ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

JUNE 2024

A Taxing Issue

America's fiscal sustainability challenges

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Market Watch

Equity Market Indices[1]	4/30/24 Price	5/31/24 Price	MTD Change	YTD Change
MSCI All Country World	757	786	3.8%	8.1%
S&P 500	5036	5278	4.8%	10.6%
MSCI EAFE	2281	2356	3.3%	5.3%
Russell 2000®[2]	1974	2070	4.9%	2.1%
NASDAQ	15658	16735	6.9%	11.5%
TOPIX	2743	2772	1.1%	17.2%
KOSPI	2692	2637	-2.1%	-0.7%
Emerging Markets	1046	1049	0.3%	2.5%
Fixed Income				
2-Year U.S. Treasury Note	5.04%	4.87%	-16	62
10-Year U.S. Treasury Note	4.68%	4.50%	-18	62
BBG U.S. Agg Corp Spread	0.87%	0.85%	-2	-14
BBG U.S. HY Corp Spread	3.01%	3.08%	7	-15
Currencies				
Chinese Renminbi (CNY/$)	7.24	7.24	0.0%	2.0%
Brazilian Real (Real)	5.19	5.25	1.0%	8.0%
British Pound ($/GBP)	1.25	1.27	-2.0%	-0.1%
Euro ($/Euro)	1.07	1.08	-1.7%	1.8%
Japanese Yen (Yen/$)	157.80	157.31	-0.3%	11.5%
Korean Won (KRW/$)	1382.10	1385.00	0.2%	7.5%
U.S. Dollar Index (DXY)	106.22	104.67	-1.5%	3.3%
Commodities				
Gold	2286	2327	1.8%	12.8%
Oil	81.9	77.0	-6.0%	7.5%
Natural Gas, Henry Hub	1.99	2.59	29.9%	2.9%
Copper (cents/lb)	456	460	0.8%	18.3%
CRB Index	291	290	-0.4%	10.0%
Baltic Dry Index	1685	1815	7.7%	-13.3%

Source: Bloomberg

INTRODUCTION

The 5% equity market pullback in April felt like a distant memory as the Fed and U.S. Treasury delivered powerful but inconspicuous stimulus to the market like they did last December, and investors responded giddily by once again driving major equity indices to new all-time highs.

The first set of gifts were hand delivered by Fed Chair Powell at the conclusion of the May 1st Federal Open Market Committee (FOMC) meeting. He not only dispelled any lingering fears of another rate hike despite stickier-than-expected inflation, but also offered de facto policy easing by scaling back the pace of quantitative tightening (QT) by $35 billion a month starting this month, $5 billion more than what the minutes from the March FOMC meeting had indicated. The extra $5 billion per month of tapering has little impact on the flow of liquidity but carries tremendous signaling value in shaping investor sentiment and financial conditions. The message was immediately interpreted as risk-on and that the Fed's got the market's back.

The Treasury did its part by drawing down the Treasury General Account (TGA) from over $962 billion at the end of April to $700 billion. Adding the $94 billion decline in the Fed's Overnight Reverse Repo facility in May, the combined liquidity injection of $356 billion into the economy and financial system was the most aggressive since the late-October to mid-December 2023 period, which also coincided with a big market rally.

With Chair Powell all but guaranteeing that the rate hike cycle is over, the market has entered a Goldilocks period with the economy showing some signs of weakening but not enough to derail earnings growth, and the Fed is on standby to help if needed. While the guessing game on the timing of the first rate cut may create some volatility on bond yields and equity valuations, the important takeaway is that, historically, equities have performed quite well from the time that the Fed pauses its tightening cycle to the start of the next interest rate cutting cycle. In fact, the time to start worrying is after the Fed starts the easing cycle, which has historically preceded or coincided with the onset of recession.

