

## 2 Gray Beards Week 145

**Nick:** Hello ladies and gentlemen. Today is the 11th of October and it seems appropriate as that Chinese saying goes to say, may you live in interesting times, because all we really need to talk about is what Trump tweeted late on Friday before, just before the market's closed, really, and that is that he will, in response to China's letter to.

Many nations, which went out last week, and what, which was known by the market about cutting back on the supply of magnets and rare earth. Metals and minerals that he will impose a hundred percent tariff over and above what he already has in place on all Chinese goods. Starting November 1st, the market response was instantaneous.

Basically, we lost the best part of 3%. In the SPX bonds did a little bit better. But what we have to decide today really is a, we can only play the percentages because we don't really know what is in Trump's mind or in the Chinese mind. I'll give you my opinion and Andy can chime in and then contradict me.

But to me it seems that the Chinese have a plan. And nothing that Trump does short of nuking them is going to make them deviate from their plan. Do we know what their plan is? Probably not in great detail, but it's obvious that they're responding to the trade war, which Trump started not. In the second term, but still in the first term.

And that just during the Biden administration went into a hiatus and nothing changed. As soon as Trump came in, he again reinforced that trade wall, and this seems to be the Chinese response. They've had years to prepare for it. They've been buying gold handover fist. They've been avoiding buying treasuries as much as possible, and this is part of their plan.

I think we can probably all agree that the Chinese don't do things in hurriedly or not having thought them through. So it's unlikely that they didn't have an idea of what Trump's reaction might be, and therefore the odds to me that they will cave in on Monday morning or anytime soon.

They have chosen this path and the odds must be that they will continue along this path. Andy, do you agree with my assessment or do you have any other ideas about what is going on?

**Andy:** Yeah. I think the context is the important thing. We spoke about this in our pre-meeting, and this is a trade war.

It's been a trade war for 10 years. It's not there's been wiggles, there's been escalations, there's been deescalations, but we're in a trade war and it's not going away. Trade wars can resolve in two ways a deal in which. Both parties are unsatisfied, but willing to end or an ongoing trade war which could end in violence or something severe.

And a 10 year trade war isn't, doesn't care about yesterday, doesn't care at all about yesterday. It's just a wiggle.

I don't know. I could easily imagine a scenario where China outweighs waits out the president could be three years. Why not? Why the heck not sure. They don't make any exports to the United States 'cause trade essentially has to cease it a hundred percent. Tariffs.

**Nick:** No, and we've, we all agreed on that.

An additional a hundred percent. So that's now 140% basically means that trade. From a hundred percent goes down to 20%, 30%, something like that. That's a huge hit to everything really. And a massive increase in CPI at some stage.

**Andy:** Yeah. So CPI is going to go up because the measured inflation is gonna go up in a one-time way in that unless tariffs get bigger.

Once it goes to a new level, the prices stay at that level. Similarly, growth is gonna get a hit. Because while the prices have gone up, no one's gonna buy those things. There's not gonna be any actual economic activity. There's just gonna be a price increase.

And so that means that economic activity's gonna come down and 1, 1, 1 off way. So the question becomes, okay. So that we know that, and, what's the follow on consequence? And so generally when there's a significant negative hit to the real economy, people lose their jobs. And when people lose their jobs, they can't spend as much, which means it cascades into a cycle in which ultimately the policy makers either it gets interest rates fall so much and stock prices fall so much that animal spirits wake up and say, ah, I'm gonna borrow some bo I'm gonna borrow against some investments I'm gonna make, including in the stock market.

So it can deal without a policymaker response, but typically these things end when a policymaker responds. And my initial, my view is that we just have to look to the policymakers and the fed's not gonna change. The fed's gonna, the fed's expected to cut in July. We have to talk about Horizon too.

We're looking out a month or even this week, 'cause this week's gonna be potentially pretty wild. The central bank's gonna cut. They cut, they were planning on cutting. Even though there's some limited data, they're gonna cut. So that's not gonna change. But to say that it's stimulative, no they're not expected to cut much.

