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The R-Stars Align for Higher Dots: Allocating Global Assets Accordingly

- Stubbornly high inflation just keeps getting in the way. The r-star and dots refer to the U.S. Fed, but the analogy includes the ECB and BOE as well.
- Decisions should have been obvious for global central banks by now – that both the level and growth rate of inflation would be low and slow enough for a pause – but this has just not been the case.
- Complexity is now added to the soft-landing playbook, in which the potential for slow economic growth would be followed by rate cuts designed to spur recovery. . .que sera, sera.
- But it just may not be that easy. And maybe that playbook is wrong.
- So, what does this mean for creating a global asset allocation? We discuss in this audiocast.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. The R-stars aligned for higher dots. So what do we do about global asset allocation? Where are the opportunities? Where are the interesting places to invest? Well, the first thing that we have to get into is that stubbornly high inflation just keeps getting in the way. The R-star and the dots refer to the U.S. Fed, but the analogy also includes the ECB and the Bank of England which also have upcoming policy meetings. The decision should have been obvious for global central banks by now - that both the level and the growth rate of inflation would be low and slow enough for a pause - but it's just not the case. This adds complexity to the soft landing playbook in which the potential for a slow economic growth would be followed by rate cuts to spur recovery, *que sera, sera*. It just may not be that easy and maybe that playbook is wrong. So what does this mean for creating a global asset allocation? Let's get into it.

The first thing I want to discuss is understanding that the is a difference between "taking the fight to inflation" and "fighting inflation." The difference is that the former is more proactive, the latter more reactive for each central bank. Despite claiming to be proactive, what will matter more is how structurally robust or rigid their economies are **perceived** to be. Let me say that one more time because it's really the emphasis of this audiocast: what will matter more is how structurally robust or rigid their economies are **perceived** to be. Let's start with the U.S. which I think is the most robust economy. Inflation is absolutely going the wrong way. The Cleveland Fed now forecasts headline month-over-month inflation in August to be released this week at 0.8%. The Bloomberg consensus is 0.6%. The bottom line though, is that either number is still way too high. Sure, such a rise may come down to technicals, like surging gasoline prices, but it's still a cause for concern. The Fed was hoping for month-over-month inflation to run on average around 0.2% between now and the end of the year to meet their target. This is why a number that's well above 0.2%, whether 0.6% or 0.8% or whatever, anything above 0.2% is a problem. On top of that wages may be cooling, but not fast enough. If we look at the recent unit labor costs released last week, they're running at about a 6% gain quarter-over-quarter, annualized. However, the one thing I'll say about the U.S. economy is that this is matched by robust growth, an important distinction to make. Third quarter GDP estimates are being upgraded by forecasters - not

downgraded - but upgraded by forecasters, to levels around 3%. In fact, the Atlanta Fed forecasting is tracking somewhere close to 5.6%.

Now let's turn to the Bank of England and the UK economy. They meet next week, same as the Fed, and they have their own unique set of problems. Inflation is still way too high for comfort and growth is just not keeping up. Furthermore, higher interest rates will place pressure on consumption as mortgage rates reset higher, which is a headwind to say the least. Turning to the ECB this week, I would say the Eurozone is the least robust set of economies and they are the most structurally rigid. Recession risks are accelerating but inflation remains way too high. Yes, inflation is falling, but Europe is the most structurally rigid of the three having the least robust and most structurally rigid economy. The ECB has the highest stakes to not only lower inflation, but to also keep it anchored. The pressure is really on them to get this right, more so than any other central bank. And they cannot rely on higher growth to offset today's need to fight inflation, like in the U.S. and possibly the UK. Economic robustness and rigidities play a major role in how assets may perform in each region, and our asset allocation decisions are informed by this.

We do have a constructive outlook, but to be fair, it's increasingly becoming fragile in the U.S. It's hard to think about a recession when third quarter growth is accelerating, but at the same time, it's hard to believe that rate hikes will not ultimately take their toll. At the September 20 Fed meeting we may see higher dots from the dot plot. That's right, higher dots from the dot plot and a November hike is still a possibility. Now the markets are pricing that the Fed hikes rates in November at about a one-third probability. Personally, I think it's closer to 50/50. They may pause in September, but I think that that the possibility of a rate hike in November is more than appreciated by markets and a near-term headwind to U.S. equity prices, especially if we see a deceleration in 4th quarter growth, which is widely expected. But as we stated before, we think a recession that comes sooner rather than later is good news. Why? Because the market is more likely to look through a near term rough patch versus a later slowdown that has more time for excesses to build and actually risks a harder landing. As such, we remain slightly overweight U.S. equities with a tilt to the broader value sector, primarily because the U.S. is structurally more robust and can better handle policy actions and adjust better to inflation. On the flipside, we are underweight European equities because of the structural rigidities and that make it more difficult to withstand inflation and ECB policy actions. For the UK markets we remain cautious, but feel the Bank of England will remain aggressive with policy. That's a little bit of a moment of pause for us here and I guess we'll get more information during the next week and a half. Although we did not mention Japan, we really haven't changed our outlook here. We are overweight Japanese equities, for reasons I've mentioned in previous audiocasts: better growth and inflation dynamics, still easy policy. The Bank of Japan is focused on growth and certainly Japan is likely to be a winner from the geopolitical tensions between the U.S. and China.

Looking at fixed income, there's really nothing much to see here. Yes, it's an interesting market but a market that has been in a range, and I suspect that's going to continue. In the U.S. the Fed is likely to be in a higher-for-longer posture. They likely hike in November, probably not in September. The 10-year treasury yields are likely to remain in a range. We think the yield curve will likely steepen because there is still an inflation impulse that's out there in the markets and the term premia is too low. We still target

three years of duration in a fixed income portfolio, and again, we like to get there with a barbell approach: owning some front-end cash money markets and short duration on one side, then higher quality, longer duration - even some high yield - averaging to three years. For the UK and Euro bond markets we again still see yields in a range. We are going to learn more in terms of the central bank policies, but will remain very much range bound. We are cautiously optimistic on credit. Yes, default risks may rise but the rise may likely be manageable based on our softer landing outlook.

So here we are. We do have a softer landing view, but it doesn't mean we avoid recession or feel some choppiness over the next couple of months into the end of the year. We do think, however, that global manufacturing still has some room to move higher. The service sectors are certainly are doing reasonably well. It's not an obvious call to make, but we are still optimistic and positioned accordingly. Just be mindful of the different central banks and the difference in structural rigidities and robustness of each economy, because that's how we're making our asset allocation decisions.

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