2 Gray Beards Week 158

Nick: Hello. Good morning. Today is January the 10th. We had a pretty boring week. Really, Andy? We were waiting for this SCOTUS decision on Friday, which didn't arrive. Now he could come on Wednesday. Every time, no news comes out from SCOTUS or about the appointment of a new Fed chair. The market rallies because people sell their hedges and roll them into next week or wherever, and assets just keep on doing better.

So we have a situation in which all the employment data, and we saw that confirmed in NFP on Friday. Say there is no hiring and no firing, and yet the GDP keeps on increasing. We've got GDP now, which is a nowcast, and therefore unlikely to come true around 5%, which, Trump is very pleased with. The real number will be in the twos, but it still shows an economy which is growing quite strongly.

Yet no labor Slack is being taken up, which can only mean that we are in the middle of some sort of a productivity boom, whether it's caused by AI or whatever else, and the market loves it because the prices of assets will continue to rise if there is a productivity burn. What. Are your impressions about that, Andy?

Andy: Yeah, that's certainly true. Listen if vol goes, gets compressed, because nothing happens, assets go up. That's why you own assets. It owning assets is a short volatility position. You benefit whenever volatility goes down. That's a fact. The flows are consistent with that because outta the money puts historically on risky things.

Traded a significant premium to out of the money calls. And so, the market's always hedged because people are short, realize that assets are a short volatility position. And so they hedge, they sell calls. They buy puts, and so whenever volatility comes down, there's all sorts of reasons. It's literally the basis of my framework for understanding why you wanna own assets.

When volatility it comes down, assets go up. And so we saw that, in a micro way, it's also true every single day that it's very unusual when volatility goes up and assets go up. And it's very unusual when volatility falls and assets go down. Typically they are highly correlated and they should be highly correlated because if there's no risk to assets, which is partly part of the volatility, if there's no risk to assets.

You should bid up assets. You should lever up assets. So, yeah, there's no doubt about it. So when we saw that this week, there was, we all went into Friday thinking there was actually a SCOTUS decision coming and there wasn't. So volatility fell and assets rose, and it's nothing more complicated than that.

I wish I wish there was some sort of real great insight. That's just the nature of markets. So you have to think to yourself, well, what's volatility gonna do in the future? Because that would say, if you think volatility is gonna fall more, you wanna lever up your portfolio ahead of that. And if you think volatility has fallen too much, you wanna dele your portfolio.

And that's literally the basics basis of my key beta. Signal how much beta I want to own. So no doubt about that. In terms of next week, well actually let's review last week. So what I saw is two, new things that were not part. We talked about Venezuela last week. Oil really didn't do much.

There's lots of conversation with more investment in oil. It doesn't look like the Trump administration is enthusiastic about causing an increase in oil prices and quite the opposite. I think they wanna see oil prices lower, so oil didn't do much and that was to be expected. On the other hand the administration and for that matter, Bernie Sanders.

Are targeting the banks and they targeted them with two executive orders neither one of which actually can be implemented and one that probably can't. The one that probably can't was announced on Friday after the close, and that was that Trump wants a moratorium, a one year moratorium on bank's ability to charge their credit card.

Banks are the issuers of credit cards, not Visa and MasterCard. They're just the processors, but banks ability to charge above 10% interest on credit card loans. As we all know, those are have been historically high lately, and. Throughout my life they've been a joke. Right? 20% credit card rates for are, have always been a joke.

And so that's been the target of the populace and Bernie Sanders and now Donald Trump seem to agree. And so he announced that he wanted to cap credit card rates at 10%. There's lots of negatives about that. Obviously the primary one and the one that most rational human beings, economists, et cetera.

Not that those are the same, are clearly focused on is that when you reduce credit card interest rates from 20% to 10%, a lot of people get their ca credit cards canceled because the banks don't want to extend credit at 10%. Now, that's all true. There's no doubt about it. It's also true that some of the credit card interest if it were to happen interest rate reduction would enable people to take on more credit.

They would want to take on credit at 10%, and that would be stimulative to the economy. So that's also true. But the question is, what's the balance of that? And what's the goal of the administration? So we know the goal of the administration is to get elected. And so to get elected. In this day and age, it seems that the story is to make life more affordable to people who cannot afford life.

