

The Market vs. The Economy

- It may seem strange to speak about an economic **soft patch** and the subsequent need for rate cuts **when equity performance has been strong**.
- But we must remind ourselves that **the market is not the economy, and the economy is not the market**.
- What may be good for equity prices in the near term, may not be durable for robust economic activity in the longer term.
- Over time, both the market and the economy should equate, something referred to as **intertemporal risks**.
- The Fed will be wrestling with this uncertainty and explaining their policy actions in the months ahead. In fact, they might cut rates while inflation is above target and equities are strong.
- **What's at stake?** A sweet spot or policy mistake that could fall poorly on the markets.

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 we're going to talk about that age-old battle, the market versus the economy. It may seem strange to speak about an economic soft patch and the subsequent need for rate cuts when equity performance has been strong. But we must remind ourselves that the market is not the economy and the economy is not the market. What may be good for equity prices in the near term may not be durable for robust economic activity in the long term. Over time, indeed, both the market and the economy should equate. This is what's referred to as intertemporal risks because these things happen in different time frames. The Fed will be wrestling with this uncertainty and explaining their policy actions in the months ahead. Cutting rates while inflation is above target and equities are strong. What's at stake? A sweet spot or a policy mistake that could poorly fall on markets. Let's get into it.

Let's talk about the market versus the economy and what's the difference. The economy is commonly measured in terms of output or GDP. We commonly think of the growth rate of GDP as a measure of the economy. Equities are valued in terms of earnings and the growth rate of those earnings. Clearly, both should be linked. If a country's GDP is growing, then it means the companies in its economy should also see rising rates of earnings.

But there is a difference from an investment perspective. It doesn't happen all at the same time. Investors in equities are forward looking and therefore tend to pull forward earnings to today's present value and establish a fair price today. We don't do this with GDP. We make forecasts on GDP, but it's not the same as a present valuation of an asset price. If the market currently expects 12-month forward earnings in the S&P 500 to be \$305 in 2026, a growth rate of over 12%, then today's present value on

asset prices will reflect this. Of course, if there are adverse shocks, then the present valuations of assets readjusts. But the consumers that make up 70% of the economy or GDP rely on their own personal earnings or income, meaning coming from jobs, which do not adjust as quickly as market prices. Companies that hire and pay workers are therefore more closely aligned to GDP expectations that exist over a longer term time period. This is why equities can rally while economic conditions are seemingly soft and the sell off while economic conditions are seemingly strong. Therefore, again, the market is not the same as the economy nor the economy the same as the market.

So why does all this matter to the Fed? Simply because the Fed needs to incorporate information from the market, the so-called financial conditions, but make a judgment on the economy and therefore policy rates. The risk is that they make a mistake and mistakes of this magnitude can be costly and make matters even worse. As we see it, the Fed will err on the side of lower policy rates because they see a greater risk in the unemployment rate rising than inflation rising. Why? Because their framework that forms the relationship between wage inflation and the unemployment rate, the Phillips curve, indicates that if the unemployment rate rises, then there is likely to be downward pressure on inflation. The Fed feels comfortable that it's not making a mistake to lower interest rates because such an action mitigates the risk in the labor market.

So why does this now matter to asset prices? Equity valuations are in the sweet spot to benefit from this uncertainty in the Fed's judgment. The Fed has made the decision to lower interest rates, which essentially lowers the rate by which the cash flow for equities is discounted. Lowering the discount rate increases the present value of equities as a result. Recall what I said earlier. Equity investors make forward looking valuations on the market, and if earnings are not only expected to grow, but their cash flows will be discounted at a lower rate, and the present value of equities or valuations are supported. If it turns out that the labor market strengthens in 2026 like I think it will, then the Fed will be quick to stop cutting rates, worry less about the labor market and more about inflation. This does not mean that the Fed reverses policy and starts hiking. Likely they will need to see a few quarters of labor market strength, just to be sure.

So how are we positioning? On balance we remain optimistic on equities and we're keeping our positive outlook. We are finding segments of the market that stand to benefit the most from tax policies, higher productivity and deregulation. These are themes that we've discussed in the past, and we're expressing this through baskets of equities that connect to these themes. In fixed income, we remain slightly underweight duration because we think 2026 may give way to inflationary pressures and keep the yield curve steep. We disagree with the forward pricing of the Fed funds rate to reach 3%, but rather see the bottom in the policy rate cycle closer to 3.5%. Credit spreads are tight and we are reducing exposure there.

Bottom line, we expect turbulence in 4Q as we gain more clarity on what the initial conditions will be for 2026. And no, it's not too soon to start thinking about the year ahead.

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