Caron’s Corner Transcript – 6.12.2023

The Balance of Risks Tips To Easier, not Tighter, Policy

- The Fed meeting is this week and potential highlights include:
  - The “dots” drift higher, keeping more hikes alive, though the Fed might pause in June.
  - Despite an upward drift in inflation forecasts, the Fed will maintain a 2% inflation target.
  - An indication of stronger expectations for the labor market.
- However, this applies only to the U.S.
- On the other hand, **global** central banks may merge their policy reaction function to the “**balance of risks,”** a policy that balances growth and inflation risks.
- The implication is that in relative terms, global policy is *easier*, not *tighter* and thus supportive of riskier assets.
- In all, this broader perspective may help drive investment decisions.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. The balance of risks tips to easier, not tighter, policy. Now this may sound like a contentious statement given that we have a lot of central bank meetings this week where the Fed and the ECB are both expected to hike rates. But let me explain.

All eyes are on the Fed meeting this week. That will include a release of their Summary of Economic Projections (SEP) which is a quarterly forecast table as well as “everyone's favorite” - the dot plot. Here are some potential highlights. The dots may drift higher showing Fed officials are keeping more hikes very much alive, although they may pause in June and depending on data, then may decide to hike again. The SEP may show an upward drift in inflation forecasts from the Fed given how sticky it has been, especially at the core, but they will likely maintain a 2% inflation target as a longer-term target which they're bound to by form. This SEP may also reflect stronger expectations for the labor market and they may reduce their 4.6% unemployment rate forecast by a few tenths of a percent as a mark-to-market exercise.

But enough about the U.S. It's as important to understand the context of what's going on with global central bank policy. Global central banks may merge their policy reaction to what is commonly called a “balance of risks,” a term we will hear quite a bit about moving forward. It’s a policy that balances growth and inflation risks to justify why they may be unwilling to adopt policy to push inflation down to target and keep it there. The implication is that in relative terms, their policy is easier, not tighter, and supportive of risk assets, a broad perspective that may drive investment decisions. So let's get into it.

I'd like to start out by saying that the world is round, not flat - and what I'm referring to is how global central banks are actually functioning right now. The global central bank “party” started last week with hawkish surprises. On June 7th, the Bank of Canada surprised us by increasing policy rates by 25 basis

points. They were expected to hold but hiked. Why? Because inflation remained too hot for comfort and they saw policy inconsistent with their 2% target. Before that, on June 6th, the Royal Bank of Australia (RBA) also hiked 25 basis points. Again, this was against consensus expectations to hold. And why? Well, once again, because inflation is remaining too high. The RBA said inflation is still too high and it will take some time before it falls within its 2-3% target range. Furthermore, in addition to the Fed meeting on June 14th, the ECB meets on Thursday, June 15th and they're widely expected to hike another 25 basis points. Then the Bank of Japan meets on Friday, June 16th, and while they may keep policy rates unchanged, there is a chance they may widen the bands on yield curve control, which would be a *de facto* move to higher rates. But, this is not the consensus view.

The common theme here is that the 2% inflation target is illusory. Global central banks will hike - but slowly - and this is what I mean by relative easy policy. It's relative to inflation. Meanwhile, we can look at certain central banks in Emerging Markets. China, for example. China is seen as easy policy designed to stem financial and economic downturns. Last week, China asked its big banks to cut deposit rates to boost growth. Banks may also cut time-deposit rates and move to stimulate consumer spending and boost credit supply.

In other emerging markets, the National Bank of Poland outlined conditions for cuts to the policy rate from its current level of 6.75%. In Mexico, looking at the recent monetary policy minutes from their last meeting, policy rates were unchanged at 11.25% in a unanimous decision ending the long and deep hiking cycle of 725 bases points that started back in June of 2021. Right now the market is actually pricing is that these policy rates come down substantially to 6.5% over the next year or so, down from 11.25%. So while we have some central banks hiking, but slower relative to inflation, we have other emerging market central banks that are already starting to think about cutting interest rates - and may even actually start doing so. So what's the point, and why does this matter to investors? Let's go through a few common themes.

Many developed market central banks are finding it difficult to stop hiking policy rates because inflation has remained sticky higher. This is broadly a global theme, not just in the USA. Central banks keep chasing that illusory 2% inflation target but do not seem willing to hike rates fast enough to a high enough level to actually get there. This is the key observation. As a result, central bank policy, despite trying to end the hiking cycle, may only slowly raise rates from here. This means that central bank policy remains easier for longer, and also means that it is less likely that inflation falls to target and actually stays there. Now when we look at emerging market central banks, they've already hiked rates aggressively and have showed strong credibility with respect to fighting inflation. But they are now talking about ending their hiking cycles, and even cutting rates, which we should also view as credible. But developed market central banks may keep policy easier for longer relative to inflation targets. And again, that's the key distinction. It's relative to inflation targets and emerging market central banks may start easing. All told, this means policy globally is relatively easier which is good for risk assets. No matter what the theatrics are around what the Fed, ECB and BoJ say or do this week, keep this in mind.

Remember, equities are a nominal valuation asset class and their valuations can broadly perform well when inflation is in the 2 - 5% range. Historically, that's been the case because valuations are based on

nominal cash flows that inflation clearly adds to. If inflation gets too high beyond that, then that becomes destructive, but as long as it's within that 2-5% range it's shown historically to be OK. But, inflation weighs heavily on bond performance because their payout tends to be fixed (hence, "fixed income") and inflation is subtracted from those valuations, reflecting real rates and real returns, adjusted for inflation. Real rates are more of a bond concept that are not necessarily applied to equities.

We still think that defensive allocations to cash and fixed income are relatively high relative to equity exposure, which may need to be adjusted in the absence of a hard landing. And there are many stocks outside the "magnificent seven," as I like to say, that have average valuations below their historical PEs, ones that can rise as the global economy may move away from a hard landing. We see this as a possible investment opportunity. Keep all this in the back of your mind and as we get significant amounts of information this week, including inflation data. Note that many investors have to factor in this exposure for these nominal assets versus assets that don't do so well with inflation. And as we always like to say, "it's better to be balanced than defensive."

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