Caron's Corner Bullets – 5.5.2025

The BEAT for May: Our Monthly Asset Allocation Outlook

Key Themes

- Loss of Faith in U.S. Assets? No!
- Where's the Fed, or Trump, Put
- The High Correlation Risks of Bond and Equity Returns
- Fiscal Policy Is Up Next: From Tariffs to Taxes

Top Ideas

- Adding Duration: Dislocation in U.S. Treasuries present a buying opportunity
- Taking a Breather in Emerging Market Debt
- Adding to Municipals: Attractive Relative Value
- Increasing Our Exposure to Germany

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. The BEAT is our Bonds, Equities, Alternatives and short-term Transitional investments. This is our asset allocation framework and we are going to talk about our monthly outlook for May.

There are a couple of key themes, and this is one that I've spoken about before, which is that many questions have come up in terms of a loss of faith in U.S. assets. You know where I stand on this: The answer is NO! There's no loss of safe haven status here, but there are some technicals that go around this, and we think the narrative in which there's a loss of trust and faith in U.S. assets, including the U.S. dollar as a reserve currency, is a great extrapolation and exaggeration of the truth. We believe the U.S. dollar's performance has mainly been tied to U.S. equity asset performance over the last several years, and this has prompted an exponential rise in foreign assets converting local currency into U.S. dollars to buy U.S. assets. Now that is starting to be rebalanced as equity assets in the U.S. start to move sideways and money gets repatriated back to local currency - that's really what's going on. It's a rebalancing, not a loss of faith or sale of U.S. Treasuries or dollars. Again, a rebalancing. The caveat there is important.

The next question that people ask is where's the put? Of course we're talking not about the Fed put, but the Trump put. In other words, where does the narrative change from the current administration to help support the equity markets? This is a common question. Where does that policy put reside in markets? Again, this is not about the Fed put, but the Trump put. Judging by recent history, the communication on tariff policy changed when the S&P 500 fell towards the 4850 level. So this may represent a support level for equities, but the monetary policy side may be more complicated because inflation is running higher than target, making the Fed more reluctant to cut. However, we may see a rate cut as soon as June as the Fed may respond more towards a rise in the unemployment rate above 4.5%. Maybe that's something to look at instead of just focusing on inflation.

The next topic is about the high correlation risks between equity and bond returns. It's really not supposed to work this way. Longer duration bond yields rose as equities sold off, leaving many to question if there was a loss in confidence in U.S. Treasuries. Again, we do not think this is the case, rather there's a technical explanation. Equity and bond correlations have been rising for the past several years and historically has become more correlated when inflation persists above the 2% target level, which is what's happening now. This is why we think equity and bond returns are highly correlated or more highly correlated than they have been in the past. The second is a technical unwind of the so-called “basis trade,” i.e. short bond futures versus long cash U.S. Treasuries. It's another levered long position in U.S. Treasury that many of the faster money players are unwinding this position, based on the recent sell-off in equities throughout the month of April. Of course there has been some recovery in equities recently, so we do think that some of this volatility in the bond markets will start to calm down.

Fiscal policy is up next. This is a really big theme for May, from tariffs to taxes. We explained the three components of Trump's policy process as deregulation # 1, tariffs # 2 and taxes #3. #1 and #2 are underway, so now we start on #3. Trump's budget has been voted on and approved to be done through a procedural process called reconciliation, which only requires a simple majority and makes it easier to pass. In addition to making the 2017 Tax Cuts and Jobs Act more permanent, there may be an increase in state and local tax deductions and possibly a reduction in even corporate taxes. Net/net, we may get some fiscal stimulus out of the tax negotiations, but we may not have enough information until around the 3rd week of May. But maybe July 4th is really the date that many people are targeting. But we should note this as a tailwind for markets as opposed to a headwind, which is what tariffs had represented.

Onto our top ideas and what are we doing in portfolios. Well the dislocation in U.S. Treasuries presented a buying opportunity, meaning that as yields rose we bought duration. We bought around the 10-year point when the 10-year Treasury yield was closer to 4.4 - 4.5%. As stated, we see the rise in U.S. Treasury yields as mainly technical in nature and do not believe it's a loss in safe haven status. The backup in Treasury yields is largely due to this technical unwind of what I described as the basis trade, and this presented a very good opportunity for us to adjust our duration a little bit longer.

We are now looking towards emerging markets (EM) and are starting to take a little bit of a breather in EM debt (EMD). Technically we are reducing our position in EMD. This asset class has performed relatively well, so for a given credit rating, EMD generally offers a spread pickup versus corporate debt. Today spreads versus corporate debt look a little bit expensive compared to the historical averages. It's only slight, but would like to take some profit and reduce our allocation to EMD and move that into other areas, namely cash, at the current time.

Municipal bonds have become very attractive, especially on a relative value basis. Following an April sell off, yields of municipal bonds are well above one standard deviation wide compared to the index's

5-year average. From a relative value perspective, the muni-to-treasury ratios look increasingly attractive, rising to over 90% on some parts of the curve. We continue to see relative value in this segment of the credit markets.

Moving on to Europe, we have been overweight Europe and we started to talk about this in January. The one thing we'd like to call out is that most of our overweight focus is now on Germany, where we are increasing exposure there in Europe. We continue to look for market segments that are relatively less exposed to tariff risks and are direct beneficiaries of the nascent fiscal stimulus wave that's going through in Europe. German mid-caps actually fit this bill nicely, as the incoming government's agenda seeks to prioritize a re-industrialization by incentivizing equipment and infrastructure investments, cutting a lot of the bureaucratic red tape and reducing energy costs. While this will have benefits for broader Europe as an ecosystem, we think German mid-caps stand to benefit most.

Onto the materials sector, where we had been overweight. We did get good performance out of materials, but most of this came down to a rise in gold prices. Gold has risen to lofty levels and some of the tariff talks are starting to get a little bit softer and there might be more of a pathway for negotiation. What we're starting to see is that gold is starting to come under some pressure. So the number one item that drove the performance in the materials sector, the gold component of materials, is actually now starting to falter. As such, we want to take some profits here and back away.

Overall we do think that there are some interesting opportunities as we move into the month of May. Again, we are looking to fade some of the rally in gold prices through an unwind of overweight in the material sector. We still like Europe, specifically German mid-caps. We like municipal bonds and are adding some duration U.S. Treasuries, particularly around the 10-year note when those yields get up towards that 4.4% - 4.5%. So there's a lot to do and think about in May. Thank you all for listening. I will be back next week with a special edition of Caron's Corner featuring artificial intelligence.

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