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When Air & Sunlight Weren't Free

On November 4, 1677, a tearful 15-year-old noble lady named Mary, daughter of the Duke of York, married William Henry, a Protestant Dutch prince twelve years her senior, in London's St. James' Palace. The ceremony was attended by her uncle, King Charles II, who had arranged the matrimony as a union of political convenience to assuage the Protestants' concern that James, the Duke of York, had converted to Catholicism nine years earlier. The duke was the heir presumptive as King Charles II had no legitimate children. Mary was second in line to the throne since she and her younger sister were the only surviving children of the duke and his first wife Anne, who passed away in 1671. The newlyweds settled in the Hague a month later, and their initially awkward marriage gradually blossomed into a strong partnership.

Upon King Charles II's death in 1685, Mary's father was crowned as King James II in England and Ireland and James VII in Scotland. His push for religious tolerance and promotion of Catholics to key posts alarmed Anglicans, but they viewed these moves as temporary since Mary, the Protestant heir presumptive, would eventually succeed James – all ten children born to James and his second wife, Mary of Modena, between 1674 and 1684 either died in infancy or were stillborn. However, Mary's succession was called into question in 1688, when Mary of Modena gave birth to a prince who would be raised Roman Catholic. It prompted a group of Protestant nobles – later called "the Immortal Seven" – to persuade Mary's husband William, Prince of Orange, to overthrow his Catholic father-in-law in order to "rescue the nation and the religion."

Mary was torn between her loyalty to her father and duty to her husband, and she convinced herself that a rebellion was necessary to "save the Church and State." King James II became aware of William's preparations for war but was confident that his numerically superior army would crush the invaders. William and his 20,000 strong Dutch army landed in England in November 1688 and were met with little resistance as James' army, consisting of mostly Protestants, either surrendered or pulled back. A key blow to King James II was the defection of General John Churchill, an ancestor of Prime Minister Winston Churchill. By early December, James decided to flee for France but was captured. William marched into London without much resistance and, perhaps out of deference to his wife Mary, deliberately let his father-in-law escape from captivity to settle in France.

This largely bloodless rebellion, or the Glorious Revolution, turned out to be the last time that Great Britain was successfully invaded by a foreign force and set the stage for dramatic political changes.

On April 11, 1689, William and Mary were crowned at Westminster Abbey as joint sovereigns. However, with

English nobles having played a crucial role in installing them as heads of state, the joint sovereigns realized that power sharing with Parliament was inevitable. In December of that year, the Parliament of England passed the Bill of Rights, which solidified its power over the constitutional monarchy – the King or Queen could no longer raise taxes, suspend laws, or maintain a standing army without the Parliament's consent. The Bill of Rights also enshrined fundamental rights such as the freedom of speech, assembly, and petition. A century later, it became a blueprint for the U.S. Constitution.

Another key development during the reign of William and Mary was the creation of the Bank of England in July 1694 to help finance the kingdom's war with France. The Bank of England later evolved into a model for central banks around the world.

In 1696, Parliament enacted a supposedly progressive tax scheme – the window tax – to help narrow the chronic revenue shortfalls for King William III, by then the sole sovereign after Queen Mary II's passing two years prior. Each house in the country was subject to a two-shilling house tax, and those with more than ten windows were assessed with additional taxes, which increased with the number of windows.

Victorian terrace townhouse with bricked out windows, Hadleigh, Suffolk, UK

The window tax was modeled after King Charles II's hearth tax (also called the chimney tax) first imposed in 1662, when two shillings were assessed each year for every fireplace or stove in any dwellings. It was highly disruptive as tax collectors, known as chimney men, would go into each house for inspection and tax collection. This unpopular tax was abolished in 1689 following the Glorious Revolution. The window tax was viewed as less intrusive as the assessment could be made externally by "window peepers" with no intrusion of people's privacy.

The window tax led to some unintended consequences. Whereas most households could not get rid of their stoves to avoid the hearth tax, many homeowners simply bricked up their windows to keep the total number below ten, which resulted in less ventilation and lighting. The situation got worse in the mid-1700s, when the Industrial Revolution led to a migration of working-class families into large tenement buildings in densely populated cities. Since each building was treated as one dwelling unit under the terms of the tax, windows in tenements were often boarded up.

