Caron's Corner Transcript – 7.29.2024

Introducing our FEAR Framework: Fed, Employment, Assets and Rates

- It's getting hot in the investment environment, as volatility is spiking and asset prices don't know what to make of the situation.
- In order to cut through the noise and find a signal, we have developed our **FEAR Framework**:
    - **(F)** Fed: Fed policy, namely when and by how much they may ease, is key for asset prices.
    - **(E)** Employment: There is a balance between the jobs market softening enough to contain wage inflation, thus price inflation, but not weaken to much as to destroy demand.
    - **(A)** Asset Prices: Equities and other assets will be influenced by many factors, but we still think fundamentals matter most. Fed policy and economic demand, stemming from the labor situation, are likely the most important factors.
    - **(R)** Rates: In the end it comes down to the price of money i.e. interest rates. Rates are used to calculate the present value of cashflows – the essential ingredient in valuing asset prices.
- These **FEAR** factors are linked together and you'll be hearing a lot about the **FEAR Framework** from us in the future

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Today we are introducing our FEAR framework which represents Fed, employment, asset prices and interest rates. Well, it's getting hot out there and not just because it's summer, but because asset prices don't know what to make of the current situation and volatility is spiking. In order to cut through the noise and find the signal, we find it useful to develop a framework to help us think through the situation. So let us introduce our FEAR framework. F represents the Fed and Fed policy, when and by how much they may ease is a key component for asset prices. E is for employment, as labor market conditions play a key role too. There's a delicate balance between the jobs market softening enough to contain wage inflation, and thus contain price inflation, but not weaken so much that it destroys demand. A is for asset prices. Equities and other assets alike will be influenced by many factors, but we still think fundamentals matter. Most Fed policy and economic demand stemming from the labor situation are likely most important. Lastly R is for rates, namely interest rates. After all it comes down to the price of money and that's interest rates which tells us how to calculate the present value of cash flows, the essential ingredient to valuing assets. It's all linked together and you'll be hearing a lot about the FEAR framework from us in the future.

Let's talk about the Fed. As we know the dual mandate for the Fed is price stability, which is inflation and full employment. At this point the Fed has early signs of confidence to cut rates because inflation is declining, albeit not yet to target levels. Well, what gives the Fed full confidence to cut inflation and have it remain anchored at near target levels at this stage? The Fed needs to see further softening of the labor market which signals falling wage inflation in order to have full confidence that inflation will stay anchored. This is why we believe the Fed's focus will turn more towards employment than inflation at this time. This is what makes a Fed rate cut in July or September a close call. Now, we really think that it's probably 50/50 for September, not July, but you know, that's going to depend on what happens in markets. And that's despite what futures are actually pricing in. So this is what we'll be listening for at the July 31 FOMC meeting.

Let's move on to employment and let me first start by saying this is an area of great debate. It's a murky picture at best and it's hard to have confidence when the picture is so murky. The monthly non-farm payroll establishment survey data shows that the number of monthly jobs growth has come in strong at the initial headline print, but is commonly gotten revised lower in back months. This could be from statistical quirks in how the survey data is calculated, which is a deep topic, and suffice it to say it's a very murky discussion. The unemployment rate has been rising and may rise further towards 4.3% by the end of this year. According to Fed estimates. This is calculated from the Household survey which has shown nearly zero jobs growth this year. The JOLTs data and weekly jobless claims have also shown a softening in the labor situation. More uncertainty is being added to the mix, add that to estimates from immigration and the picture becomes even less clear. Bottom line, the key data for the Fed to have confidence to cut rates is not very clear at all. So we'll be watching employment indicators closely.

Onto asset prices. Well, equity prices have fluctuated wildly in July. Perhaps it's all down to the long overdue correction and the narrowness of the market. However, second quarter GDP data has the price to the upside coming in at 2.8% versus 2.0% expected, which paints a potentially stronger picture for 2Q earnings. The positives were building inventories, Capex, consumer spending in combination with falling inflation that pushed real GDP for the second quarter higher. It came down to Capex that accounted for over 80% of this outperformance. Well, that was then, and the question is, how repeatable is this or will there be give back in the third quarter to offset the second quarter whopper. Nevertheless, we have seen a long overdue broadening in the market performance where small caps outperform large - something the market was not well positioned for. But will that continue? small over large? We're skeptical because it will take a broad rise in earnings and a cyclical recovery for this to continue. Maybe it's just a correction. That said, we don't think this is the start of a bear market, either we're still neutral equities with risk-on tilts.

Finally, let's look at interest rates. This is where the plot thickens. The market has already priced the Fed to cut rates, only to be disappointed. So the question is how much more can bond yields fall from current levels? Let's pick this apart. Let's go with the consensus and say the Fed cuts two times in 2024 and then four times, which is once per quarter, in 2025 for a total of 150 basis points of rate cuts. By the end of 2025 this puts the Fed funds rate at 4%. The next question is then what will be the shape of the yield curve at that time? When the Fed cuts typically the curve steepens. Let's say the twos/tens curve steepens out to an average level of about 50 basis points. This means that the two-year yield may be close to 4% and the 10-year yield by the end of 2025 may be close to 4.5% which is higher than where it is today. This leads us to two conclusions. First, one may not benefit greatly by owning long duration if we have a soft landing, even if the Fed cuts 150 basis points by the end of 2025. Second, rate cuts may do little to support equity asset prices as a long term discount, which is say the 10-year yield may not fall by much, if at all, and it could actually rise. So lurking beneath the serene surface of positive market performance this year is plenty to fear by market participants that it can all go wrong very quickly. This is why we created the FEAR framework to step through the ironies, nuances and uncertainties currently in the market. In the end, we still think fundamentals matter most along the way, there will be noise and volatility which creates opportunities. So we will use our FEAR framework extensively in the forthcoming market cycle. Stay tuned and thank you all for listening.

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