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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The Intrepid 13

It was late August 1804 when U.S. Navy Lieutenant Richard Somers presented his bold plan to Commodore Edward Preble, who was looking to score a decisive victory over Tripoli. Somers was essentially volunteering for a suicide mission – he would pack his ship with explosives, sail into Tripoli Harbor in the dead of night, and blow up his ship to destroy the enemy fleet.

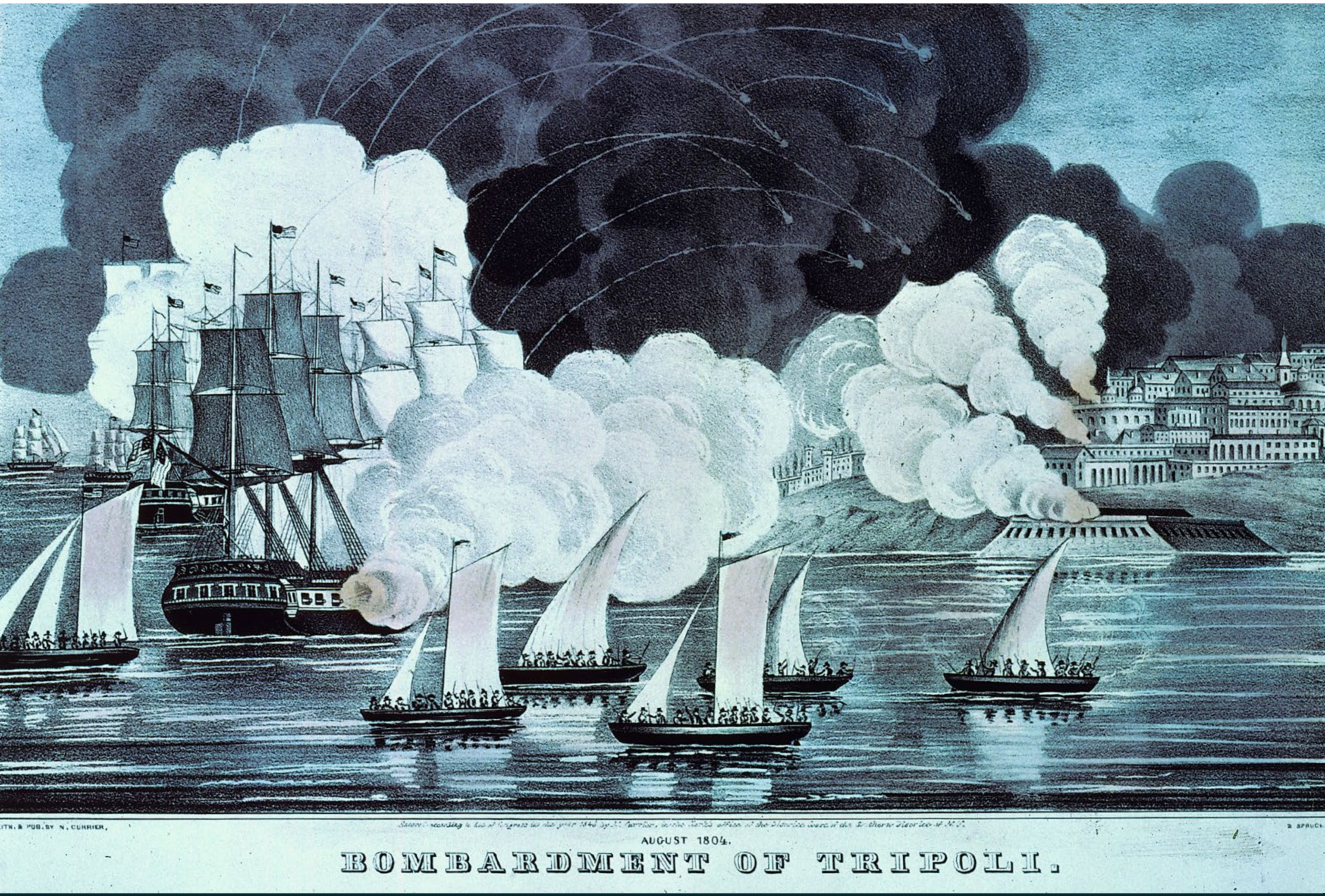
Somers was inspired by his good friend Stephen Decatur Jr.'s exceptional valor earlier that year. Lieutenant Decatur and eighty volunteers, most of whom were U.S. Marines, set out on a stealth expedition to recapture or destroy USS *Philadelphia*, which was seized by Tripolitan forces after running aground on an uncharted reef. Decatur disguised his vessel, a captured Tripolitan ketch rechristened USS *Intrepid*, as a merchant ship and sailed into the harbor in the early evening of February 16. He and his men then boarded *Philadelphia* and quickly subdued the Tripolitan crew. After Decatur and his men realized that *Philadelphia* was not seaworthy, they set the ship ablaze and steered *Intrepid* back to safety despite heavy enemy fire. The daring raid made Decatur an international hero and greatly enhanced the U.S. Navy's reputation – Britain's Lord Horatio Nelson, one of the greatest naval commanders in history, called it "the most bold and daring act of the Age."

