ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

MARCH 2024

Life Imitating Art

The Godot recession and political theatre

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Market Watch

Equity Market Indices[1]	1/31/24 Price	2/29/24 Price	MTD Change	YTD Change
MSCI All Country World	731	761	4.2%	4.7%
S&P 500	4846	5096	5.2%	6.8%
MSCI EAFE	2248	2286	1.7%	2.2%
Russell 2000®2	1947	2055	5.5%	1.4%
NASDAQ	15164	16092	6.1%	7.2%
TOPIX	2551	2676	4.9%	13.1%
KOSPI	2497	2642	5.8%	-0.5%
Emerging Markets	976	1021	4.6%	-0.3%
Fixed Income				
2-Year U.S. Treasury Note	4.21%	4.62%	41	37
10-Year U.S. Treasury Note	3.91%	4.25%	34	37
BBG U.S. Agg Corp Spread	0.96%	0.96%	0	-3
BBG U.S. HY Corp Spread	3.44%	3.12%	-32	-11
Currencies				
Chinese Renminbi (CNY/$)	7.17	7.19	0.3%	1.2%
Brazilian Real (Real)	4.96	4.97	0.3%	2.3%
British Pound ($/GBP)	1.27	1.26	0.5%	0.8%
Euro ($/Euro)	1.08	1.08	0.1%	2.2%
Japanese Yen (Yen/$)	146.92	149.98	2.1%	6.3%
Korean Won (KRW/$)	1334.65	1331.40	-0.2%	3.4%
U.S. Dollar Index (DXY)	103.27	104.16	0.9%	2.8%
Commodities				
Gold	2040	2044	0.2%	-0.9%
Oil	75.9	78.3	3.2%	9.2%
Natural Gas, Henry Hub	2.10	1.86	-11.4%	-26.0%
Copper (cents/lb)	391	383	-1.8%	-1.4%
CRB Index	272	275	1.0%	4.3%
Baltic Dry Index	1398	2111	51.0%	0.8%

Source: Bloomberg

INTRODUCTION

February 22 was a special day for human ingenuity and perseverance. America celebrated its first lunar landing in 52 years, executed by a private company, Intuitive Machines, whose share price has also gone to the moon leading up to the landing. Investors rewarded Nvidia's technological ingenuity with the biggest ever single-session increase in market value – $277 billion – following the company's blowout earnings report. The euphoria sent major stock indices around the globe to fresh new highs. Japan's Nikkei 225 Index finally surpassed the prior peak reached on the last trading day of 1989, albeit by only 0.47%. Imagine having to endure 34 years of losses to finally eke out a small gain; it's not what we mean by investing for the long run.

While investors were feeling bubbly, former Treasury Secretary Larry Summers warned that markets have been underestimating political and social risks. Fed Governors Jefferson and Waller both cautioned against premature easing. The Fed's recent backpedaling on the timing of rate cuts has pushed up bond yields and nudged the market to now price in only three cuts for 2024, in line with the Fed's guidance.

With AI-related stocks having gone parabolic, there is the worry that a market bubble may be forming. However, it's hard to characterize the entire stock market as a bubble when the Russell 2000 Index is still down 16% from its peak. While equities may be due for a pullback for a variety of reasons – frothy sentiment, narrow leadership, back up in bond yields – the downside risk in the first half of the year might be limited as investors will look to the Fed's eventual rate cuts as a security blanket. Washington will also shower the economy with more fiscal stimulus ahead of the November elections.

The market outlook will get more complicated by autumn when elections come more into focus. With the U.S. economy having been propped up by unprecedented procyclical fiscal largesse, elections are now far more consequential. Given the tightness of the key races and a wide ideological gulf between Republicans and Democrats, policy uncertainties, such as the size of the fiscal cliff and trade policies in 2025 and beyond, will remain elevated until the electoral outcomes are known.

Lastly, a day after the Intuitive Machines' lunar landing, it was revealed that the lander had tipped over on its side during touchdown. The news sent the company's share price down nearly 40%. Let's hope that it is not an omen for other market highflyers.

JIMMY C. CHANG, CFA
Chief Investment Officer
Rockefeller Global Family Office
jchang@rockco.com
212-549-5218

The Exorbitant Privilege

Samuel Beckett's *Waiting for Godot* is one of the most iconic plays in the 20th century and has entered the English lexicon as a phrase to describe the futility of an endeavor or unfulfilled expectations; the elusive Godot has come to embody something that is eagerly anticipated but never arrives.

