

## 2 Gray Beards Week 161

**Nick:** Hello. Good morning. Today is the 31st of January. January has been a very long month, hasn't it, Andy? At least we have some clarity now as to who the next chair is. It's wash as I thought all along. Let's examine what his policies are likely to be. Again, we are not going to do anything just because he might do something in four months time, but we just want to start thinking about why he has been picked as opposed to anyone else and what his goals eventually might be.

Let me start it off. I think that he is going to be. Reforming the the regulations around the financial market, how much, how many treasuries, banks need or can buy and hold on their balance sheet and what the reserves for that need to be. But also he's going to be a. Hawk in terms of trying to eventually reduce the size of the Fed's balance sheet.

The only implication, direct implication for markets that I can see from that is that he is going to try and incentivize. The financial system to hold more treasuries via giving them more carry. I think that is the important takeaway that I am taking away from this. Not that I want to do anything right now, but that is always going to be in the back of my mind as I adjust the portfolio in the next few months.

Naturally, I would want to have some sort of confirmation. From the horse's mouth, as it were, and I'm sure that in the next three months or whatever the Confirmer confirmation process lasts, he is going to give us far more clues about what it is that he wants to do. One last takeaway from me, now we have a situation in which Wash is a.

The Fed chair and we have beers, the Treasury Secretary, and the common link between them is actually Stanley d Dren Miller, as both have worked very closely with him. So I think we're probably in good hands because I would always bet on Stanley Dren Miller. Doing the right thing, but we shall see. That's probably just my bias having dealt with him and him bearing me on, on, on a few phone calls back in the eighties.

But in any case. Andy, what do you think? Because those are my initial thoughts. What are yours?

**Andy:** Firstly I think worse is qualified. I had serious doubts on some of the candidates that were interviewed and in particular the long running front runner of that, of Kevin Hassett, but it wasn't.

And the other choices, Waller who was my preference though? I didn't think he'd get it. Waller, Warsh and Rick Reer, who was a late consideration they're all fine. They're fine. It's a tough job. It's gonna be a tough job. Marshaling the committee, which has diverse opinions. There's continued pressure on Powell, whether he stays or goes and what that all means.

He could stay on his governor passed his term. He I had an expectation that there was no chance he would until the subpoenas, and now he's in a difficult position where. The last guy who held the Fed chair role who didn't resign his governorship when he left the Fed was Mar, was Mariner Eccles in the forties, and they named the building after him because he spent the three years while he was not in the chair, but still a governor.

Aggressively defending the Fed's independence and really setting the stage for the Fed's independence. During Truman's attack on the Fed who, as all presidents do, wanted lower interest rates and easier policy. So it's extremely familiar and unprecedented that he would stay on if he thought the Fed's independence was under siege, on face, just on the most naive checker board, not chess, not 3D chess, but checkerboard sort of analysis.

Choosing war is less of a threat to the Fed's opinion. Independence than if they had chosen Hassett. I don't give anybody any credit for that, and I think the market had moved past Hassett a long time ago. So anyway, qualified guy. Perfectly qualified guy. When I think about the, his, the direction and why he was chosen, I think about the three voices that are.

Influencing that are the three voices from the administration that are commenting on monetary policy. Trump, who pretty much single-handedly, pretty much entirely consistently, has said he wants all interest rates lower and he wants the fed to cut a lot. Now we all want that. It's better to have lower interest rates than higher interest rates unless inflation becomes a problem.

Gotcha. Inflation's still a problem anyway, that's Trump. He's the leader of the free world, probably has a fair amount of influence in terms of who the pick was. In fact, he made the pick. So that informs that pick. The other part is Bessant, who has been. Extremely consistent in his rhetoric that he wants long-term bond yields lower and thinks short-term bond yields are too high and wants short-term bond yields down and has been highly critical of the prior

administration and the Fed around the size of its balance sheet and the treasury issuance process that.

The Yellen administration used to manage long-term interest rates. He's been a lot of talk about being hawkish the balance sheet and dovish the front end, but he's done nothing about it. We get another chance for him to act on terming out the debt. He won't do it. That's this week in the quarterly refunding announcement, which we expect to be very show no change.

If it does change, we're, we'll be all over that, but for now it's, we don't expect it to change. Then there's Myron and Stephen has been who authored the first paper and thankfully credited me and my work about the use of the balance sheet to manage financial conditions by the treasury is a hawk on the balance sheet, but in a very specific way that's consistent with what Nick just said.

He wants to enable through deregulation for to reduce the importance of reserve management. In managing the short term interest rate as we know. Last dec in early December, the Fed decided to aggressively buy \$40 billion of T-bills per year, per month because they think they had overshot, QT and reserves had gotten to a unsustainably low level.

I'll we'll discuss that more in more detail in the future, but Myron says. Reserves aren't the thing, it's the regulatory world and we don't need anywhere near amount, the amount of reserves in the system and thus can shrink the size of our balance sheet if we use deregulation. So again, hawkish the Fed's balance sheet and.