Somers and Decatur, both 25 years old at the time, were two rising stars in the Mediterranean Squadron dispatched by President Thomas Jefferson to protect American commercial ships from state-supported piracy along the Barbary Coast – the coastal regions of Algiers, Tunis, Tripoli, and Morocco (modern day Algeria, Tunisia, Libya, and Morocco, respectively) – and secure the release of captured American sailors and ships through diplomacy and, if necessary, the use of force.

The Barbary pirates were mainly Muslim corsairs and privateers who raided merchant ships and coastal towns in Europe to capture people for ransom or slavery from the sixteenth century onwards. European countries had responded with a combination of naval patrols, military expeditions, and payments of tribute in exchange for safe passage of their ships. Prior to the Revolutionary War, American merchant ships were protected from piracy under Great Britain's treaties with the Barbary states. Of course, this protection ended following America's independence, and American ships and sailors were subsequently sporadically seized by the Barbary corsairs.

The young nation had to quickly learn to negotiate with the Barbary states and pay tribute. Congress also authorized the construction of six frigates, which became the foundation for the U.S. Navy. Unfortunately, despite formal treaties, several Barbary states continued to seize American ships and demanded ever higher tributes and ransoms.

In May 1801, newly inaugurated President Jefferson was confronted with his first international crisis when Pasha Yusuf Karamanli of Tripoli declared war on the



Bombarding Tripoli. Tracers arc in the sky as ships of the US navy bombard Tripoli in an action against a ruler who supported the Tripolitan (Barbary) pirates. August 1804.

U.S. for failing to meet his new tribute demands. Having previously dealt with the Barbary piracy issues as Minister to France and the Secretary of State, Jefferson decided that a show of force was necessary to defend America's honor and finances. Four naval ships led by Commodore Richard Dale were dispatched to the Mediterranean in 1801, and the squadron wound up embroiled in several skirmishes with Tripolitan corsairs. It was the beginning of what was later called the First Barbary War.

By the time Edward Preble was promoted to lead the Mediterranean Squadron in mid-1803, the war was in a stalemate. The loss of USS *Philadelphia* in October 1803 was a blow to the U.S. as the Pasha had imprisoned the ship's 307-man crew for leverage and ransom. If not for Decatur's burning of Philadelphia, the Tripolitan force would have refurbished and used the frigate, putting the U.S. Navy at a severe disadvantage.

THE INTREPID 13

On the evening of September 4, 1804, Decatur poignantly bade his dear friend Somers farewell and watched the explosive-laden *Intrepid* sail into the evening haze at 8 pm. Somers and his twelve-man volunteer crew were to ram the ship into the enemy fleet, light the fuses connected to the powder, and evacuate into two small boats with the hope of rowing to safety before the massive explosion detonated.

The rest of the U.S. fleet waited anxiously outside the harbor as darkness fell. At 9:47 pm, a tremendous explosion and burst of light shook the horizon, followed by burning shells and fireworks arching across the sky. Preble and Decatur knew immediately that something had gone awry as not enough time had passed for *Intrepid* to reach its destination.

On the following morning, thirteen disfigured and burnt bodies floated ashore at Tripoli and were hastily buried nearby. Not a single Tripolitan ship was damaged. What had set off the *Intrepid's* premature explosion remains a mystery.

The failure of Somers' suicide attack forced Preble to retreat from direct assaults on Tripoli. The stalemate was finally broken in America's favor in 1805, after William Eaton, the U.S. Consul in Tunis and a former U.S. Army officer, convinced the exiled ex-Pasha of Tripoli, Hamet Karamanli, to launch an attack on his younger brother, the reigning pasha. Eaton and eight Marines led 400 Arab and Greek mercenaries marching 500 miles across the desert and capturing the port city of Derna. The loss of Derna and his brother's challenge to his reign forced Pasha Yusuf Karamanli to cease hostilities against the U.S.

