ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

JULY 2024

Way Too Transparent?

The evolution of Fed policymaking

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Market Watch

Equity Market Indices[1]	5/31/24 Price	6/30/24 Price	MTD Change	YTD Change
MSCI All Country World	786	802	2.1%	10.3%
S&P 500	5278	5460	3.5%	14.5%
MSCI EAFE	2356	2315	-1.7%	3.5%
Russell 2000®[2]	2070	2048	-1.1%	1.0%
NASDAQ	16735	17733	6.0%	18.1%
TOPIX	2772	2810	1.3%	18.7%
KOSPI	2637	2798	6.1%	5.4%
Emerging Markets	1049	1086	3.6%	6.1%
Fixed Income				
2-Year U.S. Treasury Note	4.87%	4.76%	-12	50
10-Year U.S. Treasury Note	4.50%	4.40%	-10	52
BBG U.S. Agg Corp Spread	0.85%	0.94%	9	-5
BBG U.S. HY Corp Spread	3.08%	3.09%	1	-14
Currencies				
Chinese Renminbi (CNY/$)	7.24	7.27	0.4%	2.4%
Brazilian Real (Real)	5.25	5.59	6.6%	15.2%
British Pound ($/GBP)	1.27	1.26	0.8%	0.7%
Euro ($/Euro)	1.08	1.07	1.3%	3.0%
Japanese Yen (Yen/$)	157.31	160.88	2.3%	14.1%
Korean Won (KRW/$)	1385.00	1376.50	-0.6%	6.9%
U.S. Dollar Index (DXY)	104.67	105.87	1.1%	4.5%
Commodities				
Gold	2327	2327	0.0%	12.8%
Oil	76.99	81.54	5.9%	13.8%
Natural Gas, Henry Hub	2.59	2.60	0.5%	3.5%
Copper (cents/lb)	460	439	-4.6%	12.9%
CRB Index	290	290	0.1%	10.1%
Baltic Dry Index	1815	2050	12.9%	-2.1%

Source: Bloomberg

INTRODUCTION

Despite the continued market rally, June was a month of contradictions and uncertainties that left investors with more questions than answers.

The closely scrutinized U.S. monthly employment report had the establishment survey reporting a much stronger-than-expected addition of 272,000 jobs while the household survey showed a contraction of 408,000 in the employed population. The latter sent the unemployment rate rising to 4%, which was 0.6% above the cycle trough and a sign of an incipient recession based on historical patterns. Inflation readings came in softer-than-expected, but the Fed still dialed down the expected number of rate cuts in 2024 from three to one.

The European Central Bank (ECB) started its easing cycle by cutting its policy rate by 25 bps to 3.75%, but it also raised its inflation forecasts for 2024 and 2025. This contradiction was soon overshadowed by strong gains in the European Parliament elections by rightwing populist parties, which prompted French President Macron to dissolve the Assemblée Nationale and gamble on a snap election that has further complicated the country's fractured political landscape.

South of the border, Claudia Sheinbaum's landslide victory in Mexico's presidential election sent the country's currency and stocks reeling, as investors feared that her leftwing populist party would pursue electoral and judicial reforms to effectively eliminate political checks and balances. The Indian market sold off briefly on the news that Prime Minister Narendra Modi's party failed to win an outright majority.

These rising political risks coupled with the Tories' expected electoral Waterloo in the U.K. may have led investors to divert more funds to U.S. markets. Ironically, we also have political and policy uncertainties that may become more pronounced in the months ahead. With the U.S. economy showing warning signs of a consumer-led recession, the stock market has become more concentrated as investors have piled into a handful of AI beneficiaries. Investor optimism still appears elevated as market liquidity and fiscal stimuli have remained plentiful for now. To wit, the Congressional Budget Office (CBO) just raised the current fiscal year's deficit to $1.9 trillion, an increase of $408 billion or 27% more than its projection in February due to greater-than-expected spending. Such a spending spree is unsustainable, but to many politicians, the fierce urgency of the upcoming election supersedes everything else.

