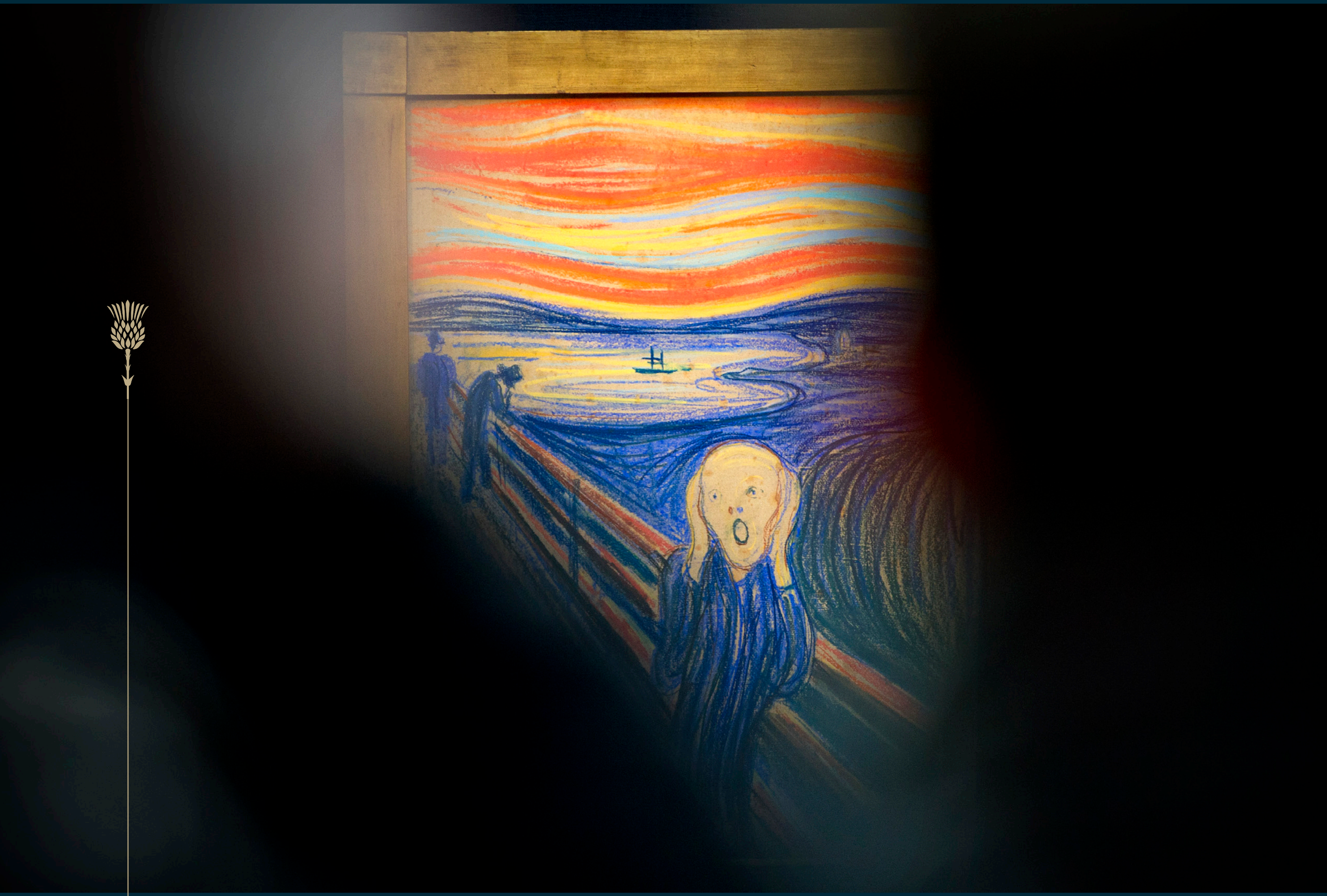
ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

