Rockefeller Global Family Office
45 Rockefeller Plaza, Floor 5
New York, NY 10111

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Jimmy C. Chang, CFA

Chief Investment Officer
Rockefeller Global Family Office
(212) 549-5218 | jchang@rockco.com

The Great Transformation

Dawn of a progressive era; Biden's Fed legacy

The financial market's reflation thesis was reinforced with the passage of the $1.9 trillion American Rescue Plan Act and the accelerated rollout of vaccines across the country. Higher growth and inflation expectations drove the 10-year Treasury yield up 34 bps in March and 83 bps YTD to close at 1.74% at the end of the first quarter. Despite the fear of bond yields rising too much too fast, equities still went on a tear with the S&P 500 Index price gaining 4.2% for March and 5.8% for the first quarter. By the end of March, the reflation expectation along with "helicopter money" from the Fed and the Treasury drove institutional and retail investor sentiment to multi-month highs. Indeed, the risk-seeking appetite was so strong that a Non-Fungible Token (NFT) of a digital collage of images by a hitherto little-known digital artist was sold for over $69 million by Christie's. To be clear, that NFT did not even include the copyright to the digital work; it was merely a blockchain ledger which points to a file that stores a copy of the images. I can't help but recall those vintage Crazy Eddie commercials with the pitchman shouting, "The prices are insaaaane!"

While the U.S. managed to accelerate the pace of vaccine delivery, Europe was hit with the perfect storm of under procurement, blood-clot-induced suspensions, and anti-vaccination sentiment. More infectious variants of the SARS-CoV-2 virus also pushed up daily new case counts there, prompting several countries to reimpose varying degrees of lockdown. Japan's hospitality industry let out a collective sigh of resignation after Tokyo Olympics organizers decided to ban foreign spectators. Concerns over the relative weakness in foreign economies sent the greenback higher but took down commodity prices.

Archegos Capital Management, a little-known family office, shot to global fame (or infamy, to be precise) as it was hit with the "margin call of the century." Several investment banks frenetically unloaded tens of billions of dollars worth of stocks tied to Archegos' leveraged bets. It was the third high-profile financial "blow-up" over the past three months – Melvin Capital had to be bailed out and Greensill Capital filed for Chapter 11 – even though financial conditions have been extremely accommodative. While the billions of dollars of estimated losses by banks did not appear to have triggered a systemic crisis, it begs the question of other hidden risks in the system, including what may happen when the Fed eventually starts tightening. Regulatory agencies have begun to look into this situation, which would hopefully forestall similar mishaps in the future. Investors were also reminded not to confuse risky leverage with investment genius.

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PEAK LIBERALISM

Lyndon Baines Johnson, aka LBJ, had reached the zenith of power upon defeating Senator Barry Goldwater in the 1964 presidential election by a landslide – his 61 percent of the popular vote was the largest share of any candidate since James Monroe's uncontested victory in 1820. The burly Texan, known for his domineering personality and bare-knuckle politics, was brimming with confidence that he was about to effectuate the biggest social transformation since FDR's New Deal. He had allegedly characterized Harry Truman's Fair Deal as small potatoes, dismissed Dwight Eisenhower for having sat on his hands for eight years, and lamented that John F. Kennedy couldn't get the Congress to pass the time of day. LBJ had unveiled his vision, the Great Society, during a speech in May 1964. It encompassed lofty goals of ending poverty and racial injustice, reforming education, building out urban centers and the country's transportation infrastructure, and conserving the environment.

Having already spent 24 years in Congress and 4 years at the White House, LBJ was keenly aware of the nature of presidential power. He knew that his ability to influence would dwindle with each passing day as his political capital gets used up on various issues, especially the unexpected. He asked his staff to leverage the transient honeymoon period with Congress to get as many programs passed as possible before the halo effect faded into oblivion.

