ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

SEPTEMBER 2024

Sea of Liquidity

Who will be beached when the tide recedes?

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Market Watch

Equity Market Indices[1]	7/31/24 Price	8/31/24 Price	MTD Change	YTD Change
MSCI All Country World	814	834	2.40%	14.67%
S&P 500	5522	5648	2.28%	18.42%
MSCI EAFE	2381	2453	3.02%	9.72%
Russell 2000®[2]	2254	2218	-1.63%	9.40%
NASDAQ	17599	17714	0.65%	18.00%
TOPIX	2794	2713	-2.92%	14.63%
KOSPI	2771	2674	-3.48%	0.72%
Emerging Markets	1085	1100	1.40%	7.44%
Fixed Income				
2-Year U.S. Treasury Note	4.26%	3.92%	-34	-33
10-Year U.S. Treasury Note	4.03%	3.90%	-13	2
BBG U.S. Agg Corp Spread	0.93%	0.93%	0	-6
BBG U.S. HY Corp Spread	3.14%	3.05%	-9	-18
Currencies				
Chinese Renminbi (CNY/$)	7.23	7.09	-1.87%	-0.12%
Brazilian Real (Real)	5.65	5.61	-0.77%	15.43%
British Pound ($/GBP)	1.29	1.31	-2.07%	-3.02%
Euro ($/Euro)	1.08	1.10	-2.01%	-0.09%
Japanese Yen (Yen/$)	149.98	146.17	-2.54%	3.64%
Korean Won (KRW/$)	1371.20	1337.80	-2.44%	3.86%
U.S. Dollar Index (DXY)	104.10	101.70	-2.30%	0.36%
Commodities				
Gold	2448	2503	2.28%	21.35%
Oil	77.91	73.55	-5.60%	2.65%
Natural Gas, Henry Hub	2.04	2.13	4.47%	-15.39%
Copper (cents/lb)	418	415	-0.75%	6.54%
CRB Index	278	277	-0.39%	5.01%
Baltic Dry Index	1708	1814	6.21%	-13.37%

Source: Bloomberg

INTRODUCTION

The sharp market correction in early August came and went like a summer storm followed by rainbows and sunshine. Much credit goes to the Bank of Japan's (BOJ) capitulation, which took further rate hikes off the table after its July 31 decision to raise the policy rate to a mere 0.25% contributed to the unwinding of the yen carry trades. The Treasury Department also played a vital role in stabilizing the market – $230 billion of liquidity was pumped into the market via drawdowns of the Treasury General Account (TGA) and Overnight Reverse Repo (ON RRP) facility during the first half of the month.

One of the catalysts for the sell-off was the surprisingly soft July employment data, which had the unemployment rate surging to 4.3%, nearly a full percentage point above the cycle low of 3.4%. The weak jobs picture was further confirmed by the Bureau of Labor Statistics' preliminary annual benchmark review of employment data, which cut the number of new jobs created between March 2023 and March 2024 by 818,000. The scale of the downward revision was five times the annual average revision over the past 10 years, and calls into question the validity of incoming data that will affect the Fed's policymaking. Indeed, the Fed has become so concerned about the labor market that at Jackson Hole, Fed Chair Powell emphasized that he and his colleagues "do not seek or welcome further cooling in the labor market conditions." Chair Powell also made it clear that "the time has come for policy to adjust...and the timing and pace of rate cuts will depend on incoming data, the evolving outlook, and the balance of risks."

The fact that Chair Powell eschewed words like "gradual" and "methodical" in describing the upcoming interest rate cutting cycle left the door open for a 50-bp cut at the Federal Open Market Committee (FOMC) meeting on September 18. This overtly dovish stance was a gift to equities, bonds, and gold but sent the U.S. dollar tumbling and could be criticized as being political ahead of the November general election.

The Fed's dovish position is setting up an interesting test for September, which is historically the weakest month of the year. While financial conditions have been easing rapidly, economic fundamentals, electoral uncertainty, and geopolitical tension may still weigh on sentiment and valuations. The Fed will need to properly nudge the market's rate cut expectations for not only September, but also the remainder of the year to avoid triggering undesired market tantrums and volatility.