NOVEMBER 2023



October Surprises

Higher uncertainty triggering greater volatility

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Market Watch

Equity Market Indices[1]	9/30/23 Price	10/31/23 Price	MTD Change	YTD Change
MSCI All Country World	657	635	-3.3%	4.9%
S&P 500	4288	4194	-2.2%	9.2%
MSCI EAFE	2031	1952	-3.9%	0.4%
Russell 2000®2	1785	1662	-6.9%	-5.6%
NASDAQ	13219	12851	-2.8%	22.8%
TOPIX	2323	2254	-3.0%	19.1%
KOSPI	2465	2278	-7.6%	1.9%
Emerging Markets	953	922	-3.2%	-3.6%
Fixed Income				
2-Year U.S. Treasury Note	5.05%	5.08%	4	65
10-Year U.S. Treasury Note	4.57%	4.92%	35	104
BBG U.S. Agg Corp Spread	1.21%	1.30%	9	0
BBG U.S. HY Corp Spread	3.94%	4.37%	43	-32
Currencies				
Chinese Renminbi (CNY/$)	7.30	7.32	0.3%	6.1%
Brazilian Real (Real)	5.03	5.04	0.1%	-4.6%
British Pound ($/GBP)	1.22	1.21	0.5%	-0.5%
Euro ($/Euro)	1.06	1.06	0.0%	1.3%
Japanese Yen (Yen/$)	149.37	151.69	1.6%	15.7%
Korean Won (KRW/$)	1349.40	1350.65	0.1%	6.7%
U.S. Dollar Index (DXY)	106.17	106.72	0.5%	3.1%
Commodities				
Gold	1849	1984	7.3%	8.8%
Oil	90.8	81.0	-10.8%	0.9%
Natural Gas, Henry Hub	2.93	3.59	22.7%	-19.7%
Copper (cents/lb)	374	365	-2.3%	-4.1%
CRB Index	285	281	-1.2%	1.2%
Baltic Dry Index	1701	1502	-11.7%	-0.9%

Source: Bloomberg

INTRODUCTION

October turned out to be a fateful month with big surprises. For the first time in U.S. history, the Speaker of the House was voted out by his colleagues, which paralyzed the institution for three weeks and offered little assurance for responsible governance. The Middle East became a maelstrom of instability after Israel was hit with the worst terrorist attack on civilians in its history and began to respond with military attacks in Gaza. The 10-year U.S. Treasury yield hit a cycle high of 5%, a level that no strategists had forecasted just a few months earlier. U.S. GDP (gross domestic product) reaccelerated to an annualized real growth rate of 4.9% in the third quarter, making a mockery of the 0% consensus growth estimate at the start of last quarter. Lastly, Byron Wien, a Wall Street icon best known for his annual “Ten Surprises” list, passed away at age 90.

Escalating geopolitical tension, surging Treasury yields, and policy uncertainties led to higher market volatility and lower stock prices. The S&P 500 Index and Nasdaq Composite both entered correction territory, having declined more than 10% from their summer highs. However, it’s probably fair to say that these indices are still mired in the bear market that started in 2022.

The surprisingly strong 3Q23 GDP growth was largely driven by robust consumer spending and inventory buildup, which are unlikely to continue into year end. Indeed, real disposable personal income stagnated in the third quarter while the personal savings rate dropped sequentially from 5.2% to 3.8%. The potential loss of momentum in the fourth quarter has led to downward revisions in the S&P 500’s earnings estimates for 4Q23 and full-year 2023 despite better-than-expected 3Q23 results halfway into the earnings reporting season.

Many investors are still hopeful that November, a seasonally strong month that benefits from the resumption of corporate stock buybacks after earnings are reported, will usher in a year-end rally. However, the risk/reward asymmetry in geopolitical developments will likely keep a lid on potential rallies. At this point, it is hard to see any upside from the turmoil in the Middle East, but the potential damage to the social fabric and security in the region and beyond could escalate rapidly. As such, other than making a contrarian bet against depressed sentiment, it’s hard to argue for a risk-on stance with equity valuations still looking rich relative to higher risk-free rates.

