

2 Gray Beards Week 142

Nick: Hello, ladies and gentlemen. Today is the 20th of September. Last week we had the FOMC and the new dot plots and the economic projections. I don't know about you, Andy, but they made very little sense to me. What they did and the new dot plots, which I think we can completely disregard from now on, because even Powell admits that those are just wild guesses from individuals and they are so data dependent from now on that really.

The dot plots themselves make not a lot of sense, but the economic dot plots were interesting because they upped inflation slightly so they get back to target later on. If they ever get back to 2% which is beginning to look doubtful to me. And they increased the GDP projections, but they kept the unemployment projections the same, and they cut rates and they say they're gonna cut rates more.

So what'd you make out of it, Andy?

Andy: Yeah, going in expectations were high for a very dovish fed people talking about 50 basis points. They ended up cutting 25 and an expectation that a policy mistake was going to be made with extreme dovish ness. And the markets were priced that way. Gold was at its all time high.

Short term interest rates were pricing in three cuts. Through year end and a bit more to a low of 2.9% by December of 26. And so that was in the pricing bond market yields were. Long term bond market yields, expecting very dovish fed. Were also not worried about inflation or inflation targets.

Inflation expectations had been down and bond yields were the 10 year was flirting with 4%. And equities were doing well, very well for since June and on an expectation that whatever's gonna happen, the fed's gonna either do one of two things, cut enough to save the economy if the economy is in fact weakening or cut more than enough.

Because they wanna stimulate the economy and don't care about inflation. And so going in, the expectations were pretty high. And so they didn't beat expectations while delivering relatively dovish outcomes. The short term interest rate sold off the long term bond market sold off. Gold sold off, though it's recovered a little bit on Friday, and equities really did their best, of all the things Russell 2000 in particular really liked cutting. And so that along with

Intel be getting a very large investment in Nvidia causing that stock to rally 30% ignited tech stocks.

And so we also had options expiration week. That was a major expiration. Through Friday. And so while equities initially hated the less, less dovish ness, they bounced, and while bonds initially loved the fact that they were not as dovish as expected they sold off, ultimately sold off.

So mostly. The Fed didn't out dove the market. And we still are in a position where market consensus is either hawk, any sort of hawkishness, any sort of, Hey, we're gonna keep interest rates high is n. No longer the majority opinion of the FOMC. There are a handful, just a handful of governors who are the more important persons and and presidents who rotate who remain hawkish.

Everybody else is either. Dovish or very dovish after this month. And so the market consensus has it, right? It's either gonna be the Fed's gonna cut a lot because they need to, or they're gonna cut a lot anyway, because they wanna stimulate the economy, which is the. Trump manipulating the Fed.

So there are no hikes. There's no hikes. And so the question is which one happens and which one do the markets perceive is going to happen before? It happens because obviously by the time we don't know anything, right? Five months, five meetings from now will be pal's last. It's just five meetings. It's not very many meetings.

Two more this year and three next year. And then the new fed chair is gonna be put in place and we don't know who it's gonna be. But the presumption is that Fed chairman will either cut rates more than Powell would have. Well, well will cut rates more than Powell would have. And so that's already in expectations, like everybody on the planet knows this.

And so for me, I look at what's happened and I look at what is priced into markets, and I look at what the volatility market is saying, and man, I'm confused. I think there's a possibility that we are at an all time at an actual topping point for markets and like, like I weigh that as a high probability, not a certainty, nothing like 50%, but 20%, 25% that we're at a topping point for equity markets.

I also put pretty high possibility. I don't know if it's 25% or 15%, but we go up 15% in the next three months. So, gosh, what do you do when you have no idea whether we're at an absolute topping point and are gonna fall 15%, or we could

go up 15%? And so to me that says, reduce your risk and maintain your leverage.

And to do that you have to be willing to buy volatility. And so that makes me think where's the volatility market right now? And shockingly, despite this amazing tipping point of great uncertainty, where a 15% upside and a 15% downside are both very reasonable high probability outcomes. Equity vol for three.

