Caron's Corner Transcript – 2.13.2023

From Too Tight to Too Easy. What's Next for Asset Prices?

- In what was otherwise slated to be a slow week for data last week, a lot happened. The narrative in the market started to change from worries that the Fed may be making a mistake and tightening too much, to now questioning whether the Fed might be too easy and need to do more.
- Once again the culprit is inflation and inflation expectations. Investors are starting to question if inflation will fall enough and stay low. As you know, this has consistently been a key risk factor: the risk that inflation becomes unanchored and the Fed needs to do more than what's priced.
- But as they say, sometimes it's not just about the destination, the journey may be just as, if not more important. Why? Because market prices are often path dependent.
- Let's get into it!

The Initial Conditions: A review of risks before the journey started

- Going back to December's FOMC meeting. The market understood the Fed to be leading the market into a recession, as a necessary requirement to reduce demand and bring inflation lower, to target, and keep it there.
- Inevitably, the labor markets were expected to suffer and the unemployment rate to spike. Thereby deepening recession risks.
- Many started to call for an end to the tightening cycle at 4.75% at the Feb 2 meeting. The Fed was driving the economy off a cliff into recession.
- Cash was at record and cycle high levels as investors were understandably worried.
- Calls for earnings collapsed, and a deeper equity market correction were abundant.
- The UST 10y yield drop toward 3.30% seemed to all but confirm the 1H23 recession. Because, after all, the bond market is 'smarter' than the equity market, right? Except when it isn't.

The Journey – Part 1: What we observed along the way

- The jobs market turned out to be stronger. Just see the data from a few weeks ago.
- Noticing the strength in jobs, **<u>the Fed changed its base case to a soft-landing</u>.** The significance is that the Fed no longer feels a need to push back against higher asset prices to accomplish its goal of containing inflation. Supporting this change was:
    - Powell doubling down on his 'disinflation' comment at a speech last week. No walking things back.
    - Last week the Fed's Williams also acknowledged that 5% to 5.25% may be appropriate. Previously he was thought to be closer to 5.5%

  - A solid belief from the Fed that we will see falling inflation: 1) goods deflation, 2) wages falling as layoffs in higher paying tech/industrial sectors are shifting to lower paying service sectors.
  - It is now possible for the Fed to see inflation fall without being forced to drive the economy into a recession and bring the unemployment rate higher… Thus making the Fed less worried about rising asset prices.
- Asset prices, credit and equities, took notice and valuations rose. This is bringing cash off the sidelines to chase returns.
- Earnings are falling as expected but investors are willing to look through this and keep valuations, or multiples elevated

The Journey – Part 2: What may happen in the months ahead

- The narrative in the market shifted from hard landing to soft landing. Maybe the next step is no landing at all.
- This will keep high levels of cash looking to buy dips and chase returns. 'Risk-on' is a risk. Investors can't afford to miss a rally.
- The blame game. Inflation got the *blame* for keeping earnings elevated in 2022. As we started 2023 inflation got the *blame* for pushing earnings lower. But if growth does not slow as much as expected, will inflation get the *blame* for stabilizing earnings? Possibly. This suggests 'good' inflation that comes from better growth. IMPORTANT!
- Inflation **<u>is</u>** falling though, keep that in mind. This is increasing real wages and consumer purchasing power. A net positive for top line revenue growth.
- Pushing the bad news out to 2nd half from 1st half of 2023
  - Recession has been pushed out becoming expected by consensus to come in 2H23 vs 1H23
  - As this shift, or pushing out of bad news continues, markets may perform well as 'risk' of a soft, or no landing scenario needs to be factored in.

Destination Unknown

- It all comes down to inflation, not just falling but becoming anchored at acceptable levels near target. We see the big risk to be that it becomes unanchored, which would make the Fed restart the hiking cycle. But we are not there yet!
- In the meantime:
  - Fed fund futures are not priced for this. Thus there is a <u>risk</u> that the market pricing believes the Fed and those rates rise.
  - As those discount rates rise, it could weigh on valuations, push yields higher, spreads wider and equity prices lower.
  - **BUT FROM WHAT LEVEL?** This is the key question. We may get a sell-off in 2H, but perhaps from more elevated levels.

    - Conclusion: It's difficult to forecast the future, but for now, over the nearer term, the risk seems to be higher prices.
- Our asset allocation thus has a more 'risk-on' tilt. Something we started building upon last December. We maintain this bias and are looking to add on dips.

Jim Caron: Hello, everyone this is Jim Caron, Co-CIO of the Global Balance Funds at Morgan Stanley Investment Management. Well, I think the question is from too tight, to too easy with reference to the Fed and what's next for asset prices. So let's talk about last week for a moment and what was otherwise slated to be a slow week for data. A lot actually happened. And the interesting thing is that the narrative in the market actually started to change from worries that the Fed may be making a mistake and tightening too much to now questioning whether or not the Fed might be too easy and need to do more and once again the culprit is inflation and inflation expectations. Investors are starting to question if inflation will fall enough and stay low. And as you know, this has consistently been a key risk factor for us. It's the risk that inflation becomes unanchored and that the Fed needs to do more at some later point, and do more than actually what's priced into the markets, but as they say, sometimes it's not just about the destination. The journey may be just as if not more important and why that is, is because market prices are often path dependent. So the journey tends to matter.

