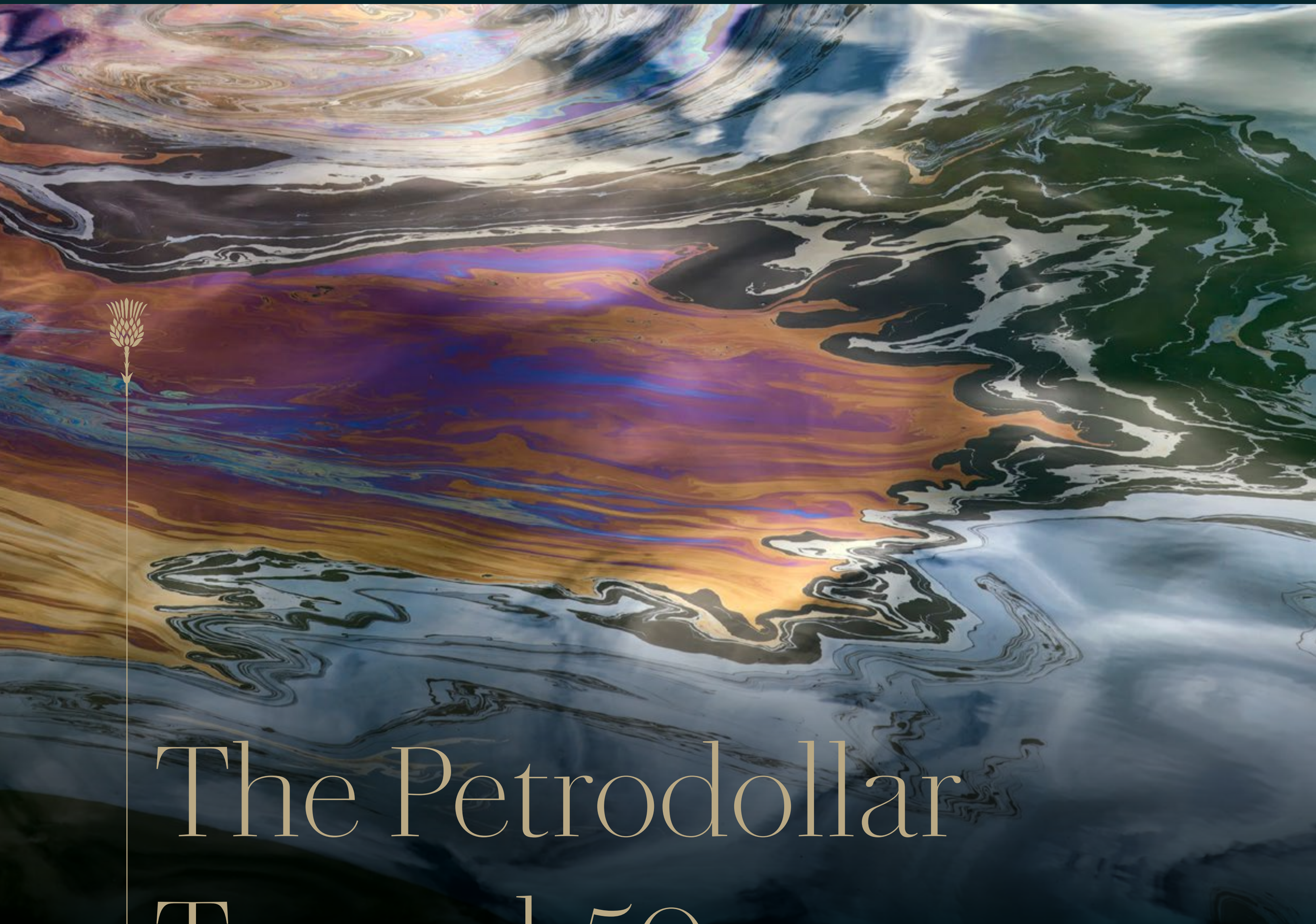
ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

