The Chessboard

October 2024

-Gray Howard, Senior Portfolio Manager

To understand modern day politics is to understand global macroeconomics, particularly through the lens of history. It all comes down to money and power which is why politics, geopolitics, and global financial markets are all inextricably linked. [1]

We've been discussing the global debt crisis and its implications since the summer of 2020- Inflation, currency devaluation, geopolitical tension, wealth inequality, and social unrest. Today, the Congressional Budget Office is projecting that the U.S. will run a 5% budget deficit for at least the next 10 years. Meanwhile, the total US debt is around 35 trillion, the U.S debt to GDP is north of 100%, and the Fed's balance sheet is around 7 trillion.[2] Not an ideal situation, but as I've stressed for over 4 years, **the economic and investment implications are not what you might think.** [3]

As we head toward one of the most intense elections in a long time, it's important to remember this situation did not happen overnight and will not be resolved quickly, regardless of who is elected, in my judgement.

Our current situation began as WWII was winding down and the Allied nations came together in 1944 to create what was known as the Bretton Woods Agreement. This created the International Monetary Fund (IMF), the World Bank, and the global monetary system we have today. As a result, the U.S. dollar became the global reserve currency and other member countries were required to guarantee the convertibility of their currency. In return, they had the ability to convert U.S. dollars into gold. This was key, as it insured that countries could not meaningfully devalue or manipulate their currency, which had been the case leading up WWII.[4]

For countries to trade freely around the world, it was imperative to have strong treaties and alliances to preserve, protect, and promote this system, or the *International Rules Based Order* as referred to today. As a result, the United Nation's Charter was signed in 1945 and the North Atlantic Treaty Organization(NATO) was created in 1949. Since then, there have been many regional wars but one could argue these alliances have prevented another major global conflict like WWII. [5]

However, the world is very different now for five key reasons:

1. **Ageing System**- The architects of this international system are no longer here and much like a family business, the preservation of global alliances and treaties become more difficult with each generation. Primarily because the strategies and tactics used in the past become less

effective in the future. Particularly, after the Church Committee hearings in the 1970s that exposed many of the abuses by the US intelligence agencies.[6]

2. **Global Players**- After the fall of the Berlin Wall, the U.S. had the pleasure of operating as a regional hegemony with no other countries to seriously challenge it. This is no longer the case as China is now the second largest economy, and Russia and Iran are sitting on a combined 280 billion barrels of oil reserves. Meanwhile, they are all non-NATO countries yet, boxed into a global monetary system that's at the mercy of the U.S. dollar and the U.S. political system.[3]

3. **U.S. Dollar** - The U.S. dollar has been a fiat currency since Nixon ended the gold standard in 1971. Therefore, the only thing backing the U.S. dollar is the full faith and credit of the United States. But given the large structural deficits and currency devaluations, the U.S. dollar system has been put into question. For example, during the early days of Covid-19 when financial markets were getting crushed, U.S. Treasury yields spiked as foreign buyers no longer viewed U.S. treasuries as a safe haven asset due to the amount of money the U.S. would soon print.[7]

4. **Inflation & Debt Monetization**-Inflation is the result of excess money creation either through bank lending like in the 1970s, or direct federal spending like we have today. The latter is referred to as debt monetization, where the government prints money to cover the budget. Again, this didn't happen overnight. In 2012, Fed Chair Ben Bernanke, stated in response to quantitative easing, "*And you know we've been increasing our balance sheet for some time, and we've been very clear that this a temporary measure. It would be quite different matter if we were buying these assets and holding them indefinitely, it would be a monetization*." At that time, the Fed's balance sheet was around 2.8 trillion, today its around 7.1 trillion.[8]

5. **Information Age**-Before the internet, most received their information through mainstream newspapers and broadcast news. Today social media is a huge source, and these companies have teams of content moderators with evidence of governments applying pressure to censor certain content. Mark Zuckerberg's letter to congress is great example. Regardless of whether this is a violation of the first amendment, or justified in the interest of national security, the narrative is far more difficult to control than it once was.[9]

Investment implications?

