Caron's Corner Transcript – 6.5.2024

The BEAT for June - Our Key Themes and Top Trade Ideas

- We are tapping on the brakes, for now, because we think markets are fully valued for a soft landing.
- In addition, we think 2H24 can be volatile due to 1) the U.S. election and 2) inflation and therefore, rate policy uncertainty.
- Remember, risky assets are more sensitive to interest rates and we think rate volatility can rise after falling so sharply.
- Strategically, though, we are still optimistic about risky assets. Equities can hold gains this year and the default cycle may be tame if we have the soft landing we expect.
- Tactically, we want to enter 2H24 unencumbered by legacy positions chasing the market. We prefer to meet 2H24 volatility and opportunities with dry powder and a clear mind.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to The BEAT for June. One of the things that is changing this month is that we are starting to tap on the brakes, at least for now, because we think that the markets are fully valued for a soft landing. In addition, we think that the second half of 2024 can actually be quite volatile. Clearly, there's going to be a U.S. election and inflation, and therefore rate policy uncertainty. Risky assets are more sensitive than normal to interest rates, and we think rate volatility can rise after falling so sharply. Strategically, we are still optimistic about risky assets. Equities can hold gains this year and default cycles may be tame as we have a soft landing. But tactically, we want to enter the second half of 2024 unencumbered by legacy positions or chasing the market. We prefer to meet the second half of 2024 volatility and opportunities with dry powder and a clear mind. So let's get into what we think are the four key themes for June.

The first one is, no surprise, selling into strength, which is against consensus as equities reach new highs. We did start to move from our overweight position in U.S. equities towards our current neutral stance. This occurred in two tranches, the first half at the end of March the second in mid-May. And we recognize this runs counter to consensus upgrades. But our decision is motivated by the markets nearing our bull case scenario of 5350 in the S&P 500 which in our view, fully prices a soft landing. We would turn positive again if we saw sufficient reacceleration in broad cyclical economic growth, but this is not our current view.

In terms of global equities, they've been on the rise, but as we like to say, it's all about the base effects. We think that the rest of the world is just catching up to what happened in the U.S., just catching up to U.S. growth. Over the past few months we've seen a meaningful rebound in outperformance of European and Chinese equities versus the U.S. and Japan. We increased our exposures from underweight to neutral in both of those markets at the end of the first quarter of 2024 and participated in both rallies. But now we're holding at neutral. Despite many market narratives advocating for an overweight position, the rebound in the ex-U.S. and ex-Japan markets is coming from a low multiple base. That explains the recent relative outperformance. However, these markets still have relatively

more challenging growth fundamentals ahead that make it difficult for them to sustain this level of performance. Thus, we hold neutral exposures.

The third theme revolves around how the Fed is falling out of sync with global central banks. The ECB and the Bank of Canada are set to cut rates ahead of the Fed. The immediate impact of this can be found in the relevant strength of the U.S. dollar, even against emerging market currencies. The irony is that the dollar should be under pressure due to excessive fiscal stimulus and the resulting deficit. As we enter the second half of 2024 and move into the post-U.S. presidential election cycle, we believe the dollar could come under some pressure and may benefit the most as central banks can move more freely to cut without risking the adverse effects of currency and therefore inflation in their countries in their local countries. But let's stay tuned to that.

The fourth and final point is inflation. We like to say that all roads lead to inflation. Yes, inflation is falling, but will it become anchored? This is the key question that we've been asking for a long time. The market breathed a sigh of relief as inflation data seems on a bumpy path lower. But the key question is whether it can fall towards target and anchor at those levels. This seems to be more likely in Europe than in the U.S., as Eurozone headline HICP inflation at around 2.6% inspires confidence that the ECB policy may make it fall further and become anchored. Confidence is lower in the U.S. which has a competing measure of inflation declining, but relating to different narratives, leaving room for uncertainty. If U.S. inflation proves unanchored, the risk is global central banks are less able to cut rates and support domestic economic activity. This will influence asset prices greatly, but again, it all comes down to inflation.

Let me now turn the audiocast over to Ewa Turek to discuss our top trade ideas:

Thanks Jim. The first idea I want to highlight is about adding cyclicality in a measured way. A positive inflection in global manufacturing PMIs and some rebalancing of ex-U.S. growth suggests the potential for a broadening in equity leadership. However, as you mentioned Jim, inflation uncertainty holds us back from adding to risk equity segments. We think a barbell of quality paired with some cyclical exposure offers the best risk reward profile.

This leads us to our second idea. European banks, a cyclical exposure that we are very excited about. The first argument in favor of the banks is attractive capital returns. The industry offers a sustainable 10%+ shareholder yield, made up of dividends and share buybacks. Secondly, we also see long-term rating potential for the sector higher through the cycle. European interest rates and higher nominal GDP growth vis-a-vis the previous tough decade should support higher sustained profits for shareholders.

Our third idea addresses European equities more broadly. While we like European banks, we're maintaining a neutral allocation to European equities. Despite better relative economic data in Europe, we don't see a clear path to sustainable outperformance from European equities and this comes down to earnings. Earnings growth remains below peers across most sectors and the expected cyclical rebound already large looks largely priced into areas that stand to benefit from it.

The final trade idea relates to fixed income. We think that higher real rates may present a deal for bond investors. The move higher in real yields over recent months will likely bring in more buyers of fixed income. This opportunity is particularly pronounced in Emerging Market debt where central banks have kept interest rates higher than normal to reduce the risk of local currency devaluations against the dollar. Additionally, lower quality credit provides attractive opportunities in this respect, given we expect a soft landing and a lower default level. Back to you Jim.

Thanks Ewa. As the month of June goes on, or as we like to say, as The BEAT goes on, we will be back with more updates throughout the month. Thank you.

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