AUGUST 2024



The Petrodollar Turned 50

The reports of its demise are greatly exaggerated

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Market Watch

Equity Market Indices[1]	6/30/24 Price	7/31/24 Price	MTD Change	YTD Change
MSCI All Country World	802	814	1.51%	11.99%
S&P 500	5460	5522	1.13%	15.78%
MSCI EAFE	2315	2381	2.89%	6.50%
Russell 2000®[2]	2048	2254	10.10%	11.22%
NASDAQ	17733	17599	-0.75%	17.24%
TOPIX	2810	2794	-0.55%	18.08%
KOSPI	2798	2771	-0.97%	4.35%
Emerging Markets	1086	1085	-0.14%	5.96%
Fixed Income				
2-Year U.S. Treasury Note	4.76%	4.26%	-50	1
10-Year U.S. Treasury Note	4.40%	4.03%	-37	15
BBG U.S. Agg Corp Spread	0.94%	0.93%	-1	-6
BBG U.S. HY Corp Spread	3.09%	3.14%	5	-9
Currencies				
Chinese Renminbi (CNY/$)	7.27	7.23	-0.56%	1.78%
Brazilian Real (Real)	5.59	5.65	1.01%	16.33%
British Pound ($/GBP)	1.26	1.29	-1.63%	-0.97%
Euro ($/Euro)	1.07	1.08	-1.04%	1.96%
Japanese Yen (Yen/$)	160.88	149.98	-6.78%	6.34%
Korean Won (KRW/$)	1376.50	1371.20	-0.39%	6.45%
U.S. Dollar Index (DXY)	105.87	104.10	-1.67%	2.73%
Commodities				
Gold	2327	2448	5.19%	18.64%
Oil	81.54	77.91	-4.45%	8.74%
Natural Gas, Henry Hub	2.60	2.04	-21.72%	-19.01%
Copper (cents/lb)	439	418	-4.87%	7.35%
CRB Index	290	278	-4.25%	5.42%
Baltic Dry Index	2050	1708	-16.68%	-18.43%

Source: Bloomberg

INTRODUCTION

What a political roller coaster these past few weeks have been! Hollywood could not have come up with a more intriguing plotline: an early presidential debate exposing an electability concern some have harbored; an inexplicable security failure that allowed a 20-year-old assassin to fire direct shots at a former President who is campaigning to return to the White House; the palace intrigue that forced the sitting President to abruptly announce via X (aka Twitter) that he was dropping out of the race; the scramble by both political parties and the media to "define" a new presumptive nominee who has yet to be battle-tested in a national election.

These developments, along with several softer-than-expected inflation readings, led to rapid sector rotations and heightened volatility in the stock market. Investors suddenly took profits on Big Tech stocks in droves and plowed money into cyclical laggards such as regional banks and smaller cap companies. The durability of cyclical stocks' outperformance is still in question as the earnings reporting season thus far is mixed at best, especially with some notable earnings misses and downbeat guidance among consumer-related companies such as McDonald's, Visa, Nike, Starbucks, Procter & Gamble, Nestle, and Diageo. While a Goldilocks soft-landing scenario appears to be the base case for most investors, the recent collapse in Treasury yields – the 10-year yield has dropped to 3.8% at the time of writing – portends rapidly rising odds of recession even if the Fed starts its rate cutting cycle in September.

On the international front, the Third Plenum of the Chinese Communist Party failed to deliver the consumption-driven stimulus that investors were looking for. The German economy, now the third largest in the world, surprised on the downside with an unexpected contraction in the second quarter. Unlike the U.S., the rest of the world is still struggling with sustainable growth as they lack the privilege of a global reserve currency to let them borrow and spend aggressively. However, America's exceptional "sugar high" of fiscal stimulus and excess liquidity will start to wear off by late 2024. This is why the U.S. general election is so important to the market – the control of Congress and the White House will dictate the future path of this era of "fiscal dominance," and the next president will pick the successor to Fed Chair Powell. That said, investors cannot yet make high conviction bets on the outcome as the race will likely remain too close to call with potentially more surprises ahead.

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Death of the Petrodollar?

A view of the scene aboard an American warship aboard the USS Quincy at the Great Bitter Lake in the Suez Canal, Egypt, 14th February 1945. President Roosevelt Conferred with King Ibn Saud of Saudi Arabia.

