Caron's Corner Transcript – 12.4.2024

The BEAT for December – Key Themes and Top Ideas

In this audiocast Jim Caron discusses his team's key themes for December and into 2025.

- **Monetary Policy: Boring Is Good**
- **Fiscal Policy Is Where the Action Will Be in 2025**
- **2025: More About the "E" Than the "P"**
- **Inflation Is the Wild Card in 2025**

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. The BEAT for December. Well, this is really going to take on a "year ahead" vibe. Let me start with four key themes that we're thinking about in December, that are going to take us into 2025. The first one is monetary policy and the tag line there is that boring is good. The second is fiscal policy is where all the action is going to be in 2025. From an equity market perspective, it's going to be more about the E than the P, more about the earnings than the price in the P/E multiple. Lastly, inflation will likely be the wild card for 2025. Let's get into some of the details.

Global central banks are expected to cut rates and keep them low in 2025, except for Japan who is cautiously hiking rates. This should lead to lower volatility in range-bound bond yields which may produce a boring outcome. But that's actually a good thing. The surprise would be if inflation became unanchored and markets started to price in rate hikes. This would be bad as it would upset risky asset valuations that count on stable rates. As we see it, the terminal Fed fund's policy rate may likely be closer to about 4% - 3.75% to 4% - compared to many expectations of 3.5% or lower. But if rates stay higher, which meaning that they don't fall as much, but it's for good reasons, then that's okay with us.

As I said fiscal policy is where all the action is going to be in 2025, and it's going to be a question of largesse versus austerity. It can be argued that parts of Europe, like Germany, may need expansionary fiscal policy, but the U.S. needs austerity. Taxes and tariffs will dominate the narrative where some tax cuts may get extended, but others may not. Tariffs are likely to become more targeted than broad and will have both demand side and supply side implications. And don't forget about deregulation, which may have the biggest impact of all. It's complex and we caution not to be led astray by simple answers. From an investment perspective. There will be winners and losers but fiscal policy is where the action will be and it's what we're going to be focused on.

Now, more about the E than the P. This has triggered major portfolio changes for asset allocation and investment selection, meaning the elements of alpha may dominate return attributions compared to simply focusing on multiple expansion at the index level: In other words, the beta. Earnings growth and quality is more generously found across the broader market, instead of the narrow breadth of names. The lines between growth and value and large versus small will be blurred. Broader market valuations are better placed to expand and investment selection may be largely driven by fiscal policy and tariffs, taxes, deregulation and the like.

As mentioned, inflation is the wild card in 2025 and this is what I'm worried about the most. And it's really a question of whether or not inflation remains anchored or becomes unanchored. Inflation has fallen but will it remain anchored at lower levels that allow central banks to cut rates further or will it become unanchored, slowing or altogether stopping rate cuts? This is the key variable to watch in 2025 because it will drive monetary policy and govern fiscal policy. We think inflation will remain stable but fall short of reaching target, which is about 2% target. This means central banks may fall short of reaching their forecasted terminal rates. And this is okay as I said before, as long as labor markets stay strong. But it will create tensions if not and we'll be keeping a very close eye on this.

So now let's go into our top five ideas going into 2025. Let's start with fixed income. The first one is that we are taking bank loans from neutral to overweight. So leverage credit, floating rate credit towards a more overweight posture. Clearly the reason is that we don't think that rates are necessarily going to continue to trend lower. Therefore having something with a more floating rate nature, but also get some additional credit spread, may actually look somewhat attractive to us. Bank loan spreads have not tightened as much as other risky segments of the fixed income market such as high yield. High yield has become very expensive and we would favor bank loans over high yield. But we are moving towards that overweight in the bank loan sector.

As far as equity goes, the overall equity exposure for us is going towards a more neutral basis, but we are going to mix that up a little bit. In other words, we're going to take down European equities, moving them to underweight. As we like to say, when it rains, it pours, and Trump's second term adds to an already significant list of headwinds facing European equities. Trade uncertainty harms the chances of a cyclical rebound in the European region and is likely to hit is likely to hit hard as some of the larger sectors within European equities such as materials, industrials and autos within Europe. We continue to tilt towards banks as a structural story of attractive capital returns remains in place. Cheaper valuations also look compelling.

Now, if we're going underweight on the European side, then we are putting that money towards the U.S. So we are going from underweight U.S. equities as we position prior to the election just because of all the uncertainties. But now we're moving that underweight to an overweight and that's what we have done already. Adding to non-mega cap exposures is really the key, really the broader parts of the market. We view post election dynamics as positive for U.S. equities with our base case for a soft landing still intact, we've added to us equity exposure through the non-mega cap names of the market. Again, the broader market - think S&P 600 or S&P 400 - more of the mid cap sector is where we think the actual valuations and earnings trends are likely to be accelerating more into 2025.

As far as duration goes, this is very tactical for us. I want everybody to understand that we are, we've been underweight duration for quite a long time. We are moving to an overweight in duration when yield levels got up to around 4.4, 4.5 or 5% in 10-year U.S. Treasuries (USTs). That was a trigger for us to start to add duration for a couple of reasons on a stand alone basis. I think bond yields 10-year UST yields are attractive at that level. As long as the Fed is going to cut to 4% we think that 10-year yields around 4.45 - 4.4 look attractive, but also they also represent a hedge to our equity exposures at that level. If we have both those things going for us, not only is it attractive on a stand alone basis, but it is also attractive from a hedge perspective to our overweight in U.S. equities. Think of the whole portfolio allocation, you know, in its in its context and that's the way that we're representing these ideas. So net net, what we would also say on duration is that if 10-year UST yields got down towards 4% or slightly below 4% we would move that overweight probably back to underweight. It is a very tactical decision for us on duration. This is not a core long term view. It's, you know, we're managing our duration very, very tactically. So there we have it as we move into 2025.

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