



The Petrodollar Turned 50

The reports of its demise are greatly exaggerated

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%

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.

Jimmy Chang



JIMMY C. CHANG, CFA

Chief Investment Officer
Rockefeller Global Family Office
jchang@rockco.com
212-549-5218



FDR's Final Act of Goodwill

On January 23, 1945, three days after being inaugurated for his fourth term as the President of the United States, Franklin D. Roosevelt (FDR) boarded the *USS Quincy* and sailed for Yalta, a resort city on the southern coast of the Crimean Peninsula. FDR's physicians had advised against the grueling 7,000-mile journey, but FDR felt it was important to personally negotiate with Winston Churchill and Joseph Stalin at the Yalta Conference to shape the postwar world order.

At the conclusion of the Yalta Conference on February 11, FDR was visibly frail and exhausted. However, instead of sailing home, the *USS Quincy* headed for the Suez Canal where Roosevelt was to meet with Emperor Haile Selassie of Ethiopia, King Farouk of Egypt, and most importantly, King Abdul Aziz, aka Ibn Saud, of Saudi Arabia.

At the start of the 20th century, the Arabian Peninsula was ruled by a patchwork of sheikhdoms under the authority of the Ottoman Empire. The British did not see much strategic value in this barren land other than ensuring that their trade route with India, the jewel in the crown of the British Empire, would remain unobstructed. After WWI, the partition of the Ottoman Empire, an ally of the defeated Germany, made the peninsula a British protectorate. However, unless their interests were affected, the British by and large avoided taking sides in the conflicts among rival tribes.

Born in 1875 to the House of Saud, a sheikhdom based in Riyadh, a young Ibn Saud and his family were forced into exile in 1891 when his father, the Emir of Najd, was defeated by the rival House of Rashid. A decade later, Ibn Saud led a contingent of relatives in guerilla warfare on the House of Rashid to restore his family's reign.

After two decades of military, political, and diplomatic maneuvering, Ibn Saud finally destroyed the House of Rashid by 1922. He then spent the next decade subjugating and consolidating other tribes to finally establish the Kingdom of Saudi Arabia in September 1932.

In 1931, American businessman Charles R. Crane was introduced to Ibn Saud in Jeddah, a port city by the Red Sea. Upon learning of Ibn Saud's interest in finding artesian water on the peninsula, Crane offered to commission one of his engineers, Karl Twitchell, to prospect for water and minerals in Arabia. A year later, Twitchell reported that he was negative on water aquifers but had found evidence of ancient mines, indicating a potential of finding oil. In 1933, with Twitchell's help, the Standard Oil Company of California (Socal, rebranded as Chevron in 1985) outbid their British rivals to win a 60-year concession to explore and produce oil in the Saudi desert.

After several years of unsuccessful exploration, Socal was about to give up on the venture in late 1937. However, thanks to the perseverance of Max Steineke, Socal's chief geologist in Saudi Arabia, his team finally struck black gold on March 4, 1938, which made the Kingdom a key player in the region – as the guardian of Islam's two holiest cities, Mecca and Medina, and an important oil exporter. It also put the Kingdom on America's geostrategic chess board.

Due to heightened security concerns in 1945 – the region was at risk of attacks from German bombers – Ibn Saud's meeting with FDR was arranged in secrecy. On February 12, Ibn Saud surprised the Crown Prince by telling him to run the country until his return. The King



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.

and a delegation of 47 then boarded *USS Murphy*, which had dropped anchor in the port of Jeddah a day earlier. It was the King's first trip outside the Arabian Peninsula and his subjects were left in total shock.

On February 14, *USS Murphy* docked alongside *USS Quincy* at the Great Bitter Lake in the Suez Canal. The 70-year-old king, three princes, and two ministers crossed the gangplank and met with the 63-year-old FDR, who was sitting in his wheelchair on the deck of *USS Quincy*.

FDR's objectives were to secure access to Saudi Arabia's vast oil reserves, win the Kingdom over as an ally, and enlist the King's support for more Jewish settlement in the Levant. Despite his failing health, FDR was in top form for his engagement with the King. Out of respect for the King's Wahhabism which forbade smoking, the

chain-smoking President refrained from lighting a cigarette during the five-and-a-half-hour-long meeting.

Ibn Saud was so charmed by FDR that he said the two of them were really twins: they were the same age (FDR did not correct him on it); both were heads of states with grave responsibilities; they shared a common interest in horticulture; and both had physical infirmities – the King had difficulty walking due to old battle injuries. FDR replied that the King was lucky that he could still walk, but the King said FDR was more fortunate with a wheelchair. With a stroke of diplomatic genius, FDR said, "If you think so highly of this chair, I will give you the twin of this chair as I have two on board," and immediately ordered the wheelchair to be moved across the gangplank to *USS Murphy*. The wheelchair would become one of Ibn Saud's most prized possessions.

