Caron's Corner Transcript – 4.24.2023

An Economy: Shaken, Not Stirred

- James Bond most famously ordered his martini "shaken, not stirred." But why?
- Well, shaking creates aeration, making the martini smoother and more complex; stirring does not have the same effect.
- Make no mistake, the smoother martini is still potent, but much softer on the palate.
- In my mind today's market might "taste smooth," but is nonetheless potent and comes with risks.
- The question we have to ask is why aren't asset prices responding to these risks? We discuss in today's audiocast.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. An economy, shaken not stirred. We all know the famous movie line, a medium dry vodka martini shaken, not stirred. It's one of the most recognizable movie lines and we all know it's how James Bond liked his cocktail. But why shaken, not stirred? Well, because when any cocktail is shaken, it becomes aerated. Stirring does not have that effect. The aeration is what makes what would otherwise be a strong drink tastes smoother and allows for complex flavors to become infused. Make no mistake, it's still a potent drink, but not as hard and softer on the palate. The analogy I'm trying to make is comparing today's economy to a deceptively stiff drink, one that tastes smooth but is nonetheless potent and comes with risks. If this is the case, then why aren't asset prices responding to these risks?

What we're going to discuss is shaking the data points, not stirring them. The dangers of an economic slowdown are apparent and many data points, along with their historical relationships, now consume the consensus narrative as potent ingredients for a recession and a substantial drop in earnings. However, these potent ingredients are shaken together and not stirred with other data points, such as tight labor markets and wages, a buoyant service sector and a much stronger than expected first quarter 2023 GDP. This positive momentum from the first quarter with nominal growth running somewhere around or above 7% creates a buffer. There a few more data points to consider. For example, China posted double-digit annualized Q1 GDP which is coming in above 4% percent on the first quarter, Q-over-Q. This makes their 5% growth target for 2023 more of a certainty unless we get a bad sequential growth from Q2 to Q4 of 2023 that is weaker than the Q4 2022 run when COVID was spiking and there was talk of lockdowns etc. This week, U.S. GDP may follow suit with a stronger above 2%, maybe 2.5% or even higher, annualized print for the first quarter. Manufacturing and service PMIs have been surprising to the upside as well. Even western Europe, despite the ECB rate hikes, may post a gain that's above 1% in Q4. As a result, global GDP is on track to rise above 4% on an annualized rate in Q1 of 2023. For context, this level of growth represents strong quarterly gains typically seen only in a recovery period when coming out of recession. So maybe softer and smoother, but the risks are still there. Let's talk about that.

Make no mistake the risks to the economy still exist, but the risk distribution may be may be smoother than acute. Without an acute shock that correlates risks together, a slowing economy may take more time to manifest - and time is not the friend to the bears. No, it's their enemy. This is because the possibility for a smoother distribution of the potency of the risks may mean there's more time on the clock for investors to adjust positions. This could also mean that default risks for credit related assets are lower or come in lower. The time value of money works against those who stayed out of the markets, although today, cash actually does have some yield and some benefits, but there are many missed opportunities to own value assets at a discount. To be sure, economic conditions are weakening and the lagged effects of rate hikes will take will take a bite out of things. For example, last week’s jobless claims in the U.S. ticked up 245,000, a sharp rise, and this time we can't blame seasonals or technical adjustment factors. Wage growth is losing steam which does put consumption at risk and GDP growth as well. Cash flows, profit margins and earnings at risk. That's the waterfall of risks, something we have to be worried about. Much of the positive effects from the reopening of China in Q1 are now largely behind us. The remaining quarters of the year will be more difficult for China. Germany, the engine of growth in Europe, is sluggish especially after a weak Q4 2022 run of GDP. They're at risk of slipping into a technical recession, potentially on softer Q1 GDP results.

So what do we do with this information? How do we think about our asset allocation around this? Well, our base case remains that economic conditions are forming a rounding bottom, not an acute shock or sudden stop in activity. Fixed income and carry is attractive. We like investment grade (IG) quality risk but we prefer to manufacture it by bar-belling high yield assets alongside high quality short duration assets and cash in combination. This creates an IG exposure but with lower duration - and reducing interest rate exposure is an important point for us in our portfolios.

Speaking about the interest rate cycle, we think the Fed reaches a peak terminal rate of 5.25% and tries to stay there all year long, unless something materially large occurs and they're forced to cut rates. In this sense, we disagree with market pricing. But, as stated many times before, we understand that forward rate pricing for Fed cuts comes more from the risk distribution effects of being late in the tightening phase of policy, and reflective of the probability that if rates moved faster and by more in any direction, then it would be lower. This means the distribution is skewed towards lower rates and that's why the forward rates are where they are. So we're not disagreeing with the pricing necessarily, we understand it, but we do think the Fed wants to stay on hold for the entire year unless something major happens. But, since it's already in the price, we believe there's more value to have asymmetric exposure to the right tail events, which is where the worst doesn't manifest itself. And we do push back against the Fed potentially not having to cut rates at least for another 12 to 14 months. In equities we can extend this further to owning small and mid-cap sectors that may benefit from a right tail event where better things can happen, or at least the worst outcome does not occur. We still like large cap value and dividend instruments to earn income.

Keeping on the theme of a stiff drink, a wise person once said one martini may not be enough, but three is definitely too many. Perhaps the market knows how to manage these risks responsibly, but you know how we feel – it’s better to be balanced than defensive and apply risk controls to one's portfolio.

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