ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

JANUARY 2024

Peering into the Unknown

"The eternal mystery of the world is its comprehensibility."
– Albert Einstein

est^d 1882

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Market Watch

Equity Market Indices[1]	11/30/23 Price	12/31/23 Price	MTD Change	YTD Change
MSCI All Country World	694	727	4.7%	20.1%
S&P 500	4568	4770	4.4%	24.2%
MSCI EAFE	2125	2236	5.2%	15.0%
Russell 2000®2	1809	2027	12.1%	15.1%
NASDAQ	14226	15011	5.5%	43.4%
TOPIX	2375	2366	-0.4%	25.1%
KOSPI	2535	2655	4.7%	18.7%
Emerging Markets	987	1024	3.7%	7.0%
Fixed Income				
2-Year U.S. Treasury Note	4.68%	4.25%	-43	-18
10-Year U.S. Treasury Note	4.33%	3.88%	-45	0
BBG U.S. Agg Corp Spread	1.04%	0.99%	-5	-31
BBG U.S. HY Corp Spread	3.70%	3.23%	-47	-146
Currencies				
Chinese Renminbi (CNY/$)	7.14	7.10	-0.5%	2.9%
Brazilian Real (Real)	4.92	4.86	-1.3%	-8.0%
British Pound ($/GBP)	1.26	1.27	-0.8%	-5.1%
Euro ($/Euro)	1.09	1.10	-1.4%	-3.0%
Japanese Yen (Yen/$)	148.20	141.04	-4.8%	7.6%
Korean Won (KRW/$)	1290.10	1288.10	-0.2%	1.8%
U.S. Dollar Index (DXY)	103.50	101.33	-2.1%	-2.1%
Commodities				
Gold	2036	2063	1.3%	13.1%
Oil	76.0	71.7	-5.7%	-10.7%
Natural Gas, Henry Hub	2.80	2.51	-10.3%	-43.8%
Copper (cents/lb)	383	389	1.6%	2.1%
CRB Index	274	264	-3.6%	-5.0%
Baltic Dry Index	2937	2094	-28.7%	38.2%

Source: Bloomberg

INTRODUCTION

2023 was full of market surprises: a regional banking crisis, AI (artificial intelligence) euphoria, America's economic resiliency, and China's economic malaise, just to name a few. However, none of them was more stunning than Fed Chair Powell's December pivot that suddenly ditched the "higher for longer" policy prescription like the way "transitory inflation" was unceremoniously retired two years ago. Ironically, implicit in the earlier-than-expected pivot is the Fed's tacit acknowledgement that high inflation is indeed transitory so they can start working on fending off recession, which has been acting like the elusive Godot of Samuel Beckett's surreal play for more than a year.

Market historians will be studying this pivot and its consequences for years to come. While the jury is still out on whether Chair Powell has made the right call, investors have been emboldened to expect the most favorable outcome – immaculate disinflation with double-digit earnings growth and rapidly falling interest rates. The euphoria is reminiscent of the sentiment in late 2021, before the Fed unleashed the most aggressive tightening cycle in four decades. Interestingly, the S&P 500 Index ended 2023 a mere 0.6% below its all-time-high reached on January 3, 2022. It's as if equities took a two-year sabbatical during the Fed's aggressive interest rate hiking cycle and returned unscathed after the pivot. However, the index is still 10% lower in real terms due to inflation. Investors also have more attractive investment alternatives than two years ago since interest rates have normalized to pre-Great Financial Crisis levels and look poised to move lower cyclically.

The expected market movers for 2024 include the nature of the U.S. economic landing (the alphabet soup includes no, soft, hard, and even slow or delayed landings), timing and scale of the Fed's easing, pre-election fiscal maneuverings, and the most divisive and consequential election in decades, if not in more than a century. Of course, there are always surprises ahead, potentially on the geopolitical front.

As legendary trader Jesse Livermore observed decades ago when stock quotes were still delivered on ticker tape, "The stock market is never obvious. It is designed to fool most of the people, most of the time." With the consensus being wide of the mark on some big calls in 2023, one should take the market's current Goldilocks outlook with a grain of salt by being diversified and preparing to be surprised.