LBJ's assessment of his political capital turned out to be prescient. Vietnam soon became a distraction as he was compelled to escalate America's military advisory role in Saigon despite his gut instinct that things would end badly. In February 1965, he approved a systematic air bombing campaign – Operation Rolling Thunder – to halt the Viet Cong's advances and to retaliate for its killing of U.S. military advisors. However, the situation soon deteriorated rapidly, prompting General Westmoreland, the top military field commander, to request a large, open-ended build-up of troops in early June. It was, in effect, a proposal to Americanize an open-ended war with no clear exit plan.

LBJ's staff presented him with a gamut of options from seeking Congressional authorization to invade North Vietnam to an exit with a negotiated peace as a fig leaf. LBJ knew that an invasion was unrealistic and prohibitively expensive, but an exit from South Vietnam could ruin his Great Society agenda. While his landslide electoral victory had given Democrats control of more than two-thirds of the seats in each chamber of Congress, LBJ worried that a retreat from Vietnam could incense hawkish Dixiecrats to team up with Republicans to filibuster his civil rights and social programs. He was also afraid that Robert F. Kennedy, the newly-elected Senator from New York with presidential ambition, would accuse him of reneging on his late brother's commitment to Vietnam.

Equity Markets Indices[1]	2/28/21 Price	3/31/21 Price	MTD Change	YTD Change
MSCI All Country World	657	673	2.5%	4.2%
S&P 500	3811	3973	4.2%	5.8%
MSCI EAFE	2169	2208	1.8%	2.8%
Russell 2000®[2]	2201	2221	0.9%	12.4%
NASDAQ	13192	13247	0.4%	2.8%
TOPIX	1864	1954	4.8%	8.3%
KOSPI	3013	3061	1.6%	6.5%
Emerging Markets	1339	1316	-1.7%	1.9%
Fixed Income				
2-Year US Treasury Note	0.13%	0.16%	3	4
10-Year US Treasury Note	1.41%	1.74%	34	83
BBG Barc US Agg Corp Sprd	0.90%	0.91%	1	-5
BBG Barc US Corp HY Sprd	3.26%	3.10%	-16	-50
Currencies				
Chinese Renminbi (CNY/$)	6.48	6.55	1.1%	0.4%
Brazilian Real (Real)	5.60	5.63	0.5%	8.4%
British Pound ($/GBP)	1.39	1.38	1.0%	-0.9%
Euro ($/Euro)	1.21	1.17	2.9%	4.1%
Japanese Yen (Yen/$)	106.57	110.72	3.9%	7.2%
Korean Won (KRW/$)	1123.40	1131.90	0.8%	4.2%
U.S. Dollar Index (DXY)	90.88	93.23	2.6%	3.7%
Commodities				
Gold	1734	1708	-1.5%	-10.0%
Oil	61.5	59.2	-3.8%	21.9%
Natural Gas, Henry Hub	2.77	2.61	-5.9%	2.7%
Copper (cents/lb)	409	400	-2.4%	13.5%
CRB Index	190	185	-2.9%	10.2%
Baltic Dry Index	1675	2046	22.1%	49.8%

Source: Bloomberg

In order to preserve the momentum in advancing his domestic agenda, LBJ chose to finesse the Vietnam issue. He would placate Congressional hawks by meeting General Westmoreland's requests and by permitting him to go on the offensive. However, LBJ downplayed the Americanization of the war by claiming in public that there was no real change in his Vietnam policy.

LBJ's political maneuvering worked like a charm as he was able to get the 89th Congress to pass 84 of his 87 submitted bills, the most impressive legislative achievement in congressional history. The Great Society initiatives created Medicare, Medicaid, Head Start, food stamps, and expanded Social Security. LBJ also got Congress to pass

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the Voting Rights Act, expanded immigration from non-European countries, significantly increased aid to public education, and established the National Endowments for the Arts and Humanities. The federal bureaucracy was expanded with creation of the Departments of Transportation as well as Housing and Urban Development. It was the zenith of American liberalism.

