ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

FEBRUARY 2024

Barbary Corsairs Redux

Investor complacency in the face of rising tension

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Market Watch

Equity Market Indices[1]	12/31/23 Price	1/31/24 Price	MTD Change	YTD Change
MSCI All Country World	727	731	0.5%	0.5%
S&P 500	4770	4846	1.6%	1.6%
MSCI EAFE	2236	2248	0.5%	0.5%
Russell 2000®2	2027	1947	-3.9%	-3.9%
NASDAQ	15011	15164	1.0%	1.0%
TOPIX	2366	2551	7.8%	7.8%
KOSPI	2655	2497	-6.0%	-6.0%
Emerging Markets	1024	976	-4.7%	-4.7%
Fixed Income				
2-Year U.S. Treasury Note	4.25%	4.21%	-4	-4
10-Year U.S. Treasury Note	3.88%	3.91%	3	3
BBG U.S. Agg Corp Spread	0.99%	0.96%	-3	-3
BBG U.S. HY Corp Spread	3.23%	3.44%	21	21
Currencies				
Chinese Renminbi (CNY/$)	7.10	7.17	1.0%	1.0%
Brazilian Real (Real)	4.86	4.96	2.0%	2.0%
British Pound ($/GBP)	1.27	1.27	0.3%	0.3%
Euro ($/Euro)	1.10	1.08	2.0%	2.0%
Japanese Yen (Yen/$)	141.04	146.92	4.2%	4.2%
Korean Won (KRW/$)	1288.10	1334.65	3.6%	3.6%
U.S. Dollar Index (DXY)	101.33	103.27	1.9%	1.9%
Commodities				
Gold	2063	2040	-1.1%	-1.1%
Oil	71.7	75.9	5.9%	5.9%
Natural Gas, Henry Hub	2.51	2.10	-16.5%	-16.5%
Copper (cents/lb)	389	391	0.4%	0.4%
CRB Index	264	272	3.3%	3.3%
Baltic Dry Index	2094	1398	-33.2%	-33.2%

Source: Bloomberg

INTRODUCTION

For most of my 30-year investment career, investors had never heard of or cared about QRA, which refers to the U.S. Treasury Department's quarterly refunding announcement that outlines Uncle Sam's near-term plans for bill, note, and bond issuance. In the good old days, it was taken for granted that government debt could be issued without disruption to the market. Now, with the Federal Reserve shrinking its balance sheet and Uncle Sam running bloated deficits, how the Treasury meets its financing needs has suddenly become a market moving event.

Higher-than-expected borrowing announced last August led to a sharp rise in bond yields and dragged down the stock market. The Treasury Department wised up in November by announcing increased bill issuance, which allowed its planned bond sales to come in below expectations. It worked like magic: bond yields collapsed, and stocks rallied; the economy benefited from a rapid easing of financial conditions. Of course, the Fed also joined the holiday party by making a sharp dovish pivot in mid-December.
The dynamic federal duo was at it again on January 31, when the Treasury released its QRA in the morning and the Federal Open Market Committee (FOMC) concluded its meeting in the afternoon. Investors were largely pleased with the Treasury Department's lower-than-expected financing projections based on higher estimated tax revenues. The Fed, on the other hand, tried to rein in the market's aggressive assumption that the first interest rate cut would take place in March. The FOMC statement specifically stated: "The Committee does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward two percent." However, Chair Powell did acknowledge that the committee will start in-depth discussions at the March meeting about tapering quantitative easing.

Despite Chair Powell's pushback against investors' aggressive easing assumptions, the market has continued to price in a perfect combination of an economic soft-landing, disinflation, double-digit earnings growth, and five to six interest rate cuts by the Fed. I would caution that the real world remains imperfect with arguably the most dangerous geopolitical backdrop in decades.

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Troubled Waters

The Red Sea is the primary Euro-Asian maritime shipping route as it connects the Gulf of Aden and the Arabian Sea to the Mediterranean Sea via the Suez Canal at its northern end. It is estimated that 24,000 ships carrying roughly 10% of the world's seaborne trade volume passed through the Red Sea in 2023. The Red Sea is also vital to the energy trade – Russian oil is shipped to Asia via this route, and Middle Eastern producers such as Qatar, Iraq, Saudi Arabia, and the UAE sail their vessels in the opposition direction to deliver oil and liquefied natural gas (LNG) to Europe.

Shortly after Israel started its military campaign against Hamas last October, the Houthis in Yemen, an Iran-backed Shia insurgent group that has gained control of much of the country, began attacking commercial ships in the Red Sea and claimed that their military operations will continue until Israel pulls out of Gaza. Suddenly, this often-overlooked rebel group created one of the most serious crises in freedom of navigation in decades. This situation is reminiscent of state-sanctioned Barbary corsairs that terrorized the North African coast more than two centuries ago. U.S. naval fleets were dispatched to fight two wars in the region in early 19th century to ensure safe passage for American merchant ships.

In the face of escalating provocations from the Houthis, the U.S. and the U.K. launched joint strikes against military targets in Houthi-controlled areas of Yemen. The Houthis still refused to back down and vowed to target U.S. and British assets. Commercial shippers were driven away from the Red Sea for security as well as economic reasons – marine war insurance premiums have reportedly soared by as much as 20-fold while shipping rates between Europe and Asia have jumped up by four to five-fold over the last three months.