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The Light Bender

On a spring day in 1936, Rudi W. Mandl nervously entered the office of the *Science News Letter* in Washington D.C. with a stack of papers showing math scribblings and a friend as a translator. Mandl, a 42-year-old immigrant from Moravia, later a part of Czechoslovakia, was looking for someone to help him publish an idea derived from Einstein's theory of general relativity – "the light from a distant star will be bent as it passes the nearer star and the effect will be a great brightening that anyone can see with a small telescope."

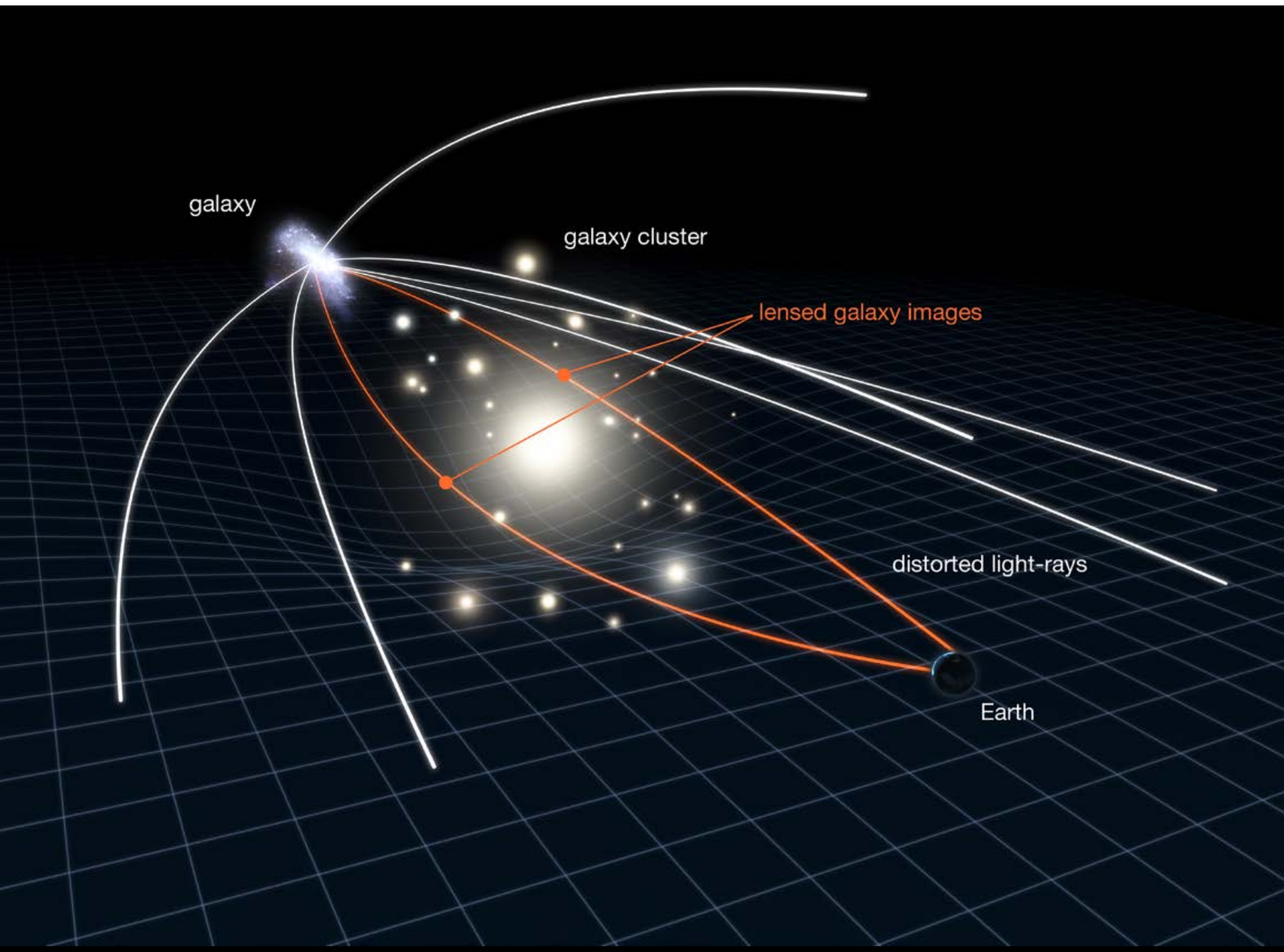
Upon learning that Mandl was working as a dishwasher for a living, the staff writer was inclined to dismiss him as a crank. However, Mandl's enthusiasm was so contagious that they suggested paying for his expenses to meet with Professor Einstein himself at Princeton. Mandl was only too happy to take the offer.

