I am going to write this up for everyone, because I had many questions on it. Yesterday I wrote this:

"Disinversions bring volatility and volatility brings degrossing and that brings air pockets because of heavy cash selling of risk assets. Yield curve is warning us to be very careful and not short volatility. or too long risk."

How do I think the yield curve transmits to risk assets? Remember, we are always talking probabilities, that is all the market is, a probability setter/discounter. When probabilities go up, prices go up, when probabilities go down, prices go down (or vice versa, of course, depending on what we are trading).

After a significant tightening has occurred and the YC has inverted, there comes a point when the market (the market is all of us, our collective knowledge) starts betting that real rates are now so restrictive that at some point they have to do "the job". Whatever that "job" is, usually to bring down inflation. When we reach that point the market starts to discount the odds that the economy can't take it anymore.

That goes in phases. People who have been with me for a long time will remember when 10s-30s inverted very briefly in 2022 and I jumped all over them, because inversions that far out just make no sense and I have never seen an inversion in 10s-30s that lasted any length of time.

https://www.tradingview.com/x/F3IN9Ht7/

Every time we made 10-15bp in a few days. And every time 10s-30s disinverted very quickly. My personal explanation as to why a 10-30s inversion cannot persist is simple: some of us might know what tomorrow will bring, but none of us is smart enough to know what the world will look like in 10 years. Why would I PAY someone for me to take additional duration risk in 10 years' time, for an extra 20 years? What could anyone possibly know about that timeframe? Nothing. Therefore, the market just does not allow that to persist.

Remember: a YC inversion is abnormal, by definition. It only happens in times of stress/necessity to achieve a goal.

Once the real interest rate is high enough to achieve that goal (again, all probabilities that the market is discounting), the next phase is discounting WHEN the curve will disinvert, because the real interest rate will harm the patient. By harm I mean solving one problem (usually high inflation) and cause a different one (usually higher unemployment/recession).

That disinversion goes in phases. The first one is normally 5-30s. People get confident enough that over the period *of a few years*, the job is done. So, they lend 5s.

https://www.tradingview.com/x/HWpAtbZZ/

As data about the economy is gathered, they get more confidence. And think they can pinpoint the timing better. So, they lend shorter: 4s, 3s...

https://www.tradingview.com/x/ZmVniXSm/

3-10s disinverted yesterday.

And then 2s.... https://www.tradingview.com/x/ZNnAzbCg/

2-10s is still inverted, but on its way…

The final one (and the REAL indicator of a shitshow already in full swing) is 3months/10yr.

https://www.tradingview.com/x/YqLfChqg/

When that disinverts it's already too late, most probably.

Now, if the bond market is confident that the economy is getting weaker (again, all odds and degrees of rate of change) and transmitting that message through the YC, what happens?

The **odds** in risk assets change. From betting on continued strong growth with strong earnings, you have to bet on either a slowing of that growth rate or a reversal. In either case, that will result in changes in volatility levels. If you were certain that growth was strong, now you are less certain. **Less certainty** of outcome raises the volatility level. If realized vol was 7-10% (as it was very recently), it now goes to say 15%. That causes a big shift in VAR on a manager's book. His VAR explodes. Therefore, he now needs to DEGROSS. Sell risk assets, to bring the size of his book down to meet the new VAR reality indicated by higher volatility. First of all, he sells high duration assets, as those are the most sensitive. The highest duration assets are equities.

Then he needs to sell high duration bonds. As many people as are buying bonds, there are sellers too (like this manager above). And that is why long bonds go nowhere in this scenario. But all the cash raised through degrossing goes into the shorter end. And that is why the pressure on the YC to disinvert actually increases. Over the past few days: 30s nowhere, 2s down in yield a bunch.

Eventually 30s will rally too, but much less than the short end.

But overall, the current necessity is for SMALLER risk books. Hence the selling of risk assets.