And nowadays that's most of the populist. Populous pop population. And so that's why we're seeing this populist both sides populist revolution. And so Trump is targeting that and doesn't care about the credit card comp bank issuers. And there's a question about why they should care. Not to pick on one bank, but Capital One is of all banks, has happens to have a significant portion of its profitability linked to charging high interest rates on credit cards, stocks up 42% since, trump took office. That's a target man. They got plenty to give. So then let's talk about the other thing, which is a real thing that can be implemented immediately, and that is that Trump said that he has.

Authorized Fannie Mae and Freddie Mac to government controlled they're in conservatorship. They've always been government backed, but they are heavily backed by the government today to buy $200 billion of mortgages. Now, let's put that in scale. $200 billion of mortgages, but tomorrow would have a price impact even on a $13 trillion mortgage market.

They're not buying 'em tomorrow. Every year in, even though QT has ended, the balance sheet of the Fed continues to run off at a pace of its MBS holdings at a pace of $20 billion a month or $240 billion a year. So. To one extent, it's just taking the opposite side of that runoff, but that wasn't expected.

And so a $200 billion mortgage purchase and we don't know how fast it'll be, it won't be too fast, should reduce mortgage interest costs. That's something that housing affordability cares about. People want lower interest rates on their mortgages so that they can buy their home and their monthly payment is lower.

And this will do that depending on how they implement it. It'll do it by at the basic level. It'll do it by reducing the spread. Between where wholesale mortgages clear the market, that means the institutional market for mortgages after they've been originated by banks and treasuries.

And so that spread should contract on the, at the same time it puts some downward pressure on banks who, again. Make their profit profits by, I'm sure you've all seen the big short, they explained it in that movie in an elegant way, but they make their profits by. Originating a mortgage and then selling that mortgage that on the following Monday at the wholesale rate.

And they take out the spread between the wholesale rate and the, and that's a large spread. It's, a hundred ish basis points. I'm just being u using extremely round numbers and that's bank profitability Immediate. NPV Bank profitability that goes into the mortgage origination base business.

The fact that mortgages are being purchased should reduce the wholesale spread to treasuries, and it's possible that the only impact is that banks pass on that savings to clients. It's also possible that because of the political climate that their mortgage spread, the retail spread also falls. So that's an interesting question.

They also could buy mortgages and issue debt short term and not hedge it. This is Fannie and Freddy, and if they were to do that would also reduce long-term interest rates. So all of that was announced. The mortgage market has adjusted a little bit, not yet. The buying hasn't started yet, but mortgages did.

Retail mortgage rates did fall fairly meaningfully. And we'll see if they sustain themselves. On that news, the big question is, will it have any impact on the macro economy? And the first question one has to ask is, will, it will have any effect on housing? And I think the answer to that is if you artificially suppress mortgages, you make.

Those who want to buy a home more enthusiastic about buying, which means they're willing to pay a higher price. And so the entire impact, and that doesn't mean that they'll actually experience much improved affordability, maybe a little bit, but most of the improved affordability of a lower mortgage rate will be passed on to the seller of the house in a higher price.

And so. Once again, I think the conclusion one has to make is that both of these things, both of these, this new announcements have been tar, are targeting bank profitability, which has been wonderful and supports asset prices.

Nick: Yeah, so basically what we are saying is the banks are an easy target into the midterms and it's political and some of it will happen and some of it won't, but the banks are probably, not the place to be kind of thing for the next six months we'll say.

Andy: And just based on this week's news, of course, banks couldn't report. The banks are probably gonna report great earnings that comes first in January. That's. Now if this week

Nick: that comes on Monday,

Andy: are they gonna report starting Monday?

Nick: Yes. JPM is on Monday.

Andy: Oh, I didn't realize that. Okay. I thought it was the following week anyway.

Yeah, you'll see it. The warnings are gonna be great.

Nick: Yeah, absolutely. So probably time to get out of XLF into something else, but I'll discuss it later on.

Andy: That makes

Nick: sense to me. The other news that I saw was, besson finally announcing that we will have a Fed chair either before the 19th or after the 23rd when Davos takes place either before or after that the Trump goes to Davos.

Andy: I saw that. I think

Nick: that's significant, isn't it?

Andy: I saw that. Do you think Davos like the after. There's centuries of time after Davos.

Nick: Yeah. But certainly in January he confirmed the decision comes in January.

Andy: Is that you in I'm not sure. I think it's just odd that they are gaming this so much, but.

Nick: Yeah, but the, what's interesting is that Walsh keeps on gaining and is now in the lead, and that really made duration slightly better bid. Nothing, nothing to write home about. And I'm convinced that Walsh certainly for a time will keep the yield curve. Flatter than it would've been otherwise.