Unfortunately, LBJ did not have much time to savor his domestic policy accomplishments. His popularity started to slip in 1966 as Vietnam had become a quagmire. American troops in Vietnam had grown from 23,300 at the end of 1964 to 184,300 by year end 1965; the number would eventually peak at 536,100 in 1968. LBJ was stigmatized with the term "credibility gap" as many sensed that he was less than forthcoming about what was really happening in Vietnam. By the time that LBJ started his re-election campaign in early 1968, he was hounded with people chanting, "Hey, hey, LBJ, how many kids did you kill today?" On March 31, 1968, at the end of a televised speech on the war, the weary president shocked the nation by announcing that he was pulling out of the election.

Upon boarding Air Force One for the final time on January 20, 1969, the outgoing president lit up a cigarette for the first time since his heart attack in 1955. Exiled by his own party despite his great advancement of liberal causes, the trip back to Texas marked the start of his self-destructive spiral with chain smoking and overeating.

On the afternoon of January 22, 1973, secret service agents rushed to LBJ's house after receiving his call for help. LBJ was found unconscious and alone in the bedroom, with the telephone receiver still gripped in his hand. He was rushed to the hospital and pronounced dead on arrival.

PEAK LIBERALISM REDUX?

Nineteen days before LBJ's passing, a tall 30-year-old with thinning hair was sworn in as the youngest member in the Senate. No one could have predicted at the time that this freshman senator from Delaware would embark on a similar political journey as LBJ – decades of deal-making in the Senate; VP to a young and inexperienced, but charismatic President; and finally reaching the pinnacle of power despite many misgivings among his own party's activists.

For most of his career, Joe Biden has been regarded as a nice guy and a political moderate; he is affectionately called "Uncle Joe" by some. However, emboldened by the Democrats' control of both chambers of Congress, albeit at razor-thin margins, President Biden is embarking on the most transformative progressive agenda since LBJ. Indeed, at a recent roundtable with several presidential historians in the East Room, the President reportedly peppered them with questions about FDR - a clear indication of his ambition to go big.

The Biden Administration will follow the passage of the $1.9 trillion American Rescue Plan Act with two multi-trillion-dollar infrastructure bills (the $2.25 trillion package is just the first of two planned bills) partially funded by tax hikes. On the social policy front, Democrats' legislative agenda largely encompasses three categories: immigration reform, voting rights expansion, and gun control. Some of these issues will energize activists on both ends of the ideological spectrum.

In anticipation of the GOP's fierce opposition, Democrats have been calling for the repeal of the Senate's filibuster rule. As recently as early March, the White House had signaled President Biden's preference for status quo on this issue. However, progressives, with the help of the media, have cleverly coaxed the president to agree at his March 25th press conference that filibuster is a "relic of the Jim Crow era." It's a shrewd move that makes it hard for the White House to not support watering down or repealing the rule. Republicans cried foul by pointing out that the filibuster rule traces its origin to 1806 and it was Senate Democrats that broke the record in filibuster usage by a wide margin during the Trump presidency. The fate of the filibuster rule will likely depend on whether centrist Democrats like Senators Joe Manchin and Kyrsten Sinema will go along with the progressives. Repealing or substantially degrading it will likely mark a watershed moment in American politics, as some view it as the last line of defense against the "tyranny of the majority." Democrats should also heed the warning that elephants have a very good memory.