So let's get into it. And the way I'm going to frame this is by looking at some of the initial conditions before the journey actually started. So let's just take a moment and review that. Going back to December, going back to December's FOMC meeting to be more precise, the market understood the Fed to be leading the market into a recession as a necessary requirement to reduce demand and bring inflation lower to target and to keep it there. Inevitably, the labor markets were expected to suffer, and the unemployment rate was going to spike as many people had thought, thereby deepening recession risks. Many started to call for an end to the tightening cycle at 4.75% at the February 2nd meeting because the thought was that the Fed was driving the economy off a cliff into a recession and cash as we've talked about before, it was at record high levels or cycle high levels. As investors were understandably worried. There were calls for earnings to collapse and a deeper equity market correction all those calls were very, very abundant. Even the US 10 year Treasury yield dropped down into that 3.3% level, which seemed to all but confirm the first half of 2023 recession. Because after all, as some people say, the bond market is smarter than the equity market. Right? Well, except when it isn't.

So now let's go to the journey and it's going to be two parts of this journey. So part one of the journey is what we actually observed along the way and it was that the jobs market turned out to actually be stronger. Just the data from a few weeks ago. But here's where it gets very, very important is that noticing that the strength in the jobs market was there, the Fed started to change its base case to a soft landing that wasn't their base case before. But now they started to become much more emboldened in this view. That's now becoming a base case. The significance is that the Fed no longer feels the need to push back against higher asset prices to accomplish its goal of containing inflation. And supporting this change was, let's just go back again to last week, Powell actually doubled down on his disinflation comment at a speech he made last week and many people thought he was going to walk things back. He did not. Even Fed's Williams started to acknowledge that the appropriate level for policy was 5-5.25%. Why that's important? Because he previously thought it was going to be closer to 5.5%. So with this soft landing now becoming more entrenched in the Fed’s view what we're starting to see is even some of the more hawkish people on the committee are starting to lower their terminal expectations for Fed funds.

So it's really a solid belief from the Fed that we will see falling inflation, we're certainly seeing goods, as Powell likes to say goods deflation and wages are falling as layoffs in the higher paying tech industrial sectors are shifting to lower paying service sectors. So it's now possible for the Fed to see inflation fall without being forced to drive the economy into recession and bring the unemployment rate higher. And this makes the Fed less worried about rising asset prices. This is a very, very key part of the argument. It's why I think asset prices have been bubbling up. You know, when I say asset prices, we're looking at credit and credit spreads that are starting to narrow and equities of course. All of the valuations across these started to rise and what this is also doing is bringing cash off the sidelines to chase returns and earnings are certainly falling as expected. But investors may be willing to look through this and keep valuations or multiples elevated because if we have a soft landing when everybody was mainly expecting a recession, then you have to build in a better possibility for the future economic environment and that's essentially what's going through the market.

So that gets us to the second part of the journey, which is what may start to happen in the months ahead, forecasts are difficult. So this is just really just some expectations as we see them now. The narrative in the market has shifted from hard landing to soft landing and maybe the next step is no landing at all. A question of course, is, “Is this fully priced?” Now this will keep high levels of cash looking to buy dips and chase returns and as we've said in the past, risk on is a risk and investors can't afford to miss the rally.

So now there's a blame game that's going on and it's really all about inflation. Inflation got the blame for keeping earnings elevated in 2022, and as we started 2023, inflation got the blame for pushing earnings lower. But if growth does not slow as much as expected, “as much as expected,” those are the keywords, will inflation get the blame for stabilizing earnings? And we think that's possible and this suggests that there's good inflation that's coming from potentially better than expected growth. This is important because this really outlines the shift in the narrative and it's why investors are willing to assign a higher multiple to equity prices even though earnings are likely to be soft, which we know that that's what the data has been coming out and showing. But now we also have to remember that inflation is falling. Keep that in mind this is increasing real wages and consumer purchasing power which is a net positive for top line revenue growth. But the fact that inflation is falling, it's really a question of the trend. Data point to data point, sure there could be some volatility in that. But the Fed believes that inflation is on a downward trend. So what this has done is it's pushed the bad news out to the second half of 2023 from the first half. So recession has been pushed out becoming more expected by consensus to come in the second half of 23 versus the first half of 23 and now this needs to be priced into the markets and that that's where I think some of the dip buying mentality is starting to develop as this shift or pushing out of bad news continues, markets may perform well as the “risk” of a soft or no landing scenario needs to be factored in. And again, the risk is for a soft landing or no landing scenario.

So now let's talk about the destination. Well, as we like to say destination unknown. So we have to all figure this out. I wish we all could identify what the destination of markets would actually be. But it really all comes down to inflation, not just falling but becoming anchored at acceptable levels near target. And we see the big risk to be that it becomes unanchored, which would make the Fed restart their hiking cycle. But we're not there yet. We have to take this in sequences. Sequencing is important. Right now, the market is pricing in the possibility for there to be a no landing or soft landing from the possibility of a recession. So that's a positive turn of events. Now, the market needs to think about this a little bit differently.

So in the meantime, the Fed funds futures are not priced for this. If you look at where forward rates are there, they're very, very low and still expecting the Fed to cut rates at some point this year. So there is a risk that market pricing believes that the Fed may actually keep rates stable and that those interest rates actually start to rise in the future and as those discount rates rise, it could weigh on valuations and push yields higher spreads wider and equity prices lower again. But this is at some point in the future. And the other important thing is to ask is yes, all that can happen, there could be this downturn in markets, but from what level? This is the key question. So we may get a sell off in the second half of 23, but perhaps it comes from more elevated levels.

So our conclusion is that it's difficult to forecast the future, but for now over the nearer term, the risk seems to be for higher prices. Our asset allocation thus has more of a risk on tilt and it's something that we started building upon last December and we're going to maintain this bias looking to add on dips until we see different data come through. So with all that, I want to thank everyone for listening in and I will not be back next week. I will be on holiday next week, but the following week I'll be back with another Caron's corner. Thank you.