Caron's Corner Transcript – 3.27.2023

Old Risks Create New Challenges

- The market environment today is filled with negative sentiment, where the consensus now calls for a recession in 2023.
- But, we have to distinguish whether the slowdown was scripted - and thus expected - by central banks, or if something more nefarious is at hand.
- Recession risks, however mild, have certainly increased and are largely already in market prices, but the risk of a hard landing has also increased.
- Commercial real estate exposures at smaller banks, deposit ratios, increased costs of credit and other unknowns have recently become risk factors.
- But wait, weren't those risk factors there all along? And if not top of mind a few weeks ago, then why are they in the spotlight today?
- There are also risk factors centered on reduced lending by smaller banks, risks that are difficult to observe and therefore difficult to measure.

Jim Caron: This is Jim Caron, Co-CIO of Global Balanced and Risk Control strategies. In today's markets, old risks are creating new challenges. The market environment today is filled with negative sentiment, and the consensus calls for a recession in 2023 have now been further emboldened. But it's important to remember that we need to distinguish whether the slowdown was just the scripted slowdown that was expected and planned from all the central bank rate hikes or if it's something more nefarious. Recession risks have certainly increased even if only a mild recession, which is largely in the price, but risks have also increased due to commercial real estate exposures at smaller banks, deposit ratios and the increased cost of credit. But wait, weren't those risk factors there all along? If they were if they were not top of mind a few weeks ago, then why are they being so highly emphasized today?

So what's changed? That's the question that we always have to ask ourselves, and what we realized is that there were many risk factors that existed at the onset of 2023. That's why so many people had forecasted a recession in 2023 despite the fact that many factors were seemingly unconnected. In other words, there wasn't a spark or a catalyst that was obvious that could correlate these risks, meaning we couldn't bring all those risks together. The run on deposits at smaller banks in the US appears to be that catalyst, bringing together what were seemingly unconnected risks. The catalyst that ignited higher correlations in the markets. Now, once the banks were subject to deeper scrutiny, we could connect the work-at-home bubble to lower occupancy rates for commercial buildings to recession risks that may increase the unemployment rate and further reduce occupancy rates and ultimately commercial real estate and the outsized holdings from smaller banks. All of these risks started to coalesce and started to dominate the narrative.

So this is what has changed now. Those who were proposing a narrative for a soft landing or a mild recession now find themselves defending it against an onslaught of market bears who now feel emboldened. Additionally, the upcoming fundamental data in the second quarter is likely to support the bear case. Understand that first quarter GDP is running at pretty hot levels, now forecasted at around 3%, but a lot of that strength was due to a warmer winter that pulled forward demand and wreaked havoc on seasonal factors. If all that holds true, then the second quarter is where one can expect payback from this first quarter strength. Q2 data faces an uphill battle. In addition to contend with skittish markets, and that is sure to reduce business and consumer confidence, we then have to start to assess the risks that are unobserved and hard to measure.

Last week Powell said that traditional measures of financial conditions may understate the true tightening. What he's referring to is that financial conditions typically include **observable** measures like the US dollar, equity prices, interest rates and credit spreads. These measures are observable market data points. The point that Powell is making is that if bank lending is reduced and the distribution of credit to the real economy falls lower, then this actually may represent a bigger tightening, but not one that is easy to measure. There is no market instrument that reflects this tightening and it will be both difficult to observe and measure. We'll simply have to wait and see how this develops in the broader economy. It only adds to the uncertainty and may keep market volatility elevated. It's likely that the news flow in the coming weeks and months will have an asymmetric influence on the downside in asset prices rather than the upside. We need to take this into account that there's an asymmetry of the news flow that might be viewed more negatively. What we need to do now is find ways to manage volatility because we think it's going to be a key way to find opportunities in the market.

So I went through the bad news. But here's the other side and we have to take this into account. While we recognize that the near term will likely be volatile and stressful, it could be that the result is a slowdown in economic activity and a reduction in longer-term inflation risks that could be longer term beneficial as per the prescription of central bank tightening. It might just be a longer term positive that also needs to be weighed against the shorter term negatives. Of course this thesis is only valid if we avoid a systemic event or a deep protracted recession, and I suppose the jury is still out on this. But our base case is that we encounter neither.

But, this potential good news will also add to volatility and can create sharp snap backs resulting in higher prices. That also adds to the volatility. In the meantime, bounces in the market can be used to reduce risk exposures and match the current economic climate to positions and portfolios. Interest rates seem to be way ahead, already discounting several rate cuts, and it's hard to find value there. But credit may offer some value as yields are little changed from the start of this year despite the lower move in US treasuries. If we don't have that deep protracted recession and default risks rise, but they don't rise all that much, it might be an interesting place to start to look again. The premise of this view is that we avoid a systemic risk event and a deep protracted recession, and that has to be part of one's decision making process as well. But it seems the strategy could be the right size positions and exposures so that one can absorb what is likely to be a volatile next few months and quarter and keep some dry powder for investment opportunities when they may present themselves. As we have said before, it's better to be balanced and defensive and it's essential to incorporate risk controls in one's investment portfolio and this could not be more true today.

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