

2 GRAY BEARDS

Week 167 Summary

March 14, 2022 | Nick & Andy

The Master Variable: Oil

Andy opens with a blunt framing: in the current environment, every market is one trade — oil. Oil up means bonds down, stocks down, dollar up, and grains up (via the fertilizer channel). Everything moves together. This correlation will eventually break, but for the near term it is the only thing that matters.

The implication is that investors should not try to be clever about asset class selection this week — watch oil, full stop.

Macro Outlook: Stagflation Lite

Andy's medium-term read is structurally bearish on growth. High energy and food prices are sticky — they're necessities, they don't respond to demand destruction in the same way, and they will crowd out spending everywhere else. The key headwinds stacking up:

- Fiscal stimulus fading — OBBB-related tax refunds and lower rates were expansionary and are ending
- Fed stuck — can't cut (inflation not fixed) and won't hike into a supply shock
- Labor market flat — no job growth; AI-driven layoffs (Meta firing 20%, DOGE pressure) adding headwind
- Demand destruction in non-essentials — consumers redirecting spend to gas and food

Verdict: bad for equities, directionally better for bonds. But that longer-term thesis is irrelevant for the coming week — oil dominates all near-term signal.

The FOMC: A Non-Event (80% Probability)

Nick and Andy agree the Fed's most likely move is to do nothing and make no headlines — roughly 80% probability. Dovish or hawkish outcomes are each ~10%. The political environment (war, supply shock) makes Powell want to stay out of the news.

Scenario analysis:

- **Dovish:** Yield curve steepens sharply. Short end rallies only marginally (a few SOFR contracts). Long bonds get hammered as inflation fears dominate. Any equity rally gets sold into.
- **Hawkish / mentions hikes:** Everything gets destroyed. Short end obliterated. Long bonds paradoxically become a buy because hiking into a supply shock virtually guarantees recession. Major curve flattening, equities down hard.
- **Base case (neutral/no news):** Real rates continue drifting higher. No relief for equities. Status quo preserved.

The ECB: More Hawkish, Matters Less

The ECB has a single-sided inflation mandate and will be hawkish. This is already showing up in European short-term rate markets, which have been hit harder than US equivalents. The direct impact on the US curve is marginal, but the important effect is the narrowing of US-Europe rate differentials.

Nick's longer-term view: as differentials compress toward zero (which Trump would welcome), that's net negative for the dollar. The recent DXY move from ~96 to ~100 is war-premium; he doesn't see the dollar powering higher on a sustained basis through year-end.

Duration and Equities: Not Yet

Neither Nick nor Andy sees value in owning duration here. Long bonds have been moving in lockstep with equities — they haven't provided any hedging benefit. The thesis for buying duration only works once:

- A ceasefire/war resolution clears the oil supply shock, OR
- 30-year real rates hit ~3.00-3.25% (nominal ~5.25%) — at that level the probability of recession is high enough to force a reassessment

Real rates have already risen ~20bp in recent weeks. Another ~25bp gets you to the trigger zone. At that point equities would likely also be cheap, and bonds start functioning as actual insurance again.

Until then: hold current equity allocations, sell rallies, sell calls against holdings (vol is expensive, collect it). Don't add duration.

The Ceasefire Playbook

Andy and Nick game out the scenario nobody expects next week but everyone needs a plan for. If something resembling a ceasefire or Iran negotiation materializes:

- Equities spike 3%+ immediately
- Playbook: do not chase it — sell calls into the rally
- Reason: the inflation fear fades but the growth fear takes over — where does growth come from? Equities become range-bound, not a new bull market

Nick is explicit: anyone expecting new highs on a war resolution is wrong. The market transitions from an inflation narrative to a growth narrative, and the growth story doesn't support a breakout. Expect a sector rotation story rather than an index story.

Bottom Line

- Watch oil — it is the only variable this week

- Fed does nothing; ECB hawkish but secondary
- No new equity longs, no duration — sell rallies
- Duration trigger: 30yr real ~3.00-3.25% / nominal ~5.25%
- Ceasefire rally = sell calls, not add longs
- Post-war equity market: range-bound growth story, not a new leg up

