Caron's Corner Transcript – 1.2.2024

A Pull-Back from the Pull-Forward? What to Watch Out for in 2024

- At the beginning of each new year we often get the question, **what are you watching out for in markets?**
- The baseline consensus would suggest a calm year with **bonds returning mid-single digits** and **equities similarly**, perhaps a bit better than bonds.
- This suggests a year of low volatility, but we think 2024 will be anything but that.
- In 2024 it will be critical to manage and **watch closely the interconnectedness between interest rates/Fed policy and equities**.
- This brings the associated risks of inflation forward, where it appears everything seems to hinge on that.
- But instead of forecasting the future, let me discuss a few key items on the equity/interest rates connection we are watching out for to start the year.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. At the end of last year the big topic in the market was pulling forward returns. So the question is will there be a pull-back from the pull-forward and what are we watching out for in 2024? First let me say Happy New Year to everyone. As we start the new year, it's worth reminding ourselves of what the collective best guesses are for the year in markets. In other words, the consensus expectations. We often get the question, "What are you watching out for in markets?" So let's discuss that to start the year.

First we need to establish a baseline, the consensus, which suggests a rather calm year with bonds returning mid-single digits, i.e., their coupons plus a bit, and equities not too far off from the same, perhaps a bit better than bonds. This suggests low volatility, but we think 2024 will be anything but low volatility. As such, it will be critical to manage and watch closely the interconnectedness between interest rates/Fed policy and equity market performance. This brings along the associated risks of inflation to the forefront, as it appears everything seems to hinge on that. So instead of prognosticating about the future, let me discuss a few key items on the equity rates connection that I'm watching out for to start the year. And of course, no discussion about 2024 would be complete without including risks of political volatility. So let's get into it.

What I'd like to do is start out with four key things I'm watching out for to start 2024. First, we are watching out for the possibility that inflation doesn't fall as much as expected. If it doesn't, then the recent rally inspired by lower policy rates may give back some of the late 2023 pulled-forward returns in the first half of 2024. Here are a couple of points to think about along these lines. Although we are encouraged by the recent drop in inflation, there are risk factors that suggest otherwise. Lower interest rates may keep housing or shelter prices higher than expected, which is over 30% of the inflation basket. In other words, housing needs to decline for inflation to materially fall and become anchored. If it doesn't, it creates upside risk for inflation. That means Fed policy risk which will impact equities. Now, consensus expectations for a soft landing is not fully consistent with lower inflation. If we get a soft landing, inflation may not fall as much or stay anchored. Year-over-year (YoY) inflation measures are going to become harder to beat in the second half of 2024, meaning that inflation could find technical support to rebound. This is something that we've talked about in the past the first half of 2024. We think that it's going to be easy for inflation to come down just because YoY base effect measures are going to make it easier for inflation to fall. But in the second half that starts to change. Labor markets may also remain tight and that's going to keep inflation supported as well.

The second thing that we are watching out for is that the late 2023 bond rally may have pulled forward returns more so than equities. This comes at a time when many investors are looking for the safety of fixed income. The U.S. 10-year yield has fallen over 100 basis points (bps) since late October and 2-year yields are trading 110 bps below the Fed funds rate. A sharp decline in policy rates is required to justify these moves. It could be that the rally in bonds reflects a rotation out of ultra-short duration and cash and this may be overdone. Putting things into context for the yield curve based on forward pricing, if we look at the 2-year/10-year swaps curve, it's priced to steepen by 70 bps over the next year. The majority of that steepening is priced to come from a drop in the 2-year rate while the 10-year rate stays roughly unchanged. The point here is that one of the more overcrowded trades in the market, the curve steepener, well it needs to steepen by more than 70 bps to profit.

The third thing to be watchful of is credit valuations. All-in yield is less appealing relative to credit spread levels. In the same vein of bonds pulling forward returns, credit is challenged from a valuation perspective. It used to be that in 2023 we could dismiss the tightness in spreads as an argument against owning credit because the all-in yield was very high. This is now becoming a less compelling argument given the recent sharp decline in yields and the tightening of spreads. For example, high yield in the U.S. were recently in the 8% to low 9% area, with an index price or the dollar price of the index around 88. But now yields are closer to the mid 7% range with a dollar price closer to 93. Now we still think there's some value here, but the starting point is less attractive than what it was.

The fourth thing that we're watching out for - and I think investors are going to like this one - is the risk to further upside in equity prices. Equity upside risk, like any other risk, needs to be hedged. This was our mantra in all of 2023 and it remains so to start 2024. According to Bloomberg and ICI (Investment Company Institute) data as of December 20th, money market funds have reached an all-time high of about $5.9 trillion after receiving inflows last year of $1.35 trillion. Meanwhile, equities only received $95 billion of inflows, an asymmetry that creates technical support for equities. Now, if we do get a soft landing, then inflation may not fall as much as expected, but enough to keep the Fed at bay perhaps only cutting interest rates by 50 to 100 bps. This, by the way, is less than what the market is currently pricing. This should keep top line revenues, profit margins and earnings higher, helping to keep multiples high as well. At some point, the markets will then start to look forward to 2025 earnings which are around $270 and apply an elevated multiple which could then see the S&P 500 go above 5000. Now this is a risk to the upside and it's a risk to those who may still be underweight equities. In other words, a disappointment to the upside. Again it’s not our base case, but a risk case scenario and a risk case that we should be wary of and potentially hedge.

As we said before, bonds may be more overpriced than stocks, and while positive for equities, this may be negative for bonds. We thus go back to thinking that bonds may become more at risk because they have pulled forward returns more so than equities. Weirdly, the bullish equity scenario may most likely be the one in which inflation falls a little. The Fed cuts by less than priced and flows turn equity positive, as cash that went into bonds gets steered toward equities, all of which is consistent with a soft landing. That said 2024 is also a U.S. presidential election year and fiscal policy, both responsible and irresponsible, will likely dominate markets more than monetary policy. This will also spill over into 2025 as the Trump tax cuts from 2017 expire and new tax policy is debated. The impact on earnings will be "big league" as they say.

So there are many things to watch out for in the new year. But it's important to balance these risks with both upside and downside surprises because that's the way the distribution of risk risks look to us with both up and downside year ahead. Remember, expectations for markets are really just a "best guess" that will get revised many times as new information comes in. As such this is not as a prognostication about the future of 2024, but rather what we are more immediately watching out for in the new year.

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