2 Gray Beards — Week 168

Executive Summary | March 21, 2025

Situation

Real yields spiked last week and are now sitting at a historically critical level — 30-year TIPS at ~2.75%, the high end of the range seen over the past five years. The move cascaded across every major asset class simultaneously: equities, gold, and nominal bonds all sold off with nowhere to hide. Oil and Bitcoin were the only holdouts, with oil supported by geopolitical risk and Bitcoin simply not moving in either direction. The underlying driver is a combination of forced de-leveraging — portfolios that had been heavily positioned in high-carry trades (Korean stocks, EM currencies) are unwinding — and a central bank pivot from expected cuts to pause/hike.

Central Banks

- Fed: Wants to look through oil-driven inflation but markets aren't buying it — two hikes now priced in the US. Cuts are off the table until a new Fed chair (Waller) is confirmed and has established relationships within the FOMC. Year-end at the absolute earliest.
- ECB: Base case is two hikes. Inflation-only mandate means they have less room to balance growth concerns against price stability.
- BOE: No clear read. Internal disagreement — some members think hikes are needed, others want cuts. UK outcome is essentially binary and wide.

What Resolves This

Everything runs through long-term oil prices. The December oil contract pricing ~$80 tells you the market thinks the Iran situation is not a quick fix. A rapid resolution would take the inflationary pressure off central banks, stimulate consumption, compress risk premiums, and send equities back toward all-time highs. A sustained $80+ regime materially raises recession risk via the consumption channel. Nick's base case: the situation resolves, but slowly — real rates come down 30-50bps over time, not in the next few weeks.

The Three Scenarios for Real Yields

- ✓ **Buy:** Spike through 5-year highs, then recover → Buy equities, long bonds, gold. This is the all-clear. Andy wants to see this specific pattern before adding meaningful risk.
- ✗ **Avoid:** Spike and consolidate at new all-time highs → Don't buy. Signals the de-leveraging isn't done and more asset downside is coming.
- **— Hold:** No spike — yields grind at current levels without a capitulation move → Stay with current positioning. No need to lever up without a table-pounding entry.

Positioning & Targets

- Current equity allocation: ~35–40%. On a real equity flush — S&P at 6,300 or below (a ~10% correction), with vol elevated and real yields adequately high — target allocation rises to ~65%, near maximum.
- S&P could go to 6,000; you won't time the exact bottom. Build the position on the way down once the conditions are met.

Bottom Line

We're at historically attractive real yield levels but haven't seen the spike-and-recover confirmation that would justify a meaningful increase in risk. The bet is that 2.75%+ real yields can't be sustained for long — they never have been. Iran/oil is the master variable. Quick resolution puts equities near all-time highs. Prolonged conflict opens the door to recession. Don't act before the signal. When it comes, move decisively.