

## The Big Easy

- The “Big Easy” is the nickname for New Orleans, Louisiana, but in this case refers to **the “big easing” of both fiscal and monetary policies.**
- **Monetary policy easing** is thought to be needed to support the labor market, and while true, there is another reason lurking – to avoid the risk and vulnerabilities of a liquidity squeeze.
- **Fiscal policy easing** may be seen as corporate tax relief and again, while true, what lurks is a foreign policy angle related to tariffs and geopolitical influence, i.e., the cost of tariffs needs to be offset to fund foreign policy matters.
- All in all, this is **not just a simple game of economic relationships.** There is something deeper at work that may keep easy policy at work for longer.
- This may produce **an underappreciated boost for asset prices**, thus suggesting that expensive valuations are not so expensive at all.

**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.

Today it's all about policy, both fiscal and monetary, to support asset prices, which we think has many dimensions – and is underappreciated by the market. Let me share how we are thinking about this, something I call the Big Easy. Now the Big Easy is commonly thought of as a nickname for the city of New Orleans, Louisiana, but that's not what this is about. What I'm referring to is the big easing of both fiscal and monetary policy with ulterior motivations that may keep policymakers at it for longer than traditional economic relationships would otherwise suggest. Monetary policy easing is primarily thought to be needed to support the labor market. While that may be true, we think there's another reason lurking in the shadows, namely to avoid the risk of the vulnerabilities of a liquidity squeeze. Fiscal policy easing may be seen solely as a corporate tax relief to spur investment in domestic business and create growth. Again, while this may be true, what lurks beneath is a foreign policy angle related to tariffs and geopolitical influence. In other words, it's necessary to offset the cost to tariffs to fund foreign policy matters. What I'm trying to get at is that it's not just a game of simple economic relationships. There's something deeper at work, something that may keep policymakers at it for longer. This may produce an unappreciated boost for asset prices, thus suggesting what many think are dear valuations may not be so dear at all.

Let's start with the Fed. The need to cut rates extends beyond just the labor market, but for quantitative tightening (QT) and liquidity squeeze reasons. Let's get into this. The Fed may be cutting to support the labor market and while that's true, liquidity concerns from a shrinking balance sheet, i.e., QT, may be another, larger motivation. The policy rate needs to be thought of as the price of money. The balance sheet can be thought of as the quantity of money aka liquidity, and as the Fed's balance sheet shrinks it

implicitly tightens policy. Keeping policy rates unchanged while the balance sheet shrinks is an explicit tightening, and this may be why the Fed cut interest rates partially last week. Evidence is that repo rates have been rising recently as the SOFR overnight rates are exceeding the interest on reserve balances. For example, on September 15th, corporate tax date, the repo rates went to 4.42% versus 4.4%, and this is starting to show some liquidity squeezes. Why? Because reserves are declining as the Fed's balance sheet shrinks. This increases the price of money as its quantity falls, which is a double whammy. Therefore, reducing the price of money to restore its balance with its supply alleviates this risk of a liquidity squeeze. So when, so when people refer to this rate cut as an insurance cut against a weaker labor market, yes, that's probably true. The additional insurance is to reduce the vulnerability of a liquidity squeeze. Why is this important? Because it may keep the Fed cutting rates further than some may think is otherwise justified by simple economic relationships.

Now onto foreign policy and funding tariffs through fiscal policy. This is really about turning headwinds into tailwinds. One of the focal points of the market risk was tariffs, and the cost to businesses, profit margins and inflation that came through tariffs. That was the risk. This was thought to be a headwind, but so far has not been the case. Earnings continue to surprise to the upside. Business investment has been increasing, capital expenditure has been good and inflation is only showing a minor presence in the data. The tailwind is corporate tax relief from the One Big Beautiful Bill Act (OBBBA). On September 15th, again, corporate tax day, the government recorded a \$104 billion reduction in payments from corporates versus the expenses related to tariffs, which were \$94 billion. On net, there was a benefit. So when we look at the \$104B saved from reduced taxes versus the \$94 billion paid through tariffs, it was a net positive. These are the benefits that are coming through the OBBBA, and it's really there to offset some of the potential squeeze from tariffs. An additional tailwind comes from deregulation. One can think of excessive regulations as a tax on corporates, thus, deregulation is a tax relief. So on net there is a greater tailwind than headwind to the economy and asset prices, and that may be why risky asset prices have been doing so well as of lately. To be sure, tax policies that create incentives for corporates to invest, boost domestic manufacturing, increase hiring and increase productivity are all positives for asset prices traditionally. But for how long can it continue? Well, we think for longer than one may expect. Our reasoning is that there is an intersection between foreign policy and economic policy at work today. Some call this coercive foreign policy. A strong economy and asset prices are needed to fund foreign policy, so this keeps policymakers again at it for longer and even pushing harder.

From an allocation standpoint what we're doing is broadening our investment lens and keeping an open mind as to the drivers of asset prices, and therefore valuations. On balance, we remain positioned optimistically on risky assets. Overall we don't think valuations are extremes, default risks in the credit space may stay low and we're still looking to add to portfolio positioning.

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RO 4833237 Exp. 9/30/2026