

2 Gray Beards Week 136

Nick: Hello everyone from a very dark and windy day in Miami. So what are we going to make of last week? We really had very little new data. We had just had weekly claims, which keep on showing that the employment situation is roughly in balance, a very slow demand for labor. Also very little supply of labor, and that probably has to do a lot to do with the visa situation for new workers or for illegal workers being repatriated.

And the isms were weak. They really were. And also the prices paid component was quite high, which Bonds didn't particularly like because it. Does seem to show that there is some pass through of higher prices from the tariffs. We had lots of bond auctions both in internationally and in the us and none of those bond auctions, not even at the short end, went very well.

In fact, they all tailed, which was rather surprising, especially at the short end, and we ended up the week with. All of them being a little bit underwater, but I don't think it means too much because we have some very important data next week, which we'll discuss later. Earnings continue to be very good.

And two sort of newish developments. One is that Trump and Putin are meeting next Friday in Alaska, which probably means that a deal to end the Russia Ukrainian war is very close to being done. If war are inflationary, then peace cannot be inflationary. It must be deflationary or nothing at all, but good for growth.

And the other one is something which is probably a long way away, but we need to discuss, and that is that there's more and more talk of these tariffs actually being made illegal and the US having to refund. The tariffs that we, which have been collected. Shall we start with that one? Andy, what do you think of that one?

Because Trump keeps on tweeting it, which is a little bit odd to me, but you probably have some thoughts on it.

Andy: Yeah, sure. So what do we know about the tariffs? We know that they have been ex implemented via executive order. They are. Some would argue that they are taxes, and taxes are the purview of the Congress, not the president.

Though there are all manner of other periods of time in which and valid reasons why the president can. Implement tariffs things like national security interests, which is one of the reasons why they've associated some of the tariffs with fentanyl. 'cause that's deemed a national security in interest.

But that legal case is irrelevant. It'll be decided it'll then. If it goes against the Trump administration, it will be stayed by the Supreme Court who will then listen to the testimony and then make their own decision, and then the issue will still not end. Because when the, I think it's very clear that the Trump administration and Trump himself really.

Are committed and believe in tariffs to rebalance global trade and to get back in his words, the money that's being taken from us via global trade. Now you can agree or disagree with that, but whether it's true or not, but without a doubt Trump seems to be, to clearly believe that is the value of tariffs.

And so he is very committed to them. And so if the Supreme Court would strike, would strike them down. He would look for other ways to implement them. It's almost certain that what he can't do with this Congress, maybe with the next one in 2027 when it's convened, but would still require a significant.

Increase in red house and Senate senators, which is not really likely. He's gonna have to come away with some of the other loopholes that are exist in the laws, and those may be challenged by the same people. Then we might have the next round of tariffs that he invents. Challenged stayed, blah, blah, blah.

So the, I guess the point is this is, it's interesting to speculate and president Trump aggressively tweeted at directing himself at the radical left court. Over the course of the LA twice, maybe even three times last week. Claiming that if they were to repeal the tariffs, we would have a 1929 style stock market crash and a great depression.

Now, that's his style. Whatever. Whatever he's doing that for is another matter, but it would have a major impact. And so it's interesting and people are talking about it, so we think it's important for you to know, and I think that speaks to what could happen in the near term. The answer is. In the circuit courts right now, it's being done on bank, which means a whole bunch of judges are sitting in the court.

And so there'll be a Una there won't be a necessarily unanimous, but there'll be a comprehensive decision made by the court. The case is being heard. It started being heard last week, not this week, the week before last. And. That'll take

time and there'll be news coming out as people hear the what's happening in the courts.

And Trump may respond based on his information. So there'll be a circus. And then sometime, as far as we can tell, based on our research and research of credible people any real decision won't happen until Q4, which is after September 30th, for instance. And then as mentioned. If it falls in favor of the Trump administration the tariffs will persist.

If it doesn't fall in favor of the Trump administration, it's highly likely, if not certain, that the Supreme Court will be asked to hear the case. It'll be appealed to them, and a stay will be likely asked for. Likely granted, that'll keep tariffs in place while the Supreme Court does its work. And that could take as long as six to nine months.

And then whatever their decision is, Trump will make another decision because I think he is strongly. Of the view that tariffs are both his purview and incredibly important. And so will that be a constitutional crisis? No. It'll just be another version of trying to use existing laws that remain to institute the tariffs.

So that's the timeline. And we can get all excited about the tweets and we can think about what the outcome would be. And I've thought a lot about what the outcome would be, but we're not gonna get any decisions. So it's all just academic at this stage.

Nick: Yeah, and it's important to stress that because it certainly has no current implications for anyone's portfolio.

