ROCKEFELLER
GLOBAL FAMILY OFFICE

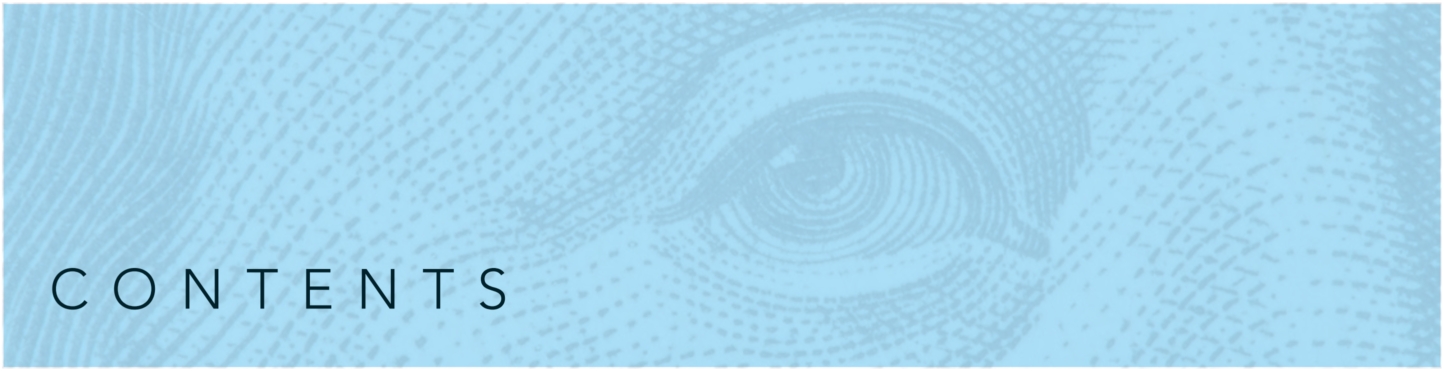
ISSUE 1

FEBRUARY 15, 2023

MACRO & MARKET OUTLOOK FOR 2023 AND BEYOND

A NEW ERA

The world is at a major inflection point of crucial, long-term secular trends. In this series, we look at the major transformations set to dominate the macro environment for the coming decade.



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F O R W A R D

Dear Reader,

This is a story about how the world may look over the next ten years, and beyond. Cyclical forces tend to take center stage in discussions around seeking new opportunities and managing potential challenges. However, we strongly believe that we are now at a rare, pivotal moment. The world is at a major inflection point in crucial, long-term secular trends that generally sustain for decades. The launch of this "A New Era" series is aimed at helping investors understand how to navigate this sea change.

In many ways, the next decade will look very different, if not opposite, from what we have experienced in the prior decade. The era of easy money is over; no more "rising tides lift all boats." The new macroeconomic environment will likely be characterized by higher uncertainty, higher inflation and real rates, and more modest global growth. The investment implications of such once-in-a-generation structural transformations are abundantly profound, with cascading effects unfolding in the coming years. What's clear is that the investment strategies that worked particularly well in the past decade will be more challenged in the next.

There are clear reasons for caution, pause, and reflection: it is well known that investors have the tendency to chase momentum; to look in the rear-view mirror and double down on winning strategies that have delivered the most handsome returns. This is particularly risky when the supporting macro and market forces are now in reverse. There are also ample reasons for optimism. The potential for outsized returns is often the greatest during those rare moments of radical transformations in the macroeconomic environment. Such a moment is now.

C H L O E D U A N S H I , C F A ®

Head of Investment Research & Strategy
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SIMMER & ERUPTION

HOW WE GOT HERE

By any measure, the past three years have been extraordinary.

2020 was a year of great loss and despair, brought on by a pandemic that ravaged the world. As the pandemic raged on, the initial shock faded and created a period of healing and hope.

2021 was a year of brazen optimism, fueled by the determination to recover and rebuild. Historic events, such as wars, typically present opportunities for structural transformations: the chance to tear down and forge something new.

In this instance, however, the world did not march down a fresh path when it emerged from the wreckage of the pandemic, partly due to the rapid speed at which major events unfolded in the previous two years.

