Caron's Corner Transcript - 11.28.2022

Assets Are Rallying, but Is the Market Getting It Wrong?

- There is little doubt that the likelihood of a soft landing has increased.
- Inflation has fallen and the Fed is putting less pressure on its policy brakes.
- This has created an asset rally, yes, but also some attendant risks.
- At this point, position technicals may be trumping longer-term fundamentals.
- Bottom line? Don't fight the tape. The market is not wrong, although positioning might be.

Jim Caron: A lot has been discussed about the market lately, especially the rally in risky assets and people are asking the question, is the market wrong? Well, I don't think the market is wrong, but the positioning might be. There's little doubt that the likelihood of a soft landing has increased as inflation has fallen and the Fed is putting less pressure on the brakes. The result is an asset rally but also some attendant risks and position technicals may be trumping longer term fundamentals. That's what I want to discuss in today's Caron's Corner because I think the technicals are actually quite important right now.

Let's start with the fundamentals. The question that we have to ask is, do the conditions that increase the likelihood of a soft landing keep inflation from falling durably to target levels, namely 2%, and keep it there? Getting inflation to 2% is not enough - getting it down to that level and **keeping it there** is really what the key is and we do think that there is risk to that. The good news is that asset prices may appreciate bad news in that this creates an easing of financial conditions that reduces the odds of inflation falling to target and actually staying there. This may be the making of a policy mistake because it may release a second round of effects of inflation and cause the Fed to hike more aggressively later. That's the key risk that we all have to be worried about. It's not in the near term, more down the road, that if we do get an easing of financial conditions and we get second round effects of inflation that could create more problems later. It may be better for policy to overshoot tightening to avoid this risk and that could be announced at the December meeting. But we'll see.

This also increases the risk of a recession sooner - but milder - than what we would otherwise have expected, something we detailed in past podcasts and we call the R.I.P. Cycle – Recession, Inflation and Policy risk. In summary, the more the Fed successfully fights inflation, the more they increase the likelihood of a recession nearer term. But if they don't successfully fight inflation, we don't get that recession near term. In that case maybe we get that recession later and it's a harder landing and that's really the key issue that we have to focus on.

Nevertheless, this sets the stage for the debate at the December meeting and it's going to start with this week's job support, followed by inflation data and then ultimately culminating with the Feds Policy decision, which is a debate between 50 and 75 basis points. We'll hear Powell speaking later this week and he may give us he may give us a hint on that as well. But ultimately, the Fed needs to pick its poison: tighter policy and a mild recession or an easing off with a near-term soft landing, followed by a resurgence of inflation that leads to even tighter policy and a deeper recession later.

The key here is that the market gets a vote on all of this too. Risky asset prices have rallied. Equities are higher and credit spreads are tighter because of the increased chance of a soft landing. And that's good news. Right? Well, not so fast because if we look at the yield curve, what we're seeing there is that it's inverted even further as those seeking a hedge against recession are bidding up the price of long-term bonds, higher-quality, longer-duration bonds that stand to benefit the most in a hard landing or recession scenario. So this actually casts doubt on the "good news" and that's why I say not so fast in the near term, though asset owners prevail because both bond performance and equity performance does well. It creates an asset reflation which ultimately eases financial conditions, but works counter to what the Fed is trying to achieve. Lowering inflation durably and a reacceleration of asset prices creates a hotter economy and likely leads to higher inflationary pressures, and that's actually the problem that we are faced with.

Inflation is falling and it's likely to keep falling in 2023 due to number of reasons. One, goods prices are falling. Two, the base effects of lowering of the year-over-year rate of price increases, but at the same time the jobs market, while slowing, will likely remain strong overall and this increases real wages (wages net of inflation) and keeps consumption high. If you want proof, look at October's surprisingly strong retail sales data. We think of this as the season of risk because all of this is starting to come to a head at this point and it's leading into the Fed meeting in December. Trying to time how a scenario for events will play out is very difficult, but it's useful to go through the exercise to prepare yourself for the potential risks.

If we do have a deeper recession based on a policy mistake, it will not like be realized until later in 2023 or even in 2024. This is because it seems likely at this point that the Fed is winding down its rate hiking cycle and may pause the terminal rate around 5% as per market pricing. And although there is some disagreement around that, where some see reaching 5.5% or higher, but that's certainly not the consensus, where 5% is actually is the consensus. The pause in policy rates will have the earmarks of a soft landing in 2023 and may usher in a risk-on sentiment. If this develops, we wouldn't want to fight it because it could push markets to higher price extremes given the current light positioning of risk. Perhaps this is already unfolding and it's what we're seeing, and it may actually bid up entry points to put these positions on in 2023. So if it turns out that inflation falls durably and there's no sign of a reacceleration of inflation and say job vacancies fall and wage inflation declines without causing the unemployment rate to spike? We can reference the Beveridge Curve and note what the Fed has pulled off. Never before have we seen soft landing with current initial conditions in place. But if it turns out that inflation does not fall durably and the Fed must keep policy rates higher for longer and even potentially restart a rate hiking cycle, well, we see that as the definition of a policy mistake in that scenario and this would have sharply negative impact on risky asset prices.

The important thing here is to balance these risks. The near term good feeling of risky asset prices doing better because of thoughts of a soft landing versus what might ultimately culminate into a harder landing later. Because if inflation doesn't fall durably, we have to balance the risk between a soft landing and a policy mistake that may dominate the narrative at some point next year. So we don't think that's a discussion for right now. We think it's a discussion for next year, but until then asset prices have the wind at their backs. We still advocate three years of duration as a sweet spot for diversified exposure of fixed income. We think three years is very appropriate and we like high quality and the recent surge in economic activity is likely to be seen in the fourth quarter. Just by looking at some of the earlier data readings will keep equity earnings higher than many had suspected previously. In fact, the sectoral leadership is clearly suggesting that a sharp drop in earnings is not imminent. If you look at Financials, Industrials and Materials, they're the best performing groups going back to November and October and within Financials, it's the Brokerages. If the economy was going too slow in Q1 or a wave of earnings resets were going to fall upon us, Brokerages wouldn't be leading. In fact, analysts keep pushing out their lower earning views into the future and they've been doing that all year long.

The bottom line is, don't fight the tape, the market's not wrong. But, positioning might be. That's the key here because we do think that risky assets have the wind at their back, especially if the Fed decides to slow. But the next question for next year is whether or not that turns into a policy mistake. We need to balance those risks. We're going to be discussing this theme and see how all of it unravels, even discussing how we may want to reposition a portfolio to address these risks in future editions of Caron's Corner. Thank you.

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