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A Passionate But Flawed Man

It was a long journey that President Warren Harding embarked on during the summer of 1923. Dubbed the “Voyage of Understanding,” the transcontinental tour of the Western U.S. made him the first sitting president to visit Alaska and Canada.

Harding, a congenial freshman senator from Ohio, won a landslide victory in the 1920 presidential election. The 60 percent popular vote support that he captured was the highest since President James Monroe’s uncontested reelection victory a hundred years earlier. Harding’s campaign message was simple – a return to normalcy. While his choice of the then obscure word “normalcy” was mocked by many, it resonated with the populace who had suffered through the Great War, Spanish Flu, rampant inflation, and economic hardship during Woodrow Wilson’s presidency.

Harding was a believer in small government and laissez-faire – one of his campaign slogans was, “Less government in business and more business in government.” He rolled back regulations, cut tax rates, and abolished the wartime excess profits tax that his predecessor tried to make permanent. His administration and the Republican-controlled Congress established the Bureau of the Budget (renamed the Office of Management and Budget in 1970) and the General Accounting Office to instill financial discipline on the federal government.

While Harding had delivered on many of his pro-business and small government pledges, they did not bear fruit fast enough to avert a drubbing during the 1922 midterm elections, where Democrats achieved significant gains in the two chambers of Congress and state capitals.

These political setbacks led Harding and his advisors to pursue a strategy of spending time away from Washington to connect directly with the electorate and lay the groundwork for his 1924 reelection campaign. In addition, the voyage allowed Harding to escape Washington’s oppressive summer heat and revel in the great outdoors including Yellowstone and Zion National Parks, and the glaciers in Alaska.

Things were going swimmingly during the first month of the trip, but the grueling schedule took a toll on Harding’s health by late July. The 57-year-old president suffered from abdominal pain and high fever, forcing him to cancel a few stops on the West Coast to get examined by physicians at the Palace Hotel in San Francisco on July 29.

Shortly past 7 p.m. on August 2, under the warm glow of the setting sun, First Lady Florence sat by her husband’s bed in the hotel’s presidential suite and read him a flattering article in the *Saturday Evening Post*. Harding was apparently pleased and uttered, “That’s good, go on.” Those turned out to be his final words as he suddenly shuddered and passed away.

The unexpected death of the popular, outwardly healthy Harding stunned the nation. It led to accusations of malpractice against the physicians and even fed the rumor mill of something sinister. It did not help that Florence Harding refused to allow an autopsy and instead ordered to have her husband’s body embalmed.

President Warren G. Harding and First Lady Florence Harding, on the back of a Northern Pacific train, on Harding's ill-fated trip to Alaska. 1923.

Rumors of suicide or murder swirled as some tried to link Harding's death to Jess Smith, a political operative who died of a self-inflicted gunshot wound at a posh Washington hotel two months earlier. Smith was a close associate of Attorney General Harry Dougherty – Harding's political confidant and architect of his 1920 electoral victory – and allegedly forced out by Harding upon discovering something untoward.

In the months following Harding's passing, investigations by the Republican-controlled Senate uncovered malfeasances perpetrated by some members of the "Ohio Gang" – Harding's long-time political allies and friends. The most egregious misconduct was the Teapot Dome scandal, which involved Albert Fall, the Secretary of the Interior, leasing the federal government's Teapot Dome oil field in Wyoming to business cronies without competitive bidding and accepting bribes worth millions in today's dollar. While Harding was never implicated in any of the improprieties, his legacy and reputation were damaged posthumously.

