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Nick: Hello, good morning. Today is the 20th of June, and certainly we had an interesting week in terms of what the Fed decided to do, not so much what they did, but what they said they would do in future. The excitement came from Walsh's presentation about what is going to happen in the future and what is going to change at the Fed But there was also the excitement of the dot plots because they signaled that a majority of the FOMC actually wishes to start hiking rates, and two or three members actually are looking for more than one hike into year-end.

Let's actually talk about what Warsh said and what he wishes to change, i.e., he wants to basically get rid of forward guidance or reduce it substantially. That basically means that he wants to go back to the days when Greenspan was chairman, if not to the days when Volcker was chairman. What happened during those periods?

They were very interesting periods because the market did not have all the information that the Fed s- has been spoon-feeding it for the past, let's call it 15 years, ever since the GFC in any case. And therefore, the market had to anticipate not only the next Fed move, but how far the hiking cycle or the easing cycle would go and anticipate it and run all the way towards the terminal rate of that cycle.

So, for example, I remember extremely well in 1986 when Volcker was chairman, that we were cons- constantly trading about 100 basis points below where the Fed funds rate was because that is where we anticipated the end of the terminal cycle of easing to be. And then in 1987, we were trading like 200 basis points over where Fed funds were because w- that is where we were anticipating that cycle to end.

So what happened on Wednesday? We had a major flattening of the yield curve because he said, basically, "Boys, I will deliver 2% inflation." And that is what the market loved at the long end and hated at the front end because the way to deliver 2% inflation when inflation is running close to four is by hiking rates.

And there hasn't been a single hiking cycle that delivers a 2% reduction in inflation basically You know, grosso modo as it were, by only tightening 25 basis points or even 50 basis points. It has to be a significant tightening cycle if the data continues to be bad. So now we are hugely data-dependent because I can tell you for nothing that if the CPI continues to be above expectations and does not very quickly start heading towards 2%, that the market will be looking for hikes, substantial hikes, and if he doesn't get them, then the long end will start losing confidence in his words, will not believe him, and will test him.

That is what I took away from Wednesday. What do you think, Andy?

Andy: Yeah. So, I mean, let's just be clear what he said. So I think one of the key things is... Sorry, let me just fix this. One of the key things is the idea of forward guidance, which Nick really covered. We don't know what he's gonna do and how he's gonna manage expectations, if at all.

Um, forward guidance is useful as a tool, and I don't think he threw it away. I think he just said, "Now's not the time to use forward guidance. We don't know. We don't know how the econ..." It's really useful to use forward guidance when interest rates are zero and you can't ease because you can't cut.

So you just tell people, "We're gonna keep it at zero for X number of years." That's forward guidance, and it's useful because, hey, you know, you're saying you're not gonna cut. It's also useful when you're raising rates to say you're gonna raise rates until inflation is dead. That sort of forward guidance is useful.

But when you don't know, and we don't know and they don't know how the economy's gonna play out because of the war and the impact on oil, the damage potentially done to the oil infrastructure, which could change the price of oil, so that's a very short-term thing. And more long-term, what the impact of AI will be on inflation and what it is today.

And so there's-- And the ongoing deficit and what that means. So there's lots of unknowns, so it's just not a time to use forward guidance, and so he stopped. And I think he's gonna hold true to that. Um, every question about where rates are going, he deflected. Um, on the other hand, he does have a s- five large initiatives to recast the way the Fed does business, and I think those will take time to play out.

And it basically says if you wanna take forward guidance from those, that information, which I don't, but if you wanna take forward guidance, the forward guidance is pause And so now we're gonna have to deal with data. And I think Nick's right to say data will have a bigger effect because there's no magnet toward-- of what the Fed is planning anymore.

Now stepping back for a second, I think the twos-10s, 10s-30s, the curve, short rates, all of those things reacted to, to Warsh saying that he's gonna kill inflation, and the long end of the yield curve reacted to dec- a significant decline in oil prices and the peace deal in the war. And so those are supportive of assets except for gold, I, and oil, but those-- that's the big picture. On the other hand, the front end had to react to the hawkishness of the committee because I looked at-- Just while we were on here, I looked at the dot plot. Six of the members are for two or more hikes. That's a third of the committee are for two or more hikes by year-end.

So that's a significant number, and a majority are for at least one. That's th-three more people are for at least one. So the committee's on board for not a hiking cycle. You know, a lot of people wanna take Markets generally wanna know whether we're on the verge of a significant hiking cycle due to inflation.

Finally get, the Warsh-announced mandate to get-- to finally get inflation back to 2%. That's gonna require action. That just doesn't happen, right? And on the other hand, oil coming down, disinflationary impact. Um, it's always been a supply shock. Jobs are not strong, but not weak, but not strong.