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A Tumultous Election Season

On Sunday morning, March 31, 1968, Vice President Hubert Humphrey was packing for a diplomatic trip to Mexico when he heard a knock on his apartment door. He was surprised to see President Lyndon B. Johnson (LBJ) paying him a home visit. Johnson walked in and asked Humphrey to read the draft of the presidential address that he planned to deliver that evening. As Humphrey read the text, his jaw dropped – the President was about to announce the end of his reelection campaign. Johnson put his index finger to his lips to signal Humphrey to keep it in confidence. He then said, "You'd better start now planning your campaign for president."

The 1968 presidential primary season had just gotten underway a few weeks earlier. As the incumbent President and leader of the Democratic Party, LBJ was expected to coast to victory at the March 12 New Hampshire primary. However, Eugene McCarthy, a liberal Senator from Minnesota who lacked both name recognition and campaign funding, shocked the political establishment by garnering 42% of the votes to Johnson's 50% in the first primary of the season. McCarthy's anti-Vietnam War stance resonated with young people and attracted thousands of highly motivated college students, including a 20-year-old Wellesley College student named Hillary Rodham, to campaign for him in the Granite State. Four days after that primary, LBJ's reelection prospects were further complicated by New York Senator Robert F. Kennedy's (RFK) entry into the race. The charismatic RFK, a nemesis of Johnson and popular figure within the Democratic Party, was an even more formidable political opponent. With both the Vietnam War and his reelection campaign turning into quagmire, the politically astute Johnson decided that it was time to call it quits to protect his political legacy.

LBJ's withdrawal caught most observers by surprise, but little did they know that greater chaos and surprises were still ahead.

On April 4, Reverend Martin Luther King Jr. was fatally shot on the balcony of the Lorraine Motel in Memphis. It stunned the nation and led to riots in more than 100 cities. Two months later, shortly after delivering a victory speech for the prized California primary, RFK was shot dead point-blank at the Ambassador Hotel in Los Angeles.

The assassination of RFK left McCarthy and Humphrey, who threw his hat into the ring on April 27, as the leading contenders for the nomination. However, Humphrey did not win any primary races and instead relied on the party machine to accumulate delegates. He employed a "favorite son" strategy that relied on local or regional politicians running in primaries against McCarthy and pledging their delegates to him. By the time Democrats gathered in Chicago on August 26 for the Democratic National Convention, a presumptive nominee was not yet determined, but Humphrey believed that he had accumulated enough delegates.

Chicago Mayor Richard J. Daley had hoped to use the convention to showcase his success in running the city, but that plan was at risk of being ruined by tens of thousands of protestors from across the country. The self-styled "law-and-order" mayor deployed 11,000 police officers and 6,000 National Guards to maintain order, and ringfenced the International Amphitheatre, where the convention was held, with barbed wire. Daley also plotted with LBJ, who never thought much of Humphrey and even had his phone illegally wiretapped by the FBI, to get Humphrey's delegates to switch allegiance to the

There is a commotion on the floor of Convention Hall 8/28 after the 3rd session recessed. Delegates marched around the floor carrying "Stop the War" signs and a huge black banner, protesting the majority decision to adopt the Johnson-Humphrey Administration policies on the war in Vietnam.

President. The scheme to have Johnson re-enter the race at the last minute was finally called off when Texas Governor John Connally, a confidant of LBJ, expressed doubt about its feasibility.

The convention turned out to be one of the most contentious and violent political events in American history. Melees between police and anti-Vietnam War protestors led to injuries among hundreds of demonstrators, bystanders, reporters, and cops. Inside the arena, televisions showed live footage of the violence outside while various factions of Democrats argued over the party's platform.

With LBJ out of the race for good, Humphrey won the nomination. However, in order to placate Johnson's loyalists, Humphrey's policy platform was revised to be more hawkish than he preferred.

On the other side of the aisle, the Republicans had nominated a candidate who was written off by many only a few years earlier. After his defeat to John F. Kennedy in the 1960 presidential election, Richard Nixon ran for governor of California in 1962 in hopes of resurrecting his political career. Upon losing the election to Pat Brown, Nixon blamed the media for unfair coverage and said in his concession speech, "You won't have Nixon to kick around anymore because, gentlemen, this is my last press conference." However, in the tumultuous year of 1968, a steady hand appealed to many. Nixon was able to tap into the so-called "silent majority" and outmaneuver prominent opponents such as Michigan Governor George Romney, New York Governor Nelson Rockefeller, and California Governor Ronald Reagan to win the nomination.