In 1927, Harding's family man image was marred by *The President's Daughter*, the first kiss-and-tell book by a self-proclaimed presidential mistress in U.S. history. Nan Britton, a native of Harding's hometown Marion, claimed that her daughter Elizabeth, born in 1919, was fathered by him. Britton said financial support from Harding was cut off by Florence after the president's death, which forced her to write the book for money. The book's salacious stories created much controversy, and some booksellers and printing shops were raided by police vice squads. The backlash against Britton was so strong that she was forced into hiding.

A PASSIONATE BUT FLAWED MAN

In 1964, about 1000 pages of love letters written by Harding to his long-time family friend and paramour Carrie Fulton Phillips were discovered by Phillips' estate. The letters confirmed what Washington insiders had known for decades but were kept secret from the public. Harding's nephew bought the letters from Carrie Phillips' daughter and donated them to the Library of Congress with the stipulation that they be sealed for fifty years.

Half a century later, the unsealing of the letters in 2014 created quite a stir for late night talk show hosts and historians. The former had a field day making fun of the 29th president's passionate and racy writings while the latter gained a deeper understanding of Harding's character and inner-most thoughts. Harding was deeply in love with Phillips, but he felt duty-bound to Florence, an indispensable business and political partner who was frequently ill and left him childless. Harding and Phillips' 15-year affair ended with intervention from Harding's political operatives during the 1920 presidential campaign, yet they remained friends till the end.

A year after the release of the steamy love letters, the DNA tests of Nan Britton's grandchildren and descendants of Harding's brother vindicated Britton's claim 88 years earlier — Warren Harding was not childless after all.

Legacy Reassessed

When Harding was inaugurated in March 1921, the U.S. economy was in the throes of the Forgotten Depression of 1920-1921 caused by soaring post-Great War unemployment, the Spanish Flu, and price instability. The Dow Jones Industrial Average would keep on sliding until August 1921 for a peak-to-trough decline of 47%. Harding chose not to stand in the way of American entrepreneurship and industriousness and implemented pro-market policies that would later be coined supply-side economics six decades later during the Reagan era. Harding and his successor, Calvin Coolidge – the original supply-siders – wound up turning the Forgotten Depression into the Roaring Twenties while generating a budget surplus every year during their presidencies.

On the social side, Harding's conciliatory and calm temperament brought together a nation plagued by racial violence, labor tension, and the first Red Scare – disturbances and protests stoked by anarchists and communists. Harding released Socialist leader Eugene Debs who was convicted of sedition in 1918 for opposing the draft. General amnesty was granted to political prisoners of socialist and anarchist persuasions.

View of the traffic and illuminated advertisements in Times Square at night, seen from 45th Street looking northward, New York City (1921).

New York, The Theatre district around Times Square, New York, showing large crowds leaving the theatres (1927).

Harding fought against racial injustice by calling for political, educational, and economic equality for African Americans and supporting an anti-lynching bill. His administration hired many African Americans after reversing its predecessor's discriminatory policy of dropping them from government positions. His mediation resolved several high-profile labor strikes, and he publicly shamed U.S. Steel into replacing their 12-hour workday policy with an 8-hour workday.

Despite these accomplishments and his immense popularity with the people, Warren Harding has been placed at or near the bottom of presidential rankings for decades. Most historians have little respect for Harding due to his short tenure, scandals among his cabinet members, and extramarital affairs. However, imagine having a president today who could create years of economic prosperity, restore fiscal discipline, and heal a divided nation. History has shown that dream so far, to be an evasive one.

An Unsustainable Fiscal Path

Prident. Bill Clinton delivering his State of Union address, framed by VP Al Gore (L) & House Speaker Newt Gingrich, on Capitol Hill.

1993-2007: FISCAL PROBITY

In January 1993, nearly 70 years after Harding's death, Bill Clinton, a gifted politician who shared some common traits with Warren Harding – the affability, empathy, and zest for life – attended a pre-inauguration strategy session with his advisors. According to Bob Woodward's book, *The Agenda*, then President-elect Clinton was told that one of the priorities for his administration was to placate the bond market with a credible plan to reduce the deficit, which was running at nearly 5% of GDP at the time.