The First Barbary War ended with the signing of the Treaty of Peace and Amity on June 4, 1805, which had Tripoli pledging safe passage for U.S. ships and a formal trade relationship. The U.S. agreed to pay a ransom of $60,000 for the crew of *Philadelphia*. Eaton and Decatur returned as national heroes, though the former was bitter that Jefferson had paid a ransom and not restored Hamet Karamanli as pasha. Decatur would reprise as a victor and national hero ten years later for leading the Second Barbary War against Algiers. Sadly, the naval legend was killed in 1820 by an embittered fellow officer in a duel at the prime age of 41.

Richard Somers, whose remains never returned home, was mourned by the public in 1804 but not elevated to the pantheon of great American heroes. However, he has remained an inspiration to the U.S. Navy as six ships have been named USS *Somers* in honor of him.

Modern-Day Piracy

The state-sanctioned piracy along the Barbary coast was finally ended by the French conquest and colonization of Algiers in 1830. By that time, Barbary pirates were no match for the technologically superior European naval forces.

After World War II, as the sole naval superpower in the world, the U.S. became the de facto guarantor of the freedom of navigation in international waters, which played a crucial role in fostering global commerce as the international goods trade is mostly seaborne. However, state-sponsored piracy made a return during the first decade of this century when warlords in Somalia hijacked commercial ships in the Gulf of Aden and the Arabian Sea for ransom. The issue was finally contained, though not eradicated, after several years of counter-piracy operations conducted by international naval task forces which, at one point, was a 34-country coalition operating out of Bahrain.

Ironically, technology has played a crucial role in empowering modern-day pirates, who have become quite sophisticated with the use of GPS, satellite phones, night-vision goggles, and online tracking of commercial shipping routes. Some pirates also have ties to organized crime and regional government officials. Unfortunately, piracy has become an unavoidable part of international shipping, and many commercial ships are now protected by armed security to repel potential attacks.

Armed pirate keeping vigil along the coastline at Hobyo town, northeastern Somalia. January 7, 2010.

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 opposite direction to deliver oil and liquefied natural gas (LNG) to Europe.

The southern end of the Red Sea narrows into a 16-mile-wide strait, called the Bab el-Mandeb, sandwiched between Yemen on the Arabian Peninsula and Djibouti in the Horn of Africa. This transit chokepoint is so vital that several countries have set up military bases in the Republic of Djibouti, a former French colony with 976,000 inhabitants. The U.S. has a long-term lease for a naval expeditionary base in Camp Lemonnier, which is situated next to Djibouti City's international airport. In 2014, the U.S. successfully blocked a Russian attempt to build a naval base in the country. However, two years later, the U.S. was blindsided by Djibouti's decision to let China build its first overseas military base – the People's Liberation Army (PLA) Support Base – just eight miles away from Camp Lemonnier. The PLA expeditiously put the naval base into operation in 2017 and has since worked on further expansion. France, Italy, and even Japan, which has a pacificist constitution, also operate military bases in Djibouti to facilitate naval operations and provide logistics and intelligence support.

While Djibouti has built its economy around trade and military bases, Yemen, its neighbor across the strait, has been mired in instability and poverty with frequent outbreaks of civil wars. Parts of the country have provided sanctuary for Al-Queda and ISIS.

In 2014, Yemen's Shia Islamist political and military minority organization, known as the Houthis, took over the capital city Sana'a and gained an upper hand in the civil war. Inspired by Iran and Hezbollah, the Houthis' official slogan reads, "God is the Greatest, Death to America, Death to Israel, A Curse Upon the Jews, Victory to Islam." In 2015, alarmed by the Houthis' rapid rise and its Iranian connection, Saudi Arabia led a coalition of Sunni Arab countries to commence a military campaign, code named *Operation Decisive Storm*, in an attempt to oust the Houthis from power.

To the chagrin of the coalition, the military intervention was anything but decisive. It turned into a quagmire as the Houthis were surprisingly well-armed by Iran and North Korea, and Saudi's energy infrastructure was vulnerable to drone and missile strikes from Yemen. The Houthis also attacked several commercial vessels flying Saudi and UAE flags in the Red Sea. The international community wagged its finger and condemned the Houthi's attacks on ships but could not establish a deterrence.

