's zero or even say it's 10 percent. That's another 50 billion. And then we saw last week a significant walk back of the 25 percent tariffs. That were supposed to be implemented on last Tuesday to no tariffs for at least a month. Perhaps there are tariffs to come, but if there are no tariffs to come, there are no revenues to come.

So you can see there's something on the order of 50 to. 200 billion of tariff revenues that is something the president can administer and it has implications it's Inflationary in a short term way, which we saw some concern amongst democratic participants in the michigan survey suggesting that which had a very high inflation number on friday, A one time price increase.

It's also anti growth because people have less to spend and have to lever up to consume the same quantity of goods now that all their goods are more expensive. So that's something the President owns and doesn't require Congress. They also own the Immigration policy, which let's not get crazy about deportation.

Let's talk about labor supply. The crosses from immigration crosses to the United States have fallen rapidly. And that is a supply, you can, it's, regardless of politics, that is a supply of labor. Supply of labor in the United States is tight already meaning the people here have jobs as shown by the numbers and to get more people to participate, you either have to have people cross into the country or somehow people who are happy to be retired or.

Not sitting out in the labor force have to be induced to come in, which is, which would require a wage increase typically and so labor supply is constricted and that's going to keep labor tight, which is going to keep inflation bid and growth down. So those are the 2 big policies that don't require Congress.

Really, what we have is DOGE, which is working on discretionary spending programs. focused, which is about a trillion dollars of our total spending. And I expect, and they lopped off a big one with a relatively controversial USAID number, which was roughly 50 billion. And that's great. And I expect more reduction in discretionary spending, which by the way, will ultimately have to be Approved by Congress.

Congress is in the position of dealing with the two major, the big major thing. It is the entire administration and particularly Besson's highest priority that the TCJA, the 2017 Tax Cut Act, is extended. If it were not to be extended, you're talking about many hundreds of billions of tax increases, returning of taxes to where they were.

That would be significant damage, which would do significant damage to the economy. It's gonna happen. How does it happen? It only happens with

Republicans in the in the House and Senate. Democrats are not necessary for the conversation nor likely to break. Toward the cross the aisle. They have just no incentive to, and anyone that's deeply involved in politics will understand, will tell you that this is a Republican decision.

And so what do they need? They need to have a majority. And there are about 20 people in the Congress that are budget hawks. Republican budget hawks. And they're going to have to be convinced to allow the debt ceiling to be increased so that the continued deficit growth at six and a half percent of GDP continues.

What will that be? It'll be in Medicaid. SNAP, which is food stamps, and income security programs that are going to get cut. All of those directly targeting the poorest people in the country, that all those programs pay people who are poor. And that's politically controversial for the rest of the rest of the Republican Party to cut those types of programs while you're ensuring the continued tax cuts for wealthy and corporates.

whatever your politics are, that's the reality. And so that's the dynamic and it's deficit neutral. So basically where we're at is the deficit is going to be moved by tariffs and any future tax cuts just to keep. And the question is, if we, if they do raise tariffs, what does that do to what will they use the revenue for?

Will they? Reduce taxes like they the tips and the tips, service people's tips or social security taxes or any of the most recent programs that the Trump administration talked about just 2 days ago will they spend that money either way the deficit is not going to 3 percent without almost impossible to do.

Execute in a political sense cuts.

Nick: So we are saying that at best, even with doge and with tariffs and, throw the kitchen sink at it, he's not going to be able to get to 3%. He might get to five, he might get maybe even slightly below five, but there is absolutely no way he gets the three without making the economy.

Very much weaker, which actually will increase the budget deficit. So, it's, it, how, it's very unlikely that we go anywhere near three. What does that mean for bonds and for equities and for our positions at the moment, because there's no point in looking just at next week's numbers, because we know we have CPI, we have PPI.

But those are unlikely to be much out of line. And therefore we're trying to give ourselves longer term guidance. What do you think that actually all means, longer term, for our positioning? Because it seems to me that a purely beta portfolio is really going to struggle for the next few weeks and months ahead before we get a real signal.