"You mean to tell me that the success of the program and my reelection hinges on the Federal Reserve and a bunch of [expletive] bond traders?" an exasperated Clinton asked.

Clinton did not heed the advice early in his presidency, and "bond vigilantes" – a term coined by investment strategist Ed Yardeni to describe investors who sell bonds to drive up interest rates to signal their displeasure with bond issuers – carried out what was dubbed "the bond market massacre of 1994" by driving the 10-year Treasury bond yield from 5.2% in October 1993 to a cycle peak of 8.03% by November 7, 1994, the day before that year's midterm elections. On the following day, the Republican Party, which had campaigned on Newt Gingrich's "Contract with America" that featured a balanced budget as one of the promises, won control of the House for the first time since 1952. This historic shift in power forced President Clinton to pivot to the center. Four years later in 1998, the Clinton Administration and Congress delivered the first budget surplus since 1969, and this feat continued into 2001. While one can argue that the balanced budgets were facilitated by higher capital gains tax receipts from the dot-com bubble, it still required fiscal discipline to not spend the extra revenue.

All told, 1993 through 2007 was an era of fiscal probity despite the expensive "War on Terror" during President George W. Bush's tenure. The annual federal outlays and receipts averaged 18.8% and 17.6% of GDP, respectively, resulting in an average budget deficit of just 1.2%. This exemplary fiscal management lowered the federal debt as a percent of GDP from 65% in 1993 to a cycle low of 54% before rising to 63% by the end of 2007.

2008-2019: SURGING DEBT

The era of fiscal probity under Clinton and Bush 43 was ended by the Great Financial Crisis (GFC) that pushed the global financial system to the brink of the abyss in late 2008. The deep recession cut the federal government's receipts to a range of 14.5% to 15% of GDP from 2009 through 2012, materially below the 17% average since the early 1950s.

On the spending side, fiscal stimulus and rising medical subsidies required by the Affordable Care Act, aka Obamacare, lifted federal outlays as a percent of GDP to an average of 23% during those four years. While the federal deficit was brought down to a respectable average of 3% during President Obama's second term, it rose again during the Trump Administration as a result of what President Trump claimed to be "the biggest tax cuts in history."

Washington was able to run up debt without pushback from bond vigilantes thanks to the Federal Reserve's ultra-loose monetary policy, which kept the Fed funds rate at near zero for seven straight years from 2009 through 2015. The Fed's aggressive purchase of Treasury and mortgage securities via three rounds of quantitative easing (QE) also overwhelmed and pushed bond vigilantes into retirement – it was hard for bond bears to go against a price-insensitive buyer who has the license to print money. The Fed's balance sheet had increased from $900 billion pre-GFC to $4.5 trillion by early 2015.

U.S. Federal Outlays, Receipts, & Deficits

	FY1993-2007 Average	FY2008-2019 Average	FY2020-2023 Average	FY2022*	FY2023**
Federal Outlays/GDP	18.8%	21.2%	26.4%	22.7%	23.4%
Federal Receipts/GDP	17.6%	16.1%	17.1%	19.0%	16.1%
Federal Deficit/GDP	1.2%	5.0%	9.4%	3.7%	7.3%

Source: Congressional Budget Office, St. Louis Fed
* FY2022 outlay data does not include $379 billion of non-cash costs of student debt forgiveness program.
** FY2023 outlay data does not include $333 billion of non-cash credit from the removal of student debt forgiveness program.