In 2023, many economists and investment strategists probably felt like the hapless characters in the play as the most anticipated recession in decades failed to materialize. Not only did the U.S. economy avert a recession, real GDP growth accelerated way above trend in the second half of the year.

While "Godot" did not show up in the U.S., it has made its presence felt in several other major economies. China, the world's second largest economy, experienced a shrinkage in nominal GDP in U.S. dollar terms in 2023. Japan and the U.K. have officially entered recession in the second half of 2023. The Bundesbank has warned that the German economy may have already slid into recession.

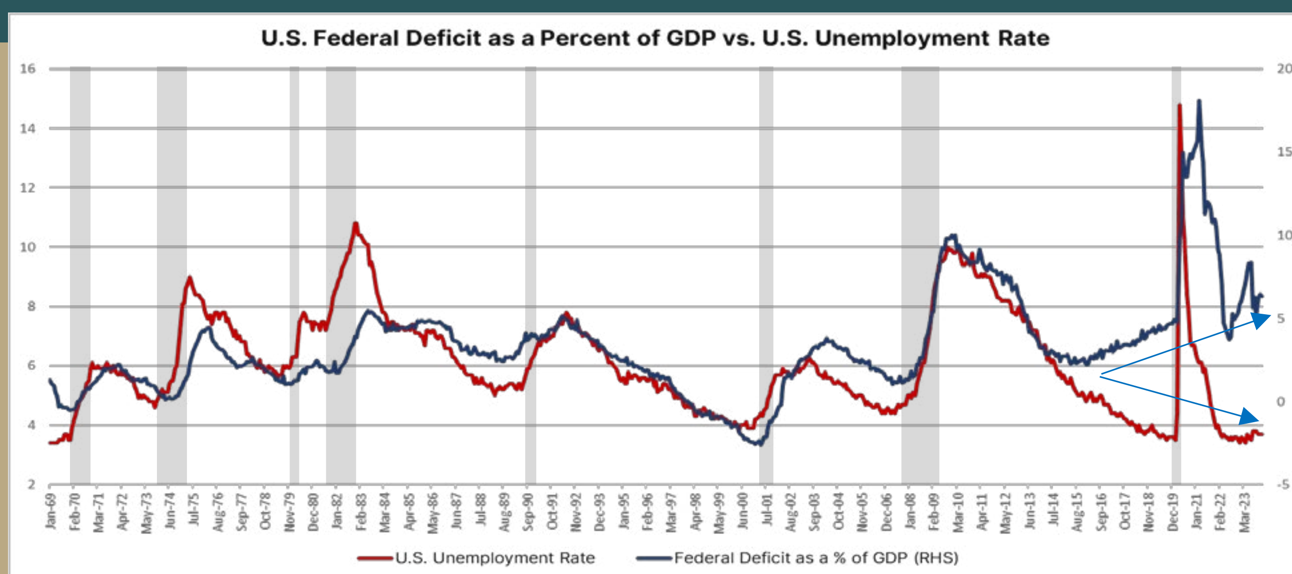
While pundits often play up the U.S. "exceptionalism" due to America's strong economic performance in the post-COVID period, what really sets the U.S. economy apart from the rest of the world is the exorbitant privilege of printing the world's reserve currency. The U.S. has been able to raise a huge amount of debt to stimulate the economy without stoking sustainably higher interest rates, an advantage that most other countries can only dream of.

Political Theatre & Stealth Quantitive Easing

Historically, our fiscal policies have been counter-cyclical. That is, the government's budget deficit should rise during tougher economic times and fall during boom times. That was exactly what had happened in the U.S. before 2017 – federal deficit measured as a percent of GDP rose and fell with the unemployment rate (Chart 1). Since 2017, this common-sense fiscal management was abandoned in favor of juicing the economy fiscally even during boom times, as shown in the growing divergence between the deficit and jobless rate (excluding the pandemic period).

From September 2016 to February 2020, the unemployment rate dropped from 5% to 3.5%, yet the federal fiscal deficit ballooned from 2.6% of GDP to 4.9%. This rise in deficit was largely due to President Trump's procyclical tax cuts. In 2021 and 2022, with Democrats having gained control of both chambers of Congress, President Biden wasted no time implementing ambitious spending initiatives. The result is that the federal government's outlays have been raised structurally from roughly 20% of GDP over the six years prior to the pandemic to 23% and higher over the next ten years, according to the Congressional Budget Office (CBO).

