Caron's Corner Transcript – 8.5.2024

The BEAT for August: Key Themes and Top Ideas

- We cannot stress enough the importance of the jobs data, where a softening, especially in wages, will give the Fed confidence that inflation is anchored and triggers Powell to cut rates
- We created a FEAR Framework (Fed , Employment, Asset prices, Rates) to understand and measure the interplay of these key variables
- Currently we are seeing a friendly dynamic in which inflation is falling, the Fed is expected to ease, bond yields have fallen and labor markets are cooling, but not collapsing to point where it destroys consumer demand
- This balance is friend to both bond and equity assets. . .but for how long, and is it sustainable?
- We answer that through our asset allocation and portfolio construction described in The BEAT for August.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to the Beat for August. We can't stress enough how important the jobs data is. A softening, especially in wages, gives the Fed confidence that inflation is anchored and will trigger the Fed to cut rates. We created a FEAR framework where FEAR represents the Fed, Employment, Asset prices and Rates and is used to understand and measure the interplay of these key variables. Currently, we're seeing a friendly dynamic in which inflation is falling, the Fed is expected to ease, bond yields have fallen and labor markets are cooling but not collapsing to the extent that it destroys demand. This balance is a friend to both bonds and equities. But for how long? And is it sustainable? We answer that through our asset allocation and portfolio construction described in The BEAT for August.

Let's talk about these key themes. The first one is the labor market, this is the most important. It is sending somewhat mixed signals but holds the key to cutting rates at headline levels. The initial announcement of monthly jobs has been stronger than expected, but now what we're seeing is that more recently for July that is actually starting to falter. But, it's also been subject to steep revisions lower in prior months. The Bureau of Labor Statistics shows that the Household survey tells a different story, namely that the rising unemployment rate, which is now at 4.3%, is signaling weakness which is being corroborated by weekly jobs claims numbers. A softening in jobs data will lower wage inflation sustainably and provide the Fed confidence to cut rates, and that's what we think is in front of us.

Inflation, and when does bad news become bad news? Well, I think we're there now. Inflation is falling in the U.S. but it's also falling in Europe and it's sticky in Japan. Risky assets have performed well on signs of economic weakness that lowers inflation. That is a "bad news is good news" scenario. But once the source of falling inflation becomes a loss of demand, then bad news becomes bad news, and we're seeing early signs of this starting to happen at the current time, where political volatility will be with us for a while.

And that's a third point. We invested in a long French equity position during the dip in June. Despite the surprise victory of left-wing coalition, we maintain our thesis that policies are required to move toward the center in order to succeed. UK elections came and went and the U.S. presidential convent conventions are unlikely to create a discernible investment in information. Our mantra is that politicians govern differently than they campaign.

Now turning to China. While we've seen more of the same, China's twice a decade Third Plenum, which focuses on the long-term trajectory of the economy, has wrapped up with little fanfare. While expectations were low, there was some hope for reforms that would improve growth prospects. We don't have the full picture but the initial statements maintain a focus on high-quality development, meaning continued industrial subsidies and exporting excess capacity. The rest of the world seems to be pushing back on this policy.

Now let me bring in Ewa Turek to talk about our top trade ideas for August.

Thanks Jim. We have four ideas to highlight for August. Firstly, we're maintaining our overweight to high yield bonds. This month has yet again bolstered the case for a soft landing as inflation data in the U.S. came in below consensus. Consistent with this view is that default risks stay contained as a result. We think high yield bonds may offer competitive returns in second half of 2024 relative to equities and we've been adjusting risk exposure to the portfolio through this segment of fixed income.

Secondly, we are moving back to an overweight and municipal bonds high yield. Municipals are very attractive as their yields stand one standard deviation wide to their five-year average. Adjusting for the top Federal tax rate of 37 percent and the net investment income tax of 3.8 percent, that's a 9.5% return on a taxable equivalent basis.

Third, as Jim mentioned, we've been playing politics via French equities. We're maintaining that overweight, as the election outcome leaves our pieces intact. While we might see some short-term uncertainty as negotiations to form a new government play out. We ultimately expect a convergence of policies towards the center rather than to the extremes. Initially, equities may be range bound, but we expect recent underperformance to reverse as investor concerns due to political noise recede.

Finally, in terms of the large cap versus small cap debate, we continue to prefer large caps. Historically, small cap out performance has depended primarily on an acceleration in economic growth and that's not our base case in the second half of this year. While the recent decline in yields has been a tailwind to small cap stocks, we think softer economic data likely limits the durability of this trade.

Thank you, Ewa and we will be back with more updates later this month. Thank you all for listening.

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RO 3762431 Exp. 8/31/2025