Myron can't be any more dovish. He is, he's got a dot that he, he diss at every meeting and has a terminal interest rate that is a hundred basis points lower than the median. So he's as dovish on the front end as could be. And and hawkish on the balance sheet. So you got three guys and they picked.

The new Fed chair, and so the odds are the new Fed chair is gonna cut interest rates aggressively gonna deregulate so that he doesn't blow up the bond market and reduce the importance of reserves, thus allowing him to shrink the balance sheet. But man, and institutionally, the Fed is dominated by. Lori Logan, Robert Purley, who is the Soma manager mu, who is was also at the New York Federal Reserve Board and worked around the Soma portfolio and hammock who spent her entire career at Goldman Sachs trading the repo book and short term interest rates.

**Nick:** That's exciting as a career,

**Andy:** those four people. Have just decided that the only way you can manage the short term interest rate is to have all banks full of reserves. And the only way you keep all banks full of reserves is you grow the balance sheet and those four caused QE to slow. Sorry, QT to slow to taper caused QT to end and are absolutely the voices that are being trusted by the entire Federal Reserve in as an institution that reserve management had to be initiated in December.

And what have we seen when they plowed reserves into the system? We've seen a doubling in the silver price. A 25% in price improvement in the gold price, the dollar cracking. All of those things are consistent with excess reserves blown into the system. Asset prices in general may be even supported, but that's less of a connection.

The connection has been money and money got flooded into the system starting in December, and the outcome is what it is what it is, but that's the institution that's in charge right now and it's completely out of line. With the new management. New management. So the question becomes is, can we can that, by the way, those four people, if you've ever met a repo trader, they are narrow and deep.

More so than any other person I've ever met. In the financial business. Yeah. All they focus is focus on is the overnight rate and the ticks about around that. And every cha and every, even a little bit of volatility in that market causes red flags of a financial, of a dooming financial crisis about to occur.

And there've been a couple of cases where. There's been a small doom event associated with the repo market. 2019 is a good example, but man, they threw up their hands every month when just regular old end of month occurrences happen. And this last month, they threw up their hands enough so that they force the Fed to buy \$40 billion of bills a month.

These guys are in charge and so new management has its work cut out.

**Nick:** Yeah.

**Andy:** But markets expect old management to dominate. The short end expects very few rate cuts inconsistent with all of the dovish Leaders outside of that are representative of the administration. The curve is extremely flat. It's steepened a little bit, but it's mostly flat.

Expecting no hawkishness on the balance sheet and money, the dollar, gold, silver are all acting like it's, full steam ahead. Keeping reserves ample. So

**Nick:** actually,

**Andy:** so we'll see. The question is does, we've got months before this goes into place, but does the rhetoric around shifting the Fed from a reserves a, an ample reserves short-term rate, hawk long-term balance sheet, dove into a the opposite.

Short term rate, dove hawk balance sheet, does that start impacting asset prices? And Nick, I assume the most, if it did. The most natural thing will be a steeper

**Nick:** Oh yeah. The curve would steepen a lot. It would all depend which way it steepens, whether it's a twist or a bull on how they deregulate and how much of.

The backend duration, the the banks would be willing to buy and at what level, et cetera, et cetera. But certainly there is absolutely no reason to short the two year note. That is, the only question is how far does it go? I didn't think it goes that fast straight away, unless,

**Andy:** unless the economy takes off.

And these guys the dove, the dovish fed. Reverses, but that seems even less likely than any other potential.

**Nick:** And let's very briefly get a segue into the other thing that happened this week, which was slightly unusual, it not unprecedented, but unusual, is that the Fed, first of all did nothing, and he was as boring an event as you can possibly imagine.

Walla dissented. So there were two dissents Steve, Myron and Walla. But Walla wrote a dissent. And what he said in that dissent basically was, and I'll paraphrase in two sentences, he said. The job market is a lot weaker than data seems to suggest, and when it cracks and it will crack, it will be far worse than we expect.

Basically, that's what he said. So this week we have. Every single piece of jobs, data that you could possibly imagine. We have the jolts, the A DP non-farm, the weekly claims again, and the NFP. So we have every single piece of jobs data. The jobs data is still catching up from the government shutdown, but this is the first opportunity that we.

Get to see if Waller is right, but I certainly think that the first time we get a weak number in employment, IE high unemployment, everyone is going to jump on the bandwagon and say, Waller's, right? And here we go, boys. And

that is going to be the time that you want to be maximum long of the short end in the bond market.

You want to be short the dollar. That will be, what I'm looking for. But just to go back for a second to what you were saying Andy, I think that one of the first signs we will get to see if the if the new Fed is serious, is if these guys get fired. Because the other thing that we haven't mentioned is they've said that the personnel, and they've said it several times, the personnel at the Fed needs to change.

So I think they're very conscious of what you've been just saying, that the guys currently in charge just will not be able or willing to change the way they're operating and if they get fired. Then we know that these guys are serious and things are going to change. Would you agree with that?