By the end of 2019, gross federal debt had ballooned to 106% of GDP, the highest level since 1947, when the country was saddled with debt from funding WWII. This dramatic surge in debt was a result of twelve years of elevated budget deficits – from 2008 through 2019, the average annual budget deficit was 5% of GDP as the federal outlays and receipts averaged 21% and 16%, respectively. To put these numbers into perspective, the European Union's fiscal rules for its member states cap budget deficit and government debt as a percent of GDP at 3% and 60%, respectively. While these rules don't apply to the U.S., which has an exorbitant privilege as the issuer of the most important global reserve currency, they do demonstrate how much Washington has deviated from what is considered prudent fiscal management.

The low interest rate environment made it easy for politicians to pile on new debt; despite a 43-point rise in debt-to-GDP from 63% in 2007 to 106% in 2019, the federal government's net interest expense as a share of GDP had only increased from 1.64% to 1.75%.

2020-2023: GOING FOR BROKE

In the spring of 2020, the sudden outbreak of COVID-19 plunged the global economy into an unprecedented crisis, prompting policymakers to create even greater rescue measures than during the GFC. With a general election around the corner, Washington made deficit spending great again by offering far more fiscal stimulus than any other country. According to the Brookings Institution,

AN UNSUSTAINABLE FISCAL PATH

measured as a share of GDP, U.S. fiscal stimulus was about 50% larger than in the U.K., and roughly three times as much as in France, Italy, or Spain. Most of the stimulus checks to households went to people who had not been economically harmed by the pandemic. The Paycheck Protection Program, which offered forgivable loans to small businesses to maintain their payrolls, wound up costing the government roughly $225,000 to $350,000 per job preserved. It would have been cheaper for the federal government to pay for those jobs directly.

With financial market seizing up in March 2020, the Fed also unleashed the most aggressive money printing operation in history – $3 trillion dollars of bonds were purchased in a span of three months from March through May. The massive liquidity injection worked like a charm as prices of practically all assets took off in unison, and much of the $4.5 trillion net U.S. Treasury issuance in 2020 wound up on the Fed's balance sheet.

While one can rationalize aggressive fiscal spending in the face of a global pandemic, unprecedented lockdowns, and economic dislocation – federal outlays reached 30.7% of GDP in 2020, 61% higher than the average outlay of 19% over the prior seventy years – it is hard to defend continued fiscal and monetary largess in 2021, especially with vaccines speeding up the return to normalcy. In 2021, federal outlays only came down a bit to 28.9% of GDP while the Fed continued its aggressive quantitative easing program despite rising inflation. All told, in a span of two fiscal years, Washington racked up $5.7 trillion of new debt, which pushed the debt-to-GDP ratio above 120%.

The elimination of pandemic-related spending and strong tax receipts from 2021's stock rally helped bring the budget deficit down to a more manageable 3.7% of GDP in 2022 (excluding non-cash expenses such as the student debt forgiveness program). The Fed, having expanded its balance sheet to $9 trillion by early 2022 – ten times the pre-GFC size in 2008 – belatedly embarked on the most aggressive tightening campaign in four decades in order to bring down surging inflation. However, this inflation-fighting effort was partially stunted by a new round of fiscal largess from the federal government. Fiscal year 2023's budget deficit, excluding non-cash items, doubled from the prior year's level to roughly 7.3% of GDP.

Four years into the current decade, the federal deficit has averaged 9.4% of GDP. Stripping out the 2020-2021 crisis years, the deficit still averaged an unsustainable 5.5% over the last two fiscal years. Unfortunately, the fiscal outlook gets even worse from here. The Congressional Budget Office (CBO) projects federal receipts over the next ten years, including the sunset of some Trump tax cuts, to average around 18% of GDP, one point higher than the last seventy years' average. However, federal outlays are forecasted to average around 24% of GDP, more than four points higher than the 19.7% average over the last seventy years. The resulting average annual budget deficit at over 6% of GDP will catapult the federal debt-to-GDP ratio by 20 points to over 140%.

The Return of Bond Vigilantes

United States government bond trading at Solomon Brothers, the largest bond trading firm in the world.

