

## 2 Gray Beards Week 143

**Nick:** Hello, ladies and gentlemen. Today is the 27th of September and we are heading towards the close of the third quarter. What have we learned, Andy, in the past week? I think that the overarching message is that the employment situation is still in this weird balance that we've been talking about for weeks.

Whereby demand for labor is very low, but so is the supply and the economy is actually, if anything stronger than we thought. We've had the Q2 revisions and those were up. The unemployment claims keep on not changing, and PCE was exactly in line to maybe a smidgen softer than expected.

Which tells us that inflation is or will be by year end exactly where we thought it would be around 3% for the PCE, but it's not accelerating, and that probably is the more important thing than the level itself. So if it's not going to be high than expectations. And the economy is strong. Well, it's all pretty good for equities, isn't it, Andy?

Certainly. Why they can't dip very much at the moment. What are your thoughts? What is keeping this economy afloat and what is actually stronger than we have been anticipating?

**Andy:** Yeah, I guess the way, so I think I've had it wrong as it relates to the GDP. I expected a GDP that would print below two for Q3, Q2, we knew was gonna be hot.

There was a lot of recovery from the liberation day. And so we knew Q2 was gonna be warm and you know, we're getting. That fairly clearly in the data. Remember, all the data that we finally got this week was for Q2. But what's interesting is Q3 data is now coming in the projections for Q3 as measured by the which I expected to be weak.

And have been wrong. Now it's coming in every piece of new data, not the GDP, which we got on Thursday, which again was Q2, final Q3 data is coming in hot. You're getting durable goods orders, you're getting CapEx spend. You're getting a lot of things that are strong. And so the GDP now, I think it printed 3.9% for Q3.

It's not gonna print the below two that I expected. It's gonna print it could print two and a half, it could print three and a half. Gosh, it could print four, but more

likely it's gonna print higher than I expected with almost certainty. And so I asked myself, what'd I miss?

And it goes back to the jobs, which, you know, I don't think we're missing the jobs and I think the Fed and others are. Even the new Fed members are talking about, you know, meaningful concern about the job market in the expectation that it'll roll over in the near term. And it always is super laggy. Like jobs are the last thing to roll over in an economy.

So that's still going according to my expectations that we have a potentially weak labor market in front of us. Inflation, as Nick said, you know, we knew it was gonna be high and it's high. Everyone knows it was gonna be high and it's high. It's not as high as I expected. Which tells me that the real economy, then we will come back to the thinking about this, but the real economy is not creating significant new demand.

Tariffs are raising prices, but there's not like demand that sort of causing an inflation escalation at all, or acceleration. So you say to yourself, well what about the economy? It's roaring and how you have to say why I definitely missed the full range of AI spent from Mom and Pops subscribing to their, you know, clicking the button on their co-pilot, on their Microsoft Outlook and Excel and office software that says, do you want copilot?

Sure. \$30 a month and they click it and now they're. AI enabled those subscription revenues to more hardware that's being purchased that has AI capabilities across the world.

Companies who are not AI companies, but look at their competitor, who's in the, a brick and mortar business or an internet business, or any business that isn't in the business of selling ai, a consulting firm, a bank, a retailer. All of them are spending money in an aggressive fashion to compete so that their competitor.

Doesn't beat them in this AI enabled world. I think of it as like, you know, Amazon came out that was a very disruptive technology in 2000 to the booksellers, but the booksellers also started online presences. Everyone had to have a website, everyone had to have e-tail, and even the brick and mortars participated and they spent like crazy.

Right before they were put out of business by the actual disruptor. But that spending, that competitive spending. You talk to any corporation in the world right now, and you say what projects are more likely to get funded? When your

staff comes to you with a project, the C-Suite is gonna rubber stamp anything that says we're spending money to stay competitive in ai.

They're going to be very hesitant to do something that says we wanna spend money on building another store or another factory, or hiring workers. They don't care about that. They wanna make sure they don't get disrupted by ai, so they're spending like crazy. That spending is landing at Palantir.

OpenAI. Public companies like Microsoft, Google, Amazon, less so Apple and Tesla, but then those guys are spending another thing that runs into the GDP, which is called CapEx. They're spending on all manner of things from chips to data centers, which require lots of other things other than chips.

