2 Gray Beards Week 180

Nick: Hello, good morning. Today is the 13th of June. Let's very quickly run through what happened last week, because it's going to matter far less than what happens next week at the FOMC. So first of all, no surprise, the ECB hiked rates, and from now on they are completely data dependent, as they should be.

Let's remind ourselves the ECB only has one mandate, and that is inflation, that they have missed for many, many years, just like the FOMC has. And therefore the hike was absolutely no surprise and fully priced into the market. Now, in the, uh, in the US, CPI and PPI again were strong numbers, but ever so slightly better than the market feared, and therefore not really anything that moved asset prices.

What did move asset prices slightly higher was the prospects for peace that, uh, President Trump announced, and it looks like at, in the next few days, we will have a memorandum of understanding signed between the US and Iran. So finally, we will be able to see where oil prices can settle, and that really helped bonds and helped equities in turn, which was no big surprise.

Let's talk about the bond market. The bond market swallowed those auctions last week without any problem. It's fairly priced at the moment. There's a lot of carry, so the market is comfortable at the moment, and it, it will only become uncomfortable if there is a change in policy from the FOMC. And let's discuss the FOMC because that is going to change absolutely everything next week should an unexpected outcome follow.

But the odds of it are low, right, Andy? What are our base expectations?

Andy: Well, it's a tricky situation. I mean, I think the big picture is that no central banks globally are about to engage in either a significant hiking cycle or a significant cutting cycle. To me it seems very clear that the central banks have an inflation problem that's not going away, hasn't been solved, and, um, that prevents them from going into any sort of cutting cycle.

Um, and yet there is general view that the inflation is going to subside. And that keeps a significant portion of every central bank from engaging in a hiking cycle. I'm not sure what it'll take for these guys to ever hike like they ought, perhaps ought to. But I don't think they're gonna do it coming up.

Nick: Right. So le- let's see what the various outcomes might be because the market is priced both in equities and in bonds as a, as a result that for no change and no significant announcement from Warsh. Now, what would justify the current pricing, I think is no big surprises, i.e., no dissents either way, an unchanged FOMC policy, no dissenters including Warsh, and no big talk from Warsh about AI being disinflationary, oil prices going back down to the 60s and therefore disinflationary as well.

No big talk about things are just fine, inflation will take care of itself. Because I don't think the du- the long end of the curve would like that kind of nonchalant, "Oh, everything's great, boys. Don't worry about it." So what would actually surprise markets apart from, you know, a, a complete dissonance between the rest of the FOMC and the chair of the FOMC?

I think really for Warsh to be hawkish would be a big surprise. Do you agree with that?

Andy: Yeah

Nick: Because he could easily come out and say, "Look, boys, we've missed our target for whatever it is, five, six years on the trot. This is absolutely unacceptable. I know what I said earlier, but now that I'm in this position, I think that I'm going to dissent, and I think that we should start on a hiking cycle."

That would be- Yeah,

Andy: That's if, uh, Nick was the central banker. This is Warsh. He's told you exactly what he thinks. He told you this in every conversation he's had that's been public since he was named, nominated, and that is he expects the war to end and oil to come down. He expects that'll keep a, a lid on prices.

He thinks other prices are, in general, using the trimmed mean, less inflationary than perceived. He thinks AI is a long-term disinflationary aspect. He thinks, uh, short rates should be brought down, and he thinks the balance sheet should be uh, reduced. And he thinks the Fed's communication policies, including forward guidance, possibly the dot plot, and possibly the the speeches made by the central bank's m- members is too much.

So let's just benchmark... Wri- wind that back if you want. Benchmark with what I said he has been. That-- This has been him. And so now we have to compare what he has been to what he is, and we'll know what he is based on words and actions. And so my central case is he repeats all those words My, if he deviates, that'll be interesting.

Nick: Right. So if he actually repeats everything that you've just said, is that positive for assets or negative for assets?

Andy: I mean, I think it's neutral. I don't think it's, uh, short term, I think it's probably on the slightly bull steepening, equities up sort of thing, but not really much and hard to say.

Nick: But should we be adding to our positions, i.e.

should we be adding to risk? Should we be going longer duration? What should we be doing? Let's be absolutely practical.

Andy: Sure. So I'll tell you what I'm doing with, uh, my beta portfolio. And what I encourage us to do, we may or may not do it for the Two Graybeards portfolio. In the event that the central banker, that Warsh does not come out and focus entirely on the inflation mandate and in any way tweaks the language I just said to more hawkish.

I generally think bonds have cheapened up. They're not at our target of 3% real rate, I get that. Gold has cheapened a lot. Commodities are now down. Equities are down a little bit. If he's w- where he has been to where, to more dovish, I'm gonna deploy some cash.

Nick: Gotcha. That-- No, that makes perfect sense.

Andy: If he's hawkish, I'm just gonna watch.

Nick: Okay. So-

Andy: I'll leave that ...

Nick: hawkish to me would be doing a Volcker, i.e. just saying, "We are-- We've missed our inflation target, we're hiking." But the other... And would he have support on the committee to do that? I, you know, it's doubtful. Um, but that would be definitely hawkish. What do you think happens in the hawkish case?