JIMMY C. CHANG, CFA
Chief Investment Officer
Rockefeller Global Family Office
jchang@rockco.com
212-549-5218

It was 45 years ago this month that President Jimmy Carter, in the face of opposition from all his political advisors, made the momentous decision of appointing Paul Volcker Fed Chair. Volker wound up being lionized for breaking the back of inflation, yet few gave Carter credit for appointing Volcker in the first place.

When Volcker took over the Fed, the primary monetary policy tool to contain inflation was to increase the fed funds rate – the interest rate that banks are charged for overnight loans from other banks to meet reserve requirements. Higher fed funds rates should theoretically increase the cost of credit to curtail borrowing and spending by businesses and consumers.

Volcker believed the Fed would need to take a more aggressive approach to enhance its own credibility and tame inflation. On Saturday, October 6, 1979, Volcker convened a special and secretive FOMC meeting, which was followed by a hastily organized weekend news conference.

Volcker's new policy initiatives sought to directly control the money supply in the system rather than target a narrow range in the fed funds rate. In other words, the Fed would take aim at controlling the quantity of money (bank reserves) instead of the price of money (interest rates). However, the trade-off was that the fed funds rate would fluctuate over a significantly wider range to restrain lending – in the fractional reserve banking system, money is created when banks increase aggregate lending and vice versa. The resulting policy directives, delivered with unanimity by the FOMC on that momentous Saturday evening, were to set the fed funds rate between 11.5% to 15.5%, lift the discount rate to 12%, and unveil higher bank reserve requirements.

Volcker's new policy prescription sent shockwaves through the economy and financial markets, and the effective fed funds rate surged to as high as 17.6% in less than three weeks. However, with high inflation expectations having become ingrained after a decade of rapidly rising prices, it would take two recessions and the fed funds rate rising to as high as 20% to finally break the back of inflation.

American President Jimmy Carter sits in the White House library for the first of his fireplace chats, Washington DC, February 2, 1977.

Greater Transparency

Volcker's successor, Alan Greenspan, was once feted as the Maestro who presided over the Great Moderation, a twenty-year period of stable inflation, steady economic growth, and muted business cyclicality. Chairman Greenspan elevated the importance of the Fed's communication with the market by initiating the publication of a Policy Statement at the conclusion of each FOMC meeting for greater transparency and market impact. Prior to 1994, policy directives from each FOMC meeting were officially released to the public two days after the subsequent meeting.

Greenspan also became famous for his nuanced communications, coined as "Fed speak," to signal the Fed's intentions and shape market expectations and behavior. Another lasting impact from the Greenspan era was the "Greenspan Put," or the "Fed Put" – the belief that the Fed would come to the rescue during market dislocations.

Greenspan's successor, Ben Bernanke, had quipped that monetary policy is "98% talk and 2% action." In November 2007, the Bernanke Fed started to publish the FOMC participants' economic forecasts, called the Summary of Economic Projections (SEP), on a quarterly basis. In January 2012, the Fed began releasing the "dot plot" – a chart that shows the FOMC members' interest rate forecasts – with the SEP. At that meeting, the Fed also formally announced an explicit inflation target of 2% as measured by the annual change in the price index for personal consumption expenditures (PCE).

Alan Greenspan, Paul Volcker and Ben Bernanke - 2014

Mere Mortals

Stock Market Opens Ahead Of Fed Chair Powell's Speech In Jackson Hole

The Fed's open communication strategy has turned Fed officials into policy rock stars as their speeches command more attention and excitement than any other public officials. However, this greater transparency has also exposed Fed officials as fallible humans who are prone to groupthink and recency bias (the tendency to overemphasize the importance of a more recent experience). What else can explain how the vaunted Federal Reserve, supported by hundreds of economics PhDs, missed the subprime crisis and post-COVID inflation?