🌿 FDR'S FINAL ACT OF GOODWILL

A day after the historic meeting with Ibn Saud, FDR met with British Prime Minister Churchill for the last time in Alexandria and then embarked on the long journey home on *USS Quincy*; it was the final voyage of his remarkable life.

Churchill had followed FDR to Egypt as he was afraid of the U.S. meddling in a region that was still in the British sphere of influence. On February 17, Churchill hosted Ibn Saud at a summit at Faiyum Oasis, a desert resort 60 miles south of Cairo. Nicknamed the “British Bulldog” for his obstinance, Churchill’s sometimes blunt manner was the opposite of FDR’s suavity. During the luncheon, Churchill told the King that he heard that smoking and alcohol were forbidden by Islam, but his own rule of life “prescribed as an absolute sacred rite smoking cigars and drinking alcohol before, after, and if need be, during all meals and the intervals between them.” This cultural insensitivity, of course, failed to endear Churchill to the King, who valued personal relationships far more than diplomatic treaties.

Less than two months later, Ibn Saud was stunned to learn of FDR’s sudden passing on April 12, 1945. However, the goodwill FDR established at the secret rendezvous has lasted to date. He had told FDR that his first desire for Saudi Arabia was its independence, followed by FDR’s friendship as he believed that America had never colonized another country. In August 1945, the King signed the Dhahran Airfield Agreement which allowed the U.S. military to build and operate an airbase on Saudi soil. In 1951, two years before his passing, Ibn Saud formalized the Kingdom’s alliance with the U.S. by signing the Mutual Defense Assistance Agreement, setting the foundation for the strategic partnership between the two countries, a milestone that the farsighted FDR had envisioned as a part of a new world order.

Birth of the Petrodollar

After Ibn Saud’s passing, his successors relied on the U.S. for military assistance against pro-Soviet Arab nationalists led by Egypt’s General Nasser who sought to topple Arab monarchies under the guise of Pan-Arabism. However, Saudi Arabia became more assertive with the West after the Six-Day War between Israel and Egypt broke out in June 1967. King Faisal, Ibn Saud’s third son, joined other Arab nations in briefly cutting oil exports to the U.S. and U.K. It was a turning point in the Kingdom’s foreign policy as Faisal buried the hatchet with General Nasser and pursued pan-Islamism.

In 1968, the U.K. pulled its troops out of the region, but the U.S. was too preoccupied with the Vietnam War to fill the power vacuum. It created an opportunity for the Soviet Union to expand its regional influence while the conservative King Faisal and reform-minded Shah of Iran began a latent rivalry for regional leadership. In October 1973, shortly after Soviet-backed Egypt and Syria launched their surprise attacks against Israel on Yom Kippur, King Faisal imposed a total oil embargo on the U.S. in retaliation for the U.S. military aid to Israel. It marked the lowest point in the bilateral relationship.

The 1973 oil embargo was a wake-up call and big blow to the U.S., which was importing more than a third of its oil and already mired in a series of crises. The U.S. dollar, on a trade-weighted basis, had lost more than 20% of its value since the Nixon Shock of August 1971, when President Nixon abruptly ended the greenback’s convertibility to gold and ushered in the fiat money era where currencies have no intrinsic value other than the backing of the issuing government. Inflation, as measured by the Consumer Price Index (CPI), had surged to 7.4% before the embargo and would later



US Secretary of State Henry Kissinger meets with Egypt's President Anwar Sadat, on November 7, 1973 during his visit to Cairo.

surge to 12% by year-end 1974. The oil embargo caused a quadrupling of the price of crude oil – from \$3 to \$12 a barrel – and effectuated a sudden transfer of wealth from oil importing countries to the exporters in the Middle East. Politically, President Nixon was distracted by the Watergate investigation.

With the U.S. caught in a bind and the global economy taken hostage by the oil embargo, Washington contemplated several emergency policy options, including a far-fetched plan to use the U.S. military to take over oil fields in the recently founded United Arab Emirates (UAE). The U.S. settled on a strategy that sought to exploit the rivalry between Iran and Saudi Arabia, as well as their distrust of the Soviet Union, to turn them into U.S. allies, customers, and investors. The U.S. would position the Shah of Iran and King Faisal as the “Twin Pillars” to ensure regional stability, a steady flow of oil, and as a bulwark against communism. With the Watergate scandal consuming Nixon’s attention, Secretary of State Henry Kissinger was given much latitude to pursue his legendary “shuttle diplomacy” in the region in an attempt to turn the crisis into an opportunity.

