

### **Bucking the 2023 Consensus Expectations. But When?**

- Consensus expectations are that bonds will outperform equities in 2023.
- But, falling longer-term bond yields are inconsistent with the market's positive risk sentiment.
- This is a paradox as falling U.S. Treasury yields "sound the alarm" as a flight to safety, but tighter credit spreads i.e., lower default risks and buoyant equity prices reflect "no need for alarm!"
- This dilemma can play out as noise in the near term, but in the intermediate and longer term one asset ultimately wins and the other loses. But which ones?
- In other words, we expect long standing relationships, aka correlations, to reassert themselves... eventually. But when exactly? We must keep a close eye on that.

**Jim Caron:** This is the time of the year when we start to think about the next year in terms of asset performance. And one of the things that has been discussed a lot is that bonds are expected to perform better than equities in 2023. The question though, is will it be that easy?

Typically falling longer term bond yields are inconsistent with positive risk sentiment and we've seen risk sentiment improved as long term bond yields have fallen. So this is the dilemma for market risk because falling U.S. Treasury bond yields sound the alarm with a flight to safety while tighter credit spreads or lower default risk add buoyancy to equity prices as cash flows and earnings hold up well, no need for alarm. However, in the near term this can play out as noise, but intermediate and longer term one asset wins and the other loses, but which one? In other words, we expect longstanding relationships with correlations reassert themselves eventually. And this may ultimately be what upsets consensus expectations in 2023.

Let's get into it. The first thing I want to talk about is one form of market confusion and there's two of them. But this is the first one and I call it "Powell vs payrolls." Last week we got two important pieces of information that that were conflicting. The first one is that Powell spoke and signaled that the Fed would slow its pace of tightening. Note that slowing from 75 basis points to 50 basis points in December is not exactly dovish, but I suppose that would have been a risk on signal and that's essentially what happened as prices did well after that.

Now the second piece of data though, that conflicted that was that payroll data came in surprisingly strong above consensus at 263,000 and wage growth came in at 0.6% month over month in November and it led to a year over year acceleration to 5.1% wage growth from 4.9%. That's a move in the wrong direction. So therefore that signaled risk off. Now, labor force participation fell to 62.1% from 62.2% and that's still though 1.3% below pre-pandemic levels. So even though the labor force participation rate is falling, which really signals a tight labor market, what we're really starting to see is that wage pressures may remain sticky and that's the key takeaway. The path and the pace matter, both for the terminal policy rate, and as people like to say it's a destination, not the journey. Powell may slow the pace of tightening, but the terminal rate is yet to be determined. We still think a terminal Fed funds policy rate between 5 and 5.25% by first quarter, as that still seems like a logical range at the point.

The second aspect of market confusion is the yield curve versus equities. The Fed is still hiking rates, putting pressure on the front end while longer maturity bonds are falling, where for example, the 10-year yield is falling towards 3.5%. Now the inversion of the yield curve suggest that longer maturities are being bought as a hedge against recession risk. Perhaps this is also due to technical positioning factors that indicate most short duration benchmarks and a need for bond yields lower in order to get back to more neutral levels. In other words, like we discussed last week, technicals may be dominating prices more than fundamentals at the moment, but is the long end safe from higher terminal rate pricing? That's a key question right now and I think the answer is yes, but only to a degree. So let's take a deeper look at the yield curve.

I know it's common for most people to look at the 2-year, 10-year curve as a reference, but the curve the Fed looks at more closely is the spread between the 10-year and the 3-month T bill. That curve rarely gets inverted more than negative 75 basis points before reversing. Front-end rates may fall back and rise now currently around minus 65 to minus 70 basis points. The risk is that we may exceed this minus 75 basis point area for a short while this time around. The 3-month / 10-year curve may remain historically very inverted, could even invert a little bit further, but history suggests not for long. It's then important to connect the yield curve to risky assets, namely equities and credit. The information I derive is that if this curve keeps inverting and that signals risk off and I know many people are debating whether or not it makes sense for bond yields to keep falling. But I think the bigger question maybe what is driving yields lower like recession risk for example, is ultimately a negative for riskier assets like credit and equities. For instance, if the driver of lower bond yields is due to falling inflation at the hands of collapse and growth and earnings, then surely this can't be a positive for risky assets. To me, lower yields and more inverted curves indicate the Fed is trying to crush financial asset prices to tighten financial conditions in order to bring down wage inflation and ultimately overall inflation more durably, which means to bring inflation down and keep it down around its target levels.

This is all true, but we can't forget to question if the well anticipated recession is already in the price. Can we have our cake and eat it too? In other words, in terms of returns, can't bonds and stocks correlate positively? After all, they correlated negatively in 2022. So maybe a positive correlation of bond performance and equity performance for a period of time is just payback from what we saw in 2022. Yes, over the near term, we can see technical and positioning factors create conditions for longer maturity bond yields to fall while risky assets rally. This can go on for a while until the technicals are sorted out. But eventually an inverted curve induced by Fed policy hikes will tighten financial conditions and riskier assets may suffer. In the meantime, technical forces should not be underestimated the all-in yield for instance, for credit assets is still high. Despite the recent tightening of credit spreads, it will attract buyers and spreads could move even to more extreme levels. In an environment where we get slower growth in a mild recession, which is our base case, then this actually bodes well for both assets. Well at least for now, equity assets may benefit from technicals, but a slowdown in growth in a mild recession, while it may put downward pressure on prices near term, eventually it suggests that one may look to buy the dip and add risk once all of these assets are more properly priced in in 2023.

What we're starting to think about is bucking the 2023 consensus eventually. This is something that we want to be a little bit patient with but we also want to try to understand the dynamics and inter relationship between bonds and equities and credit spreads and riskier assets alike to make sure that

we're getting it right. Is the 2023 consensus correct to suggest that bond performance has a tailwind while equity performance has a headwind? This may be true in the early stages of 2023 as inflation is likely to keep falling. The Fed may end its rate hiking cycle in the event of a soft landing, and then the opposite is true. Equities may overtake bonds but probably down the road and clearly, this is a very difficult thing to forecast with precision, but this is where valuations and what's priced in matters a lot.

Again, focusing on what's already priced in, and putting it all together, we still like holding fixed income in a portfolio with an average duration of around three years. We've discussed that for a long time. But some riskier assets including select equity sectors and emerging markets are already priced for recession, and if it turns out the landing is not so hard, then some of these assets are poised to perform very well. That actually may be the story for 2023 - and we don't want to miss that.

As we discussed last week, it all come down to inflation and the risk for a Fed policy error. If inflation reaccelerates later in 2023 and the Fed has to restart its hiking cycle, then all bets are off. The Fed needs to be successful at bringing inflation down and keeping it down and preventing a reacceleration of inflation because that would cause them to restart their hiking cycle, devastating to risky assets, which makes a balanced and well diversified approach to a risk adjusted portfolio a key for 2023 as we see it. It may not hurt to be patient and buck the consensus expectations in the new year, but as I like to say, eventually. This won't be a beginning of the year theme, but it's something that we may want to start to construct portfolios to try to capture because the reward to risk characteristics seem very favorable.

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