

2 Gray Beards Week 146

Nick: Good morning ladies and gentlemen. What a weird week we had last week Andy? We were just talking and we've been in the markets 40 years apiece, and we've never seen a week in which volatility goes from basically 18 to 28% and back down to 21, 22, and it's really not reflected in the price of any asset, just.

Completely dead market trading in a 2% range, two and a half maybe, and we end up the week better than we started it. Very weird. We don't know quite what to make of it, whether it's a warning or an indication of things to come. Or whatever, but we have to mention it because it did happen. And it's something that neither of us, as I've just said, has ever seen before.

Andy, you've got an idea of what might have caused it. I don't. So why don't you tell us what you think might have happened

Andy: last week? I wanna talk about the vol the Vix and the spike in short term volatility, but I also wanna point out that. This is just another thing of a market environment that I've never seen anything like a combination of every asset doing extremely well and doing it in a sustained way to levels that haven't been seen for each asset.

In a long time, so just look at the picture of all assets and at the same time, volatility had been fairly low and realize

Nick: volatility still is,

Andy: yeah, realize volatility remains very low. In 1995, I started trading volatility as a prof, as a profession after being on a convertible bond desk and doing it more as a hobby and started doing that in equity derivatives.

And the place I did that is in a trade called the dispersion trade. And in the dispersion trade, you look at single name options. Their pricing and what's expected in terms of their future volatility and compare it to index volatility. And what happens is that during periods of extreme market stress, oh, so what you can tease out when you do that is the expected correlation of assets, meaning.

You traded when you think af well, you go short index volatility and long single name volatility, a basket of options on single names. When you think markets are going to be uncorrelated, meaning index vol, indexes are gonna go nowhere, but single names are gonna go up and down all over the place. And so you set that up when you think correlations are going to be very low, of course.

In a massive selloff, that trade has a very difficult time because the correlations all jump from zero or low to one. As we know, every stock goes down in a crash. And so market participants have aggressively pursued this dispersion trade, our very short index vol, and very long single name vol, particularly as we lead up to earnings, which tends to be when that trade really works out, because some earnings are good, some earnings are bad.

Stocks move all over the place, but the index does nothing. And so I think when you look at that, you'll find that. The pricing of that trade is at an all time unattractive level for that trade, and yet it's very crowded, which leads to the possibility of a squeeze. And the squeeze could be people are forced to cover their short volatility in indexes.

So I think there were some of that going on last week. Markets didn't cause that, there wasn't it's not the type of thing that would, be obvious now. That's what happened. And now the question is now stepping back and saying all these very unusual things are happening that I've never seen.

Like not only this vial spike, but the broad range of things that are going in markets I've never seen. I've seen bonds be at 10% and stocks crash, but bonds rally. At least as much as stocks crashed. Certainly on a leverage basis. I've seen bonds at 0% and stocks at their. At their lows and said, okay, it's okay to own assets because bonds are super rich, but stocks are super cheap.

This is an environment where gold is up 65%. Stocks are up significantly for the year, but mostly for the last few years, and certainly off the bottom in April. And bonds are not offering much in terms of return. I've never seen those, all the things adding up to the way they do.

Nick: But what we are really saying is that the volatility spike of last week shouldn't really be taken as a macro signal if all it was this dispersion trade being taken off or blowing up, or however you like.

And the other

Andy: thing that happened last week was credit. And that also I would not take as a signal that something's about to blow. Why do you think, you had some views on why,

Nick: All we've really had have been certain indicators that some regional banks are going to take some losses on some fraudulent cases or.

Cases of bankruptcy of their customers, but those losses are very small. In comparison to, what a systemic risk would cause, and the names where these losses occur are very small banks and really not systemic at all for the system. Therefore, the Fed is extremely unlikely to have to intervene in any way.

And they have hundreds of levers, hundreds, dozens of levers they can use short of moving rates in. When and if this should become more systemic. But the odds of that happening are extremely low. And certainly for my own account, I started buying some bank stocks on Friday and we'll continue to buy them because I think they're now getting to cheap levels.

But that's an aside. And certainly nothing that would worry the big money center banks and nothing that really should affect them for sure. Certain sectors of the S and P are doing far worse than others, XLF being one of them. And this could be yet again, what caused this dispersion trade to be taken off or to actually be reduced?