At the time of this writing, the U.S. has redesignated the Houthis as a terrorist organization and is reportedly planning for a sustained military campaign against them. The irony is that the U.S. economy is barely affected by the Houthis' blockade of the Red Sea, yet our service men and women are doing the fighting while the most negatively impacted nations have been standing on the sidelines paying lip service. Some of the most affected countries have even refused to condemn the Houthis and instead blamed Israel for the crisis.

Whistling in the Dark

Ukrainian air defence fires at a drone over Kyiv on May 4, 2023

Last October, in the face of the escalating Middle East crises, my colleague Ruchir Sharma observed in a *Financial Times* op-ed that the collective mind of the market often dismisses geopolitical threats on the expectation that political leaders will be forced to take steps to prevent escalation so "our worst fears will not come to pass." He has been spot-on as equities have subsequently soared while crude oil prices steadily moved lower.

Most investors have been expecting the crises in the Middle East to gradually subside. While smaller-scale conflicts away from Gaza have been simmering unabated – such as U.S. bases and assets in the region having been attacked on more than 150 occasions in the last few months – the administration is expected to keep a lid on the situation for a variety of reasons.
While investors have been prescient in downplaying geopolitical risks up to now, there are some disconcerting longer-term developments that may eventually weigh on the market in the form of higher equity risk premium to compress valuations:

- After a period of renewed solidarity in the wake of Russia's invasion of Ukraine, the U.S.-led Western alliance is fraying at the edges. Our divided government has been unable to negotiate more aid for Ukraine, which will likely give Russia

WHISTLING IN THE DARK

more leverage in dictating the terms of the eventual ceasefire. Countries that were convinced by the U.S. to boycott Russian natural gas and now rely on U.S. LNG may now be worried that the White House has just suspended approval of new LNG export permits.

- If the Houthis can get away with shutting down the Red Sea to commercial vessels, other entities may be emboldened to test the U.S.-led liberal world order for territorial, financial, or reputational gains. With the U.S. distracted by wars in two theaters, North Korea appears to be opportunistically fomenting a crisis.
- Iran and its proxies in Syria, Lebanon, Iraq, Yemen have become more powerful and menacing while the Sunni-counterweights in the region are in retreat. The balance of power will further shift in Iran's favor should it acquire the nuclear bomb. Will Israel decide to take the matter into its own hands before that eventuality?
- The nature of warfare is being transformed by the proliferation of inexpensive low-tech equipment that helps non-state entities conduct asymmetric warfare more effectively.
- The risk of terrorism on U.S. soil appears to be on the rise as the porous southern border has let in many individuals of unchecked background from countries hostile to the U.S.

Hedging the Left Tail Risk

The increasingly dangerous world raises the importance of portfolio hedging against geopolitical risks. For many decades, U.S. Treasury bonds have been the preferred hedge as investors tend to flock to them during times of crises. However, U.S. Treasuries also had the benefit of secular declines in inflation and interest rates from 1982 to 2021. On a few occasions when the crises stoked fear of higher inflation, bond yields had climbed higher. For example, 10-year Treasury yield had surged in sympathy with crude oil prices after Saddam Hussein shocked the world by invading and annexing Kuwait in the summer of 1990.

With crude oil remaining an important form of energy and a sizeable amount of it produced in geopolitically unstable regions, oil related equities can be considered a form of hedge to complement Treasuries. Some of the integrated energy stocks with attractive dividend yields look rather defensive despite their sensitivity to economic growth.

Gold has historically been a safe haven when unexpected conflicts broke out – for example, its price surged in reaction to the Yom Kippur War in 1973, Iraq's invasion of Kuwait in 1990, the 9/11 and 10/7 terror attacks in 2001 and 2023 respectively, and the Russian invasion of Ukraine in 2022.

Another way to hedge a portfolio is having exposure to market volatility, which tends to spike in times of unexpected escalation of geopolitical tension or market dislocation. There are seasoned alternative asset managers who have a good track record in managing volatility as an asset class.

Beyond these potential hedges, there are secular opportunities driven by a more dangerous geopolitical backdrop.

One logical outcome of my "Warring Twenties" thesis is that defense spending in many parts of the world will likely outstrip GDP growth in the years ahead. Companies, both domestic and overseas, with sizeable exposure to the military industrial ecosystem should benefit from this tailwind, even though their equity valuations in the short run could be affected by budget considerations and electoral outcomes.

The tragic war of attrition in Ukraine has demonstrated the importance of the West's industrial capacity to meet the demands of war. A multi-year reshoring of production to friendlier countries and the U.S. should benefit many domestic industrial and infrastructure-related companies. Emerging market countries such as Mexico, India, and some ASEAN (Association of Southeast Asian Nations) countries are likely long-term beneficiaries of multinationals' diversification of overseas production from China. However, there is one potential obstacle ahead for many of our trading partners – should Donald Trump make a triumphant return to the White House, they may face a renewed tariff risk.

Nobel Laureate Myron Scholes – best known for the Black-Scholes option pricing model – once observed, "At times of shock, converting illiquid assets to cash to build flexibility is very expensive. Finding an umbrella in a rainstorm might be impossible or very costly." With the market currently in a giddy mood and volatility subdued, investors can buy umbrellas ahead of potential rainstorms relatively inexpensively. While there is a cost to hedging and the rainstorm may turn out to be a mere passing shower, one can have peace of mind knowing that there is an insurance policy to reduce the potential drawdown.

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