

## 2 Gray Beards Week 167

**Nick:** Hello. Good morning. Today is the 14th of March, Andy, since I was away early, part of ne last week. Tell us what you think is going on apart from the obvious about the straight of full moose and the fact that everyone is now afraid of massive inflation in food and energy over the next few months.

That seems to be the obvious part, but what are we. Really waiting for to decide that we want to add to equities or bonds or duration or anything, because next week it's going to be much the same. We have the FOMC, we have the ECB, but we still don't have any resolution to this war. Is it just headlines that we are trading and that the market is thinking about, or are we.

Is there something deeper that we can tell our subscribers?

**Andy:** Yeah, so the way I'm thinking about this is one thing I think you just have to accept for the moment is that every trade, every market is just oil. That's all. If you now, that's just a fact. If oil goes up, bonds go down, stocks go down.

If oil. It goes down, stocks go up and bonds go up. And the same thing applies to the dollar oil up, dollar up. Obviously commodities are oil and oil impacts, impacts grains through the fertilizer channel, which means that oil up. Grain's up. So it's all one trade. And so when that happens, I think one has to look at the fact that it's not going to always happen.

Like even if we have, and it's very possible this could happen, we have a significant extension of the war instability in the, in the supply of a supply can, an ongoing supply shock in oil, which can mitigate. But stays constrained in some way. That's a reasonable possibility at some point. The correlations that we're observing over the last, certainly all last week, but since the war started do break down.

And so your job is to figure out. What are the macroeconomic implications so that you can then look at specific asset classes and say, where's the opportunity? You also have to think about policy makers and my way of thinking and it's, it's not, let me tell you, it's not at all what ha is relevant for this week.

Like completely irrelevant. The correlations to go to oil is all that's gonna be happening this week. If there was a war system a ceasefire, oil smashed everything else up, the obvious things we all know what's gonna happen next week, and we'll talk about the FOMC and so on. But when I think about that, so

what I'm thinking about is what is the macroeconomic implications of what has happened, what already has happened, meaning energy prices are gonna be high for a while, not just a few weeks.

Energy prices are gonna be high and sticky for a while. What does that mean? Food prices are going to be high and sticky for a while, and those are necessities that humans need globally, and those prices are going to be high without any underlying improvement in wages. In government spending in levering up, all of this stuff is gonna be disinflationary and negative to growth in all things that aren't food and energy.

And so then the question is I think that's a true statement, which means you'd favor bonds over stocks. That would be the first step to, to thinking about that. Now again, bonds and stocks are both gonna go down if oil goes up and they're gonna go up, if oil goes down. That's it for now, for next week, but in my mind, I'm thinking about the longer term impacts on the economy.

And the economy has been vulnerable for a variety of reasons. The, it's been supported by very strong. OBBB related, stimulus tax, refunds lower taxes in general that have been expansionary and that are ending as the tax, as tax season comes up. And aren't likely to be reversed, and so we'll have a declining fiscal stimulus.

The Fed is not cutting in this environment. They're stuck, so you don't have a monetary stimulus. The labor market just is flatlined. There is, there's no job growth. Now thankfully, there's no job supply as pork population is dwindling, but that's not likely to change. You saw metas firing 20% of their staff over the weekend open e Trump Musk's ex AI is gonna fire.

You're gonna continue to get this sort of AI job pressure. So when I look at things and say, gosh, what do I think about the overall economy? This is not what we, a big demand. Curtailment for, because people have to pay for their gas and oil and food. A demand, the rest of the economy, demand de destruction that's going to occur.

It's pretty bad for equities and again, pretty good for bonds. So that's my leaning from last week and the impact of the war, but it's irrelevant to what an investor does next week.

**Nick:** So let's talk about the FYMC and the likelihood of their response. So they, I suppose they could be dovish and just look through the impact of the

energy and food, because after all, that is their job as well to look through those things.

