

Is All News Really Bad News? What May Happen Next in Markets

- Call us skeptical that all news is bad news. We are also wary of the rapidly changing narratives that the market is clutching onto as it swings from one monkey bar to the next.
- It's hard to time things perfectly, but we see inflation moving lower and the narrative for the terminal policy rate to eventually settle at 5.25%. If there's risk to this view it's to the upside, but not higher than 5.50%.
- Why is this important? Because the sharp selloff in assets is based on a narrative of rising inflation and tighter policy. If this proves false, or if a more balanced narrative emerges - let alone one in which inflation falls (as we think it will) - then we see it as a sharp positive for asset prices.
- Fixed income assets just reset and gave up most of this year's gains, perhaps making now a better entry point. Near 9% High Yield and Emerging Market yields do seem attractive for what we think will be a soft landing with low default risks.
- A stabilization of inflation and policy risks may also be friendly to equity markets. Don't underestimate the high cash levels that will chase returns.
- Once again, a balanced approach like ours, one that allocates across a combination of stocks and bonds, all within in a risk-controlled framework, may be ideal for this choppy environment.

Jim Caron: Hello, everyone. This is Jim Caron, Co-CIO of Global Balanced strategies. What I'd like to discuss this week is market news and how bad it all really seems, and ask the question is it all really bad news and what may happen next. But before I get into that first, allow me to make a caveat to this week's audiocast. Anyone who has listened to me in the past knows that I believe the big risk for 2023 is that inflation becomes unanchored and it creates a risk for the Fed to be forced into the market to tighten policy even further. This has been my long time primary risk concerned. So what I'm about to say next may sound surprising and that is that I think the market today is too worried about higher inflation and it's because the pendulum has swung too far from markets being worried about disinflation and the Fed doing too much, to now worrying too much about inflation and the Fed doing too little. My base case remains consistent: inflation is likely to fall significantly in the first half of 2023 and maybe even into the early part of the second half of 2023, and the risk is that it becomes unanchored. But that's a conversation for the second half of 2023, not the first half. So with this caveat and nuance out of the way, let's get into it.

The first point I want to raise is the associated risks of rapidly changing narratives. This has been what's so surprising so far this year. We're only two months into the year and never underestimate how quickly the narrative that explains the market can flip, and over short periods. This is what's happening now in the first quarter of 2023 and we may not be done. We're seeing this narrative continuing to flip flop and let me now go through what that is. The first is that we started the year with a view that the Fed might hike 50 basis points by late January. This flipped to the final hike being at the February 2nd FOMC meeting and a terminal policy rate of 4.70%. Now today we flip again and we're back to inflation being a problem and the Fed needing to hike even more - much more - and we even hear cries today of 6%

policy rates. All this flip flopping is happening in just the first two months of the year, and markets today can't help but see it as bad news, and I think this is important context for what may happen next. I'd like to now look at what I think are competing, and at times misleading, narratives that can be broken down into two key features. The first one is that the jobs market is red hot, the 2nd one is that the red hot jobs market contributes to wage inflation and the Fed needs to tighten much more.

So let's start with the jobs market. Is it really red hot, and if so for how much longer? Unraveling technicals for the jobs market may reveal it is strong, but not as strong as some may think. As we dig into these technicals I believe an alternative narrative will soon emerge and suggest the jobs market is not as strong as we've been recently led to believe and that inflation will start falling. Yes, I do think that the recent inflation numbers have been surprising to the upside. We saw a stronger January PCE and that confirms what we already knew from earlier in this month, that the January CPI was very strong and that inflation was higher than expected in January. This is definitely priced in the markets at this point. But there may be seasonal statistical course at work here that will wash through over time. For what it's worth most economists still do see inflation falling to the 2-3% inflation range by the end of the year and the unemployment rate rising by about 1%. And yes, I know they've been wrong before but here's where the plot thickens and challenges today's most recent inflation narrative.

