Caron's Corner Transcript – 10.14.2024

A Bull in a Candy Shop

- A Bull in a China Shop implies volatility and a destructive outcome.
- China has been part of the recent volatility, but the *good* kind when markets go up. We might instead say A Bull in a Candy Shop, meaning calm and not destructive. Maybe.
- Jobs data has been seemingly positive and the recent Gross Domestic Income (GDI) has proven much stronger. All to the good.
- But what about the risks? Inflation is creeping higher and adds further scrutiny on the Fed's ability to cut rates, already priced in by markets.
- Tensions in the Middle East also might create more systemic risk that is hard to anticipate and even harder to hedge.
- And let's not forget the potential volatility around the U.S. election only weeks away.
- Despite all this equity markets have moved higher and credit spreads have remained tight. So where do we go from here?
- Let's get into it!

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. A Bull in a Candy Shop. While a Bull in a China Shop is the common expression that applies to a volatile and potentially destructive outcome, China has been part of the recent market volatility but the good kind when markets go up. So perhaps some rephrasing is needed to say A Bull in a Candy Shop is a calm and happy place, not destructive. Maybe. Additionally, jobs data has been seemingly positive in the recent round of Gross Domestic Income, which has proven much stronger, all to the good. But what about the risks? Inflation is creeping higher and puts further scrutiny on the Fed's ability to cut rates as previously expected and priced in by the markets. Tensions in the Middle East also create a potential for more systemic type of risk and which is hard to anticipate and even harder to hedge. And let's not forget about potential market volatility around the US election, which is now only a few weeks away. Yet, equity markets have moved higher and credit spreads have remained tight. Where do we go from here? Let's get into it!

Well, first let me say I'm not bearish, but I am growing skeptical. Let's start with China. A common mistake is for Westerners to view China through the lens of Western developed markets. Yes, China is adding stimulus to support market sentiment, but that really misses the point. The point is the transmission mechanism for this sentiment from an improvement in financial conditions, which is basically liquid asset prices, to a durable increase in real demand in Western markets. This is a fully developed economic theory employed by central banks. A rise in stabilization of financial asset prices increases confidence that leads to investment in consumption and thus improves GDP. This is a

procyclical event without going into extensive detail. Suffice it to say that China's domestic market operates differently than developed markets. China's sizeable stimulus plan can surprise a market that has been largely underweight China and has attracted hot money inflows. The question is if it is durable enough to lift animal spirits and make it a procyclical event such that it feeds upon itself and is thus sustainable. This is yet to be seen. But I'm skeptical.

I'm also skeptical about the US jobs data, namely the last non-farm payroll report. In fact, this whole data series has been less reliable than it used to be pre-Covid. We've discussed the massive amounts of annual downward revisions to this series based on the birth/death rate of companies and we've also noticed that this series has been besieged by downward revisions, just as a general statement. The latest September reading of this report may be subject to the same as it seems that there have been some statistical quirks and seasonal adjustments that may have overstated this report by about 100,000 jobs. You see, typically there is a large downward seasonal adjustment to the September data, but this time we only saw less than half of that adjustment come through. This may have overstated the non-farm payroll number which may get downgraded in later months. Also keep in mind that inflation is not yet dead. The three-month annualized pace of core CPI jumped from 2.1% to 3.1%. How do you like them apples! And the super-core inflation reading? Remember the super-core spiked to a way too high for comfort 0.4% month-over-month level. Putting this all together, this means that anyone counting on Fed policy rates to aggressively drop to support valuations may have to rethink this a little bit.

OK, enough with the skepticism. What are we doing about all this? Like I said, we're not bearish but we have reduced our risk on tilt to a more neutral risk weighting. We're neutral US equities but still favor a large cap over small and growth over value. Perhaps that weights us toward tech, which makes for a risk on tilt. Maybe that's debatable. In bonds we sold when yields plummeted recently, but are now looking to take back half of that short with US 10-year treasury yields above 4%. Thus, we're adding a little bit of duration back to portfolios. We also reduced our overweight to high yield during the yield plunge. But we may end up taking some of that high yield exposure back into the markets because the yields have started to come back up. But for right now, we're still neutral. We are buying oil futures due to the tensions related in the Middle East and we realize this could flip either way. But with these tensions in the Middle East flaring up and the backward curve, we'd rather own it as a hedge. It’s not admittedly a high conviction view, but just risk management.

So there we have it. We can't forget that A Bull in a Candy Shop is just a bull. But bulls can be unpredictable just like bull markets. We are staying nimble for now, not heavily risked up.

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