The financing of federal debt in 2023 was done through mostly short-term bill issuance: of the $2.6 trillion net debt raised, $2 trillion, or a whopping 77%, was in



Source: Bloomberg

Treasury bills, and notes and bonds accounted for just 15%. The market was able to absorb so much Treasury bill issuance in 2023 thanks to excess liquidity in the Fed's overnight reverse repo facility (ON RRP). The size of the overnight reverse repo peaked at $2.5 trillion at the end of 2022. In 2023, investors shifted $1.5 trillion from the reverse repo facility to soak up newly issued Treasury bills.

From a market liquidity standpoint, the $1.5 trillion drawdown of the overnight reverse repo in 2023 had more than offset the impact of the $700 billion QT-induced reduction in the Fed's holding of Treasuries securities. The financial system wound up getting a net liquidity injection of roughly $800 billion to absorb the Treasury's debt issuance.

This market-friendly "stealth" QE has continued into 2024. However, the overnight reverse repo is likely to be fully drained by year end, which would subsequently create a real contraction in market liquidity should the Fed continue to reduce its Treasury holdings. I suspect that the Fed will likely conclude quantitative tightening before the reverse repo facility is drained to avoid a liquidity crunch.

Uncle Sam's interest expenses are running up rapidly. The CBO's latest projection has the net interest expense as a share of GDP rising to 3.1% in the current fiscal year, and then climbing steadily higher to 3.9% by fiscal year 2034. The historic high for this ratio is 3.15%, last reached in 1991 when the U.S. economy was coming out of a recession. With the net interest expense as a percent of GDP poised to reach new record highs, it may just be a matter of time before bond vigilantes make their presence known once again.

I believe the Fed will need to restart QE in the not-too-distant future to help fund our deficit spending and beat back bond vigilantes. The latest CBO projections actually assumed that QE will resume in fiscal 2026, and the Fed's holding of Treasury securities will roughly double from today's $4.6 trillion to $9.3 trillion by the end of fiscal 2034.

The One-Stock Market

Over the last few weeks, some of the narratives that have powered the impressive equity rally since late October have fallen by the wayside, at least temporarily. The hope of aggressive rate cuts – as many as seven 25-bp cuts in 2024 – was dialed down to be in-line with the Fed's three cut guidance after higher-than-expected inflation readings. The 10-year Treasury yield has climbed to as high as 4.32% in February, a substantial rise from late December's 3.79% low. However, these developments were brushed off by equity investors as the euphoria over Artificial Intelligence (AI) eclipsed all else.

Since the start of the earnings reporting season in mid-January, stocks enjoying the AI-halo effect have gone parabolic. The quintessential example of AI euphoria has been Nvidia, and its February 21 earnings report was arguably the most anticipated market event year-to-date. Goldman Sachs' trading desk called Nvidia "the most important stock on planet Earth."

I can't help but ponder about the absurdity of a single stock dictating the movement of the entire global market, but I am also cognizant of what the great John Maynard Keynes had warned, "The market can stay irrational longer than you can stay solvent."

"Ever Tried...Fail Better."

The parabolic moves in AI-related stocks are reminiscent of the blow-off top of the dot-com bubble in 2000. The difference is that many of today's market darlings are established companies with growing sales, profits, and free cash flows. That said, their valuations are extended, and it remains to be seen exactly how disruptive AI will be for business models.

Given the tremendous outperformance of mega-cap stocks and the high expectations built into their valuations, it may be time to consider trimming these outsized winners. Investors should explore various tax-efficient rebalancing methods with the use of exchange funds, tax loss harvesting, and option strategies.

Rising Treasury bond issuance and the seemingly inevitable debt monetization portend higher volatility for Treasury bonds – they are becoming trading vehicles rather than traditional hedges on risk assets. It seems that the market is increasingly looking for hedges against future debt monetization, or money printing-induced purchasing power debasement. This trend may help explain why gold has managed to appreciate by 12% since the end of 2021 – slightly ahead of the S&P 500 Index's total return – despite a 300 bps rise in the real 10-year yield and an 9% appreciation in the U.S. Dollar Index. That said, gold has remained a frustrating investment to many, especially compared to the turbocharged Bitcoin. Most goldbugs, especially investors in gold mining stocks, can easily relate to one of Beckett's quotes: "Ever tried. Ever failed. No matter. Try Again. Fail again. Fail better." My base case remains that, as the Fed restarts QE in the not-too-distant future to monetize the government's mounting debt, gold will finally break out of its four-year trading range to new all-time highs.

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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ROCKEFELLER
GLOBAL FAMILY OFFICE

45 ROCKEFELLER PLAZA FLOOR 5
NEW YORK, NY 10111

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