2 Gray Beards Week 153 - Detailed Summary

This transcript features Nick and Andy discussing Fed policy expectations and market implications as of early December 2024. Here's what they're analyzing:

The Current Market Situation

Nick opens by noting that despite a relatively quiet week with no major economic news, bond markets are showing stress. November economic data showed essentially zero change, yet the terminal rate moved up about 12 basis points. What caught his attention is that instead of the expected yield curve flattening, they got a small steepening—an unusual dynamic that removes support from equity valuations.

Bond Market Mechanics

Andy explains the underlying dynamics: when the economy strengthens and inflation stays elevated, bond yields rise across the entire curve. The current conditions show a resilient real economy, sticky inflation, and stimulative fiscal policy coming in 2026. This is pushing yields higher independently of Fed action.

The Fed's role complicates this picture. They can be ahead of, behind, or aligned with economic outcomes. If they're ahead (recognizing strong growth and acting hawkish), the curve should flatten because long-term bondholders would expect the Fed to succeed in slowing the economy. But that's not happening, which raises questions about market expectations.

Fed Committee Dynamics

They note the Fed committee is divided. Waller, Williams, Myriad, and Bowman are dovish—some have dissented or called publicly for more aggressive rate cuts. The administration has been pushing for cuts. However, Nick observes that this dovish faction has recently been "quieter"—pounding the table less. They haven't become hawkish, just less actively dovish. This shift is important because it suggests the market's expectations for aggressive easing may be misplaced.

The December Rate Cut Expectations

With a 87% probability priced in for a cut next week, the market appears complacent. But here's the critical distinction: it's not whether a cut happens, but what kind of cut it is. They identify three scenarios:

Dovish Cut: The Fed signals continued, aggressive easing. Nick argues this is nearly impossible to justify given strong employment data, strong GDP growth, and sticky inflation. Doing so would betray the Fed's principles and credibility on the 2% inflation target. People already doubt

the Fed's commitment to fighting inflation—a dovish cut would deepen that doubt and could trigger a "bond vigilante" response, actually steepening the curve.

Hawkish Cut: The Fed cuts but signals it's nearly done. The dots don't project further cuts, Powell uses language like "we're on pause" or "data dependent," and explicitly takes January and March off the table. This would signal the Fed is much closer to neutral than markets expect.

Ultra-Hawkish/Terminal Cut: Powell says "we are at neutral" or "we are done." Nick says if Powell uses the word "neutral," he's selling everything. This would be catastrophic for equities because it removes the hope that the Fed will ease further to support asset prices.

The Equity Market Problem

This is where their analysis becomes bearish. Equities currently are being supported by the assumption that the Fed will eventually ease significantly because economic weakness will force them to. But the data isn't weak. If the Fed instead signals they're nearly done (hawkish cut), equities are caught in a vice:

- They no longer get hope of Fed easing
- Long-term rates are staying elevated or even rising
- Valuations that priced in lower rates become harder to justify

Nick states bluntly: "That to me is a top in equities. It's a top in all risk assets." He believes if there's any spike higher on the Fed cut, that should be the signal to sell—particularly if it's clear the cut is hawkish.

The Bond Market as a Tell

Andy raises an important point: the real constraint may be monetary conditions. Mortgage holders are still at 2.5-3% rates locked in from earlier. Corporations and investors are under-levered. To actually stimulate consumption and economic activity, you'd need to cut much more than 25-50 basis points to change behavior. The current rate level may already be neutral or even loose on a real basis.

However, the key question becomes: what does long-end demand look like? They're watching whether long bonds can rally after a hawkish cut. With 1,520 basis points of carry on the 30-year, there should be demand from banks and hedge funds for basis trades. If bonds don't rally even with hawkish Fed guidance and strong carry, that signals a deeper structural problem with the long end—possibly driven by Japanese selling or broader capital flows.

If long bonds fail to rally after a hawkish cut, it means something more fundamental is broken. As Nick puts it: "there just seems to be very, not good demand for the long end" despite the attractive carry. This would be "yet another support level taken away from equities."

The Technical Setup

They note specific timing: the 10-year auction is at 1 PM Wednesday (before the 2 PM Fed announcement), and the 30-year auction is Thursday. This means they won't expect immediate curve flattening, but by Friday, if long bonds are still struggling higher in yield (lower in price) despite a hawkish Fed, that's a red flag for all assets.

The Core Thesis

Their summary: A dovish cut is highly unlikely given the data. So we're in the "gray area" of how hawkish the cut will be. The more hawkish it is, the more critical it becomes that long yields decline—otherwise it signals a generalized problem with the long end that removes multiple supports from equities.

They expect to potentially change portfolio positioning based on what the Fed does and how the long end responds. Nick says he expects sending their subscribers an email about position changes is "highly likely this time."

Bottom Line: This is a bearish setup. No matter what happens next week—whether it's a moderately hawkish or very hawkish cut—equities are losing a key support (Fed put) and may see rising long-term rates persist. That combination could mark a meaningful top.