

Red Light, Green Light, Yellow Light: Risks and Fat-Tails in 2023.

- There are many competing narratives for 2023, many of them with great merit.
- A lot is at stake, more than just the oversimplified commentaries about falling inflation, a Fed “pivot, and the possibility of a soft landing.
- In fact, I believe there is a real fat-tailed risk lurking in 2023 that many underestimate and is not currently priced in the market. This is most worrisome to me, a red-light risk.
- But there is also a fat-tail on the other side of the probability distribution that would likely result in very positive asset performance, a green-light risk.
- And, there is a yellow-light risk as well, all discussed in the podcast.

Jim Caron: Much of the narrative right now is surrounding whether or not we have a soft or hard landing and what the Fed does and inflation does. Look, I think these are risks that we need to consider. But I do think that there are two very fat-tailed risks that are out there and there's also a third risk that I'd like to get into in a bit more detail.

There are many competing narratives for 2023, many of them with great merit. There's a lot at stake and I think more than just the oversimplified commentary that encompasses falling inflation, the Fed pivot and soft landing possibilities. In fact, there's a real fat-tail risk lurking in 2023, that many seem to underestimate and I don't think is properly priced into the market. And this is what worries me most because this is the negative risk that's out there. But there's also a fat-tail on the other side of the probability distribution that would result in a very positive asset performance in 2023. And that needs to be addressed to and it's worrisome for asset managers because, you know, look after the weak performance in 2022, one doesn't want to miss out on possible upside to recoup those losses, which is why I categorize this as a risk. In this podcast, I'm going to discuss both fat-tail risks and the third risk.

I'm going to use the traffic light analogy here, which is red light, yellow light, green light and I'm going to start with the red light risk and this is the negative risk scenario that I see in the market. This scenario likely comes in the second half of 2023 which is where the market may come to believe that inflation, while having declined, may not be anchored and is at the risk of re accelerating. I think the big risk is that inflation comes down, but doesn't stay down, and reaccelerates higher. This would force the Fed to restart their hiking cycle from a high base of around 5.25, which is where we think the Fed will end based on what the Fed told us at their December meeting. So that would be, you know, problematic for the market. Importantly, this is not priced by Fed funds futures that show a pivot toward lower policy rates by the end of 2023 and it certainly counters the Fed's forecast or forecasted path of policy rates heading lower. This is why it's a fat-tail risk and would cause asset prices to reprice in a dramatic fashion lower.

A couple of things that could happen. Credit spreads could widen and default risks not only pick up, but start to actually materialize, which causes default risks to rise even more and so on and this becomes a

vicious cycle. Additionally, floating rate assets related to credit may not offer much of any hedge because losses from credit deterioration may outweigh gains from rates floating higher. That's another important factor to consider; longer-duration equity exposure. This is mainly in the growth sectors that tend to dominate the index level performance. Other assets could come under great pressure. Higher quality, longer duration interest rate products like US Treasuries, which are supposed to be a safe haven. Investment grade, and high-quality could also see performance erode as rates move higher. Just look at what happened in 2022. High quality short-duration may be one of the places that is the most attractive in an environment like this. So in summary, a repeat of 2022, but this time credit comes under more stress, which again would be very problematic. What's worse, this may come after a positive first half of 2023 scenario that lures people into increased risk allocations as they may chase performance.

Now let's talk about this more positive scenario which I'm going to call the green light. This scenario is more likely to come in the first half of 2023 and the reason is because, point number one, inflation is likely to peak at some point in the first quarter, on a more global basis, I think it's already peaked in the US, but I think it's going to be peaking more globally sometime in the first quarter. The second point is that central banks have seemingly ended their tightening cycles. Again, this could all happen in the first quarter of 2023 and the US dollar may stop rising and look, you know, as we've talked about before, softening US dollar is positive for global risk factors. The fact that the dollar stops going up could be, you know, another positive that's out there (point 3). The fourth is the potential for China reopening may start to become priced into the markets and start to get priced through. If the pandemic, covid situations get better and China is certainly trying to stimulate the economy. If that all starts to hit in the first half of next year, these could all be positive tailwinds for risk. And judging by the flow data that we've seen in 2022 it doesn't appear that many investors are positioned for surging inflows into riskier assets and this may cause them to chase performance and push valuations to even higher extremes. That's something else to watch out for.