Investors breathed a sigh of relief in late May when President Biden and then-House Speaker McCarthy struck a deal to resolve the debt-ceiling crisis. However, unbeknownst to many observers, the deal sowed the seeds for further political dysfunction and awoke bond vigilantes who had been defanged by years of quantitative easing.

With the deal having suspended the debt ceiling until the end of January 2025, the Treasury debt issuance spigot was opened. On July 31, the Treasury Department announced quarterly debt issuance estimates that exceeded the market's expectations. The following day, Fitch Ratings, citing a litany of issues such as the erosion of governance and rising deficits and debt, downgraded the U.S.A.'s long-term credit rating. This one-two punch alarmed investors and sent Treasury bond yields on an upward spiral. By the end of September, our national debt had increased by $1.7 trillion in just four months, and House conservatives were upset that then-Speaker McCarthy leveraged Democratic support to pass a 45-day temporary spending bill to avert a government shutdown rather than fight for spending cuts. Rep. Matt Gaetz, one of McCarthy's harshest critics on the right, filed the obscure "motion to vacate" and McCarthy was stripped of speakership with eight Republicans and all House Democrats voting for his removal. This palace coup threw the

THE RETURN OF BOND VIGILANTES

House into three weeks of paralysis and the crisis was finally quelled with the election of the relatively unknown Mike Johnson as the new Speaker of the House. If there is a silver lining, it is that Speaker Johnson may have some political capital to avert a government shutdown in 2023 and he seems genuinely concerned about the national debt issue. However, the division between moderate and hardline House Republicans will likely cut short his honeymoon period.

This erosion of governance coupled with large Treasury debt issuance and quantitative tightening emboldened bond vigilantes to sell Treasuries short and push up long bond yields above 5%. Even Fed Chair Powell, who has in the past eschewed commenting on fiscal policies, found it hard to stay mum on the issue. On October 19, when asked about what was driving up Treasury bond yields, he said it was not due to the Fed's rate hikes or higher inflation expectation and added that it's not a secret that "we are on a path that is not sustainable fiscally."

To investors who have been in the business for more than 15 years, the normalization of interest rates to pre-GFC levels may not be viewed as something to be alarmed about. Indeed, if inflation winds up settling in the 2.5% to 3% range, a 10-year yield at 4.5% to 5% can be viewed as reasonable and non-threatening. However, with much of the developed world having been spoiled by the ultra-loose monetary policies of central banks for more than a decade, the readjustment to pre-GFC interest levels will likely be painful and accident-prone.

The clearest example is the "Silicon Valley Bank syndrome" affecting the U.S. banking system, which is burdened with hundreds of billions of dollars of unrealized losses from bonds purchased when interest rates were much lower. While these banks have been thrown a lifeline from the Fed's Bank Term Funding Program (BTFP) to meet liquidity needs, their profitability and lending capacity have been impaired. Some are now afraid of tapping the equity market to raise new capital for fear of triggering the short selling of their stocks. The fact that the S&P Regional Banks Select Industry Index is still 50% below its early 2022 peak speaks volumes about the seriousness of the challenges.

In commercial real estate, rising interest rates have pushed up refinancing risk and bankruptcy. Higher cap rates – the income yield of properties demanded by investors – have driven down property values. On the residential side, the 30-year fixed mortgage rate has soared above 8%, a level not seen since the summer of 2000. While an 8% mortgage rate did not impede housing transactions then, affordability has gotten much worse as home prices are now 65% more expensive when measured as a multiple of median household income – 7.4 times today vs. roughly 4.5 times in mid-2000. It means that either mortgage rates or home prices, or both, need to come down to improve housing affordability.

The normalization of interest rates to pre-GFC levels has also been pressuring equity valuations since early August, as higher risk-free rates should theoretically lead to lower valuation multiples.

Over time, the lagged impact of higher interest rates will likely push the U.S. economy into recession and debunk the wishful narrative that our system today is less interest rate sensitive. What has not been interest rate sensitive is Washington's debt-fueled spending of late, but the return of bond vigilantes could in time impose financial discipline like they did in 1994.

