Caron's Corner Transcript – 8.28.2023

A Hawkish Hold? Our Asset Allocation Decisions Amid Cloudy Skies

- The much awaited comments from Fed Chair Jay Powell at Jackson Hole came and went with no new information.
- Predictably, the Fed remains vigilant on fighting inflation and maintains its elusive 2% target.
- So what changed? Well, his message was more hawkish, acknowledging that while policy is restrictive it remains uncertain if it's sufficiently high enough.
- The risk distribution of this uncertainty is skewed towards holding or further rate hikes, not cuts. We interpret this as a **Hawkish Hold**.
- In this audiocast we discuss what this means for our asset allocation decisions where, in the end, we prefer buying weakness than selling rallies.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. A Hawkish Hold and our asset allocation decisions amid cloudy skies. The much awaited comments from Fed Chair Powell at Jackson Hole came and went with no new information. Predictably, the fed remains vigilant on fighting inflation and maintains its elusive 2% target. So what's changed? Well, he packaged this message differently. He was more hawkish. He acknowledged that policy is in restrictive territory but remains uncertain if it's sufficiently high enough as a result. He's not thinking about cutting, but instead of hiking more if needed. We call this a policy reaction function and our hawkish interpretation stems from the Fed's uncertainty of this function. As a result, the risk distribution of this uncertainty is one-sided, skewing toward holding or future hikes, not cuts. We interpret this as a Hawkish Hold, hence the title. But what measurement in their policy reaction function should we watch - and what does this mean for our asset allocation decisions? Let's get into it.

So "navigating by the stars under cloudy skies" is a direct quote from Powell's concluding paragraph in his speech last week. So let's talk about defining the uncertainty. With this quote from his concluding paragraph, Powell tells most of the story. He is playing on the concept of r* (aka R-star) which is economist speak for the theoretical neutral policy rate that balances full employment/economic health with stable prices or target inflation. He flat out stated that the Fed is not really sure what the r* level is, or what it should be. Yes, it's higher than average today, but given the still strong labor market and still easy financial conditions, r* may not be high enough, and they are prepared to hike further.

Let's put some numbers to this. The Fed policy rate today is 5.5% and headline PCE inflation is 3.3% which suggests that the real policy rate, the policy rate minus inflation, is 2.2%. Now the Fed's models still indicate that the stable real policy rate for r* is modeled to be just 50 basis points. Today it's 2.2% and therefore 170 basis points over the modeled neutral policy rate. So yes, as Powell said, policy rates are restrictive, but that doesn't answer whether they are they restrictive enough to bring inflation to target and keep it anchored there? Powell is uncertain about this and he sees the risk skewed to further policy rate hikes to ensure inflation remains anchored near target. This is the key takeaway. Bottom line here is, as I commented last week, Powell is more focused now on containing inflation than preventing a recession. This is the veiled message that I thought he'd deliver and as I see it, he did just that.

So let's think about our asset allocation decisions amid these cloudy skies. The market is pricing that over the next two Fed meetings there will be no hike in September and about a 50/50 chance of a rate hike in November, and I tend to agree. That said we seem a long way away from the cuts in the first half of 2024 that many are expecting. So what gets us to the promised land? Let's look at some economic data points. Labor conditions need to weaken, the unemployment rate needs to rise and consumption needs to be reduced. But this may be a slow process because as inflation falls, real wages actually rise. Remember, people are paid a nominal dollars and the recently received wage increases are unlikely to fall. Instead, they're likely to grow, just more slowly. The promised land may be further away because the consumer might be more resilient.

Now, this argues for policy rates to stay higher for longer and fall by less when the Fed starts cutting. With respect to bonds, longer duration bond yields may not fall as much as one might think, especially as inflation declines seem tenuous. Term premia is still too low. If we take a look at 10-year TIPS (Treasury Inflation-Protected Securities) real yields, reflecting the average of headline inflation over 10 years, it sits at about 1.9% today. This is based on Bloomberg data as of the Friday (8/25) close and is probably too low of a rate if you ask me. We still like owning shorter duration assets with an average duration of about three years, but achieving that by owning some front-end duration and some longer-term index level duration that we average down to three years. This is a barbell type strategy which we have referenced many times before. Now credit spreads may come under pressure, but we do not expect a blowout rise in default rates. A technical reason supporting this is the lower than average dollar price that bonds are already trading at. This is somewhat of a technical reason, but it's an important technical. And yes, we still like owning high yield and credit exposure.

On to equities. As economic conditions slow and the labor market moves towards normalizing, we will likely see pressure on margins and valuations. If we look back, companies had a free ride to raise prices at will in order to maintain margins. Well, no more. In order to keep the volume of sales up, they will need to discount prices and this will put pressure on margins and earnings. BUT if we take a look at the first and second quarters of this year, the earnings drops reflected this risk. The third quarter is looking closer to flat in terms of earnings growth, but it may also be pressured lower. Sequentially, earnings growth rates are expected to be better, NOT worse.

Investors may be attracted to buying this inflection point. If we see the earnings decline in the 1st and 2nd quarters bottom out in the 3rd and possibly start to rise in the 4^{th}, well this could be a positive, maybe even rising to 2024. Time will tell, but as we have said before, it's very economic and data dependent. We do expect a slowdown and a mild recession, but the markets may be willing to look through this. It's important to note that the S&P 500 P/E (Price/Earnings) multiple is currently about 20. But if we subtract out the 7 big stocks that are bolstering the multiple, the P/E is around 15. As a result, we like holding the value sectors because they are priced to reflect a slowdown when compared to growth. Having said that, we still like owning growth, but want to pick our spots. It is worth repeating that a lot of the S&P 500 valuation comes from very few stocks. So if we own the breadth, the broader value sector, we might be better off. Now small cap stocks may struggle initially as large caps have more pricing power during a margin squeeze, but we still like having some exposure to small caps because the upside could be significant.

Overall we think we are taking a hard walk towards a soft landing. Conditions are slowing - but not collapsing - and speed matters. Those betting against the market need to be right – and quickly right -= because it's costly to be short. In addition, market positioning is still skewed towards safety versus risk and as a result, we see the asymmetric outcomes as higher, not lower, in markets. However, we do respect the fact the market is in need of a correction.

Putting it all together, we prefer buying weakness than selling rallies.

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