Caron's Corner Transcript – 4.2.2024

The BEAT for April: Our Top Themes - and One Major Allocation Change

- From an allocation standpoint, we are moving U.S. equity from Overweight to Neutral.
- We have been Overweight equities since late 2022, but are already closing in on the upper end of our year-end expectations. It's time to take a break.
- Why? Because there were big surprise factors in 1Q that pushed equities higher, ones that are unlikely to be repeated in 2Q.
- As we see it, the market needs time to grow into equities' revised valuations
- As for our Key Themes in April:
    - Fed rate cuts: the pace is in question, but the path is almost assured
    - Inflation is priced to be contained over the long term
    - Labor markets are cooling, not collapsing
    - The land of the rising rates: changes to Bank of Japan policy

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. The BEAT for April: Our top themes and one big allocation change - and what is that big change? Well, we are moving U.S. equities from overweight to neutral. We've been overweight equities, U.S. equities specifically, since late 2022 and are now seeing reasons to reduce. We're closing in on the upper end of our expected year-end equity price level expectations and this is all happening by the end of the first quarter. So we think it's time to take a break and take profits. Why? Because there were big surprise factors in the first quarter that pushed equities to higher levels that we think are unlikely to be repeated in the second.

The first surprise was that 2023 fourth-quarter growth was much stronger than expected and generated more than expected growth momentum as we entered the first quarter of 2024. The second point is that it increased the probability that we would achieve our 2025 consensus bottom-up earnings of $275. This is now starting to become more fully priced. The third point is that we learned of greater-than-expected fiscal stimulus plans for 2024, which in turn boosted GDP expectations and earnings. The fourth point is that the Fed remained easier than expected in the first quarter relative to the stronger than expected data. Lastly, the fifth point is that jobs data turned out to be stronger than expected. All told, positive surprise factors of this magnitude are unlikely to be repeated in the second quarter. The market now needs time to grow into these valuations.

Let's now move on to our key themes for April. Number one is Fed rate cuts. We do think that June may be the first time the Fed starts to cut interest rates. The one thing to keep in mind here is that the pace of rate cuts is what's in question, where the path is almost assured. This means that people are not

expecting or pricing in a rate hike, but instead expect the Fed to cut rates. It's just a matter of when. This is keeping the Fed's inflation fighting credibility intact to the extent that they believe that inflation is dropping and rate cuts could be justified with this decline in inflation.

The second of our key themes is that inflation is priced to be contained over the long term. This is something that is very important and key to highlight. If you look at 10-year breakevens or five-year/five-year forward inflation swap pricing for either the U.S. or Europe, the market is comfortable pricing in lower policy rates in the future, because those forward inflation expectations are still remaining relatively low and maintained. As such, long-term interest rates aren't really rising very rapidly. This gives more credence to the fact that central banks still have inflation fighting credibility, which is still a positive and likely to be seen as we go through the second quarter.

Our third theme is about labor markets, which are cooling, but not collapsing. This is a key element of the soft-landing view, where the labor market is cool enough to slow wage inflation, which in turn should lower price inflation. Simultaneously though, labor must remain strong enough to avoid a collapse that would trigger a sharp decline in consumption and GDP, which would lead to the risks of a recession. We're closely monitoring how this ultimately plays out between wages, unemployment and consumption. This is a key risk that's on our radar.

Our fourth and key theme is something we like to call “the land of the rising rates” which implies important changes to the Bank of Japan (BoJ) policy, where wage/price inflation is taking root. This is evidenced by the recent Shunto, the annual pay negotiations led by many of the Japanese labor unions, which ended in larger than expected wage increases. This is also reflective of what's been going on from an inflation standpoint, which has been rising in Japan and staying elevated. Ultimately, the BoJ is ending their negative interest rate policy, and we think is a seismic event for markets. It illustrates that one of the main drivers of global disinflation and an anchor to low interest rates has now ceased to exist. This is a risk factor for us to monitor in April, but so far so good.

Now let's turn to our top ideas, where I'm going to bring in Ewa Turek from the Capital Markets Group to discuss.

Thanks Jim. We have five ideas to kick off the second quarter. The first one is what you were alluding to at the start, which is a downgrade to global equities. We're downgrading from neutral to overweight, in effect taking profits from the strong year-to-date rally. Now it's important to highlight that we haven't turned bearish on equities, we just don't see any asymmetry going forward. What I mean by that is we think the upside and the downside of equity prices is more balanced from current price levels.

Secondly, sticking with equities, we're neutralizing some of our regional tilts. The path to neutral means that reducing the highest rate of global equity allocation, namely U.S. exposure, and at the same time upgrading allocations to both Europe and China from underweight to neutral. Our thinking here is that the global economy is in a more stable position relative to prior expectations, which may benefit China, and in turn Europe.

Our third idea also involves regional tilts, where we are maintaining our overweight in Japanese equities. Here we are maintaining a neutral view on the U.S. dollar/yen, despite the change in BoJ policy rates and that's because the change was well anticipated. We don't expect it to have a significant delta on the trend for either Japanese equities or the yen. We think that the structural trends in place that exist for both the Japanese equity market in the yen are unlikely to be ne negated by a well anticipated rate hike.

Now let's move on to fixed income and our final two ideas. First, we continue to hold a neutral view on rates. We expect bond yields to remain range bound at the start of the year, and believe that bond yields were too aggressively priced for rate cuts. However, that pricing has since corrected and looking forward, we think it's unlikely the economy is going to accelerate to the point where rate cuts are taken off the table. Net/net that means we expect bond yields to trade in a range, which means that bonds only offer carry and little else.

Finally, we continue to prefer low-quality over high-quality credit. This position is consistent with our soft-landing view and related expectations for default rates to remain contained. We prefer owning lower-quality, or high-yield credit, over investment grade (IG). Our rationale is that IG spreads are tight and provide more duration exposure than carry income. In our portfolios, we prefer earning duration in higher-quality government bonds set against high yield bonds. This is our barbell approach, as discussed many times, which is weighted such that the credit quality of the pair is still IG rated, but carries a higher yield with less duration exposure. Back to you Jim.

Thanks Ewa and thank you all for listening to The BEAT for April. Remember that BEAT stands for bonds, equities alternatives and transition, which is really our expression for cash. Thank you all and we will be back next month with another BEAT.

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