Caron's Corner Transcript – 9.20.2023

FOMC Recap: A Hawkish Fed - Good for Inflation but Bad for Markets?

- The Fed did not move policy rates, staying in the 5.25 - 5.50% range.
- Core inflation is still elevated and has yet to fall materially.
- The risk is that inflation becomes unanchored later, so the thought is they might as well break its back now.
- Their risk assessment might be that a recession sooner will likely be milder than one later, which they expect to be harder. We agree with this.
- The way we measure today's policy meeting is by evaluating what they communicated about their future policy actions, discussed in this audiocast.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Here we are with another Fed meeting in the books. And what was the goal of today's meeting? Well, it was to keep the threat of raising rates alive. The Fed decision was well anticipated, with no move in policy rates, as 5.25 - 5.50% remains the range. Now the way that we measure today's policy meeting is really by evaluating what they communicated about future policy actions, what they might do in the November and December meetings and also going into 2024. In other words, what was at stake for the Fed at today's meeting?

Well, it was to set market expectations for a possible move if needed at the November meeting. The market was pricing about 33% possibility of a rate hike in November and in my opinion the goal for the Fed was to move it closer to a 50/50 possibility. Mission accomplished! They also wanted to communicate this by "raising the dots." This was the other thing that I think they needed to do and they did exactly that, as the November meeting is now a live meeting. That's what we learned from the Fed press conference and their statement. Again, mission accomplished and by the way, they have justification for doing this. First, supercore inflation (reflecting inflation for goods and services, excluding energy, food and housing) is still elevated and has yet to fall materially. Second, there is a risk that inflation becomes unanchored, so the Fed feels they might as well break inflation's back now when they have it on the run and not wait until later. The third thing is that their risk assessment might be that a recession sooner will likely be more mild versus a later recession, one that would likely be harder, meaning a harder landing. We do agree with this and I think the Fed is willing to press that opinion, although they will not come outright and say that. Ultimately, their goal is to continue to put policy pressure on the market, or the threat thereof in place, to ensure inflation falls without needing to actually hike. So now let's get into the meat of it.

What we want to talk about is the Fed's long-run forecasts which they gave us today in their Summary of Economic Projections (SEP) and compare this to what we think might be the long-run market performance. Let's start with the long-run Fed expectations that come from the SEP. Here are some notables metrics versus June. In 2024 the Fed upgraded their GDP growth forecast to 1.5% up from 1.1%

back in June. This is stronger growth from the Fed in terms of expectations for 2024. The Fed's core PCE inflation is still unchanged at 2.6%, but note they expect core PCE will be 3.3% in 2023. In terms of unemployment they actually improved their labor market outlook for 2024 and think the unemployment rate will rise to only 4.1%, compared to 4.5%, which is what they last forecasted in June 2023. This is an upgrade to the jobs situation. In terms of the dots, this is what everybody was looking at, including me. The 2024 and 2025 dots do show rate cuts, but fewer rate cuts by 50 basis points each year. This is an important statement here in that they are still showing rate cuts, but not as many rate cuts, as what investors were thinking going into 2024 and 2025.

Let's look at the policy rate path. If we think about 2023 and we look at the dot plot, the median dot is for a 5.625% policy rate. In 2024 there's an expectation that the Fed will cut rates by 100 basis points down to 4.625%, and going into 2025 the Fed would expect to further cut interest rates down to 3.375%. All told, 125 basis points of rate cuts is what's being expected or forecasted by the Fed from 2024 to 2025. So, yes, the Fed is still looking for rate cuts, but just not as much as what investors were thinking prior to this meeting, and certainly not as much as what they previously stated back in June. Now, the other thing to note is that the 2026 long-run dot. The expectation going out to 2026 sits at about 2.875% versus the median long run dot at 2.50%. In other words, the long run expectations for the Fed is still about 3/8 of a percent (0.375%) higher than their long-run median. This is really sending a message - a BIG message - that the Fed is expecting to be “higher-for-longer” in terms of rates, and I think we ought to take them seriously across their metrics and time frames. To repeat, they're basically saying “higher-for-longer.”

Putting it all together, the Fed is doubling down on their soft landing call. What they're basically saying is that if inflation falls towards target, policy rates are higher-for-longer, but this has little impact on the unemployment rate rising. In our view, this is very ambitious and optimistic on behalf of the Fed. Ultimately, the Fed is trying to lower inflation, but more importantly, trying to keep it anchored. A re-acceleration of inflation, one that causes the Fed to hike in 2024, will be more devastating for markets. We want to avoid that at all costs.

Now let's talk about the market, the long-run market, specifically what will the markets need to discount as risk factors going forward? So take the Fed seriously about higher-for-longer. As I said before, another rate hike in 2023 is very much a possibility. This policy may steer the economy toward a mild recession in the first half of 2024, which could actually be bullish for markets as it does not destroy its underlying strength. Furthermore, markets may look through a recession that comes sooner - which maybe be more mild - compared to a recession that comes later, which could mean a hard landing.

Let's discuss bonds. How does the bond market anticipate this or how does the bond market discount this risk? First, let’s look at the 10-year U.S. Treasury yield. In my view, 10-year U.S. Treasuries at this point are likely in a range of 3.85 - 4.55% over the medium term. Now we don't like holding long duration as a hedge because we think rate cuts will pressure front-end rates lower and the curve may re-steepen or un-invert moving forward. We believe that long-term rates may be much more range bound and that a better hedge might be somewhere closer to the front-end of the market. One of the things that we've talked about many times before is that we like the three-year point in holding duration

and we do this by creating that three-year duration with a bar bell approach across a broad fixed income allocation. We own some high-quality, short-duration securities in combination with some Core and Index duration of around six years with Investment Grade (IG) quality. Netting that all together we get about three years of duration. To repeat, we like to be shorter than the Index duration.

In terms of credit, we think default rates are likely to rise as higher-for-longer rates will slow the economy and increase the tightness in financial conditions. By the way, that's what higher-for-longer rates are designed to do, right? That's what's supposed to happen. That said the yield on High Yield, and specifically asset-backed securities related to the housing sector, still look attractive to us. In particular, we like more conservatively managed loan funds, bank loan funds and the like, ones that are more conservatively managed. We also think this is appealing because the valuations look interesting to us, the dollar price is interesting and the all-in yield is good as well. We expect the slowing of the economy, but not a collapsing of the economy. This makes the rise in default risks manageable, and I think we're being paid to take on some of this credit risk.

In terms of equities, if we enter into a mild recession or a softer landing, we think equity valuations of around 18 to 20, as measured by P/E multiples, can be sustained once we enter a recession. Of course, equities will likely revalue lower, but we do see that as a buying opportunity. Our goal is to construct a well-balanced portfolio allocation across Value and Growth sectors, with some Fixed Income, in order to maintain our holdings throughout the volatility and the anticipated bumps ahead. However, we do see the Value sector in equities as more attractive and where the opportunities to add alpha are actually better. In other words, we like the broader, equal-weight market more.

I guess we're all data dependent now, not just the Fed. Like I said, the economy is showing signs of cooling, but not collapsing. We believe many investors are likely too heavily weighted in longer-duration fixed income and cash and may not be allocating enough to the possibilities that things go right and that there might be some upside. When all is said and done, a well balanced portfolio is what we like to withstand this expected volatility. Thank you for listening.

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