

2 Gray Beards

Week 169 | March 28, 2025

Hosts: Nick & Andy Constan

Brief Summary

Nick and Andy open on the Iran conflict and spend the episode working through its macro consequences. Their shared view: the gap between US demands (permanent end to Iranian regional influence) and Iranian terms (sovereignty, control of the Strait of Hormuz, compensation for damages) is unbridgeable in the near term, and further escalation is the base case. That backdrop flows directly into the macro: oil at \$20–40/barrel above year-ago levels is a near-certain GDP headwind of 50–100bps — on a 2–3% real growth world, that’s a meaningful slowdown. Recession is lower-probability but no longer dismissible. Friday’s market action — equities down hard, gold up, short-end bid — was the first real pricing of that risk. Equity options imply a 25% chance of SPX 5,000 by year-end; Andy considers that extreme. At current levels (~6,375), the call is don’t sell. The target accumulation zone is 6,000–6,100, with 30-year real rates approaching 3% as the trigger for duration. Near term: quarter-end options dynamics likely create a weak open Monday followed by a technical recovery into Tuesday (~6,475). NFP drops on Good Friday into near-zero liquidity.

Geopolitics: Iran

The State of Play

- Trump signaled resolve in Miami: Iran to be “resolved once and for all” — hawkish framing
- The opposing coalition: Iran backed by Russia and likely China; US aligned with Gulf States and Israel — each with substantially different interests
- European spectators on the sidelines, not a meaningful force

Why the Gap Is Unbridgeable Near-Term

US position: end Iranian regional influence permanently. Iranian position: this is a war of aggression; we want sovereignty, control of the Strait of Hormuz, compensation for killed leaders, and no reduction in military capacity. Both anchors are rational from each side’s perspective and have no overlap.

- Andy frames current talks as delay tactics, not genuine negotiation
- Neither side has yet faced the conditions that would force capitulation: Iran would need to be militarily destroyed; the US would need catastrophic economic damage or mass casualties — neither present
- Markets could theoretically pressure Trump, but Andy is skeptical midterms or equity drawdowns are on his decision calculus

Base Case vs. Tail

- Base case: further escalation, slow resolution, Iran eventually caves
- Tail: Iran capitulates tomorrow and accepts all US terms — very low probability, but worth being positioned for because it would be a V-shaped equity recovery

- Oil elevated for an extended period is the embedded macro consequence of the base case
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Macro: Oil, Growth & Rates

Oil as the Transmission Mechanism

- World is paying \$20–40/barrel more than one year ago; consumers already paying \$50/barrel more at the pump
- Heating oil corrected 20% for Andy personally — immediate household budget impact
- GDP drag: 50–100bps on a 2–3% real growth world = a slowdown is essentially locked in as base case
- Food and fertilizer prices follow oil — necessities, not discretionary, so demand doesn't simply compress

Supply Pressure on Financial Conditions

The oil shock is compounding an already strained issuance environment:

- US government: hundreds of billions in new war financing issuance
- Gulf States: oil revenues down, need to sell assets or issue to fund operations
- Global rearmament: Europe and others recognizing need to spend on defense CapEx
- All piled on top of a 6%+ US debt-to-GDP deficit and global AI/infrastructure CapEx commitments
- Result: persistent upward pressure on real yields, tight financial conditions, headwind to asset valuations

Friday's Market Signal

- Equities down hard, gold up, short end got a bid — first market pricing of recession possibility
- Long end did not rally — so not a clean recession trade yet; more “beginning to think about it”
- Slowdown = base case; recession = lower probability but no longer negligible

Bond Auctions

- Very bad auctions last week with massive tails — unsurprising given the issuance backdrop
 - 30-year real yields approaching 2.78–2.80%; target level of interest is 3%
 - At 3% real, duration becomes attractive — watch for that level
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Equity Markets

Current Level & Earnings Math

- S&P at ~6,363–6,375, roughly 600 points off all-time highs — a correction, not a crash

- S&P earned \$278 last year; Andy's realistic bear case: \$310 earnings (10% YoY growth) at 18x PE = 5,600
- Pessimistic scenario: \$250 earnings at 18x = 4,500 — Andy calls this “a joke”; possible but very low probability
- Options market pricing ~25% probability of SPX hitting 5,000 by year-end — Andy views this as extreme
- Hyperscalers not scheduled to cut CapEx; forward earnings are “pretty baked in the cake”

What to Do Now

- If you weren't scaling out at 6,900, don't start selling at 6,375 — that's the wrong trade
- Prepared investors who were underweight risk: now is your time to “shine” — but timing matters
- Target accumulation zone: 6,000–6,100, possibly 6,200
- Rallies are likely but won't stick — earnings headwinds and higher real rates prevent sustained upside
- Path of least resistance: down toward accumulation levels, with high volatility along the way

Quarter-End Technical Setup (Near-Term)

- Significant options expiry at quarter end next week creates a specific short-term pattern
- Andy expects: weak open Sunday night/Monday morning, sharp recovery closing into ~6,475 on Tuesday
- Not a pin, but statistically significant based on options positioning
- A large Monday dip would be a potential long entry; until Tuesday plays out, bias toward buying not selling

Calendar & Upcoming Events

- Quarter-end options expiry: major technical event, see setup above
- NFP release: Friday, April 4 (Good Friday) — bond markets closed, equity futures open with near-zero liquidity
- Portfolio options expiring March 31 — Nick to cover in next segment
- Everything else likely overshadowed by Iran developments

Positioning & Strategy Summary

- Stay underweight risk until 6,000–6,100 zone on S&P
- Watch 30-year real rates: 3% is the trigger for adding duration
- Be prepared to act fast if Iran capitulates (tail scenario) — V-recovery would reward buyers
- Don't chase rallies — they're unlikely to hold given the macro backdrop
- Slowdown is the base case; position for a grinding bottom with multiple false starts, not a clean V