Caron's Corner Transcript – 8.26.2024

A Tale of Two Economies: The Best of Times, The Worst of Times

- The title comes from Charles Dickens' "A Tale of Two Cities," which captures the simultaneous existence of both **prosperity and suffering** leading up to the French Revolution.
- The reference to **prosperity and suffering** is what economists today call a **bifurcated economy**, one that is filled with data inconsistencies, even at the sector, company and consumer levels.
- Meanwhile, volatility stays low, while asset performance continues to chug along.
- But in our view, something's got to give. Something's got to break. These inconsistencies cannot exist in perpetuity.
- But they **<u>can</u>** last for a long, long time and this is what's dividing the market narrative between the bulls and the bears.
- Both have a good case to make. **But who will be right?** Let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. "A tale of two economies, the best of times, the worst of times. So let me first acknowledge the title of this audio comes from Charles Dickens, A Tale of Two Cities, a book about the period leading up to the French revolution that captured the simultaneous existence of both prosperity and suffering. The reference to prosperity and suffering is what economists call today a bifurcated economy, one that is filled with inconsistencies within the data even at the sector and company levels, and of course for the consumer. Meanwhile, volatility stays low and asset performance continues to chug along. Something's got to give, something's got to break. These inconsistencies cannot exist in perpetuity, but they can last for a long time. This is what's driving the division in the market narrative between the bulls and the bears. Both have good cases to make but who will be right? Let's get into it.

Start with the arguments for the best of times. Those are that the economy is cooling, not collapsing, and reaching a level of normalization. After a long period of high growth and high inflation, we have been able to stabilize the economy in the absence of a recession to put things into balance. This outcome is rare and qualifies as the best of times. Perhaps the Fed is turning out to be the master steward of the economy. With Powell now signaling at Jackson Hole that he plans to cut rates despite 2.3% Atlanta Fed GDP estimates for 3Q and inflation still running above target around 3%. Powell is doing all of this to engineer a soft landing.

Given that the Fed has plenty of room to cut rates, which means that the Fed put has a lot of value, it means that multiples can remain elevated above 20x. Despite expectations for a slowing economy, the employment situation is weakening, but at a slow enough pace such that demand is not being destroyed, and the consumer may remain strong enough to spend and support equity earnings and margins. In addition, there are other comments that Powell made at Jackson Hole, which highlight that there is policy support for jobs. I want to quote Powell here. He said at Jackson Hole, 'we do not seek or welcome further cooling in labor market conditions.' Now why is this important is because it represents

a shift in statement where the Fed pointed out that in the past, that a weakening in the jobs market was necessary to anchor inflation by stabilizing wage inflation. It also suggests that the initial pace of rate cuts could be front-loaded, or at least more rapid, which could be supportive of risky assets. The reason that these would be front-loaded or rapid is because Powell would want to support the jobs market. Nevertheless, a cooling or a normalization of economic activity will keep demand stable until a new economic expansion cycle begins, increases EPS growth and propels equity indices higher. At least that's the hope embedded in a soft landing.

These are all arguments for the best of times, but it may not be so simple. Let's talk about arguments for the worst of times. This is where the bears will argue that it's only a matter of time before the cooling of the economy turns into a collapse. After all, that's usually the way it works and sure, layoffs and job loss metrics are low for now. But it's only a matter of time before job losses mount, which will end up hurting earnings and margins and ultimately reset equity valuations lower. Here's how I'm going to really focus on the jobs market and here are some indicators: higher unemployment, triggering the Sahm rule, which is a recession signal; higher job losers rates are starting to creep in a weaker conference board jobs survey; weaker New York Fed job survey data; weaker NFIB employment survey data; flat household employment for almost a year; sharply declining temporary employment for the past 2.5 years. Most recently, last week in fact, we saw an 818,000 downward jobs revision to the 12-months prior to March 31, 2024, which drops the average jobs growth on a monthly basis from 242,000 per month to 174,000. The recent deterioration in labor markets may trigger a vicious cycle in which job losses lead to less consumption, which then lead to falling earnings and margins. But again, this too may not be all that simple. The bear argument may not necessarily be as simple as what I'm stating there. Again, it's really a juxtaposition between the best of times and the worst of times.

Since we're talking about time, well, what time is it today? What should we be focusing on? We think it is time to get cautious and move to neutral, yes, but not yet time to go bearish or underweight risk. The way that we've constructed our asset allocation in our strategies is we would like to move U.S. equities from overweight - these are purchases that were made in early August - and now we'd like to move those purchases back down to neutral. So we want to go from overweight U.S. equities down to neutral. We want to maintain a slight overweight to Japanese equities, which is a place that we are still structurally bullish. We also want to maintain an overweight to European equities, albeit only slightly and something mainly expressed with financials.

We want to maintain an overweight to high yield. We still believe that there is a soft landing in front of us and that default risks may not get realized. We remain overweight short duration, high quality assets. You can think of this as somewhat defensive, something that also includes cash alongside of our overweight to high yield. This is all part of our barbell strategy, something we've talked about a lot in the past. We are reducing bank loans from overweight to neutral. What we want to do is reduce lower-quality credit and floating rate assets with the Fed about to embark on rate cuts. We are reducing duration a little bit. We think the bond markets have already pulled forward 200 basis points of rate cuts, which seems pretty aggressive, so we are starting to take some chips off the table in terms of duration. This is representative of our tactical asset allocation that we will describe in more detail in next week's edition of The Beat for September, our asset allocation publication.

Ultimately, we still think the markets will be volatile, but also trade in a range. Let's call that range 5200 - 5650 for the S&P 500. The equity market seem particularly vulnerable to weak economic data points, especially soft data on jobs. Additionally, we think political volatility will accelerate in September and October. Our move toward a more neutral footing is not bearish and will allow us to participate in upside, and provide dry powder in the event that there are some sell offs where we can buy dips. In all, the tactical asset allocation and portfolio construction for us still remain the key."

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