

2 Gray Beards Week 158 - Comprehensive Summary January 10, 2026

Market Overview and Volatility Dynamics

The past week proved relatively uneventful from a market perspective, characterized primarily by what didn't happen rather than what did. The anticipated SCOTUS decision on Friday failed to materialize, potentially pushed to Wednesday or later. This pattern of non-events has created a predictable market response: each time expected news from SCOTUS or regarding the Fed chair appointment fails to emerge, markets rally as participants sell hedges and roll positions forward, supporting asset prices through reduced volatility.

The employment data, confirmed by Friday's NFP report, continues to show an unusual dynamic: no meaningful hiring and no firing, yet GDP growth persists. Current GDP nowcasts project approximately 5% growth (though the actual figure will likely settle in the 2% range when officially reported), indicating an economy expanding quite robustly. The combination of strong economic growth without corresponding labor market absorption suggests the economy is experiencing a productivity boom, potentially driven by AI adoption or other efficiency gains. Markets favor this scenario because productivity improvements support sustained asset price appreciation without the inflationary pressures typically associated with growth.

The Fundamental Relationship Between Volatility and Asset Prices

Andy elaborated on a core investment framework: owning assets is fundamentally a short volatility position. When volatility compresses, asset prices rise—this is the essential reason to own assets in the first place. The flows in options markets consistently reflect this dynamic, with out-of-the-money puts on risky assets historically trading at significant premiums to out-of-the-money calls. This premium exists because market participants recognize that holding assets inherently means being short volatility, so they hedge by selling calls and buying puts.

This relationship manifests not just over longer periods but on a daily basis. It's highly unusual for volatility to rise while assets simultaneously appreciate, and equally unusual for volatility to fall while assets decline. The correlation is strong and should be strong—when there's minimal perceived risk to assets (which volatility partially represents), investors should bid up assets and increase leverage. This past week demonstrated this principle in microcosm: anticipation of a SCOTUS decision created hedging demand and elevated volatility, but when the decision didn't arrive, volatility fell and assets rose.

The key investment question then becomes: what will volatility do in the future? If an investor believes volatility will continue falling, the appropriate response is to increase portfolio leverage ahead of that move. Conversely, if volatility has already fallen too much, deleveraging becomes prudent. This framework forms the basis of Andy's key beta signal—determining how much market exposure to maintain based on volatility expectations.

Banking Sector Under Political Pressure

Two major policy announcements emerged last week specifically targeting the banking sector, representing significant political developments with uncertain implementation prospects.

Credit Card Interest Rate Cap

Trump announced a desired one-year moratorium on banks' ability to charge above 10% interest on credit card loans. This represents a populist measure with support from both Trump and Bernie Sanders, targeting what many view as exploitative 20%+ credit card rates that have persisted throughout modern financial history.

The economics of this proposal present clear trade-offs. Standard economic analysis suggests that capping rates at 10% would lead banks to cancel credit cards for riskier borrowers, as extending credit at that rate wouldn't be profitable for higher-risk customers. This would reduce credit availability for those who need it most. However, the policy would also enable some consumers to take on more credit at the lower 10% rate, providing economic stimulus. The net effect depends on which force dominates.

The political calculation appears straightforward: the administration's goal is reelection, and the current populist narrative centers on making life more affordable for people struggling with costs—which now encompasses most of the population. Trump is targeting this constituency and doesn't particularly care about protecting credit card issuing banks. Capital One provides a specific example: the bank has significant profitability tied to high-interest credit cards, yet its stock is up 42% since Trump took office. From a political perspective, "they got plenty to give."

The legal question remains whether this can actually be implemented as an executive order—it probably cannot—making this more of a political signal than an immediately actionable policy.

Fannie Mae and Freddie Mac Mortgage Purchases

The second announcement, which can be implemented immediately, authorizes Fannie Mae and Freddie Mac to purchase \$200 billion worth of mortgages. To contextualize this figure: \$200 billion represents a meaningful amount even in a \$13 trillion mortgage market, though the purchases won't happen overnight.

This policy effectively works against the Federal Reserve's balance sheet runoff. Even though quantitative tightening (QT) has officially ended, the Fed's MBS holdings continue declining at \$20 billion per month or \$240 billion annually. The Fannie/Freddie purchase program would essentially take the opposite side of that runoff, though this expansion wasn't previously expected.

The mechanism for reducing mortgage costs operates at multiple levels. At the most basic level, the purchases will compress the spread between wholesale mortgage rates (the institutional market where banks sell originated mortgages) and Treasury yields. This wholesale spread compression creates downward pressure on retail mortgage rates. Banks profit from mortgage origination by creating loans and selling them the following Monday at wholesale rates,

capturing a spread of approximately 100 basis points (using rough numbers). This represents immediate NPV bank profitability from the mortgage origination business.

Government purchases should reduce this wholesale spread to Treasuries. Whether banks pass the entire savings to retail customers or also face compression in their retail spread remains an open question, particularly given the current political climate. An additional complexity: Fannie and Freddie could purchase mortgages and issue short-term debt without hedging their duration risk, which would also exert downward pressure on long-term interest rates.

Mortgage markets have already begun adjusting to this news, with retail mortgage rates falling meaningfully, though the actual purchasing hasn't started. The sustainability of these rate improvements remains to be seen.

