2 Gray Beards Week 154

Nick: Hello. Today is the 13th of December, and last week we had the big FMC meeting, so let's talk about that. They did something that we. Didn't think they needed to do, and that was add 40 billion of bills into the system per month for the next four months. I guess they were worried that they'd overdone it with QT and they wanted to be absolutely sure that the turn of the year would pass off Uneventfully and also tax season in April.

Now we know that there isn't going to be a tightness, any kind of tightness in terms of the repo rates, which they obviously think is very important for the market. They cut, didn't they? That was at 85%, [00:01:00] so they never disappoint. But what do you make of the dot plots where they are for next year and what do you make of the unchanged unemployment and.

Bringing down the the dot plots for the for inflation slightly. The market didn't really react very well to all of it. All in all, did it?

Andy: Yeah. We'll get to the market in a bit, but, the, from the FOMC standpoint while there had been some rumblings from the administration that they were now focused on affordability, that was and there was also some rhetoric at the end of the week that Hassett is not the SHU in and it's now a two man race between Hassett and Warsh. There could have been some less dovish doves at the Fed. Because they're getting the message from the administration that, let's [00:02:00] slow down a little bit in terms of cutting rates.

Quite the opposite happened. The lowest got for 2026, which has to be Steve Myron. Is now at 2.125, which is, what is that? That's from three and a half down to two. That's six cuts over the next eight meetings. So that's full speed ahead now. He's alone. He dissented. He wanted 50 this month. No one else dissented on the cut side, but two of the president's con voters dissented on the, cuts wanted no cut. So the what the dot told plateau us is nothing changed at the median, but. The division still very strongly remain in place. The econom, the economic dots, they're optimistic. They're optimistic on inflation, that it'll continue to head toward [00:03:00] target. They're optimistic on eco the economy with.

Not downgrading the employment rate and upgrading the growth rate. And I think the logic is sensible. Tariffs are assuming they are allowed to be legal and even, and if they're not, it just is a more extreme case of this tariffs aren't going up in 2026, so that's not an inflationary pressure.

In the, impact of the OBBB is pro-growth versus in 2025 it was anti-growth. So you have a fiscal impulse that's positive. So I think they all took that, and there we are, but the market reaction was pretty severe.

Nick: Yeah, no, the yield curve steepened quite aggressively and continued on Friday, right.

Into the close. Even though this uncertainty about Walsh was brought in. [00:04:00] Yes, the bond market doesn't like it. And as we've said, duration is something that you want to avoid for the foreseeable future. Whatever happens because I just can't see how rates very close to. Wherever the core PCE is going to be, whether they're slightly below or slightly above, which is, as you said, what they are implying with their dot from their dot plots.

Can. Be anything but a curve steeper. So we don't really need to talk about that. Duration is basically something which is off the table buying it for the foreseeable future until we really know what the economy is doing. Is this though the basement trade?

Andy: Yeah.

Nick: Adding 40 billion into the system for probably no reason.

Let's face it. What's the question? We don't know.

Andy: That's the question. The, the Fed has been [00:05:00] extremely cautious about anything to do with financial stability.

Nick: They, and that's what they're telling us, isn't it? That they're more concerned about financial stability.

Andy: I think more if you think, if you look back to what happened during the actual it wasn't really a crisis for a few banks in 2023 with that was SVB was the. But even Republic Bank were also dragged into it. They added roughly a hun 120 billion of reserves into the system to save the banking crisis.

In this case, they're adding 160 billion. With no crisis. So either there is either they're very confident that they've gone too far with QT and so they need to back and drain too many reserves, or they are just being extremely cautious because there's no sign. Of meaningful [00:06:00] stress. There's a little stress.

Yeah, A little stress, but meaningful stress. No signs of it at all. Not in the financial markets, not in anything gold. Before SVB was 1800, it's now 4,300 equities were 3,800. They're now 6,800. There's no crisis, but they're acting. Least as aggressively as they did during SVB. And so you have to ask, is that warranted?