In early 2021, the Saudis proposed a peace plan in order to “end the human sufferings of the brotherly Yemeni people.” The new U.S. administration also revoked the terrorist designation on the Houthis as a conciliatory gesture to facilitate humanitarian aid. These moves were initially spurned by the Houthis, which continued to lob attack drones and missiles at not only Saudi Arabia, but also Abu Dhabi and Dubai. A tenuous ceasefire was finally reached in the spring of 2022.

Shortly after Israel started its military campaign against Hamas last October, the Houthis, backed by arms and funds from Iran, 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. Their attacks appear to be calculated moves on a multidimensional chessboard involving the long-standing Shia-Sunni divide, Iran’s challenges to the West, and more expansively, a new Cold War in what I coin the Warring Twenties.

Commercial ships have reacted to the attacks by avoiding the Red Sea and instead sailing around the Cape of Good Hope – the old Euro-Asian maritime route used before the completion of the Suez Canal. The route adds approximately 5,500 nautical miles and 10 to 14 days to a typical voyage. China, which ships more goods through the Red Sea than any other

TROUBLED WATERS

country, has dispatched six frigates to the region to safeguard its assets.

In December 2023, the U.S. launched *Operation Prosperity Guardian*, a multinational security coalition modeled after the anti-piracy efforts a decade earlier to ensure the freedom of navigation in the Red Sea. The U.S. Defense Department named ten coalition members – Bahrain, Canada, France, Italy, Netherlands, Norway, Spain, Seychelles, and the U.K. – and indicated there were at least ten other member countries that chose to remain anonymous. The operation attained some early success as a number of shipping companies resumed sailing through the Red Sea by late December.

On January 10, the U.N. Security Council adopted a resolution demanding the Houthis to cease attacks on commercial vessels. The Houthis responded by firing more than 20 drones and missiles against military and commercial ships in the Red Sea. They seemed determined to force the international community's hand – to escalate the military deterrence to keep its credibility, or risk being exposed as a paper tiger.

The Hegemon's Burden

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 once again 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, from 0.05% of the value of a ship before the Middle East military conflicts to currently around 1%. Shipping rates between Europe and Asia have jumped four to five-fold over the last three months. The longer transit time around Africa has forced some companies, such as Tesla and Volvo, to temporarily pause production in their European plants due to delays in their just-in-time supply chains.

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.

In short, a terror group in one of the world's most impoverished nations has rendered foreign powers impotent in maintaining the freedom of navigation. Observers note that the failed state of Yemen essentially has one hand out for humanitarian aid, and the other slapping the international community across the face. The burden of restoring freedom of navigation has disproportionally fallen on the shoulders of the U.S. and U.K., the reigning and erstwhile hegemons of the world. How would the situation evolve if the U.S. were to tell European and Asian countries to deal with the crisis themselves?

Houthi military spokesman Yahya Sarea making a statement in Sanaa, Yemen. Dec. 26, 2023

Whistling in the Dark

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. Lately, however, the oil market is starting to exhibit some upward pressure, especially after a Marshall Islands-flagged fuel tanker carrying Russian produced naphtha, a flammable mixture used as an industrial-grade solvent and fuel, was hit by a Houthi missile on January 26.

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.

Similarly, the market has downplayed the Red Sea crisis as a temporary disruption. Sultan Ahmed Bin Sulayem, the CEO of Emirati logistics company DP World, said at Davos, "Trade will continue regardless of whatever will happen around the world." He also added that he does not see the turmoil in the Red Sea persisting long-term.

WHISTLING IN THE DARK

Many observers appeared to be betting that after Israel completes its *Operation Swords of Iron* and pulls out of Gaza, the Houthis will take credit for Israel's withdrawal and consider ceasing attacks on commercial ships. Regional players, perhaps with mediation by China, will probably broker a safe passage arrangement with hidden tributes to the Houthis, such as increased humanitarian aid to Yemen, from which the Houthis will skim a sizeable chunk.

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 allies are once again worried about rising isolationism in the U.S. while the partnership among Russia, China, Iran, and North Korea appears to be growing stronger. Our divided government has been unable to negotiate more aid for Ukraine, which will likely give Russia 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. One can assume it's not lost on our geopolitical foes that that they can outlast the fickle U.S. in a war of attrition. Let's hope the late Henry Kissinger was wrong when he privately quipped, "It may be dangerous to be America's enemy, but to be America's friend is fatal."

