2 Gray Beards Week 123

Nick: Good morning ladies in gentlemen. Today is the 10th of May and we are filming this in the first hours of the morning. Just immediately after the Chinese delegation apparently walked out of the talks with Bessant in Geneva, which is never a good sign. So the over the weekend betting markets are indicating that we are going to open somewhere around.

Percent lower inequities and a percent higher in the risk of currencies like the Yen and Swiss. Irrespective of how far down we go, we are talking about a risk golf move, which is going to dominate Monday and Tuesday. Just wanted to give you that information, but let's discuss first what happened last week and what we think is in store for next week.

Andy, do you wanna kick us off and tell, tell us what you thought of the price action last week, which was fairly uninspiring because really nothing moved very much. I. Equities, what? They closed down a quarter of a percent on the indices and the bonds were up five basis points. So really nothing that indicated what asset prices should reflect, and that's maybe what we need to concentrate this week on.

Andy: Sure. So, yeah, you know, you recapped what happened? There was A-F-O-M-C meeting right. I would say, you know, we people want to define the outcome in a simple word, hawkish or dovish. My view is going in a very dovish outcome was impossible. And we said this in our last I. Conversation, very dovish was very unlikely, very hawkish was very unlikely.

And really, we were gonna be in this very, very narrow range of mildly dovish to neutral. I would say it was on the hawkish side of neutral, but you know, now we're talking about very, very narrow shades of gray. The big takeaway was they don't know. They don't know whether growth is going to fall rapidly hitting employment due to the policy and the ongoing economic outcomes, nor do they know whether inflation is going to go well.

They are fairly confident we're gonna see a short term inflationary burst, but. They don't know how much when it happens, nor how long it persists. They're on hold and I think, so what I noticed in terms of price action was, um. I think sometime middle of last week, maybe it was early this recent week, um, there was as many as five, well, four-ish cuts priced into 2025 and five or six into, you know, the next, before we hit a terminal rate of close to 2.9%.

That really reversed. We ended the week with. 20 June coming mostly off the table and 2025 falling to uh, 33, about 66 basis points of cuts, which is less than three. I think that's probably an opportunity, you know, given our outlook that the Trump policies are anti-growth, and we go into that when we talk about next week.

There's a good chance the economy slows down enough so that the Fed has to cut maybe as much as 50 and probably as much as 50 on the first cut. And that could be July. It could be September, but it's coming. And so, you know, that's probably the thing that sticks out in my mind, but it's hard to trade for an unlevered account.

Nick: Absolutely. Now, uh, what struck me in the FMC meeting is that he emphasized that he will be looking at the speed, at the rate of change of the employment data. So he is really looking for an acceleration of unemployment. To give him the timing for the cut. Now, when is that likely to happen? When can we first see it?

Well, we've been fairly consistent in saying that the real data is unlikely to deteriorate until we hit a window of late May to early June, and then we can see the repercussions of the Trump tariffs. In the real data and not before then. And I think that what he made fairly clear. Here's another thing that we've been saying for a while and you've just mentioned, and that is that when they do see that acceleration of unemployment, they will know that they're way behind the curve and therefore the odds of them moving by 25 basis points have to be less than the odds of them moving by 50 or more.

I think that the real reason why they are on hold is because they can afford to be on hold. If, I mean real rates are. Neither high nor low real rates on tenure nodes are just over 2%, and therefore they are neither at levels where we'd be, where we would be real buyers, IE at 2 75 or 3%, nor are they at levels around, you know, sort of 1 55 or lower.

Where we would not be interested in buying bonds at all. So they have what they consider a mildly restrictive policy at four, let's call it four and a quarter, and they can afford to cut very rapidly. Down towards zero Fed funds, real rates. I if you say that inflation is roughly two and a half percent, they can take fed funds very quickly down to zero IE to 2 50, 2 50, and really stimulate the economy and slow down the rate of unemployment.

Change. So they are comfortable at this level simply because, A, they don't know, but B, they have a lot of room to cut should they need to be able to cut.

So for the time being, they're on hold. And that's all we can say. We still think, I think both of us, Sandy, that the first move that the Fed is going to do without going into when they're gonna do it is gonna be a cut.

