Caron's Corner Transcript – 12.4.2023

Pulling Forward "the Boring," Making 2024 a Year for Balance

- As mentioned in my previous podcast, much of the year-ahead research is calling for falling inflation, stable to lower policy rates, tighter credit spreads and a modest upside to equities.
- If all this were to be the case, then we could expect low volatility in 2024 i.e., a "boring market."
- But the combination of weaker home sales, a soft inflation print, anemic Gross Domestic Income and ISM data and a Fed seemingly ready for a victory lap on inflation imply rates have peaked and may come down.
- As a result, both bonds and equities have rallied, and volatility, as measured by the VIX, has slumped, all appearing to confirm many of these year-ahead forecasts.
- There is one problem with all of this - **It's not yet 2024!** In fact, it seems the markets are pulling forward "the boring" bits of the expected returns for 2024.
- But, as also mentioned in my prior podcast, **I think 2024 will be anything but boring!**

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Pulling forward "the boring," making 2024 a year for balance. In my last podcast a few weeks ago I commented on the many year-ahead research pieces are calling for falling inflation, stable to lower policy rates, tighter credit spreads and a modest upside to equities. And if that were to be the case, then we could expect a low volatility 2024 market dynamic. In other words, a boring market. Well, here we are, a few soft data points later with weaker home sales, a soft inflation print, anemic gross domestic income (GDI) and ISM data and Fed speakers whose comments were akin to warming up for a victory lap on inflation, all implying that rates have peaked and may come down. As a result, bonds have rallied, equities have rallied and volatility, judging by the VIX, well the VIX index has slumped to 12 all seemingly on track to confirm the year-ahead forecasts by many analysts. But there's one problem with this. **It's not yet 2024**! If only the year ahead started on November 1st. It seems the markets are pulling forward the boring bits of the expected returns for 2024. But also mentioned in my prior podcast, I think 2024 will be anything but boring at these elevated levels of returns in the markets. Now the hard work begins, so let's get into it.

As we like to say, you can get there from here, but it will be a rough ride. I largely believe the market performance in the year ahead could be close to consensus expectations. In other words, a market performance that's consistent with a soft landing. But I think the journey to that endpoint will likely be a roller coaster ride with squeaky boards and loose nuts and bolts for several non-economic reasons. The first one is geopolitical tensions are elevated and likely to stay hot. There are election tensions in the U.S. presidential race, Taiwan elections, China policies and even European constitutional core challenges. Fiscal policies may take center stage, which are far more unpredictable than monetary policies and come with the consequences of deficits. And energy, well that's likely to remain a wild card as well.

There are many reasons to worry from an economic perspective too. In the U.S. we saw a large gap between the upwardly revised 3Q GDP at 5.2% versus GDI, which only came in at 1.5%. Note that GDI measures the same thing as GDP, but from an income perspective, typically a gap of this size precedes a hard landing or recession with GDP ratcheting down to GDI. Inflation is also falling, but that may not be good news because it could stem from a loss of demand, which may signal margin and earning pressures going forward. Those margin and earnings pressures could threaten the strong labor market as companies may need to shed labor, causing the unemployment rate to rise to higher than expected levels outside the boundaries of what would be considered a soft landing. As we found out last week, ISMs have set below 50 for the 13th consecutive month (50 being the threshold between an expanding and contractionary economy). The good news is that it may have troughed, but the bad news is that there aren't really many strong signs that it may accelerate above 50 anytime soon. Broadly speaking, this is why we think it can be a rough ride in 2024. It's because the initial conditions create a stiff headwind to surprise to the upside.

But is there room for optimism? We do think the answer to that is “yes,” but it's going to mainly come from balanced portfolios, a balanced approach to the markets. From our perspective, something the start of 2024 may have in common with the start of 2023 is that the tails are still fat on both sides of the market. To the upside and to the downside. The risks associated with the rough part of the ride for 2024 are reasonably well known, at least in what they might be, but not necessarily in their magnitude. In general terms we probably don't need to worry about central bank rate hikes in 2024. Perhaps we may even anticipate cuts. And yes, economic growth is cooling but it's not collapsing. We may see a mild recession as a result which I would still characterize as a soft landing. Jobs and the unemployment rate may come under pressure which may challenge margins and earnings, but year-over-year earnings comps will be easier to beat for the majority of the market. Speaking about the majority of the market PE multiples are closer to 16.5 versus the index at 18.5 when you exclude the magnificent seven, (Apple, Amazon, Alphabet, Nvidia, Mets, Microsoft, Tesla), or if you look at the equal-weighted S&P 500 versus the cap-weighted. In many ways, the broader market has factored in a slower 2024 already and has room to surprise to the upside from a valuation perspective.

So what might mean for investors in 2024? It could be that a well-balanced portfolio may outperform the index in 2024 opposite to what's occurring in 2023. As of Friday December 1st, the S&P 500 index was up about 19.8%, compared to the S&P ex the magnificent which was up only about 7.0%. The performance characteristics may flip in favor of balanced portfolios. That means a more diversified portfolio, not just concentrated on certain growth names in the tech sector, may beat the index whose returns are heavily reliant on just seven stocks. This may be the great opportunity for 2024. Of course, we cannot predict the future, but if we are to have a high conviction call for 2024 it would be that a balanced portfolio return may outperform the index on a relative basis. So as we like to say, when the tail risks are fat on both sides, it's better to be balanced in control for risks along the way.

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