STRATEGIC OUTLOOK

Strategic Frontier Management

Q4 2024

Risky Business of Regime Change

We observe a regime change, which we have highlighted was likely taking root. This new regime began with the maturing of the *Fourth Industrial Revolution* coinciding with supply chain fragility that emerged during the Global Pandemic. This new regime is more similar to the 1981-2000 regime, before the Federal Reserve embarked on monetary policy experiments that didn't reduce volatility or suspend basic principles of economics and finance.

The *Risky Business of Regime Change*, including need for higher-for-longer interest rates, raises concerns about the global bond market's ability to absorb rapidly growing long government bond supply. Risk of a U.S. Government Debt Crisis is high given potential for rapidly steepening yield curves, even as central banks begin to cut rates, downgrade of U.S. debt, or a *liquidity crunch*.

So, what triggered Regime Change? President Biden sought to reverse nearly every policy, agency rule, and executive order, as well as tax reform and foreign policy of the prior administration. In so doing, many misguided new economic, regulatory, energy, basic resources, trade, financial, education, criminal justice, immigration, and fiscal (inc. tax + spending) policies it applied had real effect on the U.S. economy. This combined with years of implicit moral hazard of monetary market manipulation (inc., forward guidance, quantitative easing, and low interest rates) for an extended period. That real effect began with soaring CPI inflation, peaking at 9.0% in June 2022, thereby boosting anchored inflation expectations. Average inflation will not simply retreat to 2% again.

This new differentiated economic regime emerging is characterized by higher secular inflation, thus higher inflation expectations (SFM: 2.5% PCE, 3.0% CPI inflation), reduced potential growth, and low productivity, while limiting profit margins and global competitiveness The inflationary consequences of the radical pivot in U.S. policies require higher equilibrium interest rates of 3.5%, not 2.9% implied in the Fed's long-term forecast. Consider a 4.2% Fed Funds rate vs. 3.2% CPI inflation are 44-year averages (since 1980) compared to 2.5% CPI inflation and 2.9% Fed Funds expectations. Higher rates increase the fiscal deficit, while compounding the federal debt at higher interest rates.

The remarkable era of innovation since 2001, known as the *Fourth Industrial Revolution,* drove globalization and secular disinflation, but has moderated. We became accustom to lower inflation and interest rates, assuming the *New Normal* was forever. Back-to-back *Crises* (2000 Dot-Com & 2008 GFC) adjusted expectations of normal equilibrium, but *Risky Business of Regime Change* could lead to exogenous volatility, yield curve steepening overshooting, or trigger a government debt crisis. Behavioral recency bias regarding lower inflation and interest rates is now suspect, as seen in expectations.

Normalizing Federal Reserve holdings requires a $5 trillion reduction over the next couple years. So, who is going to buy excess U.S. Treasury bond supply as China and Japan are net sellers as Treasury must extend maturity to fund a high fiscal deficit? Sentiment should be more negative after a decade of Treasury bonds lagging cash, but the yield curve remains insidiously inverted—a further drag on bond market performance.

We believe *Regime Change* will require greater fiscal austerity from Congress to bring down the unsustainable debt burden, now over 120% debt/GDP, that exceeded the post-World War II peak. Enacted elements of the *Build Back Better* boondoggle misappropriated $4 trillion in imprudent wasteful spending. The US government ran a fiscal deficit of $2.3 trillion ($8.2% deficit/GDP) over FY2024 thru Sept 30th, thus requires cutting over $2.5 trillion from the budget to extinguish the fiscal deficit. There is no fiscal flexibility to manage any crisis for the foreseeable future now.

The anticipated U.S. economic hangover in the private sector continued in 2024. We expect lower potential economic growth of 1.8% or less given pivot in U.S. policies. Intermittent recession, if not stagflation, as consumer confidence suggests, and negative industrial production or real retail sales confirm. We expect slower earnings growth and lower margins with fiscal spending and monetary cliffs ahead. We foresee financial and economic headwinds increasing in the future.