If it's a cut, it's gonna be a big cut rather than a small cut.

Andy: Yeah. So moving into next week, um, you know, as Nick said, um, a few hours ago, there was rumors which have yet to be confirmed exactly what's happening in the trade talks that they could have, um, broken down completely, or the participants could have separately left the hotel for lunch.

The, it's sort of, in Beijing it's, it's sort of irrelevant for anything but very short term trading. Let's just frame where we think things come down. The UK did a deal sort of. And that there are no actual laws that were created, or even the trade deal itself has yet to be inked in any way, official or unofficial.

But they're paying 10% plus some other things. And,

Nick: and this is the biggest ally,

Andy: and this is our biggest ally, so. I wouldn't wanna place too much emphasis on that 10% because if for some reason the Trump administration like needs to give somebody else 5%, they can always go back to the UK and say, yeah, I will cut 5% from you too.

So I don't wanna overstate how this deal that's again, just on paper creates a benchmark for all future deals. But. I think it does. And again, not something that set in stone, but it does. And when you look at China and the objective from, you know, both Trump terms certainly is, is uh, uh, 2024 campaign and everything.

He's said terrorists are going up in China, they're going up around the world. And when you add up the tariffs, it's a meaningful tax on the American economy and should have a meaningful impact on GDP, which is good for bonds and bad for stocks. And we're also looking at immigration, which is a very, you know, a centerpiece policy, which slows the amount of growth in the workforce, which slows growth and is modestly inflationary.

And then you look at the, um. Fiscal policy and we got some data since, well, I don't know, some data since we last talked. They mentioned they, uh, announced their budget, uh, a week ago, and that is, has a meaningful expenditure cut to everything. But the military and border security and in aggregate is a meaningful budget cut about 169 billion, if I'm not mistaken.

And they're also. Was news of the, this week on the progress on the reconciliation bill, which just establishes what gets paid now, but also in the future on mandatory. And the Senate is now after hemming and hawing is now actually more aggressive than the House on Medicaid cuts, which are. So meaningfully anti-growth and the president is now willing to, um, potentially willing to negotiate a higher tax on people who earn two and a half million dollars or more in income.

Um, to pay for some of this, the tariff revenues can pay for some of the other tax cuts that are being proposed. The expenditure side is setting up to be if all this gets passed, the biggest fiscal tightening in our lifetimes. And so that's not good for growth and it favors bonds over stocks. It is also disinflationary.

And so when you add up what is, forget the daily noise associated with tariffs, when you add up what tariffs will be if you add up an administration that is aggressively pursuing expenditure cuts on a smaller government footprint. You end up with something that is solidly anti-growth and favors stock, uh, bonds over stocks in a big, big way.

Nick: Yeah. So let's discuss what you think is a reasonable valuation for equities in that case. Because even if you take the, uh, the, uh, the, the SMP uh, uh, multiples for 2020, uh. Six or the earnings for 2026, what is a reasonable multiple for next year? Once, let's say that all the tariffs have been settled and all the deals have been done, and the UK benchmark of 10% is a reasonable benchmark.

And once you've thrown, you know, sort of everything in there, even if the slowdown is very modest. What should the multiple be? Where should we be trading in stocks? What's a cheap level, or not even a cheap level, but a reasonable level to think that the s and p can go down to.

Andy: So let's kick that around. I think the first thing is that forward multiples 12, the next 12 months of EPS.

Listen, last month's earnings, this earnings, we just got NVIDIA's still ahead of us, but the earnings were okay as we expected because the economy was still okay in, uh, the first quarter. The guidance was softer and that has resulted in a forward earnings expectations, uh, dropping from 2 75. To 2 70, 270 $5 per s and p to 270.

Now that is a still a year over year growth of 9%. That, to me, can't make, I mean it can, but

Nick: I. It seems, well, he never does. It's always revised lower. Right?

Andy: Um, I think it, it, it's, it's a very aggressive starting point, but let's use that. So if you take two 70 and you put a sort of slow down, multiple of 18 on it, you get, what do you get?

You get, uh, 4,900

Nick: ish.

