Caron’s Corner Transcript – 6.5.2023

You Must Ask the Right Questions to Find the Best Answer

- Sometimes knowing the right questions to ask is essential to finding the best answers.
- This is particularly important in situations where the right answer is not obvious, much like today’s markets.
- Why? Well the question about economic fundamentals is straightforward; conditions are slowing, likely leading to a recession.
- Yet this would lead to the wrong answer with respect to market performance.
- Since stronger year-to-date market performance is not the obvious answer to weakening fundamentals, then maybe we are asking the wrong questions. Let’s discuss.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. The markets are very interesting right now and sometimes asking the right questions is going to be necessary to finding the best answers. This is particularly important in situations when the right answer is not obvious, and I see today's market conditions precisely this way. This is because the question on economic fundamentals is straightforward, where conditions are slowing and likely leading toward a recession. But this would give us the wrong answer in terms of how the markets would perform, since stronger market performance, like we've seen so far this year, is not the obvious answer to weakening fundamentals. Well then maybe we're asking the wrong questions. Let's get into it.

There are five key fundamental questions that I'd like to rephrase or at least ask again. Let's go back to the start of the year when the question was when (not if) would we have a recession in 2023. Now as we approach the mid-year point, we can more safely conclude that consensus expectations for recession to start the year were likely wrong. The question now being asked is will it occur later in 2023 or in early 2024? But perhaps this is still the wrong question. Instead, perhaps the right question is how deep a potential recession may be. Not when (or even if) we have one because if it's a mild recession or a softer landing, then when or if we have a recession may matter less to market performance. This is why in our analysis we tried to simplify the question and expect a non-hard landing scenario. When and if mattered less than how deep with respect to possible outcomes for market performance.

In other words, if we ask the question this way, “Do you believe in a hard landing or non-hard landing scenario?” then the answer becomes more relevant to the market. This is also why we developed our investment philosophy in thinking about a balanced positioning rather than a defensive one, because “risk-on” is a risk and like any other risk needs to be hedged. So if we ask a good first question, then the follow-up questions can help put us on the right path. The second question, which is a bit more obvious, is “what is the consensus and how is the market positioned?” This takes us right back to the first point. Since the start of the year, the consensus has been bearish and is still bearish today. Investors are still positioned defensively. The third question then becomes a proverbial favorite. “What move in the market hurts the most people?” In other words, the counter-consensus trade is commonly what prevails

unless an exogenous shock occurs. To repeat "risk-on" is a risk that needs to be hedged and clearly the trade that hurts the most people is a movement higher because people just aren't positioned that way. There's then room to dig a bit deeper and ask a forth question: "What may cause the market to upset the consensus?" The answer is becoming more obvious, where a strong jobs market is keeping the consensus stronger than expected at this point in the cycle. Lastly, the fifth question could be "But aren't conditions in the economy slowing and will that eventually hurt the jobs market and consumer?" The answer here is yes, but perhaps it's not slowing fast enough to justify the bearish narrative and market positioning. I've said that many times and this is really where it becomes interesting. What's most important is how the market - not us but the market – answers those questions.

Let me make a few observations. The VIX (Chicago Board Options Exchange's CBOE Volatility Index) fell below 15 to 14.6 as of Friday's close (June 2nd), its lowest close since the pre-pandemic "happy days" in early 2020. This is also below long-term averages outside of the QE-designed asset inflation period and the highly- leveraged, market-madness, pre-2008 crisis period. At that time the VIX fell to around 9, which was extremely low. We are in neither of those periods now and to understand this better what we really have to look at is how volatility is correlated to market levels and market performance. Low volatility is often correlated with periods of higher asset prices i.e. risk-on. Because people are typically naturally long assets and buy vol (volatility) to hedge when there is fear of asset prices falling. This is why higher volatility is correlated with lower asset prices. The key question today is "why is the VIX falling in spite of the bearish narrative?" The answer is that not many investors today are fully invested in the market and thus there is less need to buy vol to hedge to the downside. As a result vol, represented by the VIX, is falling. This is a key piece of information, namely that investors are underweight risk.

Now the next question to be answered by the market is "if investors need to play catch up and chase performance, what might they buy?" Well, we think the answer here is the broader U.S. market. Listen we all understand that the technology sector (tech) has led the way big time this year. Tech is up over 30% year-to-date (as measured by the S&P 500) as of Friday's close. But the 10 remaining sectors in the market are flat to down except for industrials which is up by a low, single digit amount. But the broader market may be a better-valued way to attract new money and investment - and do not underestimate the pressure professional investors are under to show respectable performance in 2023 after a very weak 2022. The broader U.S. market may have more scope to play catchup and perform better than even Europe. This is something to watch.

Now let's talk about high quality bonds. This was another consensus favorite and it may not be the ideal asset class today because interest rate risk or duration risk may weigh on performance. High quality bonds are up only 2 - 3% YTD based on the Bloomberg U.S. Aggregate index as of last Friday's close. We still like reducing interest rate risk exposure in favor high yield and sub-investments rate areas of the market, mainly in the BB sector. Bonds can still be a good ballast to a portfolio, but we do have to be very mindful of interest rate sensitivity and the weighing on performance that it could bring, especially if the data doesn't get bad, fast enough and interest rates stay relatively high. As we like to say "it's better to be balanced than defensive."

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