Caron's Corner Transcript – 4.17.2023

What the Yield Curve and the Dollar Are Telling Us

- This week we want to take a big-picture macro look at two key drivers of longer term market dynamics: the yields curve and the U.S. Dollar (USD).
- From a U.S. domestic perspective the slope of the yield curve provides a market based pricing of Fed policy, inflation and by extension, GDP growth, economic conditions, labor, wages, etc.
- From a global perspective it is important to look at the USD, which is always topical, but extremely hard to forecast given the many variables and co-dependencies.
- The yield curve is priced to reverse much of its inversion/flattening and steepen going forward, and the USD is trending weaker. Both are macro signs of easier financial conditions ahead.
- But, the consensus narrative for a more negative outlook still prevails. What gives?

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Last week we took a look at the micro parts of the markets, a bottoms up look at Q1 and Q2 forecasted earnings, and noted that the first half of 2023 may represent the year-over-year trough in the reported earnings cycle and that we may see marginal improvement thereafter. As we said, sometimes it's the delta (change) that matters and this helps us understand the markets near term dynamics better.

This week, what we would like to do is look at the bigger picture macro view to understand some of the key drivers of the longer term market dynamics. I want to focus on two things, the yield curve and the US dollar (USD), and we can break this down as domestic and global. From a domestic (US) perspective, we will focus on the yield curve since the slope of the curve provides a market-based pricing of Fed policy and inflation, and by extension, GDP growth, economic conditions, labor wages, et cetera, but only by extrapolating economic relationships into the future. From a global perspective, we'll look at the USD which is extremely hard to forecast because there are so many variables to consider and co-dependencies. But it's always topical. These two important macro variables, the yield curve and the USD, are pricing for easier financial conditions ahead. The yield curve is priced to reverse much of its inversion/flattening and steepen going forward. The USD is currently trending weaker. Again, both are macro signs of easier financial conditions or stimulus ahead. But the consensus narrative for a more negative future still prevails. So what gives?

Let's start with the yield curve. Many people are focused on the flattening of the yield curve, so let's use the 2/10 US Treasury curves that represents the spread between the 10-year US Treasury yield and the 2-year US Treasury yield as a reference. Throughout 2022 the 2/10 curve was a harbinger of bad things to come after flattening and inverting. When I say flattening or inverting yield curves, particularly in the case of an inverted yield curve, that's when the shorter rate, the 2-year yield is actually greater than the 10-year, the longer term rate. This type of inversion is typically associated with a tightening of monetary policy that leads to recession. Here are some corresponding numbers. The 2/10 curve did flatten from a

spread of +90 basis points (bps), meaning the difference between the 10-year and the 2-year yield was 90 bps positive. If we go back from December 31, 2021 to the trough on March 8, 2023 it dropped a negative 108 basis points which means it went from plus 90 to minus 108, a flattening of nearly 200 basis points (based on Bloomberg data as of the market close on Friday April 14). So the 2/10 curve flattened and inverted quite substantially and just look at the financial performance of 2022. It wasn't good, so flattening curves do matter.

But if a flattening curve matters then shouldn't a steepening curve matter too? Yes. So let's look at what the market is pricing into the future. To make the math a little bit easier, let's use the swap curve and I'm going to base this on is the SOFR rates, the Secured Overnight Financing Rates. In other words, these are the new LIBOR rates. We're going to use the swap curve and the market is pricing the yield curve to steepen over the next one year period by about 75 bps. It's inverted today and it's likely to steepen by 75 bps over the next one year. Period. Although this may reverse much of the inversion of the curve, the level that it lands on still may remain flat, meaning either side of 0 bps i.e. the 2-year and 10-year rate might be equivalent. The slope of the curve doesn't turn more decisively positive until two years from now based on future market pricing. Nevertheless, it's a steepening move which portends easier financial conditions into the future. Of course, this all suggests that the Fed is priced to cut interest rates significantly over the same period, and again, a reflection of market pricing.

Now, an implication of this is that owning long duration fixed income assets may not be such a great hedge. In other words, if the curve is supposed to steepen, which means that longer-duration bonds would underperform front-end bonds, such that owning the longer-term duration bonds might not be such a great hedge, because much of the decline in the level of longer-term rates is already in the price. If the curve steepens the longer duration assets may not be as beneficial, of course, unless one expects the market to move into a deflationary trend with a full flattening of the curve, which is when all yields come down and the curve flattens led by the long end.

Let me make a caveat here since I'm talking about forward pricing of the markets. The caveat is that the futures of forward markets do not predict the future, it just reflects a fair price today if one were to enter into a forward starting position. But having said that, it's still very informative. Again, this is not a predictor of the future, just a measure of what today's value would be if you enter into that trade today. So with that caveat, we're not suggesting that the "all-clear" siren has been sounded because what the market is worried about is an event that makes the Fed cut rates and the curve to steepen. This is where the risk lies because if that event is bad enough to make the Fed cut rates significantly, then that could be a risk-off event for markets. We cannot dismiss this important point.

Now let's turn to the US dollar (USD) and see what it might be telling us. The USD is another important macro variable to consider and the relationship to keep in mind is number one, the stronger dollar represents a tightening of global financial conditions, because many liabilities are USD-based. As such, the global debt burdens increase along with a stronger dollar. Of course the opposite is true when the dollar weakens, as it represents an easing of global financial conditions for the for the same reasons, but in reverse. Typically the USD appreciates during risk events and a flight to safety. This is not currently being priced into the markets right now as the USD index peaked around the start of Q4 2022 and has

been trending lower ever since. Last week it made new lows on year-to-date levels. To some degree this can be attributed to a narrowing of the interest rate differentials as the Fed is nearly done with its interest rate hiking cycle whereas other major central banks like the ECB still have more to go in terms of rate hikes.

Another factor that could explain why the USD has started to weaken is commodities. We saw that commodity importers outperformed exporters given the fall in commodity prices due to the warm winter. There was more favorable stance towards, for example, the euro, who's a commodity and energy importer, something that could have created some of the differential to make the euro strengthen and the USD weaken. Still, the declining trend in the USD represents an easing of global financial conditions in the absence of a severe risk event. Although the USD still remains at strong levels relative to its long-term averages.

The point we're trying to illustrate is that by looking at macro variables, many of the risks in the markets are more balanced than what the current market consensus narrative implies. It does not mean the "all-clear" has been sounded - there are certainly risks - but we think there are opportunities to find and build value into portfolios. And as always, it's better to be balanced and defensive and apply risk control measures along the way.

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