ROCKEFELLER
GLOBAL FAMILY OFFICE

CIO MONTHLY PERSPECTIVE

JUNE 2023

Unnecessary brinkmanship

Political theatrics over a still unsustainable fiscal trajectory

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Market Watch

Equity Market Indices[1]	4/30/23 Price	5/31/23 Price	MTD Change	YTD Change
MSCI All Country World	655	646	-1.3%	6.8%
S&P 500	4169	4180	0.2%	8.9%
MSCI EAFE	2144	2042	-4.8%	5.0%
Russell 2000®2	1769	1750	-1.1%	-0.7%
NASDAQ	12227	12935	5.8%	23.6%
TOPIX	2057	2131	3.6%	12.6%
KOSPI	2502	2577	3.0%	15.2%
Emerging Markets	977	959	-1.9%	0.2%
Fixed Income				
2-Year U.S. Treasury Note	4.01%	4.41%	40	-2
10-Year U.S. Treasury Note	3.43%	3.65%	22	-23
BBG U.S. Agg Corp Spread	1.36%	1.38%	2	8
BBG U.S. HY Corp Spread	4.52%	4.59%	7	-10
Currencies				
Chinese Renminbi (CNY/$)	6.91	7.11	2.8%	3.0%
Brazilian Real (Real)	4.99	5.06	1.4%	-4.3%
British Pound ($/GBP)	1.26	1.24	1.0%	-2.9%
Euro ($/Euro)	1.10	1.07	3.1%	0.1%
Japanese Yen (Yen/$)	136.30	139.34	2.2%	6.3%
Korean Won (KRW/$)	1338.50	1326.35	-0.9%	4.8%
U.S. Dollar Index (DXY)	101.66	104.33	2.6%	0.8%
Commodities				
Gold	1990	1963	-1.4%	7.6%
Oil	76.8	68.1	-11.3%	-15.2%
Natural Gas, Henry Hub	2.41	2.27	-6.0%	-49.4%
Copper (cents/lb)	387	364	-6.0%	-4.6%
CRB Index	268	254	-5.3%	-8.6%
Baltic Dry Index	1576	977	-38.0%	-35.5%

Source: Bloomberg

INTRODUCTION

After spending weeks warning that the imminent debt ceiling impasse would trigger financial Armageddon and economic calamity, the media might have been disappointed that President Biden and House Speaker McCarthy reached a deal with little fanfare over Memorial Day weekend. The compromise proved unpopular with politicians on both ends of the ideological spectrum—progressives felt Biden caved to political extortion while conservatives fretted that McCarthy did not go far enough. Indeed, by leaving mandatory and defense spending untouched, the deal only caps spending on 15% of the federal budget for two years. The estimated reduction in spending amounts to roughly 0.25% of GDP in 2024—a mere 4% of the projected deficit of 6.1% of GDP, which seems like rearranging deck chairs on the Titanic. Barring unanticipated obstacles in whipping votes for Congressional approval, Washington is once again kicking the can down the road, this time to 2025 when the next round of debt ceiling debates coincide with the expiry of many of President Trump's tax cut provisions.

The standout during the debt ceiling drama was the U.S. equity market, which has been climbing the proverbial wall of worries—the banking crisis, stickier-than-expected inflation, a disappointing Chinese reopening, a technical recession in Germany, and rapidly rising nominal and real U.S. Treasury yields as well as a strengthening U.S. dollar over the last few weeks. Ironically, the debt ceiling saga has been a boon to equities—with the statutory $31.4 trillion debt limit reached in late January, the Treasury Department was restricted from issuing net new debt and had to draw down the Treasury General Account (TGA) by $500 billion, which has been a direct liquidity injection into the economy and financial system.

The market's focus will now shift back to the Fed and economic fundamentals. The Fed has been signaling a pause at the upcoming Federal Open Market Committee (FOMC) meeting on June 13 and 14, which is prudent in light of continued stress in the banking system and signs of weakening consumer spending. There is also the concern that a deluge of Treasury issuance in the coming quarters could soak up liquidity to temporarily drive stock and bond prices lower. In short, the debate between the Fed's doves and hawks, and between market bulls and bears, will likely remain unresolved for a while.

