

2 Gray Beards Week 154 - Detailed Summary

December 13, 2024

Federal Reserve Actions and Policy Discussion

FOMC Meeting Outcomes

The week's primary focus was the Federal Reserve's FOMC meeting, which delivered several significant announcements:

T-Bill Purchases: The Fed announced an unexpected addition of \$40 billion in Treasury bills per month for the next four months (totaling \$160 billion). Nick and Andy initially believed this action was unnecessary, suggesting the Fed may be overcompensating for concerns about:

- Potentially overdoing quantitative tightening (QT)
- Ensuring smooth year-end market functioning
- Managing liquidity through tax season in April

Rate Cut: The Fed delivered a 25 basis point rate cut with 85% market expectations, maintaining their pattern of never disappointing markets.

Dot Plot Analysis

The updated dot plots revealed significant internal division within the Fed:

Dovish Extreme: The lowest projection for 2026 came in at 2.125% (likely from Steve Myron), representing six rate cuts over the next eight meetings - a dramatic shift from 3.5% down to approximately 2%. Myron dissented, advocating for a 50 basis point cut this month.

Hawkish Opposition: Two of the president's voters dissented in the opposite direction, preferring no cut at all.

Median Outlook: Despite the internal division, the median projection remained unchanged, though the spread of opinions demonstrates deep disagreement about the appropriate policy path.

Economic Projections

The Fed maintained optimistic forecasts across key metrics:

- **Inflation:** Slightly lower projections, continuing toward the 2% target
- **Unemployment:** No downgrade despite labor market concerns

- **Growth:** Upgraded economic growth expectations

Rationale: The Fed's logic centers on tariff dynamics - assuming tariffs are implemented, they won't increase further in 2026, removing an inflationary pressure. Additionally, the impact of fiscal policy (OBBA - likely referring to budget/spending measures) shifts from anti-growth in 2025 to pro-growth in 2026, creating a positive fiscal impulse.

Market Reaction and Bond Market Dynamics

Immediate Market Response

The market's initial reaction was overwhelmingly positive across all asset classes - a classic "debasement trade":

- Bonds rallied
- Stocks rallied
- Gold rallied
- Dollar fell

This reflected investor interpretation that the liquidity injection would debase the currency and support risk assets.

Two-Day Reality Check

However, by Friday (two days post-announcement), the market had significantly reconsidered:

What Persisted (logical debasement trades):

- Strength in precious metals
- Strength in commodities (excluding energy)
- Strength in non-dollar equities

What Reversed:

- The yield curve steepened aggressively through Friday's close
- Bond market selling intensified
- Tech stocks, particularly the Magnificent Seven, came under pressure

Key Takeaway: The market ultimately concluded that the persistent debasement trend would manifest as anti-dollar movement rather than broad asset appreciation.

The \$160 Billion Question: Warranted or Excessive?

Historical Context

Andy provided crucial historical perspective comparing the current intervention to the 2023 banking crisis:

2023 Banking Crisis (SVB, Republic Bank): The Fed added approximately \$120 billion in reserves to stabilize the banking system during an active crisis.

Current Action: The Fed is adding \$160 billion with no apparent crisis - more liquidity than during an actual banking emergency.

Crisis Indicators Comparison

Then (2023):

- Gold: \$1,800
- S&P 500: 3,800

Now (2024):

- Gold: \$4,300
- S&P 500: 6,800

There are no meaningful signs of financial stress despite the Fed acting as aggressively (or more so) than during an actual crisis.

Two Possible Interpretations

Scenario 1 - Justified Caution: The Fed has correctly identified that they've gone too far with QT, draining too many reserves from the system. This represents prudent prevention of a crisis that markets haven't yet detected.

Scenario 2 - Unwarranted Stimulus: The Fed is being excessively cautious, injecting significant liquidity when no meaningful stress exists in financial markets.

Liquidity Mechanics and Market Impact

Who Loses T-Bills?