Equity markets soared since October 2023 on hopes the Federal Reserve would cut rates up to 6 times this year, but deferred until September. Our forecast of higher-for-longer called for just two cuts this year, combined with an increase in Long Treasury supply between a still large fiscal deficit, reduced Fed holdings, and need to extend Treasury issuance maturities. The inverted yield curve should steepen even with interest rate cuts.

Regrettable Misadventures

Many are rightly fixated on the U.S. inflation rate as CPI price levels increased over 17.5% since January 2021, and will continue rising without deflation or recession. Unleashed higher inflation expectations and pricing power will be difficult to contain as higher wage increase persist still lagging behind higher cost of living. There is still a housing shortage keeping inventory low and prices higher with a surge in household formation.

Then there is the issue of global energy price inflation, which affects everything, including transportation and manufacturing, yet energy prices are more likely to rise than fall much given efforts to transitioning away from fossil fuels. *Magical Thinking* of "endless" disinflation and "inconsequential" massive fiscal deficits compounding US Federal Debt is illusionary. Yet, inverted yield curves persist from the United States to across Europe. Misguided Presidential Executive Orders and imprudent regulatory agency rules boosted secular inflation, while reducing global competitiveness, potential real growth, productivity, and thus, sustainable profit margins, thereby undermining potential earnings growth.

Investors in Government Bonds were devastated for the last three years (US10Ts Return: -5.7% A.R.), and over the last decade barely exceeded cash despite greater risk. Manipulating bond yields combined with rising rates has led to a challenging market for fixed income investors. An inverted yield curve should limit demand for extending portfolio duration, yet investors would rather anticipate rate cuts time and again even as the Federal pushes out their horizon of rate cuts. We remain in the camp of higher for longer interest rates.

This new regime we discuss should be more consistent with 1981-2000, suggesting 2000-2024 was an anomaly that skewed long-term financial and economic norms. We observed emergence of bizarre relative returns of risk premiums, including small vs large, value vs growth, or the term risk premium absent in inverted yield curves. Many of these risk premium anomalies were extended by irrational momentum—investors chasing sexy growth, higher yield, or appealing thematic stories well beyond reason. In this new regime we expect reversion to normal—not that its different this time, but reversion to decades old paradigm of U.S. economic characteristics.

The extended era of disinflation has been winding down with the *Fourth Industrial Revolution* maturing, and gave way to rising inflation expectations, for otherwise avoidable reasons. Massive unnecessary fiscal stimulus and money growth with low interest rates for an extended period increased explicit moral hazard. Monetary normalization is exposing financial weakness as interest burdens soar with extended leverage. This compromised marginalized companies and households relying on too much debt as interest burdens increase.

Economic Outlook

President Biden promised to lift America from the global pandemic and unite the country, but neither objective is evident. The U.S. private sector has muddled along after a strong rebound from the shortest recession observed during the global pandemic. Momentum carried through Summer 2021, but the U.S. private sector economy has since stalled. Nearly every policy or executive order and agency action enacted by President Trump was reversed or modified. Beyond impacted economic, energy, financial, trade, or regulatory policy, consequential foreign policy disasters also are too numerous to list—many also having economic impact.

Hope that inflation will ease into disinflation again is likely wishful thinking given the history following periods of high inflations spikes. We expect the new regime is likely to feature inflation at an uncomfortable level for the Federal Reserve given stickier forces of higher inflation expectations driving energy, resources, transportation, labor, food, and housing costs. Second order effects of delayed labor and contract cost adjustments have yet to take hold, but coming into focus. Recent labor demands and businesses exercising pricing power are supported by lagging contract resets. Historically, inflation doesn't decline monotonically, rather it tends to ebb and flow, often resetting at a new elevated level.