All of that is coming into a, what I call a K. You know, we talk about the K economy where the poor are doing badly and the rich are doing well. You can also think of the K economy as the top end of the K is anything to do with ai, and the bottom end is anything that doesn't and that khap economy. KHAP, GDP composition is radically steep.

Lately, and we're seeing that in the individual companies talking about their CapEx plan, their investment plan, all of those sort of things. And so there's end client demand for AI services and there's downstream CapEx that comes with it. And both of those are accelerating at a more rapid pace than I ever could have expected.

**Nick:** Then the only question remaining is have we priced it all in already?

**Andy:** What will it do to, and, and how will the central banks and policy makers act in an economy where, as we said, the job market is still sketchy, and by the way, AI's bad for jobs. Yeah. There's no doubt about it.

AI is designed to destroy employment. So how will they respond to that? And will inflation respond to the K invest the, the upper leg of the K investment? And it's unclear. It's unclear that the measured inflation or the, the inflation that hits you and me at home is gonna be caught, is going to be accelerating just because the.

AI spend is high when the other half of the K is weak. And you look at, you know, Nick pointed out staples, staple stocks are not acting very well and haven't acted well for months and months. And so you say, is inflation gonna be a problem? Probably not. And so that leads, and then you put this in context with the president.

Who is, who wants and is installing people to do his bidding to lower interest rates, and you say, would you lower interest rates in a 4% GDP world? Well, you would, if inflation isn't a problem and the 4% is CapEx in AI and really, and masking otherwise weak GDP. You'd cut and what happened last week is cuts got priced out pretty aggressively.

We had entered the month before last time we spoke, we had said that the Fed is not going to be out do to out dove the market. And they really failed because since the Fed. Short term interest rates have priced out 25 basis points of cuts in the trough rate and are now only pricing in less than four cuts over the next 10 year and a half.

And the long end backed up by, I don't know, 10, 20 basis points from the peak the day of the fed meeting. So they did out dove the market. And so then you look at things like. Gold and commodities and Bitcoin and some of those other things. And so you look at what happened last week and equities didn't do much, but things that expect the fed, the president to manipulate interest is low rates lower.

**Nick:** Yeah. Now the long end, I firmly believe from now on in the bonds is only going to care about inflation as long as inflation doesn't accelerate. And we all know it's going to be 3% PCE or even 3.1 by year end. Then we are, okay. We are at 4 75 and we are not doing anything, and we are just clipping the higher coupons and everybody's going to be happy to be in the 10 to 20 year area.

I believe somewhere around 12 to 15 years is the sweet spot. Everybody's just going to ride the curve and everybody's happy. The two year naturally has to react to expectations of what the Fed is going to do. I thought certainly at 4 43, it was a ridiculous rate for the two year, far too low.

**Andy:** 43, sorry.

**Nick:** 3 43. Yes, I'm getting the big figures wrong now. But at three, you know, 360, 365 when he gets there. You can't be short it anymore because the expectations are always going to be coming back as soon as the first week jobs number hits, you know, the Fed's cutting. So you could have, yeah, I

**Andy:** think it's important to say you look at Thero, if you fell down from.

Space and looked at the economy and saw a 3% inflation rate a 4% GDP print for the current quarter, and employment at 4.4%. You'd be hiking,

**Nick:** right? But we all know that even if nine numbers out of 10 are strong, as soon as the 10th hits and it's weak and its employment, the Fed is likely to cut, especially sometime in the middle of next year.

When Powell has is gone and we have a new chair installed and all these controversies O over Lisa Cook are over and we have a board, which is basically a Trump majority board, then we know that that is, you know, basically what's going to happen, you're going to have, right. The

**Andy:** When you land from Mars, you don't look at the economy in various ways. You don't. You look at it and you say, you'd be hiking at, given that we're at 4%, you'd be hiking with these numbers, but that's looking backward. The question is, will the GDP continue to be exaggerated due to AI spend and.

Does that even matter to inflation and jobs? Like, does the GDP that this hot GDP suggest inflation is gonna be rising and jobs are gonna be rising? And right now the market says no, it doesn't. It says inflation's not a problem is coming down from peak and employment is still out of balance and. Then you say, well what if the market's wrong?