WHEN AIR & SUNLIGHT WEREN'T FREE

The window tax wound up not only burdening the urban poor with higher rents from landlords passing on the window tax, but also depriving them of sufficient fresh air and natural light in their living quarters. By the eighteenth century, it was acknowledged that poor ventilation had resulted in the spread of diseases such as typhus, smallpox, and cholera, and the lack of sunlight had stunted children's growth, which was later understood to be caused by the deficiency of vitamin D.

Despite popular backlash against the window tax, it outlasted King William III, who passed away in 1702, by 149 years. Parliament had even expanded the window tax in 1766 by lowering the 10-window exemption to seven, which led to a rapid drop in the number of houses with more than seven windows.

A national movement to abolish the window tax gained significant momentum after a motion to repeal the tax failed by only three votes in April 1850. Novelist and social critic Charles Dickens was active in the campaign and argued, "Neither air nor light have been free since the imposition of the window tax." Finally, in July 1851, the window tax was consigned to the dustbin of history after Parliament replaced it with the Inhabited House Duty that assessed property taxes based on the size and value of each dwelling. Another contributing factor was that Her Majesty's Treasury (under Queen Victoria) had found a new source of tax revenue – personal income tax was made permanent in 1842.

Punishing Income Tax Rates

Many of America's founders were distrustful of big government and cautious about taxation. However, to fund the Revolutionary War, the Virginia General Assembly passed its version of the window tax by levying one shilling for each glass window on all inhabited houses for four years starting in September 1781. It was progressive in the sense that only more affluent households could afford glass windows during that period.

Before the Civil War, many states were deeply suspicious of the federal government, which limited Washington's revenues to tariffs and excise taxes on goods such as alcohol and tobacco. In 1861, Congress imposed the first federal income tax to help pay for its war effort, but this unpopular measure was repealed in 1872. In 1894, Congress imposed the nation's first peacetime income tax, but it was struck down as unconstitutional by the Supreme Court the following year. Personal income tax in the U.S. was finally made permanent with the passage of the Sixteenth Amendment, and it has grown into the biggest source of revenue for the federal government at roughly 50%.

When the federal personal income tax was established in 1913, it started with seven income tax brackets with rates moving up at 1% increments from 1% to 7%. The top rate applied to incomes above $500,000, which is equivalent to roughly $15.8 million in 2024. However, income tax brackets and rates started to balloon in 1917, when the U.S. entered the Great War – there were 21 tax brackets with the top rate of 67% on income above $2 million ($49 million in 2024). A year later, the top rate was lifted to 77% on income above $1 million.

During the 1920s, Presidents Warren Harding and Calvin Coolidge, two original supply-siders, succeeded in unleashing the private sector's potential by reducing government spending, taxes, and regulation. Coolidge said in his 1925 inauguration address, "The collection of any taxes which are not absolutely required, which do not beyond reasonable doubt contribute to the public welfare, is only a species of legalized larceny." He cut the top income tax rate to just 25% on income over $100,000 in 1926 ($1.8 million today). The economic boom that Coolidge unleashed – the Roaring Twenties – enabled him to not only balance the budget every year during his presidency (1923-1929), but also cut the federal debt by about one-third.

As the Roaring Twenties gave way to the Great Depression of the 1930s, partly due to policy errors like tariff increases and ill-timed monetary tightening, President Herbet Hoover had to raise taxes to balance the budget and fund relief programs in 1932. The top income tax rate was raised to 63% on incomes above $1 million ($23 million in 2024). In June 1933, the weary nation was shocked and incensed to learn from a congressional hearing that J.P. Morgan, the most powerful banker on Wall Street, and his partners paid no income taxes in 1931 and 1932. The public outcry for fairness led President Franklin D. Roosevelt and Congress to close various loopholes and raise the maximum estate tax from 45% to 60% on the portion of an estate exceeding $10 million ($234 million in 2024) in 1934. The top personal income tax rate was lifted to 79% in 1936, and eventually peaked in 1944 during WWII at a whopping 94% on income above $200,000 ($3.5 million in 2024 terms). The maximum estate tax also hit a record high of 77% on the portion of an estate exceeding $50 million in 1941 ($1 billion in 2024).