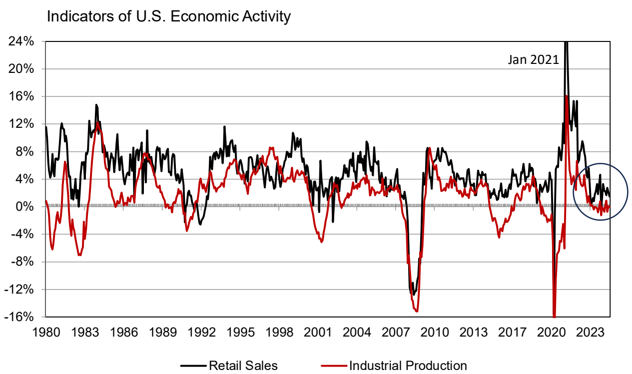
We could have limited higher inflation expectations if not for excessive fiscal and monetary stimulus well beyond pandemic-driven support needed in 2020. The Fed was too late normalizing monetary policy believing inflation was transitory, while the *Build Back Better* boondoggle, split between the *American Rescue Plan, CHIPS and Science,* and the *Inflation Reduction Act,* proved costly in imputed policies for little benefit to society. Intermittent recessionary conditions in 2023 were a prelude to disappointing growth in 2024-2025. We forecast slower US GDP of 1.8% in 2024, as CPI inflation moderates, but still averaging 3%, and above the Fed's implicit target.

Economic Forecasts	2020	2021	2022	2023	2024e	2025e	2026e
GDP Growth (Y/Y Real)	-1.1	5.8	0.7	3.2	1.8	2.0	2.0
S&P500 Op Earnings Gr	-13.8	49.0	4.8	2.2	6.2	6.4	8.0
CPI Inflation (Y/Y)	1.3	7.2	6.4	3.3	3.1	2.8	2.5
Unemployment	6.7	3.9	3.5	3.7	4.3	4.5	4.5
Fiscal Deficit (vs.GDP%)	-15.5	-11.2	-6.9	-5.0	-9.4	-9.0	-7.0
Fed Funds Target[1]	0.25	0.25	4.50	5.50	4.75	3.75	3.50
10y Treasury Notes	0.91	1.50	3.83	3.87	4.50	4.80	4.80
S&P 500 Target	3756	4766	3840	4770	5200	5300	5800
S&P 500 Total Return %	18.4	28.7	-18.1	26.3	10.3	5.2	8.7

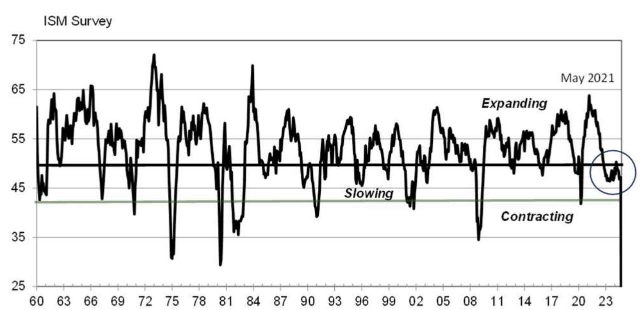
1. *Target denotes top of published ¼% policy target range*
Source: Strategic Frontier Management (Year-end or Y/Y change)

The economic surprise of 2024 may be the resilience of U.S. GDP, indicating the economy skirted recession. We observe recessionary-like conditions in weakness of higher frequency economic variables, such as retail sales, industrial production, business sales, and even earnings. Economic conditions seem more consistent with recession. Without new government spending programs, wasteful expanded entitlements or transfer payments, and government hiring, we think GDP and unemployment would have been far more concerning.

The next charts illustrate a clear economic decline in U.S. growth since early 2021 despite government spending more than an additional $3 trillion in unnecessary fiscal spending or expanded entitlements. There wasn't much improvement in 2024. Economic growth measured by industrial production oscillating around 0% since May 2023, negative real retail sales, and ISM Survey persistently below 50 are indicative of an economy flirting with recession. Business Sales and Export growth also have rolled over.



