Caron's Corner Transcript – 6.23.2025

"You Say Slow Growth, I Say No Rate Cuts, but Let's *NOT* Call the Whole Thing Risk-Off"

- The seemingly mixed message from the Fed created confusion last week.
- Their quarterly Summary of Economic Projections **are worse across the board**: higher inflation, higher unemployment and lower growth for year-end 2025.
- But at the same time, they kept their policy rate forecast of two cuts for 2025 unchanged from March to June.
- If the Fed's economic projections are weaker across the board, then **why wouldn't they increase the number of cuts this year?**
- Looking deeper into this confusing message, **there is a positive asset price message.**
- So, *Shall We Dance* into these markets? Let's get into it!

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, our asset allocation framework across Bonds, Equities, Alternatives and short-term Transitional (cash) investing. Well, a lot has taken place over the past week. Let me start with the events between the US and Iran. This is always hard to determine. Geopolitics are always very, very difficult to determine and find a cross-section in markets between how this is going to impact things into the future. The one thing that we'll probably say here is that as long as this is not a long and protracted event that impacts oil prices, then I think the impact on markets will be relatively minor. So it's very important to think about the baseline of where the markets were as this event between the US, Israel and Iran took place over the weekend, and then try to determine how we go forward.

I'd say if we look at an economic perspective of things, we'd have to look at the Fed meeting because I thought that was really telling, and I'm entitling the piece relative to the Fed as "You Say Slow Growth, I Say No Rate Cuts, but Let's *NOT* Call The Whole Thing Risk-Off." The reason I say that is because there was a seemingly mixed message by the Fed at their meeting last week which created confusion in their quarterly Summary of Economic Projections. They were worse across the board. They forecasted higher inflation up to 3.1% at the June meeting versus 2.8% in March, higher unemployment rate to 4.5% versus 4.4% prior and a lower growth forecast to 1.4% for 2025 versus where they were in March at 1.7%. But at the same time they kept their policy rate forecast to two cuts for 2025, unchanged between their March meeting and June. So if the Fed's economic projections are weaker across the board, then why wouldn't they increase the number of cuts this year? Why keep it the same as their forecasts were back in March? If we look deeper into this confusing message, there was a positive asset price message in here. So "shall we dance" into these markets? Let's get into it.

Watch what they do, not what they say. We have to understand that policy rates are what the Fed does. It's how they interact with markets. It's their action item. Economic projections, their forecasts, are what they say. It's their forecasts based on several variables that can change as time goes on. Understanding this nuance is very, very key. The dispersion around the Fed's forecast has increased. Four members of the FOMC were calling for rates to be on hold in March, but that number has risen to 7 in June. So why are there more people calling for no rate cuts if their economic forecasts have worsened? The answer is in the distributional effects. It breaks down like this: more Fed forecasters assign a higher downside risk probability than an upside. This increases the dispersion, which gets explained by the distribution of outcomes, which is where the medium lies in a lower growth driven higher inflation and higher unemployment rate. These are their forecasts. This is how the distribution effectively gets sorted out. This is the mathematical outcome, and it's how the Fed's forecast models work. Note that the Fed is very model dependent. However, given the higher error factors, and the dispersion around their forecasts, it reduces the Fed's need to take action via lower policy rates, and this is what's really creating confusion. This may ultimately be the consequence of volatile data expectations due to tariff policies that will be resolved not until later in the second half of 2025.

So why might this be a positive for markets? Think of it this way. If the Fed thought growth was going to slow with a high degree of certainty, then it would be forced by their models to lower their policy rate forecasts. But since they didn't lower their forecasts, in fact, more people think that the Fed should be on hold this time around, then they must believe that there is a highly convex upside to the data. If the fallout from tariff policies does not manifest, this is the key. Looking at it differently, it means there is more upside convexity than downside in the economic data and therefore asset prices too, because if the Fed did project more rate cuts, they could create a frothy upside to these asset prices which could also be destabilizing. It also means that the Fed has laid the groundwork to cut rates aggressively if the data does in fact soften. This adds another positively convex upside to asset prices.

Putting it all together, we've been adding to equity risk over the past several weeks and will continue to do so on weakness. To match the upside over downside convexity of risks for bonds, we think yields remain stable around current levels. Spreads should be stable as well. So just because the Fed lowered its growth forecasts doesn't mean we call the whole thing risk-off, and I think Fred and Ginger would approve. Thank you all very much.

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