Right? 'cause nobody really believes that Hassett, it has the authority to do anything much or persuade anyone on the committee, because let's not forget, he's going only going to be one vote on the committee and whoever is chair needs to persuade the other governors. Two lower rates and therefore probably wash is the better candidate and would somehow keep the long end of the bond market from completely blowing out if they were to cut too much.

But there you go. What do you think of the very short end? Because now we are absolutely not discounting any rate cuts really until. April, may time when Powell leaves office. We are getting to very interesting levels at the very short end, I think, because yeah, I agree.

Andy: Not only is there no chance, essentially no chance priced in for a January cut, which makes sense to me.

And I didn't think we'd get a January cut for a while. March is starting to leak so that there's only a 25% chance that over two meetings, they'll cut it all. That's interesting.

Nick: And that's basically Powell down.

Andy: Well, you got May.

Nick: Yeah. Well,

Andy: and then Powell's gone.

Nick: Yeah.

Andy: And so I expect them to cut more than is priced because, but it's for many reasons.

But populist Trump's view number one the economy is. Economy's not letting up. Like economy's saying, don't cut. There's nothing that says in the economy today based on the data that we're getting, and the data is really atrocious right now in terms of its quality. We're getting GDP now figures that are projecting a five plus percent GDP in 2020 in Q4, which is up from a already robust number in 2020 in Q3.

The economy based on the data is just not letting up at all, but the data is of the poorest of quality I've seen in a long, in my career because of the shutdown. And we may get a shutdown in on January 30th. And then we're SOL as it relates to data for a long time anyway, the point being that cuts are com being priced out, and right now the terminal rate is at its low for the last few.

Many months at two cuts total before essentially a long pause, and then eventually a small increase in rates. And that is that's new. The market wants cuts. Gold expects, easy policy stocks expect easy policy. But the, to your note is saying. Hold it. We might not get as many cuts. And so yeah, I think there's an opportunity to fade that.

Nick: Yeah.

Andy: And that will you know what's fed funds? 365, 360 8, somewhere right in that range.

Nick: 360 3 on average. And so the two year note is just not going to go through that level.

Andy: Yeah,

Nick: exactly. So next week we might get an opportunity.

Andy: Yeah, exactly.

Nick: Okay, so that's about last week, but what'd you think next week?

CPI? We already said no reason to expect it to be worse than the expectations, because even if they're not manipulating the data it's, it is what it is, right? The quality of it.

Andy: Yep. So, this PI number could really be a I don't see a chance given the way they've announced they're calculating the data, and perhaps this is already built into expectations, but I don't see the CPI missing on the upside.

It just doesn't fit with the pattern. So that'll be supportive of asset prices next week.

Nick: Yeah.

Andy: To the extent that it's taken seriously, which,

Nick: and all the other data that we are having, like PPI and and retail sales is all full November. So really nothing new and nothing that the market is going to respond to with any ferocity at all.

And apart from bank earnings, which as we said. Start with JPM on Monday morning. We have three tens and thirties that are gonna keep the curve under pressure for the early part of next week, and that could be our opportunity to buy some twos and I will definitely send out an email if that were to happen.

But otherwise. Do you still We're waiting for,

Andy: we're waiting for Gado a little bit,

Nick: Yes. We are completely waiting for Gado because the

Andy: The SCOTUS decision, the court itself has announced they're going to release some decisions on Wednesday. They have six cases, two or market relevant and four are not, that they could release decisions on.

So we're gonna be waiting for Gau on Wednesday. And if the, the decision is announced. You might get some volatility, you could get an un unexpected outcome, but if it's not announced, vi's just gonna come down again.

Nick: Yeah, no, I mean it, we have to wait for the SCOTUS decision because there's an outside chance that it's absolutely horrific.

They have to pay back 250 billion worth of tariffs that they've raised and spent. So you know, the issuance could be just enormous, and that's going to really push asset prices down. It's not the base case of the decision by any strategy of the imagination, but if it were to happen, it would be.

Very bad.

Andy: Yeah. And the question is, how hedged are people after Friday? I would think people are quite a bit less hedged

Nick: and I think, I rolled my hedge immediately into next week, you just don't know how Some people are probably giving up, as you said. So we, but we have to wait because, we are prudent and that's the prudent thing to do.

Andy: Yep.

Nick: Okay, Andy, thank you very much indeed, and I guess I'll speak to you next week.

Andy: Next

Nick: week, Nick. Bye.