They're just expected to make some normalization cuts. So that's not gonna change unless something significant changes in the economy. And we'll come back to that in a second. And we just talked about the policymakers. Listen, I understand that Trump has frequently tackled chickened out on his willingness to impose actual tariffs, delaying them, suggesting there's gonna be a deal, et cetera.

And listen, the betting man would say he's gonna do it again, but I think you have to put that in context. Like ultimately, he really only tackled once, and that was by delaying. On, I think it was NOV April 9th, the stock market went up 10%. Now it was at much lower levels than today. Why did he taco well. Some may think a taco because stocks were down. That's possible. But one definite thing that had happened that period of time, you just remember it's important to remember these things. There was a very strong bond market reaction and a implication of why, and the implication was, hey, this is a trade war.

Our trading. Enemies, partners, whatever you wanna call 'em opponents whatever they are, they used to be partners are hate selling our treasuries. And we saw that in two ways. Now, it turned out not to be true, and so they didn't hate sell, but turns out they what happened was long-term bond yields rose a lot.

And swap spreads, which are a measure of the liquidity available on the treasury market. Panic. Got more negative spreads, which is a clear indicator of significant stress in the underpinnings of the US government bond market. And Besson knows this. Everybody who's ever traded fixed income, certainly Nick and I know that you can't have the US government bond market exploding.

And it's not the yields per se, though. The yields went up. It's the underpinnings that are what you cannot have happen. And so Bessant saw this and told Trump you got a delay. And he did. And the market reacted.

That's not happening right now. The long-term bond market is rallying. The short term bond market is rallying. Swap spreads are as healthy as they've been since Trump was elected. There is no stress in the government bond market that requires a. Taco a reversal of this thing. Now he could do it anyway.

Who the heck knows? We don't know. But the odds are not with a the odds are not forcing him to give up on this tariff. And so given that, I'm gonna look at the watch the bond market and if it starts, if the yields start blowing out and if swap spreads start getting much more negative than they are today, I'm gonna look to buy equity calls.

But none of that's happening today. So gosh, I would think you'd wanna own equity puts.

**Nick:** Yeah, no I completely agree with you that he tackled because of the bond yields the long bond yields just absolutely got to unsustainable levels. Certainly, if he wants to continue spending as much as he is and running that kind of a 7% debt.

To GDP deficit. So at the moment, he has no reason to tackle and he would look incredibly weak if, he threatened something on Friday and pulled it on Monday, it would be a complete Chinese victory and he would've gained nothing. So I think the odds of that happening must be extremely low.

The bond market, I think is in a good place. IE it can rally quite a bit from here because we, none of us really believe that. At 145% tariffs, there will be any trade. And therefore the markup in CPI is just going to be a figment of our own imaginations kind of thing. So what do you think? Is it time to buy tips?

Because if CPI goes up and it's just marked up. You get the double benefit, A, the lower interest rate because of the economic activity going down, and B, that the spread, the 2% over CPI, the CPI is artificially high. Is that the best idea that we can come up with all the highest probability idea for this, to react to this event?

**Andy:** That tells me that talks too about whether inflation is if these post tariff prices are going to stay increase from there. If so, then you wanna own tips over nominals if you think, sure, inflation's gonna spike in the very near term, but then is gonna stay level because no one can afford to buy the stuff or even decline.

Or if you think a glo, the global economy is gonna weaken and the CPI prints are gonna be low because oil prices continue to sell us. Yeah,

**Nick:** Look at oil, that's the other thing. It's absolutely collapsing telling us that the market is forecasting A, a glut of oil, but B, that we don't think that this amount of oil can be absorbed by the economy because.

We are going to have a hit to economic activity, right? And therefore need

**Andy:** less oil, right? And so for me, again, I don't know how this is gonna play out. You get hate selling and the bond market starts puking. You're gonna wanna buy equities on the dip. You get no hate selling and you get a weakening economy and no taco and no nothing.

I think you wanna own, I don't think you wanna own long-term tips short-term. Okay. But long-term tips. I think you wanna own nominals. I think you wanna own calls on nominals.

**Nick:** Yeah, no it does seem that we are going into a risk off period. From my experience, when these types of shocks happen and there's so much that is unknown.

