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Nick: Good morning. Today is the 2nd of May, and time is flying. We had a semi-interesting week, didn't we? Andy? Last week we had the FOMC, which was slightly more bearish, a tad more bearish, and people are probably making far too much of it. We had Powell basically deciding to stay, but. I think we both think that he's going to leave as quickly as he as he's allowed to leave IE as soon as the investigation is completely dropped and not brought back.

So I don't think that is really going to be a problem going forward. Walsh is now on his way. Powell has said his last meeting, Walsh is coming. What do we think that Walsh is going to try to attempt to do? Let me first of all say what I think and then you can agree or disagree with me. I am gonna take him at his word and he has said that the Fed's balance sheet is too large.

I think that is something that everyone can agree with. And probably the fed's balance sheet is too long. IE two, duration heavy. He probably needs to bring that down. So I think what he needs to do is build a consensus within the FOMC that a he, they need to reduce the size of the balance sheet B, reduce its composition IE to lower duration, and.

If they were to do that, that would be a tightening of financial conditions because if you sell securities long dated securities duration heavy, and bring down the size and the composition of the balance sheet, that is undoubtedly a tightening of financial conditions. In return for that tightening of financial conditions, I think he will seek.

One or two rate cuts so that he gives the banks who are the natural buyers of long duration, a steeper yield curve, and the yield curve bull steepens, or the very least the. 30 year bonds stay roughly where they are. So he will bring down the twos, the fives, maybe the tens a tad, but leave the thirties where they are.

And that is what I think that he needs to build a consensus about. And that is what I am taking in. At his word for that is a process though, isn't it? Andy? That takes probably weeks and weeks of discussion inside the Fed. A, to build the consensus that is the way they want to go, and B, to persuade all the people who are very reticent that that is the correct approach to get on board and actually vote.

For both measures, more or less at the same time. Yeah. What do you think?

Andy: Yeah, I mean, I think it's a, uh, the way I think about this is just sort of step back and say, what is this organization like, what has it been like, what it's likely to be like going forward and put war in a position of saying. Hey, I'm gonna be doing this job for four years at least I'd like to do it for another four years after that.

That would be, otherwise it would not be a success. So I'm in it for the long game. Let's start with that assumption. I have a the, as always, every fed chair comes in nominated by a president, and that president has an objective, but. And as, as seriously as I take it, I'm not going to jeopardize the next eight years of my life for a rash decision.

Now, I could be wrong about that, but that's how I assume worship is gonna operate. So then you step back and say, what's this? What's the existing committee like? And the existing committee is split, and I think the highest level thing is. What does the committee think about inflation and the path and what they need to do to manage inflation?

That's the highest and most important thing because pretty much the entire committee, except perhaps Myron, um, who's no longer a member as of un, unless until Powell resigns. Are okay with the job market, okay, with that side of their mandate, the rest of, or at least balanced relative to inflation.

Nobody's panicked on the job mandate. They may be cool about inflation, but they're not panicked about the j, none of 'em are panicked about the job market. And for good reason. So you do have a couple of other second order things, which is. There's a portion of the committee and likely the soma, the of the very important New York Federal Reserve Board.

So a portfolio manager who care about reserve bank reserves. And so they are, they care a lot and have influenced the committee a lot, particularly over the last year to make sure we don't have a repo crisis. And they wanna maintain a significant balance sheet, so they're gonna be resistant to any decision around balance sheet.

And then there's another group that actually is pretty upset about inflation and concerned about it and worried about and. Wanting to at least be very patient with rate cuts. So those are the two second order thing groups he's gonna have to deal with. There's another second order group that knows the balance sheet's messed up, that knows we have, that.

It's too, potentially too big in an absolute size and certainly has way too many mortgages and probably way too much duration for the purpose of the, for the purpose of the balance sheet. So that cohort is gonna overlap. There's a Venn diagram of how those cohorts all overlap. And so if I were wars, and I agree with Nick, I think the best thing to do is take him at his word in which he says, I want to tighten by changing balance sheet policy.

And I want to offset that tightening by short lowering short-term interest rates. Now, he walks in and he says, okay, that's my, you've heard my vision. This is my vision. Let's talk it out. And he needs to bring the people that are concerned about the Abso that don't wanna lower the absolute size of the balance sheet on.

He wants to get help from those who want to change the composition, and he wants to make sure that the committee is. Has a consensus regarding whether there should be an absolute easing or an absolute tightening. And that just takes consensus building. And so the question, and I think Nick and I think that the answer is he'll, it's a process and he'll do it.

Is, um, could he do something different? And the something different would be be more of a bull in a China shop and demand rate cuts first while promising balance sheet to offset. Because perhaps he wants to placate his boss or perhaps he believes an easing is, is appropriate, or whatever it is. And that's one method.