MANNA FROM HEAVEN

Since the start of the pandemic, the federal government has allocated $5.3 trillion of emergency spending to bail out the economy. To put this number in perspective, it exceeds the total cost of World War II that spanned four years – $4.1 trillion adjusted for inflation to today's dollars. This massive injection of money into the economy along with the salutary impacts of the faster-than-expected vaccination rollout will likely turbocharge the U.S. economy in 2021. The passage of the $1.9 trillion rescue fund has prompted the Federal Open Market Committee (FOMC) to increase its 2021 real GDP growth projection from last December's 4.2% to 6.5%. It also lowered its unemployment rate expectation to 4.5% for year end 2021, and to 3.5% by the end of 2023. Importantly, the FOMC acknowledged that inflation will likely pick up – its core PCE inflation expectation was revised up to 2.2% by year end 2021, and to 2.1% by the end of 2023. However, despite these upward revisions on growth and inflation forecasts, the FOMC still expects to keep the Fed Funds rate unchanged through 2023.

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Congressional Republicans have been unified in their opposition to the $1.9 trillion rescue package, which they claimed to be bloated with Democratic goodies to bail out blue states' profligacy. Putting partisan rhetoric aside, the massive package is indeed about quick dissemination of money to various entities rather than targeted investment for the future. About $740 billion are earmarked for individuals (e.g., the $1,400 check for qualified adults and children, unemployment programs) and small businesses (e.g., grants to restaurants). There are also $143 billion of tax credits for this year. For example, the expanded Child Tax Credit will give $250 per month to each qualifying child ages 6 to 17, and $300 per month for each qualifying child under the age of 6. Washington will also dish out $350 billion to state and local governments, and $86 billion to bail out 185 union pension plans.

Democrats would argue that money earmarked for education can be considered an investment for the future. The rescue package has $123 billion for K-12 education and a $40 billion allocation for higher education. The former will help alleviate many public schools' budget issues over the next three and a half years. However, the latter is not allowed to be used for capital projects, and half of the $40 billion needs to be spent on financial aid.

THE INFLATION DEBATE

To the Democrats' chagrin, Republicans have found an unlikely "ally" in their opposition to the rescue bill – Lawrence H. Summers, a one-time Washington insider who had served as President Clinton's Treasury Secretary and President Obama's Director of National Economic Council. Summers, who is not known to mince words, warned that the U.S. is experiencing the "least responsible fiscal macroeconomic policy" in four decades and both political parties are to blame. He predicted that there is a one-in-three chance that inflation expectation will become unanchored as the U.S. economy may face the "most serious incipient inflation problem" in four decades. He also pegged an equal chance that inflation expectation will be held back by future tightening that would cause a recession. That leaves the probability of success – a soft-landing to full employment and 2% inflation with no economic disruption – at just 33%.

Larry Summers' "going rogue" on the Biden Administration has led to rebuttals from policymakers, liberal economists, and investment strategists. They have sought to downplay the risk of higher inflation beyond the next few quarters with one or several of the following arguments:

1. The fiscal rescue plan is just a temporary sugar high and the economy will likely slip back to "secular stagnation" sooner than investors may realize.
2. Secular forces such as aging demographics and technology will still exert deflationary pressure.
3. It took many years of policy mistakes in the late 1960s and 1970s for inflation to become a real issue; we are far from it today and the Fed knows what it's doing.
4. Even if inflation becomes a real threat, the Fed has plenty of tools to clamp it down.

While these are all sound arguments, one cannot dismiss the influence of recency bias. Many forecasters might have convinced themselves that disinflation is likely to remain the dominant trend because inflation was subdued for most of the last decade despite very loose monetary policies. Indeed, the Fed appears to be so comfortable with its transitory inflation meme that it has opted to ditch its crystal ball and adopted an outcome-based policy - the august body will not tighten until inflation becomes entrenched above 2% for an extended period of time.

I believe the real test for the Fed will likely be the December FOMC meeting. The Consumer Price Index (CPI) would have risen sustainably above 2% by then. Congress should have just passed the $3 trillion "Build Back Better" infrastructure bill via budget reconciliation. Assuming that the economy has indeed grown at or better than the FOMC's latest 6.5% projection, how will the FOMC participants adjust their economic forecasts and the expectations for the Fed Funds rate with additional stimulus to be injected into the economy? Will Chairman Powell still insist that the zero-interest rate policy will be maintained through 2023?

