

2 Gray Beards Week 134

Nick: Hello. Good morning and today is the 26th of July. Massive week. Coming up next week. Very little. Really happened last week, but let's quickly. Trot through it because we have a lot to tell you about next week. The data keeps on showing an economy that is okay. It's neither accelerating nor decelerating.

Weekly claims keep on being very well behaved, far better behaved than I really anticipated. It's pretty clear now that Trump is not going to fire Powell, but he's just going to keep the pressure on for lower rates and basically get a how should we put it, a poodle in place in May of next year when Powell's turn is over.

Earnings continue to be very good in the equities. They are. Probably beating by most all time kind of thing, but that's only because the expectations were so low. And really you can tell that because the price reaction in all the companies that report and beat is really nothing to write home about.

Very modest gains in those companies. There are just no sellers of risk assets in general and stocks particularly. Everything keeps on just. Going a little bit higher, including the long end of bonds, but that is probably much more a factor of the fear of what the QRA might bring. And we'll talk at length about that.

And also the fact that we have a lot of auctions at the short end next week, which is twos, fives, and sevens, and the yield curves slightly flattened, but. Really nothing to write home about, and the ECB was slightly more hawkish than people. I thought it would be, I, it didn't give any kind of signal that they would cut rates in September and that sort of got the euro a little bit better bid, but nothing to write home about.

But next week is the important one. We have QRA on Monday and Wednesday. Really the signal is likely to come, if there is one is likely to come on Wednesday at eight 30 when they publish what they are going to issue for the next quarter and give guidance for the subsequent quarters. So Andy we have a slide.

Let's talk about this slide that has been prepared for our subscribers. What do you think? First of all, the odds are for each of the eventualities possibilities, and let's try and explain what the reaction function of the market would be to each.

Andy: Right. So the QRA really has five moving parts. It's the projection of the deficit a projection of what the treasury general account level will be kept at, which is the treasury's checking account, how many gross coupons they're going to issue in court in Q4.

They announced the next quarter and. Lately they've been also undertaking a liquidity program, buyback, which is buying off the run long-term treasuries, and they've been providing guidance about when things may change. So we have laid out three scenarios. One we call gasoline, the other we call expected, which isn't really market priced, but what many of the analysts generally think.

So there's a question about what's priced into markets and then cold water, which is a not likely where the the hints of terming out the debt. Are start to drift in. And the two big moving parts are, well, three, I guess with the guidance are the treasury auction sizes, the buyback and the guidance.

And so we've laid out on this chart what we think is going to happen and well could happen. And so in the gasoline case, we have a hundred billion dollars reduction in gross coupons. Now it could be 50 billion, it could be 150 billion. This whole thing came when Trump said I've instructed my people to no longer issue.

Bonds greater than 90 nine months long. Back in mid July, early July, which we highlighted. Now. We issue 1.1 trillion per quarter this quarter every quarter for the last few quarters. So issuing none would be a big deal, but we're just using, issuing 10% less in this number to show the impact, and it's big.

A hundred billion dollars less coupon issuance in Q4 would be the equivalent of turning on QE at roughly a third of that per month, roughly \$35 billion of QE per month. And as we know, QE is gasoline on the economy and on financial markets. Add on top of that, there's a possibility that they increase the treasury buyback program from 30 billion currently to 60 billion in the event they do that.

It's also another \$10 billion per month of qe. So those are the sort of gasoline items. More likely they do nothing on the coupons. They do increase the buyback because that's seen as good policy, but they finance it with bills implicitly, which is a modest QE like influence, and they don't change their guidance, meaning they plan on maintaining this level of coupons for the next couple of quarters at least.

Cold water is more about guidance than anything and about buyback in the cold water case. The coupons are left the same. They're not increased. No one expects that. We don't expect that. We think that's zero probability. They don't increase the liquidity program buyback, though. They say we are ready to, if we need to, and they change the guidance.

To the next several quarters instead of the next several quarters, at least subtle. But it does give an idea that they're aware that the debt eventually does need to be termed out, and the deficit is going to create, the ongoing deficits are going to create. A greater need for more coupons. So add all those things up.

Those are our three different scenarios, and as you can see in the market reactions, we've talked about gold, which is a. Debasement asset, the US dollar, which is the thing that could get debased, nominal bonds, short-term interest rates, equities, and we've added what we call a purchasing, power protection portfolio, which is a third gold, a third SPY, and a third tip.

