

2 Gray Beards Week 148

Nick: Hello, ladies and gentlemen. Today is the 1st of November time flies. Let's very quickly go through what happened last week because we had some quite important developments. First of all, the FOMC, which quite sensibly decided that after cutting on Wednesday, they were going to introduce some ambiguity.

As to the future rate of cuts, simply because they don't have any data to base those cuts on. Until the government ends its shutdown, they are just getting the private sector data that we are all getting and that really isn't showing much deterioration in the employment picture. It is still the same picture.

IE very slow growth in demand, but also very slow growth of supply of labor and therefore they do have doubts as to where the terminal rate should be or even what the neutral rate should be. Most continue to think that we are very slightly above. The neutral rate. IE very slightly restrictive, but they don't know how.

Restrictive We are until they get more data and I think that is a perfectly acceptable position to have. What happened as a result? We told you last week that the odds of them being to able to out dub the market's expectations were very low. And so it proved the whole yield curve backed up by about 10 basis points.

It was more or less a parallel shift. And the dollar went up by about a percent, and that has actually made financial conditions. More restrictive than they were last week, which really doesn't make any sense. The fed cuts rates and conditions become more restrictive. It would've been better had they just been on holiday for a week.

But there you are. That is the situation, and we thought that this is perfectly acceptable as a position to hold by the Fed. As a result, I think equities, despite the certain stellar earnings, and let's face it, the earnings from Amazon were very good indeed. The earnings from Apple were perfectly acceptable, given the market expectations and Google's were.

Good. There are no other ways to describe it, but you saw what happened to meta. Meta was down 12% on the week, and only because the market is

beginning to work out that all this investment in AI infrastructure is not going to produce the commensurate cash flow. That they would expect to go with it.

They, it certainly will produce a cash flow and a return. It just nowhere near as high as they thought it might. As a result, as I said, equities closed more or less exactly where they opened on Monday morning, but the Monday morning open was actually higher as a result of the speculation about a positive China.

Tariffs outcome. And indeed Trump and Ze seem to have had a good meeting. Trump announced a small cut of 10% in Chinese tariffs on the Fentanyl side because he obviously has assurances from Ze about limiting the supply of fentanyl that comes out of China. In any case, it's all marginal and. Equities are hugely overbought.

They are very overbought in my view, and that is why we have the hedge that we have on, and I think that we should maintain that hedge. What is going to happen next week is far more interesting than what happened last week. And Andy, we have the QRA and you are our QRA experts. So why didn't you kick it off?

Say what you think the QRA is going to be, and certainly if you have any other comments about the FOMC. I didn't mention QT ending in December because I thought you would like to do that.

Andy: Sure. Let's start with looking back. The, so last week on this EPIs on our show, we discussed how there was really no chance for the.

FOMC to out dove what was priced into markets. There was a hundred percent chance of a 25 basis point cut in October and a hundred percent chance of a December cut and then a terminal rate that was basically around three. And we said, there's just no upside for that and. That's what happened.

There was no upside. And so what happened is the FOMC didn't change its rate path. It didn't change what it saw in the economic data. It didn't in any way really and none of the various members have expressed any meaningful difference. All they've said. Powell reiterated it, and then multiple people that sort of align with Powell, not the ones that align with Trump, but the ones that align with Powell all stepped in line and reiterated the same point, which is that December should be closer to 50 50.

They've done a lot conditions financial. No one is blind to. What's happening in the asset market, gold stocks, et cetera. Credit, it's easy market. The market has

made conditions easy. Now it's important to recognize conditions are easy based on market pricing. The Fed attempts to change those conditions by its rate path, its forward guidance and its balance sheet actions.

The market decides whether the whether conditions are easy or not, and there's just no question. You can't look at anything, any asset price and the recovery in asset prices, the gain in wealth. The narrowness of credit, the availability of credit to think that conditions are not easy, but they're easy because the market has priced them easy, not because of anything the Fed has done.

And so what the Fed said is hey, you're getting a little too easy. Let's bring it back. And we're not necessarily going to cut rates as aggressively as you think, and that was their goal. Not to say that they won't. Just to say that. Hold it. Hold it, fellas. You're already ahead of us. Let's just come back to where we are.

And that's why we tightened. That's why the financial conditions tightened because the Fed said to the market, Hey, you're way ahead of us. So that's what happened last week. Also, there were a couple of specific announcements in the press conference regarding the future. Back, last, early in the month, Powell signaled that they were going to end QT sometime in the coming months.