On April 17, 1936, Einstein graciously received Mandl in his Princeton office. The odd couple – a professor with disheveled hair and a bald amateur science enthusiast – held a long talk in German. During the course of their discussion, Mandl's enthusiasm might have drawn Einstein to consider publishing a report about the subject. Einstein later lost interest and suggested that Mandl publish the work. Lacking proper academic credentials, Mandl had no success finding publishers to review his work. However, he told the *Science News Letter* that Einstein had agreed to publish on the idea. Intrigued, a staff writer wrote to Einstein in September 1936 asking about the status of the report.

Einstein was probably amused by Mandl's persistence and submitted a short note to *Science* titled, "Lens-like Action of a Star by the Deviation of Light in the Gravitational Field," which was published in the December 4th issue of the journal. The most famous physicist in the world started the report stating, "Some time ago, R.W. Mandl paid me a visit and asked me to publish the results of a little calculation which I had made at his request. This note complies with his wish." He also added, "There is no great chance of observing this phenomenon."

The dismissive tone showed that Einstein did not think much of the idea, and he wrote to the editor that "the little publication, which Mr. Mandl squeezed out of me" was "of little value, but it makes the poor guy happy."

Some were baffled why Einstein did not dismiss Mandl's idea if he was not fully convinced. Decades later, upon reviewing Einstein's notebooks from his earlier academic years, researchers learned that he had postulated exactly the same effect in 1912 and derived how light would be bent by a massive object, causing deflection like passing through a gravitation lens. At the time, Einstein was not yet established academically and some of his ideas were viewed as outlandish. Twenty-four years later, Mandl probably reminded Einstein of his earlier struggle to get new ideas accepted. Einstein did not believe that the gravitational lens phenomenon was observable given the technology of his days, but he must have felt that this unprovable idea was still worth a mention for posterity to hash out.



Gravitational lensing in action
Credit: NASA, ESA & L. Calçada

Mandl took a lot of pride in having collaborated with Einstein, but his fortune did not improve, and he died in obscurity in 1948. When Einstein passed away in 1955, gravitational lensing was still a theoretical curiosity and would remain so for another 24 years.

In March 1979, an Anglo-American team of astronomers detected two identical quasars near the fringes of the then observable universe. They postulated that the twin blue celestial objects were either coincidental cosmic twins or two images of the same object – a manifestation of gravitational lensing. The latter turned out to be the case, with the light from one image arriving 14 months behind the other.

This groundbreaking confirmation turned gravitational lensing into a major tool of discovery in studying the evolution of the universe. It also created a

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new puzzle – the degree of light deflection of the Twin Quasar had to be caused by a mass far greater than the visible matter that scientists can detect. It proved the existence of an invisible mass first postulated by astrophysicist Fritz Zwicky in 1933 – he had attributed some gravitational anomalies in the study of galaxy clusters to an undetectable mass in the universe termed *dunkle Materie*, or dark matter.

Roughly twenty years after the Twin Quasar discovery, more advanced technology such as the Hubble Space Telescope (HST) launched in 1990 enabled cosmologists to make another seminal discovery: dark energy. A key project for HST was to measure the degree of deceleration in the universe's expansion due to the pull of gravity. However, astronomers were surprised to learn that the universe's expansion was actually accelerating. This acceleration was theorized to be propelled by an "anti-gravity" called dark energy.