And that's the sort of portfolio that we would want to own. If we got the sense that the government has decided to throw gasoline on the co, the economy and dease the dollar. And so in each of the green and red boxes in gold, you see a high conviction buy in gasoline in. US dollar, a high conviction sell and so on.

And you can see mostly the high conviction trades happen in the gasoline scenario and the low conviction trades happen in the expectation, in the expected outcome. But there are the, in the remote possibility that they throw cold water on the economy. There are some high conviction trades as well,

Nick: right?

So. W let's discuss how we would change our portfolio. Under reach under gasoline, it's fairly obvious. What we need to do is get rid of all the cash and the short term bonds because those are gonna get debates, as it were. And we need to go into tips. We need to go into equities, and we need to go into gold.

We need to go into Bitcoin, and we also probably need to go into. Commodities. So a third of each, that kind of protection portfolio, which only happens really when we are convinced that the government wishes to debase the currency and run the economy very hot. Now, would equities perform well?

Yes, they should, shouldn't they? Because they also are a real thing. They're like real yields and the economy will be run hot. The deficit, will although it. What would happen to the deficit? Do you think there are sectors that really we need

to avoid in terms of equities? What, which sectors would you not want to have in that scenario?

Andy: Right. So in a gasoline scenario,

Nick: yes,

Andy: the the economy runs hot because it's stimulated by suppressed long-term interest rates. That means that. Companies that experience strong growth in earnings based on that are favored and it's a debasement. And like every currency de debasement in history, it's not really great for equities long term.

You don't want your currency debased long term. But what you do see in every other case in a debasement is, in local terms, equities rally a lot, and the ones that rally most are the ones with the pricing, power, growth ability, and risk premium. That is attractive. And so I think you're more likely to see a Mag seven sort of style rally than you are going to see a Russell rally.

Because those companies have less pricing power where the Mag seven continues to have lots and they have less exposure to long-term interest rates, which may not do particularly well. So I think it's probably a, a

Nick: QQQ kind of scenario,

Andy: QQ sort of scenario versus Russell,

Nick: right.

Okay, so basically what we want to do is increase our allocation to QQQ, even XLI. That should do, reasonably well in that kind of scenario and add some some other sectors that are not going to be affected. Do you think materials are a good sector?

Andy: Well, they're gonna have the, they're gonna have the exposure to, one of the sectors I've been thinking about and I'm just, we're, we didn't prepare for this, so I'm just going to go off that is, in a hot economy, you're probably gonna see some strength in commodities generally, and oil in particular.

So I, I think you might wanna look at XLE to be honest. X-L-E-X-L-B, things like that. Materials, things like that, all that sort of stuff Makes some sense.

Nick: Yeah.

Andy: But you have to, you have to fit, we have to fit it in regarding our overall portfolio. And if we're buying a bunch of gold and buying a bunch of commodities, maybe you just want to.

Diversify with QQQ instead of going into sectors.

Nick: Right? So basically what we're saying, in the unlikely event that gasoline comes about, we are upping our equity allocations to a third. We're upping our gold allocations and in gold I include Bitcoin and. Commodities to a third and a third goes into tips.

Something with a little bit of duration because you never know. We might get stagflation and you, we want to get rid of all our cash. Cash becomes trash,

Andy: particularly dollar cash, I could imagine for foreign investors. Cash being okay because it's already reflected a fairly easy monetary policy in the foreign central banks.

But you don't want dollar cash, that's

Nick: for sure. Right? And under expected, there's really not much that we need to do. Is there, Andy? Well, what do you see? Because everything is a sort of low conviction. That they're going to be smaller moves and that

Andy: the dollar has gone so far, so fast, and this would show at least not crazy Debasement urge.

So I could imagine the dollar does okay, but. I've laid out what I think gold probably sells off a little bit. Equity sells off a little bit. Bonds rally a little bit. There's nothing to do.

Nick: Yeah. But we're talking very marginal moves. We're not talking about big moves. So let's talk about cold water because if you asked me, cold water is a 1% chance gasoline is a 9% chance.

Expected is a 90% chance if I had to, allocate probabilities to them in this 1% chance. I think that yeah, you are right. Gold gets absolutely killed. And also, nominal the curve should really steepen quite substantially because we'll still be expecting a dovish FOMC president and FOMC in general starting in, May, 2026.

But we also expect. An increase in coupons and the yield curve should really steepen quite substantially, which should pressure equities quite a lot. I think the first reaction in equities is going to be down several percentage points over the course of the first few days. Would you agree with that?