Kissinger wasted no time in building a strong bond with Egyptian President Anwar Sadat, who was looking for a face-saving rapprochement with Israel after the Egyptian military’s initial victories were turned into defeats. Kissinger’s intense diplomacy and masterful negotiations helped broker the first Egyptian-Israeli Disengagement Agreement in January 1974. With Sadat assuring King Faisal that the U.S. was indeed evenhanded in brokering the agreement, the King ended the oil embargo in March 1974.

On June 8, 1974, the U.S. and Saudi Arabia established a Joint Commission on Economic Cooperation to formalize the transfer of American “technical knowledge, advice, skills, and resources” to help modernize Saudi Arabia’s economy and military. Following the signing of this historic agreement in Washington, Nixon cemented U.S. presence in the region by embarking on a five-country tour of the Middle East across Egypt, Saudi Arabia, Syria, Israel, and Jordan.

❁ BIRTH OF THE PETRODOLLAR

In July 1974, Nixon sent newly appointed Treasury Secretary William Simon to Saudi Arabia to convince the Kingdom to recycle its windfall profits into financing America's widening deficit. As a former Salomon Brothers executive in charge of government and municipal bonds, Simon was the right salesman to market U.S. Treasuries. His pitch was straightforward: the U.S. would promise to buy oil from and offer protection to Saudi Arabia; in return, the Kingdom would invest its newfound wealth in U.S. Treasuries, the safest and most liquid investment in the world. King Faisal agreed to the arrangement on the condition that the Kingdom's purchase of Treasuries remain strictly anonymous. The King feared that the country's oil money could wind up being seen as indirectly financing the U.S. aid to Israel.

Simon and his staff formulated some creative ways allowing Saudi money to flow into the U.S. Treasury through the backdoor. Instead of using the standard auction process to buy Treasuries, Saudi Arabia's purchases would be "add-ons" to the auctions. The Treasury also lumped the Kingdom's holdings of U.S. Treasuries with 14 other nations under the generic heading of "Oil Exporters" in its monthly report of debt ownership by foreign countries.

With Saudi Arabia plowing most of its trade surplus into U.S. dollar denominated investments and purchases, the Kingdom decided to price its oil exports solely in the greenback, which in effect pegged the U.S. dollar to crude oil and created a "black gold standard" for fiat money. In December 1974, Saudi Arabia informed the U.K. that it would no longer accept pound sterling's in payments for oil, a move that sent the value of the currency reeling and symbolically marked the end of the pound sterling's status as a viable global reserve currency. The U.S. dollar, on the other hand, became the de facto global reserve currency as most oil-importing countries need to acquire the greenback to pay for black gold. Thus, the "petrodollar" was born.

U.S. Secretary of State Henry Kissinger meets with King Faisal of Saudi Arabia. Saudi sources said Kissinger tried, but failed, to get King Faisal to agree to lift the Saudi embargo on oil shipments to the U.S. when the Geneva conference opens.



Death of the Petrodollar?

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 aforementioned 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. President Obama was

critical of Saudi Arabia's role in fomenting sectarian strife in the region and believed Iran was ultimately a rational actor that would respond to incentives. As New York Times columnist Thomas Friedman wrote in 2015, the "Obama Doctrine" preferred "engagement" over "endless sanctions and isolation" in dealing with enemies such as Burma, Cuba, and Iran. In an unprecedented diplomatic move, Prince Turki Al-Faisal, Saudi's Chief of General Intelligence Directorate, penned a scathing op ed in 2016 – *Mr. Obama, we are not 'free riders'* – to openly criticize America's cordial pivot to Iran.

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. The U.S. daily oil production soared from 5 million barrels per day when Obama was inaugurated in January 2009 to nearly 10 million barrels per day by early 2015. The rapid production growth led to a sharp decline in oil prices and forced the industry to cut back production in the middle of the last decade. 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. However, the bilateral relationship was strained by the murder of Saudi dissident Jamal Khashoggi, which implicated Crown Prince Mohammed bin Salman Al Saud, popularly known by his initials, MBS.

❁ DEATH OF THE PETRODOLLAR?

Trump's successor, President Biden, initially vowed to treat Saudi Arabia as a pariah due to its human rights abuses, including the murder of Khashoggi. 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.

In 2022, the Kingdom not only refused to condemn Russia's invasion of Ukraine, but also made investments in Russian energy companies in defiance of Western sanctions. In 2023, China, the largest buyer of Iranian and Saudi oil, significantly elevated its stature in the region by brokering the rapprochement between Iran and Saudi Arabia. BRICS, the Global South organization run by Brazil, Russia, India, China, and South Africa, formally invited six countries, including Saudi Arabia and Iran to join the group. BRICS has made de-dollarization a policy priority as the Global South has been seeking to reduce their dependence on the Western-centric global economic and world order. With Chairman Xi Jinping having personally lobbied MBS and other regional leaders to price their energy sales to China in yuan, many believe that it is just a matter of time before the Kingdom makes such a move official.

