ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

MAY 2024

Paradigm Shifts

The rise of AI and fall of free trade

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Market Watch

Equity Market Indices[1]	3/31/24 Price	4/30/24 Price	MTD Change	YTD Change
MSCI All Country World	784	757	-3.4%	4.1%
S&P 500	5254	5036	-4.2%	5.6%
MSCI EAFE	2349	2281	-2.9%	2.0%
Russell 2000®[2]	2125	1974	-7.1%	-2.6%
NASDAQ	16379	15658	-4.4%	4.3%
TOPIX	2769	2743	-0.9%	15.9%
KOSPI	2747	2692	-2.0%	1.4%
Emerging Markets	1043	1046	0.3%	2.2%
Fixed Income				
2-Year U.S. Treasury Note	4.62%	5.04%	41	78
10-Year U.S. Treasury Note	4.20%	4.68%	48	80
BBG U.S. Agg Corp Spread	0.90%	0.87%	-3	-12
BBG U.S. HY Corp Spread	2.99%	3.01%	2	-22
Currencies				
Chinese Renminbi (CNY/$)	7.22	7.24	0.3%	2.0%
Brazilian Real (Real)	5.01	5.19	3.6%	6.9%
British Pound ($/GBP)	1.26	1.25	1.0%	1.9%
Euro ($/Euro)	1.08	1.07	1.2%	3.5%
Japanese Yen (Yen/$)	151.35	157.80	4.3%	11.9%
Korean Won (KRW/$)	1347.35	1382.10	2.6%	7.3%
U.S. Dollar Index (DXY)	104.49	106.22	1.7%	4.8%
Commodities				
Gold	2230	2286	2.5%	10.8%
Oil	83.2	81.9	-1.5%	14.3%
Natural Gas, Henry Hub	1.76	1.99	12.9%	-20.8%
Copper (cents/lb)	401	456	13.9%	17.3%
CRB Index	290	291	0.4%	10.5%
Baltic Dry Index	1821	1685	-7.5%	-19.5%

Source: Bloomberg

INTRODUCTION

After several months of euphoria over a seemingly improving macro backdrop and imminent rate cuts, investors had a rude awakening in April.

For the first time in modern history, Iran launched a direct attack on Israel, firing hundreds of drones and missiles in retaliation for Israel's apparent strike on the Iranian consulate in Syria. While ostensibly temporary, this sudden turn of events reminded investors that geopolitical tension can unexpectedly flare up. As military conflicts in the region persist, investors have sent gold, viewed as a safe haven, to new highs.

On the economic front, the Consumer Price Index (CPI) for March came in higher than anticipated. With three consecutive stickier-than-expected CPI reports to start the year, the Fed was compelled to begin backpedaling its three-rate cut guidance for 2024. The market reacted by pushing the 10-year Treasury yield to as high as 4.7%, and the rapid rise in bond yields finally triggered a pullback in equities.

With the policy debate within the Federal Reserve on 2024 rate cuts seemingly having turned from *when* to *if*, the U.S. Dollar Index (DXY) has gained nearly 5% year to date. Since Japan has the widest interest rate differentials with the U.S., the yen had weakened to a 34-year low of 160 yen/dollar before Japan's Ministry of Finance finally intervened. By month end, the yen was still down by roughly 10% versus the dollar year to date. A weak yen has raised the prospect of a sizeable devaluation of the renminbi, as China may elect to use currency to further boost its exports to offset still-soft domestic demand. The continued yen weakness and potential renminbi devaluation could unleash a chain of competitive devaluation to impact fund flows and financial markets. Of course, much will depend on when the Fed starts easing to narrow the interest rate differentials with the rest of the world. To wit, starting in June, the Fed will slow down the pace of reducing its Treasury securities holdings from $60 billion to $25 billion a month – a positive liquidity move for the market.