They could be stick with their current dot plots and basically do nothing or they could be hawkish. Now, what are the odds of them being dovish or hawkish? I think you'll probably agree with me that they are. Fairly negligible. I would've thought 10% of each and 80% that they do absolutely nothing.

**Andy:** Yeah. If I were the FOMC, I'd try not to make news this week. The ECB though, with a single-sided inflation mandate. It's gonna be hawkish. So that, and you're starting to see that in all of the short-term interest rate markets in Europe, which were, the US markets were pretty damaged with twos trading above fed funds now, but markets overseas have been.

Devastated by higher, shorter term rates, and that's consistent with a mandate, which is one sided. The US I think they just want, particularly given the political environment and the fact that we are at war, I think they're gonna want to make no news. And that means doing the middle thing of what Nick said.

Of course, they could be dovish. They sh, if you just heard my preamble, they should be dovish. Because the economy's gonna weaken on this high oil price. But on the other hand, there are enough guys out. Inflation has not been fixed. It's still, gosh it's running on five years of above target, maybe even longer now, above target inflation.

That's just, that's not doing your job as the Federal Reserve, that's gonna be tempered by. Most of the board, most of the entire FOMC recognizes that they cannot hike into a supply shock.

**Nick:** Yeah. Let's let's try and put some numbers on that. Let's, if they are, for whatever reason, if they're dovish, I think that will result in a huge steepening of the yield curve.

I think the long bonds are going to hate it, and any rally inequities is going to get. Absolutely smashed. The first reaction you make,

**Andy:** I'm, you're not even sure twos will rally that much. They'll rally a little bit. Correct. But it might be just the first few SOR contracts that bounce on any sort of dovish.

**Nick:** So what we are basically saying is that we are sellers of everything, bonds and equities on a rally because they're dovish. If they are hawkish, I think

then the short end gets destroyed because that means that not only are they not staying where they are, but they are thinking of hiking.

**Andy:** Yeah.

**Nick:** If

**Andy:** they mention the word hike.

**Nick:** Yeah, I mean if they mention the word hike, everything gets destroyed, least of all long bonds because I think those, then you are looking for where to buy them because that will drive the economy into the ground if they start hiking. So you're looking for a major league flattening and probably a very strong move down in equities.

But these are. Outliers. We both recognize that the odds of either happening are very low and therefore we don't need to think about it. And all that needs to happen is for that to happen. And then we'll send out an email and change our allocations. We just want you to be prepared and know how we are thinking.

The ECB. Yeah. Does it really matter for the US what the ECB decides? It'll have a marginal effect on the US curve, but I think the major impact is actually going to be in the differentials between the US and. Europe, the differentials would come in quite significantly, and I think that is still the way that I've been seeing things for a long time, and that is why I am not particularly bullish.

The dollar this. Little reaction that we've had from, let's call it 96 in the Dixie, all the way to 100 is what you'd expect at a time of war. In fact, you'd expect more but interest rate differentials over time, if they head towards zero, which is what Trump would love to see them at, is actually going to be negative The dollar.

And I, I still think that is the most likely outcome over the course of the year. Let's

**Andy:** go back to, let's come back to next week with our central case. Our central case is Powell. The dots don't change much. There's a, it's a, there's a summary of economic projections. They're all over the map and they're probably not gonna change much.

Powell doesn't. Talk about hikes. Doesn't overplay the supply shock is transitory and just tries to make new, no news. What happens to markets? What? Ignoring the FOMC, where are we for next week?

**Nick:** I think that's the likelihood that the longer end of the bond market does better is very low. I think the likelihood is that real rates continue to go higher, and they've gone up about what 20 basis points in the past couple of weeks.

That keeps some pressuring equities. I don't think that story changes until we have a permanent resolution to the unblocking of the straight of ous and therefore that the market can look forward to a normal supply of oil, a normal supplier, fertilizer, et cetera, et cetera.

