2 GRAY BEARDS Week 177

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Nick: Hello everyone, today is the 23rd of May. So we had a pretty quiet week, didn't we, Andy? Not a lot happened, but the one thing that we have to discuss is Waller's speech on Friday, which was, by his standards, distinctly hawkish. Let me summarize basically what he said during his speech and also in the Q&A after that. He basically said that the Fed is going to remove the easing bias, that he thinks that we are still slightly restrictive, but that we need to be restrictive because the Fed has missed the inflation target six years in a row. And therefore that any shock that happens just is likely to put doubt in the mind of the public as to whether the Fed still has a 2% inflation target. And he wants to make sure that inflation expectations, the market-based ones, i.e., the ones two years out, three years out, or four years out, which he specifically mentioned, do not get unanchored from where they are. The market starts doubting that the Fed really wants to achieve a 2% inflation target and therefore that if it's necessary to hike, they will hike. Now, Waller is a dove, but he's not the only dove on the committee and we are under new management. Walsh was sworn in on Friday as well, and he might have different ideas. But I think he was pretty hawkish and that we are now certainly in a period where the Fed does nothing for a while, but looks at market-based expectations of inflation very, very hard indeed to decide whether to hike or not. Easing is completely off the table, I think. And even Warsh would acknowledge that. So are we just basically trading oil at the moment? Because if oil goes up, inflation expectations are going to go up. If oil goes down, inflation expectations, rightly or wrongly, are going to go down. How do you read it, Andy?

Andy: Yeah, I mean, think Warsh put a sorry Warsh got put on the committee by Trump now that was formalized on Friday. And the Waller speech and the minutes all really capped what has been a multi-month since the war shift of global central bankers from whatever they were, whether it was cutting, pausing, leaning toward cutting, pausing, pausing, leaning toward hiking or hiking. Everybody's now formally moved to pause, hike. Every central bank. And you know, at the end of this week, we finally got what I would say is the full confirmation of that. Now, Warsh has a challenge. Probably his first real event will be the June press conference. But everybody's on the same page right now. Cuts are off the table and hikes are possible. And so the markets reacting to that the bond markets reacting to that with twos continuing to weaken. They're not quite as weak as they as the worst but they're pretty weak and after really selling off the long end sort of stabilizing and improved a little bit this week on again what I think is just really culminating a transition from dovish to hawkish global central banks. And so I think that's what's happened. And so you just can't expect cuts in any way. Even to the extent that, you know, the Waller speech talked about the labor market, he, like all of us, recognized that the US labor market could get much, much worse. In the event that AI actually destroys jobs, for instance. But absent that, and that can take some time, absent that with no immigration and no increase in thus no increase in the numerator for employment the denominator for employment You're in a position where employment numbers are likely to just be stable for an extended period of time and so even bad labor numbers are just not going to get the central banks off the off their newfound hawkishness, so that's pretty much where we're at. And so for me, the only thing that's going to get them dovish is a stock market sell-off. And we're, you know, that doesn't seem in the cards. Yeah.

Nick: So let's, you know, we're looking for this mythical 3% level in real rates to switch our allocations. Now I have my view as to what gets us there. And that is only a Fed chair, i.e., Walsh, not paying attention to what Waller described as his trigger for tightening. And that is inflation expectations, de-anchoring market-based inflation expectations, de-anchoring from the current levels. If inflation expectations start going up by 10 2030 basis points and he does not hike that I think will get the long end to panic. And the increase in nominal rates is going to translate through into real rates and we get to 3% and then we switch our portfolio. What other scenario can you see if any that gets us to 3% because the question we have to pose to ourselves is do we jump in now or do we wait for 3%?

Andy: Yeah, I mean, to answer the question, I think the answer is we have some VWAB, which is long duration that gives us some exposure to the long end of the curve.

Nick: Yes, but I mean to do a significant reallocation.