Instead, we saw a rapid acceleration of existing economic, political, and social dynamics that had already been simmering for quite some time.

Tensions continued to build before erupting in 2022, first in the form of peak inflation uncertainty and then followed by peak rate uncertainty.

The world faced a series of exceptional challenges: from the Russian invasion of Ukraine to an unprecedented energy crisis in Europe, from China's continued lockdowns and widespread financial distress to the UK's sterling meltdown.

To some extent, these crises served as side plots for the global financial system that helped push the main story forward: the central narrative of 2022 was the world's confrontation with the cumulative consequences of the pervasive reliance on monetary and fiscal stimulus.

> *The central narrative of 2022 was the world's confrontation with the cumulative consequences of the pervasive reliance on monetary and fiscal stimulus.*

This story was further complicated by other issues, among them the continuous rise of protectionism globally, outstanding vulnerabilities within energy transition, and deepening demographic crises.

We expect that 2023 will mark the end of the tightening cycle narrative in the context of near-term positioning. As the market prepares for a landing, asset class behaviors are increasingly reflecting peak growth uncertainty.

LOOKING AHEAD

Looking further ahead, we believe that the events that transpired over the past few years as a result of the "simmer and eruption" dynamic will be remembered in the history books as a pivotal period with profound implications for investors.

It is generally quite profitable to be correctly aligned with the long-term direction the world is traveling.

Importantly, the potential for outsized returns is the greatest during those rare moments of radical transformations in the macroeconomic environment.
That moment is now.

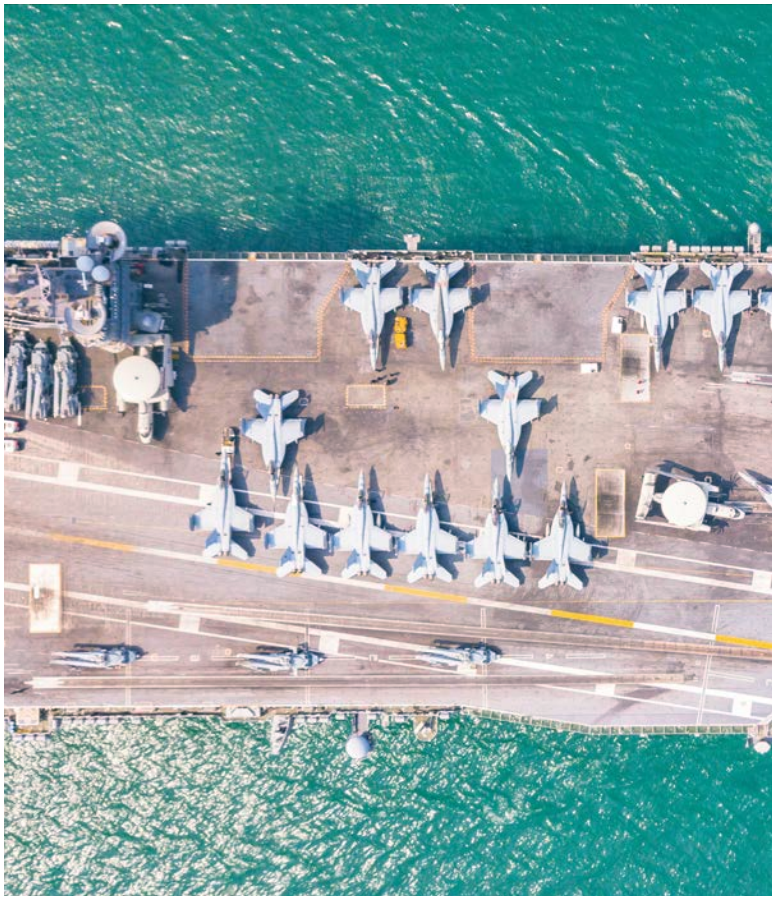
The world is in the midst of a collision of multiple, simultaneous inflection points of major long-term trends that generally sustain for decades.

We would note that the transition from one regime to another is not linear or immediate due to the cyclical forces at play. Rather, it is a more nuanced, volatile, and iterative process. It is likely that we will take a step back before moving forward. Therefore, it is crucial to differentiate cyclical from secular dynamics.

