Caron's Corner Transcript – 12.18.2023

Where Do We Go From Here? Neutral May Be the New Defensive

- The markets seem to be **pulling forward 2024 market returns** into 2023, leaving us to wonder whether there will be anything left for next year.
- Yes, we do in fact think there will be opportunities in 2024 but **they will likely stem from active management** and taking advantage of **tactical opportunities**, more so than just *buying, holding and hoping* for returns.
- In prior podcasts, we moved from underweight to neutral duration in October. **Now, we are moving from overweight to neutral on equities**, but are nonetheless optimistic.
- Today we think **positioning toward neutral risk exposures across portfolios is a good tactical decision** because it gives an investor room to maneuver in the weeks and months ahead.
- **Get Neutral, but be Tactical. This may be the new Defensive.** Why? We discuss in the audiocast.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Where do we go from here? Neutral may be the new defensive. Recent market performance seems to be pulling forward market returns for 2024 into the later part of 2023, leaving us to ask the question, "Will there be anything left over for the year ahead?" Well, we think there will be opportunities in 2024, but it will likely stem from active management and taking advantage of tactical opportunities more so than buying, holding and hoping for the best. That worked in 2023, but may not work as well in 2024. As you may recall from prior podcasts, we moved from underweight duration to neutral in October and now we're moving from overweight equities to neutral, but with some optimism. At this time we think positioning toward neutral risk exposure across portfolios is a good tactical decision because it gives one room to maneuver in the weeks and months ahead - to take advantage of dislocations both to the upside and to the downside of markets. Get neutral, but be tactical. This may be the new defensive. Why? Well let's get into it.

The first thing we want to discuss is the current interest rate cycle and the related path, pace and magnitude and how that matters for bonds and equity returns. The recent Fed pivot answers the question on the path of rates, namely it's likely heading lower. We're no longer debating the possibility of another rate hike, but the pace and magnitude of the future interest rate moves remain in question. The Fed is still saying "higher for longer," but as we explained in last week's podcast, that likely refers to real policy rates. Nominal policy rates can still fall to match declining inflation, and if they do, then real policy rates may remain higher than the real neutral policy rate estimated by the Fed. Thus "higher for longer" is still valid and achieved by their construct.

The pace of rate cuts may be methodical and slow, potentially starting late in the first quarter of 2024. The market's pricing in six cuts or 150 basis points in magnitude next year and bond returns will likely follow a similar pattern, all else being equal. The recent drop in yields has pulled forward six 25 basis point cuts in the year ahead. If the Fed feels the need to move faster to avoid a recession, then we may

see a 50 basis point rate cut somewhere in the mix. It might not all be 25s and this would represent upside potential for bond returns. It's also possible that the Fed feels it necessary to cut by more than 150 basis points. It could be that they cut by 200 basis points next year. By our estimation, this then puts us somewhere between a soft landing/mild recession to a more normal recession. 200 basis points of cuts gets us there. So that's what we're going to kind of go with for 2024. This is not a forecast per se, but just a way of thinking of the downside risks. Clearly it matters to bond performance, especially credit.

So why the Fed is cutting? If it's preemptive to avoid a recession, that's a positive for duration and credit spreads. If it's in response to something worse than a mild recession, then we need to be concerned about spreads. A reshaping of the yield curve is another point to consider. We think the yield curve will normalize, that is, re-steepen if the Fed cuts rates. This should come as no surprise as it's typical when the Fed cuts.

Let's have some fun with math. Right now if the Fed cuts by 200 basis points, and again, this is the scenario between a soft landing or mild recession to a normal recession, then we would expect the Fed Funds rate to go to 3.5%. The two-year U.S. Treasury yield would then move close to that level. But as a curve steepens, then the Fed Funds 10-year spread will also steepen and normalize to say plus 25 to 50 basis points. This would put the 10-year U.S. Treasury fairly priced between 3.75 and 4%, not far from where we are. Now of course, if we have a deeper downturn and return to a disinflationary era, then the 10-year could fall much further. But this is not our base case. Structurally, we think we are in a reflationary environment and that term premium will return to manifest as a steeper curve.

As the saying goes, stocks need bonds, but bonds don't need stocks. This is an old adage implying that equity returns are more dependent on what happens in the bond market, compared to bond returns which are less dependent on equity returns. Today however, both market returns are highly correlated for that old adage to apply. We need to believe there will be a decline in the high correlation of returns we have observed over the past few years. In fact, we do think correlations will fall in 2024.

So where do we go from here? We think bond returns will be more policy driven in 2024. As per usual, duration will be a big part of bond returns. But since starting yields are higher in 2024 compared to 2023, we think there is more cushion. Spreads have tightened quite a bit, so excess returns, that's the return in excess of risk-free duration from say U.S. Treasuries, may come under some pressure. Bond returns may also be competitive with equity returns and attract inflows into that asset class. Cash, on the other hand, may no longer be king in the year ahead.

Equities need an additional catalyst to achieve positive returns from these levels beyond the ones that have recently been priced in since rates have fallen. From a macro perspective, this could come from a softer than expected landing or better than expected growth or stronger than expected labor market, where the consumer keeps consuming and profit margins and earnings power continue to stay strong. From a more bottoms-up perspective, equity returns could come from increases in the lower valuation sectors. Said another way, the broader market that did not participate as much in 2023's upside.

The way to take advantage of this is through owning better-balanced portfolios that include fixed income. The risk is that the starting point for 2024 already has a lot priced in and there's a setback early in the year. Timing this is nearly impossible to do, and this is why we advocate getting neutral. That way one can participate in the upside but also has dry powder in the event that there is a draw down. On the flip side, if the rally extends too far, then one can reduce from a neutral level to a more underweight exposure. Our point here is that we may need to be prepared to be active and tactical to achieve outsized returns in 2024. We think positioning in a balanced portfolio closer to neutral is a good and nimble starting point to take advantage of what we think will be a highly volatile 2024. So perhaps to start the new year, neutral is the new defensive.

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