2 Gray Beards Week 113

Nick: Hello. Good morning. And today is the 1st of March. Time flies. Well, what happened last week? We didn't really have much data. We had a whole load of bond auctions and there was a relentless bid in bonds all week. Wasn't there, Andy? So basically what the market is saying at the moment is that it's worried about a growth scare.

Which is going to come from the reduction of the budget deficit towards three percent. All the work that DOGE is doing to reduce the budget deficit via reducing the number of federal employees and cutting out waste waste and expenditure. So the market is beginning to believe the Besson 333 story, isn't it Andy?

What do you have to say?

Andy: Well, it's certainly beginning to believe the 3 percent deficit reduction target the real growth target. I don't get if the 1st thing happens and what I think is

Nick: best and really, right? It doesn't.

Andy: So. We've been talking about last week and for a couple of weeks now, I've been talking about, and we've been talking about a growth slowdown.

And so the question is of course, when the market begins talking about a growth slowdown, it does it overshoot that slowdown or undershoot that slowdown? And then of course, does a slowdown actually happen or not relative to those expectations? And it's quite clear for, the. entire world seems to now be thinking about a growth slowdown and talking about a growth slowdown.

And so that's impacting prices. And I think that's the right thing. And I think there is going to be a growth slowdown, but as yet data hasn't really borne out now, unfortunately for growth slowdowns. All data that has to do with growth from GDP to production data to, and most importantly, jobs data, lags growth significantly.

It's not surprising that it takes. At least a year for the NBER, which determines whether a recession has happened, to announce that a recession has occurred. The data just doesn't show up first. It shows up with a very significant lag. And so, not surprising, we're seeing no weakness, no meaningful weakness in the data yet.

There is some weakness, but there's not meaningful data that would suggest that we're in for a meaningful slowdown yet. So what we're doing here at Two Grey Beards is we're considering the policy statements and what they're going to do to growth so that we can project what we think growth will do.

And then we're trying to compare that to what market participants have priced. And I think the most notable thing last week was we saw the, well, the data was very light, but we saw the Congress pass a reconciliation bill, which while maintaining the tax cuts in, from 2017, also, and thus keeping the budget deficit growing, also significantly reduced the the Expenditures suggesting a total of between one and a half and two trillion dollars over the next 10 years of expenditure cuts, and that will, and then on top of that, we continue to see additional news from Doge which is likely to cut jobs and expenditures, and all of those things are going to continue.

Eventually find their way into hopefully more efficient, less wasteful places in the private sector, but that's to come while the government anti growth impulse ripples through the economy. And so we project or. I'll speak for myself. I project an actual growth slowdown. Then we have to look at the bond market and since gosh, it's only been two weeks since a hot CPI number on the 12th the priced in cuts for the next call it 18 months have gone from one to three.

And that's a lot. And so the market is, and the bond market, the long term bond market followed with a fairly aggressive drop in long term bond yields. And so the market currently is, now needs actual Growth to slow down, which I think it will, but needs that data to cause bonds to rally further from here.

Nick: I agree with you. All we've done now is increase the probabilities that the growth scare will occur. We are nowhere near 100 percent of course, and that is why you keep on seeing this price action whereby bonds are constantly bid and they really have Very little of a trading range that just beat, they just go up in price while equities fluctuate very wildly and very, very strongly because they just don't know whether to price them off bonds or price them off what is going to happen.

And you've got a tug of war and that is what is happening at the moment. I think we're going to remain in this tug of war for quite some time in equities and bonds have probably done enough for the time being until and unless they see some meaningful data. I just refuse to believe that the Fed is going to cut without a corresponding CPI.

I don't think, I think they've learned their lesson. I don't think they're going to lead the market. I think they're going to allow the CPI to tell them whether they can cut. We all know that they would like to cut, but I don't think they will do it without the data. And therefore the next CPI number in two weeks time is going to be very important for the bond market.

Andy: Yeah, so it again, it's a question of our bonds worth owning as a well, they're always worth owning as a portfolio balance and you have to own some bonds. And so the question is what type of bonds and at this stage, bonds are pricing in a weakening economy that modestly weakening economy. I would roughly.

Say that it's where expectations were for a third quarter, four and a half percent nominal GDP where we now may be pricing something like four. Now, is that what we'll get? I think we're going to three and a half. But only until then are you going to get a lot more juice in bonds.

Nick: Yeah, I would certainly agree with that.

And next week we are not really going to get the data that is likely to change that picture because all we have is some PMIs. And then we have the NFP on Friday, and probably it's too early to expect that NFP to reflect the cuts that DOJ is making in the federal workforce. And also the economy was Very strong during the month of of January.

So it's unlikely that this is the date or this is the week that we get the data. That's going to change the picture very much at all. We also have the ECB meeting and that I think that they are going to cut, but the market is already pricing that in, so I don't expect much movement from that. either.

What would be interesting to discuss is this sequencing of the 3 3 3 that Besant wants to do. I just can't see, and I'd like to know if you agree with me, how a reduction in the budget deficit is not going to reduce substantially growth in the U. S., and therefore, how is it possible to have, let's say, bonds reflecting real rates being at, say, 2%, so if we have sticky inflation around.

Let's call it two and a quarter. So you get inflation coming down that still gives us bonds at four and a quarter Maybe four percent Which is not a million miles from where they are now in the 10 year note I mean what 25 base 20 basis points So given that how much bonds can help equity valuations?

And the answer is to me not a lot And therefore it's, if you held 50 percent bonds and 50 percent equities, I still think that over the next three months or six months, or however long it takes for the data to fully reflect what is going on, how you would not lose money on that portfolio. I think that it's more likely that you lose more.

In equities than you make in bonds, would you agree with that, Andy?

Andy: Yeah, absolutely. That's the conundrum for the 60, 40 or whatever proportion, the fully invested portfolio right now is that bonds no longer offer anything but insurance for a real growth slowdown, which they.

Undoubtedly still offer meaningful protection if we have a meaningful slowdown. But equities are entirely not priced for that. A modest slowdown, bonds aren't going to do much and equities are going to tumble a bit. Maybe 5, maybe 10 percent, but you won't make money. And what if we're wrong and there's no slowdown coming?

Gosh. The fed just isn't going to cut in any real time. And so you're going to get a new highs in bond yields. And so that will hurt relative to equities, which are already pricing, strong growth. So it's quite a conundrum. We, I don't have much allocation. In fact, I'm short in my alpha account, a beta portfolio, because the potential returns for a fully allocated long only portfolio just seemed.

Quite poor right now.

Nick: Yeah. And that is why we have to be more active this year rather than last year, because the likelihood, the odds of a pure beta portfolio performing all by itself are not as good as they were last year. It's as simple as that. And I'll go through what we need to do over the course of the next couple of weeks when I review the portfolio.

Okay. Sounds great. Thank you very much indeed. See you next week.