Impact on Housing Affordability and Bank Profitability

The critical question is whether this policy will meaningfully impact the macro economy through housing. When mortgage rates are artificially suppressed, prospective homebuyers become more enthusiastic about purchasing, increasing their willingness to pay higher prices. Consequently, much or most of the improved affordability from lower mortgage rates gets captured by home sellers through elevated prices rather than genuinely improving affordability for buyers.

The overarching conclusion from both announcements is clear: both policies target bank profitability, which has been exceptional and has supported rising asset prices. Banks represent an easy political target heading into midterm elections. While some portions of these initiatives will be implemented and others won't, the sector faces headwinds for at least the next six months, making it potentially unattractive for investors despite strong recent performance.

Interest Rate Outlook and Fed Policy

The market is currently pricing essentially zero probability of rate cuts in January, which both Nick and Andy view as appropriate. More significantly, March is "starting to leak," with only a 25% chance now priced for any cuts over the next two FOMC meetings. This represents a meaningful shift in expectations.

The terminal rate has reached its recent low—the market now expects only two total cuts before a long pause, followed eventually by a small rate increase. This represents new information: the market had previously anticipated more accommodative policy. Current fed funds average approximately 4.363% (ranging from 4.365% to 4.368%), creating an important technical level.

Andy expects the Fed to cut more than currently priced, driven by several factors. First, President Trump's populist orientation favors lower rates. Second, while economic data suggests strength that wouldn't typically warrant cuts, that data quality has deteriorated significantly—perhaps the worst Andy has seen in his career—due to government shutdowns and collection problems. A potential January 30th government shutdown could further degrade data quality. GDP nowcasts projecting 5%+ growth for Q4 (up from an already robust Q3) may not reflect actual economic conditions.

The key rate positioning insight: at 4.363% fed funds, the 2-year Treasury note is unlikely to break through that level. With Treasury auctions (3-year, 10-year, and 30-year) scheduled for early next week, curve pressure could create an attractive entry point for 2-year notes.

Fed Chair Speculation

Scott Bessent recently announced that the Fed chair decision will come either before January 19th or after January 23rd (when Trump attends Davos), though the specificity of this timeline raises questions. Walsh continues gaining favor as the leading candidate, which has provided modest support for duration (longer-dated bonds).

Market participants believe Walsh would be more effective at keeping the yield curve flatter than alternatives. The reasoning: Kevin Hassett, if appointed, would likely lack the authority or persuasive ability to influence the full FOMC, as the chair represents only one vote among the governors. Any chair needs to convince other governors to support rate cuts. Walsh presumably has better relationships and credibility to accomplish this, potentially preventing the long end of the bond market from "completely blowing out" if cuts prove too aggressive.

The market has now essentially priced out any rate cuts until April-May, coinciding with when Powell would leave office, creating interesting positioning opportunities for those who believe cuts will ultimately materialize.

Week Ahead: Data, Earnings, and the SCOTUS Decision

Economic Data

CPI data releases next week, but neither Nick nor Andy expect upside surprises. Even setting aside questions about data manipulation, the way inflation calculations have been announced makes an upside miss inconsistent with the established pattern. This should prove supportive for asset prices, to whatever extent market participants take the data seriously.

Other scheduled releases—PPI and retail sales—cover November data, providing nothing new that would provoke significant market reactions. The primary exception is bank earnings season beginning Monday morning with JPMorgan, followed by other major banks throughout the week. These reports will likely show strong results, though the recently announced policy headwinds create questions about forward guidance and sustainability.

Treasury Auctions

Three-year, 10-year, and 30-year Treasury auctions scheduled for early next week will exert pressure on the curve, particularly given current positioning. This technical pressure could create the opportunity Nick mentioned to establish positions in 2-year notes at attractive levels, potentially prompting an email alert to subscribers if conditions align.

The SCOTUS Wild Card

The Supreme Court itself has announced plans to release decisions on Wednesday across six pending cases—two are market-relevant while four are not. This creates the week's primary uncertainty and the reason both Nick and Andy are maintaining hedges despite ongoing volatility compression.

The base case scenario expects a reasonable outcome, but the tail risk scenario presents genuinely concerning possibilities. If the Court were to rule that the government must repay \$250 billion worth of tariffs that have already been collected and spent, Treasury issuance would need to surge dramatically, potentially pushing asset prices down significantly. While this outcome remains far from the base case, its severity justifies maintaining protective positions.

The pattern has been consistent: each time an anticipated SCOTUS announcement doesn't materialize, volatility falls and assets rally as hedges are sold. Nick rolled his hedges immediately after Friday's non-announcement into next week's expiration. Others may have given up on hedging after repeated delays, meaning Wednesday's decision (or non-decision) could generate significant volatility depending on positioning.

If the decision is announced, markets might experience volatility regardless of outcome—even an expected result could trigger positioning adjustments after weeks of anticipation. If the decision is again delayed, volatility will likely compress further, supporting additional asset price appreciation.

Strategic Positioning

Given this setup, the prudent approach involves:

1. Maintaining hedges through Wednesday's potential announcement, despite the cost of carry from repeated volatility compression
2. Looking for opportunities to fade the pricing out of Fed rate cuts, particularly in 2-year notes
3. Evaluating exits from financial sector exposure (XLF) given regulatory and political headwinds
4. Remaining patient for the SCOTUS decision before making major portfolio adjustments

The overarching theme remains: volatility compression supports asset prices, productivity growth supports economic expansion without inflation, and political targeting of bank profitability represents a new headwind for that sector. The week ahead offers potential tactical opportunities in rates while maintaining appropriate caution around binary political/legal events.