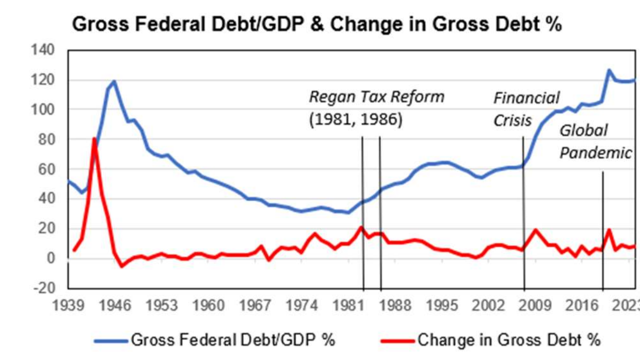
The private sector has flirted with recession for some time now, but real GDP remains positive by virtue of U.S. government spending and public sector employment growth. U.S. equity profits languished over the last three years despite fiscal spending that should have bolstered growth. Since growth peaked in Spring 2021, private sector real growth declined to a negligible level. ISM is a reliable higher frequency indicator of U.S. growth and suggests the economy is weaker than GDP implies. ISM hovered below 50 since Fall 2022, and is trending lower in 2024, highlighting dismal policy effects since 2021.



When spending exceeds the capacity of government to collect revenue, countries run fiscal deficits that compound the government debt burden. During the Global Pandemic, U.S. government spending soared to 47% of GDP, and was still hovering at 34% in 2023 according to the US Bureau of Economic Analysis.

Fiscal deficits of 6-8% compound frightening Debt/GDP exceeding 120%. We think there is increasing likelihood of a Government Bond liquidity crisis, which require steeper global yield curves in a self-reinforcing bond market sell-off. Interest burdens are soaring with higher interest rates, as the Federal Reserve reduces Treasury holdings further increasing supply. US Treasury has favored higher yielding shorter maturities, which increased interest cost. Issuance maturity must extend while yields are lower, but can force longer yields higher.

The *Build Back Better* boondoggle played out in the American Rescue Plan ($1.9 Trillion), *Inflation Reduction Act* ($891 billion), and *CHIPS and Science Act* ($280 billion), plus other actions such as Student Loan forgiveness at high cost of future fiscal stability. Many *Interpretive Agency Rules* and *Executive Orders* were successfully challenged in the Courts, but given soaring fiscal deficits and unsustainable debt burden, inefficient programs must be restrained or cancelled by the next Congress, yielding an inevitable fiscal cliff in 2-3 years

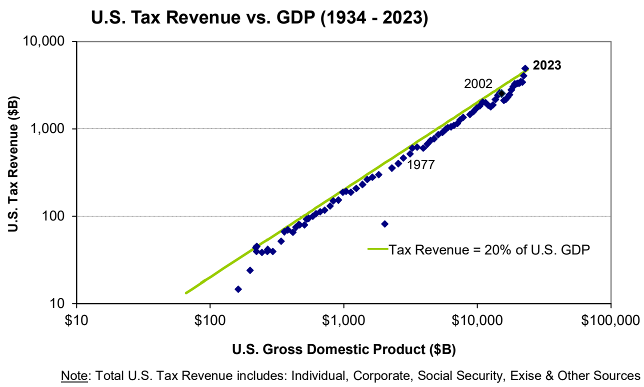


Source: U.S. Office of Management and Budget

Excessive spending on subsidies, tax credits, and other programs in extraordinary spending bills drove higher deficits, but there isn't much shovel-ready infrastructure to show for it, including absence of new power plants or transmission lines to meet rapidly increasing electricity demand. Instead, EPA and other government agencies would rather de-carbonize, incentivize electric cars and charging stations, as well as limit gas stoves and water heaters, which will further overwhelm the electric grid.

Misguided US policies reduced global competitiveness, potential growth, productivity (higher inflation), and profit margins, resulting in negligible U.S. earnings growth in 2022-2023. While expectations are high, we expect earnings to be disappointing again in 2024. Higher interest rates and low-to-negative money growth globally also limit economic growth. Our indicators of economic conditions (inc., growth, inflation, margins, etc.) highlight the dramatic economic impact of adverse new policies.