Uncharted Waters

Who wouldn't yearn for the kind of normalcy wrought by President Harding's blend of fiscal prudence and nation-healing temperament? Instead, we are grappling with elevated uncertainty in politics and financial markets. The supposedly "risk free" Treasury bonds have been going through a horrendous bear market as surging long bond yields have wiped out years of returns. From its peak on August 4, 2020 to the trough on October 19, 2023, the iShares 20+ Year Treasury Bond ETF (TLT) has suffered a 51.8% price decline and a cumulative total loss of 48.4%.

Despite the sizeable losses, there are no signs of investor "capitulation" as fund flows into this ETF have increased materially. Many investors probably believe, as I do, that while long bond yields might not have peaked for the current cycle, the risk/reward tradeoff is getting more attractive.

One risk to this sanguine view on bonds is the cautionary message from the recent shift in the yield curve. At the risk of sounding rather wonky,

UNCHARTED WATERS

the recent surge in the 10-year yield has reduced the 2s-10s yield curve inversion from a peak of 108 bps (1.08%) on March 8 to 16 bps (0.16%) at the end of October. This so-called "bear steepening" of an inverted yield curve – the 10-year yield rising faster than the 2-year yield – is quite rare historically. In the past, yield curve inversions have ended with the 2-year yield falling more rapidly than the 10-year yield to reflect imminent Fed easing in the face of economic weakness. The current bear steepening reflects concerns about either higher inflation or Treasury supply potentially outstripping demand.

With disinflation and recession being my base case for next year, I still expect the traditional bull steepening (a more rapid drop in the 2-year bond yield than the 10-year, or rising bond prices at both ends) to occur in 2024. This view, of course, differs from the Fed's higher-for-longer guidance as policymakers no longer expect a recession. However, history has shown a soft landing to be rare following an aggressive Fed tightening.

The next recession will further increase Washington's already bloated debt load as deficits will move even higher cyclically due to lower tax receipts and higher transfer payments. While a recession typically drags long bond yields lower, bond vigilantes may not back away until the Fed is forced to restart QE or pursue some form of yield curve control, which will put pressure on the U.S. dollar and complicate the battle against inflation. Ultimately, Washington will need to demonstrate a commitment to get back on a fiscally sustainable path. It makes the 2024 general election especially important for the market as the two major parties have very different fiscal philosophies, and the occupant of the White House in 2026 will appoint Chair Powell's successor. With Washington seemingly incapable of cutting spending sufficiently to restore fiscal sustainability, I suspect it is just a matter of time before policymakers start floating a trial balloon for a plan like Europe's regressive value added taxes (VAT) to raise federal receipts. As consumption accounts for nearly 70% of GDP, a 5% VAT would raise tax receipts by roughly 3.5% of GDP, which would put the country on a more sustainable fiscal path.

In the final analysis, we are sailing in uncharted waters with Washington exhibiting no urgency for fiscal discipline despite elevated debt, the Fed trying to stay tighter for longer, bond vigilantes agitating for higher rates, and two dangerous wars escalating tension far beyond the battlefields. Such an uncertain macro backdrop calls for exposure to safe havens such as precious metals and U.S. Treasuries. Since the October 7 terror attacks on Israel, gold has lived up to its haven status with an 8% appreciation. While Treasury bonds have been disappointing due to the return of bond vigilantes, Treasury bills yielding 5%+ have been one of the best performing assets since the start of 2022, when it became clear that the Fed was about to end the era of easy money. As Treasury bond yields grind higher, their self-correcting mechanism – higher yields choking off economic growth to usher in lower rates – will ultimately make them a good investment in the last stage of the business cycle. In short, it is prudent to remain patient, selective, and defensive while looking for opportunities arising from unavoidable dislocations in various parts of the global economy.

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