A NEW ERA

THE PATH FORWARD

The new regime is likely to be dominated by the following four macro themes:



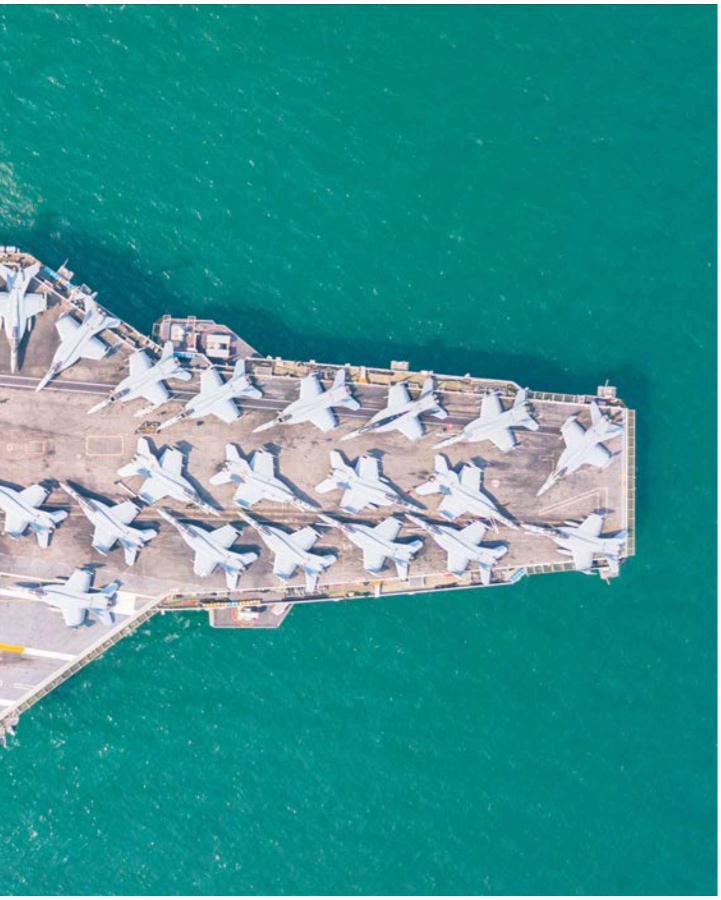
I. A more uncertain world, with increased geopolitical instability & heightened policy risks

The past few years have underscored the significant challenges of heightened geopolitical risk for investors. who have come to embrace the reality that geopolitical dynamics influence financial market outcomes and reshape the global economy in consequential ways.

Instability has been on the rise, fueled by intensifying pressure from multiple fronts, from China's aggressive repression of liberalism coupled with rising global ambitions, to the increasing mistrust of the US by the Gulf States, and the list goes on.

In response, countries have begun to intervene more actively in their economies, as environmental and technological policies increasingly overlap with political and security agendas.

This dynamic, charged by rising nationalism and protectionism, has contributed to ever increasing policy risks. As we elaborate in the following, this backdrop of a more uncertain world has profound implications for shifts in fundamental macro forces, e.g., inflation, growth, and rates, ultimately leading to more volatile market movements and asset returns.



II. Structurally higher inflation and inflation uncertainty

While the underlying drivers of today's elevated inflation will abate as the tightening cycle continues, we see the deflationary pressure that dominated the past two decades in retreat. In its place, new sources of inflationary pressure have emerged:

Rising geopolitical instability, nationalism, and protectionism have intensified the push for deglobalization, which is synonymous with an increase in reshoring efforts, input costs, tariffs, and subsidies for domestic production.

We have also observed that the heightened focus on national and business security is unleashing a significant capital expenditure (capex) wave towards improving resilience (e.g., from "just in time" to "just in case") against more frequent geopolitical shocks.

The accelerated energy transition movement is also inflationary due to a combination of intense, ongoing investments in green technologies and infrastructure, as well as continued reliance on fossil-fuels and rising demand for raw materials.

