

CIO OUTLOOK

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CHALLENGES AND OPPORTUNITIES FOR RISK ASSETS

Despite a few setbacks on the inflation front, the US economy continues to march along a path of benign conditions for risk assets and investment styles that typically flourish in low-vol, risk-on environments. However, navigating these seemingly favorable conditions requires a nuanced understanding of both the macroeconomic landscape and potential tail risks.

Growth Trajectory versus Inflation Concerns

Equities as an asset class and carry as an investment style have performed very well so far this year. In my last outlook, I characterized the growth/inflation mix prevailing at the time as “goldilocks,” as higher growth would lead to concerns of overheating while lower growth would lead to recessionary fears. Since then, growth has continued along a robust but sustainable path; however, we have had several negative surprises on inflation that have put markets and the Fed on alert. On the growth front, GDP is tracking close to 2.4%, a robust number but not far away from potential growth. If we assume that potential growth is 1.8%, as stated in the Fed’s Summary of Economic Projections (“SEP”), and that the output gap coefficient in a Taylor style policy rule is 0.5, this means that from a growth standpoint, Fed Funds need to be just 40 basis points above neutral (the neutral rate stated in the last SEP is 2.6%).¹ Growth volatility has also been incredibly low during the last year and a half. The stable growth dynamics have driven asset volatilities down and have helped push equity valuations to or near historical records.

Stock Market Resilience versus Earnings Multiples

It is interesting that stocks have done so well in the face of higher rates and stubborn inflation. To recall, the market has taken out roughly 125 basis points of cuts (5 cuts of 25bps each) for 2024, yet stocks pushed to new highs. Part of the move in stocks was at the expense of higher valuations; however, corporate earnings have also been quite robust, in particular earnings in cyclical sectors. With almost all companies in the S&P 500 having reported Q1 earnings by now, the data shows that 80% of companies

¹ Of course, inflation is not at target and the “inflation gap” implies at least 100 basis points extra to the optimal policy rate.



have beaten estimates. More importantly, actual YoY earning growth in cyclical sectors was strong at a 10% pace, and while overall earnings growth was just 5%, we are on course for earning growth of 9% in 2024. So while we have record stock prices, we are not necessarily seeing too much overvaluation of earnings multiples (1 year forward SPX PE is around 22 times).

On the inflation front, however, the price data appears problematic no matter how you analyze it.

Core PCE

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
2023	0.51%	0.36%	0.34%	0.31%	0.29%	0.17%	0.12%	0.10%	0.33%	0.14%	0.09%	0.15%
2024	0.50%	0.27%	0.32%									

This table shows many interesting patterns. First, we can see the massive deceleration of inflation during the second half of last year. For the period June to December 2023, Core PCE annual inflation is just 1.9%. Clearly this in itself explains the Fed’s pivot to a dovish stance in December of last year. However, Core PCE had a strong rebound this year with the January through March period posting 4.5% annualized. Even worse in terms of outlook, since the inflation for the second half of 2023 was very low, this means that we are facing very difficult dynamics in terms of base effects for the rest of 2024. While inflation might actually become a much bigger problem, so far the pickup has been more of a wake-up call to the fact that the Fed is not yet done. Clearly what this leads to is “higher for longer.” Quoting Powell from Jackson Hole 2022:

“The successful Volcker disinflation in the early 1980s followed multiple failed attempts to lower inflation over the previous 15 years. A lengthy period of very restrictive monetary policy was ultimately needed to stem the high inflation and start the process of getting inflation down to the low and stable levels that were the norm until the spring of last year. Our aim is to avoid that outcome by acting with resolve now.