JIMMY C. CHANG, CFA

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

The most underrated founding father

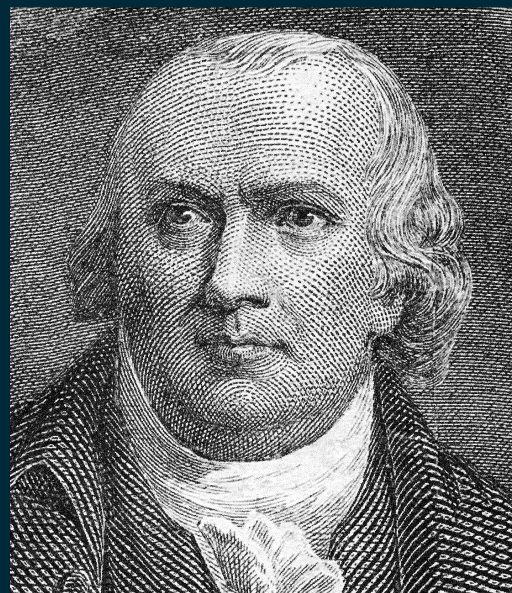
It would have been a wonderful, exemplary life if not for the shocking fall from grace in his old age. Starting out as a scrappy kid born out of wedlock in Liverpool, England, this immigrant leveraged his hard work, business acumen, and good luck to become the richest man in America at age 41, right when the American Revolutionary War was getting started in 1775. He played a significant role in financing the Continental Army, including the use of his own personal credit and wealth. He managed the young nation's finances and founded America's first *de facto* central bank. George Washington regarded him as a most trusted advisor and confidant. However, his luck ran out in later in life—bankruptcy led to his confinement in a debtors' prison for three years. This fall from grace tarnished his reputation and may explain his absence from the pantheon of great Americans. Robert Morris, once known as "the Financier," is perhaps America's most underrated founding father.

Morris immigrated to Oxford, Maryland in 1747 at age thirteen in 1747 to reunite with his father who had prospered in the tobacco trade. At sixteen, he became a trainee at a Philadelphia-based shipping and banking company when his father died from an infected wound. Morris had an instinct for identifying business opportunities and was not afraid to take risks. He was made a full partner at age 21 in the newly renamed Willing, Morris & Company.

His charmed life and good fortune continued for the next few decades. He built up an impressive network of contacts and businesses in the American colonies, the Caribbean, and Europe. Together with other investors, he underwrote the voyage of the *Empress of China*, the first American commercial vessel to sail to China.

At age 35, Morris married Mary White, a 20-year-old from a prominent Maryland family, and went on to sire seven children. He also financially supported a daughter born out of wedlock and stayed connected with her throughout her life.

While Morris was a native of England, he was vehemently opposed to British tax policies in the American colonies. In 1774, he was elected to the Philadelphia Committee created by the First Continental Congress to enforce boycotts



against British goods. After the Revolutionary War broke out, Morris was appointed to the Pennsylvania Provincial Assembly's Committee of Safety to supervise defenses. Due to his success in smuggling gunpowder from abroad, he was made the chief supplier of gunpowder to the Continental Army.

Morris was entrusted with more responsibilities after being elected as a delegate to Congress in late 1775. In addition to procuring arms and ammunition, he became the *de facto* commander of the Continental Navy and was also involved in managing relationships with foreign powers, especially France. He was so valuable to the war effort that he was not removed from these key posts despite having expressed ambivalence about America's independence. However, after the Continental Congress adopted the Declaration of Independence on July 4, he joined the other delegates in signing it.

In 1781, the newly rebranded Congress of the Confederation realized that it had to create departments of war, marine, finance, and foreign affairs to deal with the government's growing challenges. Morris was unanimously voted as the Superintendent of Finance, the precursor to the Secretary of the Treasury position created in 1789. Congress later appointed Robert Livingston as the Secretary of Foreign Affairs, Benjamin Lincoln as Secretary of War, and asked Morris to take on the additional responsibility as the Agent of Marine, which unofficially made him the leading department secretary. The three of them along with General George Washington and Secretary of the Continental Congress Charles Thomson served as the leaders of the *de facto* executive branch of the young nation.

