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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The Fiscally Disciplined Era

In 1781, to help fund the Revolutionary War, the Virginia General Assembly passed a window tax that levied one shilling for each glass window on all inhabited houses for four years. It would take another 132 years for the nation's tax code to evolve into today's framework – the Sixteenth Amendment's passage in 1913 finally enabled the federal government to levy personal income tax, which has grown into its largest source of tax revenue.

The federal personal income tax started with seven income tax brackets with rates moving up at 1% increments from 1% to 7% in 1913. The top rate was hiked to 77% during WWI and peaked at 94% during WWII. 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% after WWII. In 1965, President Lyndon Johnson lowered personal income tax rates to a range of 16% to 70%.

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.

Reagan 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.

As the leader of the New Democrats movement, President Bill 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.

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. President Barack 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.

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.

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Elections Have Consequences

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.

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 under this scenario.

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. 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. Having borrowed so much from the future, Washington may now be constrained in its capacity to deal with future economic and geopolitical challenges.

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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