And while it might be entertaining to talk about it, and I'm certain we will, somewhere near Q4 when the first decision is likely to come. Court of appeal, then you know, it will matter because the market will start pricing in certain things. But at the moment, I think that they superfluous to talk about it.

And I think it's also certainly to talk to, I think it's T portfolio

Andy: also. I think it's also important that markets may move in a speculative direction based on the outcomes of these various things. But a balanced portfolio isn't really exposed to that. If you're long bonds and long stocks, you're not really exposed to the changes because no tariffs is likely to be pro stocks and anti bonds.

And yes, tariffs is likely to be anti stocks and pro bonds, but a balanced portfolio is not exposed. In either case, the balanced portfolio is exposed to things like. Aggressive easing or aggressive tightening or things of that nature that or major changes in GDP but even those aren't really necessarily issue.

What they are exposed to is major and consistent inflationary pressures. That's why the 60 40 portfolio didn't work in 2022, and both bonds and stocks fell because that was a big inflationary issue. So what we're on the lookout for you guys is. Is the Fed going to ease or tighten? And is inflation a persistent problem or is it possible even that it becomes a disinflationary problem?

And so that's where our focus is whether growth is strong or growth is weak. A balanced portfolio handles that.

Nick: Okay, let's talk about something which is probably more pressing than the tariffs repeal, and that is peace between Russia and Ukraine. It seems to me that Trump and Putin would not be meeting next Friday in Alaska if there wasn't a real probability that they would strike a deal.

Now, a deal between Trump and Putin, and let's face it, I don't think Trump cares very much for Ukraine is going to be what it's going to, if anything, suppress. Any potential for appreciation in things like oil and certainly should bring more supply to the metals markets, which might have been stressed because of the Russian sanctions.

I can't believe that. Putin would strike any kind of a deal, which does not involve A, the return at some stage with some timetable of his frozen assets, which are sitting at Euroclear, which is around \$400 billion. And B, the suspension or removal of the tariffs in some sort of a timetable given.

Unconditional on Russia fulfilling certain obligations. All of that is very good for growth in Europe, I think, because you will have a. Need to rebuild Ukraine with hundreds of billions of dollars, and therefore probably not good for the European bond market. But it's not bad for the US stock bond market because it's just going to bring the yields between Europe and the US closer together.

That probably gives a further lift to the to, to the euro against the dollar. Probably takes it up two, three, 4%, something like that. So if anything, it's good for the US stock market as well as the dollar weakens. So I can't see that. I can't see that it's bad for stocks. It's certainly good for stocks in Europe and we have the A CWX, so we are not really worried about that, but that is something that one can think about upping once we hear what the news are.

But otherwise, that's about it. You have any other concerns about that? Potential agreement.

Andy: I really don't have much of an edge on this. I think the only one you have met multiple parties. You've not included Zelensky. There would have to be a presumably puppet government overthrown to overthrow the Zelensky government and to agree to such a, to any deal that the Russians and the US.

Cook up for them because as I understand, it seems like it requires seeding a significant amount of Ukrainian territory to the Russians. And then the Europeans are gonna have to be cajoled in some way to not support Zelensky. There's lots of hair on this and we've been close before.

I have. No confidence whatsoever that a deal that is, that ends the conflict in the Ukraine will come out of this Russian summit. But certainly there's a higher likelihood that there's something that will come out given the principles are gonna be there and they wouldn't show up without close to a deal.

But again. Nope. The relevant principle, which is the government of the country, the country that's been invaded is not present, so we'll see. I, it's not something that I can trade. I don't have an ability to change my investment philosophy based on this. I think peace in the Ukraine is also inevitable.

And so what's new is another way of thinking about this. But I guess it would be bullish for European stocks and bearish for European bonds if bombs stop dropping. Yeah. Hard to say. It wouldn't be.

Nick: Yeah. No I certainly agree with you. I think it's good for stocks in general, but especially European stocks, and it's.

Bad for European bonds and probably good for US bonds because inflation is more likely to be contained through an excess supply of energy.

Andy: I agree. I can't get super excited about the whole summit thing, but that's fine. As it relates to the week though, there's significant economic data, lollapalooza of macro data coming this week with CPI and retail sales.

And what the backdrop is, we have we saw very bad. Non-farm payroll data, particularly the revisions, but also the headline data. We saw pretty bad this week. That was the week before with last week we saw pretty bad ISM data as Nick mentioned. And yet equities and bonds, frankly are looking through that.

And. We have C-P-I-P-P-I and retail sales, CPI and PPI could come in hot or cold, and same with retail sales. But if by the end of the week you end up with a situation where CPI misses to the cold side, PPI misses to the cold side and retail sales miss to the cold side, at that point you have a full.