The end of WWII did not offer much relief for income tax rates. Saddled with hitherto the highest level of federal debt relative to the country's GDP – 119% in 1946 – Washington only marginally lowered the top personal income tax rate to 91%. In 1963, President John F. Kennedy attempted to cut personal income tax rates from a range of 20-91% down to 14-65%. However, he was unable to get Congress on board as Republicans and conservative Democrats insisted on corresponding spending cuts to keep a lid on the deficit. After JFK's tragic death, President Lyndon Johnson, known for his legislative prowess, finally succeeded in getting Congress to lower personal income tax rates to a range of 16% to 70% starting in 1965.

The Reagan Revolution

Pres. Reagan holding The Official TAX AX (no caps), re tax cuts.

When Ronald Reagan was inaugurated as the 40th President of the nation in 1981, the U.S. was mired in a debilitating stagflation and Cold War stalemate. However, Reagan inherited a strong government balance sheet – decades of high taxes and 1970s' inflation had brought down the federal debt-to-GDP ratio to a post-war nadir of 31.8% in 1981 – and a demographic tailwind with the oldest baby boomers entering their mid-30s, the most productive age.

The top personal income tax rate at the time was still 70%, but it was applied to a much lower real income threshold after a decade of elevated inflation – the $215,400 threshold in 1981 is equivalent to roughly $743,000 in 2024. Reagan's supply-side economic policies simplified the tax bracket structure and slashed the top personal income tax rate first down to 50%, then 28% by 1988. Reagan also managed to cut the top corporate income tax rate from 46% to 34% by 1988.

When President Reagan left the White House in early 1989, the nation had been dramatically transformed – strong economic growth made stagflation a relic of history, and the U.S. has all but won the Cold War as the Soviet Union was on its last gasp. However, the Reagan era incurred higher levels of fiscal deficit, averaging 4.1% of GDP vs. the 1% average deficit from 1946 to 1980. As a result, the nation's debt-to-GDP ratio had climbed to 51% by 1988.

The Balancing Act

US Speaker of the House Newt Gingrich (L), R-GA, shakes hands with US President Bill Clinton

While the Reagan years saw a material uptick in budget deficits and national debt, there were still bipartisan efforts to enforce fiscal discipline in Washington. In 1985, the Gramm-Rudman-Hollings Balanced Budget Act established automatic spending cuts (sequestration) if deficit reduction targets were not met. It was replaced by the Budget Enforcement Act of 1990 which introduced "pay-as-you-go" procedures that required new spending increases or tax cuts be offset by spending cuts or tax increases elsewhere. These deficit control measures forced President George H.W. Bush to break his "read my lips: no new taxes" pledge and raised the top personal income tax rate to 31%, which might have contributed to his electoral defeat to Bill Clinton in 1992.

As the leader of the New Democrats movement, President Clinton made deficit reduction a policy priority in 1993 and raised the top personal income tax rate to 39.6% for income above $250,000. The GOP's midterm election victory in 1994 – regaining control of the House of Representatives for the first time in 40 years – pushed President Clinton further to the political center. The combination of spending discipline and elevated tax receipts – thanks to bull-market induced capital gains tax windfalls – led to four straight years of federal budget surplus from 1998 to 2001. The budget surplus and rapidly growing GDP slashed the nation's debt-to-GDP ratio from 65% in 1996 to 55% in 2001. Various market participants started to worry about the shrinking supply of U.S. debt issuance since U.S. Treasury securities have played a critical role as market benchmarks, collaterals, and domestic and international safe havens. To wit, in March 2001, the International Monetary Fund (IMF) published a research paper titled *Financial Implications of the Shrinking Supply of U.S. Treasury Securities.*

The Spendthrift Era

The dawn of the 21st century marked the beginning of a drift away from fiscal discipline in Washington. Two rounds of tax cuts by President George W. Bush (cutting the top personal income tax rate down to 35%) and the costly War on Terror reversed the steady progress on the nation's finances. By the time Bush left office in January 2009, the federal debt-to-GDP ratio had risen to 68%.