A global economy that is more dependent on commodities due to structural trends with no short-term supply solutions is likely to experience not only higher inflation but also higher inflation uncertainty.

Rising wages – led by the redistribution of income from pro-capital to pro-labor – also contribute to structurally higher inflation, especially given the upward sticky nature of wages.

Income and wealth inequality in the US has been on the rise since the 1980s, when union membership began to decline. Rapid globalization and technological advances in the 21st century further contributed to the widening of the income and wealth gap.

The resulting widespread discontent among workers has fueled political turmoil, exerting pressure on governments to take action to reduce inequality via policies such as progressive taxation and higher minimum wages.

III. More modest global economic growth

From the perspective of the equity market, the impressive earnings growth over the past market cycle, especially in the US, was significantly influenced by margin expansion, especially among large, multi-national companies.

The major forces behind such margin expansion – taxes, policies, wages, and raw material costs – all appear to have hit their limits and are now in reverse.

For example, the golden era of continued declines in corporate taxes is likely behind us. With globalization in retreat, there are fewer incentives for countries to compete for foreign investments by offering more favorable taxation policies. In addition, the fiscal debt overhang facing many countries may inevitably result in an increase in corporate taxes.

Despite greater government intervention in the economy, fiscal support for growth is likely in retreat. Following the recent inflation shockwaves, national debt monetization via stimulating inflation is unlikely to be a viable solution going forward.

As the risk of fiscal instability becomes a realistic issue even for large, developed economies which are saddled with growing entitlement spending demands, we expect greater fiscal discipline and potentially even austerity measures in some instances.

From the perspective of the broader economy, the math is simple; growth is a function of two variables: demographics and productivity.

A rapidly aging population in the more advanced economies points to fewer skilled workers, a situation made worse by structural skillset mismatches and COVID-related early retirement.

The offset effects from immigration may be hindered by rising protectionism and nationalism.

On the productivity side, while capex is generally associated with enhanced efficiency and greater output, the primary objectives in the new paradigm may be more convoluted.

Specifically, investments that are intended to improve security and resilience do so by increasing redundancy. The rise of non-economically motivated capex poses a headwind to productivity.

IV. Higher real rates and steeper yield curves

Despite our outlook for more modest growth globally on a real basis, we expect real rates – which in theory should be loosely associated with long-term economic growth – to be structurally higher, particularly on the longer-end of yield curves.

The main force at play is the reversal of monetary policies: from friend to foe. Rather than remaining in a stimulative posture on a perpetual basis (made possible by a lack of inflationary pressure in the past two decades), central banks going forward will prefer to be more balanced between neither stimulative nor restrictive.

In addition, central banks across developed countries face the question of what to do about their balance sheets, which grew rapidly in recent years through consecutive rounds of quantitative easing.

Allowing balance sheet roll off would withdraw significant liquidity from the economy, pushing the cost of borrowing higher, especially on the longer end where treasury yields are more influenced by supply and demand dynamics and thus more sensitive to central banks' retreat from bond markets.

Another driver for steeper yield curves is structurally higher inflation. Intuitively, term premium – a key determinant of the steepness of yield curve slopes – should be higher when inflationary uncertainty is greater.

In the past decade, term premium generally remained stubbornly negative, due to a combination of a collapse in upside inflation uncertainty as well as favorable technicals. Both dynamics are moving in opposite directions.

NOTABLE SECULAR TRENDS

> *It is quite clear that our case for the major shifts in macroeconomic dynamics is shaped by the rise of or acceleration in a number of influential secular trends.*

On the following pages, we highlight the most notable secular trends. We will examine each via a series of publications in the coming weeks.