Lacking the authority to raise revenue through taxation, Congress had simply borrowed and printed money to fund the war, which led to rampant inflation.

Morris wasted no time introducing an array of reforms based on free market principles. He championed Alexander Hamilton's idea of creating a central bank and convinced Congress to establish the country's first chartered bank, the Bank of North America. The initial capital was provided by borrowing from France and the Netherlands and selling shares to private investors. The bank played a crucial role in issuing currency and lending to the government. The currency issued by the bank was referred to as "Morris notes" as he was a major shareholder and personally guaranteed the bank's debts.

In 1782, several months after General Washington won the Battle of Yorktown that ensured a land victory for America, Morris introduced an economic plan to repay the country's war debt through new revenue measures.

THE MOST UNDERRATED FOUNDING FATHER

The focal point of the plan, which required an amendment to the Articles of Confederation, was a 5% federal tariff on all imported goods. The plan ultimately fell through with Rhode Island refusing to join the other twelve states in approving the amendment.

The inability of Congress to raise revenue and the refusal of many states to provide funding had even forced Morris to pay out over a million dollars of his own money to the troops in order to stave off mutiny among disgruntled soldiers. In January 1783, Morris reported that the national government had run up $42 million of public debt, which started the tradition of the annual Treasury reports to the President. Fortunately, Congress was able to furlough many soldiers as Great Britain had agreed to sign a preliminary peace agreement. Still, a mutiny over back pay in Pennsylvania in June 1783 forced Congress to vacate Philadelphia and set up a provincial capital in Princeton. Discouraged by the states' intransigence regarding funding for the national government, Morris resigned from his prominent posts in 1784 and returned to the private sector.

In May 1787, Morris opened the proceedings of the Philadelphia Convention—later known as the Constitutional Convention—by nominating Washington as the chairman. On September 17, 1787, Morris and Roger Sherman became the only people to have signed all three of the country's founding documents: the Declaration of Independence in 1776, the Articles of Confederation in 1777, and the U.S. Constitution in 1787.

Morris was elected Senator of Pennsylvania in 1789, shortly before Washington assumed the office of the presidency. Washington asked Morris to serve as his Secretary of the Treasury, but Morris recommended his protégé Hamilton for the job and instead chose to work as his dependable ally in the Senate. When the temporary capital of the country was moved to Philadelphia in late 1790, Morris offered his stately home, known as the Morris Mansion, to Washington for use as the President's House. Washington happily accepted his friend's offer and resided in the mansion until the end of his second term in 1797.

In the 1790s, Morris and his business partners speculated on millions of acres of land in anticipation of the country's westward expansion and the construction of the District of Columbia. They created the country's largest land company by issuing stocks with guaranteed dividends of 6%. When the company ran into liquidity problems, Morris and his partners issued their own private notes which were initially coveted by investors. In 1796, with Europe engulfed in an economic crisis caused by the French Revolutionary Wars, the flow of money from Europe dried up, and the credit crunch then pricked the land bubble in the US. The sudden collapse of Morris' company caused the Panic of 1796-1797 and landed the now bankrupt Robert Morris in the debtors' prison in 1798.

Morris' financial ruin was shocking to his allies and friends but cheered by his political foes who resented business elites and Federalists. Morris' former allies managed to get Congress to pass the Bankruptcy Act of 1800, in part to free him from prison. Upon his release in August 1801, his former political ally Gouverneur Morris (no relation) managed to provide Mary Morris with a small annuity of $1,500, which allowed the impoverished couple to rent a small house on the outskirts of Philadelphia. Upon his death at age 72 in 1806, Morris' only prized possession was a worn-out gold watch passed down from his father.

The Grand Backroom Deal

On July 4, 1789, the 13th birthday of the young nation, President Washington signed into law the first substantive legislation passed by Congress after the ratification of the U.S. Constitution. The Tariff Act of 1789 was a landmark bill that empowered the federal government to raise revenue and regulate commerce, an authority that Robert Morris had unsuccessfully backed in 1782. The bill also exacerbated the political dispute between the North, which was in favor of the Tariff Act, and the South, which was against it. This conflict evolved into today's ideological divide between proponents of federal power and states' rights activists, as well as the bitter rivalry between the political left and the right.