There we have it. I don't think that it has any macro implications at all. The one thing that helped equities last week is that Donald Trump eased his rhetoric, anti-China rhetoric, and Will says he will meet with, chairman Z in a couple of weeks time, but everything is building towards that couple of weeks time, isn't it?

Towards the end of this month, beginning of next Trump meeting. The Chinese then we have the tariffs at the at the Supreme Court. That's gonna happen around the 5th of November, probably a ruling. Shortly after that, we have the Fed on the 29th. A whole load of things seem to be.

Congregating around that date, end of this month, first two, three weeks of next, and that is when you could see some real volatility. I dunno whether you agree with that, Andy, or what are your thoughts?

Andy: Yeah, those are the things that, could have very digital outcomes with meaningful consequences.

I don't think we need to fear them, but I think that's the fact. They could go, they could break either way. Lemme just come back to last week and just talk about the bank thing. Bank, the bank thing was twofold. One. Was a concern that banks financial conditions are tightening, which caused short-term lending rates in the interbank market to go to significant premiums.

The second and that also and so is the, our banks. Stressed with funding. That's one question that caused bank stocks down. The other was, Hey, we're taking losses on first. Brands. We're taking losses on tricolor. How systemic, not systemic. How widespread are the losses in these banks and companies called business development corporations, which are private credit providers to smaller and medium sized businesses.

The private credit market, those stocks have cratered in the last few months as well as there's been a concern about the credit quality. So two things happened. The credit quality, neither are a big deal, but I do want to bring it back to something that also happened, which was Powell told us that he's going to end qt in the next few months.

Now what does that actually mean? Practically it means he'll either end it in December, either that moment or by January one when they meet in December. Or when they meet at the end of January, they'll end it before for the, for February. Is that a big deal? Yeah, ending QT is a big deal if it wasn't expected, but it was expected and has been expected for, people have been saying the QT is going to end for.

The last 12 months and it hasn't ended. And they had been saying like I'm, this is one of my areas of expertise. And I've been saying second quarter of 2026. Forever. Forever, literally forever. And they're gonna be a little sooner than my expectation. And my expectation was the farthest one out I saw.

So what happened was they told us they're gonna end qt, which on face is bear bullish stocks. Bullish bonds, bullish assets but in practical reality, it they're gonna end at two months early, which has no impact. So I thought I'd bring that around to say there's no bank funding issue. The Fed is ending qt, which is going to reduce pressure on reserves and the credit issues are legitimate, but not widespread enough to even think about it being systemic.

Nick: No, I agree with all those points. As far as QT and the the shape of the curve, the only thing that I would add is that the five year and now at sub 4%, even the 10 year, we keep on. Trading either side of 4%. So let's call it 4% are really unattractive. The the two year, we don't know.

They're going to ease it looks like For sure. So if that is the case, we. Should continue to own the short end, but we really should be thinking about exiting the anything in the fives and the tens and maybe putting more money to work further up the curve somewhere around 15 to 20 year. Would you agree with that?

That's. I just can't see any alternative to big money, to big funds, bond funds, and pension funds continuing to go up the curve to pick up more yield, because now. You're going to have, or in a few weeks, you're gonna have a Fed funds rate, which is somewhere around effective fed funds rate around the 3 85, 3 90.

What is the attractiveness of earning 10 year right on top of it? I don't see it. What do you think, Andy?

Andy: It's a pretty straightforward right now the Fed may cut a lot and it's mostly priced in, so that's not gonna be a cause for the 10 year to rally. The tenure itself standalone just is not that interesting.

The belly, they're issuing a ton into the threes to 10 year sector. There isn't a lot of, there's plenty of supply and the carry is crappy, even out to 10 years where it's equal to fed funds. I don't see any value in the middle of the curve. I see plenty of value at the long end. Not a ton, but a lot more.

And yeah, I would think that continues.

Nick: Yeah, no, that's the kind of allocation that one con should continue to have. Maybe a quick word about gold. It has gone parabolic. We don't understand why it's gone parabolic. And if you don't understand something, I guess the standard response is to be equal weight IE, that we should cut whatever extra weighting we have in gold because A, the price is extremely attractive.