And they chose to end it on December 1st and announce it. Yes, on, on Wednesday. Now that's a little earlier than I expected. There's some good reasons, which I'll come to on the QR when I talk about the QRA. Why they, why it helps to set a date so that the treasury can plan for that, but they set a date December 1st.

Some people have said it's way too late. Others have said, and I'm one of them, has said they could have probably gone a little bit farther to sometime in the first half of 2026 before ending, but they decided to end. So that's it. And it's no big deal that they decided to end that because they were gonna end that was already known.

They also mentioned that the. Fed will one day in the future need to increase bank reserves because anytime an actual physical bill or a coin is minted, reserves drop and currency and circulation increases, and because of the hit level of QT that has been done, reserves fall and they have a view that reserves are important and must grow at.

Basically the level of the GDP, and if you look through time, that's what happens. Reserves grow by actions of the central bank over time at a rate that is generally about the same as the GDP and when you end qt, you're ending it

because you think reserves have reached the bottom level of what you're comfortable with.

And then as GDP grows that bottom level, that starts getting higher. And so you have to adjust. And so they're gonna, and they told us they're gonna, and it's probably gonna be something like nine months from now when they start doing what they call reserve maintenance actions.

Nick: But that is not QE, right?

So what, let that,

Andy: what, so this is all in the context of something that many of those who comment on macro, like to breathlessly describe. There are some that believe so in the context of macro. We care a lot about whether reserves are adequate, ample, scarce, and we care a lot about repo financing and the cost of LE of leveraging up positions and whether financing conditions in the money markets are tight, and there are dozens, I could name just off the top of my head that put out propaganda.

That the market is going to crash because of actions in the in the financing market. And because the government was shut down, the, and the government had to raise a lot of bills in the last nine months. In the last four months, ever since the gut, the OBB was passed, financial conditions of that nature have tightened a little bit.

The reverse repo program, which is, has been a real buffer for liquidity, has gone to zero, and the treasury general account, which is the re, the government's checking account, has been rebuilt, which is squeezed financing conditions, a little bit tighter.

Now the question is, are we about to have a crisis? Financing conditions, crisis, and the usual suspects are of course saying that. And some of the less than usual, the more normal macro guys are starting to say, oh my God, we're about to have a financing crisis and they're going to have to act. Or we're going to crater.

So there's the bear case that says we're going to crater. And then there's the bull case, which says not only are they gonna act, but they're gonna act as if it's the end of the world flooding the system with liquidity doing actual QE when really nothing's happening. So that's what I think you have to take from the FOMC.

And we obviously keep quite careful attention on these conditions, but our assessment is that there's just, it's just nothing happening. It's just normal stuff. When you get to a point where you've had quantitative tightening for a long time, a TGA refill for a long time, and the drop in a form of savings called RRP.

That's what happens. And so here we are. So now, next week we have the quarterly refunding announcement, and I'll try to be brief on that. The quarterly refunding announcement tells us a couple of things. It tells us what the re and it happens once every quarter, four times a year. And what they, what it worked it's the Treasury Department's ball.

This is their one big thing that they do every quarter. And what they tell us is. What they expect the deficit will be next not only for the remaining part of fiscal year 2026, first quarter, which is what we're in fiscal year ends on, October on September 30th, but also the. Deficit expectations for 2026, first quarter, 2026 calendar quarter 2026.

And so we're gonna get an idea of what they think the deficit's gonna be, and that's gonna be inform us on what they think tariffs are gonna be. So that's an interesting piece of information. Obviously, tariffs really depend on what the Supreme Court's going to do, which we'll come back to in a moment, but.

We'll have their deficit projection, and then we'll have the composition of how they fund the deficit. And that's gonna change a little bit. There's some interesting pressures that are happening. For instance, because of the end of qt, the Fed is going to continue to allow, its. Mortgages to run off at roughly 200 billion a year pace.

But instead of burning the proceeds and killing the reserves associated with those proceeds, they're going to reinvest the proceeds in T-bills. And those are T-bills that the government hadn't been able to sell. So all of a sudden, the government who that has to fund its deficit has the Fed buying 200 billion of something that they hadn't bought any of.

And so it's gonna be T-bills, but. That means that there should be pressure on all private sector issuance. And that means, and in particular, if the re, if the Fed takes up all the T-bills that are available, the market might get s the private sector might be starved for T-bills. And so the treasury could.

Reduce the amount of coupons, it's auctioning so as to increase the amount of T-bills. In that case, that would be dovish, so to speak. It would ease financial conditions. It would weaken the dollar, strengthen gold, likely strengthen stocks

even, and strengthen bonds because there'd be less supply for the private sector to absorb.