Then you have to say, and Trump, yeah. Stops pushing for debt, lower interest rates, and I just don't think you can get there. Yeah. So you, as much as you might want to be short all bonds for that matter, but particularly the front end, given the economic conditions, that's, you know, you just can't be.

**Nick:** No, I completely agree.

I mean, everything is a matter of probabilities, and probabilities are greater or lower at levels. I think once the two year gets to three 70 or so, then it's discounting very, very little and then you can afford to go long of it. But certainly I see absolutely no point in being short the long end at the moment, unless and until.

Inflation starts reaccelerating. And that underpins equity valuations, doesn't it? It gives us not a headwind, but the opposite of not a headwind, whatever that is. It just tells us that every time equities come down, and we saw last week that they came down a percent.

Huge amount of buyers and the market just could not sustain the dip, and it came straight back. It did close, slightly lower long bonds closed, five ticks lower, and the market closed 0.1 and a half lower. So basically, bonds and equities seemed to be trading together at the moment. And that is perfectly

understandable and the dollar was stronger, and therefore that brought equities down.

It's not a trending market at the moment, but certainly the odds of it being supported in equities are greater than the odds of it being sold aggressively. Would you agree with that?

**Andy:** Yeah, and I think we should just look at into next week and see what's coming. We have a few things we have end of month which has flows that we in general look at, at, unless the market really turns lower by a couple of percent on Monday, which seems unlikely.

The flows are gonna be fairly neutral when we add them up for month end. Some are saying a big self flow, but we think there's a underlying buy from a structured product. And then you look to the government shutdown and. That's a question, you know, you have to say, will the government shut down?

And if so, what does that mean for the day in a very shortsighted thing? What does that mean for Friday's NFP number? We are gonna get other jobs, numbers that are from public private sector surveys like Jolts and but it's gonna be big data on jobs and that's really where the worry is.

The Fed isn't worried about inflation. The Fed is not worried about the kxap and GDP num GDP numbers. The fed's worried about jobs, and so a weak job print may w would be an interesting de thing to deliver in this environment.

**Nick:** Yeah,

**Andy:** it may not even come. Let's, so what do you think about the shutdown?

**Nick:** Yeah, let's talk about the shutdown because the odds have to be more than 50 50, that they do shut down the government, in which case the odds are very, very low that we get the NFP print. Mm-hmm. What it should actually do is actually be a bonds over equities kind of story. A bit of flight safety. Do you think that's gonna happen?

It always has. I think it's gonna be very marginal if it does happen and it's probably a fade. I just can't see that, that this shutdown is going to be a very prolonged, or B, that it matters for final gdp. For q3,

**Andy:** there's a big, sometimes government shutdowns are at the same time as a debt ceiling dilemma.

**Nick:** The biggest thing, this is not one of them.

**Andy:** This is just a bunch of public sector workers don't show up to work for X number of days, and when they do, they get x number of salary days repaid to them. There's some dead loss to the economy. People don't travel to Washington and maybe they don't change their or to national parks and maybe they don't rebook the trip.

So there are some dead loss losses to the economy, but in general, these sorts of shutdowns are temporary and short-lived and don't affect the overall economy in even a temporary way, let alone a permanent way. And so historically it's been a buy bond, sell equities front run. And then the market moves in that way and it's a great time to unwind that trade basically as basic message is, if we get a government shutdown and we get a big bond, rally stock sell, we think that's a fade.

**Nick:** Absolutely,

**Andy:** and you should go the opposite way.

**Nick:** The interesting thing is then what happens if we do have a shutdown and we don't have the NFP? Does the market then just basically sell volatility? What does it do if volatility ramps, volatil? We just don't know what's gonna happen.

**Andy:** Yeah, it's an unusual thing.

I haven't honestly studied much what the implication of no data being reported is on markets generally. To me, when you don't get data, that increases uncertainty until you get it.

**Nick:** Yeah.

**Andy:** But I haven't studied it enough to know whether that's actionable.

**Nick:** Okay. So basically we are saying we don't know and there's nothing to be done apart from fading.

You know, government shut down should the reaction get to extremes and I'll send out an email if that is the case. Great. Andy, thanks very much indeed. Speak to you next week. Sounds good. See you Nick.