The \$160 billion reduction in T-bill supply will primarily affect:

1. Money market mutual funds
2. Banks
3. Bank customers (including foreign central banks and domestic institutions)

Expected Market Effects

Money Market Mutual Funds: These entities must deploy capital immediately, which will:

- Drive down repo rates (which have been trading above Fed funds rate, sometimes exceeding the top of the Fed funds target range)
- Create cheaper leverage opportunities
- Potentially trigger some portfolio leveraging due to marginally cheaper funding

Banks: Limited impact expected as:

- Banks don't hold significant T-bill portfolios currently
- They could already leverage if they wanted to
- The marginal change won't likely alter behavior

Large Cash Holders (e.g., Warren Buffett): Unlikely to rotate out of T-bills into equities just because the roll yield becomes less attractive. Might consider:

- Five-year bonds as an alternative
- Maintaining current positioning
- Limited behavioral change expected

Will This Create Animal Spirits?

The critical question is whether cheaper repo funding will encourage widespread portfolio leverage. Andy's assessment: probably minimal impact because:

- The magnitude isn't dramatic enough
- Most participants who want leverage already have access
- The Fed's Treasury buying won't necessarily reduce long-term coupon issuance (won't know until February)

Conclusion: The liquidity injection is unlikely to significantly contract risk premiums across asset classes, despite the initial debasement trade reaction.

Sector Rotation and Investment Strategy

The Tech Correction

The previous week saw significant rotation out of technology stocks:

- Shift from tech into financials and industrials
- Movement toward "real economy" stocks - companies that produce tangible goods
- Example: ACO reported fantastic earnings but the stock was "murdered" for not improving 2026 guidance

Magnificent Seven vs. The Other 493

A clear bifurcation emerged:

- Mag Seven: Under pressure despite strong fundamentals
- The remaining 493 S&P constituents: Seeing inflows as better debasement hedges

Notable Example - JPMorgan: The stock fell 5% mid-week on earnings weakness but recovered strongly by week's end, signaling the rotation is genuine and sustained.

Are Non-Tech Stocks Actually Cheap?

Andy's skeptical assessment: **No, they're not cheap.**

Limited Value Opportunities:

- Perhaps in energy sector
- Possibly in real estate (but that's more of a bond trade)
- Maybe in non-nuclear, non-AI utility space (also a bond trade)
- Industrial stocks and military complex stocks have already been bid up
- Banks have also appreciated significantly

The Real Investment Thesis: It's not that these stocks are bargains; rather:

- Tech is overvalued and correcting
- Companies with real assets (including banks) should outperform those "promising future revenues that don't exist"
- This will be a stock-picker's market with significant intra-day volatility even on strong stocks

International Diversification

Foreign Stocks as Diversifiers

Nick and Andy discussed foreign equities as superior diversification versus S&P 500 constituents:

Why Foreign Stocks Make Sense:

- Fundamentally cheaper (though for good reasons)
- Dollar appears to be losing value with administration indifference to defending it
- Better diversification characteristics

Specific Recommendation: VEA ETF

Andy's Damped Spring Advisors holds significant positions in VEA (Vanguard FTSE Developed Markets ETF):

Key Attributes:

- DR-style structure provides home currency exposure
- Covers all equity markets by market cap excluding US
- Naturally underweight technology (rest of world doesn't own as much tech)
- Not denominated in debasing dollars

Positioning: VEA represents a direct alternative to QQQ (Nasdaq 100), though diversification should include some US exposure as well.

Precious Metals and Commodities

The Debasement Hedge Par Excellence

Both speakers agree precious metals represent the strongest debasement protection:

- Unlikely to collapse into year-end or early 2025
- Could pull back if significantly overbought, but won't see major reversals
- Primary beneficiary of persistent dollar debasement trends

Near-Term Outlook (Through Year-End)

"Santa's Delivery" - Things That Will Work:

1. Foreign equities
2. Precious metals
3. **Not** US tech stocks
4. **Not** broad US equities

Timing: This trade looks solid for the next few weeks, potentially through month-end, after which some lightening up may be appropriate.