All told, since the discovery in 1979 of the Twin Quasar confirming gravitational lensing, our understanding of the cosmos has gone through breathtaking changes. The universe is shown to be expanding at an accelerating pace, and the cosmic fabric that we can detect and analyze – baryonic matter (e.g., electrons, protons, and neutrons) that makes up planets, stars, galaxies – accounts for merely 5% of the vast universe. The other 95% consists of the mysterious and undetectable dark energy and dark matter at roughly 70% and 25%, respectively.

Amazingly, by stitching together what they know about 5% of the universe, cosmologists have managed to theorize the cosmic evolution since the Big Bang, estimated to have occurred 13.8 billion years ago. Scientists also created cosmic maps that depict where all matter – regular and dark – exist in the universe along the cosmic timeline.

Despite all the breakthroughs in cosmology, existing theories are constantly at risk of being upended by new discoveries. Indeed, since its launch into space in December 2021, the most powerful telescope in human history, the James Webb Space Telescope (JWST), has stirred up bewilderment and controversies. Data from the JWST confirmed that the universe is expanding at a faster rate than what the standard cosmological model had predicted. The JWST has also detected distant galaxies that are almost as old as the universe – roughly 300 million years after the Big Bang, which is too early for the formation of galaxies based on the current standard theory. A Canadian physicist postulates that the universe is perhaps 26.7 billion years old, nearly twice the standard estimated age of the cosmos. In short, we may be at the cusp of paradigm-breaking discoveries and new theories in cosmology.

Missed Calls

Astrophysicists are unique professionals who dedicate their talents to scientific discoveries like solving puzzles from the creator. Some of them can easily switch careers and command sizeable pecuniary rewards at hedge funds, yet they place more value on the search for cosmological truth, which often proves elusive.

While astrophysicists process signals from billions of years ago to reconstruct the universe's origin, investors work with historical data – macro, micro, and technical – to anticipate the future for financial gain. To many investors, getting the right answers may not matter as much as understanding the market's expectations, sentiments, and positioning – there is the market adage, "Do you want to be right, or do you want to make money?" Jim Grant, the erudite publisher and editor of the eponymous newsletter, has aptly quipped, "Progress is cumulative in science and engineering, but cyclical in finance."

Grant's observation was especially germane to 2023, a rather humbling year for many macro forecasters who have relied on erstwhile tried and true indicators to formulate their views. These indicators that have correctly called past economic cycles turned out to be either too early or just wrong so far in the post-pandemic era.

The consensus a year ago was expecting a mild recession in the U.S. based on the inverted yield curve, contracting leading economic indicators, and belief that the most aggressive monetary tightening in four decades would, in Chair Powell's own words, "bring some pain to households and businesses." On the other hand, most prognosticators were optimistic that China's post-lockdown economy would experience a strong rebound. Both expectations were wildly off the mark as the U.S. economy demonstrated surprising resiliency while China's economic malaise turned out to be structural rather than cyclical.

2023 was also punctuated by market-moving surprises – a U.S. regional banking crisis, suspension of the debt ceiling to January 2025, and, tragically, the return of terror and war in the Middle East.

The regional banking crisis was initially viewed as a negative catalyst that would push the economy into recession. However, while lending standards have tightened further, the greater impact on the market was a more nuanced Fed in managing liquidity. To wit, the aggregate U.S. bank reserve balance at the Fed, a common measure of liquidity in the system, has increased from $3 trillion at the onset of the banking crisis in early March to $3.5 trillion by year end 2023; one could characterize it as a form of stealth easing to support the banking system.

The suspension of the debt ceiling until January 2025 as part of the deal between former House Speaker McCarthy and President Biden has enabled Washington to run up the fiscal deficit in an attempt

MISSED CALLS

to bolster the economy with few restraints through the 2024 general election. In 2023, the federal deficit more than doubled from the previous year while Uncle Sam's debt increased by $2.5 trillion.