Or we overwrite with calls. That seems to be the choice that we have because really not taking advantage of these prices in gold seems to be very shortsighted to me.

Andy: We know why gold's up. The reason why gold's up is because people expect lots of fiscal spending, lots of financial easing, and by monetary policy makers, they expect they expect a continued move by global central banks to diversify away from the dollar.

All those things have happened and are true and have caused a massive rally in gold.

Nick: But at this price level, is it all discounted and more?

Andy: At the same time, the thing rallied 10%, I think 15%, maybe even 30% since Jackson Hole, some ridiculous number since the summer. And so it's in a parabolic move.

I don't know what it is, but the best thing to me is okay, you can sell all your gold, but you've just. Increased your gold allocation as a part of your A-O-A-U-M by 30%. Why not just be back at where your initial allocation is and book some profits? And so that's what my thinking on gold is.

I was, I've been a little early, I've been booking profits all the way up this last few months and geez, it just keeps going up. But yeah, the smart thing is to book some profits and get back to equal weight. Okay. And

Nick: basically what do you think we, is there anything else that we should be doing?

Because our portfolio is not very aggressive, but as you say, neither you nor I can see any value in owning assets up here. We think there. All rich, whether they be equities, whether they be bonds, whether it be gold, everything is rich and nothing makes as much sense as being safe and owning, something like a stick kind of contract, that kind of thing.

So we are talking about as close to cash as we can possibly be. What can be attractive? That's the thing. I can't see any outcome in which one asset isn't far worse than it is at the moment. Whether that be bonds or equities.

Andy: Listen, stocks could go up a lot, but bonds can, will have to go down.

Gold can go up a lot, but bonds will have to go down. Stocks can go down a lot, but bonds will go up in that case. But in aggregate, I've never seen any le any, no. And by the way. I have a memory for these things and I have systematic indicators for this thing. My systematic indicator, my person, my memory shows no similarity to any market I've ever been involved in.

And my systematic indicators show the same. So the basic thing is, I have a two gray beards has minimum asset holdings for long only portfolio that we offer to you. My my own personal portfolio has a minimum allocation. It's a little

different than two gray beards, but who cares? It's a minimum allocation to assets in general.

You have to be near your minimums or at your minimums at this stage. And the only question to that I am thinking about is, can I withhold? And for mostly for my clients, not for me. It's simple. I'm just happy to be in cash. But for my clients is are they going to be able to resist FOMO if this continues to go up?

I don't know, 5% more for asset portfolios or 10% more for gold or 10% more for equities, and then buy at the top. If you can't resist that, you can't cut your asset holdings, you still have to stay invested. But if you can and you can hold cash and ignore the hype about everybody else, that's going to claim that they got out at the absolute top, I think it makes plenty of sense.

And so the second question that says, and I think it's an excellent one, which is what will need to change besides price? 'cause price may not change. What will need to change for you to buy back and go to normal full weight in assets? That's a question for another day, but we have some ideas on that.

Nick: Yeah, and certainly nothing is going to happen next week. We haven't mentioned next week because the data we know that we are going to get CPI at the end of the week. They've announced that and CPI actually, the odds are that it's cold. The price of oil has been collapsing for the past month. The downtrend is very clear and therefore CPI should be a very decent figure and certainly nothing that the Fed, which would stop the fed from cutting rates, and that's really all they're waiting for before their meeting on the 29th to cut rates.

Absolutely nothing that is going to weigh on the bond market over the course of the next week. The only thing that would weigh on it, and that's the opposite of weighing on it, is if equities were to suddenly collapse. But as we saw last week, there are dip buyers at every one to 2% down. Dip buyer, and even that huge spike in volatility.

Couldn't really dent them, and we finished up 1.5% on the week. So it's very unlikely that anything much moves next week, even with CPI because it's all in the price. Would you agree with that?

Andy: I can't predict the next week's price, but what I know is selling, getting back to neutral on gold and taking whatever you can in terms of profits on assets, that's the important thing for you to be thinking about over the next month or two next week.

I wouldn't think much is gonna happen, but you never know.

Nick: And how wrong we would've been the last week, thinking that volatility would remain low and boom, up it goes. But at the end of the day, nothing happened. Great, Andy, I'll speak to you next week. Have a good one.

Andy: Heck have a good one.

