

Comprehensive Summary: 2 Gray Beards

Week 157

Market Overview and Central Themes

Nick and Andy analyze a quiet data week dominated by a critical disconnect: the Fed is cutting rates due to unemployment concerns, yet employment data shows no deterioration. This creates a problematic dynamic where monetary easing may be stimulating an already-stable economy, risking persistent inflation.

Three central themes emerge: (1) the Fed-data mismatch is driving long-end yields higher, (2) structural bond supply pressures make duration unattractive, and (3) two binary events must resolve before portfolio adjustments—the SCOTUS tariff decision and Fed Chair appointment.

The Fed-Data Disconnect

Opposing Signals

Fed Minutes reveal policymakers are "definitively worried about unemployment increasing far more so than inflation increasing," driving continued rate cuts. However, weekly jobless claims show employment is "absolutely steady as she goes, absolutely no deterioration in employment whatsoever."

Bond Market Response

The yield curve is steepening as the long end backs up. The market's logic is sound: if the Fed cuts because they expect rising unemployment, but unemployment isn't rising, then easing makes the economy hotter. This means inflation is "unlikely to A, go down to target, or B, stay at target, even if it's going down at the very moment."

Equity Impact: Q4 2025

Rising long-end yields created asymmetric equity pressure:

- S&P 500: Up ~1%
- Dow Jones: Up 1.5-2%
- Nasdaq: Down over 1%

The Nasdaq underperformance shows "the long end is a big headwind to equities at the moment with the higher beta stocks, the QQs being affected the most." Growth stocks with longer-duration cash flows are most sensitive to rising discount rates. Nick emphasizes this picture shows "absolutely no change"—a persistent structural headwind.

Andy's Bond Market Analysis

Market Skepticism on Rate Cuts

"The unwillingness for the market to price in more cuts tells me that the markets just will not accept this idea that the Trump appointed Fed chair will drive interest rates significantly lower."

Andy introduces the "trough interest rate" concept—the practical low point the Fed will reach this cycle, not the theoretical neutral rate. "That low rate is still north of 3%." With Fed funds already at 3.5-3.75%, the market is pricing that "cutting is almost over."

Global context reinforces this: "Every central bank is either done or in Japan's case, hike, hiking."

Andy's Contrarian View

Despite market skepticism, Andy believes "we're going to slow down meaningfully. Then there will be a cause for interest rates to be brought below 3%." This represents significant disagreement with current pricing, suggesting potential volatility if data supports his outlook.

Structural Bond Supply Problems

Multiple Supply Sources

Andy outlines comprehensive headwinds for long-duration Treasuries:

- **AI Infrastructure:** "A trillion dollars of annual spend is focused on AI"
- **European Rearmament:** Multi-year defense spending program
- **Ukraine Reconstruction:** Massive future financing need
- **U.S. Reshoring:** "The US is asking for private sector and foreign investment in reshoring and building factories, which will all be financed with either the selling of assets that these foreign nations own, like treasuries or borrowing"

The reshoring point is critical—it creates supply two ways: foreign governments either sell existing Treasuries or borrow directly, both increasing net bond supply.

Insufficient Compensation

"The 10 year and the 30 year still don't offer a lot of compensation for taking longer term exposure" despite this supply surge. The curve "that's not very steep to begin with" provides inadequate term premium.

Combined Headwind

Andy synthesizes: "Short-term rates aren't really going anywhere. Certainly not rallying, falling despite Trump's rhetoric and longer term bonds, dealing with a curve that's not very steep to begin with and has a lot of challenges in front of it."

This creates "a headwind to equities because for one, there's lots of assets for sale. Somebody has to buy them. Maybe that's an equity owner."

Critical Binary Events

1. Supreme Court Tariff Decision

Timeline: Must come by May 2026, but both expect resolution in coming weeks, likely January.

If SCOTUS Endorses Trump's Tariff Authority (unlikely):

Opens the door for aggressive tariff negotiations. Andy's assessment: "Extremely good for the deficit because tariffs are gonna be at least as big as they are and maybe larger. Bad for growth and bad for inflation, meaning inflation growth goes down and inflation goes up"—a stagflationary outcome that "isn't a great environment to own assets."

Market reaction would likely resemble Q1 2025 pre-"liberation day" action.