Because if it's not warranted, if it is warranted, good preparation, saving us. We're just not seeing the issue. But if it isn't warranted, you know what's gonna happen is there are gonna be a bunch of cohorts that are gonna have less T-bills than they want and more cash. And those are gonna be money market mutual funds, banks and customers of banks, which include foreign customers, [00:07:00] foreign foreign, central banks and domestics. And so the question is, if those guys can't, don't have enough bills because they're gonna have 160 billion lefts of them, what are they gonna do with the money? Now we know what's gonna happen to the money market, mutual funds 'cause they have to put that money to work immediately.

The. Impact will be a decline in the repo rate, which has been above the Fed funds rate, and at some point above, at some points during turns above the top of the Fed funds target range. That's gonna get pushed down. Now is that gonna cause a bunch of people Is cheaper, repo gonna cause a bunch of people, anybody to lever up their portfolio?

Animal spirits are tricky. It could, in fact, it'll probably, that push of some liquidity will probably cause [00:08:00] some levering up. Because it's a little bit cheaper, but not a lot. The other TBI holders, banks, are they gonna, do they have many T-bills? Not really. Are they gonna lever up because they have less T-bills?

Probably not. They could for one, they could lever up right now. And so that's not a, that's a push that has no impact. But on the margin, is Warren Buffet going to, look at his Tbu portfolio, which is immense, and say, oh, the roll is not as cheap as, as attractive as it was. I'm gonna buy stocks.

Probably not. Could they buy five year bonds? Maybe. And that what it'll all come down to is what the this additional bond, short-term bills and bond buying and note buying, will that cause the treasury to reduce the amount of coupons they issue [00:09:00] long-term bonds, they issue. We won't know that until February and there's no sign that they will.

And so even the animal spirits of this. Liquidity injection is not gonna really push risk premiums down. Contract risk premiums, meaning all assets aren't gonna lift. That was the initial reaction when the Fed said We're going 40 billion boys, even though they were pretty. Neutral, I would say in terms of forward guidance for rate cuts.

Assets rallied every asset. Rally bonds rallied, stocks rallied gold rally, the dollar fell. Everything was a debasement trade, but. Two days later, the only debasement trades that are persisting are the ones that are sensibly sensible to persist, which is strength in precious metals, strength in commodities, X energy, strength in [00:10:00] non-dollar equities.

And that's where the debasement is likely to happen. It's gonna be an anti dollar persistent trend. And so that's where we think we should be heading.

Nick: So last week we actually saw a big rotation as well out of tech and into financials and industrials. So basically anything that's has, I dunno real value that, you know, people who produce stuff.

Do you think that persists? Because I'm beginning to think that it will, over the course of the next few weeks you're seeing ACO earnings were fantastic and the stock got murdered because they didn't improve the 2026 earnings. It just feels like there's a big rotation out of them. Tech in general, but the Mag seven in particular, into [00:11:00] the 493 that haven't gone up nearly as much, but are a much better hedge against debasement.

Andy: Yeah, so for me, I, there's the question of is tech overdone. It's correcting. It's in a corrective phase. It looks awful. Stocks are not performing well, even on the best of news. And then there's, are these other stocks good investments? To be honest, they're not. No. Stock is cheap. They're not a bunch of stocks lying out there.

Perhaps the energy space, but maybe the real estate PA space, maybe the non-nuclear, non ai. Utility space, but that's a bond trade. There are not a lot of cheap stocks out there. And certainly industrial stocks, military complex stocks they've gotten, and banks have gotten bid up quite a bit. But, so to me it's really not about saying, gosh, I love these stocks because they're [00:12:00] cheap.

It's partly, I don't really necessarily love tech. So that's, where I'm thinking about that it's not that there's, the debasement is gonna fundamentally change these stocks. But at the same time, having real assets is useful. So companies that own real assets, which by the way include banks, are probably gonna do better than ones that are promising future revenues that don't exist.