Hamas' terror attacks and Israel's retaliation were initially thought to be potentially destabilizing to the flow of crude oil from the Middle East. However, investors have breathed a sigh of relief with military conflicts being confined to Gaza for now.

The year's final, and arguably the biggest surprise to the market was delivered gift-wrapped with a bow by Fed Chair Powell – the stunningly dovish pivot at the conclusion of the Federal Open Market Committee (FOMC) meeting on December 13 (please refer to our December 15 market update, *Volckeresque No More*). All of a sudden, the Fed's narrative has shifted from "tighter-for-longer" to debating the pace of rate cuts. Buoyed by the Fed's tacit approval for "risk-on," speculative frenzy has moved into overdrive. To wit, trading volume in non-fungible tokens (NFTs), which had collapsed for much of the year, has surged of late with useless digital images of pet rocks commanding prices of more than half a million dollars.

Defanging the Fed

Market watchers know, as should the Fed, that when the market is given an inch, it will take a mile. The FOMC's guidance of three 25-bp interest rate cuts in 2024 and Chair Powell's failure to push back against the market's more dovish expectations immediately emboldened the market to price in even more financial easing – interest rates plunged further to discount six rate cuts in 2024, starting as early as March.

Less than 48 hours after Chair Powell's dovish pivot, the Fed rolled out several officials in an attempt to rein in the market's euphoria. New York Fed President John Williams said on CNBC, "We aren't really talking about rate cuts right now." Atlanta Fed President Raphael Bostic, often regarded as a policy dove, told Reuters that he expects only two rate cuts next year starting in the third quarter. However, the message was muddled when Chicago Fed President Austan Goolsbee, a vocal critic of the GOP (Grand Old Party) and defender of Democrats prior to his appointment to the Fed in 2023, declined to rule out a rate cut in March.

Chair Powell's stunning pivot and the Fed's subsequent "open mouth operation" have created much excitement, as well as confusion, among investors, just like astronomers sifting through paradigm-breaking data sent from the James Webb Space Telescope.

U.S. Federal Reserve Chair Jerome Powell attends a press conference in Washington, D.C., the United States, on Nov. 1, 2023.

Mohamed El-Erian, a respected market observer, lamented that the Fed has a "real problem" with communication. He added that the market is "trying to bully the Fed because this Fed seems to be willing to be bullied."

Bill Dudley, former New York Fed President, called the pivot a "pretty big gamble" on the Fed's reputation. While the pivot "significantly lowers the risk of a recession and hard landing," Dudley pointed to the risks of "overheating and persistent inflation that could undermine the Fed's credibility."

Investors also debated whether politics has played a role in the surprise policy shift. Some argued that by guiding three rate cuts so far ahead of the 2024 presidential election, the Fed was trying to inoculate its eventual rate cuts before the election from being viewed as politically motivated. Others were more cynical in pointing out that, to the data-dependent Fed, the only major change in data of late was in the President's approval ratings.

Of course, the Fed may have only become more concerned about the economy since the latest Beige Book, released in late November, showed that most of the Fed's twelve districts were experiencing weakening or stagnating economic activity. As San Francisco Fed President Mary Daly said on December 18, "we have to be forward looking and make sure that we don't give people price stability but take away jobs."

Another factor may be the Fed's unspoken mandate of facilitating the financing of U.S. government debt issuance. From early August to late October, U.S. Treasury yields had risen rapidly as investors became alarmed at the surge in debt issuance. In early October, JPMorgan Chase CEO Jamie Dimon warned that the world was not prepared for 7% rates. The market's concerns over Washington's fiscal sustainability issues were aptly reflected in the title of a November 1st report issued by the Public Policy Center of the Conference Board: *FY2023 Spending on Debt Interest Explodes to Exceed Defense*.