On the political front, House Speaker Johnson managed to pass the contentious $61 billion aid package for Ukraine with more support from Democrats than his fellow Republicans. He also forced a somewhat reluctant Senate to pass the TikTok divest-or-be-banned bill by attaching it to the critically important foreign aid package. It has started the countdown to a showdown with China on the fate of the popular social media app's existence in the U.S.

In short, while investors were inundated with earnings reports, greater macro surprises were unfolding in the backdrop. We are indeed still living in interesting times.

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The AI Debate - Open or Closed

The Maschinenmensch in a screenshot from the 1927 film Metropolis.

Metropolis is hailed as one of the greatest works of the silent film era. Premiered in Berlin in 1927, the film was initially met with mixed reception as its 153-minute runtime was too long for that era. Various distributors later cut it down to as short as 91 minutes by 1936. With the original reels having been lost during WWII, the heavily re-edited 1936 version wound up as the "official" version for the next seven decades, and audiences were left guessing about the original plot and intent. In 2008, the original version was finally tracked down by a dogged film historian in the archive of a museum in Argentina.

After an 83-year hiatus, the original version – now digitally enhanced – had its world "re-premier" at the Berlin Film Festival on February 12, 2010. Today, one can easily view all versions of the film, including colorized and audio-dubbed, on YouTube. I suppose it's only a matter of time before an AI-enhanced version becomes available. Indeed, AI's shockingly fast evolution has started to disrupt the film industry.

On February 15, 2024, OpenAI introduced Sora, a text-to-video tool that creates short videos based on a user's text description, also known as a prompt. The impact was swift and dramatic.

In one instance, after seeing the Sora demo, filmmaker Tyler Perry indefinitely suspended an $800 million studio expansion plan that he has been working on over the last four years. While Perry sees tremendous cost savings with AI, he is concerned about the job prospects of so many people in his industry. He said that the only way to deal with the impending disruptions created by AI is to have all interest groups galvanize as one voice "not only in Hollywood and in this industry, but also in Congress."

As if on cue, California senatorial candidate and Congressman Adam Schiff introduced the *Generative AI Copyright Disclosure Act*, which would require AI companies to file with the Register of Copyrights all copyrighted works used to train their models. The bill is intended to protect human content creators so they can be compensated or be allowed to enforce their rights against unauthorized use of their works.

This proposed bill is merely an opening salvo of upcoming policy and competitive battles over AI. Among venture capitalists and technology companies, there are debates on whether AI should be made open or closed source and the role of regulation.

Open-source proponents, including leaders at Meta and venture capitalist Marc Andreessen, believe sharing technology will ensure greater transparency, maintain America's influence and leadership over AI development, and prevent companies from monopolizing the huge potential market.

On the other side of the debate, OpenAI and venture capitalist Vinod Khosla, an investor in OpenAI's for-profit business, have been advocating greater government regulation and less sharing of AI technologies.

In short, while investors are enamored with the AI industry's immense potential opportunities, many companies are confronted with elevated regulatory, competitive, and business model uncertainties. It may be one of the reasons why investors have favored the "arms dealers" in the AI race – providers of semiconductor chips, servers, data centers, infrastructure, etc. However, without a defensible revenue model for AI applications, the torrid pace of investment may not be sustainable.

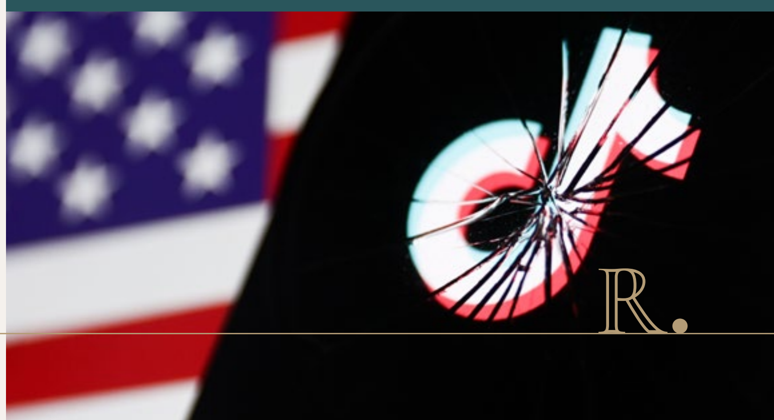
Tick-Tock for TikTok

The House of Representatives passed a bill on April 20 to give ByteDance up to one year (270 days plus a 90-day extension by the President) to divest TikTok and attached it to the highly important and urgent foreign aid package for Ukraine and Israel. This maneuver forced the Senate to vote on TikTok's divestment, and President Biden to subsequently sign it into law.