The next three months for at the money vol is 14%. And to me that says there's something to do here.

Nick: So what you're saying is that we don't know which way the market's gonna jump first, but whichever way jumps the option. Pricing is just too cheap for the current disequilibrium because I feel. Much the same way as I felt during 2007 and most of 2008, is that in a very short period of time, we will have very different pricing.

I have no idea whether the market is now going to preemptively rush up in the expectation that the next chair is going to have negative Fed fund rates. Run the economy really hot or that we've priced in that possibility already. I just have no idea if either of you know which of those comes first.

Andy: Well, there's certainly evidence that we have priced something like that a lot. You don't have gold rally, 42% in a year and 40% this year without some thought that. There's going to be significant, unnecessary easing of financial conditions and you don't have equities with essentially a one direction bid Since June, obviously we bounced in April from April Lows, but once you got to June and the attack on Powell began in earnest and the actual.

Hey, he's gonna literally be leaving in May. Got, gets closer. You've had a one-way bid for equity, so some of it's priced, and that tells you that it could go either way.

Nick: Yeah, no, absolutely. So how far can the market go then if it decides that it wants to go up first? More. And let's say that a lot of people have missed this move and they decide that they want to get in.

It could be a literal melt up is what we are saying. It could be anywhere between five and 10%. Without any problem whatsoever, although, and then you can have a complete reaction the other way if people realize that their assumptions

are actually wrong and that we've gone far too far, we've probably gone too far now, but we can easily go up another five to 10% in the next three months.

Is that what we're saying?

Andy: Well, I think it can go up five to 10% in any three months in. All of history, you can, the odds of going up five to 10% in three months are pretty darn high. It could be even more than that. Like I don't see any reason why we can't go up 10% or more. At the same time, I don't think we will.

But it's so cheap to participate in that upside with substantively less downside. Today that it's crazy not to act on that set of pricings. And I think the important thing here is Nick and I have seen this for centuries practically and. It's happened again and again. Nick mentioned on our preparatory call for this meeting, the unusual circumstances of June of 2020 where, gosh, we had rallied a thousand points off the lows, 30 odd percent off the CO lows.

And. Everyone was like, well, we still COVID. Iss still raging. There's no there's no, everyone's staying at home. Everyone's riding their Peloton, doing their work through DocuSign and watching Netflix and staying on their phone

it looked like it was a, the beginnings of a bubble, and then that ripped 15% into September where you actually had a meaningful unwind of all of those trades, such that Peloton is essentially zero now. And all of these other stocks came in big, and the big tech stocks all came in substantially when the data had changed. So we said, are we in June or are we in September? And the answer is, we don't know. There's a series of fundamental things that are going to occur besides the normal data, we're gonna get a Supreme Court decision probably before Thanksgiving on tariffs.

Trump thinks if the Supreme Court bans tariffs that the stock market crashes. I think if the Supreme Court not that it matters what I think, but I think if the Supreme Court bans tariffs, that's incredibly pro-growth and disinflationary allowing the Fed to cut meaningfully. And so I could see stocks ripping on that news.

Trump thinks they crash like 1929, so no one knows, but that event. Is coming, like that is gonna be an event and a market moving event. And so you ask yourself, does it have to happen with a catalyst? You go back to September of 2020, were June, and you say, did anything change? No. All that happened is the markets either melted up and then or corrected and there was no catalyst for these things.

You can't point to an event and say, gosh, that's why the stock market peaked in September of 2020 and had a big correction. So there are things that can happen completely without a catalyst just because of that's how markets work. And so again, no one knows. We think the economy is slowing down slowly.

That inflation isn't a problem, that the Fed should cut and will cut at a meaning, a reasonable pace to a neutral rate somewhere in the low threes, high twos. That's our outlook. That doesn't mean the stock market can't go up or down 58%. What it does mean is these gray beards are telling you that we've seen a lot of things and the next three months.

