Caron's Corner Transcript – 8.12.2024

There Is Nothing to Fear, but FEAR Itself!

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- It is a simple way to connect the points we've been highlighting since late June, namely that jobs/the employment situation was now the primary concern for the Fed and significant risk factors to influence markets

- We saw the elements of **FEAR** playout over the past week, as our timing was quite lucky.

- Markets and asset prices moved a lot, but **we do not believe the associated risks to economic fundamentals match the move in prices.**

- Does that mean there is nothing to fear? No, not at all!

- So, let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. "There is nothing to fear but fear itself." Well, when times get tough in markets, you got to look to Winston Churchill for quotes to help get you through it. A few weeks ago, we introduced our FEAR framework to better understand and analyze the interplay between Fed policy, which is the F in fear, the Employment situation, Asset prices and interest Rates. And that's the FEAR framework. It's a simple way to connect the points we've been highlighting since late June that jobs and the employment situation was now the primary concern for the Fed and risk factors to influence markets. We saw the elements of FEAR play out over the past week and our timing was quite lucky. Markets and asset prices moved a lot, but we do not believe the associated risks to the economic fundamentals actually match the price performance in the markets. So does that mean there's nothing to fear? No, of course not. Let's get into it.

"The farther backward we can look, the farther forward we can see." Again, another Winston Churchill quote. Indeed, the moves in the markets we saw over the past week were of historic proportions. The VIX index reached 65 intraday and at one point rivaling the Global Financial Crisis level, and also 1987 when we had that inevitable stock market crash. The one-day standard deviation of moves in Japanese equities have not been seen since the 1980s when their economic bubble burst and kicked off over 30 years of deflation. If history is any guide, then I think it's safe to say that the catalysts of the price action and volatility we saw last week does not rival those events. So perhaps the price action told us more about market positioning than economic fundamentals and that is what we conclude. So the FEAR, with the emphasis on the E for employment, is that the labor market will quickly deteriorate, which may create a sudden stop in consumer spending which impacts earnings, shrinks margins and then leads to further weakening of the employment situation because it catalyzes layoffs - a vicious cycle. Typically that is the way it works. Classic end-of-cycle dynamics. Many people cite the Sahm rule as a result. This was created by Claudia Sahm, formerly of the Fed, which states that a 0.5% rise in the unemployment rate above its three-month moving average over the past 12 months signals a recession. But who

disagrees with this? Claudia Sahm herself, who posted on her website that a recession is not imminent even though the Sahm rule is triggering. What she highlights is that her own rule is likely overstating the labor market's weakening due to the unusual shifts in the labor supply caused by the pandemic and immigration. However, she does agree that the risks of a substantial weakening of the economy or recession in the next several months is elevated and I think most economists would agree with that, which is adding to the case for the Fed to begin to start cutting rates. The point is that this is not a typical cycle. Many historical relationships have not worked as expected if we have learned anything from this cycle.

So back again to Mr. Churchill. “If you are going through hell, keep going.” It felt like that in the markets last week. It's fitting advice for what we saw in the markets, and here are some and here are some reasons to keep going. Economic fundamentals are cooling or normalizing, but they're not collapsing. The speed of the market move is more significant than the magnitude of the move itself. The market move says more about positioning which is really the narrow breath and the magnificent seven as people call them, than it does fundamentals. This is an important connection to make. Bonds seem to have made their move, post Fed and payroll data. U.S. Treasury yields already seem to be pricing for a normal rate cutting cycle. And that might be rate cuts in the amount of 150 basis points or even possibly 200 basis points in this next rate cutting cycle. And we're not seeing major shifts to liquidity or squeezes or collateral related issues. These are typically indications that the market is not functioning well, you know, due to a volatility shock and as a result, the Fed is not likely needed to cut rates inter-meeting. This is what they would typically do if the market was losing its functionality, which we're not seeing happen. So that's really good news.

Now, credit spreads may widen but credit markets are not likely to seize up again. This seems like a normal repricing. As for equities, the questions we ask ourselves are number one, is this the start of a bigger bear market, and number two, is this a correction or a normalization? Well, if you ask me, I pick scenario two, it's more of a correction or normalization. Additional culprits are unwinds of overcrowded trades. People are selling possibly the mag seven or tech or large caps. Anything that really went up a lot this past year, people may sell in order to preserve year to date gains. Also the sell off in the U.S. dollar/yen trade, which is a strengthening of the yen and weakening of the U.S. dollar, which is what people call the yen carry trade. People are exiting Japanese equities as a result. Now what we have to remember about Japan is that it's not an extremely liquid market, but a very high beta market. When it gets overcrowded, you do tend to see these big unwinds take place. But again, it's more about positioning more likely than it is about the economic fundamentals. Also the Bank of Japan came out and made comments to the effect that they may not hike rates later this year as feared because of the instability that their recent surprise rate hike actually caused. So there's no evidence at this point that there are second order effects from the volatility shock or an unwind that might be, you know, impairing other financial institutions. This is also very important. So again, the volatility shock is not triggering any market dysfunctionality, at least not that we know of yet. And that's actually a very strong positive for us.

We think it's premature to assess that all the economic fundamentals have turned sour. As long as we have a soft landing, then we think the sell off represents a reset in prices, a buying opportunity but cautiously, patiently.

Clearly, this is an evolving story and markets may remain choppy until we get through Jackson Hole in a few weeks. The next rounds of data points on the jobs market. As we see it, the jobs market is cooling, not collapsing and we are going to look at volatility to find opportunities. So stay tuned. Thank you all very much for listening.

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RO 3782085 Exp. 8/31/2025