The economy needs stimulus. We're on the verge of a cutting cycle. Those two things like a massive hiking cycle and a massive cutting cycle, I don't see either of those things happening. So the question is what will happen to price? And how s- will Warsh get tested? And what's the test? We all know he's willing to cut if he can.

What we don't know is he's will-- is he willing to hike? The committee wants to hike. Is Warsh willing to hike? And so the test of Warsh will be, let's say data comes in. We don't know which way the data's gonna come in. There are lots of uncertainties, but let's say the data comes in hot How hard do we think the bond market will test Warsh to actually deliver a hike, like even in July?

Yeah. How hard do you think they are gonna test the Fed? 'Cause that's the dimension. Yeah, I do too

It and Israel, Israel's not on board with this and the IRG

Nick: If that does happen and the data especially I'm now going to concentrate on CPI alone from now on. I think that is going to be by far the most important piece of data that we get If having said you will get, I will deliver 2% inflation, I am not the previous administration at the Fed. I will deliver 2%.

How are you gonna deliver 2% unless you go onto a real hiking cycle if the data is hot, with the proviso

Andy: that the data is hot. Or, or to, or, or shrink the balance sheet, I guess, is one possibility.

Nick: Whatever it is, it's actions that the bond market will demand, and it'll push until action is taken.

So unless, if the data is hot and he doesn't hike in, in July, I think that the bond market at the long end is gonna have a tantrum, test him, and then he will have to hike. But he'll still be behind the curve. So it really, to me, he either does a 50 or he goes home. I think 25s now are for the birds.

So if one goes back to what Volcker used to do or what Greenspan used to do, when did they do 25s? Never, right? It was 50 or nothing. And the big message that you should take away, whether we are right or we are wrong, is the one thing that we are definitely correct in is that volatility will rise at the short end of the curve.

You will have m- much more extreme reactions to data. Before you could almost say that whatever the data was, you wouldn't have more than five to 10 basis point reaction at the two-year. Now you could easily get double that in a day. You know, easily double. And that is you know, what does that lead to?

That leads to people having smaller positions, right? And because the bigger moves lead to smaller positions that you're worth that you are supposed to be risking. So you have de-risking in bonds, and that tends to lead to de-risking in equities as well, right? I, and I can't see how it doesn't.

What do you think about that, Andy?

Andy: I think that's right. Th- th- there's just a matter of how much. What we're saying is that two-year notes and shorter term interest rates are almost definitely going to respond more to data than they have. Now, what does that mean?

The change in short-term rates has been in the nature of five to 10 basis points on big days. That could go to 25 basis points on a big day. What does that mean to 10-year notes? The 10-year note's not gonna react quite as much to that, so that might mean volatility on 10-year notes goes from a few basis points to a few more basis points.

So When more risk is seen in the Treasury curve, generally that means higher yields. That people just say, "Hey, if I'm gonna take more risk, I'm gonna need more yield." And I think that's what, I think that's the natural issue. Now, the initial reaction has been the, quite the opposite. The initial reaction has been risk premiums, which is partly the 10s, 30s yield curve, have actually declined.

So that's, that tells me that people are not quite at peace yet with this idea of more volatility, and I think they're gonna find out. So what I think's gonna happen is we're gonna see slightly higher yields, five, 10 basis points higher yields, more short-term realized volatility on the STIR curve, and more short-term realized volatility on the whole curve, which should d- be a slight pressure on asset prices.

Until the hiking cycle or cutting cycle is well-priced, unknown and well-priced. For now, it's just a matter of, you know, you just don't wanna be making large capital allocations to any point on the curve.

Nick: So next week, what do we have? We have twos, fives, and sevens, which basically- Plenty more

means they're going to cheapen up the front part of the curve even more just in case. But then we do have some data. We have PMIs, we have home sales, we have PCE, which we know, and then we have durable goods and the usual jobless claims. They're all going to be, you know, not really important data, but they're going to give us a sense o- of where we are.

And I can tell you for nothing that if the data is hot, the bond market at the short end reacts far more to the upside in yield than if the data is weak-ish. We are not going to see the two-year note below 405, which is where it was when the, uh, FOMC came out for a very, very long time. That's just not going to happen.

Can we see it at 425? Easy. Can we see it above 425? Easy. So that is the direction of short-term rates. The long end, I think, is now more or less anchored because we have to believe that he's willing and able to get rates to get inflation back down to 2%. And if he does get inflation back down to 2%, a 5% yield in the 30s is wonderful.

Why? Because it's the 3% real, that we've been talking about for a very, very long time. So that is why the long end isn't moving. The long end will only move up in yield now, significantly up in yield apart from the three, five basis points that he normally moves, if it's disappointed by his reaction to hot CPI and PCE data.

