Caron's Corner Transcript – 9.5.2024

The BEAT for September: Key Themes and Top Ideas

- We expect the Fed to cut rates 25 basis points at their meeting later this September.
- However, there is a clear focus by the Fed on the jobs market and "not welcoming further deterioration."
- This raises the question of how fast or front-loaded rate cuts may be, and certainly puts three cuts on the table in 2024.
- Additionally, bond and equity markets will be especially sensitive to weaker jobs and economic data releases. In other words, there will be an asymmetry on more and faster cuts being priced-in in reaction to weak data, then priced-out in reaction to strong data.
- This will have implications for the USD/JPY (yen) relationship and concerns over yen-carry trade unwinds.
- And if that weren't enough, this month will amplify political volatility in the U.S.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group and I'd like to share with you some thoughts on The BEAT for September. New in September are rate cuts expected at the upcoming Fed meeting later this month, which we think will be about 25 basis points of cuts. However, there is a clear focus by the Fed on the jobs market and to quote Powell, "the Fed is not welcoming for deterioration." This raises a question of how fast or front-loaded rate cuts may be. Certainly it puts three cuts by the Fed on the table. Additionally, this means the bond market - and equities too - will be especially sensitive to weaker jobs and economic data releases. In other words, there will be an asymmetry on more and fast rate cuts being priced in, in reaction to weak data, than priced out in reaction to strong data. This will have implications also for dollar/yen and concerns over the yen carry trade unwinds we've seen in the last month. And if that weren't enough this month, we amplify political volatility in the U.S.

Let me start by discussing our four key themes for September. The first theme is something you've heard from us before, which is coming from our FEAR framework in that speed matters. Remember FEAR is a framework that discusses the interplay between F for Fed policy, E for employment, A for asset prices and R for rates. So 5.5% Fed policy was designed to weaken employment and wage inflation in order to lower an anchor CPI. This is happening, but the market is fearful that the speed of job losses may trigger a recession. However, the increase of entrance into the labor market may be the reason why the unemployment rate rose, not because people are quitting their jobs or getting laid off.

The second point is volatility in market fundamentals. The volatility in markets may be telling us more about excesses in crowded market positions than economic fundamentals. To be sure the economy is slowing, but we see this as a normalization of economic activity and the employment situation than a collapse. However, this catalyzed a sudden exit from crowded positions in a very narrow market and

caused volatility to spike. We do believe volatility should be elevated, but we do not believe it's a signal or a particularly strong one calling for a hard landing basically due to these technicals.

The third theme is about equities trading in a range, at least for now. We believe we are still in a secular bull market. Our bias is to maintain positive tilts within our asset allocation. Our base case for a soft landing, which includes the possibility of a mild recession or at least a short-lived recession, remains intact. We see the cooling of the economy as a normalization of economic activity that brings with it a reset in market prices that ultimately reduces the extreme narrowness of the S&P 500 index and creates opportunities for broadening that includes large cap value sectors. Inherent in this view is the expectation for overshoots both to the upside and to the downside. This creates an opportunity for us to trade the range.

The fourth theme is that bond yields are well priced for rate cuts. Once again, bond yields are priced to perfection. Bonds are priced for the Fed to cut interest rates by over 200 basis points by the end of 2025. While there may be some room for yields to move lower, we think it will take a hard landing or a deeper recession to see a material drop in yields. We still believe that we are in a structurally higher inflation regime for years to come. Of course, inflation can fall from here, but we do not think it will fall below 2% for a material period of time. Instead we think it bounces off that level, and as a result, bond yields should trade with a spread above the terminal Fed funds level of say around 3.5% that might be by the end of 2025. This is why we think that declines in bond yields are limited from here.

Let's move on to our four top trade ideas for the month of September. The first one is going to be downgrading loans to neutral but keeping a high yield overweight. Now moving loans to neutral from overweight, the market is pricing 200 basis points of rate cuts over the next year, possibly cutting further even into 2025. The yield in loans floats with short term rates and will fall as the Fed cuts. This decline in yield relative to the credit quality associated with loans makes this asset class less attractive. By comparison, high yield is a higher quality asset, mainly BB rated, and it has higher interest coverage ratios and EBITDA margins. With these other factors in mind, we think it's worthwhile to rebalance loans to neutral from overweight.

The second idea is in equities. As we like to say, the worst of times, the best of times and really what we want to do is take advantage of volatility. We believe the equity market is in a secular bull market and we'll therefore see corrections as an opportunity to buy. As a result we did add to equity exposure in early August during the weakness. But at the same time, we still believe the economy is cooling into a soft landing. Thus, we believe the market can overshoot to the upside as well, which is why we sold exposure and returned to neutral later in August after the rally. Today we sit with a much more neutral footing. We do not believe the economy is set to accelerate over the next few months, which makes the S&P 500 around 5,650 our near term upper bound. At the same time, the economy is not collapsing, which makes 5200 attractive, and 5,350 seems more like fair value. We plan to trade around these ranges.

The third idea is Japanese equities. We want to maintain an overweight here. The Japanese equity market entered into a correction, not the start of a bear market as we see it. Japan remains a structural

overweight for us in terms of equity exposure. Many of the factors that brought us to this conclusion are still intact. Namely, we see Japan in a structural recovery that will be supported by policy and favorable corporate governance. To be sure, Japan will go through periods of correction as we've seen, but we do not yet have a full position on and we will use these corrections to increase exposure. Policymakers seem supportive of growth and will risk modestly higher inflation to achieve it. Tailwinds from Japanese yen weakness is likely past its cycle peak, but we expect a manageable pace of currency appreciation.

The final trade idea for September - and this may be controversial - is moving to underweight duration. And yes, we're doing this despite the fact that the market is expecting the Fed to cut interest rates over 200 basis points by the end of 2025. And the reason that we're doing this is because we believe that this is already fully priced into the markets. If we think about a spread between the 2-year treasury rate and let's say the 10-year rate, well that usually trades above Fed funds at terminal value of 3.5% Fed funds. Let's say if we get there, if the 2-year and the 10-year rate traded is spread above that, we think we're kind of already there in terms of yields. So anything around 4% or slightly below 4% to us today seems like a fully valued bond market.

Thank you all for listening to The BEAT for September.

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