In mid-June 2024, there was a flurry of news reports about Saudi Arabia deciding not to renew the 50-year petrodollar agreement and its new plan to sell oil in multiple currencies, including the yen, euro, and renminbi. Even the Washington D.C.-based think tank, The Atlantic Council, which specializes in international affairs, was swayed into publishing a report on the impact of this agreement's expiration.

The demise of the alleged petrodollar agreement turned out to be fake news as such an agreement had never existed. The rumor mills were probably referring to the U.S.-Saudi Arabia Joint Commission on Economic Cooperation established in June 1974. This joint commission was designed to oversee the implementation of the U.S.-Saudi Arabia Technical Cooperation Agreement signed on February 13, 1974, which has been renewed many times, most recently in May 2023.

The petrodollar scheme was in essence an informal arrangement of convenience – the Kingdom selling its oil in U.S. dollars and recycling the money into U.S. Treasury securities and American military equipment – that has seemingly outlived its utility.

The world today is quite different from 50 years ago when the petrodollar arrangement was made. The bilateral relationship began to fray in the early 2010s. The Saudi monarchy blamed Washington for not firmly backing regional leaders during the Arab Spring, which led to the ouster of Egyptian President Hosni Mubarak in 2011. The Kingdom also felt betrayed by the Obama administration's outreach to Iran, which resulted in the lifting of sanctions against the Kingdom's nemesis in exchange for Tehran's promise to suspend its nuclear weapons program for a decade.

Economically, Saudi Arabia and the Middle East have gradually become less vital to the U.S. as the "Shale Revolution" has expanded domestic energy production and made America less dependent on foreign oil. Today, with over 13 million barrels of oil produced per day, the U.S. has reclaimed the title of the largest oil producer in the world.

Many believe the U.S.-Saudi relationship was mended by President Trump, who made Saudi Arabia the first destination in his inaugural foreign trip as President. The Trump administration also restored the hardline policies of sanctions against and isolation of Iran, which reestablished U.S. credibility and goodwill with Sunni states and paved the way for the historic Abraham Accords.

Trump's successor, President Biden, initially vowed to treat Saudi Arabia as a pariah due to its human rights abuses. The Biden administration also renewed the outreach to Iran. However, the U.S. soon realized that its leverage in the region was on the decline as the rift with Saudi Arabia created an opening for Russia and China to expand their influence. With the Biden administration striving to keep a lid on crude oil prices and inflation going into the 2024 general election, President Biden has, to the chagrin of human rights activists, made a U-turn in his dealings with Saudi Arabia. The kinetic wars in the Middle East since last October have raised the importance of the U.S.-Saudi alliance to the region's stability. In recent months, the two sides have reportedly been working on an extension to the Abraham Accords by having Saudi Arabia normalize relations with Israel in exchange for a U.S. defense pact, as well as assistance to develop a civilian nuclear program.

US President Joe Biden being welcomed by Saudi Arabian Crown Prince Mohammed bin Salman at Alsalam Royal Palace in Jeddah, Saudi Arabia on July 15, 2022.

Whether a deal can be struck before the end of Biden's term remains to be seen, but the Kingdom's interest in a formal defense deal with the U.S. will likely outweigh the superfluous move to price the Kingdom's oil exports to China in yuan. After all, getting paid in U.S. dollars makes economic sense as the Saudi riyal has been pegged to the greenback since 1986, and the U.S. remains the de facto security guarantor to the Kingdom.

No Credible Alternatives

Many countries have tried to circumvent the dollar-dominance in global trade and finances, but the problem with the de-dollarization effort is that there are still no credible alternatives to the dollar. The Eurozone's sovereign debt crisis has diminished the euro's competitiveness versus the greenback. Some believe that the Chinese renminbi could become a viable global reserve currency, but it is held back by the country's increased friction with the West, strict capital controls, overt currency manipulation, and lack of sufficient renminbi-denominated investment options for foreign central banks that hold the currency in reserves.