Note also that there is a consensus view for earnings to decline in the first half of the year. Much of that is already well socialized and is very likely already in today's price. But probably not all of it. There is ample room for credit spreads, which have narrowed, but they could narrow even further in 2023, particularly in the first half across investment grade and high yield sectors and even floating rate credit-related assets. This is the kind of performance that bond investors in particular will not want to miss. So suffice it to say that sometimes too much of a good thing is not good because we may end up with extreme positive valuations and while that might be viewed as good news because prices go up, it also creates for bad entry point for risk which then creates another vulnerability and could lead to disruptive unwinds if conditions deteriorate in the second half. The question is, is there any middle ground and I think there is, and this is the third component that I want to talk about.

As you know, a probability distribution typically comes in three pieces, two tails and the middle. I'm going to call the middle the yellow light and this is where I think there can be some middle ground, but it may be volatile, and that's really the key message here. This is the soft or not so hard landing scenario. In this scenario inflation moves to a 3.5% level, which is what the Fed forecasted last week. This would be good news, although you know, there may be more work to do. The Fed may see that a 5–5.25 policy rate, and holding it there for a period of time, is sufficient. It may even start to look towards easing in 2024 again, this is all as per the Fed's forecast. So let's just take them at their word. Now. This is not

exactly a pivot, well, it's more of a rounding talk, but you know, let's take the win and let's not get too much into that. So the fact that inflation may be coming down and the Fed may stop hiking and may even start pricing some rate cuts, you know, could be a positive that is stimulative for asset prices. We could even see the U.S. dollar stabilize and begin drifting lower. Additionally, if we get the earnings correction in equity prices base and then prepare to regain upward momentum, this would also be a positive and bonds could perform well in this scenario, especially riskier credit sectors that were not quite priced for this. This is all a real possibility, but it comes at a cost, and the cost is that it's not likely to be obvious, even though this middle ground scenario seems to be a negotiated truce between the red light and the green light scenarios. It may not be obvious and I think it comes with higher volatility. If it were obvious then it would just be in the green light scenario by definition, but what is being described here is a shorter and fatter distribution with two fat tails.

I'm going to get a little bit mathematical here because whenever you have a short fat distribution with two fat tails um you get a wider standard deviation. The distribution tends to be bigger in that sense. If you have a higher standard deviation, another way to say that is that you have higher volatility mathematically. That's correct. So, short in fact distribution to have higher volatility. So again, while we may end up here in this yellow light scenario, it may not be obvious. So thinking about these two fat tails and a very wide distribution in the middle is really more of a volatile type of an environment that we may be heading into.

The next question then is how do we invest for this potentially red, yellow and green light scenarios? The key takeaway is that each of these scenarios have reasonable probabilities of occurring and they need to be accounted for and hedged. It's not just about the U.S. and the Fed and central bank policies, but it's also about global factors that include oil, energy, China, Russia, Ukraine, to name just a few. In bonds, we still like the three-year average duration point on the curve for a fixed income portfolio. It's the not too long, not too short level of duration and we've talked about before and this plays well across all three scenarios on a probability weighted basis. The higher credit quality in this short duration space is also very much encouraged and note today risk free rates are higher and this will actually compete with equity as well. So if we get policy rates upwards of 4, even into the 5% level, the risk free policy rates are starting to get more attractive and actually compete with other riskier assets. Across equity markets we broadly think the value sectors may have the best risk-adjusted returns and that's a phrase, you're going to hear me say a lot. Risk-adjusted returns. But we need to recognize just how much the growth sectors have devalued in 2022 and could sharply rebound in a lower rate environment, which may occur in the first half of 2023.

So in summary, we do need to think about balancing portfolio allocations globally to achieve better risk-adjusted returns, and this comes through a disciplined balance of risks when constructing a portfolio. I believe that we are entering into a secular period of thinking about risk-adjusted returns and this is something I'm going to speak on regularly going forward and for the foreseeable future. Essentially diversifying a portfolio is going to be of the utmost important going forward. We went through a period over the past decade or so, not including 2022, where being overweight in the growth sector did very, very well for performance, but going forward, I think returns may become more balanced. Therefore having a portfolio that is well-diversified, well-balanced and trying to optimize risk-adjusted returns is the way we should think about constructing portfolios for the current environment.

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CRC 5355151 Exp. 12/31/2023