RESHAPING THE FED

Those who claim that it took years of policy mistakes at the Fed to stoke higher inflation in the 1970s often blame former Fed Chairman Arthur Burns for succumbing to President Nixon's pressure to keep interest rates low. In reality, the inflation genie was already out of the bottle even before Burns became the Chairman in 1970. As discussed in last month's report, it was LBJ's "guns and butter" policies that sowed the seeds of higher inflation. The pace of U.S. federal government spending had accelerated from a 5% annual rate between 1961 and 1965 to 13.7% annualized from 1966 to 1968. Coincidentally, after languishing below 2% for seven years, inflation rose above that threshold in early 1966; it exited that year at 3.5% and subsequently surged to 6.2% by year end 1969.

Since its founding in 1913, the Federal Reserve has experienced many bouts of intervention from the White House in spite of its supposed independence. LBJ had once shoved Fed Chairman William McChesney Martin Jr. against the wall in late 1965 after failing to coerce him to stop hiking rates. During that incident at LBJ's Texas ranch, the president had reportedly shouted something like, "My boys are dying in Vietnam and you won't print the money I need." Before he was unceremoniously banned for life from Twitter, President Trump had sent out more than 100

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tweets aimed at jawboning Chairman Powell to pursue a loose money policy.

With the genteel Uncle Joe in the White House, I doubt that Chairman Powell is at risk of being manhandled or publicly humiliated. However, with his current term as the Chairman ending next January, it is not far-fetched to suspect that he might feel a tiny tinge of pressure to keep a loose monetary policy stance. It's probably not lost on the Chairman that his predecessor, Chair Janet Yellen, is now at the helm of the Treasury Department and favors a very progressive agenda. The winds of change in Washington have also prompted Chairman Powell to weave issues such as climate risks and racial inequality into his public comments and policy initiatives.

Progressives are probably salivating at the prospect of reshaping the Fed to be more supportive of the Democrats' big government agenda as President Biden will appoint four individuals to the seven-member Federal Reserve Board of Governors before the mid-term election. It's probably a foregone conclusion that the Vice Chair for Supervision, Randy Quarles, will be replaced when his term is up in October 2021. The new administration would prefer a progressive to regulate banks. It is not clear if Chairman Powell will be reappointed for another term, but I suspect the progressive wing of the Democratic party will lobby for someone with a more diverse background. President Biden will also decide whether to retain the highly regarded Vice Chair Richard Clarida when his term is up in September 2022. Lastly, there is a vacant position that President Biden can easily fill in the coming months.

A progressive transformation of the main governing body of the Federal Reserve System could go a long way in fostering a closer relationship between the central bank and the White House. In a progressive era with fiscal policies becoming the dominant driver of the economy, one could argue that the real unspoken mandate of the Fed is to facilitate Uncle Sam's deficit spending and debt financing. While no self-respecting Fed official would ever admit to such a heresy, the so-called bond vigilantes may start to anticipate the upward pressure on inflation in the long run. In short, I remain concerned that inflation could wind up surprising markets on the upside even beyond the post-pandemic cyclical recovery phase.

THE PROGRESSIVE TRANSFORMATION

When viewed from the angle of ideological leaning or actual control, it's probably fair to say that many key institutions – the executive and legislative branches of the federal government, the mainstream media, social media, and our higher education system – have turned "blue." President Biden also has a golden opportunity to reshape the Fed through key appointments over the next 18 months. Progressives have yet to achieve total ideological dominance as conservatives still have the upper hand on the Supreme Court, the radio airwaves with right-wing talk shows, and the filibuster rule in the Senate as the last line of defense. On balance, however, it appears that progressives have an overwhelming edge.