The Fed's forward guidance might have also diminished rather than helped the organization's credibility. For example, the SEP from the December 2021 FOMC meeting pegged the fed funds rate at the end of 2022 at 0.9%, even as inflation accelerated to nearly 7%. That SEP's 2.1% fed funds rate projection for year-end 2024 reflected the Fed's erroneous belief that the most virulent inflation in four decades can be brought back down to 2% with rates remaining accommodative (i.e., below the 2.5% "neutral" fed funds rate). Senior executives at Silicon Valley Bank might have taken that dovish forward guidance to heart and subsequently failed to hedge their holdings of longer-dated Treasuries, eventually triggering significant losses and the bank's collapse.

Last November, in an op ed titled "*Federal Reserve Officials Talk Too Much*", seasoned market observer Mohamed El-Erian wrote that during a prior week, eleven top Fed officials had given 20 speeches. We've also seen dueling Fed speakers seemingly debating policies in public. It is understandable that there is mounting concern about overcommunication by the Fed and the unintended market impact. To wit, in early January 2024, some investors had priced in as many as seven rate cuts for 2024. At the most recent FOMC meeting, the dot plot reduced the projected number of rate cuts in 2024 from three to one, though Chair Powell said it's a close call between one and two.

The likelihood of a rate cut at the September FOMC meeting has increased with recent softness in retail sales, conflicting employment data, and improving inflation readings. A few more upticks in the unemployment rate might enable Chair Powell to convince policy hawks to get on board with an insurance rate cut against a potential recession.

After the September FOMC meeting, the future path of the fed funds rate will be heavily influenced by the outcome of the November election. This is where the dot plot predicting policy rates two or three years out makes little sense. There are at least four electoral scenarios with potentially different fiscal policy prescriptions to impact inflation and economic growth. Some have warned that a Republican sweep may even prompt the Fed to consider hiking rates in 2025.

With the U.S. general election in November being a pivotal event in this age of fiscal dominance, many things may be kept in a holding pattern for now. This may explain why stock markets have become so concentrated with a few AI related stocks – having secular tailwinds – leading the pack while the rest confront policy and economic uncertainties. Year-to-date through June, the S&P 500 Equal Weight Index trailed the S&P 500 Index 5% to 15.3%, and the economically sensitive Russell 2000 Index returned less than 2%. Such an environment calls for some rebalancing even though it has been psychologically difficult to trim the big winners.

On the fixed income side, I continue to favor extending duration since it's just a matter of time before the Fed starts easing. In addition, the pace of easing could turn aggressive next year as the unprecedented fiscal stimuli start to wear off.

One casualty of the Fed's "higher-for-longer" interest rate policy is pension fund and endowment cash flows from illiquid investments. Higher rates have slowed initial public offerings (IPOs) and mergers and acquisitions (M&A) activity needed to fund cash distributions to these institutional investors. The reduced cash distribution has left many private equity investors in limbo, and some are forced to sell their stakes at a steep discount, which creates an opportunities in the private equity secondaries market.

There is a role for gold in a diversified portfolio as it is a hedge on policy mistakes, especially on the monetary front. In the near term, gold also serves as a haven in the face of elevated geopolitical issues, especially with Israel and Hezbollah appearing to be on a collision course for greater military clashes.

In the final analysis, with the secular bond bull market likely in the rear-view mirror, the Fed and investors will need to adjust to potentially higher secular inflation and neutral rates. Such an environment portends higher volatility despite the market's recent complacency. The November election will also have a far-reaching impact on monetary policies as the next administration and Congress will nominate and confirm Chair Powell's successor in 2026. An overtly political appointee could damage the Fed's hard-earned reputation as Washington's last bastion of responsible stewardship, as well as market confidence. The ideal pick would be someone with the courage and stature of the late Paul Volcker.

PRINCIPAL AUTHOR

Jimmy C. Chang, CFA

Chief Investment Officer
Rockefeller Global Family Office

EDITOR

Joan Park

Investment Strategy Specialist
Rockefeller Global Family Office

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ROCKEFELLER
GLOBAL FAMILY OFFICE

45 ROCKEFELLER PLAZA FLOOR 5
NEW YORK, NY 10111

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