Nick expects initial bond rally (growth concerns) followed by reversal as inflation fears dominate.

If SCOTUS Rules Against Trump (more expected):

Would be "equities negative overall and bond positive overall, which is exactly the opposite of the situation we have at the moment." Removes tail risk of extreme tariff escalation.

2. Fed Chair Appointment

Timeline: Trump said he'll "nominate someone in the first very early on in 2026." Both expect announcement in December or early January.

Candidates: Speculation shifts between Hassett, Waller, Warsh, or Powell staying.

Expected Impact: Andy downplays likely market reaction: "I don't think we're gonna get a massive market reaction based on the Fed share."

Reasoning: "How much are they going to actually lower this trough interest rate? Until he starts actually doing the cutting is gonna be the big question, and that's gonna be whether the cutting is necessary or not."

Portfolio Impact

Nick: "Those are two very important market moving events that we can't really do anything much to our portfolio before they're resolved."

Andy agrees completely. This discipline recognizes that portfolio positioning cannot effectively hedge all possible outcomes simultaneously.

Data Quality Skepticism

Andy expresses profound skepticism about upcoming releases: "Since the shutdown, I've had no interest in the data. I don't believe it. Not that I don't think anybody's manipulating it. They may be, but that's not what I'm saying. I'm saying it's crappy collection and unlikely to resolve until well past January."

He notes "a huge industry of people who will whose job depends on how important this data is"—creating systematic bias toward overstating individual releases regardless of actual information content.

Trading implication: "If the market were to move significantly based on any data that comes out next week, I'd wanna fade it."

Upcoming releases include ISM, PMI, ADP, weekly claims, and NFP—all to be largely ignored. Nick notes they'll only email subscribers "if anything happens that we think is really important in NFP, we, however unlikely that happens."

Portfolio Positioning

Non-U.S. Equities

Andy: "We prefer non-US stocks. They've performed extremely well. The dollar is vulnerable, one of the possible outcomes is either the bond market, we lose the bond market or we lose the currency."

This binary framework is crucial:

- **"Lose the bond market"**: Yields spike, creating economic stress
- **"Lose the currency"**: Dollar weakens substantially

"So one way or the other, foreign stocks are very attractive to us." In either scenario, non-U.S. holdings benefit through diversification or currency gains.

Sector Selection

"We also own some good industries that also would benefit in that world, and we're not overweight some of the things that the US market is focused on"—avoiding expensive U.S. mega-cap tech concentration, favoring sectors benefiting from dollar weakness or inflation.

Duration: Short-End Only

"We're out of the duration market for all intents and purposes."

Nick specifies re-entry criteria: "We are looking for the two to two and a quarter percent range" in real rates before "start buying something like the tenure."

"When that happens, if stocks are backed up enough, it will be a great buy for both bonds and stocks. But we are just not there yet."

Gold

"We have plenty of gold." Would "add gold if we were to see a weakness" after recent pullback from highs.

Gold serves as inflation hedge, dollar debasement hedge, geopolitical risk hedge, and real asset alternative to negative-real-yield bonds.

Core Thesis

Andy: "The basic picture is US long-term assets, stocks and bonds are just not very attractive relative to other things you can hold."

Positioning summary:

- Avoid: U.S. long bonds (supply headwinds), expensive U.S. growth stocks (rate sensitivity)
- Favor: Non-U.S. equities, gold, short-duration securities, inflation/dollar-weakness sectors

Minor Event: Maduro

Nick mentions Maduro's imprisonment but considers it "not a market moving event." Andy agrees it's "a non-market event" with modest oil implications ("a little bearish oil, which is a little bullish bonds").

Nick would "fade" the IG weekend market showing oil up, demonstrating their approach of ignoring noise-driven moves.

Forward Outlook

Communication plan is simple:

- **Normal course:** No portfolio changes, no updates—"steady as she goes for the first week of January"

- **Exception:** Email only if NFP shows something genuinely important (unlikely)

This patient approach—waiting for binary event clarity while maintaining disciplined positioning—characterizes their investment philosophy. They prioritize risk management, maintain clear analytical frameworks (trough rates, binary outcomes, structural supply-demand), and demonstrate willingness to do nothing rather than chase current market action.

The conversation reveals sophisticated investors who recognize that sometimes the best action is inaction until the opportunity set improves or major uncertainties resolve.