And the other method is try to build a consensus. And then the other method, which is, is to not be truthful about what he's saying. And I think we have to put that aside until there's evidence that he's not being truthful. And so what does that mean for June? It means it would be, there is people talking about wars coming in and demanding a rate cut in June.

He may. He may. He may do that. But if so, he's gonna have to be. Really aggressive on the balance sheet.

Nick: Amen.

Andy: And I don't,

Nick: it's unlikely.

Andy: I just don't think he can get that act together quickly. And the market doesn't expect it at all. 0% chance of a cut in June, 0% chance of a cut in July. But when I think about it and say, you know, where are we?

If it is true that he can get the committee, which by the way, he's gonna get the committee. These guys aren't gonna fight him for their, for 80 for four years, they're just not gonna do it. That will go very poorly for them, not just because of the way the politics works. It'll go very, and I don't mean anyone's gonna threaten them, I'm just saying they're gonna, their voices are not gonna be, they heard, they're gonna see, be seen as obstructive to the chair's desire.

So I think you would get a, so the, the direction we're heading is lower short term rates. Offsetting tightening by higher or equal long-term rates. And so we're setting up for a, a bull steepening under wash. And for me, it's just a matter of time. Now, of course, the data, it's gonna fluctuate.

This is a dynamic process. It's not, you know, if oil's at 150, that's gonna have a different dynamic than if oil's at 70. And so I, I just wanna disconnect from how the data evolves to how, if I were vs and I wanted to run the Fed with a smaller, less duration ex exposed balance sheet and lower short term rates, how I would get there.

Nick: This all remains to be seen, right? This is our speculation as to the path ahead. We will see if we are right, but what are the consequences if we are right? That basically means that. Asset prices are gonna be capped for a while because more duration into the market, and we'll see with the QRA next week, because let's not forget the QA is coming next week and we doubt that there are gonna be any changes there because they're already pre announced that there shouldn't be.

But what they could do is they could announce some changes. For the future. That's always a possibility. So we need to see what happens there. But if we're correct, and that is the path, really, asset prices are not going to like it in the short term. They might like it in the long term, but in the short term, they're gonna be capped.

And let's not forget that we have. Meta doing, you know, sort of however many billion of corporate issuance, all the other hyperscalers issuing bonds like crazy. And also a huge amount of IPOs coming along on top of everything. So with this kind of mood music, really, it's unlikely that asset prices can really power ahead after what they've done in you know, this month, which has been incredible really.

So we are looking really for a retracement rather than continuation of the powering ahead. Okay. So let's talk about the other events that happened with the, uh, basically the earnings. All the earnings are fantastic, right?

But really the net net effect from the earnings is not all that great because. You know, you Google apart, which is up like 12%. Everything else meta down 10%, Microsoft down 3%, apple up four, Amazon up two. So if you take Google outta the equation. The rest haven't done very much at all, but all the other sectors are also coming in with very good earnings and it's very noticeable that you have XLI.

You can have XLF, you have XLB. All as, as big laggards to this move. This is really a, a tech move and nothing else. What'd you make of that?

Andy: Well, I mean, you can see it in every bit of economic data and certainly the, the common view is that, aI is going to is ai, um, spending AI investment, uh, where that investment goes to semiconductors and other picks and shovels is massive and growing rapidly. What I did notice is that the future growth is likely to be lower, but it's still growing at a rapid rate.

And so you know, the, that favors investing in tech stocks, all else being equal on the other hand. So earnings expectations for Nasdaq for the year over year earnings expectations are now what is it, 44% if I'm, yeah. 44% year over year expectation of earnings change, they made 700. The NASDAQ made 710 last month, year per share, and they're gonna make 1,180.

Based on, you know, huge, huge earnings expectations. Um, now what's interesting to me is almost every, it's not tech. You look at almost every sector except maybe drug prices, pharmaceuticals all earnings are expected to grow a lot,

Nick: but the stock price is doing nothing.

Andy: But what I'm saying is that the earnings expectations for every stock, not just tech, but every stock is are very robust.

But you're right. From a performance standpoint, the last week was all about tech, but not, I guess, not surprising to most. I given that it was also their earning, they are the dominant companies and their earnings, and frankly their stocks, you know, except for Google, as you said, were pretty mixed.

Nick: Yeah. So where are we then? We have to look forward to QRA, which is likely a non-event unless they guide differently. Is that correct?

Andy: Yeah, I mean the, the, like every QRA for the last, gosh, it's been two

Nick: years.

Andy: It's been since 20

Nick: November of 23.

Andy: Yeah. The last time they increased auction sizes was for the auctions of April of 2024, which they told us about in November.