Progressives could significantly expand their political dominance if the filibuster rule is repealed. It would pave the way for the passage of not only their proposed immigration and voting rights bills to enhance their electoral edge, but also the D.C. Admission Act to create a deep blue 51st state with one House and two Senate members. Free of filibuster, Democrats could reshape the Supreme Court by adding more seats or setting term limits. While these are pure conjectures at this point, should they come to fruition, the conservatives' edge will be confined to just the radio airwaves, a category with an aging and dwindling audience.

POLITICAL SENSE & SENSIBILITY

I suppose some of my conservative friends are probably feeling demoralized these days. Democrats' goodie-laden stimulus bills are quite popular with most Americans and should continue to generate fiscal tailwinds for the Democratic base going into the mid-term election. The GOP seems to lack a coherent message and still faces internal battles between Trump loyalists and the so-called country club Republicans. Five Republican senators have decided not to run for re-election in 2022, which may enable Democrats to make more gains in the Senate. However, in spite of these seemingly overwhelming advantages, Democrats may still lose the House in November 2022.

Since World War II, the White House incumbent's party tended to lose mid-term elections by an average of 26 seats in the House. With Democrats currently having a slim margin of 219 to 213 with 5 vacancies, the GOP will need to flip a net of just 5 seats to retake the House. Republicans will likely exploit two of the progressives' vulnerabilities – the migrant issues at our Southern border, and the Kafkaesque cancel culture championed by some on the left. The former has been a standard wedge issue in American politics for decades, and the latter has alarmingly grown beyond college campuses into the real world.

The cancel culture phenomenon is eerily similar to some of the tactics used in totalitarian societies to enforce conformity and obedience. Here in the West, the cancel culture has created a climate of fear to cower individuals and businesses into silence or even submission. It has investment ramifications as companies could be unfairly hit with boycotts and reputation damage, and policymaking could also be impacted. Former President Obama was prescient to have eloquently called it out in 2019, "This idea of purity

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and you're never compromised and you're always politically 'woke' and all that stuff. You should get over that quickly. The world is messy, there are ambiguities. People who do really good stuff have flaws." I suspect the GOP will attempt to make the cancel cultural an electoral issue as Richard Nixon had done with the culture war in the 1968 general election. Left unchecked, it may drive the so-called silent majority, a term coined by former President Nixon, to cancel many progressive candidates in the upcoming mid-term election. History does not repeat itself, but it rhymes.

BUMPIER RIDE AHEAD

In the final analysis, COVID-19 has accelerated America's embrace of big government and our officials don't even bother with the pretense of fiscal probity anymore. Remember how we used to be awed by President Obama's $787 billion fiscal stimulus and the promise of President Trump's $1 trillion infrastructure program? These numbers are a yawner today as we have become de-sensitized by multi-trillion-dollar spending packages. Unfortunately, there is no such thing as a free lunch. Ultimately, the big government agenda is likely to result in higher inflation, more taxation, and less liberty. Interestingly, these are the prescriptions to narrow wealth and income inequalities as higher inflation would reduce financial asset valuations and the impact of taxation is, well, self-explanatory.

I expect long bond yields to climb even higher in the coming quarters even though they probably won't move up in straight lines. The greenback appears to have upward momentum in the near-term thanks to America's vaccine supremacy, but the intermediate-term trend is likely lower due to our rising twin deficits and other regions' catch-up in herd immunity. These potential developments favor floating rate securities, investments with shorter durations such as preferred and cyclical stocks, and overseas equities. Real assets such as select industrial and precious metals will likely be buoyed by higher inflationary expectations.

Financial markets are still in the honeymoon period with the new administration. However, market narratives will gradually evolve from a predominantly good news period (vaccination, stimulus, re-opening, etc.) to a less accommodative mode (higher inflation, higher yields, higher taxes). I believe the bull market is still the overriding trend until proven otherwise, but the elevated sentiment also makes the market vulnerable to corrections. In short, the "easy money" (if there was ever such a thing) has been made, and the ride ahead will likely be bumpier.

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