I can tell you what I think the bond market's going to do. It's going to flatten the curve like crazy, and I would be very tempted to buy some long-term bonds.

Andy: Yeah.

Nick: I.e. long duration.

Andy: I agree with that. I guess the question is, so generally the central bank thinks... Sorry, the market, the two-year note, which is just the market's version of this, of a central bank, says, uh, the Fed sh- that, that no reason to buy bonds except as a pure carry trade funded overnight with Fed funds.

No reason to buy bonds when inflation at 4%, two-year notes when inflation's at 4%, because you'll make zero return. So-

Nick: Apart from the carry.

Andy: Well, no. Uh, that's if you're just an outright buyer, like you- Yeah,

Nick: yeah ...

Andy: you make no money, no real return. So I don't see So I would think you would want even more return than that if the central bank says, "We agree, and we haven't stopped f- and inflation isn't dead."

So the question that I ask when I l- if the f- if the central bank leans hawkish, there's the idea of a one and done idea where they h- hike once or twice and then are done. It's pretty rare that the market says, "Yeah, we believe you." That is-- That's all it'll take. And frankly, I don't believe it.

If we really have a persistent inflation problem, 25, 50 basis points of hikes isn't gonna do it. So to me, if they're really hawkish, I think y- I think the two-year note's gonna sell off pretty hard Do I think that will affect equities? Probably. Probably negatively. Probably s- um, negatively for any risky growth asset, even gold, even commodities.

A surprise hawkish outcome, I think the only thing that's safe is long-term bonds at that point, and they're not gonna do great either.

Nick: Yeah. But the, uh... What are the odds of that? I would say, I don't know, sing- single digits.

Andy: The odds of a hiking cycle starting are not single digits. Maybe they're, I don't know, tens or 20s because inflation isn't dead.

The odds of an FOMC that flips to a hawkish narrative on Wednesday has to be as close to zero as you can get.

Nick: So what we're really saying is that he is likely to do not very much. The only thing that I think has a 50/50 probability of happening, excuse me, is that he abolishes the dot plots And would that have any market consequences in your opinion?

Andy: Man, I like to consume all the information they have, and so have paid a fair amount of attention to the dots and find it interesting. And, you know, as a person who also likes to do read Fed officials, I like having them talk and yak, and sometimes it creates short-term alpha. But man, enough.

I hope he does something to quiet the noise. And the dot plots are, are noise, and the Fed-- The f- I think the Fed press conference eight times a year, I'd like to see that stick around. But all the other stuff, good riddance. That said, will he do something radical? Maybe. Probably not. He's gonna have to sort of talk it through with his peers about what they're trying to accomplish.

Eliminating forward guidance has been something that's been in the air at the Fed for a couple of years now. I th- I don't know that he'll announce it, but I think he'll act as if forward guidance has been eliminated.

Nick: But if he actually just says, "Dot plots, I hate them. No more," do you think that has any market impact?

It should really increase the volatility because uncertainty rises.

Andy: Yeah,

Nick: I mean, I think it's like- And every time that uncertainty rises and volatility increases, that tends to suppress asset prices.

Andy: Yeah. I mean,

Nick: it's like- But do you think it's gonna be significant?

Andy: I mean, I think it's like the SEC going from quarterly reporting to semi-annual reporting, which is being discussed.

Less information is... if they, the Fed tells us what they're gonna do and then they do it, that's different than the Fed not telling us what they're gonna do, in that it becomes a little bit riskier. What happens, I think it's light. If I had to guess, if they went from m-

What they do now to no dot plots. Every president and governor is muzzled. Warsh only speaks eight times a year at the press conference and two times in front of Congress. Minimal. The minimal communication possible. I don't know. It's probably good for five basis points more in 10-year note yields and maybe, I don't know, half a multiple point in equities.

So nothing.

Nick: Nothing significant. Okay. So in summary, and tell me if I'm being fair, we're saying that 80, 90% chance that it's a nothing and it's more or less where the market is priced. If the central bank is not hawkish and it's a basically a nothing burger, we should increase allocations by a few percentage points to all risk assets.

Naturally, if there's a dovish surprise and he actually keeps on repeating that he dissents with the committee, it's going to be very, very good for equities and, you know, steepen the curve incredibly, and then we will know what to do. And if he actually does what I would like him to do, and that is be bearish, i.e.

hawkish, then equities are going to really suffer, and we will be waiting to buy assets at much cheaper prices, including at the long end in bonds. Because we could then get to something like 5.25% in nominal yields at the long end, which would be a great buy. But so those are our choices, right, Andy?

Andy: Yeah, I think that's right.

A little bit of cash deployment on not hawkish and backed, and if, if hawkish, patient buying favoring the long end.

Nick: Okie dokie. Well, in any case, all we can do is be prepared. We know what we want to do on, you know, whatever the outcome is. He might easily surprise us and say something we completely have not mentioned or expected.

So let's send out an email immediately after the 2:30 announcement or actually he starts speaking at 2:30. Yeah. So probably 3:00, 3:15 by the time we've understood what he's said at, at the presser and deploy capital as appropriate.

Andy: Yep.

Nick: Excellent.

Andy: Sounds good, Nick. Have a good weekend.

Nick: You too. Bye bye.

Andy: Bye.