

Focusing on the Signal in Volatile Markets

- The conflict in the Middle East has left markets and economic fundamentals experiencing a shock from higher oil prices.
- This **translates into an inflation shock**. But **when the inflation shock becomes a growth scare** is a critical factor to monitor.
- The key questions for market valuations are:
 1. **How long will this last?**
 2. **What happens if anything breaks? And if it does...**
 3. **How long will it take to repair?**

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, our asset allocation framework across Bonds, Equities, Alternatives, Taxes and short-term Transitional (cash) investing.

A lot is going on in the markets. There is a lot of volatility. What we want to do is reflected in the title of this podcast "Focusing on the Signal in Volatile Markets." Both markets and economic fundamentals are experiencing a price shock from oil due to the conflict in the Middle East. This translates into an inflation shock. But when the inflation shock transforms itself into a growth scare is another key factor we monitor. The key questions for market valuations are: How long will this last? What, if anything, breaks? And how long will it take to repair? Let's get into it.

First I'd like to look at signposts. These are the macro signals for the market. Nobody fully knows the answers to this, but we do know the fault lines on which volatility is transmitted to markets. These become signposts that identify macro signals for us to watch and monitor. While there are many, there may be macro signposts to really keep an eye on, namely **correlation, liquidity and contagion**.

The first one is correlation. Bond and equity returns have been highly correlated. That is, equity and bond prices have been moving in the same direction. Equity prices have been moving down. Bond prices have also been moving down, which means yield is going up. This is a problem for markets because it represents two asset classes having losses simultaneously, and it takes away the value of a hedge from the bond side. But you can't fully understand correlation without causation, and we know what it is. Higher oil prices imply higher inflation, which pushes bond prices lower or yields up along with equity prices based on higher rates, eroding equity valuations. This implies that high-quality bonds are not working as a hedge to equities, which means there is no place to hide except for cash. But if oil prices stay high for an extended period, then it forms growth headwinds from higher energy prices. That is a growth scare which leads to a stagflation risk, which is a bigger valuation killer.

The second one is liquidity. What may follow high correlation is the potential for a liquidity squeeze due to those high correlations. Investors may elect to sell assets broadly. But this is contingent on being able to transact in the first place, and at a reasonable price. Among many measures of this are repo, or financing, market pressures. A breakdown here can significantly impact leverage and asset prices based on leverage costs. Another is the demand for U.S. dollars (USD), because a lot of debt is denominated in USD. But you know, we have to look at FX-basis trades to see this as an early indicator. Forwards and short term USD-based futures markets will also be watched.

The third one is contagion. We monitor parts of the market that may be indirectly impacted by the oil price shock. If it lasts for an extended period of time, it can broadly spread across a spectrum of assets and sectors in the markets. We need to look beyond just disruption and consider impairment. Here are some examples. Extended supply chain and production disruptions. This could create stresses between receivables and deliverables. Debt and payment exposure from leverage, short-term financing, financial receivables versus financial stresses. It impacts real economic growth or on a protracted basis, meaning not temporary, that leads to margin compression, layoffs, loss of demand and creates a stagflationary shock. Again, a valuation killer.

But it's important to note that context matters. These signposts are major fault lines for systemic stress in markets upon which a spider web of other fault lines can form. For private markets, valuation is key and we think about the following: Paying a reasonable valuation for levered capital structures where you want to grow revenue and potentially expand margins, and then benefit from healthy financing and transaction markets for recapitalization and exits. The other is transaction ability and private market liquidity of capital flows, meaning capital commitments, capital calls, buy, own, sell, distributions and round again. This has been dislocated since 2022 with low distributions and low commitments (for example) but has started to recover. However, perhaps the recent volatility in markets is another phase of rolling disruption to market confidence needed for M&A and distributions to normalize.

As for public markets, price discovery is more easily observed. P (price) multiples and the rerating of equity market sectors should be watched, as well as credit market spreads, CDs, default risks, USD liquidity metrics and funding and financing markets, for example, the repo markets. So far, what we're seeing is that these stresses are not emerging in a very sharp way such that the risks seem systematic.

As for economic fundamentals, initial conditions also matter. Economic fundamentals were reasonably strong going into this oil market shock. But again, we have to compare a growth shock versus an inflation scare. Jobs, data, consumer demand, ISM/PMIs tracking above 50, which is good. Inflation was falling lower. Earnings releases were surprising. Higher confidence measures were also moving higher. A growth shock is easier to recover from than an inflation scare. The initial conditions for growth were good, so we may be standing on decent ground, at least for now.

The initial conditions suggest the broad global economy can absorb a one-two month oil price shock and look past the event. But inflation has a risk of being stickier, especially if higher oil prices now prevent prices on a year-over-year basis from falling as many had forecasted. However, this is all barring an unforeseen risk event that tips the market into a more systemic risk scenario, which is clearly a concern

in markets today. And central banks, what about them? Well, especially post-Covid, they have ample forms of measures like FX, swap lines, repo facilities and balance sheet tools already established that could mitigate a systemic liquidity shock. But markets will still reprice if systemic risks rise. We're not there yet, but this is what we will be watching for.

So how are we positioning? Our base case remains that there are strong fundamental underpinnings in the economy. That and easier fiscal policies will allow for prices to resume higher. However, timing is key and we recognize there are risks for conditions to worsen before they get better. As a result, we are looking to add to higher conviction themes like cyclical broadening of the market and even some select financials. We're also looking to initiate other technology sector positions, if the market dips enough to give us an attractive entry point. In bonds, we hold a modest underweight in duration but own high-quality, front-end assets. The underweight in duration is designed to mitigate the high correlation risk between equities and fixed income, a central and structural theme for us, but is also a way to earn some income. We're also holding ample levels of liquidity, in cash, in case needed.

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