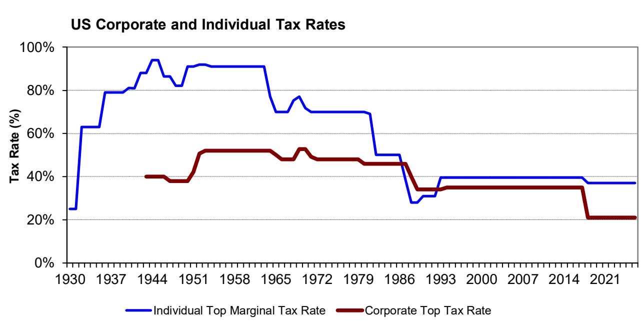
We have often cited *Hauser's Law* in discussion about tax policy and unsustainable fiscal deficits. This "Law", really an axiom, was put forward in 1993 by William Kurt Hauser: *"No matter what the tax rates have been, in postwar America tax revenues have remained at about 19.5% of GDP*". Hauser realized the *Laffer Curve*, illustrating a relationship between tax rates and levels of tax revenue are analogous to his empirical axiom.



Source: Office of Management and Budget

It is a remarkable empirical observation that the U.S. Government individual tax collection can't exceed 18-20% of GDP since 1934, irrespective of widely varying tax rates. It is not illogical that this characteristic number may be unique for each country. Cutting taxes increases growth and productivity, boosting tax revenue. Raising tax rates can't boost tax revenue, as raising tax rates tends to slow economic growth, which limits income growth, thus tax revenue. Similarly, cutting tax rates increases real growth and income, thereby boosting tax revenue, while keeping inflation in check—hence necessity of dynamic scoring.

Notable variations appear after the economy stumbles through recession, causing income to decline (ex: 1977, 2002, and 2009). This is further evidence that change in tax revenue is mostly a function of economic growth, not tax rates. Higher taxes reduce incentive to work, produce, invest, and save, thereby dampening overall economic activity and job creation. Only better government management of spending and increased efficiency can we hope to reduce the total debt burden.



Tending to focus on federal tax rates and Treasury debt, ignores the burden of state, plus municipal spending, and debt. Many states have low-or-negligible income tax, but for those with higher tax rates like California, New York, or Illinois, government program inefficiency seems to correspond to much greater budget issues. The wailing for the wealthy and business to just pay their fair share fall flat considering actual tax data, which corresponds to a highly progressive tax rate schedule. Democratic Socialists in Congress seek to tax unrealized capital gains, which is impractical and does nothing to increase tax revenues, only pulls forward timing of taxes due, while being antithetical to encouraging potential growth and entrepreneurialism. Increasing the corporate rate would be inflationary, while reducing U.S. global competitiveness and potential growth.

Presidential Candidate Kamala Harris promises to increase capital gains and dividend tax rate from 20% to 28%, boost stock buyback tax (introduced in IRA) from 1% to 4%, and corporate tax rate from 21% to 28%. Few candidates, if any, win by promising to raise taxes! The 2017 Tax Cut and Jobs Act reduced the top corporate tax rate from 35 percent to 21 percent and the average combined federal and state rate from 38.9% to 25.8%, which was roughly equivalent to the OECD average rate of 26.1%. The Tax Foundation analyzed Kamala Harris' tax plan—hiking corporate tax rates would reduce potential GDP growth by 0.6% and about -2% overall from all her proposals, depressing real wages.