With the federal government now having secured reliable revenue from tariffs and excise taxes, Hamilton was asked by Congress to deal with the public debt left over from the Revolutionary War, a task that Morris was hamstrung with six years earlier. Hamilton came up with an ambitious plan—the federal government would not only honor debt issued by the Continental Congress, but also assume the outstanding war debt of the states. Such a move, he believed, would establish the nation's creditworthiness and attract more domestic and foreign investment. However, the anti-Federalist camp, led by Hamilton's erstwhile ally James Madison, refused to endorse the plan for fear of granting the federal government too much power. Madison and his fellow Southerners were able to block this plan

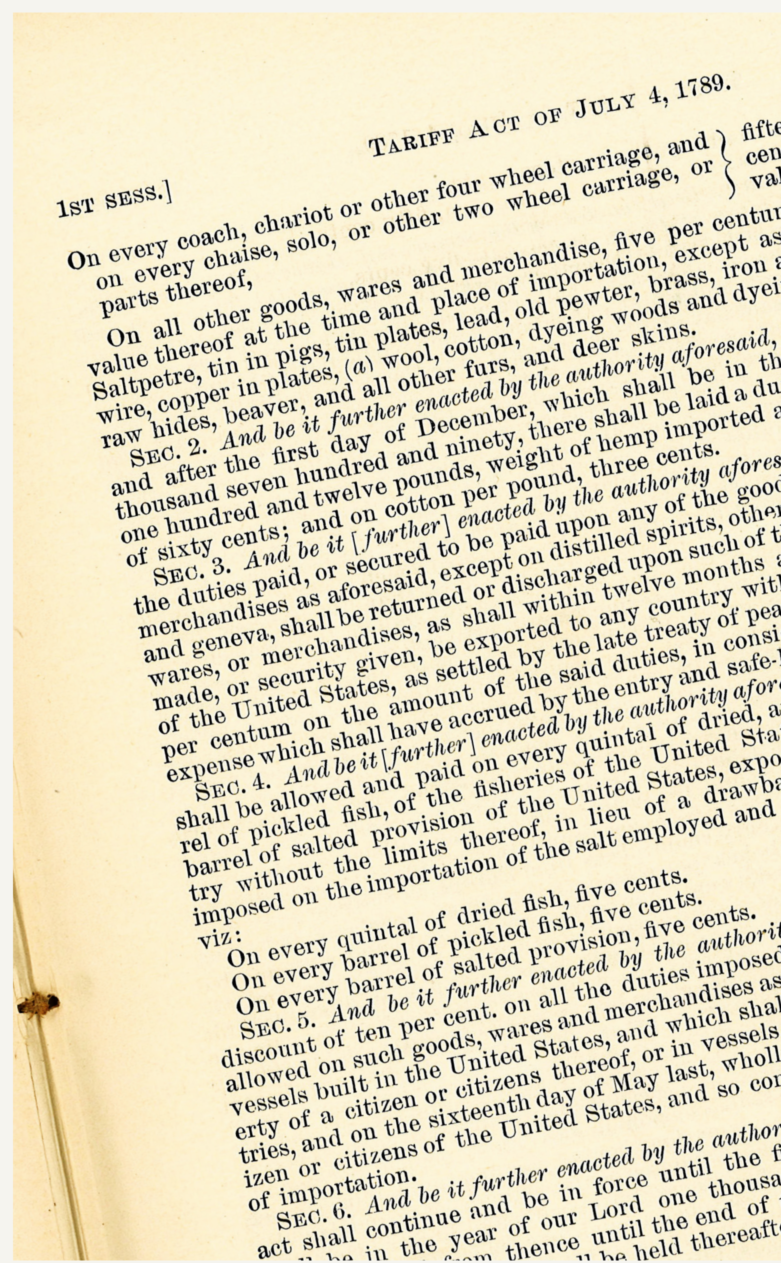
THE GRAND BACKROOM DEAL

in Congress, and a dejected Hamilton had to seek assistance from the newly appointed Secretary of State, Thomas Jefferson.