DEFANGING THE FED

While Washington's medium to longer-term fiscal issues have not gone away, Chair Powell's pivot has effectively alleviated Uncle Sam's near-term financing pressure by driving interest rates sharply lower. With lower U.S. Treasury yields narrowing the interest rate differential with Japan, there is now less pressure on the Bank of Japan to exit its yield curve control policy. Keeping Japan's monetary policy looser for longer helps sustain the existing global funding paradigm that has Japanese institutions buying overseas assets (e.g., U.S. debt) and funding carry trades (i.e., borrowing at low rates in yen and investing in higher yielding non-Japanese assets). In short, U.S. policymakers need to ensure sufficient foreign demand for the ever-growing issuance of U.S. debt.

Regardless of what really drove Chair Powell to make the stunning dovish pivot, the "tighter for longer" policy narrative no longer has any bite and credibility, and investors are now emboldened to believe that the Fed has their backs – the so-called Fed Put has been resurrected. The message from Chair Powell's pivot is that it's hard to be Volckeresque when the national debt-to-GDP ratio is 120%; the Fed will likely be looking for excuses to quickly bring the Fed funds rate back to neutral territory, say around 2.5%, unless inflation takes a turn for the worse.

Clues from the Presidential Election Cycle

With the benefit of hindsight, I should have placed more emphasis on the presidential election cycle than the inverted yield curve in 2023. Since 1955, with the exception of 2011, which was a flat year, the S&P 500 Index had double-digit returns during the third year of every president's first term. The reason is simple – White House incumbents would use fiscal policies to boost the economy during the third year of their first terms in an attempt to build up sufficient momentum for their reelection. In 2023, the fiscal impulse – government hiring, excess savings, and doubling of the fiscal deficits – has indeed trumped the impact of the Fed's monetary tightening.

Based on the presidential election cycle theory, 2024 is poised to be another good year for equities as the S&P 500 Index has been up in every presidential reelection year since 1944. This pattern even held up in 1980 despite a recession during the first seven months of the year. Of course, the S&P 500 Index's 32% price gain that year had a lot to do with Ronald Reagan's landslide victory over Jimmy Carter, who was besieged by the Iranian hostage crisis. The last time the S&P 500 Index was down in a presidential reelection year was 1940, when FDR ran for an unprecedented third term in the shadow of Hitler's aggression in Europe.

Equity returns in presidential election years were checkered when the White House incumbent was not running for reelection – 2000 and 2008 were both down years due to financial bubble implosions (dot-com and housing, respectively). The last time a president eligible for reelection opted to drop out of the race was Lyndon Johnson, who officially bowed out on March 31, 1968. Barring unforeseen or unusual developments, President Biden is expected to seek a second term. Even if he were to drop out of the race, the fiscal stimulus designed to prime the pump during the election year has already been put in place with the passage of the Infrastructure Investment and Jobs Act of 2021 and the Inflation Reduction Act of 2022.

Conservative House Republicans have been using the threat of a government shutdown to agitate for spending cuts – they even managed to oust former Speaker McCarthy for compromising with Democrats. The government shutdown theatrics will resume later this month, but most congressional members will try to avoid a bruising fight ahead of the general election. In fact, they have been working on delivering more fiscal goodies to voters ahead of the election: there is a bipartisan effort to reach a $100 billion deal consisting of $50 billion for a child tax credit expansion and $50 billion for a renewal of some expired business tax credits. The Internal Revenue Service (IRS) may also restart the Employee Retention Tax Credit (ERC) program, an extremely generous and stimulative tax refund that was suspended last September due to rampant fraud.

Geopolitical Risks

With the Fed's dovish pivot having significantly loosened financial conditions and additional fiscal stimulus on the docket, the pre-election outlook for the U.S. economy has improved materially. However, elevated geopolitical tensions could still roil the global economy and markets.

The military conflict in the Middle East has so far been limited mostly to Gaza, more geographically contained than feared, though still tragic. While the White House has been pressuring Israel to bring its military operations to a quick end, there is the risk that our geopolitical foes may seize on our electoral concerns – Washington's preference to minimize conflicts, especially those that could send commodity prices soaring – to press for an advantage. It also remains to be seen if Israel's recent alleged assassination of Iran's top military commander in Syria will lead to wider conflicts in the region.