A TUMULTOUS ELECTION SEASON

With Nixon leading by double digits in most polls after the conventions, Humphrey repeatedly challenged him to a debate. Nixon ignored him and quipped to the media that Humphrey's got to first settle his debate with himself. Privately, Nixon was worried that LBJ would unleash an October surprise – a peace deal with North Vietnam before the election – to give the Democrats a big electoral boost.

On October 31, five days before Election Day, Johnson announced on national TV the cessation of "all air, naval, and artillery bombardment of North Vietnam" and expressed hopes for a peace deal. This Halloween treat sent Humphrey's poll numbers sharply higher at the expense of George Wallace, the American Independent Party's candidate. On election night, the race turned out to be too close to call and Americans went to bed without knowing who their next president would be. Finally, at 11:01 am ET on November 6, unofficial numbers from Illinois indicated that Nixon would receive the state's 26 electoral votes to surpass the 270 threshold to become the 37th President of the United States.

President-elect Richard M. Nixon strikes a victorious pose after defeating his Democratic opponent, Vice President Hubert Humphrey, in a closely fought election.

History Rhymes?

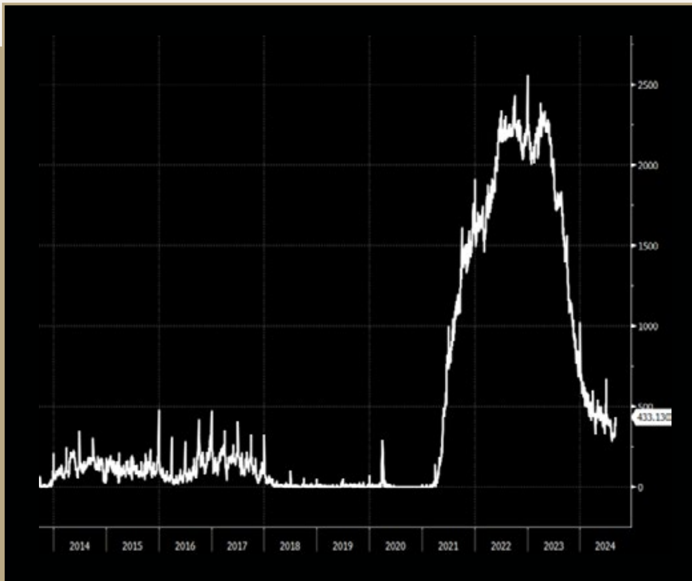

Chart 1A: The Overnight Reverse Repo (ON RRP)

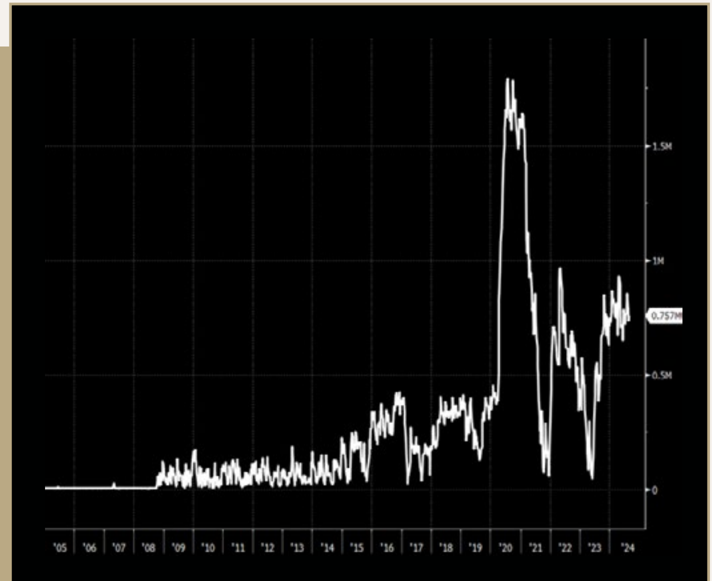

Chart 1B: The Treasury General Account (TGA)

Source: Bloomberg

Humphrey's electoral defeat and the divisive nomination process led the Democratic National Committee to establish the Commission on Party Structure and Delegate Selection to reform the party's presidential nomination process. The commission laid the foundation for today's presidential primary system designed to ensure that delegates are awarded based on popular votes. The reformed nomination process has created some memorable races – Ted Kennedy's challenge to President Jimmy Carter in 1980, Bill Clinton's "comeback" in 1992, and the epic race between Barack Obama and Hillary Clinton in 2008.

