Caron’s Corner Transcript – 6.26.2023

2H 2023 Outlook: From Whatever it Takes to Whenever it Breaks?

- ECB President Draghi said “whatever it takes” referring to the ECB’s commitment to ease policy sufficiently in response to the financial crisis.
- Perhaps “whenever it breaks” is more to the point - and we should ask if central banks are equally committed to tightening policy to head off an inflation crisis.
- In the June 12 Caron’s Corner I noted that central banks will decide between the two based on the balance of risks between growth and inflation.
- Today, policy seems to be siding with growth, i.e. a soft landing, which means inflation may run hotter for longer and keep real rates low or negative, stimulative for risky assets. A virtuous cycle.
- But this can’t go on forever. The balance of risks may tip to become more aggressive about inflation, especially if it becomes unanchored. And recall, unanchored inflation is my greatest fear.
- This will be the key debate amongst policy makers in 2H 2023.

Jim Caron: Hello, this is Jim Caron, Co-CIO of the Global Balanced and Risk Control strategies. Well, it's that time of the year where everybody comes out with their second-half-of-the-year outlook. This is mine and I promise you it will probably be the shortest you get this year.

The title is “From Whatever it Takes to Whenever it Breaks?” “Whatever it Takes” is a direct quote from ECB President Draghi that refers to the ECB’s commitment to ease policy sufficiently in response to the financial crisis, made back around 2011 or 2012. But perhaps we should update this quote today to say “Whenever it Breaks” and ask if central banks are equally committed to tighten policy to head off an inflation crisis. We addressed this topic in the last Caron's Corner where I said that central banks globally will decide this based on a balance of risks between growth and inflation. Right now, they're choosing to support growth at the expense of inflation. But for how much longer?

Current policy seems to be erring on the side of growth. A soft landing, in other words, which means inflation may run hotter for longer and keep real rates low or negative, which is stimulative for risky assets. Some think of this as a virtuous cycle, but it can't go on forever. The balance of risks may tip the other way and central bank policy may become more aggressive about inflation than supporting growth, especially if inflation turns out to be unanchored. As you may recall, unanchored inflation is my greatest fear. This is the key debate for the second half of 2023, so let's get into it.

One of the points I like to make, and a bit provocatively, is that rate hikes have been happening, yes, but tightening, no, not yet, maybe later. Interest rates have gone up and there has been policy tightening but not relative to what was expected to happen to inflation or even financial asset prices. In other words, the rate hikes haven't yet had a material impact on inflation. The key point here is that central

bank rate hikes do not yet seem to be doing the trick to push inflation to acceptable levels and keep it anchored there. To repeat, anchored, that's the key point here. But perhaps there are lags and the thought is that maybe monetary policy works with a really big lag and they've done enough. We'll see.

However, it does seem now that central bankers may be getting a bit nervous and even surprising markets over the past few weeks. Another round of central bank meetings is likely another round of surprises - meaning hawkishness and hikes. But why is everyone still surprised? This is literally what is happening around the developed markets globally. Either the central bank hikes rates or they don't make any dovish comments, but instead remain hawkish. There are several examples of this: the Royal Bank of New Zealand, the Royal Bank of Canada, the Fed, the ECB the Bank of Japan, the Norges Bank, the Swiss National Bank and the Bank of England. In the past few weeks all of these banks were being more hawkish or even restarting hiking cycles and theoretically surprising the markets to the upside in terms of their hawkishness.

So are we surprised? No we shouldn't be, because recession risks are receding in 2023, not accelerating, and until that changes, we need to accept that. Although still hawkish developed market central banks seem to be betting on the lagged effects of policy hikes to lower inflation and anchor it. This is their gamble and I think we have the third quarter and part of the fourth quarter to see if this actually plays out. If it doesn't happen, then the risk is that central banks become even more aggressive and this would be negative for asset prices.

Tilting the balance of risks to inflation is what to watch for - and the culprits are the same. They don't even pretend innocence. Wages and service inflation are the loud and obnoxious anarchists disregarding the traditional norms of correlations of prior cycles. Inflation is not falling as expected based on rate hikes, and it remains sticky at the core. Despite a historically aggressive tightening, headline inflation will fall, yes, but central banks focus on core inflation. The good news is that if the jobs market stays strong, it's difficult to have a hard landing or deep recession. The bad news is that this may provoke central banks to hike rates excessively in order to weaken jobs, trigger a recession and get inflation anchored around target levels. Yield curves are flattening and inverting and we all know why. Recession is still a risk and paying a hefty premium to buy long duration with negative carry is the preferred hedge.
But if we are in an inflationary environment, then long duration adds risk too. Additionally, if we do enter into a recession then central banks will cut rates, and long-term yields will drop initially, but then stop falling and eventually rise or not fall as much as hoped for, as the inflation risk premium starts to move higher (which is very undervalued at the moment).

Now, that said, we still think a recession occurs and if it does, it will be mild. Given the persistent strength in the jobs market, we like keeping duration risk at the shorter end, 2 to 3 years on average at the portfolio level. We get there with a mix - or a barbell - of BB high-yield and high-quality short duration. When you buy both of those, it's a barbell. When you add them together, average them, you get roughly an investment grade credit, but with less duration sensitivity. We said this in the first half of 2023 and we're still saying this in the second half of 2023. Equity indices may suffer as the high flying tech stocks could be revalued down if rates rise. But the breadth of the index, the remaining 10 of the

11 sectors in the S&P 500 outside of tech, still seem better-valued and likely priced already for a mild recession at the mid-year point.

The debate is the same as it was at the start of the year. Strong labor markets, sticky core inflation and central bank policy are all still key drivers of asset prices, but the stakes are higher now because this is the part of the cycle where things break. The second half of 2023 may provide the data necessary to decide where, when and how we land. But there is plenty of room to be surprised as fat tails exist on both sides of the risk distribution.

Remember, as we like to say, it's better to be balanced and defensive.

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