In, in, um, February of 2024. The auction sizes are gonna be the same, and so that shouldn't change the, uh, supply demand dynamic for corp uh, government bonds. They're gonna have to increase auctions sizes eventually. You know, the first thing that they're gonna do is tell us that they're gonna change language and say they're not comfortable with several quarters of similar auction sizes.

They're gonna downgrade that to quarters. A few quarters, a quarter, something like that. And they're not gonna, there's no need to surprise us with, you know, hey, we're gonna increase auction sizes this Wednesday during the QRA. So they're not gonna do that. It's possible that if. The Besson administration wants to, um, pump asset prices even more than currently.

They could reverse and cut auction sizes. That would be a very effective way of causing stocks to rally 10% between now and election.

Nick: Oh, yeah.

Andy: Very effective. Um, in fact, it would, and it would help bonds too, so you'd get mortgage rates under pressure. You know, they could, they could do it. It would take the dollar into the below 95 on Dixie, in my opinion.

Yeah. But they could do it. So we're just gonna pay attention. And so on Wednesday at 8 31, we'll have a synthesized view of what's happening with the QRA. Don't hold your breath. It ain't gonna change. But

Nick: if it does change the way you said it's, it's off to the races. We are talking literally double digits.

Andy: There's two 1% tail chances, there's an off to the races chance of 1% and there's a, hey, they're gonna sell a lot more bonds soon. Chance, which is bad for all assets, bonds, and stocks. 1% chance of that. So 98% of the CHA chances, nothing's gonna happen. Those two 1% tails will require action by investors and we'll tell you what to do.

'cause by the way, QRA does not get reacted too fast. So if we get a 1% chance of either of those two things happening, we're gonna get you in the market in the right direction,

Nick: right?

Andy: But just to be clear, it is gonna happen.

Nick: The only thing that we haven't talked about is the other central banks, because they all met and none of them did anything.

The ECBW had very, very high expectations by some that they were going to hike, but they made it pretty clear that they will hike in June. So the market. What you know, wasn't as disappointed as it as it could have been. But all the other central banks, apart from the Fed, of course, are headed in the direction of hikes.

They just are looking for the correct timing. So the Bank of England, the ECB, the Bank of Japan, who are also in then intervene the MOF to keep the yen steady. They're all looking to hike. They're just. Not deciding on the absolute timing, do you think that that is significant for anything including the dollar, or do you think that this is all in the market?

Because it seems to me that everyone's discounting that they are going to hike. It's just not this, it wasn't this week. It'll be in June.

Andy: Yeah, I mean, all these central banks are in the same position. They mostly have an inflation mandate, but they don't wanna fuck up their economy, even though that's not part of their mandate.

Uh, they all are leaning toward hikes, um, some more than others. I think you, it, uh, and so yeah, e everyone expected them to not hike this time and they didn't. And everyone expects them to hike sometimes in the future, and they probably will. The only action that did happen is that the moths, the Ministry of Finance of Japan bought a bunch of, in 34 billion US dollars worth in, um, you know, around the one 60 level, which was a real intervention.

It was not just a sort of a, you know, they, they literally intervened and the next day intervened at even stronger M levels. They don't want the yen to keep cheapening. And I think that's a realistic goal, be a realistic need because Asian countries in particular are very exposed to oil prices and oil prices in dollars are up a lot.

And so a weak yen means oil prices in yen are up even more. And so they do need to. Provide some help for yen based oil price. And so they did. And the question is, will the market test them? I'm not sure they will. But will the market, you know, credit them for. Yen that now belongs at one 50 instead of one 60.

Probably not. So what I think we're gonna see is a period of very narrow TR range trading, which we had been trading at for a very significant amount of time prior to that prior to the intervention. And I think it just continues.

Nick: Yeah, but what does it actually mean if they keep on intervening or having to keep intervening?

It just means there are less dollars to go around, doesn't it?

Andy: Yeah,

Nick: they have to sell assets. And that basically caps asset prices as well? Yeah, it's,

Andy: I mean, 34 billion raised by the Bank of ge. Uh, the, the Ministry of Finance doesn't require them to sell any, you know, long-term treasuries, but if that number were to get to a hundred billion and then you start straining the system a little bit, and longer term treasuries would be negatively infected and.

Thus stocks would be negatively affected, but for now, I think they can, we'll see, we'll pay attention. And to the extent that they be, that the interventions become so numerous and sizable that it, it affects global yields, will let you know.

Nick: Okie dokie. So I think we, we have our plan. We know what we're gonna do in the 1% chance, either way that the QRA is significant, and we will let you know by email, right?

That's all we can say.

Andy: Yep. Pay attention to 8 31 on, you know, that's about the timing or

Nick: on Wednesday, a

Andy: few minutes later on Wednesday. But other than that, it's uh, it's, um, the same as we've been saying.

Nick: Great. See you next week. Bye-Bye.

Andy: Bye.