Andy: 48 60. Yeah. Which was the lows for the equity market. That's just. And that's not a recession at multiple, and that's a very aggressive forward earnings in a slowdown. If you keep today's multiple, which if I'm not mistaken, is around 21.1 and you apply it to earnings that are, that grow a little bit, but don't grow a lot.

Maybe to, instead of two 70 to 2 55, you're still talking about the equity market being in the around 5,300, and that's with the same multiple and just earnings, slightly growing, slightly less than forecast. So. When I look at that, fair value for equities is somewhere between forty nine hundred and fifty three hundred.

And, um, I think we end up there before this is said, and over all is said and done.

Nick: And this is even without an inflation, uh, without a recession. Because if we have a recession, you are likely to get 16. Multiple.

Andy: Yeah.

Nick: On two 50.

Andy: Yeah. Yeah. I mean, that's 4,000, you know, that's sort of a recession level.

Nick: Yeah, so, and that really explains why we are at 10% allocation in equities.

Andy: What about the upside? You know, if, if everyone, you and I, you and I see this, we're just guys, we have some experience, but what about the upside? Why are stocks at 5,700.

Nick: Yeah. Um, I keep on asking myself that and really the answer would have to be that the market is betting that the Trump administration will just roll back the overwhelming majority of their policies and not just on tariffs.

And I just can't see that. I just can't see that a guy who's just got in with a very. Strong mandate and will completely reverse the center point of his policies. I just don't see why he would do that without market forcing him to do that. Right.

Andy: Right. 5,700, he's got no pressure to reverse. Absolutely.

Absolutely. 4,500, 4,000. He's got quite a bit of pressure to reverse. And so my view has always been why did you get the market to 4,500 reverse and run the economy into the midterms in recovery mode instead of teetering on the brink of a slowdown? Um, but you know, I get, anyway, that doesn't answer the question.

I guess the answer to the question is, Nick said it. Fiscal reverse is what it will take for equities to deliver above cash returns in 2020. Uh, in 2025. This is what we've said from the beginning. This remains our view. It just doesn't make sense, but. Animal spirits definitely impact markets and we've had a V-shaped bottom from the liberation day lows, and that's created some animal spirits, which can, you know, for me as an opportunity, for us as an opportunity, we're low inequities because of it, but I have no confidence that it's without the reversal of the Trump agenda.

Nick: And the other point might be that liquidity is still quite high, and you can see that probably in the price of Bitcoin because you have had a significant appreciation of Bitcoin in the past month, let's say, or approximately 20%. I mean, we bought it at 83, 80 4,000, and now it's 103,000, so that's 20%. It could be very well that people who have liquidity, who have money are saying to themselves, I don't like the valuation of equities.

I certainly think that long duration bonds are risky here or will not make a lot of money. What's left? Do I buy gold at 3,300? Well, it's already appreciated. Well over 20%. What hasn't appreciated this year, a Bitcoin was down 20%. I'll buy Bitcoin, and now Bitcoin is basically unchanged on the year. So that could be what is happening, that people, instead of buying equities, instead of buying bonds, instead of buying gold at these levels.

Have piled in on these alternative assets that they don't know much about, but they see their word down on the year and the floods by some of that. So that could be the situation very easily, but I still, I, I really would not go leveraged. In any direction here unless I see some really good valuations on equities and I don't think we'll see that for quite some time.

I mean, are you really negative for the next say month? Andy, can you see our targets are not targets, but are levels that we've just discussed reached in the next month or so so that we can. Go in there with full confidence that these are reasonable valuations and left by, let's say a 50, 60% allocation to stocks.

Can you see that? I.

Andy: I would say I could see 5,300, I can't see 4,800, but anything's possible, obviously. Uh, at 5,300, would I want to go all in on equities? No, but I'd wanna start allocating back to a more normal level. Um, and I think there's a fairly high probability we end the month of June, around 5,300, um, with possibly a journey lower, but.

Unlikely to be higher than where we are today without that policy reversal.

Nick: Yeah. Excellent. I think, I hope we have given you an insight into our thinking and when we will be adjusting our portfolio and that time is just not now, right? That's correct. I'll talk about it more in my segment, but in the meantime, have a lovely weekend.

Speak to you next week. You as well.