So we'll look to see if they are going to cut coupon issuance during next quarter.

Nick: Okay. But what do you think the odds of that are? Very,

Andy: Very zero. Yeah. So what is highly likely is they tell us we're gonna keep the auctions the same, and that should have no meaningful market impact.

They also will give us guidance on what they think for coming quarters. They won't tell us. Hard numbers, but they'll think for coming quarters and they may indicate that they are either going to cut, keep the same, which is what the language is today, or increase the pressures to increase are quite significant.

Nonetheless, for, I think it's been five quarters now, there's been no change in the coupon auction schedule at all, and that's been fine. There are ongoing pressures, so it's possible one day one, maybe it's this quarter, probably not, but one quarter in the next few quarters, you're gonna get a, we're gonna be increasing coupon auction sizes in the coming quarters.

And when they do say that, that's going to be bearish gold, bullish, the dollar, very bearish stocks and modestly bearish bonds. But again. Is that gonna happen this quarter? Probably not. So what I'm saying is that there's this very wide range of probability where that nothing happens next week and quite meaningful, but also highly unlikely alternatives.

So the bottom line is we should expect nothing and we'll tell you what to do if we see something unexpected.

Nick: Absolutely. No, I'll say straight away, but say, I'll say

Andy: That unexpected bit. The market's not gonna react very quickly, so we'll have plenty of time to inform you.

Nick: What about the Supreme Court?

We haven't discussed that because they start oral arguments next week on the fifth, I believe, and that people will listen to it and try to get it. Gauge of what the mood is on the Supreme Court, certainly through their questions to the various

Andy: lawyers, right? It starts November 5th. The opening arguments, assuming the court is able to stay open, which we think it will they haven't changed the schedule yet, but they're running outta money just like everyone else.

It is a government business. So let's assume it happens. We're gonna hear an argument from the Trump administration, and we're gonna hear an argument from the plaintiff and who knows, I guess one of the two could really have a terrible argument and thus people will project what the court's gonna do.

But we'll also get information from the. The swing voters on the court about what they're, where they're leaning. So we could get some information, but again, we might not get a decision till the earliest we'll get a decision is the is the Monday the eight 17th that's the soonest possible and more likely it's gonna.

Go into December. It could go as long as May before they decide, but they've expedited the process. So it seems fairly likely. But I think the important thing is what's the decision mean? So there's the existing IEPA tariffs are declared legal giving Trump the ability to change the tariff based on what is essentially a view that the.

There is an emergency. Who knows whether what they'll say if they do that, either the existing deals will be the same. That's one possibility. And so tariff revenues won't really, expectations won't really change. Or two, it emboldens Trump to be more aggressive with tariffs. In that case, you might get a, not a liberation day, increase in tariff rhetoric, but it certainly empowers him to swing a little bit more confidently and more importantly, have his counterparties recognize that they've been declared legal.

So it's an interesting dilemma. The alternative is that they declare them illegal. If they declare them illegal, the first question is, and the court is gonna have to address this 'cause otherwise it's gonna come back to them anyway, is how do they remedy the fact that they've collected all these tariffs in the first place.

So that might, that'll be an important thing. Again, we're now talking about the decision, which isn't gonna happen, but people are gonna project these things. And then lastly tariffs aren't going away. There are clearly much more difficult to implement, but also legal ways to enforce 80% of the tariffs that are being collected today without Congress and with within the legal realm.

And so tariffs are sticking around. So in the end. There's some interesting dynamics that could cause some chaos, but in the end, tariffs are sticking around

and as long as tariffs are sticking around, you're gonna be taxing Americans as well as some foreigners, but you're gonna be taxing Americans, which is going to be good for the deficit, which is good for bonds, bad for growth, which is good for bonds and can be bad for stocks.

Nick: But the first reaction, as you rightly said, is going to be one of chaos. And the primary thing that's gonna get hit is the yield curve. The long bond is gonna get absolutely destroyed.

Andy: Yeah. Let's say for instance Connie Barrett or Roberts, who are the swing types really make it obvious that they're gonna rule against tariffs.

You're gonna have this week, you're gonna have a reaction and it's gonna be knee jerk chaos, which is steepening of bonds and probably sell off of equities. Even though arguably reducing tariffs is good for the economy, you're just gonna get a asset sell off.

Nick: Yeah, absolutely. It's a good thing that we are hedged and we've got some optionality in our positions, right?

Indeed. Okay. I'll go through the portfolio, see what's changed, see what needs to be changed, and how we react to the various scenario that we just talked about. I'll speak to you next week, Andy. See you.