The market just leverages because they have to, because that's what their prudential risk models tell them that they have to do. And every time that happens, the stock market tends to go to around the 200 day moving average or something like that. We are miles above it. We are miles above it.

We're still over 10% above it, so we could have. I wouldn't call it hate selling, but just slow de-leveraging. And that means that people, once they've sold their stocks, what do they do? They buy bonds and they tend to buy nominals over tips. But is tips the safer trade? Because we are just talking probabilities.

Does it, you might make less in tips, but it, does it give you a bigger margin of safety? That's the real question.

**Andy:** Yeah. It's certainly less volatile. So for an unlevered fund, tips are a safer way to play than nominals. The part of the thing that you have to think about in terms of a long only portfolio is, you need bonds.

Bonds are okay. They're not the greatest thing that's since sliced bread. They might be set up well for a rally right now, but you need 'em if your stocks are gonna go down and you need 'em to perform if your stocks are gonna go down.

And I'm mixed. I would say that I would rather own some of each, but if I had to own one, I'd rather own nominals because they carry a bit more risk and thus have more to move.

In the event that the economy does weaken rapidly and I'm more, I guess the real question is when you come down to this decision is this a one-time price increase, tariff driven price increase that then results in no inflation going forward because the economy's so weak? I'm more akin to that idea than it's a.

Big inflationary stimulus where existing price increases result in additional price increases. In other words, what I do is I buy nominal bonds today versus tips and own gold because tips will outperform nominal bonds. If the feds, if the Fed and the fiscal policy makers overstimulate, that's when you wanna own tips over nominal bonds because then inflation, this one-off inflation becomes more persistent inflation.

And in that case, you'd rather own tips than nominals. So I'd be looking for a policymaker action. In terms of what we're expecting, we've got the Fed on the 29th. We've got the QRA on the fifth. And so we're gonna have some data on what the policymakers are gonna do, but I don't see anything that would say, geez, I gotta choose.

I'm not at all worried about inflation.

**Nick:** In that case, nominals, it is. So what's gonna happen next week apart from the wild durations in the stock market? According to every pronouncement that Trump might or might not make we know that we are not getting any data because the government is still shut down.

**Andy:** Out,

**Nick:** on the 24th, they've announced it, it'll be there for the, on the 24th in time for the Fed to see it. I saw there was a

**Andy:** good reason for it because it's fiscal year end and they need an inflation number to Litig to for the

**Nick:** fixed, yeah,

**Andy:** no, not for the budget.

For the standard of living increase.

**Nick:** And then they basically need it for the Fed to be able to justify a rate cut on the 29th whenever the FOMC meets. So really. What are we saying that we should be doing to the portfolio? We are saying that we should play by ear basically on Monday and send out an email and that's all we can, that's the best we can do At the moment.

We are fairly well balanced. We have lots of cash. Should the market go down a lot. We have a lot of ammo, but do we need to protect anything for the time being?

**Andy:** It's all about price for me. If you told me that the stock market was gonna open where it closed on Friday, I'd buy puts. If you told me the same about bonds, I'd buy calls.

But I don't think either of those things are true. I think bonds are gonna open up stronger and stocks are gonna open up weaker. And I think at that point. The easy money is it requires patience to execute in that way. And we could have a big sell off in that case. We're gonna want to lean to buy equities and we could have a big bond rally and we may want to lighten up bonds.

So it's, but the leaning that I'm hearing from both of us is the trade war isn't going away. That the conditions for Trump to be forced. By the bond market to, to renounce what he said on Friday are not in place.

**Nick:** Yeah, certainly the odds are extremely low.

**Andy:** And so the odds are the equity market falls and the bond market rallies.

But do we chase? I don't think so.

**Nick:** In any case, we'll be able to send out an email. If we see a rally in stocks, we'll be able to hedge some. And certainly if nominal bonds aren't. Much stronger. We need to think about buying those because they'll perform better than even corporates, won't they? Yep.

Great. Thanks Sandy. Thank you very much, and I'll speak to you next week. I'll do my bit now and we'll see what we, what changes we need to make to the portfolio. Thanks.