Bureau of Labor Statistics (BLS) data is the source of monthly jobs data. BLS has been reporting strong jobs, maybe misdirecting the facts of the matter at least for now and not purposely but based on a statistical quirk. The full story is yet to be told. The main clue comes from the Quarterly Census on Employment and Wages (QCEW) data, where Steven Englander from Standard Chartered has done some excellent work on this topic. The QCEW data comes from the BLS but with a five month lag after the end of each quarter, so it gets buried versus it's timelier, younger cousin, which is the non-farm payrolls report which we watch every month. You know, as I said, the first Friday of every month is also heavily revised and it's a shame too because the QCEW data has a significantly larger sample size than the farm payroll data and its unrevised, not seasonally adjusted and historically and statistically been more accurate. What is it showing today, is that the jobs market is likely weaker than what's being reported and will likely lead to downward revisions in the monthly non-farm payroll data. The main point here is that if the non-farm payroll data is not as reliable as we and the Fed think, then the characterization of the labor market as red hot or extremely tight may actually be inaccurate. Suffice it to say we see enough turbulence in the data that we are skeptical of the rapidly changing narratives in the markets today.

So now let's talk about what might the future bring - and clear forecasts are very hard to make. But I still think that the terminal Fed funds rate ends up around 5.25%, and I've been at that level for a long time. I still think that's the case today and this is despite the recent cries for 6% policy rates. I do think that we'll see inflation fall towards the 3% area and maybe even dip below. I always look at the housing market data which has been very soft and represents about 30% of the CPI provided you add up all of the different components involved. Weaker housing data and weaker inflation are things to be wary of and whether inflation is anchored or not is a discussion for the second half of 2023, not right now. I want to be very clear on that point, and the other point that I've discussed a lot has been the cash holdings in money markets. It's at record highs even today, just over \$6 trillion, and as we have said many times before "risk on" is a risk and it needs to be hedged. Do not underestimate how vulnerable the market is to cash on the sidelines getting put into the market chasing performance. If we get any sense of inflation or the jobs market softening, that could actually bring money back into the into risky assets. But we did start the year pricing the terminal Fed funds rate at 4.9% which seems like ancient history. But the month of February essentially reversed all of the 2024 cuts with the terminal right now pricing 5.4%. So we've gone from 4.9% terminal policy rate that was priced at the beginning of this month to the end of

February now pricing at about 5.4%, which is a 50 basis point swing and pretty impressive. But I would like to highlight how the Fed may see things because after all they are the decision makers.

Look the Fed may see things differently from the current market narrative. Sure, the Fed is worried about inflation, but they balance that risk against tightening too much as well. Importantly, based on comments from the Fed, although the path maybe that they see inflation falling. In fact recent papers from the Fed, they put forth a post World War II analogy, where the post-COVID inflation shock is similar to the post World War II shock that was a result of demand reallocation, similar to what we saw in the pandemic. This explains about 3.5% inflation above normal levels according to the Fed and can come down rapidly without the need for the Fed to unnecessarily destroy demand by overtightening. Now, I've heard this this post World War II analogy to the to the post-COVID period before, but what's important to me today that the Fed is now talking about this. This is what they believe and if they believe that inflation can come down without having to unnecessarily tighten too much, I think we should listen to what they're saying. This could prove to be a positive backdrop for risky assets. meaning that they don't have to tighten financial conditions or push asset prices lower to get the inflation down as far as they wish.

In conclusion to all of this, call us skeptical that all the news is bad news. And call us wary of the rapidly changing narratives that the market is clutching onto as it swings from one monkey part to the next. It's hard to time things perfectly, but we see inflation moving lower in the narrative, the terminal policy rate to eventually settle in around the 5.25% area, which is where we've been all along. And if there's a risk of this view, I will admit it is to the upside, it could be as high as 5.50%. Now, why is this important? Because a sharp selloff in assets is based on the narrative of rising inflation in tighter policy. If this proves false, or even if it's a more balanced narrative that emerges, let alone one in which inflation falls as we think it will, then it could lead to a sharp positive reversal upward for asset prices. That's just a risk that I think we need to be wary of, especially in light of all the cash that's still on the sidelines. Now, fixed income assets just had a reset and gave up most of this year's gains which was a strong start to the year and maybe perhaps this is a better entry point for fixed income with yields being slightly higher. Maybe we can think of this as getting a second bite at the apple as we have High Yield yields near 9% and Emerging Market yields in the high eights as well, so this is all pretty attractive for what we think will be a soft landing in a low default recycle. A stabilization of inflation and policy risks may also be equity market friendly, I can't underscore that enough, and do not underestimate the high levels of cash that is out there that may need to chase returns. Once again we like to advocate a balanced approach like ours with strategies that invest in a combination of stocks and bonds that looks to keep risks controlled and may be ideal for the current choppy market environment.

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