Caron's Corner Transcript – 3.5.2024

The BEAT for March: Top Ideas and Three Changes to Our Asset Allocations

- Fiscal policy might be more important than monetary policy.
- Inflation is not cooperating, making the Fed uncomfortable and putting bonds at risk.
- Equities are supported by a tight labor market, where consumers can still spend and help margins stay afloat.
- Capital is seeking higher real rates, such that real rate differentials in cash flows will play a larger role in relative valuations for global portfolios.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Today I'm joined by my colleague Ewa Turek to discuss The Beat monthly for March. What we want to feature today are key changes to our representative asset allocations for the upcoming month. First, we are moving to a further underweight in Investment Grade (IG) credit. Second, we are moving Municipal Bonds to neutral from an overweight. Third, we are adding to our overweight in global developed market equities. Market dynamics have changed and February has dispelled expectations for any rate cuts in March and reduced the risk of a recession in 2024. As a result, we'd like to share with you changes we've made to our current thinking.

So the first thing we want to do is talk about the key investment themes for March. One of the things that we discussed in the past was that fiscal policy is likely to be more important than monetary policy. GDP growth in 2024 may surprise the consensus to the upside, spurred on by greater fiscal stimulus than expected. After all, it's an election year in the U.S. and the incumbent party running for reelection tends to engage in spending to support the economy. This seems to be coming from tax-related plans and a pulling forward of spending from the CHIPS Act. We may learn more from President Biden's State of the Union address on March 7th and we expect it to be more impactful to the markets than usual.

The second theme is about inflation, which is currently not cooperating and putting bonds at risk. The recent run of inflation is not comforting the Fed and thus rate cuts may be further delayed. Inflation and fiscal spending plans are making the Fed's job harder. Bond valuations are dependent on Fed cuts, making managing duration risk in portfolios critical.

With respect to equities, we think they are supported by the labor market. Stickier inflation keeps nominal growth rates higher than expected and should support robust earnings growth. As long as the labor markets remain tight, consumers can still spend and help margins stay afloat. Equity markets are being supported, but the key to the story is that labor markets remain strong and this is what we are watching carefully.

With respect to capital, capital tends to seek higher real rates. As I like to say, capital goes where it's treated the best. The Fed was expected to cut rates before the Bank of England and the ECB, but now it may cut later. This means that U.S. real rates may stay elevated, supporting the U.S. dollar (USD) and U.S. assets. Broadly, real rate differentials in cash flows will play a larger role in relative valuation in global portfolios.

Let's now talk about some investment ideas. Here's where I'd like to bring in Ewa Turek to discuss our recent thoughts on the reduction in IG credit to a further underweight. Ewa.

Thanks Jim. So if we look at IG credit, risk-adjusted return prospects for the asset class have fallen in appeal due to both low yields and tight spreads. Let's look at spreads first. The overall USD-IG spread is trading at the 6th percentile since 2010. But this metric doesn't tell the full picture because at a sector level spreads and financials are trading at the 19th percentile. So if we strip out financials, U.S. spreads are at the zero percentile since 2010. In essence, you're basically not getting any spread protection with spreads. This type of IG credit will effectively trade like U.S. Treasuries (USTs). Additionally, the all-in yield on IG credit is now below cash rates in both the U.S. and Europe. In other words, you're taking spread and duration risk with zero compensation for that risk. Back to you, Jim.

Thanks Ewa. The second point is about Municipal Bonds. Similar to what we were just discussing on IG credit, current yields for higher-quality Munis equate to minimal or zero pick-up compared to USTs on an after tax basis. There is a bit more value in lower rated parts of the markets. Effectively, with this backup in rates and the tightening of spreads, we're just not seeing the spread appeal to owning some of these credit related sectors of the markets.

Looking now at adding exposure to global developed market equities there is a little bit more in terms of just adding exposure. What we're really saying here is that with the rally in the equity markets, the gross asset allocation towards equities has actually increased. What we're doing is we're holding that higher gross in equities instead of netting down the exposure, thus giving portfolios an overall overweight to equities or an increase in the overweight to equities. This is supported by other fundamentals in the markets like manufacturing PMIs which are indicating that we're at the start of a sequential, albeit lower relative to history, cyclical recovery. These are some of the reasons why we're holding higher equity allocations within our portfolios.

There are a couple of other ideas I'd like to discuss. One, we do think that there are going to be tailwinds for the USD and that's likely to persist. One of the reasons that we mentioned was the Fed, even though they're expected to cut interest rates, that they're going to do so gradually and probably slower than other central banks around the world. Therefore, the real rate differentials will favor the USD, that plus the fact that we're seeing some cyclical tensions within Europe, which is showing that it might be slower in terms of growth in the U.S. giving more favoritism towards the USD. Same thing with China.

The last thing that we'd like to talk about is our views on Emerging Markets (EM) hard currency debt. Here we'd like to maintain an overweight. Spreads and rates are likely to support the EM hard currency debt returns following the year to date backup in bond yields. The entry point for EM hard currency debt has become more attractive over the backdrop of improving economic growth. As I was mentioning earlier, from increasing PMIs and lower funding costs we should see spreads continue to tighten and these factors combined with a yield that's well into the 8% level may provide attractive returns on a 12-month investment horizon.

Putting this all together, we think that March will be a very interesting month. We have to watch for fiscal stimulus, but monetary policy is going to be very important too, so we're also going to be looking at that as well. But one of the things that we're also identifying and noticing is that spreads in credit related sectors are tight and we're just not seeing the investment appeal that was there, especially in the higher quality sectors of credit equities. On the other hand, with the rally in the markets that is grossed up positions to a higher waiting within the portfolios and we're looking to hold that.

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