Jerome Powell, Federal Reserve Chair

Macro Volatility versus Market Stability

A strong resurgence in inflation (whatever its cause) is the biggest macro risk for the current environment. So far markets have behaved in an orderly fashion even as Fed cuts were being removed. The fear is that a drastic switch from cuts, even if they are few and delayed, to hikes might trigger a discontinuous market response. Since the big inflation surge that began in the second half of 2021, the Fed has been in a “bimodal”



state of either very dovish, like they were all the way until the 2022 Jackson Hole meeting, to very hawkish when Powell switched to a Volcker style tone during this meeting, and then back to a dovish stance since December 2023. One key reason why the Fed might U-turn to a hawkish stance is the fear of repeating the policy mistakes of the 1970s.

The 1970s were a time of tremendous macroeconomic volatility. Some of the instability was a result of external shocks (or at least exogenous to the Central Bank control). In particular, the end of the Bretton Woods system and two big oil shocks, in 1973 and 1978, marked some of the most dramatic macro developments of a very turbulent period. However, there was a lot to blame with regard to the Fed policy at the time. Fairly or not, Arthur Burns, the then Fed Chair, is customarily blamed for the massive surge in inflation and GDP volatility experienced during the decade between 1970 and 1980. The key part of Burn's monetary approach that is relevant to the present discussion was his constant gyrations from accommodative back to tight policy. As soon as the economy showed signs of weakness, the Fed was ready to loosen policy hence reigniting inflation expectations once again. In particular, he reacted to a decline in GDP at the end of 1974 by cutting the effective funds rate from 13% to 5%, a move that many economic historians blamed for the massive resurgence in inflation. This in turn led to Volcker and many years of very restrictive policy, as Powell referred to in the above quote from his 2022 Jackson Hole speech.

On top of inflation dynamics, there are several economic and geopolitical shocks that can certainly completely disrupt markets going forward. We are indeed going through one of the most challenging geopolitical environments even when considering the Cold War period. The relationship between the US and China, almost regardless of who is in the White House, will continue to be a source of instability for years to come. The situation in Ukraine has shown significant setbacks which can then lead to European concerns about Russian plans for Eastern Europe. Finally, the situation in the Middle East is at peak volatility level and, as we have seen in recent weeks, this conflict can not only potentially impact energy prices but can also be a source of global political instability.

From a macro standpoint, a drastic fall in growth seems unlikely now but could not be ruled out as "higher for longer" policy rates start to impact the economy. One key reason the economy has been so resilient has been healthy corporate and household balance sheets, in particular due to both sectors having locked in long term financing at much lower rates. Clearly, the more time we spend at higher rates, the bigger the impact on refinancing costs and hence on growth dynamics.

Micro versus Macro Effects: Election Impact on Economic Policy

Another potential shock is the presidential election in the US. In the US, elections can have a significant impact on the "micro" and lead to large sector rotations according to the change in policies (defense and healthcare in particular) but tend not to be that relevant from a macro standpoint. However, this particular election might prove to be a much more significant market event. We are currently running a very high fiscal deficit particularly when one considers that the economy is far away from recession. Despite this, and



regardless of who wins, it is very unlikely that there will be any kind of fiscal tightening. The key inflationary risk lies in the potential policies of a Trump mandate (to be certain, some of these policies might be quite good in the long run but I am just focusing on the inflationary impact here). The combination of deregulation, higher tariffs, and lower labor supply due to freezes in immigration can easily push inflation back to recent highs. Add to this the potential intention of a Trump administration to change the Fed's structure to allow more presidential influence, as it has been written in the Wall Street Journal, and you have a recipe for a bond market rout.

I believe it's important to highlight these "tail" risk events, as current market conditions favor a healthy allocation to risk-on trades. However, these should be complemented by diversifying or hedging strategies to offset some of the lurking tail risks.

As I've mentioned many times, while there are periods when actively managed strategies versus passive portfolios may seem less appealing, the current confluence of numerous macroeconomic and geopolitical issues creates a fertile environment for active tactical trading. This dynamic environment presents both challenges and opportunities, making it crucial for investors to stay agile. By balancing risk-on trades with effective diversifiers, we can better navigate the uncertainties ahead and capitalize on market movements.



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