Caron's Corner Transcript – 7.3.2024

Caron's Corner: The BEAT for July

- A soft landing is still intact, but the baton is being handed off from inflation to the employment situation in 2H24.

- Confidence will be found in falling inflation if the unemployment rate rises, which signals to the Fed that inflation is not only falling, but will remain anchored.

- In some ways this is perceived as "the bad news is good news." That is, slowing inflation and rising unemployment is positive for equities because it brings the Fed closer to cutting rate.

- But the risk is that inflation is falling and the rise in the unemployment rate may hit demand, earnings and growth. At this point "the bad news will actually become bad news."

- But we haven't crossed that Rubicon. . .yet.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to The BEAT for July, where I'm joined by Greg Waterman of the Portfolio Solutions Group to help me with the key points.

Let me start with a summary. A soft landing is intact but the baton is being handed off from inflation to the employment situation in the second half of 2024. Confidence will be found in falling inflation if the unemployment rate rises, which signals to the Fed that inflation is not only falling but will remain anchored in some ways. This is perceived as "bad news is good news." In other words, slowing inflation and rising unemployment is positive for equities because it brings the Fed closer to rate cuts. But the risk is that inflation is falling and the rise in the unemployment rate may hit demand, earnings and growth. At this point, "bad news will become bad news," but we haven't crossed that Rubicon yet.

So let me go into the key themes for July keeping all of this in mind. Again, the rising probability of a soft landing remains intact this past month and has bolstered the case for a soft landing as inflation has declined. A few major central banks have cut interest rates, forward-looking wage metrics such as the Indeed Jobs Postings suggest that wage growth should continue to slow in the U.S. and in the eurozone. This in turn should help ease persistent services inflation and allow central banks to adjust rates lower. U.S. equities did surprise higher and we may have turned neutral too soon. But we have seen a narrow rally, as almost two-thirds of the year-to-date returns have been generated by fewer than 10 stocks. Upward earnings revisions are similarly narrow, and valuations also reflect the narrowing of market outperformance. The P/E ratio for the S&P 500 runs at 21 times on a cap-weighted basis but only 16 times on an equal-weighted basis. There is ample room for equity performance to broaden, but this would require a cyclical recovery. We may be starting to rethink neutral, but a cyclical recovery is not our base case, though certainly something to think about.

The U.S. labor market is reaching a crossroads though and has been rebalancing in an orderly fashion where job openings have been in decline. While the unemployment has been broadly stable, weakness in labor markets is necessary to give the Fed confidence that the fall in inflation will remain anchored at lower levels. However, with excess labor demand back at pre-pandemic levels, for the first time the labor market is vulnerable to a further deceleration in economic activity. This is something that we are watching closely.

Now, onto politics, where we think politics will drive volatility. The snap elections in France and those taking place in major Emerging Market countries such as India and Mexico are just the start of politically-driven volatility in markets for the second half of 2024. This seems contained to France and not expected to cause contagion to markets outside its borders. At the EU level, many scenarios exist, but we believe the volatility being created in this instance presents a buying opportunity.

Now let me turn it over to Greg Waterman to talk about our top five ideas for the month.

Thanks Jim. Here are our top five ideas.

First, high yield bonds. We are moving back to overweight on high yield bonds. This past month bolstered the case for a soft landing as inflation has declined and a few major central bank cut rates consistent with this view. If the default risk stays contained, bond yields, especially lower-quality credits such as high yield may offer competitive returns in the second half of 2024 versus equities, especially on a risk-adjusted basis. We look to add a risk exposure to this segment of fixed income.

Second, Munis. We see attractive yields and strong technicals, making high yield municipal yields very attractive. They are currently one standard deviation wide of their five-year average, adjusting for the top federal tax rate of 37% and the net investment income tax of 3.8%. That equates to a 9.5% on a tax-equivalent basis. Technical underpinnings are also supportive, which makes this a top pick for us.

Third, French equities, which we are buying this dip, as we expect the recent underperformance of French equities to reverse. Now short-term performance will likely remain volatile due to uncertainty about the outcome of the upcoming snap elections, but we do not see this affecting the fundamentals of key names and sectors in large cap. French equities revenues are mostly non-domestic and current valuations offer an attractive entry point into an area that still displays quality characteristics.

Fourth, European banks, where we are staying long, looking beyond any short-term volatility. European banks have come under pressure in the aftermath of European parliamentary elections. Concerns have focused particularly on France's snap elections, which could affect funding costs and the cost of equity for banks. But, we do not see these events derailing our investment case for European banks which still offer attractive capital returns and re-rating potential in the new higher-rates environment.

Fifth, equities, where we continue to prefer large cap over small cap. The window for small cap outperformance is just too narrow. Historically small cap performance depended primarily on economic growth acceleration, but greater exposure to a higher-for-longer rate environment has added inverse

rate correlation to the mix. While periods of growth acceleration with lower rates are plausible, since the end of 2023 we see this combination as relatively unlikely in the current inflation environment, at least on a sustained basis. Meanwhile, small caps are likely to underperform large caps in both sticky inflation and recession risk scenarios. Handing it back to you, Jim.

Thank you Greg and thank you all and thank you for catching The BEAT for July. We will be back throughout the month with updates.

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CRC 6743381 Exp. 6/30/2025