Fast forward to 2024, the political black swans of the last few months – the attempted assassination of Donald Trump, President Biden's exit from the race, and the subsequent nomination of Vice President Kamala Harris as the Democratic Party's presidential candidate has led some commentators to compare these current events to those from 1968.

With Washington's fiscal policies having become so dominant in shaping the U.S. economy since 2020, the prolonged political and policy uncertainties could weigh on market sentiment and business investment decisions.

While investors are fixated on the general election and policy ramifications, the implications of the Treasury Department's policies should also remain a focus for market participants. Specifically, the Treasury Department has played a major role in boosting the economy and financial markets by adjusting its debt issuance and balance in the Treasury General Account. Over the last fifteen months, the Treasury has channeled roughly $2 trillion of the excess liquidity created during the pandemic era from the Federal Reserve's Overnight Reverse Repo (ON RRP) facility to the economy and financial markets.

The rather wonky TGA and ON RRP may not show up on many investors' radars. However, as shown in Charts 1A and 1B, they have evolved into important policy tools as the balances in these facilities have become quite substantial since 2020.

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The Liquidity Sponge

The Overnight Reverse Repo is a facility created by the Fed in 2013 to help set a floor for its policy rates among non-bank lending institutions.

The Fed currently sets the fed funds rate, the interest rate at which banks lend money to each other, in a range of 5.25% to 5.5%. However, a bank with a surfeit of money can choose to lend to other banks at rates below 5.25%. To ensure that this lower bound of the fed funds rate is not breached, the Fed pays banks a 5.4% interest rate on banks' reserve balances (IORB). With banks being paid a 5.4% interest rate by the Fed, there is no incentive for them to loan money to any entities at rates below 5.4%.

Similarly, with non-banks accounting for a significant portion of lending in the U.S., the ON RRP was initially designed to let qualified institutions such as government sponsored enterprises (e.g., Fannie Mae and Freddie Mac) and primary dealers (such as Barclays Capital and Jefferies) leave their excess money with the Fed. For instance, for eligible institutions that use the ON RRP, the Fed currently pays them an interest rate of 5.3%, which disincentivizes them from lending money at rates below this level.

During 2020 and 2021, with so much money moving around the system – due to fiscal stimulus such as the forgivable Payroll Protection Program (PPP) loans to businesses and Economic Impact Payment checks to qualified individuals – money market funds (MMFs), which can invest only in securities that mature in 397 days or less, were inundated with deposits that they could not find places to invest in. In April 2021, the Fed solved this problem for MMFs by making them eligible for the ON RRP facility, and, as shown in Chart 1, a significant amount of money started to flow into the facility, peaking at $2.5 trillion by the end of 2022.

From a market liquidity standpoint, increasing the balance in the ON RRP effectively drains money from the economy and markets. That is, instead of having MMFs make short-term loans to public and private sector borrowers, the money was taken out of the system and put on the Fed's balance sheet. However, with the inordinate liquidity during the pandemic era, the Fed was in effect sterilizing the excess liquidity in the system by letting MMFs use the ON RRP.

As liquidity, excess or not, is drained from the system, it has the effect of pressuring financial asset prices. With the Fed concurrently injecting new liquidity into the system via quantitative easing (QE), the growing balance in the ON RRP was not an issue to the market in 2021 and early 2022. However, by the spring of 2022, with the Fed having stopped QE, further increases in the ON RRP drained liquidity from the system and contributed to the equity bear market.

Ceteris paribus, the simple rule of thumb is that an increase in the ON RRP drains liquidity from the market, while a decline in the ON RRP injects liquidity into the system.