On or around June 20, 1790, Jefferson hosted perhaps the most consequential dinner in U.S. history at his New York residence. Over food and fine wine, Jefferson, Hamilton, and Madison reached what was later called the Compromise of 1790. Madison would acquiesce to the passage of Hamilton's debt assumption plan in Congress, and Hamilton would placate the South by persuading his fellow Federalists to endorse a plan to build a new capital along the Potomac River, which borders Virginia—Jefferson, Madison, and Washington's home state.

On July 16, Hamilton honored his part of the compromise by successfully convincing Northerners to pass the Residence Act. On August 4, his vision was starting to be realized with the passage of the Funding Act of 1790. The Department of Treasury then issued U.S. Treasury securities backed by the "full faith and credit" of the U.S. government in exchange for certificates of state war-incurred debts at par. The credit of the U.S. was solidified at home and abroad, which helped to establish a strong foundation for our country's finances to this day.

During the 19th century, the U.S. government generally lived within its means adopting a puritanical aversion to debt. In 1835, the U.S. national debt was eliminated for the first and only time when President Andrew Jackson, ever suspicious of bankers and paper money, liquidated the Second Bank of the United States and returned the original investment to the Treasury with a profit. However, large sums of debt were still raised to meet extraordinary needs—the Louisiana Purchase in 1803, the War of 1812, the annexation of Texas and California in mid 1840s, and the exceedingly costly Civil War.


TARIFF ACT OF JULY 4, 1789.

1ST SESS.]

On every coach, chariot or other four wheel carriage, and } fifte
on every chaise, solo, or other two wheel carriage, or } cen
parts thereof, } val

On all other goods, wares and merchandise, five per centu
value thereof at the time and place of importation, except as
Saltpetre, tin in pigs, tin plates, lead, old pewter, brass, iron a
wire, copper in plates, (a) wool, cotton, dyeing woods and dyei
raw hides, beaver, and all other furs, and deer skins.

SEC. 2. *And be it further enacted by the authority aforesaid*,
and after the first day of December, which shall be in th
thousand seven hundred and ninety, there shall be laid a du
one hundred and twelve pounds, weight of hemp imported a
of sixty cents; and on cotton per pound, three cents.

SEC. 3. *And be it [further] enacted by the authority afores*
the duties paid, or secured to be paid upon any of the good
merchandises as aforesaid, except on distilled spirits, other
and geneva, shall be returned or discharged upon such of t
wares, or merchandises, as shall within twelve months a
made, or security given, be exported to any country wit
of the United States, as settled by the late treaty of pea
per centum on the amount of the said duties, in consi
expense which shall have accrued by the entry and safe-

SEC. 4. *And be it [further] enacted by the authority afor*
shall be allowed and paid on every quintal of dried, a
rel of pickled fish, of the fisheries of the United Sta
barrel of salted provision of the United States, expo
try without the limits thereof, in lieu of a drawba
imposed on the importation of the salt employed and
viz:

On every quintal of dried fish, five cents.
On every barrel of pickled fish, five cents.
On every barrel of salted provision, five cents.

SEC. 5. *And be it further enacted by the authorit*
discount of ten per cent. on all the duties impose
allowed on such goods, wares and merchandises as
vessels built in the United States, and which sha
erty of a citizen or citizens thereof, or in vessels
tries, and on the sixteenth day of May last, wholl
izen or citizens of the United States, and so co
of importation.

SEC. 6. *And be it further enacted by the author*
act shall continue and be in force until the f
in the year of our Lord one thousa
thence until the end of
held thereaft

At the onset of the Civil War, the U.S. national debt stood at $64.8 million, and the war wound up costing the nation $5.2 billion in direct expenditures. However, at the peak of that cycle, the U.S. national debt only hit roughly 30% of GDP, which is exemplary by today's standards. By the end of the 19th century, the gross national debt stood at $1.9 billion, roughly 7% of GDP. Thanks to the fiscal discipline and yeoman's work of our forefathers, the U.S. entered what turned out to be the American Century in great fiscal shape.