**Andy:** So you're so basically saying it's a, you don't need to own the bond market.

Which we don't

**Nick:** duration. Yeah,

**Andy:** you don't need to own duration. An equity allocation is fine, but you don't need to be a buyer here.

**Nick:** Not yet.

**Andy:** Not yet. To get,

**Nick:** and you need to be slightly hedged. Volatility is high, and therefore you need to be selling calls against your holdings,

**Andy:** but you'd sell rallies until you get this, cathartic ceasefire.

Which,

**Nick:** Or you get real rates high enough, which will actually almost ensure that the economy can't do much better and it's time to start buying duration, right? Because the odds of high real rates killing the economy become just too high. And that is, what could that be? It's somewhere around three to three and a quarter percent.

On 30 year real rates,

**Andy:** another 25 basis points

**Nick:** or more. Yeah. And that could coincide with real, with nominal rates being somewhere around five and a quarter percent in 30 years. So if you see that your signal that you really want to start buying duration, we haven't bought duration for ages and ages have we?

And we just don't see any value in it. That is where we start, we will start seeing some value in duration.

**Andy:** Now, presumably equities will be cheap at that point too

**Nick:** as well. Yes, and that will be, and you've seen that basically bonds and equities, as you've rightly said, have been working in lockstep.

They haven't, long bonds of not being longer of bonds as not. In any way helped you with your equity position, they go up and down together, and I think that once bonds have gone up enough, that is when you want to switch to bonds as an insurance for your equities, right? And I don't think that time has come yet, and I don't think it's going to be next week.

It could be fairly soon, I don't think it, it's likely to be next week. I think a move of 40 basis points real next week would be just a killer.

**Andy:** So what's your, so it's unedible because calls are extremely bid. Val is very high. Everyone in the market is going to miss making money from that green candle tweet that says the war has ended.

And of course, the war never ends, but something that is akin to we've, we're now talking with Iran and we have a ceasefire. Now, I don't expect, firstly, I don't know. Who the hell knows, but I don't expect it next week. But what if it happened? What's the playbook then?

**Nick:** Equities are gonna rally, right? It's going to be a three plus percent.

Yeah. The I would've thought the playbook on that will be to actually. I dunno, is it to sell calls once it's rallied? What do you think?

**Andy:** I think that's the answer.

**Nick:** Yeah it's, I think this equity market now is going to be, if we get a resolution, is going to be range bound because the fear is no longer going to be.

The the massive inflation, but it's going to be the growth, right? The growth story, which, where's the growth going to come from, and I think that any rally towards the highs is gonna get sold again. And we are going to be in a range with probably the lows being wherever we've made the low before the war.

But it's not going to power ahead. I think people who think that we are gonna make new highs on the back of it are completely wrong. I think that we are going to be range bound in equities because the. The worry is going to be the economy and can it, can it maintain this very bullish narrative that we've had?

And I don't think it can, I think that prices will be higher, as you said. There will be sticky, people will be spending more on the necessities of life, and therefore it's going to become a sector story. As opposed to an index story that everything starts going up. That's my feeling.

Okay. So all we can say is to summarize, we don't think the Fed's gonna do anything much. It's not going to wish to make headlines. If it does, we'll send you an email straight away. We will know what to do. We think that if equities rally on the back of a war resolution, which is unlikely next week, we will again know what to do and we'll send you an email immediately, and that's about it.

That's we are nowhere near levels that we think are bargains for equities. Is that correct? Vande?

Yeah. And we are nowhere near levels where we think duration is a bargain. So we are in a let's wait for those things to happen because normally they do happen at the top or a bottom of a move and really pile in when they do. We know our levels. We know the levels that we'd like to trade at and why we'd like to trade at those levels, but we are just not there yet.

**Andy:** Yep.

**Nick:** Okay. That's about it then. I've got my emails ready and ready to send them if we see the things that we want to see and the levels we want to see. But until then, I'll just go through the positions, what we want to tweak, and I'll speak to you next week.

**Andy:** Sounds good. See you, Nick.

**Nick:** Bye Andy.