President Obama entered the White House during the depth of the Great Financial Crisis, which was a big blow to the government's finances – tax receipts would remain depressed for several years, and spending ballooned as the economy was badly in need of stimulus. The top personal income tax rate was restored to 39.6% in 2013 to help narrow the deficit, but the federal debt-to-GDP had already ballooned to 100%. It would rise further to 105% by the time Donald Trump was sworn in as the 45th president of the nation in 2017.

President Trump pursued the typical supply-side economic policies of tax cuts and deregulation. While the top personal income tax rate was trimmed from 39.6% to 37%, the biggest tax cuts were targeted at businesses, with a flat 21% tax replacing the prior quarter century's seven tax brackets and 34% top rate.

Trump's procyclical policies generated above trendline growth with the unemployment rate falling to a five-decade low of 3.5% by late 2019. However, the growing economy did not generate sufficient tax revenue and the federal deficit crept up to 4.6% of GDP by 2019, a seven-year high.

Next came the unexpected budget buster – the COVID-19 crisis that shut down the economy and forced the government into crisis management mode. Emergency fiscal spending coupled with economic contraction sent the 2020 budget deficit to 14.7% of GDP, the highest since WWII, and the federal government's debt-to-GDP hit a record high of 126%.

The COVID-19 crisis and President Biden's activist government philosophy kicked off an era of "fiscal dominance" that appears to have permanently lifted the federal government's fiscal outlays even though its receipts have remained roughly the same relative to GDP:

1. During the 74-year period from the end of WWII in 1946 to 2019, the year before the pandemic, federal outlays and receipts had averaged 19% and 16.8% of GDP, respectively, which meant that the fiscal deficit had averaged 2.2% of GDP.

2. In the 2020-2023 era, which encompassed the pandemic and subsequent recovery, federal outlays and receipts averaged 26.6% and 17.1%, respectively. It meant that the size of budget deficit during these four years averaged a whopping 9.5% of GDP.

3. The Congressional Budget Office (CBO) projects that over the ten-year period from 2024 to 2033, federal outlays, receipts, and deficits will average 23.3%, 17.7%, and 5.6% of GDP, respectively.

4. The fiscal picture is projected to get even worse in future decades: the deficit is projected to average 6.6% and 7.9% of GDP during the 2034-2043 and 2044-2053 periods, respectively. By 2053, the fiscal deficit and the gross national debt are projected to rise to 8.4% and 176% of GDP, respectively.

In short, in less than two decades, Washington has squandered the fruits of 60-years of post-WWII financial discipline. Worse, the post-war demographic dividend, the baby boomer generation, has now turned into a significant fiscal challenge due to rising unfunded liabilities in Social Security and Medicare – the Treasury Department pegs the present value of the shortfall over the next 75 years at $175 trillion, which is 75% *greater* than the size of the entire global economy.

Taxing Unrealized Gains?

It's obvious that the widening gap between Washington's spending and tax receipts needs to be narrowed. While fiscal hawks pay lip service to spending cuts, the unpleasant fiscal reality is that keeping federal tax receipts at 17% to 18% of GDP is not fiscally sustainable in the face of rising net interest expenses and demographically driven entitlement outlays. While no one expects the top personal income tax rate to return to the confiscatory levels of 70% to 94% during the first half of the post-WWII era, the current 37% rate appears transitory, and policymakers have been exploring new sources of tax revenue.

The Biden Administration's revenue proposals for fiscal year 2025 seek to impose a tax rate of at least 25% on the wealthiest Americans' income, including *unrealized* capital gains. While it's called the Billionaire Minimum Income Tax, the plan is to impose the tax on households with a net worth over $100 million. The tax on unrealized gains is intended to "eliminate the ability for the unrealized income of ultra-high-net-worth households to go untaxed for decades or generations."