Andy: Yeah. It really says that the. As much as the treasury has been activist in the past, that there's a new sheriff in town and they're not gonna be activists, they're not gonna use their issuance policy to pump the market. And that's precisely why it seems pretty unlikely because it looks like, for all other intents and purposes that we're even considering a gasoline strategy, that there's something about this administration's willingness to pump that.

Is worth noting. So it would be a shock to the market that Bessant and the Treasury pushed back on Trump's explicit instructions and through cold water on, and did the

Nick: opposite. Yeah.

Andy: And did the, well, not the opposite, really. All they this cold water thing is really doing very little, which is they're leaving the buyback alone.

They're leaving the coupons alone, and they're saying, we've got a deficit. It's still gonna be meaningful, even with tariff revenue, which we think will be high, but it's inevitable that we have to increase coupons. It's just a matter of when we've waited for a over a year. Now it's been over a year when these coupon auction sizes we're due to increase.

Yeah. Now that doesn't sound very extreme. But it still seems unlikely given what the Trump administration has been guiding us to and the fact that we're even considering the idea of the gasoline. So let me just step back. There's three moving parts in terms of how this all happens. The treasury, the political appointees of the Treasury from Bessant down a few levels.

Interacts with the staff who's been there forever. Some people will call it deep state. I happen to know people there. They are Republicans. But they exist and what they do is they try to do the best for the country. And so the political guys influence them. On the other hand, there's also the tac, which is a combination of hedge funds.

Buy side investors and sell side primary dealers that convene with that group, and there is no way that they would recommend the gasoline outcome. Zero probability. They want, they, they like volatility, but they want. Lots of supply

across, lots of maturities to affect as many of their constituents as possible and generally recommend the right thing.

So I think there would be significant pushback against the gasoline outcome. And so it's will really be a tell if the political operatives from besson down throw gasoline on the fire. Expected in the cold water case are where the deep state

Nick: would want to end up, right? So what I think is that, A, we get expected, but what does expected do?

Expected increases the importance of the other data that we get. From now on IE, the jolts, the a DP, the second quarter, GDP, and finally the core PCE and the NFP, which we also have next week. They're all coming up next week and it increases their importance. But the high level point that we are giving you is that in case of gasoline, those.

That data becomes much less important because we know what this, we know what this administration is trying to achieve, a very hot running economy, and therefore what the data was last month becomes. Much less important. So any dip you get, any countertrend move you get because of the data is a buy because the long term is going to be much, much faster growth, debasement, more inflation, et cetera.

We are getting just about every house that I, whose projections I look at is looking for a core PCE increase. Into year end because of tariffs. This would really turbocharge this whole thing. So the importance of past data becomes almost zero to me. It's all what will happen, what, what this administration will be pushing.

I think that's fair to say, right? Andy? A hundred percent. Right. So. I've prepared all the emails. Oh, by the way, we

Andy: also have the FOMC.

Nick: Yeah. Well, what's the FOMC going to say? They're gonna say no change and there's gonna be a couple of Dissenters Walla and maybe someone else like Bowman, who knows.

But the odds of them cutting are very small, aren't they? Almost near, near zero, right.

Andy: And the press conference will be, a lot of reporters will be asking about the shiny objects like the building. And the firing of Powell, those are worth ignoring. Or why are they losing a hundred billion a

Nick: year,

Andy: or why are they losing a hundred billion a year?

Those, there'll be a circus of bad questions being asked. There's a small possibility that they announce a change in the reinvestment policy, which has an implication, but. Really gets muted by any treasury Department action, so not worth really focusing on for this episode. And they could pot, the press conference could ask when rate cuts are happening and probably will.

And the SEP says two rate cuts in 2025. I think the odds are somewhere between one and three. But not zero. And so with what, yeah. September. November and December you've got three meetings for somewhat like 25 cuts. Potentially two cuts. So we're getting close to the first rate cut and we'll see whether data allows for it or political pressure causes.

Nick: Yeah, and I think that's quite enough for this week really, and we've forgotten the big earnings of the big tech earnings on top of everything else. But the high level message is if the QRA is the gasoline, everything else is muted, and we know what to do. It's the same as November, 2023. You want to be very long of equities, very long of gold.

And assets that protect you against the basement. That's about it. Thank you and see you. Thanks everyone. See you soon. Good one. Okay.