Since mid-November, the Houthi rebels in Yemen, an Iranian proxy, have been attacking and even hijacking commercial ships in the Red Sea, a strategically and economically important shipping route that handles 12% of global trade and 30% of global container traffic. The Houthis know that they are no match for the might of the U.S. Navy, whose presence in international waters has helped to facilitate and protect global trade since WWII. However, they also know that the U.S. and its allies have little appetite to engage in an asymmetric conflict with a rogue state that could strike at any time, especially in a region where the flow of crude oil can be disrupted to wreak havoc on the global economy.

Attacks by the Houthis have forced major maritime shipping companies and energy giant BP to reroute vessels to go around the Cape of Good Hope instead, which lengthens sailing time by seven to fourteen days to Europe and five to seven days to the U.S., an inflationary development. The attacks are also destabilizing to our allies in the region – Israel's trade with the Far East has been disrupted, and Egypt's revenues from the Suez Canal, which account for 15% of the country's foreign currency inflows and 10% of its GDP, have been declining of late.

The Red Sea crisis is testing the world's resolve to defend the freedom of navigation. In 1988, in response to Iran's mining of international waters that damaged an American naval ship, President Reagan launched Operation Praying Mantis which destroyed half of Iran's navy. The world is quite different today with Iran and its proxies being much stronger. Striking at the Houthis risks causing unintended geopolitical and economic consequences. On the other hand, giving in to the Houthis via covert concessions would set a terrible precedent that blackmail through acts of terror works.

While tensions in the Middle East have grabbed the headlines, the war in Ukraine has dragged on similar to brutal WWI trench warfare. Unfortunately, it appears to some geopolitical analysts that Russian President Putin is regaining the upper hand – Ukraine's counteroffensive has failed, and the West's support is showing visible cracks. The much-ballyhooed sanctions against Russia have turned out to be a sham – the West has

A picture taken during an organised tour by Yemen's Huthi rebels on November 22, 2023 shows the Galaxy Leader cargo ship (R), seized by Huthi fighters two days earlier, approaching the port in the Red Sea off Yemen's province of Hodeida.

tacitly allowed Russian oil to flow through the grey market in order to keep a lid on inflation, and banned semiconductor parts are still moving into Russia with Hong Kong as the main conduit. The West will likely pressure Kiev to pursue a ceasefire, but an emboldened Putin may leverage his war of attrition to extract more concessions. The collaboration among Russia, China, Iran, and North Korea to challenge the West's world order may encourage the Global South to be more independent of the West, leveraging commodities as bargaining chips, and accelerating their de-dollarization efforts.

Beyond Ukraine and the Middle East, the South China Sea and Taiwan Strait could see heightened tension in 2024. It is reported that Chinese President Xi told President Biden during their recent summit that he is determined to take back Taiwan, though the timing has not yet been set. Should Taiwan's anti-unification party remain in power after the island nation's January 13 presidential election, Beijing will likely ratchet up its pressure on the new president, which could lead to more tension and retaliatory measures between China and the West.

When staring at stunning images of cosmic creative destruction – of the kind captured by the James Webb Space Telescope – I can't help but wonder how miraculous, yet minuscule and lonely planet Earth is. Sadly, our cosmic isolation did not foster much solidarity as violence and subjugation persist as a part of human existence.

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A Muddled Outlook

As we turn the calendar to 2024, investors are full of optimism and financial markets are priced for perfection – a disinflationary economic soft-landing accompanied by double-digit earnings growth and an exceedingly accommodative Fed. However, the checkered history of market expectations cautions that 2024 is probably not going to play out exactly as expected.

Despite seemingly unbridled optimism, there are some market inconsistencies. The six rate cut expectation does not match the soft-landing narrative as the Fed is unlikely to be that aggressive unless there is a recession. The 2s-10s yield curve – though discredited to many by now – has remained stubbornly inverted even with the Fed's pivot.