Duration Strategy: Just Say No

Unanimous Bond Bear Position

Both Nick and Andy are adamant about avoiding duration:

Core Logic:

- Rates are very close to wherever core PCE inflation settles
- Whether slightly above or below inflation, the result will be curve steepening
- No scenario makes long-duration bonds attractive
- This position holds "for the foreseeable future until we really know what the economy is doing"

Market Confirmation: Friday's aggressive yield curve steepening validated this view, with selling continuing even after speculation emerged about Kevin Warsh potentially becoming Fed chair instead of Hassett.

Upcoming Data: NFP and CPI

Next Week's Economic Calendar

Two major data releases scheduled:

- Non-Farm Payrolls (NFP)
- November CPI

Will Data Matter?

Short Answer: No, not for changing Fed members' minds.

Why Data Won't Shift Policy Views:

1. **Minds Already Made Up:** The Fed has clearly signaled intentions, with a "cacophony of opinions" that data won't resolve:
 - Six voting members total
 - Two current dissenters oppose cuts
 - Two non-voting members (who will vote in January) also opposed the December cut
 - Some members (like Myron) want aggressive easing
2. **Data Quality Issues:**

- Data remains "stale and volatile"
 - Collection methodology creates uncertainty
 - Potential government shutdown could trigger "data holiday"
 - "Foggy" environment makes trading on data unreliable
3. **January Cut Probability:** Low odds despite some members wanting aggressive action, as the Fed has telegraphed plans not to cut

Trading vs. Trending

Any market reaction to NFP or CPI should be viewed as:

- **Trade opportunity:** Short-term price movement
- **Not trend-setting:** Won't change fundamental positioning or Fed trajectory

Political and Administrative Influences

New Administration Messaging

Some nuanced signals emerged about incoming administration priorities:

- Rumblings about focusing on "affordability" rather than just inflation targeting
- Speculation about Fed chair selection: initially thought to be Hassett as presumptive choice, now possibly a "two-man race between Hassett and Warsh"
- Potential for "less dovish doves at the Fed" receiving messages to slow rate cutting

Fed Response

Contrary to administrative hints to slow down, the Fed's December actions showed continued dovish commitment, particularly in the extreme lower bound of the dot plot projections.

Summary Investment Positioning

What to Do

Diversify Across:

1. Foreign equities (particularly VEA or similar developed market exposure)
2. Precious metals (primary debasement hedge)
3. Select US stocks with real assets (banks, industrials, financials)
4. Commodities excluding energy

What to Avoid:

1. Duration (long-term bonds)
2. Concentrated US tech exposure (particularly Magnificent Seven)
3. Dollar-denominated assets without offsetting diversification

Key Themes

Debasement: The central organizing principle for 2025 positioning. While equities can serve as inflation hedges, they're "probably not as good as gold."

Anti-Dollar Trend: Persistent and likely to continue given:

- Fed liquidity injections
- Administrative indifference to dollar strength
- Relative attractiveness of non-dollar assets

Rotation Reality: Movement from growth/tech to value/real assets appears genuine and sustainable based on:

- JPMorgan's recovery pattern
- Broad sector movements
- Fundamental repricing of future promises vs. current assets

Final Thoughts

Nick and Andy conclude by committing to "make a bunch of changes to the equity allocation to take advantage of our views," signaling active portfolio repositioning to capture the debasement theme while avoiding overvalued US tech.

The overarching message: 2025 will require active management, diversification away from traditional US equity concentration, and recognition that the Fed's extraordinary \$160 billion liquidity injection—larger than the 2023 banking crisis response despite no apparent crisis—represents either masterful prevention or excessive stimulus that will drive dollar debasement trends.

The Bottom Line: Position for currency debasement through precious metals and foreign equities, maintain stock-picker discipline in US markets focusing on real asset companies, and absolutely avoid long-duration bonds regardless of near-term data fluctuations.