The White House has also proposed to raise the tax on long-term capital gains and qualified dividends from today's 20% (23.8% including the 3.8% net investment income tax from the Affordable Care Act, aka Obamacare) to 39.6% (a 43.4% effective rate with the 3.8% surcharge) for those with a total taxable income above $1 million. For those fortunate enough to earn more than $400,000 of investment income, a 1.2% additional surcharge would be assessed to bring the top effective tax rate on long-term capital gains and qualified dividends to 44.6%. In short, for higher income earners, the proposed scheme will not differentiate between short- and long-term capital gains.

Under these proposed tax schemes, an entrepreneur with 100% ownership in a private company would be obligated to pay a 25% tax on *unrealized* gains if the company is valued at $100 million or higher. For a hypothetical privately-held business valued at $200 million with zero cost basis, the tax obligation on unrealized gains would be $50 million. At first blush, if a sole business owner cannot come up with the cash to pay the tax, they would have to raise $50 million by selling 25% of their stake in the company. However, selling $50 million worth of stake would incur a 44.6% capital gains tax, or another $22.3 million of tax liabilities. The $77.3 million of tax liabilities would thus require a divestment of 36.15% of the stake in the company, assuming there are buyers who would not demand a price concession from the seller. However, raising the additional $22.3 million would trigger further taxes on realized gains, and the remaining unrealized gains and associated tax liabilities would then be reduced. In my attempt to solve for the minimum level of divestment and total tax liabilities, I went to ChatGPT for help, which wound up producing a clearly erroneous recommendation of selling more than $200 million of shares in the hypothetical company. In short, the proposed tax on unrealized gains appears too convoluted and punishing to be enacted, and like King William III's window tax, will likely produce unintended consequences on entrepreneurship and economic vitality.

Alligiance to Foreign Tax Havens

On the corporate tax front, I suspect the 21% flat tax rate and loopholes for companies to move profits overseas will likely come under intense scrutiny in the coming years. For fiscal year 2025, the White House has proposed raising the corporate tax rate to 28% and making it retroactive to 2024.

One industry at risk of being singled out for not paying its fair share of taxes despite earning significant revenue from the government is "big pharma." These companies have been profiting handsomely in the U.S. – they are allowed to charge higher prices domestically, and America's ageing demographics and obesity epidemic have created ever growing demand. However, while the U.S. accounts for greater than half of their revenue, they have managed to transfer profits to lower-tax overseas jurisdictions to minimize their tax liabilities. At a 2023 Congressional hearing, former Treasury official Brad Setser showed how a group of eight large pharma companies managed to pay merely $2 billion in taxes to Uncle Sam on $100 billion of aggregate profits:

1. For 2022, these companies reported total sales of $385 billion that were split between $214 billion in the U.S. (56%) and $171 billion overseas (44%).

2. They reported domestic profits of $10 billion (4.7% profit margin) and booked $90 billion of overseas income (52% profit margin). Some companies even reported net losses in the U.S.

3. They paid $2 billion in taxes in the U.S. (20% tax rate) and $11 billion abroad (12% tax rate). The total effective tax rate came to 13% ($13 billion of tax paid on $100 billion of profits).

4. In their overseas operations, the profits earned in small countries with low tax rates such as Ireland, Luxembourg, and Singapore far exceeded those in bigger countries like France and Germany with higher tax rates.

While it may appear unfair that big pharma can arbitrage global tax regimes to minimize their tax liabilities, there is nothing illegal. In fact, Setser pointed out that, based on 2019 data, U.S. multinationals reported earnings of $325 billion in seven low tax jurisdictions such as Bermuda, the Caymans, Ireland, Luxembourg, the Netherlands, Singapore, and Switzerland, and only $50 billion in seven of the largest foreign economies that include China, Japan, and Germany. American companies have reported far more earnings in the Caymans than in Canada and China combined.