	Single Filers		Married Filing Jointly	
Tax rate	on taxable income from	up to . . .	on taxable income from	up to . . .
10%	$0	$11,000	$0	$22,000
12%	$11,001	$44,725	$22,001	$89,450
22%	$44,726	$95,375	$89,451	$190,750
24%	$95,376	$182,100	$190,751	$364,200
32%	$182,101	$231,250	$364,201	$462,500
35%	$231,251	$578,125	$462,501	$693,750
37%	$578,126	And up	$693,751	And up

However, aren't rich executives paying lower tax rates than their Assistants? In their zeal to pass on higher tax rates, Presidents Obama and Biden often repeated the false narrative that millionaires are paying a lower tax rate than middleclass folks, and must pay their fair share. Warren Buffett and Bill Gates may be Billionaires, but they are exceptions given tax tables above or IRS published effective tax rates. Warren Buffett, CEO & Chairman of Berkshire Hathaway, earned a salary of $100,000 annually for over 40 years, which was likely less than what he paid his *Secretary*. Bill Gates earned his wealth from Microsoft stock holdings, but the $3.00 per share dividend now yields $476.6 million/year taxed at 20% capital gains or dividend rate, plus 3.8% *Net Investment Income* tax.

Dividends were exempt from taxation from 1913 – 1953 except 1933-1939, and had a reduced rate since 2003. Taxing dividends is "double taxation", because the money used to pay out dividends is from taxable profits earned by corporations. Taxing dividends and capital gains at lower rates can substantially lower the cost of capital, encourage risk-taking and entrepreneurialism, thereby increasing potential growth.

Since 1954, the capital gains tax rate has almost always been lower than the top ordinary income tax rate—it certainly has never been higher than the ordinary income rate, and applicable across most developed countries. Realized gains over longer periods results in compounding combined gains over many years, but under a highly progressive taxation, taking all of the profit as income in one year can push taxpayers into a higher tax bracket. Capital gains aren't indexed for inflation, so a seller pays tax not only on the real gain, but also gains attributable to inflation.

Such policy debates perniciously confuse wealth and income, if not misguided efforts to reduce wealth or income inequality by redistribution, seeking to justify ever more progressive taxation or question the value of adjusting capital gains and dividend tax rates. In 2013, a provision of Obamacare imposed a new tax of 3.8% on capital gains and dividends, but to what effect?

It is true that relying on long-term capital gains and dividends for income can lower effective tax rates. The representative table below shows just how our highly progressive tax system actually works using IRS data, not cherry-picked exceptions. The Top 5% pay 23.3% on average, funding ~2/3rds of total individual tax revenue, whereas the Bottom 50% have an average tax rate of just 3.3%, and fund just 2.3% of individual taxes paid:

Who Pays Most of Federal Income Taxes?

Individual Tax Returns	Top 1%	Top 5%	Top 10%	Bottom 50%	All Taxpayers
Average Tax Rate	25.9%	**23.3%**	21.5%	**3.3%**	14.9%
Total Income Taxes Paid %	45.8%	**65.6%**	75.8%	**2.3%**	100.0%
Total Adj Gross Income %	26.3%	42.0%	52.6%	10.4%	100.0%
Average Income Taxes Paid	$653,730	$187,468	$108,251	$667	$14,279
Number of Returns	1,535,899	7,679,495	15,358,991	76,794,954	153,589,908
Adj. Gross Income ($Billions	$3,872	$6,182	$7,746	$1,531	$14,722

Source: IRS - 2023 Tax Year, https://www.irs.gov/ -- Latest Federal Income Tax Data

Similar misunderstandings arise with business taxation rates, but companies with large tax-loss carry-forwards may not pay taxes some years until they are profitable again, but tax income they surely will. Maybe if we instead simplified our tax system, got rid of all special tax credits Congress used to favor allies, financial efficiency might improve. The best way to promote fiscal balance is to stimulate growth and spend taxpayer's money efficiently, then limit inflation by increasing productivity and bolstering global competitiveness, while reducing government waste, fraud, and abuse. President Biden's policies worked to opposite affect. Never before have we observed such clear cause and effect between policy changes and adverse variances in economic conditions.

Inflation

We expect U.S. CPI inflation to normalize around 3% with heightened inflation expectations—inflation is likely to remain above the Federal Reserve's implied target of 2.0% PCE inflation, which slid after more than a decade of disinflation, as behavioral recency bias guided it lower. CPI Inflation increased 20% and producer prices (intermediate goods) increased 27% since Jan 2021—only deflation of a recession can reverse price increases. Volatile food and energy have led inflation lower, but we are concerned inflation may struggle to fall further. Reducing the inflation rate only slows further price increases, but the economic damage is irreversible.