The Treasury's Checking Out

For decades prior to the Great Financial Crisis, the U.S. Treasury Department used the Treasury Tax & Loan (TT&L) accounts at large commercial banks to handle its cash flow – depositing cash raised from tax collection and debt issuance, and disbursing money for payrolls, transfer payments, and procurement. This arrangement kept the circulation of the federal government's money in the banking system. That is, when taxes were collected, money moved from taxpayers' bank accounts to the TT&L accounts at commercial banks, so there was no net change in the quantity of money in the banking system. Conversely, when the government spent money, funds were moved from the TT&L accounts into bank accounts of businesses and individuals.

This arrangement has changed since the Great Financial Crisis. Instead of using the TT&L accounts at commercial banks to handle its cash flow, the Treasury started to move its money in and out of the TGA at the Federal Reserve.

The government's use of the Federal Reserve as its primary bank rather than the TT&L accounts at various commercial banks has an impact on the liquidity in the banking system. When the federal government deposits funds raised from tax collection and debt issuance into the TGA, money is taken out of the banking system and put on the Fed's balance sheet. Conversely, as the federal government spends down the balance in the TGA, money is injected into the banking system, which increases the market's liquidity.

With the Fed boosting the banking system's reserves via its QE program in the first few years during and after the Great Financial Crisis, the balance in the TGA mattered little to the financial system's liquidity. The balance in the TGA was also kept rather low: from 2009 through 2014, it averaged $64 billion and rarely exceeded $150 billion. Between 2015 and 2019, the average balance had grown to around $250 billion as the Treasury realized that a larger balance gave it more financial flexibility during periods of contentious debt ceiling negotiations.

For example, after the debt ceiling of $22 trillion was reached in February 2019, the federal government was unable to issue new net debt but funded its operations with tax collection and drawing down the TGA from $400 billion to $175 billion by the time a new debt ceiling was agreed upon in July 2019.

The big surge in the TGA balance came in the spring of 2020 when the economy was shut down by the pandemic and the government was forced to implement emergency measures. With the Fed buying $2.3 trillion of securities from March through June 2020 to reliquefy financial markets, Treasury Secretary Steven Mnuchin opportunistically raised $3 trillion of net debt during that period to fund Washington's generous stimulus checks and build a rainy-day fund of $1.8 trillion in the TGA. This sharp rise in the TGA balance did not hurt the market's liquidity since it was more than offset by the Fed's aggressive asset purchases.

In January 2021, incoming Treasury Secretary Janet Yellen inherited a well-funded TGA of $1.6 trillion. This balance was drawn down to as low as $58 billion by mid-December 2021 to fund the government's spending as the Treasury's ability to raise net debt was curtailed by a contentious debt ceiling negotiation between August and mid-December. The rapid drawdown of the TGA – a liquidity injection to the economy and financial markets – helped fuel inflation and 2021's "everything bubble." Inflation and the market bubble would have been even greater if not for the aforementioned ON RRP being opened up to MMFs to soak up some of the excess liquidity.

While the Treasury was drawing down the TGA in the summer of 2021, it announced that it would replenish the balance to $800 billion by year's end, which was twice the pre-pandemic peak of $400 billion. The Treasury supposedly targets the TGA balance to "maintain funds sufficient to cover its one-week ahead cash need, which includes both net fiscal outflows and the gross volume of maturing marketable debt."

The Great Liquidity Drain

The Treasury Department's refill of the TGA in early 2022 and stronger-than-expected tax collection – buoyed by capital gains taxes due to 2021's everything bubble – boosted the balance in the TGA from roughly $280 billion at the start of the year to an intra-year peak of nearly $960 billion in early May. It meant that the Treasury had drained as much as $680 billion of liquidity out of the financial system during the spring of 2022.

On the ON RRP front, the balance had risen from roughly $1.9 trillion at year-end 2021 to over $2.4 trillion by the end of September 2022 – a liquidity removal of more than $500 billion.

The combination of these measures led to an intra-year drawdown of $1.2 trillion in the aggregate reserves held by U.S. banks – a 28% decline from $4.1 trillion at year-end 2021 to an intra-year low of $2.96 trillion by late September 2022. This massive liquidity drain coincided with the S&P 500 Index's peak-to-trough decline of 25%, from a high of 4,797 on January 3 to a cycle-low of 3,577 on October 12, 2022.