He's gonna see some wild things.

Nick: Yeah, that's certainly my feeling. Let's go back to really what is on the calendar next week and what we can expect from normal market events. Are we going to get anything next week that is going to tell us that the economy is slowing or not? I just feel that at the moment, the market.

The markets are very bifurcated. They don't care about a lot of data. I think the long end of the bond market only cares about inflation as long as inflation is not higher than what we are forecasting for year end, which is around 3% for PCE, which is not far from where the Fed forecasted, in fact, almost spot on.

Then they are all right that they don't care about growth nearly as much as inflation. While the short end of course cares about the speed of cuts. So we are getting, all the data that we are going to get next week, like the pmmi, the home sales, the durable goods, apart from the jobless claims, again, is it really likely to make.

The situation clearer. My real question is it worthwhile wasting?

Andy: We get a lot more data than that, Nick. I'm looking at the calendar here and we get the GDP figures for now these are the finals, but we do get the current PCE. Well, oddly enough, at recent the, and I'm tracking this story down, the BLS may not even release it.

They've just announced that they may not that they don't know if they can actually calculate it. So there's some uncertainty on the data, but that's not the point. Once again, the point about markets right now is. We've been saying this for a long time is that while the economy is slowing and inflation is likely not going to be a problem, what matters is whether the Fed will cut consistent with

that slowdown or cut more than that slowdown, and we're just not gonna get any information whatsoever based on the data on what that means.

They're cutting, they're not hiking.

Nick: Yeah, but I feel that the only way that the Fed can cut more than the market is pricing is if inflation is contained. If they see inflation contained, then they can really cut. But if it starts accelerating, I don't think there's gonna be anyone on the committee who is going to disregard that part of their mandate.

Do you think they will? Because if they do, then it's a stocks over bonds trade cubed, stocks are going to rip like crazy and bonds are just gonna fall apart.

Andy: Well, I guess you're saying if the data remains uncertain listen, if data starts really accelerating. Jobs, prints, jobless, claims start going down instead of up.

And we get a very hot NFP. To me again, all of this is just noisy data that we don't, can't extrapolate to the future. To me, the very clear thing is that the committee, all of the committee.

Voted that vote voted for a cut and most of the committee lowered their fed funds dot and so are predisposed to cut. Now the way reason they say they are predisposed to cut is because they are, think of it in a risk management sense. And so it's not the short term direction of the data that's gonna cause them to cut or not.

It's whether they believe. The balance of risks are to sustained increasing inflation or to falling job to rising unemployment. They made it very clear. Powell made it very clear. The committee made it very clear is their reaction is to cut. Because they think there is more downside to the employment picture than upside to inflation.

I don't know if any particular data point is gonna get them off that point. I think it would take months of hot inflationary data to do that. So I think the data just doesn't matter that much,

Nick: and that is precisely why you could get a complete melt up in the stock market first. It's a real possibility at this stage.

I haven't seen a disequilibrium point like this for a long time. We are at a complete disequilibrium, and I think that within the next three months, we're gonna be priced completely differently. Would you agree with that?

Andy: Yeah, a hundred percent. That's my big takeaway here is I don't know, the data's not gonna tell us.

The fed's leaning toward cutting for either good or bad reasons, and they're gonna cut. They're not gonna hike unless the world changes dramatically, which it could based on the tariff decision, and it could just for any other reasons. And there is no. Premium placed in at the money calls that would say, Hey, let's replace my a hundred percent downside equity position with a tiny call premium that can only lose what I pay and give me a hundred percent upside.

So I like that. I like, it's not that I think the market's gonna melt up. I don't. It could, the probability of the wings is just immense right now. The probability of an outside occurrence, up or down is immense in our opinion, and the pricing is not.

Nick: Right. So I will work out some option plays to take advantage of that call substitution.

And I will do that in my next segment.

