Caron’s Corner Transcript – 9.15.2025

The Fed’s Dilemma Is the Market’s Gain

- Sometimes you want to embrace conflict in the market, and this may be one of those times.
- The tension points seem to be weakness in the labor market versus higher inflation.
- The issue is that the two are not supposed to co-exist, creating a dilemma for the Fed.
- If labor markets are weak, then wage inflation tends to fall, with consumer and goods prices soon to follow.
- The Fed has a framework that forms the basis of their policy reaction function **called the Phillips Curve,** which solves this dilemma for them.
- Despite above target inflation and stronger growth expectations in 2026, **the Phillips Curve creates a path for the Fed to cut rates**, because it will tilt its dual mandate to focus on the risk of labor market weakness.
- In summary, embrace the conflict, because it can support market gains. Why? Let’s get into it!

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.

This week we talk about the Fed's dilemma, which we think to be the market's gain. Sometimes you want to embrace conflict in the markets, and this may be one of those times. The tension points seem to be weakness in the labor markets versus higher inflation. The problem is that those two are not supposed to coexist, and it creates a dilemma for the Fed. If the labor markets are weak, then wage inflation tends to fall and thus consumer and goods prices follow. The Fed has a framework they follow that forms the basis of their policy reaction function called the Phillips Curve, which solves this dilemma for them. It creates a path for the Fed to cut rates despite above-target inflation and stronger growth expectations in 2026 because the Fed will tilt its dual mandate to focusing on the risk of labor market weakness. We encourage investors to embrace this conflict because it can support market gains. Why? Let's get into it!

Here's the breakdown. The debate really isn't about whether the Fed will cut rates. We think that they will, but it's how they will justify the move. I ground my work in my outlook in the Phillips Curve, which links the unemployment rate and inflation. If the labor markets weaken, inflation should ease. This gives the Fed a consistent rationale to cut, even with elevated CPI. I see the Fed focusing more on forward-looking labor market signals than backward-looking inflation data. Last week's CPI is above target, but it's yesterday's news. Rising unemployment from higher labor force participation is actually a positive because it broadens the labor pool without signaling distress, meaning that more people are coming into the labor market. The recent rise in the unemployment rate is what economists call “a good rise.” More people are entering into the workforce as pandemic benefits expire and immigration remains constrained. This creates healthier wage competition and supports disinflation.

Speaking about inflation, wage inflation is tightly linked to CPI and remains the Fed's key concern. Goods inflation, particularly from tariffs, is transitory, and it's not really showing up very materially in the CPI data. We think it's a one-off adjustment in terms of tariff-driven inflation in the sense that it will not be persistent inflation. On the data versus perception, this is where I think the market gets a little bit confused. Official labor stats may look weak, but we think it's statistical noise that's skewing the picture. Equity markets see the underlying strength in the labor market mix. Immigration policy shifts are reshaping labor supply in ways that traditional metrics do not fully capture.

Let's get back to Fed policy because after all, that's really what matters. I expect a rate cut, but not an aggressive one. My base case is for a 25 basis point cut at the September meeting, not 50 basis points, and the Fed will move steadily and deliberately thereafter. On the outlook for 2025, markets do expect 5 to 6 rate cuts, that actually extend into 2026, so a total of about 6 cuts going forward. That's the market's expectations, but I think it's going to be fewer cuts than that, closer to 3 to 4 cuts instead. Why? Because of growth resilience. We think that GDP growth will actually come in 2026 somewhere around 2.5% GDP, a full point above where 2025 levels are expected to end the year. This is going to be driven by measured Fed easing and a recovery from the 2025 soft patch. What's the bottom line? The Fed's path is deliberate, data driven and rooted in structural labor market shifts. This framework explains why easing can continue despite sticky inflation and the growth outlook remains compelling.

What does this all mean for investing? Well, we are positive on equities, and we have been for quite some time. Typically when Fed cuts come in the absence of a recession, the one-year forward growth returns and asset prices typically tend to be very strong. Add that to easier fiscal policies, taxes and deregulation and we get further support to our risk on bias. We're looking for a broadening of the equity market, but expressing this view through a basket approach that selects equities that benefit most from the current tax and fiscal policy environment.

Now over to fixed income, where we continue to like higher yielding credit and bank loans, despite expectations for lower rates. Why? Because bank loans are priced off the forward curve, and we don't think the Fed will cut as many times as the market is pricing (currently 5-6 times, while we think 3-4). As forward rates rise, bank loans and floating rate loans, which float off the short term interest rate index, well, we think that this makes these loans perform well. With 10-year yields around 4%, we are looking to reduce duration below index levels because we just don't think the higher growth and potentially stickier, higher inflation are going to be consistent with 10-year bond yields really materially moving below that 4% level. With 10-year yields around these levels, we look to underweight some of that duration.

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