- 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 gain. North Korea has recently fired more than 200 artillery shells near a disputed maritime border with South Korea. The so-called Hermit Kingdom now calls its neighbor to the south a "hostile state" and seems to be agitating for war. With the U.S. distracted by wars in two theaters, North Korea may opportunistically foment a crisis. The situation will turn even more dangerous if China chooses to test the West's resolve to intervene in a potential blockade of Taiwan. Those who hold an isolationist world view may be forced to reconsider as South Korea and Taiwan operate the majority of the world's most leading-edge semiconductor plants, the enablers of the modern economy.

- Iran and its proxies in Syria, Lebanon, Iraq, and Yemen have become more powerful and menacing while the West pursued a policy of appeasement in the hope of incentivizing the regime to suspend its nuclear program. The regional Sunni counterweights to Iran are in retreat – Iraq's Sunni constituents have been marginalized, and Saudi Arabia has sued for rapprochement after its predicament in Yemen. Hamas, Iran's proxy in Gaza, has even disrupted Saudi's attempt for a normalized relationship with Israel. Unfortunately, the balance of power will further shift in Iran's favor should it acquire a nuclear bomb. Will Israel decide to take the matter into its own hands before that eventuality?

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

- 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 Houthis' use of explosive-laden drones to attack high-value targets in Saudi Arabia has forced their technologically superior opponent to sue for peace. Hamas militants were able to breach Israel's vaunted border defense with makeshift drones. The U.S. Navy has thwarted swarm drone attacks from the Houthis, and our enemy will likely increase the number of missiles and drones fired concurrently at U.S. ships in order to test the limits of our defense systems. America's ability to project its power around the globe with our eminent Naval force could be compromised if one of our ships gets taken out by enemy drones and missiles.

- The risk of terrorism on U.S. soil appears to be on the rise. Recently, ten retired senior FBI executives with expertise in counterterrorism wrote to Congressional leaders about a "current, specific threat that may be one of the most pernicious ever to menace the United States." They were referring to how the porous southern border has let in young single adult males of unknown background from hostile nations and regions. They warned that it's "reasonable to assert that the country possesses dramatically diminished national security at this time." While one should not automatically assume the worst based on this alarmist open letter, it would be prudent to at least consider the stern warnings from these ex-G-men.

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, the 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. Going forward, U.S. Treasuries' safe haven status could be diminished by more volatile inflation and the deluge of debt issuance.

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. That said, my investment rationale for gold is not driven by the fear of a surprise military conflict. I view gold as a hedge against the potential return of unconventional monetary policies as the Fed has the unwritten mandate to facilitate the Treasury Department's issuance of debt, which has been climbing at an alarming pace given the structural deficit issue that neither Democrats nor Republicans in Washington seem genuinely committed to addressing.
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 various volatility ETFs (exchange-traded funds) for investors to dabble in the space, but they could lose value quickly depending on how the underlying options are priced. I believe it's better to work with 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. Russia's invasion of *Ukraine* has created a sense of urgency among European countries to strengthen their defenses. NATO, or the *North Atlantic* Treaty Organization, is even planning to open a liaison office in Tokyo for closer cooperation with Japan, South Korea, Australia, and New Zealand. Jens Stoltenberg, NATO's Secretary General, characterized the move as "not about NATO moving into Asia, but instead about the fact that China is coming close to us." China, which has surpassed the U.S. in possessing the world's largest naval fleet, retorted by calling NATO a "walking war machine." The mutual distrust will likely lead to a new round of an arms race. 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. It reinforces the realization, borne out of the COVID-19 crisis, that most Western countries have hollowed out their industrial bases and are at the mercy of trading partners who could turn hostile. As such, 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.

Over the last three months, thanks to market-friendly policies by the Treasury Department and the Fed to flood the system with liquidity and lift animal spirits, the U.S. economy has experienced one of the most rapid easing of financial conditions in decades. The market has priced in a perfect combination of disinflation, economic soft-landing, double-digit earnings growth, and significant monetary easing starting as early as March. However, the real world remains imperfect, and geopolitical risks elevated.

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. Let me conclude this report with a quote from investment legend Seth Klarman: "Nowhere does it say that investors should strive to make every last dollar of potential profit; consideration of risk must never take a backseat to return."

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