In recent years, the Global South – nations in emerging and frontier markets – has been prodded by several players that are ideologically opposed to the U.S., such as Russia, China, South Africa, and Brazil, to join the effort to create a BRICS common currency based on blockchain technology for intra-bloc trading and financing. With the Global South accounting for more than 40% of the world's GDP and 85% of the population, their vision is that it should be big enough to create a credible alternative to the U.S. dollar. However, it is easier said than done.

Technically speaking, a common currency based on a basket of Global South currencies and multilateral digital settlement and payment network – Russia proposed BRICS Bridge or the Project mBridge developed by China and several other central banks – can be created without much difficulty. There are also proposals and pilots to peg the BRICS common currency to gold or a basket of commodities. However, if one uses the euro as a framework for the BRICS common currency, a BRICS central bank would need to be created, which is a highly political process among countries with disparate development models and competing geopolitical interests.

In the final analysis, while an increasing share of global trade will be transacted in foreign currencies like the euro and renminbi, the U.S. dollar's role as the global reserve currency will be maintained until a credible alternative currency offering sufficient stability, liquidity, and investment options becomes widely accepted. It's an effort that will likely take many years if not decades to materialize. However, keeping the reserve currency status does not mean that the U.S. dollar will not weaken materially versus other major currencies episodically, especially if a crisis of confidence emerges over Washington's inability to manage its debt trajectory. After all, the exorbitant privilege should be accompanied by great responsibility. Unfortunately, Washington often acts like what Treasury Secretary Connally said to foreign central bankers during the Nixon Shock in 1971: "The dollar may be our currency, but it's your problem."

BRICS Summit Hosted In Johannesburg, South Africa. August 2024.

Follow the Yellow Metal Road

Stocks and bonds are often the main focus of financial media and investment strategists, but movements in the currency market also matter a great deal. To wit, the Big Tech sell-off in July was in part fueled by the sudden and swift appreciation of the yen, which forced some hedge funds to unwind the popular carry trade of borrowing in yen to fund the purchase of Big Tech stocks.

As the Fed embarks on the highly anticipated and well-choreographed interest rate cutting cycle in the near future, the U.S. dollar may start to weaken, though much will also depend on the pace of easing by foreign central banks. It will likely rekindle the debate on whether international stocks will finally start to outperform U.S. equities. As a general rule of thumb, international stocks tend to outperform U.S. equities during periods of dollar weakness and vice versa.

The outcome of the U.S. general election will also affect the dollar and relative attractiveness of international stocks. A Trump victory could pressure international stocks due to the fear of new tariffs imposed on our trading partners, friendly or not. Trump's threat of 60% tariffs against Chinese imports, if materialized, will likely prompt China to devalue the renminbi to remain competitive, which could lead to competitive devaluation by other countries and increase financial instability. Trump also wants to weaken the dollar to boost our exports. However, foreign exchange traders may push back at this idea as higher tariffs should theoretically reduce America's current account deficit, which would strengthen the dollar, ceteris paribus. Trump will then have to pressure the Fed to ease more aggressively to weaken the dollar, but that could rekindle inflation.

The U.S. dollar may initially move lower if Vice President Kamala Harris winds up winning the presidential election, as the Democrats' proposed policies – higher taxes and more regulation – could weaken economic growth and prompt the Fed to be more aggressive in easing.

Regardless of the outcome of the November election, the Global South's concern with the U.S. government's weaponization of the dollar through the frequent use of financial sanctions will likely prompt them to further diversify their foreign exchange reserves away from U.S. Treasuries. This trend has created a steady demand for gold and appears to be one of the drivers in powering gold prices to all-time highs. I continue to believe that gold has an important role in a diversified portfolio as a hedge against several risks – higher geopolitical tension, Washington's continued fiscal profligacy, the likely resumption of unconventional monetary policies to help indirectly monetize the national debt, and continued effort by the Global South to reduce their dependency on the dollar. While the shiny yellow metal was called a barbarous relic by John Maynard Keynes, one of the greatest economists of all time, it has held up much better than the U.S. dollar during the first 53 years of the fully fiat currency era – the greenback's purchasing power, as measured by the Consumer Price Index (CPI), has declined by 87% cumulatively since the August 1971 Nixon Shock.

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