What do you think that is going to involve?

Andy: Right, so I think the key thing about that is when Nick says struggle, he means it's just not going to make any money. It's not going to go down necessarily. There's uncertainty. We're going to chop around. And there are, highly tactical things that one can do fading numbers or predicting numbers and all that.

But it's going to, the passive portfolio, which is the beta portfolio classically, it's just not going to make much money. So it's no reason to take a lot of risk if you're not going to get any return. In terms of the Looking forward, though, you have to say that Besant has this 3 3 3 plan, and it's very unlikely that all three pieces will work.

It's possible that they make extremeforget Dogebut that the Congress The Doge is going to make some cuts, but Congress is going to decide to go after the mandatory spending, military spending, veteran spending, all of the untouchable spendings, and generate the necessary decline in the budget deficit to get to 3%.

If so, 3 percent real growth is not realistic. So you can get 3 percent deficit. And something much lower than 3 percent real growth where you can get 3 percent real growth and get. 5, 6 percent deficits. So let's assume that because it's always been the case and the barriers to reducing the deficit, these untouchables are so high that we get the 3 percent decline in oil in in oil gets its 3 billion million barrels of energy equivalent reduction production good Disinflationary pro growth.

Real growth stays at 3%. And the budget deficit stays high. Well, that's going to be a strong economy broadly supported by budget deficits. So relatively inflationary. And so it doesn't make me want to, and by the way. More debt financing that despite what Besson said about more less the same amount of debt financing You'll get more debt financing.

It doesn't make me want to run out and buy bonds And then you have to think about the anti growth stuff, which is Are there going to be much more tariffs? We don't know If there are more tariffs, you don't want to be long equities, but there may not be more tariffs. And then you in a strong economy supported by high deficits, you want to be long equities.

And so what I see is uncertainty and what the future looks to me to be more likely to be an anti growth environment, which is doesn't favor long stocks and more likely to be a and does favor bonds, but it favors short term bonds. And so my direction for the portfolio is that the strength in the economy, once all of this stuff plays out, will slow a little bit.

And that's when you want to think about whether it's going to slow a lot. And that's when you want to think about buying bonds, but not yet.

Nick: Okay, so what you're basically saying is that you can see an environment at some stage within the next one or two quarters in which we actually have a growth scare.

And we get a downdraft in equities, which then we can exploit. But at the moment we are really on a hiding to nothing. If we were to increase our exposure to risk in general, is that what you're saying? Okay. So, how do we exploit this situation for the time being? What do we do? What is wise to do?

It seems that the wisest thing to do is to say, to stay with a lot of cash, so we have a lot of optionality, to stay hedged on both long term bonds and equities, which we are. And really try to do some tactical trades to increase a little bit the performance while we wait and decide which way we're going to jump because this will have a resolution.

It's just that we can't tell what it will be at this very moment.

Andy: Yeah, you'd like to think about yield enhancing, whether it's through credit, through international, or there's always selling options, but I think that's probably not yet priced attractively enough to do a lot of option selling. But those are the things that one would want to do in a wait and see environment.

Nick: Right. So we are basically sitting still, right? There's not a lot we can do, but the high point here is that at some stage we will have resolution and that's when we need to deploy our cash and even go leverage. But at the moment, the odds are that at some stage we get actually a growth scare because, these tariffs, I think, have to come.

If he's going to have a hope of reducing the budget deficit, and even then he's not going to get anywhere near to 3%. So I just can't see how tariffs are not going to play a significant role in his planning at the moment. Because I'm sure that Besson has a longer term plan, apart from what he tells CNBC or Fox News.

On a Monday or a Tuesday, right? He has to have a longer term plan. So I and I think that tariffs must be a part of it. And when that actually does come out, that will be the time that equities swoon. And then we hopefully have a bottom that we can deploy some cash into. I think that is probably the most realistic scenario going forward for the next few weeks.

Yep. So do I. Okay. And I'll do my bit discussing how we can take advantage of that next. Thanks, Nick. Have a good day. You too. Bye bye.