Evolution of the Debt Ceiling Politicking

Prior to the 20th century, federal revenue came from tariffs and excise taxes on various goods. A federal income tax was introduced by the Revenue Act of 1861 to help fund the Civil War and then repealed in 1872. In 1894, pro-free trade members of the Democratic Party managed to pass a bill imposing the nation's first income tax during peacetime to offset tariff reductions. However, it was declared unconstitutional by the Supreme Court. In 1913, the Sixteenth Amendment was ratified to empower Congress to levy income taxes. Congress subsequently introduced a graduated federal income tax schedule that year—a 1% levy on income above $3,000 (equivalent to $92,000 in 2023), and a top rate of 7% for income above $500,000 ($15.3 million in 2023).

In 1917, America's entry into WWI led to significant changes to Congress' tax policy and debt management. The income tax started at 2% for income above $1,000 ($23,700 in 2023) and progressively climbed up to 67% for income above $2 million ($47.4 million in 2023). On the debt side, instead of directly authorizing each debt issuance, as was the practice since the signing of the Constitution, Congress authorized the Treasury to issue bonds as long as the total issuance was below a statutory limit—thus the concept of a debt ceiling was born. The Public Debt Acts of 1939 and 1941 eliminated individual limits on different types of government debt and created an aggregate limit on the federal government's consolidated debt obligations. The initial debt ceiling was set at $65 billion, and the Treasury Department was required to ask Congress to raise the debt ceiling once the limit is reached.

The need for Congress to raise the debt ceiling every few years is part of the system of checks and balances. Congressional members frequently seized the vote on the debt ceiling to burnish their image of fiscal probity, especially when their party did not have control of the White House. In May 1984, then-Senator Biden made this statement before voting against raising the debt limit: "I cannot agree to vote for a full increase in the debt without any assurance that steps will be taken early next year to reduce the alarming increase in the deficits and the debt." Indeed, President Reagan's deficit spending was viewed by some as fiscally irresponsible—at the time, the gross federal debt as a percent of GDP had risen from a post-WWII trough of 30.6% in 1981 to 37.7%. In case you're wondering, our gross federal debt now stands at 120% of GDP.

EVOLUTION OF THE DEBT CEILING POLITICKING

While it was business as usual for politicians to complain about their opponents' profligacy, the vote to raise the debt ceiling was never weaponized until September 1995, when House Speaker Newt Gingrich threatened to let the government default unless President Bill Clinton submitted a credible balanced budget. The impasse led to two rounds of government shutdowns late in the year. Gingrich ultimately caved after losing the backing of Senate Majority Leader Bob Dole, who did not want the budget battle to damage his presidential campaign.

There were two other occasions when the debt ceiling battle supposedly went to the edge of default. In 2011, the debt ceiling was raised two days before the Treasury was estimated to run out of borrowing capacity, and it led to Standard & Poor's subsequent downgrade of the U.S. government's credit rating. In 2013, having run out of borrowing capacity, the federal government initiated a partial shutdown on October 1 to prioritize debt servicing. The debt ceiling was eventually raised on October 16, a day before the Treasury was presumed to run out of money.

Looking Past Temporary Disruptions

While the showdowns over the debt ceiling in 1995, 2011, and 2013 created much political intrigue and media circuses, equity markets had treated them as mere sideshows.

Equities were exceedingly resilient in 1995 as the economy and corporate earnings were booming, and the Internet craze was just getting started with Netscape's hot initial public offering (IPO). In fact, 1995 holds the distinction of having the smallest intra-year equity drawdown going back to 1928 with just a 2.5% pullback in the S&P 500 Index in mid-December.

In 2011, equities were range-bound from the start of the year until the resolution of the debt ceiling standoff on August 2, but the S&P 500 Index subsequently suffered a 12% decline. Some blamed the sell-off on the credit rating downgrade, but there were also concerns about the softening economy and completion of QE in July. The Fed eventually bailed out the equity market with the announcement of Operation Twist in late September.

One would have expected more volatility in 2013 due to the economic impact of the partial government shutdown and heightened risk of a default. However, investors showed no signs of concern as there was just a mild 4% pullback from late September to early October.

During this year's debt ceiling debate, equity investors have once again looked past debt ceiling theatrics with the belief that politicians crave brinkmanship but not suicide. Similarly, investors will likely ignore any credit rating downgrades, as Fitch Ratings has threatened to do; U.S. Treasuries had rallied with yields moving lower in the wake of the credit rating downgrade in August 2011—a clear rebuke to the largely symbolic move by the rating agency.