If anyone would have said 15 years ago that the US would now have 35 trillion of debt, but the S&P 500 would be up around 450%, they would have been laughed out of the room.3 But that is the dirty secret- when governments start flooding the system with liquidity (printing money), assets prices adjust upward to find equilibrium. Therefore, those that have owned assets have had one of the best 15 year runs in history, while those that did not, have been left farther and farther behind. Precisely why we have rising populism and geopolitical tension as the system that was designed eighty years ago is no longer working for everyone.[10]

While it's likely the world will revert to a sounder monetary system, with new agreements, new alliances, and a global currency that is backed by sort of real asset, it's unlikely it will happen very soon. For example, the Republicans controlled both houses of Congress in Trump's first two years, and yet minimal spending cuts were implemented.[2] Conversely, the Democrats controlled both houses in Biden's first two years and minimum tax increases occurred. [2] Furthermore, the Fed is now lowering interest rates and China is rolling out massive stimulus measures. This will only increase the ample amount of liquidity already sloshing around the world.[11]

Therefore, I continue to believe investors should be overweight assets classes that can adjust upward with global liquidity, such as stocks, real estate, commodities. And underweight fixed assets classes that are denominated in currencies being devalued, such as most bonds. While inflation is coming down, this is likely a small window before we see another wave of inflation down the road.

And if the economy enters a recession, or we have WWIII, the printing presses will have to be turned up even more to cover the expense; likely leading to hyperinflation as it did after Covid-19.12 Again, I can't stress this enough, the economy is being driven by the Fiscal side, not the Fed. The Fed is subordinate to Fiscal policy, but when the Treasury can't fund the budget deficit by selling bonds, the Fed will *always* step in to buy or monetize the debt at the expense of bondholders – which is why traditional asset allocation, or the classic 60/40 portfolio has not worked since 2020. 10 This is not a great situation for many, but as investors, it's important to understand the chessboard and make your moves accordingly.

Lastly, it's possible that some of these regional conflicts escalate into a greater global conflict, which would be tragic. But it all comes down to money and power and each of the global players have a vested economic interest to keep that from happening, especially the United States and China. 11

Hopefully, our policy makers will remember the words of Abraham Lincoln, " *America will never be destroyed from the outside. If we falter and lose our freedoms, it will because we destroyed ourselves."*

Please feel free to reach out if you have any questions or feedback.

All the best,

Gray

Please note: If you do not have assets under management with our group and would like more information on our process and performance, please let us know.

Sources;

1. Allan Drazen, *Political Economy in Macroecnomics*, Jan 2002
2. CBO, August 2024
3. Refinitiv
4. Federal Reserve history, *Creation of the Bretton Woods System*, November, 2013
5. Office of the Historian, North Atlantic Treaty Organization,
6. US Senate, *Committee to study government operations with respect to Intelligence activities, 1975*
7. National Bureau of Economic research, *The Treasury market in the Spring of 2020*, August 2021
8. Federal Reserve, *Transcript of Chairman Bernanke*, January 2012
9. Politico, *Zuckerberg says he regrets caving to White House Pressure*, August 2024
10. Ray Dalio, Principles for Navigation Bid Debt Crisis
11. Reuters, *China's Central bank Unveils Most aggressive Stimulus*, September 2024
12. Washington Post, *The US has Thrown 6 trillion*. April 2024
13. Connecticut General Assembly

Gray Howard
Senior Vice President – Wealth Management
Senior Portfolio Manager

UBS
The Howard Group
13024 Ballantyne Corporate Place
Suite 650
Charlotte, NC 28277
Office: 704-343-4048
Cell: 704-418-6090
FAX: 855-833-5550
gray.howard@ubs.com
https://advisors.ubs.com/thehowardgroup/

I'd like to sign up for the team's market commentary