Prior to the Fed's pivot, my base case for 2024 was disinflation and recession. The surprise pivot and significant easing of financial conditions have diminished the odds of recession. As a case in point, it appears that housing, one of the most interest-rate sensitive sectors, has gained a second wind of late with the 30-year fixed mortgage rate having dropped from around 8% to mid-6%. Anecdotally, a number of local real estate agents informed me of renewed bidding wars for the area's limited supply of houses for sale, new and existing, with some properties being bid up by more than $200,000 above asking prices. Encouraged by the Fed's dovish pivot, buyers and agents are optimistic that new mortgages will be refinanced at substantially lower rates in the near future. A recovering housing market is positive for economic growth but potentially inflationary.

For the broader economy, the gradual transmission of easing financial conditions will take some time to relieve the softening job market, rising delinquencies, and stressed consumers, especially at the lower end of the income strata. As such, the U.S. economy could still dip into a mild recession when, as a rough rule of thumb, the unemployment rate climbs above 4%. However, with the Fed having turned dovish, markets will likely look past the downturn on the belief that the Fed will quickly come to the rescue.

Barring unforeseen disruptions to the world's energy supply, the disinflation trend is likely to continue in 2024. However, a premature loosening of financial conditions before sufficient softening in demand runs the risk of creating another wave of inflation down the road, which could ultimately, to paraphrase Bill Dudley, require renewed tightening and a deeper recession to get things back under control.

With the Treasury Department having rebuilt its Treasury General Account (the TGA, which is akin to the government's checking account at the Fed) to around $700 billion by year end 2023, the liquidity backdrop could be quite favorable for financial markets in 2024. The powerful market rally in late 2023 happened to coincide with the TGA being reduced from roughly $850 billion in late October to as low as $630 billion by December 13 – a powerful liquidity injection of $220 billion into the financial system in seven weeks (an annual run rate of $1.7 trillion!). Some pundits are already anticipating a repeat performance before the 2024 general election.

I remain constructive on investment grade fixed income given my disinflation and mild recession expectations. However, following an explosive rally of late, long bond yields might have overshot to the downside for the near term. Still, since the mid-1970s, the 10-year yield has always ended up lower within two years after every easing cycle was initiated.

Equities were the big upside surprise in 2023, but they now appear priced for perfection and index level valuations are quite rich. The bubbly sentiment of late – the CNN Greed and Fear Index has hit Extreme Greed – makes equities prone to corrections, though pullbacks are potential opportunities in what I believe to be a range-bound market. I expect the S&P 500 Equal Weight Index to outperform the S&P 500 Index, as relative laggards of 2023 play catch up in 2024. I am cautious on international stocks at this point, given the economic malaise and their higher vulnerability to geopolitical risks. The Russell 2000 Index, or U.S. small cap stocks, may be a better way to gain cyclical exposure.

Precious metals remain an attractive asset as they have been buoyed by expectations of an earlier return to monetary easing and the "Warring Twenties" backdrop. Since mid-2020, despite the strong greenback, gold has been range-bound with four attempts to break above $2,100 per troy ounce. I suspect that level will be surpassed in 2024 as the Fed will not only initiate rate cuts, but also wind down quantitative tightening when the size of its overnight reverse repo shrinks sufficiently to create a potential liquidity crunch.

Lastly, the outcome of the 2024 general election could be a market moving event late in the year. Expectations of continued fiscal profligacy will eventually weigh on bonds, equity valuations, and the greenback. On the other hand, potential austerity starting in 2025 would favor bonds more than equities.

Hugh Ross, a rare astrophysicist who believes in creationism, once said, "God's fingerprints are imprinted all over the universe, waiting to be discovered by inquisitive minds." Well, investors have learned in recent years that the government's fingerprints – monetary, fiscal, regulatory, and geopolitical curves, loops, and swirls – are imprinted all over the economy and financial markets. Ironically, except for perhaps Argentina with its newly elected Libertarian president trying to rein in the public sector's highly visible hand, government intervention seems to remain the order of the day.

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DIN: 1428079438-4560