Caron’s Corner Transcript – 4.15.2024

Chips and Dip: Geopolitical Risk, Volatility and Value

- Markets are undergoing a correction that we expect will create persistent volatility.

- **Chips** is a reference to technology sectors that have **dominated momentum factors** and may correct, or **dip** lower.

- **Value** is how we think about a broadening of factors, diversification and constructing **a less vulnerable and more durable portfolio** as we enter this anticipated period of volatility.

- In fact, the market seems to be facing a “perfect storm” for a correction:

    - A sharp acceleration in prices that started in 4Q23 driven by factors that are unlikely to repeat in 2Q24

    - As a result, valuations were high heading into a likely weaker earnings seasons

    - **Geopolitical** tensions are amplifying risk premiums

    - Inflation is not cooperating

- So where do we go from here and how do we incorporate all these risk factors into our management of portfolios? We discuss in this audiocast.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Chips and dip, geopolitical risk, volatility and value. Markets are undergoing a correction that we expect will create volatility that stays with us for a while. Now, the reference to chips is clearly a play on the technology related sectors that have dominated momentum factors to high extremes and may correct or dip lower. The reference to value is how we think about broadening of factors, diversification and construction of a less vulnerable and more durable portfolio as we likely enter a period of volatility. Now, the market seems to be facing a perfect storm for correction. There was a sharp acceleration in prices that started in the fourth quarter 2023 that were driven by positive surprise factors that we think are unlikely to repeat in the second quarter 2024. As a result, valuations were high as we head into earnings season, which is right now, and that is not likely to be as strong as last quarters’. Geopolitical tensions as we all know are ramping up, and the picture is even less clear, amplifying the threat to risk premiums. Lastly, inflation is not cooperating, making it harder for the Fed to exercise its “put,” i.e. to cut rates aggressively. So where do we go from here? And how do we incorporate all these risk factors into our management of portfolios? Well, let's get into it.

Let's start with geopolitical risks. What we have to understand about geopolitical risk is that it's a systemic risk and it's both hard to incorporate into a strategic asset allocation or hedge. However, in most cases, geopolitical risks tend to manifest as a sudden shock to markets but is then dampened over time. So for instance, when Russia invaded Ukraine, although they were massing on the borders, very few people thought they'd actually attack. That was a shock, but it's still a geopolitical risk today, although the effect has been dampened over time. What tends to amplify and lengthen geopolitical risk events is if it impacts liquidity or the ability to repay debts on a broad and large scale. This is why central banks in a regulatory function use things like forbearance to avoid a system collapse of the financial industry among many other tactics to soften the blow. Sometimes the geopolitical risk event serves as a catalyst that unearths other vulnerabilities. For instance, an oil or energy shock today could exacerbate the macro risk for inflation to remain elevated. This in turn could limit central banks from preemptively cutting rates to prevent a more severe downturn, which may expose other vulnerabilities. So the point is it may not be the geopolitical risk itself that is the problem for markets, but it's knock-on effects down the road. So how do you prepare for this risk? The way we like to think about it is through liquidity management. In a strategic asset allocation, which we think is essential to manage one's needs in terms of having enough liquidity to get through these troubled times and so that you don't find yourself in a shortfall. This gets to portfolio construction and risk management, a place where managers can add value and manage risks. S

Now let's talk about the styles and risk factors that come into play. The ones that people are talking about today are momentum, quality and defensive. Now, a knee-jerk reaction to the rise in event risk is often to get defensive exposures higher in one's portfolio, and also adding quality and increased liquidity through purchases of safe-haven assets like U.S. Treasuries (USTs). But like anything else, we must look at the whole picture to assess both sides of the opportunities and risks. Fundamentally, we are still expecting a soft landing and think we can buy into weakness. This is not the start of a “bear” trend in our opinion, but more a correction. Having a market correction going into earnings season is usually a good thing. This is because it lowers the bar for earnings to surprise to the upside by either coming out stronger or less weak than expected. This is a more healthy technical set up. We note that the market momentum factor is basically near all-time highs which mainly comprises of big tech and large companies. So if momentum corrects lower, we could see a fast and sharp move lower in market prices.

We should also note that the quality and momentum factors are currently highly correlated these days. A sell-off creates a bid for quality as it typically does, which means the momentum correction can actually find a bottom and bounce. It becomes an opportunity to buy the dip because a lot of what may come down in the markets represents the high quality factor. If we were starting a bear market, then we would say it's different. People would shift out of quality and momentum and go straight into defensives. Also note that the risk for inflation to remain high gives safe-haven assets like USTs less hedging benefits these days. In summary, I don't think we are starting a bear market. If that's the case, then this is a correction and a dip buying opportunity, but we should be patient because it may take the markets both second quarter and third quarter to sort things out. Oh and the U.S. presidential election may add uncertainty to the mix.

As we start to think about the second quarter and third quarters having a choppy sideways range, we need to start to do is find areas where there's value in the market. We may have to accept that these markets may be directionless over the next few quarters and if we think this is a correction of the sharp run-up in prices that we experienced over the last two quarters, then this all seems very normal and natural. As mentioned in our quarterly asset allocation update, we did reduce our equity exposure from overweight (which we started in December of 2022) to neutral by the end of March. After the strong CPI data last week, we think that this was the start of a correction and the knee-jerk reaction to equities makes sense. Higher rates will reduce the present value of future cash flows, but the reason rates rose is because the economy is stronger, with stronger jobs and higher prices. This is a net positive for corporations, as they can pass on higher costs and preserve margins. Balance sheets are strong and interest coverage ratios are very low. The potential for operating leverage is very strong and nominal GDP growth is likely to be higher, which implies higher earnings in the fixed income space.

We still like our barbell approach, basically owning both a mix of short duration, high-quality assets balanced by lower-quality assets like high yield and bank loans. This creates a less rate sensitive but higher yielding bond portfolio which we think is well suited to what may be range bound market for some time to come. Lastly, we think with everything that has been mentioned, we could see a deeper correction to markets, but it may not be the start of a bear trend. So having a tactical plan to buy on weakness and diversify one's entry points, we think may be a good way forward with that.

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