Month of all of the relevant data pointing to a disinflationary slowdown, which calls for a rate cut. And when you look at pricing the front contract is already pricing a 90% likelihood of a 25 basis point cut in September. That'll go to a hundred percent, maybe even higher. Maybe they'll start, they'll, there'll be some markets that are pricing in a 50 basis point cut.

If those data all come in low at the same time, you'll also probably start to see a terminal rate, which is currently rusting slightly above 3% drop. 15 or 25 basis points to something in the high twos, which could drag the two year yield down to below 3.5%, which should be a significant move. Long-term bonds would follow that move given a call across the board cold and given the existing steepness of the curve.

It's more likely that we parallel shift versus steepens. So you could see a substantive rally in longer term bonds as well. On the order of, call it 15 basis points, if the twos rally 25, maybe even 20 basis points, if the twos rally 25. So then the question becomes falling interest rates, easing, fed usually good for stocks, but in the context of a.

Full month of very cold data. I think you can buy stocks, but I don't think they should rally on that news.

Nick: Yeah. Now I agree the technical situation in stocks is looking very overbought. It's very difficult to understand who is buying at these levels and why they're buying at these levels. The and it's just a few select stocks.

It's a very unbalanced rally. Very narrow, which, doesn't mean anything if other components catch up later. But at the moment, certainly if. All these, all next week's data is cold. You are going to have a substantial move in bonds, especially because I agree, they're gonna move the terminal rate lower.

If on the other hand everything is hot, you are probably going to get a 15 to 20 basis point. Move the other way in twos. The people are not going to give up on cuts. I don't think so, just because you get one month's worth of data, which is slightly hotter than expectations. People will still expect cuts.

But I, what do you think happens to equities? Because if the longer end of the curve of the bond curve moves back up and. Why should equities benefit from this inflationary environment? They, all the, everyone's been saying equities are rallying because the fed's gonna cut. What? And now they're going to rally because the fed's not going to cut.

Andy: I think the, you have this momentum for rate cuts that is being, that is partly tied up in our friend Steve Moran's appointment to become temporary governor. The, ultimately the new PAL replacement. You have the two descents that may go to three or four in the next few meetings depending on who's appointed.

And you have the Fed that actually generally likes to cut when it can even pal. So it's tough to think that to. They're proposing two cuts in 2025. That's been their guidance. We've got 90% chance of 25 in September, which leaves one more cut in early November and or December.

It's hard to believe that you're gonna get a significant. Increase in you're gonna price out cuts in the very, very short end. And so that's gonna keep the short. The two year note contained a 15 or 25 base point rise in the two year would honestly surprise me in and I'd wanna be a buyer in in an environment where.

Cuts are coming. They're not going away. Even if the numbers turn out a little hot this time, for a variety of reasons, some of them political, but what is true is because of that, that cuts are coming and because the economy is shows up relatively strong, you're gonna get a bear steepening and a bear Steepening is long-term.

Bonds sell off hard.

Listen, a strong economy is good for stocks, but the discount rate matters too. And yeah, I don't see that outcome as having a major bull move for stocks. The best thing for stocks by far would be the CPI and PPI come in cold and the retail sales comes in blazing hot.

Nick: Yeah. Absolutely. So all we can do is decide once we've seen the numbers and change our allocations and send out an email.

That's all we can do. Really.

Andy: Yep. Absolutely. And that's what we will do. Nick, you mentioned we're both, we've both been looking at this idea volatility. Short term volatility has

fallen rapidly this month as it's the summertime. The news flow has been two-sided. Markets have rallied.

Volatility is now low in very short term options. It makes me at least ask whether we should, given what we're saying about the upside for equities, we should at least ask whether we should be doing stock replacement, taking out our longs in equities and replacing them with longer term calls. What are your thinking on that?

We looked through the numbers.

Nick: Yes, we looked through the numbers. So at the money calls for one year are 12%, so you're paying away 12%. For a one year call as opposed to owning the market. So that means that you must assume that the market is going to fall at least six, seven, 8% for you to be able to buy the market and then sell the calls and make money on the move.

Can we see it at the moment? Not with the data and what we know at the moment it might turn out to be extremely smart. Once we've seen certain data, but we can always catch up, then I just don't see that it makes sense right now because if it, if the market keeps on going as it is, it's gonna be a slow grind and the theater that you lose is probably going to be in excess of what you've.

The safety margin that you've acquired. So I don't think it makes any sense at the moment. If it was seven, 8%, I'd do it in a heartbeat. But 12% paying away, that is, that feels like a hell of a lot to me.

Andy: Yeah.

Nick: Yep. Great. I shall speak to you next week and let's see what these numbers are. Yep.