A Necessary Evil?

The political brinkmanship over the U.S. government's creditworthiness will likely create more backlash against the debt ceiling, especially from progressives who tend to prefer more government spending. Some have argued that the debt ceiling is an unproductive relic from the past that has created artificial crises without imposing effective financial discipline. Critics would point to the damage done to U.S. geopolitical interests when President Biden opted to cancel his historic visit to Papua New Guinea and the Quad Summit in Australia in order to return to Washington to continue the debt ceiling negotiations.

Defenders of the debt ceiling would say that it is perhaps the only effective leverage that Congress has over pecuniary matters. If not for the threat of default, would President Biden have the sense of urgency to engage in serious budget negotiations with Congress? In the 1990s, Newt Gingrich's weaponization of the debt ceiling eventually forced Bill Clinton to pursue welfare reform and balance the budget, an accomplishment that Clinton has been proud of. The 2011 and 2013 debt ceiling showdowns resulted in budget sequestration that wound up reducing the projected budget deficit by more than $2 trillion over the 10-year planning horizon.

The harsh truth about America's finances is that we have an unsustainable fiscal trajectory. To wit, Social Security, Medicare, and net interest expenses accounted for 54% of the federal government's revenue in 2022. The Congressional Budget Office (CBO) projects that these three items will chew up 82% and 90% of revenue by 2033 and 2043 respectively. For the years 2044 through 2053, the CBO projects that they will average 102% of revenue. That's right—at the current trajectory—spending on senior citizens and interest expenses will exceed all of the federal government's revenue. The rest of mandatory benefits and discretionary spending will be financed by debt, with the budget deficit averaging over 10% of GDP between 2044 and 2053. These are numbers befitting so-called banana republics, not the issuer of the global reserve currency.

Despite these dire projections, Social Security and Medicare have become the third rail of American politics as most politicians would prefer to kick the can down the road than come up with difficult solutions to avert this slow-motion fiscal trainwreck. A combination of tax hikes and spending cuts will be unavoidable, and one day we may even have to impose European-style value-added taxes in order to help pay for the welfare state.

Bracing for Discretionary Spending Cuts

The agreement between President Biden and House Speaker McCarthy will suspend the debt limit through January 1, 2025, thereby removing this issue from the 2024 general election. Non-defense spending will remain flat in fiscal 2024 and rise by 1% in 2025, meaning that politicians will soon be haggling over which budget items to cut. It is potentially bad news for many entities that depend on government grants for basic research. It is happening against the backdrop of China aggressively ramping up basic research funding by an average of 15% per year over the last decade as part of Chairman Xi's ambitious initiatives to catch up with, and then surpass, the U.S.

The U.S. government has a long and successful history of funding basic research, starting with the establishment of the National Institutes of Health in 1930 and the National Science Foundation in 1950. Many things that we take for granted today—integrated circuits, CAT scans, MRIs, GPS, cordless tools, and even the Internet—are byproducts of research funded by NASA and the Department of Defense. America's innovative power and technological leadership are key to the country's hegemony and prosperity. However, as we enter an era of relative budget austerity, some will argue that the federal government should cut back basic research funding, which accounts for only 0.8% of the federal budget, and let the private sector and market forces deal with it.

I recently had the honor of hosting three Nobel Laureates—Dr. William Kaelin (2019 Nobel Prize in Physiology or Medicine), Dr. Robert Phillips (1977 Nobel Prize in Physics), and Dr. Donna Strickland (2018 Nobel Prize in Physics)—for a panel discussion on the importance of public funding for basic research (the video is available by request). They pointed out that the private sector is more interested in funding engineering efforts with well-defined deliverables rather than basic research, which has an element of serendipity with uncertain payoffs and long incubation periods. For example, Dr. Isaac Isidor Rabi's 1938 research at Columbia University on the use of magnetic fields to study the behavior of atomic nuclei won him the Nobel Prize in Physics in 1944. The groundbreaking work led to the invention of the atomic clock in 1948, which then paved the way for the creation of the Global Positioning System (GPS) in 1978. The invention of magnetic resonance imaging (MRI) in the 1970s was also based on Dr. Rabi's work in 1938. However, at the time, no one could have anticipated that Dr. Rabi's work would lead to these life-changing applications.