There is an adage that politics makes strange bedfellows. 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 MBS. In July 2022, Biden visited Saudi Arabia and publicly had an awkward fist bump with MBS. By September 2023, the two leaders were making hearty handshakes and smiling at each other at the G20 Summit in India. 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



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.

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. Whether a deal can be struck before the end of Biden's term remains to be seen, but MBS'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.

Putin's Rupee Problem

In April 2023, Brazil's left-wing President Lula called for de-dollarization in global trade during his visit to Beijing. "Every night I ask myself why all countries have to base their trade on the dollar," Lula said in front of his Chinese hosts, "Why can't we do trade based on our own currencies? Who was it that decided that the dollar was the currency after the disappearance of the gold standard?"

Lula's frustration is understandable. In a dollar-based global financial system, when a Brazilian company imports items from a Chinese seller, it has to convert its Brazilian real to the U.S. dollar (buy U.S. dollars) to pay for the goods, and the exporter in China would then exchange the U.S. dollar received for renminbi (sell U.S. dollars). Should a Brazilian company need to raise capital in the international financial market, the lenders would demand that the transaction be completed in the dollar. The Brazilian company would then convert the capital raised back to real for domestic use. When it comes to servicing the dollar-denominated debt, the company has to convert its cash flow in real to the dollar for interest and principal payments to its foreign lenders. Since these transactions all involve buying and selling the U.S. dollar, foreign central banks would hold U.S. dollars in their foreign exchange reserves to facilitate the transactions and ensure sufficient dollar liquidity. The dollar they hold in the reserves are usually U.S. government bonds – it means these central banks have been buying debt issued by the U.S. government, or financing Uncle Sam's big spending habits. This arrangement gives the U.S. government easier access to financing, or what the French called "the exorbitant privilege." Moreover, these foreign entities are beholden to the Fed's policies which affect the value of the dollar and interest rates.



Narendra Modi, India's prime minister and Vladimir Putin, Russia's president, pose for photographs as Putin arrives at Hyderabad House in New Delhi, India, on Monday, Dec. 6, 2021.

The reason that most international transactions are done in the U.S. dollar is because most trading counterparties and lenders want to avoid the risks and complexities of dealing with local currencies. Lula's friend, President Putin, has firsthand experience with these problems.

In 2022, in the face of Western sanctions, Russia started selling energy to India in rupee. India's payment for Russian oil was deposited into Russian banks' rupee vostro accounts in several Indian banks. Russia soon realized that, due to the Indian government's capital controls, the billions of dollars of rupees that they accumulated in Indian banks could not be easily converted to Russian rubles or Chinese yuan to be repatriated back home. India, of course, tried to pressure Russia to purchase more Indian goods and services or invest

🌐 PUTIN'S RUPEE PROBLEM

in Indian markets. The issue was partially resolved in May 2024 when Russia reluctantly decided to purchase \$4 billion worth of Indian arms and ammunitions to support its aggression in Ukraine – India is not known as a prolific arms exporter.

Russia's problem with its excess rupees explains why the U.S. dollar will likely remain the preferred currency for global trade and financing – it's the de facto world currency accepted around the world and can be wired easily via the SWIFT (Society for Worldwide Interbank Financial Telecommunication) network, a messaging system that facilitates the transfer of money between banks globally. While Lula wants to buy foreign goods and services priced in Brazilian real, other countries probably don't want to hold more real than they need to buy goods and services from Brazil in the local currency. Similarly, most commodity exporting countries would prefer to keep on doing business in the greenback unless the U.S. makes it riskier to hold the dollar.

One major risk that foreign countries face in being dependent on a U.S. dollar-based global trade and financing system is that the U.S. has become trigger happy with financial sanctions. These sanctions usually cut off foreign entities' access to the SWIFT network, making it extremely difficult for them to participate in the global financial system. The freezing of Russian central bank assets in the wake of the Ukrainian invasion also made other countries worry that their holdings of U.S. Treasuries could be impounded should they run afoul of the U.S. According to a recent report by the Washington Post, after two record breaking years, the U.S. is again imposing sanctions at an even faster pace this year. This "economic warfare" has raised alarm at home and abroad on whether it is appropriate and sustainable.

No Credible Alternatives

Many countries have tried to circumvent this dollar-dominance, 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.



Brics Summit in Johannesburg, South Africa August 22-24, 2023

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."

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.

PRINCIPAL AUTHOR

Jimmy C. Chang, CFA

Chief Investment Officer
Rockefeller Global Family Office

EDITOR

Joan Park

Research & Strategy Specialist
Rockefeller Global Family Office

PHOTOGRAPHY

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45 ROCKEFELLER PLAZA FLOOR 5
NEW YORK, NY 10111

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