Andy: Right, to really reallocate, I don't have any particular rush. I like the two and three-quarters yield that we're getting, real yield that the market's implying, and I'd be disappointed if it rallied to two and a half, but at the same time, that's a few percent on a bond portfolio, on a long bond. I wouldn't be, you know, pounding the table, it'd be disappointing. I think there's a fair chance we'd get what we expect. And the scenarios are various. The global bond market is definitely being impacted by the local economies of Japan and the UK, which are in a bit of a mess. And so, you know, we could see US long bonds back up to our 3% level simply because of local issues in those markets. Certainly, the number one reason is ongoing energy stress that isn't that doesn't that Warsh in particular looks through that says we're not going to hike into that. Now I don't think you should hike into that, so I happen to be on that same page. On the other hand. We've had inflation for 62 months. I don't care what's causing it. Kill it for Christ's sake. And so we'll see if worse wants to kill it or not. But if he doesn't, yeah, we're going to get our 3%.

Nick: Yeah. So basically what we're saying odds are that we should wait still. Otherwise in other news, Nvidia earnings absolutely wonderful. Everyone knew it. Stock didn't go up. Does that mean that equities are tired of these levels? What's your view? I mean, I've been thinking that equities are tired of these at lower levels and we kept on going up and last week basically we closed more or less unchanged. But do you think that equities now are tired? mean, how big are the odds that we get a significant retracement?

Andy: You know, I think there's it's it's mixed Listen Nvidia at is a cheap stock and it's eight and a half percent of the of the economy of the S&P 500 I mean Do you want to sell it when Nvidia sold off and obviously it sold off because everybody on the planet owns the thing? It's not like it's not like we're missing it. We're long it. If you're long QQ queues, you're long it. If you're long spy, you're long it. If you're long an active fund manager, you're long it. If you're long it in your personal account, you're extra long it. Everybody owns this thing. It's not like there's big shorts out there that are, you know, betting for a Nvidia collapse. So I get why it doesn't go up. But at the same time, I don't get why it would go down given their absolutely dominant earnings unless something really broke in the AI trade, which is something I expect to happen. I don't think there's enough pie for the AI companies plus the rest of the economy to eat without significant pain with some of those cohorts, enough of them that the S&P falls. But that's not playing out anytime soon. A dip buyer on equities and don't think they have a lot more to go, but they could easily go 5-10% more.

Nick: Yeah. Anything that we should be looking out next week because we know what core PC is going to be since we've had CPI and PPI. That's not going to be a surprise. The short end of the bond market is still going to be under pressure because we have the twos, fives and sevens, the regular auctions totaling untold billions. And then we still have, you know, trillions to come from the issuance. That is going to come from the IPO's that are going to be done in June, which are all lining up around SpaceX and later on with the AI stocks. So we have so much supply in both bonds and equities that it seems silly to start adding to risk in either portfolio at the moment. What's your view?

Andy: I fully agree. There's plenty of supply. Next week is going to be relative. It's shorter. It's going to should be relatively boring. The numbers, the economic data, there's no earnings of meaning. guess we have broad common the following week. But we'll have some, you know, there's the war that could create some sort of action. but yeah, I don't see any reason to do anything this coming week.

Nick: And let's talk about the war for a second. If there is a resumption of hostilities, is that, I mean, that's immediately bearish. We all know that. But is that a by the dip scenario or is it a wait and see scenario?

Andy: Yeah, I mean, I presume it's a I assume if the if we started bombing and it looked like it was, you know, so there's literally the moment we start bombing, whether that happens during the market hours or not, versus and what the knee jerk reaction to that would be. And I would expect it to be bearish equities and bullish oil and bearish bonds and bearish gold and bullish the dollar. And then the question is what to do about that. so at a price, I think you have to be buying assets, but I think you have to be buying assets at a decent price.

Nick: Yeah, so it's much lower than this but it's interesting. Have you noticed that gold and Bitcoin are very very weak? And I have and that is unusual. I mean are they forecasting something that the equity market is still missing who knows?

Andy: Not know. my view on those is they are well, my view on Bitcoin is I don't know why it's not going up with all the buying that I'm saying. But so that's a mystery to who the seller is. Gold, you know, gold is starting to reconnect to real yields. And so I expected that to continue.

Nick: Yeah, so and that's another indicator that we should wait on the real yields because you know if gold is going down that means it expects real yields to go up and therefore that's another reason why we should wait. Yeah, anything else that's important for next week?

Andy: Agreed. No, it's a cool and dark and gray Memorial Day weekend, but I recommend everyone enjoy it.

Nick: Not in Miami. Absolutely. Have a great time and we'll speak to you next week.

Andy: Thanks, Nick.