Caron's Corner Transcript – 4.7.2025

The BEAT for April: Key Themes and Top Trade Ideas

Key Themes

- Understanding U.S. Policy Volatility: The New Normal
- Peak Tariff Uncertainty: Next Up Is Tax Policy
- European Exceptionalism?
- The Soft Parade: Data May Get Worse Before it Gets Better

Top Trade Ideas

- Correction, Yes! Recession, No!
- Downgrade Japanese Equities to Neutral
- Municipals Are an Opportunity for Taxable Investors
- Reduce Credit Risk
- Upgrade Offshore Chinese Equities to Overweight

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner powered by The BEAT, which is our asset allocation framework across Bonds, Equities, Alternatives and short-term Transitional investments (cash, etc.). All the talk today and all the volatility is surrounding tariffs. So let's talk about U.S. policy. The way that we see this is that there are 3 rebalancings that are taking place: 1) a political realignment. The Trump administration is operating under the post-election premise that it has a mandate to shift policy in favor of the middle-class worker, and tariffs are a key component; 2) a strategic initiative to rebuild the U.S. manufacturing sector, invest in technology to enhance productivity and encourage foreign direct investment to spur capital expenditures; 3) to stabilize geopolitical risks by lessening a focus on a technocratic process to a more direct and bilateral engagement with great power nations like China, Russia, to reach agreements. Now we're not defending this process, instead explaining how U.S. policy is evolving so we understand it. This change creates volatility and that is likely to be with us for a while, meaning that it's actually going to be the new normal.

Let's talk about tariffs, what I'm going to call peak tariff uncertainty. At this point we understand what the tariff policy is. We hadn't known that until last week, but now we know. The first quarter of 2025 was dedicated to tariff policies in the U.S. that will culminate with reciprocal tariffs in early April. While the knock-on effects of this policy decision will continue to be felt for months, 2Q25 will be dedicated to tax policy and seeding the ground for Trump's budget proposal that is due by the end of September 2025. It's important that we recognize that this shift is taking place. It might not be noticeable at first because of tariff-related volatility, but at work already are some agreements at the congressional level as to what the budget process ought to be.

Let's talk about European exceptionalism. European markets have held up relatively well, especially compared to the U.S. markets, since the start of the year. Why? Well, we're seeing a big dose of fiscal stimulus in Europe that's supporting construction and defense sectors and everything along those lines. The one thing that we have to recognize though is now that tariffs have crept into the equation, there might be retaliation from Europe and that this could create a lot of volatility. But with low interest rates, a central bank that's willing to cut rates and bonds that are relatively stable, Europe has the underpinnings of easy financial conditions and should continue to have European assets perform relatively well. But remember, everything is relative.

Going back to the U.S., I call this the soft parade. The soft parade is that the data in the U.S. is likely to start getting a bit weaker and to slow down. It was very much consensus at the start of the year that there would be a cyclical slowdown - or soft landing - in 2025. This is why 3 to 4 rate cuts were priced for the Fed and the ECB over the course of the year. However, data released in 1Q25 reflected a much stronger quarter, particularly in the 4Q24, which gave momentum into Q1 and caused many people to price out zero Fed cuts. Well, we are at the point where it's now we're pricing back in 3 to 4 Fed cuts this year. It's almost like we're back to where we started at the end of 4Q24 in terms of expectations. The markets have effectively caught up for themselves, where the early part of 1Q25 was probably a blip.

Let's talk about positionings and portfolios, asset allocation, and think about some of our top ideas. What we're saying is that we are undergoing a correction right now, a reset in asset prices. That is what's taking place. But is a recession happening? That is still not our base case. Look, recession probabilities have started to increase at the moment. There is no question about that. Certainly financial asset prices are coming down, but you know what they say. **The equity market is not the economy and the economy is not the equity market**. Broadly speaking, the economy is performing reasonably well. Jobs growth is good, consumption is still there. As long as consumption stays a big part of the equation, it's hard to have a recession because consumption is 70% of GDP. All eyes will be on the jobs market in the months and quarters ahead. It’s worth repeating, but at this point we're calling this a correction, not a recession.

We have started to downgrade our positions in Japanese equities. We've been overweight Japanese equities since March of 2022, and we've taken that down now towards neutral. We just don't see the catalysts coming out of Japan to actually boost equity prices materially higher.

In municipal bonds we think that there are opportunities for taxable investors. Investment grade municipals have lagged U.S. Treasuries during the most recent rally, but now offer some of the most compelling values in the past couple of years. While far from extreme value, this is a segment of the credit markets that we would advocate adding to today.

We are reducing credit risks. One of the things that we've been looking at are tight spread levels, as spreads have remained stubbornly tight on a relative basis. They are starting to widen now, and we think that with all of the volatility in the equity markets, that could spill over into the economy. The credit markets haven't yet borne the brunt of what could possibly happen. So we're starting to take some chips off the table in our higher yielding credit space.

Lastly, we upgraded our position in offshore Chinese equities to overweight. Those offshore equities have become less correlated to the real economy, which is given rising dominance of the new economy sectors within the MSCI China Index. The new economy sector's earnings are driven by innovation in areas like AI, the internet, tech and new energy vehicles, all on an uptrend despite domestic economic volatility within China. There are early signs of stabilization in old economy sector earnings as well, and the downgrade cycle may be starting to slow down. This is coupled with improved shareholder returns as well as a very supportive government stance towards the private sector. All of these are positive developments. Valuations and sentiments still appear reasonable after the strong rebound, so this is an area that we are moving more towards a slight overweight.

With all of this in mind, there's a lot going on globally. It's a fluid situation.

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