Gradually, Then Suddenly

In his May 24th speech, *"Some Thoughts on r*: Why Did It Fall and Will It Rise?"*, Fed Governor Christopher Waller cautioned that the financing pressure from rising Treasury debt issuance "may contribute to a rise in r*," the theoretical neutral Fed funds rate, which is currently pegged at 2.5%, "in coming years, but only time will tell how large a factor the U.S. fiscal position will be in affecting r*."

With U.S. Treasury yields serving as risk-free rates underpinning valuations for practically all assets, potentially higher Treasury yields could pressure equity valuations in future years. The investment landscape will also be affected by the evolving tax code. For example, raising capital gains and personal income tax rates would make municipal bonds even more attractive to higher income earners.

While more market participants have been warning of fiscal issues, elevated deficits have so far helped to prop up economic growth and market liquidity to boost asset prices, as was the case in 2023 and so far in 2024. With the Internal Revenue Service (IRS) poised to resume processing the Employee Retention Tax Credit (ERC), the U.S. economy could get another shot in the arm while deficits run higher than projected.

In the coming months, the timing of Fed rate cuts will likely remain the focus for investors. While the market has scaled back its 2024 rate cut expectations to only one, things could still change quickly if the nascent cracks in the job market and lower-income household spending become more visible.

By autumn, the market's focus will likely shift to post-election policy implications – roughly $4 trillion of expiring tax provisions will need to be dealt with in 2025. A red sweep may trigger an equity-positive and bond-negative market response, as GOP policy initiatives – deregulation and extending Trump tax cuts beyond 2025 – are viewed as potentially pro-growth, inflationary, and deficit-increasing. The Fed may wind up keeping interest rates higher for longer, though the return of Trump to the White House will likely lead to more public harangue against tight monetary policies.

A blue sweep will probably lead to a weaker equity market on the fear of higher taxes and regulatory burdens. The bond market may have a mixed reaction – higher taxes could potentially narrow fiscal deficits, but tax receipts may be hurt by a weaker economy. With moderate progressives Joe Manchin and Kyrsten Sinema not returning to the Senate in 2025, Democrats could also roll out big spending initiatives (remember Build Back Better?) that wind up keeping deficits elevated.

A split government may bring a sigh of relief to investors who value checks and balances, but also means continued policy gridlock. As the fiscal "sugar high" of recent years wears off, equities could lose steam on rising odds of a post-election recession, which would be bond positive as Treasury yields typically move lower on weaker growth.

Regardless of the electoral outcome, investors should not extrapolate the stimulus-filled economic and market environment of 2020-2024 into the future. In less than

five years, Washington has run up the federal debt by $11.3 trillion – a *49%* increase from $23.2 trillion at the end of 2019 to $34.5 trillion today. In order to keep a lid on inflation, we have drawn down the nation's Strategic Petroleum Reserve (SPR) in a span of two years to four-decade lows. Having borrowed so much from the future, Washington may now be constrained in its capacity to deal with future economic and geopolitical challenges.

The problem with running deficits at 5% to 6% of GDP during boom times is that the deficit could blow out to the double digits when the inevitable recession hits. With foreign central banks having slowed down their purchase of U.S. debt, the Fed will likely be compelled to restart quantitative easing (QE) as a lender of last resort to Uncle Sam in the not-too-distant future. Indeed, the CBO's projections already assumed that the Fed will increase its holdings of Treasury securities by roughly $5 trillion over the next ten years. The growing realization that the Fed may need to restart QE to help fund our government spending down the road may be one of the drivers powering gold's recent rally to new all-time highs.

In the novel The Sun Also Rises, Hemingway wrote about how one goes bankrupt: "Two ways. Gradually, then suddenly." While the U.S. government will not go bankrupt because of its ability to print money, the fiscal sustainability issue can still trigger a crisis at inopportune times – bond yields could run up rapidly when so-called bond vigilantes move in collectively to discipline the government, as was the case during the Bond Massacre of 1994. The sooner financial markets start pressuring Washington to address the issue, the better off we will be in the long run.

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