**Andy:** That's interesting.

Yeah. There's this, the institutional view, they're not, they can't fire the three chair, the three governors and presidents I mentioned,

**Nick:** but they can move them along, to different positions.

**Andy:** I guess they could move the N-N-Y-F-R-B SOMA Manager.

**Nick:** Yeah.

**Andy:** If you're in the business of saying that reserves are.

Are not the right tool. And you look at this fed who only focuses on reserves. Yeah. You'd wanna make a change. Yeah.

**Nick:** What do you think the effect of that would be on equities? Because that's my fear.

**Andy:** Yeah. Let's just talk about what we're saying. We're saying the Fed currently expectations are for the terminal rate to, to be less than two cuts away.

We're also in a world in which the reserves are expected to grow rapidly for through April, and then modestly from then on, which means the Fed's balance sheet is expected to grow. We're also in a world where there's a relatively flat

yield curve and a tremendous amount of issuance that's coming from a budget deficit.

So that's the world we're in. What if we. And what we're saying is there's a world of the new boss who is for much more cuts and balance sheet decline. It's not based on what people have generally expected that QE is good for equities and QT is not good for equities. Offset by the classic notion that cutting rates is good for equities and hiking rates is bad, or pausing is bad.

Those two things intersect in a way that says maybe this doesn't really have any impact on equities at all.

**Nick:** Or maybe the volatility increases as people first sell, then realize, oh my God, why did I sell and then buy again? And so you get a big,

**Andy:** Listen, if the headline was. We're cutting.

If the headline was 10 year yields rise to four and three quarters percent, stocks are gonna be down. Yeah. If the headline that causes that is a hawkish balance sheet thing, stocks are gonna be down. If the fed funds rate is cut from three and 3/63 down to 2 6/3, generally one would think the stocks are gonna be up.

So it's an interesting dynamic. I think a shift in policy from easy reserve policy, hawkish neutral ish short-term rate policy and dovish balance sheet to the, to something different that shift. Is an event that the market's not prepared for. How it actually plays out will depend on the details, but yeah.

It seems like an obvious volatile event and so yeah, I think it's, and it's not priced, you can buy outta the money calls in case it's a do a bullish out event for cheap right now in multiple month expires. And puts are not that expensive in pretty much every market bond market stock market.

Currency market. So yeah, I think you wanna be, as a long only investor, you wanna be prepared for volatility with plenty of cash and willingness to fade point. And, otherwise, as a, as an, as a, as an option play, owning some outta the money calls, outta the money puts, is pretty good idea nowadays.

**Nick:** Let's have a very quick word about the enormous volatility we saw in gold and silver. This week? I said immediately there's absolutely no way I'm gonna catch the top, but I wasn't all that far, three days away. And probably 5%. But what do you think is going on? Do you think this is purely technical or do

you think people were just, very worried by wash and the possibility of a lower a lower balance sheet of the Fed?

Tough to tell, right?

**Andy:** You mean why the market reversed? It's hard to tell.

**Nick:** Silver off 30% in a day is not a normal reaction. I but there again, it's the silver market. It's nuts.

**Andy:** For me, I own gold and commodities in my damp, spring beta portfolio On the 20th, I did a podcast with Jack Farley, and, which I said I am

**Nick:** you're

**Andy:** reducing, I'm going from overweight to neutral weight.

Last week's episode, we agreed to lower our gold holdings. Listen, I sold a little bit on the 20th in both commodities, which have heavy metal component, including not only silver and gold, but also some of the other high flying metals and energy, which is doing well. I sold some commodity exposure to back to neutral, and I sold some gold.

None of those trades have made money. They're I would've been better off selling on Friday, even in a down 35% silver market. I would've been better off waiting a week.

**Nick:** Yeah.

**Andy:** So the point is, so we're

**Nick:** saying it's

**Andy:** not

**Nick:** significant yet.

**Andy:** Silver fell 35% and is back to its level

**Nick:** still up on

**Andy:** the air nine days.

Nine days ago.

**Nick:** Yeah. Absolutely

**Andy:** I, volatility is one thing. Owning gold is an important part of every portfolio. And trimming when you have events like that is the best strategy. Absolutely. I would expect. To be honest, I would expect a grinding process from here on both gold and silver. Who the heck knows?

**Nick:** Great. So everything we've really said is about the future. It's nothing that we need to immediately concern ourselves with all the portfolio or make any changes. So that's about it for this week's episode, right Andy? There's nothing much else that we can say.

**Andy:** I'll just briefly say, earnings came in.

**Nick:** Yeah.

**Andy:** Except for meta. Most of the stocks did poorly after the earnings events. That's worth noting and the dollar strengthened a little bit this toward the end of the week. And I'm sure nickel have something to say about continuing to transition into. Of world assets from the US dollar assets and we get a little bit better prices this week.

If we get further better prices, maybe we do a little bit more.

**Nick:** Excellent. Thanks Andy. Speak to you next week. Bye everyone.