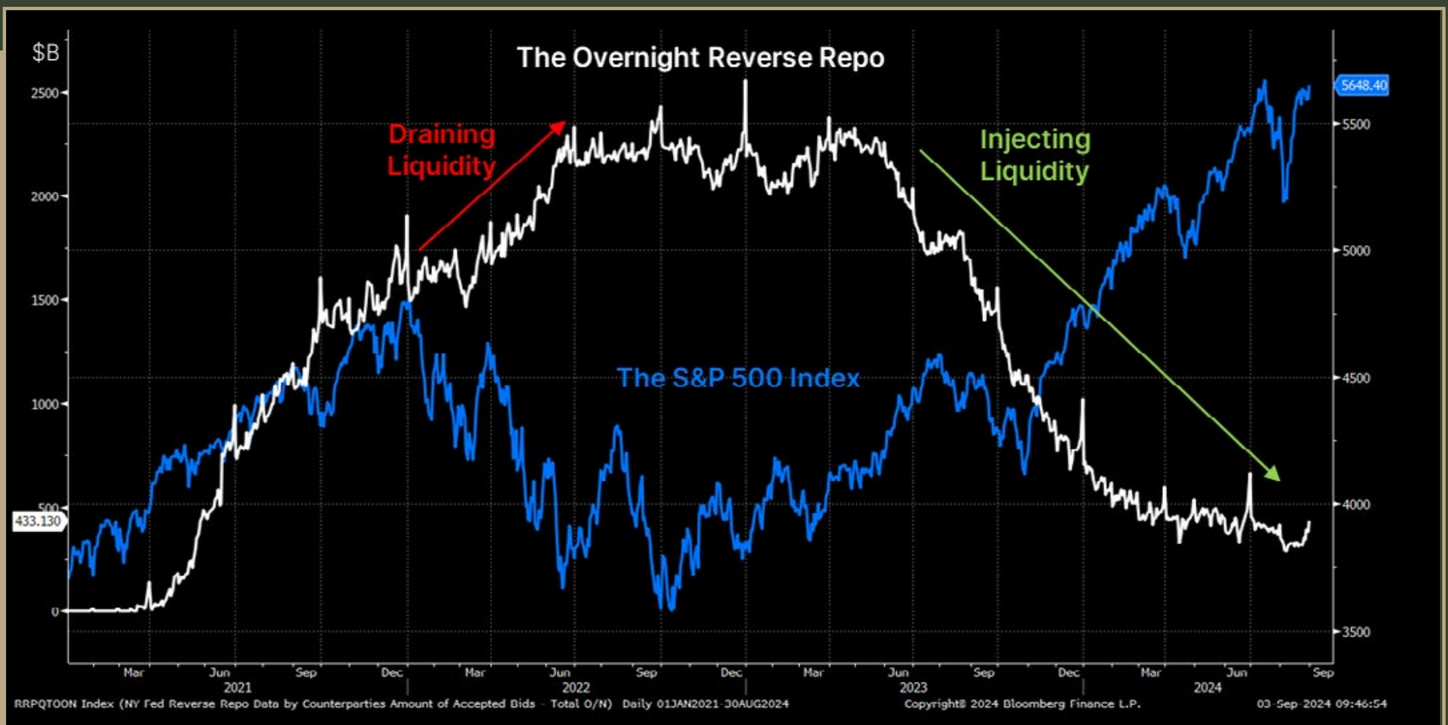

Chart 2: The inverse relationship between the Overnight Reverse Repo and the S&P 500 Index since 2022

The Activist Treasury

Investors entered 2023 with much pessimism as many market strategists and sell-side economists were forecasting an imminent recession. Markets were also rattled by the looming debt ceiling battle and a potential government shutdown as the $31.4 trillion debt ceiling was reached in late January. Little did investors realize at the time that the prolonged debt ceiling battle would turn out to be a liquidity bonanza for the market.

With the Treasury Department being unable to issue new debt after the $31.4 trillion debt ceiling was reached in late January 2023, it started to spend down the balance in the TGA, which stood at $570 billion at the time. By the time President Biden and then House Speaker McCarthy reached a debt ceiling deal in late May, the TGA had only $50 billion left. This $520 billion of liquidity injection from the TGA to the economy helped to lift the S&P 500 Index by 9% during the first five months of 2023 despite the collapse of Silicon Valley Bank, First Republic Bank, and several smaller entities - the worst banking crisis since the Great Financial Crisis. Once again, the sizable liquidity flow trumped everything else as far as the market was concerned.