Andy: If he- Right. So let me, let me play that forward. Yeah. So we get, we get CPI data before the next FOMC. I guess we get only one version before the July meeting. Yeah. Yeah. One more, one more set of inflation data. PCE, as you said, this week is already known based on prior data. So we get a hot inflation data.

For two weeks, we're gonna be waiting for the Fed. Do you think the market's gonna price in a hike in June- Yes ... in July?

Nick: Absolutely.

Andy: Yeah.

Nick: Absolutely. Ab- absolutely. And that should,

Andy: that should affect the entire curve.

Nick: Yeah. No, absolutely. If the data, if the CPI is above expectations, i.e. that means that the lower oil prices have not affected it, it's not a really a commodity story, it's a services inflation story.

If that is the story and he, and then he doesn't hike, so into the, into the, the Fed, we would be l- we would give him the benefit of the doubt, i.e. the curve will continue to flatten, the twos would go to, two hikes easy, and some more probably. And the long end would stay where it is, just below 5%.

And then if he doesn't hike, then the 30s are gonna test him.

Andy: Okay.

Nick: Then-

Andy: So let's, let's play

Nick: that out ... and that is going to kill the equity market.

Andy: So let's play that out. So we've got this coming month. We've got CPI, uh, mid-month. It comes in hot. We don't know, but if it does, th- that's the more interesting topic.

It's the coming in cool, Goldilocks- Yeah ... assets do fine.

Nick: Easy.

Andy: Easy. Coming in hot, market What we're suggesting is twos become de-anchored from where they've been and really test the number of hikes. Currently, the number of hikes priced in across the curve is 50 basis points. It happens in about a year.

It takes a year for them to hike 50 basis points. We could see that priced to 75 basis points, 100 basis points if the market really-

Nick: Yeah. No, it'll go to 50 basis points in July.

Andy: Right.

Nick: You

Andy: know? It- Right. And then obviously more- Yeah ... 75 or 100 in longer. So boom, you get that. That's a extreme flattening.

Nick: Yeah.

Andy: Um, almost it won't quite invert the curve, but it'll s- really flatten the curve because tens will say, "We're gonna sell off, but we're not gonna sell off 'cause we still trust Warsh

Nick: Yeah

Andy: And then he doesn't hike

Nick: Yeah, and he comes out with some excuse like, "Oh, don't worry because AI will do something in two years' time."

You know- Right ... and that is when- That's when,

Andy: that's when the-

Nick: Yeah ...

Andy: asset market just pukes.

Nick: Yeah. That's when bonds go, "Oh, really? Let me show you." And they go up 20 basis points in a day, you know, the long bond. And that kills the equity market. As soon as, you know, the FOMC was over, my only positions were flatteners, short gold, long dollars.

I refused to sell equities because I knew that, A, everyone loves to buy the dip, but B, there's no reason to sell equities now because the long bond is going to support them. And the reduction, as you said, 10s30s came in substantially. That means the term premia came in, and that is supportive of equities.

So I absolutely refused to sell equities at the lows because I didn't see the point of it because I knew they would rally over the course of the next couple of days. Now what I'm saying- For

Andy: my, for my beta, I've actually bought pretty much everything.

Nick: Absolutely. So what I'm now saying is that equities are unlikely to go down until the long bond makes them go down, and the long bond is unlikely to make them go down until Warsh disappoints.

Andy: Right.

Nick: So we get- And the first- Yeah. So we get- ... the first chance he has to disappoint is at the next meeting, which is, uh, l- late July.

Andy: So we get this CPI coming in cool, Goldilocks.

Nick: Everybody loves it. Buy equities, buy bonds, buy everything.

Andy: But do we... That's, I mean, that's a possibility, right?

Nick: Sure.

It's a possibility.

Andy: Are we supposed

Nick: to- I think it's a lower probability than, uh, than the other way around. Well, that's what- I think it's less than 50/50 ...

Andy: so, I mean, I guess the question is, so we get that Is there huge upside we'd be forfeiting by not, not betting?

Nick: I think I would definitely- I mean, twos, 10,

Andy: 10-year yields, twos-10s are...

You know, we'd get a steepener because inflation is coming down. Yeah. But are 10s gonna run away at current yields? Are we-

Nick: I, I don't think they do. I think that by the time the data comes out, they won't be that far different from, uh, from here. I... But I, I think we have time. We definitely have time because if the data now starts really coming down, it's a trend, right?

Because unless oil starts going up above 80 and so on, you know, if oil stays contained, the negotiations go well, the 10s don't move very much, you know, real rates. And don't forget, 10s reals are now as wide as they've been. Right. The only reason why they haven't gone higher is because the 30s have kept them down.

So I, I don't think that there's a problem with waiting at the moment. Okay. I think the odds are actually to wait.

Andy: Sounds good.

Nick: Okay. Excellent. Speak to you next week, Andy.

Andy: See ya