The TikTok saga has several potential outcomes:

1. ByteDance successfully gets the court to overturn the bill.
2. ByteDance divests TikTok to a U.S. or non-Chinese foreign entity.
3. The Chinese government refuses to let ByteDance divest TikTok, resulting in the social media app being shut down in the U.S.

For investors, the first outcome would be the status quo. The second may lead to new investment opportunities, though I doubt ByteDance or the Chinese government would let the acquirer gain access to the company's proprietary algorithm, which is the crown jewel of the business. The third potential outcome would be a bonanza for competing social media companies like Meta and X (formerly known as Twitter) as they stand to gain more user traffic and split the billions of dollars in advertising revenue that TikTok is currently amassing.



No More Thank You Notes

Lei Jun, Chairman and CEO of Chinese electronics company Xiaomi, presents the new electric car Xiaomi SU7 model at a launch event in Beijing on March 28, 2024.

The TikTok saga is just one facet of the growing tension between the U.S. and China. Putting aside the mutual distrust on geopolitical issues, the U.S. still has serious concerns about China's export-led mercantilist economic model. Treasury Secretary Yellen recently said, "People like me grew up with the view: If people send you cheap goods, you should send a thank-you note. That's what standard economics basically says." She then added, "I would never ever again say, 'Send a thank-you note.'"

To many Western economists, the global trade imbalance is in part caused by China's subsidies to businesses and exporters at the expense of domestic consumers. The U.S. and its allies are concerned that, instead of pursuing policies aimed at lifting household consumption to bolster economic growth, Chinese policymakers appear to be doubling down on export-oriented industries, especially in strategically important sectors such as electric vehicles (EV), batteries, wind and solar projects, etc.

Goodbye, Free Trade

The unspoken reality is that free trade, which has never existed in its purest form, has become a relic of a bygone era. Looking ahead, I expect more protectionist policies to be adopted by major economies. Businesses, especially smaller companies with sizeable export exposure, will likely find it more challenging to navigate the evolving policy paradigm, trade barriers, and geopolitical realignment. These trends are inherently more inflationary, as protectionism tends to increase inefficiency, duplication of skills, and productive capacity.

Qianwan container terminal of Qingdao Port in Qingzhou, China, on April 30, 2024

A Mixed Macro Backdrop

The less friendly macro backdrop has triggered an overdue equity pullback. However, with the 10-year Treasury yield hovering around 4.65%, the S&P 500 Index's current-year price-to-earnings ratio of 21 times is still on the expensive side. The consensus view among market technicians is that the S&P 500 Index has fairly strong support in the 4,700 to 4,800 range. The market's liquidity backdrop has also started to improve after the tax filing season drained some liquidity.

The recent surge in Treasury yields has made the risk/reward of extending fixed income duration more attractive. On a secular basis, the inflation outlook will depend on the push and pull between the disinflationary AI advancement and inflationary protectionism. The latter probably has a stronger impact in the next few years as it will likely take some time for AI to materially transform various industries.

Lastly, the financial industry is about to implement the "T+1" settlement process starting on May 28, 2024. Currently, it takes two business days after a trade is transacted, or "T+2", to settle the trade – transferring the securities to the buyer's account and cash to the seller's account. "T+1" will have the settlement done in one business day after the trade date. To most investors, "T+1" will not change anything other than having faster access to funds and securities. Please let your advisors know if you have any questions.

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