With the government funding issue resolved, the Treasury Department faced a new challenge – how to replenish the TGA to its target of $600 billion by the end of September 2023 without roiling financial markets with the associated liquidity drain. Treasury officials also realized that the fiscal deficit was running much higher than originally projected, which meant more debt issuance to potentially drive interest rates higher and hurt the economy going into the critical 2024 general election.

Officials at the Treasury came up with a plan that would not only solve the large debt issuance issue, but also inject extra liquidity into the economy. That is, tapping into the massive balance in the Fed's Overnight Reverse Repo facility, which stood at $2.3 trillion at the end of May 2023, to fund the Treasury's debt issuance.

With MMFs only able to purchase short-term debt securities, the Treasury Department had to alter the mix of its debt issuance, which has traditionally consisted of roughly 20% in short-term bills (T-bills) and 80% in notes and bonds. It is generally believed that an overreliance on short-term financing is not prudent as it exposes the borrower to rollover and interest rate risk.

The Treasury wound up flipping the mix of debt issuance in 2023 to 80% in T-bills and 20% in notes and bonds. This unusually heavy use of short-term funding had three near-term advantages:

1. While short-term bills had higher interest rates, their issuance reduced the upward pressure that would otherwise have been put on the longer end of the yield curve, which would have hurt private sector and individual borrowers.

2. Using short-term bills to replenish the TGA avoided a liquidity drain that could have damaged the market and economy. The aggregate bank reserves were not affected as MMFs bought T-bills with money from the ON RRP, and the Treasury parked the proceeds in the TGA.

3. Further issuance of T-bills beyond what was needed to refill the TGA became a stealth monetary easing as it channeled money from the ON RRP into the economy. That is, MMFs pulled money from the ON RRP to buy T-bills, and the Treasury then funneled the proceeds into the economy. The economy and markets thus benefited from a net liquidity injection.

THE ACTIVIST TREASURY

All told, from June through September 2023, 89% of the $1.4 trillion net debt issued by the Treasury to the public was in short-term bills. For full year 2023, 81% of the $2.4 trillion net debt issued to the public, or $2 trillion, was in short-term bills. This unprecedented reliance on short-term funding let the Treasury channel $1.5 trillion of liquidity from the ON RRP to the economy – excluding the so-called year-end window dressing, the balance in the ON RRP dropped from $2.3 trillion at the end of 2022 to $830 billion at the end of 2023. The tremendous liquidity injection, or stealth easing by the Treasury, more than offset the Fed's quantitative tightening and was one of the catalysts that sent the S&P 500 Index up 25% in 2023 despite a mere 1% growth in aggregate corporate earnings. Again, liquidity trumped everything.

Dr. Nouriel Roubini, who served in the Council of Economic Advisors and the Treasury Department during President Clinton's second term, recently co-authored a research paper that coined the term *Activist Treasury Issuance (ATI)* to describe the Treasury's adjustment of the maturity profile of its debt issuance to manage financial conditions. Roubini, known to many for having presciently predicted the subprime bubble implosion that triggered the Great Financial Crisis, estimated that the impact of the ATI in 2023 was equivalent to one percentage point of an interest rate cut and worked against the Fed's monetary tightening. One of his conclusions was that *"[t]he use of ATI to manage financial conditions and the economy into election season is a dangerous precedent that opens the door for material political business cycles in the United States."* He also cautioned that it *"threatens to raise long-run inflation and interest rates over time as future administrations make use of the same tool."* Given Roubini's stature and media presence, this controversial but insightful paper earned refutation from Treasury Secretary Yellen. To be fair, regardless of the Treasury's intention behind the large issuance of short-term bills, the easing of financial conditions was irrefutable and superbly executed.

Dr. Nouriel Roubini, Professor, New York University at The 2022 Concordia Annual Summit on September 21, 2022 in New York City.

