2 Gray Beards — Week 168

March 21, 2025 | Nick & Andy

The Setup: Real Yields Are Driving Everything

Last week was characterized by a spike in real yields, which cascaded across all major asset classes. There was nowhere to hide — equities, gold, and nominal bonds all sold off together. Only oil and Bitcoin held up, neither of which was actually moving higher.

- Real yield spike → nominal yields rise → pressure on equities and precious metals
- Gold down ~$900 from its peak; equities under pressure; bonds unattractive without recession
- The key question: where do real yields go from here? That answer runs through oil prices — not at the front of the curve, but at the back, toward year-end and into 2027

Central Bank Recap

- FOMC: Uncertainty on direction; wants to look through oil-driven inflation but can't commit. Market now pricing two hikes in the US.
- ECB: Base case is two hikes. Inflation-only mandate gives them less flexibility than the Fed.
- BOE: Confused — wants to cut but may need to hike. UK outlook opaque; could be many hikes or cuts.

What's Driving Real Yields

Andy identified two forces at work:

- Central bank pivot from cutting to pausing/hiking — lifted the entire yield curve, including real yields across all maturities. 2-year yields rose ~18bps last week; 30-year only ~3-4bps. The short end is dominated by rate policy repricing.
- De-leveraging — the bigger medium-term driver. Volatility has skyrocketed across assets and rates. Portfolios that had been heavily levered (Korean stocks, EM currencies, etc.) are unwinding. This pushes up risk premiums and real yields globally.

The short-term rate path is now largely baked in. The remaining driver of further real yield increases is the de-leveraging cycle — and how long it runs depends heavily on geopolitics.

The Iran Variable: Oil Is the Key

The entire macro setup — real yields, inflation expectations, central bank path, equity outlook — is contingent on where long-term oil prices settle. The conflict is the swing factor.

- Long-term oil (Dec contract) pricing ~$80 suggests markets expect the situation to persist for some time
- A rapid resolution → oil back to $50-70 → central banks relieved → real yields fall → equities could kiss all-time highs
- Sustained $80+ oil → materially higher recession risk via consumption drag
- Nick's base case: situation resolves, but cuts won't come until a new Fed chair (Waller) is confirmed and established — likely year-end at earliest. Short end stays above fed funds for now.

The Trade Framework: Three Scenarios

Andy laid out three paths for real yields — and a distinct action for each:

- Scenario 1 — Real yields spike through 5-year highs, then recover: Buy everything. Equities, long bonds, gold. This is the table-pounding entry. 30-year real yields at 2.75% have historically been a reliable buy signal; they're right there now.
- Scenario 2 — Real yields spike and don't recover (consolidate at new all-time highs): Don't buy. More downside ahead for assets.
- Scenario 3 — No spike, yields just grind at current levels: No urgency. Stay with current positioning; don't lever up without a clear capitulation event.

Current read: We're at historically attractive real yield levels but haven't seen the spike-and-recover confirmation yet. Patience is warranted.

Positioning & Targets

- Andy bought a small amount of equities last week — cautious, not conviction-sized
- On a real equity flush (S&P at 6,300 or below — ~10% correction), with real yields high, vol elevated, and other assets down: target 65% equity allocation, near max
- Could go to 6,000 — you won't time the bottom, so build the position on the way down
- Current equity allocation: ~35-40%. Goal is to increase by ~50% on the right setup.
- Option strategies to manage risk and capture upside are coming in Nick's segment — email alert planned when the trigger fires

Bottom Line

We're in a de-leveraging cycle layered on top of a central bank pivot. Real yields are at historically meaningful levels but haven't broken to new highs. The Iran/oil situation is the master variable — its resolution timeline determines whether this is a dip to buy or the early innings of something worse. The plan: watch 30-year real yields, wait for the spike-and-recover signal, and buy the flush in equities, bonds, and gold when it comes. Don't pound the table before that confirmation.