01

ENERGY TRANSITION:

Truth & Ironies

potential long-term macroeconomic effects:
higher inflation, higher rates, mixed on growth

GLOBALIZATION RESHAPED:

Intensifying Geopolitical Tensions & Risks

potential long-term macroeconomic effects:
higher inflation, higher rates, lower growth

02

NOTABLE SECULAR TRENDS

CAPITAL EXPENDITURE:

From Efficiency to Security, Resilience, and Redundancy

potential long-term macroeconomic effects:
higher inflation, higher rates, lower growth

03

HUMAN ELEMENTS:

Wages & Demographics

potential long-term macroeconomic effects:
higher inflation, higher rates, lower growth

04

FISCAL SUPPORT:

Endeavoring to Retreat from the Debt Overhang

potential long-term macroeconomic effects:
mixed on inflation, mixed on rates, lower growth

05

MONETARY POLICY:

From Friend to Foe

potential long-term macroeconomic effects:
mixed on inflation, higher rates, lower growth

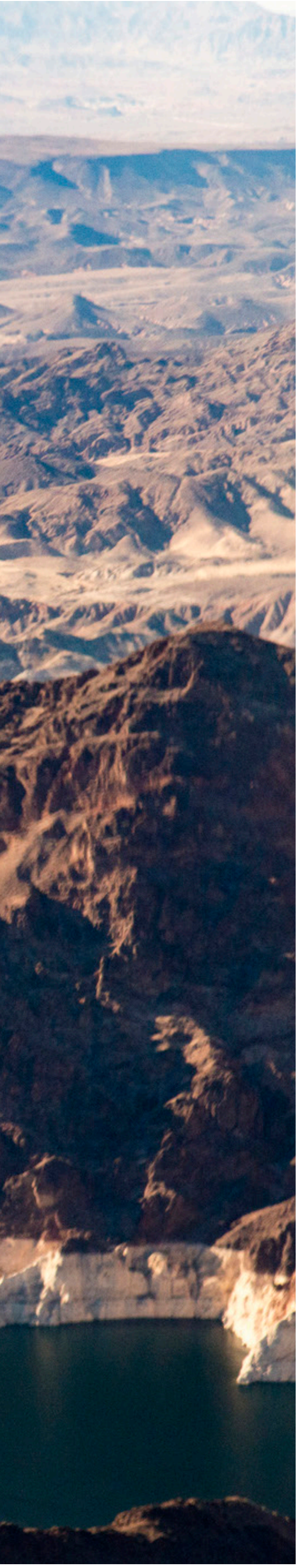
06

INVESTMENT IMPLICATIONS

AND REASONS FOR OPTIMISM

One of the most defining features of the past decade has been an abundance of liquidity, which has played a crucial role in lifting asset returns and suppressing volatility. Based on the combined effects of the dominant macro themes expected in the new regime, the era of easy money is over.

The next decade will look dramatically different from the past decade. Most importantly, no more rising tides to lift all boats and a path forward much trickier to navigate.



The shift from Beta to Alpha

Changes create opportunities. Indeed, we are entering a new paradigm with greater risks to traditional assets or beta. Yet, the same risks also present new opportunities for alpha.

Relative value strategies, which thrive in a market environment of high volatility and abundant price inefficiencies, are making a comeback.

Greater dispersions of returns within sectors and asset classes call for active management, which has struggled in past years.

Yes, the Goldilocks era of private equity is coming to an end; however, this also presents a potentially attractive entry point today for opportunistic investors.

> *Simply put, what worked well in the past decade is likely to be more challenged in the coming decade. A more volatile and less accommodative environment calls for a more flexible investment approach, with a greater emphasis on generating returns, rather than maximizing upside via exposure to global economic growth.*

Disruptive technologies & innovations

Throughout history, technological advances have shown the capacity to profoundly reshape the world, transforming life, business, the global economy, and geopolitical landscape. The world is in the midst of several significant, accelerating advances in science and technology.

Quantum computing and artificial intelligence are on the cusp of major breakthroughs. Collectively, they present the potential of unleashing the largest leap forward in computing power in human history and fundamentally revolutionizing aspects of information gathering and decision making.

The full impact of the cascading effects on the world is not yet known but already profound. Biotechnology is also on the precipice of major innovations. Genetic code editing technology has already led to historic advancements in medicine, evolution, and agriculture, with continued and growing implications for drug discoveries and life sciences.

For investors, the ability to identify the opportunities and challenges that disruptive technologies will likely present across industries - on economic, social, and geopolitical fronts - is increasingly more relevant and essential for navigating the investment landscape in the new global markets paradigm.

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