More Liquidity on the Way

So far in 2024, financial markets have continued to benefit from the decline in the ON RRP, which has injected more than $450 billion of liquidity year-to-date, offsetting much of the $525 billion reduction in the Fed's securities holdings due to QT. As of September 3, the ON RRP had a balance of $350 billion that will likely be channeled into the economy and financial markets by year end of early 2025.

The balance in the TGA currently stands at $700 billion, which is below the Treasury Department's $850 billion end-of-September target. Ceteris paribus, increasing the TGA balance by $150 billion in September could pressure the market in the near term.

The Treasury has set a $700 billion end-of-December TGA target, which would allow it to release $150 billion of liquidity back into the economy in the fourth quarter. If this $150 billion of planned decline in the TGA is realized in October, it would be a tremendous October surprise for financial markets – $150 billion of liquidity injection in a month is equivalent to an annualized stealth QE of $1.8 trillion.

The gist of these potential developments is that the liquidity backdrop remains quite favorable for the remainder of 2024. In fact, during the first five years of this decade, 2022 was the only year that experienced an outflow of liquidity, and it coincided with a down year for stocks and bonds. The other four years all benefited from the government's generous liquidity injection. However, after the balance in the ON RRP is depleted, investors will have to adjust to a new era where excess liquidity is no longer abundantly available to fuel asset prices.

Interestingly, there may be one more jolt of significant liquidity injection in the first half of 2025 if the November election delivers a split government. That is, the suspension of the debt ceiling will expire on January 2, 2025. If Washington fails to extend the suspension or set a new debt limit, the Treasury Department will be forced to stop issuing net new debt and draw down the TGA to fund the government's spending. Ironically, the longer the debt ceiling issue remains unresolved in 2025, the greater the release of liquidity from the TGA into the economy and financial markets.

However, this liquidity story is a double-edged sword. Once a new debt ceiling agreement is reached in 2025, the Treasury will then have to replenish the TGA. With the ON RRP having been depleted by that time, there will be no excess liquidity for the Treasury to tap, and the refilling of the TGA will likely directly drain money from the economy and financial markets.

When the Tide Goes Out

In the final analysis, the outcome of the November election will shed some light on whether the upcoming debt ceiling negotiations in early January 2025 will result in another liquidity boom/bust cycle via the drawdown and subsequent refill of the Treasury General Account. By mid-2025, the pandemic-induced liquidity binge will likely have run its course.

As excess liquidity evaporates in 2025, financial assets will likely have a hard row to hoe – equity valuations may contract, bond yields could be driven higher, and even gold and cryptocurrencies may come under selling pressure. Tighter financial conditions will also weigh on economic growth.

Facing these potential challenges, the Fed will likely come to the rescue by accelerating its pace of interest rate cuts to make up for the lack of additional liquidity flowing into the economy. In fact, the Fed has already scaled down the pace of quantitative tightening since June and may stop this liquidity tightening program in the near future.

If the economy takes a sharp turn south to drive fiscal deficits even higher in 2025, the Fed may be compelled to come up with justifications to restart quantitative easing without first bringing the fed funds rate to the zero bound. After all, the market has become addicted to liquidity, and central banks may not have the gumption to push back. To wit, less than a week after the Bank of Japan raised its policy rate to merely 0.25%, it was pressured by the market to take further rate hikes off the table.

Central banks' proclivity to accommodate the market's moral hazard is one of the reasons why I continue to have a favorable view of gold – the yellow metal is a hedge on monetary inflation and loose central bank policymaking.

For stocks and bonds, the key question is whether the current economic expansion is in mid- or late cycle. While the consensus remains a mid-cycle soft landing, one should not dismiss the late-cycle risk, especially with economic data having turned more mixed of late.

With the Fed about to initiate another rate cutting cycle, income-oriented investments remain attractive as they offer reasonable yields and the potential for more capital appreciation if recession turns out to be the outcome. As for equities, the prospect of lower market liquidity in 2025 and growing macro uncertainties mean that investors could become more valuation sensitive and less narrative-driven. That would favor defensive and quality stocks, especially those with attractive dividend yields. Emerging market stocks may also enjoy a period of outperformance if the U.S. dollar weakens further as a result of the Fed's aggressive rate cuts.

Warren Buffet once said, "Only when the tide goes out do you discover who has been swimming naked." The market will likely be put to that test as the tide of liquidity goes out in the not-too-distant future.

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