Caron's Corner Transcript – 10.30.2023

NEW TITLE

- Let's get right to the point - the Fed is **not** expected to hike at their meeting on November 1st, but that doesn't mean it's a non-event.
- In fact, we should **view the November meeting as setting the stage for December,** when the Fed will release their latest Summary of Economic Projections and dot plot.
- Today, the market is pricing roughly a 20% probability of a rate hike in December.
- However, I think those odds are too low and should be closer to **50%/50%**.
- This means the November meeting is important because it sets the tone for the market to readjust the probability of a December rate hike higher, which will likely have an impact on market valuations.
- Truth be told, market pricing of Fed expectations has been wrong before, as evidenced over the last 18 months for example.
- So does the market have it wrong again? And if so, what are the implications? We discuss in this audiocast.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Is the Fed losing patience and is the market underpricing the risk for another rate hike? Well, let's get right to the point. The Fed is not expected to hike at their meeting on Wednesday, but that doesn't mean it's a non-event. We should view the November 1st Fed meeting as setting the stage for their December meeting, when they will release a Summary of Economic Projections and at a dot plot. The market's pricing about a 20% probability for a rate hike at the December meeting at this time. I think those odds are too low and maybe it should be closer to 50%/50%. So the November meeting is important because it sets the tone for the market to readjust the December rate hike probability higher, which will likely have an impact on market valuations. Let's face it, market pricing of expectations for the Fed has got it wrong before, like over the last 18 months. Does that mean that the market has it wrong again? And what are the implications? Let's get into it.

So yes, I'm saying there is a chance that the Fed hikes rates one more time this year and it might be in December. So to set a baseline, market pricing now is for the Fed to be on hold until mid-2024 and then start cutting rates. What we are discussing in this audiocast is the risk case scenario that markets may have it wrong. Now, we do this because it's important to our scenario analysis when constructing portfolios and looking at the distribution of outcomes to measure upside versus downside capture of potential returns. And based on our measure we think there is good reason to be concerned about the risks associated with another rate hike. Why? Because the Fed emphasized patience. That's the magic word they used back in September. Patience. They said that they were going to be patient at the September meeting, allowing time for prior rate hikes to do their work. But the recent data and fundamentals have been consistently stronger than expected, which is testing their patience.

So where do we begin? Looking back at October, let's go through the list and start with some data points. September ISM manufacturing PMI rose to 49 from 47.6 expected and this is close to ending an 11-month streak of contraction going back to October of 2022. The latest JOLTS report signaled continued strength in the labor market with strong demand for workers. The non-farm payroll data printed 336,000 jobs versus 170,000 expected and this crushed consensus. But wages did simmer - I guess this is a bit of a goldilocks number - but was stronger nonetheless. There was a blowout retail sales number and that's always important. Whenever we look at the retail sales number, we tend to look at the Control Group and that printed 0.6% versus 0.1% month-over-month. Again, another very strong beat. A strong CPI report that came out 0.4% month-over-month versus 0.3% and a 3.7% year-over-year headline CPI. Now remember we need to see sub 0.25% month-over-month CPI for the headline to start to decline. If we see anything above 0.25% we'll get headline CPI re-accelerating to 4% or above by the end of the year. So that's an important number to watch. Inflation has been re-accelerating over the past few months with Fed Chairman Powell's favorite Super Core measure, which is still around 4% today versus a 2% target. Q3 GDP rose 4.9% versus 4.5% expected, the biggest quarter-over-quarter increase since Q4 of 2021 when the growth run rate was about 7%. We had a flash October PMI which rose to 50 versus 49.5 expected. In all these are strong data points that are going to test the Fed's patience.

Let's look at those market based probabilities again for December. Does a 20% probability for a rate hike seem low ? I think you see my point and why I'm concerned that Powell may use the opportunity at the November 1 meeting to communicate that his patience is wearing a bit thin for prior rate hikes to take effect. While we do think there are headwinds hitting the economy, many of the most timely aforementioned indicators are just not showing signs of clear, meaningful deterioration in the economy. So far, the run of data has just been too strong. What are the impacts on asset prices? Is this just a correction? Or is this the start of something more severe? Well as I like to say, the market data keeps disappointing the Fed to the upside. On the flip side, asset prices are surely responding. Bond yields have risen sharply and importantly, the yield curve is steep and perhaps this will do the heavy lifting for the Fed. Equity markets have responded both to higher yields and geopolitical risks by correctly moving lower. So again, this begs the question: Is this just a correction or the start of a more severe downturn?

Well, let's look at nominal GDP, the keyword being "nominal." Nominal GDP incorporates inflation and in Q3 printed a robust 8.5% which is supportive for cash flows and earnings. Remember that equities are a nominal asset class whose valuations are positively impacted by nominal growth. So the nominal data matters a lot for equities, but Q3 nominal growth may have peaked. If we look at real GDP for Q4, it's expected to come in somewhere around 1.0 - 1.5%, and that's going to be slower than the Q3 GDP rate. But in nominal terms, this is about a 5% nominal growth rate which again is not terrible as we see it. Our soft landing view is still intact and the recent sell off is an opportunity to add well-valued equities to a portfolio. All of this makes me think how quickly higher assets could go once it's more certain that the Fed is done tightening. If geopolitical risks subside, this too is a risk to consider. Nevertheless, the Fed has a large say in all of this and we may learn more this week as to whether they're losing patience. If they hint at a December rate hike, the market is currently not pricing for this. It's something that we should be wary of and ultimately may present an opportunity to buy weakness and asset prices.

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