

The Markets Have Been Disappointing to the Upside, Presenting a Unique Set of Risks

- Markets certainly have a way of surprising and upsetting the consensus.
- Hence our guiding principle “It’s better to be balanced than defensive.”
- To us, being defensive is a style decision, whereas being balanced is focused on asset allocation decisions.
- So why is it better to be balanced than defensive? Well we believe diversified and balanced asset allocation decisions are more likely to succeed in a greater number of market scenarios, as opposed to trying to guess a specific market outcome.
- But is a balanced approach right for today’s markets? We think yes, because the risks in the market are more balanced than the consensus bearish narrative.
- Remember, as we have iterated since late last year, “risk-on is a risk” and like any other risk, needs to be hedged.

Jim Caron: Hello, everyone. This is Jim Caron, Co-CIO of Global Balanced and Risk Control Strategies.

The markets have been disappointing to the upside and this presents a unique set of risks. Certainly, markets have a way of surprising us and upsetting the consensus, nevertheless, as investors, we still need to find a find risk, asymmetries and opportunities. Something we said all year was that risks are more balanced and that “risk-on is a risk,” and like any other risk needs to be hedged. This is why we've used the tagline all year that “it's better to be balanced than defensive.”

Here's what we mean by that. The difference between balanced and defensive is that defensive is a style decision whereas seeking balance is an asset allocation decision. So why is it better to be balanced than defensive? Because we believe asset allocation decisions that are well diversified and balanced are more likely to succeed in a greater number of market scenarios, compared to just trying to guess a specific market outcome. Say for example, an outcome that's more bearish, then trying to pick an investment style to match one's forecast - and we all know forecasts are exceedingly difficult to make consistently correct over time. So is this appropriate advice for today's markets? Well, we think it is and the reason is because we believe the risks in the market, both to the up- and downside, are more balanced than what the consensus bearish narrative might have one currently think. I'll say it again, risk-on is a risk and like any other risk that needs to be hedged.

Anyway, let's try to make some sense out of the markets today. Since the beginning of the year, the consensus in the market has been bearish calls for a recession and equity price declines led by earnings. The surprise has not been that calls for a weakening economy have been wrong. The economy has weakened and the data is not great. The surprise has been that the weakening was not nearly as bad as feared. On balance, and this is a positive surprise. This is the delta and sometimes it's the delta that matters. Let's take a look at some data. GDP came in surprisingly strong and the Atlanta Fed GDP

Nowcast survey is tracking Q2 GDP at close to 3%, about 2.9%. This is a lot stronger than projected and clearly it could be revised lower over time. But right now it's tracking pretty strong. The Q1 earnings growth rate was expected to be a whopping minus 7% on a year-over-year basis and it came in closer to minus 3% which is by no means good, but a lot better than what was originally feared. Q2 earnings growth rates were expected to track around minus 6.8% but now seems on track to disappoint to the upside. Consensus earning expectations around \$220 for this year appear more reasonable than the more bearishly feared sub \$200 calls. One-year forward PE multiples are tracking somewhere around 18 to 18.3, seemingly looking through the first half of 2023 expected weakness, more focused on a recovery in the second half of 2023 into 2024.

Now let's turn to bonds. Bond yields have also priced in a harder landing, but seem recently to be backing off given the recent rise in yields. But yields are still low and below the Fed funds rate and the expectations are still firmly for rate cuts over the next 12 months. But we also have to keep in mind that while credit spreads are not tight, they're not that wide either. So all-in yield seems attractive if one can get themselves to believe we will not see a hard landing. Beyond that, if we get a less hard or soft landing - or even no landing at all - then default risk premiums and spread product will compensate you for that risk. As such, we prefer only credit risk rather than interest rate risk. Given our view that rates markets are more aggressively priced, for a worse economic outcome, they may ultimately be delivered.

We should also note that despite the decent market performance year to date, the market is NOT the economy. The economy is slowing, albeit less than feared, and I want to make that point very clear. The economy is slowing and the market is not the economy. Equity returns are positive but "never before has so much been owed to so few" as Winston Churchill once famously said. What I'm really referring to is that only a handful of tech stocks are responsible for most of the equity gains this year. If we look at the sectors of the S&P 500, Tech is up about 25% and a distant second are Industrials and Consumer Discretionary, both up somewhere between 1 and 3%. Every other sector of the market is down, meaning that this is not a wide-breadth positive market. It's really one sector doing all the work.

So will the Fed hike in June? Our base case is no, and it's tempting to talk about this, but we think there are simply too many unknowns still out there. With the fallout from the recent stress with small banks and the legacy of 500 basis points of rate hikes, this is really just keeping in mind that the Fed is more likely to pause than to keep hiking.

What people aren't speaking about yet is the debt ceiling. This is the topic of the day and really for the next couple of weeks. But you know, while it's near-term good news that it seems like we're making progress towards a debt ceiling agreement, we need also ask what an agreement looks like and what the potential fallout may be. Yes, that's right, the fallout to an agreement. The fallout to an agreement on the debt ceiling is a tightening of fiscal policy that will run concurrent with previous monetary policy tightening. Note that many of the future US government debt obligations are based on COVID-related stimulus of the American Rescue Plan, the infrastructure plan, that has not yet been spent. A potential agreement from Biden to not spend money that has not yet been spent will amount to an additional or an unaccounted for tightening of fiscal policy. Look, this is an inconvenient truth for the Biden administration. Many independent economic groups such as Penn/Wharton have shown that the

stimulus plans really amounted to very little stimulus at all in terms of GDP growth. It might only amount to 0 - 0.1% of GDP growth over the next several years, so even though these stimulus plans were intending to create stimulus, there might in fact be a tightening of fiscal policy. There really wasn't a lot of fiscal growth or potential GDP growth from these fiscal spends in the first place.

The key point here is that there is a risk that the market narrative shifts to fiscal tightening as opposed to just monetary policy tightening. But now fiscal and monetary tightening coupled with a slowing economic data or negative sentiment, which could gain momentum, this could become a tactical risk for the market post the debt ceiling deal. Nobody is talking about this yet. Yes, everybody is talking about getting the deal done, but what happens after the deal? People are going to start talking about fiscal tightening and this becomes somewhat confusing and I think this is going to be a bit of headwind and negative. Of course the bigger risk to markets is if no agreement is made, but that's just not our base case. We think an agreement will get done, but the point here is that we're going to be talking about fiscal tightening thereafter. The risks are balanced, probably more balanced than what the markets think. We had a pretty strong run to the upside and it may be time to be a little bit cautious at this point.

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