It remains to be seen if our politicians, in their zeal to preserve pet projects with quick electoral payoffs, will wind up sacrificing the future by cutting basic research funding. I am hopeful that common sense will prevail as the future is a terrible thing to squander. It is just one example of the many difficult choices that Washington will have to confront after years of easy money and binge spending. In time, the impact of the budget ceiling deal—such as the resumption of student debt payments that could hit aggregate consumer spending power by at least $5 billion per month—will be felt by the economy and financial markets.

Liquidity Trumps Fundamentals

With the resolution of the current round of the debt ceiling crisis nearly accomplished, it's time to assess the post-debt ceiling market environment.

For fixed income, the question is whether bond yields will be pushed even higher due to a tsunami of Treasury issuance in the months ahead. Through April 2023, seven months into the U.S. government's fiscal year that began in October 2022, the federal government has run up a deficit of roughly $925 billion. This deficit has been funded by roughly $470 billion of net debt issuance before the $31.4 trillion of debt ceiling was reached, and the remainder has come from drawing down the balance at the Treasury General Account (TGA), which is akin essentially the government's checking account at the Fed. Depending on how much and how quickly the Treasury Department plans to replenish the Treasury General Account, the market will have to absorb hundreds of billions of dollars of extra Treasury issuance, which may temporarily drive bond yields higher and prices lower.

Ironically, the rapid drawdown in the Treasury General Account has been a liquidity bonanza for the stock market; the money spent from the TGA is liquidity directly injected into the economy. Since late January, the TGA's balance has declined by roughly $500 billion, meaning that the economy and financial markets have benefited from a liquidity injection of half a trillion dollars in a span of just four months, which annualizes to $1.5 trillion. It's no wonder that equities have been so resilient of late. In the months ahead, as the government replenishes the TGA, liquidity will likely be drained from the system, which will be a headwind to equities. However, the Treasury Department can lessen the headwind by issuing more bills than bonds to soak up some of the $2.2 trillion parked at the Fed's overnight reverse repo facilities.

I would take advantage of the rise in Treasury yields to lock in higher interest rates across the curve in U.S. Treasury and agency bonds, as well as investment-grade municipal securities. This may be one of the last bouts of risk-free rate spikes in the current business cycle, as I believe the economy is at risk of slipping into recession in the not-too-distant future based on indicators such as the contracting Leading Economic Indicators, inverted yield curve, tightening lending standards, and the first year-on-year M2 money supply decline since the Great Depression. With the banking system still bleeding deposits, I believe it would be a mistake for the Fed to hike the Fed funds rate in the coming months based on lagging economic indicators.

LIQUIDITY TRUMPS FUNDAMENTALS

I continue to have a cautious stance on equities given elevated valuations and the risk of recession. That said, the market consensus appears to have shifted away from the recession call as continued strength in services sectors, better-than-expected 1Q23 earnings results, and rising equity indices have convinced many that a soft landing is more likely than not. However, one would need to believe that this time is truly different to make soft landing the base case, as a recent research paper by a group of distinguished economists, *Managing Disinflations*, found that in the 17 episodes of inflation reduction in the U.S. and other major advanced economies since 1950, there was no precedent for a sizable central-bank-induced disinflation without substantial economic sacrifice or recession. While the U.S. economy may appear resilient today, I worry that the long and variable lags in the Fed's most aggressive rate hike cycle in four decades have yet to fully ripple through the economy. In other words, be mindful of the lags as an economic cycle can take longer to transpire than our patience can endure.

PRINCIPAL AUTHOR

Jimmy C. Chang, CFA

Chief Investment Officer
Rockefeller Global Family Office

EDITOR

Joan Park

Research & Strategy Specialist
Rockefeller Global Family Office

CREATIVE DIRECTOR

Robert J. Hadley

Head of Brand Strategy
Rockefeller Capital Management

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45 ROCKEFELLER PLAZA, FLOOR 5
NEW YORK, NY 10111

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