Yeah, I think that makes sense to me. One thing I would note, JP Morgan this week went on a pretty wild ride, mid midweek. They, the stock fell, what, 5% in one day in, in a brief period of time because of earnings weakness, but it ended the week very strong. So to me it's gonna be a stock pickers [00:13:00] market a bit in that way, in that you could see a serious drawdown on nothing for any stock.

But the fact that it recovered so much tells you that rotation is absolutely underway.

Nick: Yeah. What about foreign stocks? They are fundamentally cheaper for good reasons also. With the way the dollar's looking it, the dollar seems to be. Something that the, this administration doesn't really care about and it's not going to defend that value of the dollar, whatever happens, it seems to me.

So maybe a little bit into foreign stocks as well, because they're a better diversifier would've thought than anything in the s and p.

Andy: Yeah. We own a bunch in at DAM Spring we own a bunch of VEA, which is A ETF that is. Because it's e an A essentially a a DR style has exposure to [00:14:00] the home currency and is all the equity markets by market Cap X.

The us We like it because it is. Again, not denominated in dollars, which is getting debased and is re is light tech because the rest of the world doesn't own tech. So that's been a theme for us for a while. I think it's the events of last week further. Indicate that theme is likely to work. So yeah, I think that's a great, per a great alternative to QQQ for instance.

But you wanna diversify with some US stocks as well. And so yeah, I think that makes sense.

Nick: So basically the message is, let's go and diversify because you know you're getting this rotation. On the other hand, as you said. There is some debasement going on and therefore equities are a good hedge against that, but probably [00:15:00] not as good as gold.

But we'll see about that. The and precious metals are really unlikely to go down at any stage unless. We are hugely overbought. They could come back, but they're not going to collapse into year end or early next year. Yeah. I think there's gonna be

Andy: a chase into year end for things that are working and the things that are working are not tech.

They're not US equities. They're foreign equities, and they're precious metals. I think it's an easy trade for the next few weeks. By the end of the month, we may have, it may be time to lighten up a little bit, but in the short term, those are the things that Santa's gonna deliver to investors.

Nick: And let's talk about next week, because we have NFP. We have CPI for November as well. Given what the fed's done, do you think these, this data is going to change anyone's mind about anything? It sure [00:16:00] seems to me that the mines are made up at the Fed. There are two dissenters. There are, there were six voters, of which two of the voters, sorry, six members of which two of the members are going to be voters in January who were saying, don't, we don't agree with this.

Andy: Cut. And on the other hand, there are the. Those representing the administration's views and perhaps their own, but more likely the administration's views that rates need to be cut a lot. Tr I, I think January is an is low odds. I think they've told us, I think they've told us that they don't plan on cutting.

Is there anything in the data that you could be confident? Remember, this is still stale. Volatile data just in terms of what actually gets collected. And by the way, by next data series, we could be shut down, the government could be shut down again, and we'll [00:17:00] be on a data holiday. So it's gonna be real tricky to trade data and expect it to have a persistent impact.

People are in it's foggy. So I would expect to answer that question. I would say no one's gonna say none of the Fed members are gonna. Change their tune. And the tune is a cacophony of opinions right now.

Nick: So basically we ignore whatever the NFP and the CPI are. It's just a trade as opposed to a trend.

It's not going to change anyone's mind about anything. Yeah. You have just, if you step back, it's toward the end of the year. If you step back and say, do you want to own duration? No, we don't. Do you think that the Fed is likely to cut at least as much as priced? Sure. Seems like it. Though it's gonna be a struggle because there are some.

Andy: Fed members who are going to back slow that down. Equities are very well priced, [00:18:00] particularly US equities. The dollar is likely to continue to see debasement trends, so you have to position accordingly.

Nick: Yeah, absolutely, and I'll discuss that. We'll make a bunch of changes to the equity allocation to take advantage of our views.

Great. Thank you very much. I'll speak to you next week, Andy.

Andy: All right. See you Nick.