Forces that triggered the U.S inflation spike in 2021-2022 spread globally. It began with poor U.S. Energy policy driving oil and natural gas prices higher by increasing green initiatives, combined with limiting fossil fuel exploration, production, and pipeline distribution, which triggered higher energy costs, thereby higher transportation costs. This radical energy policy without precedent has already cost American households dearly in inflation, but also a debt burden that soared beyond any imaginable forecast. Taxpayers must pay that bill in years to come.

On his first day in office, President Biden canceled the Keystone XL Pipeline construction permit, and thereafter limited new leases, pipelines, and other infrastructure. The Biden Administration's reality-defying regulations sought to restrict nearly every aspect of conventional energy from oil to coal and natural gas, even nuclear power, although recently they seemed to reverse course given soaring power demand to build out Gen AI. Environmental restrictions extended to exploration and production of commodities and basic resources too.

Other Executive Orders lifting inflation (2021-2024):

- Repeated efforts to cancel or defer student loan debt—overturned by successful Supreme Court challenge.
- Imposed US Government net-zero emission standard.
- Require federal contractors to pay employees $15 per hour, indexed to inflation thereby boosting labor costs.
- IRA: Rewrote Affordable Care provisions to transition 600,000 enrolled in employer coverage, driving up private health care premiums (2025: ~10% increase).

The Executive Branch failed to encourage market-based solutions, incentivizing innovation to increase efficiency or reduce emissions—it chose instead to pick winners and losers with tax credits and handouts, chronically subject to fraud and abuse. We instead will rely on greater oil imports, and force reliance on electric vehicles and appliances, including cooking, heating and cooling our homes. Across the Atlantic, Europe found itself too reliant on Russian natural gas transiting Ukraine after Nord Stream was damaged. Yet, the U.S. restricted and limited permitting of natural gas export terminals.

The *Build Back Better*[1] boondoggle, split between the *American Rescue Plan* and the *Inflation Reduction Act or CHIPS*, proved costly to taxpayers as it further boosted inflation, but failed to benefit to society. That which could not be done legislatively (i.e., student loan forgiveness, limiting permits, immigration and criminal justice reform, gutting the *Fiduciary Rule* to support

[1] U.S. policy since 2021 was guided by the Biden-Sanders Unity Task Force recommendations that provided Bernie Sanders suspended his candidacy could ramrod his *Progressive Socialist* values into the 2020 Democratic Party Platform, including: 1. Combatting the Climate Crisis, 2. Pursing Environmental Justice. 3. Reinforcing of DEI, ESG, and 4. Elevating Social Justice and 5. Equity vs. Liberty & Equal Opportunity. In 2024, Kamala Harris' *Opportunity Economy* shares similar characteristics, principles and values despite observing the most dismal economic consequences since the 1970s.This election provides clear difference of opinion impacting the future of America.

ESG/DEI, etc.) was pursued through agency rules and regulations, if not by Executive Order. Without building sufficient power plants and transmission lines, as power-hungry AI computing needs soar, brown outs and a less reliable electricity grid increase. Power scarcity drives up transportation and electricity prices, as well as cost of other utilities and essential services.

The *Inflation Reduction Act* (in name only) appropriated $891 billion in spending, of which $783 billion was for *Build Back Better/Green New Deal* initiatives—hardly satisfying infrastructure needs we were told were critical such as: roads, bridges, airports, railroads, broadband, energy production, and essential services. Consider that $623 million was allocated to build public EV charging stations, but not one has been completed. It included $42.5 billion to expand internet access for underserved areas, tapping VP Kamala Harris to lead this *internet-for-all fiasco (opportunity economy)*. U.S. Commerce said it will take a decade to get this completed and operational.

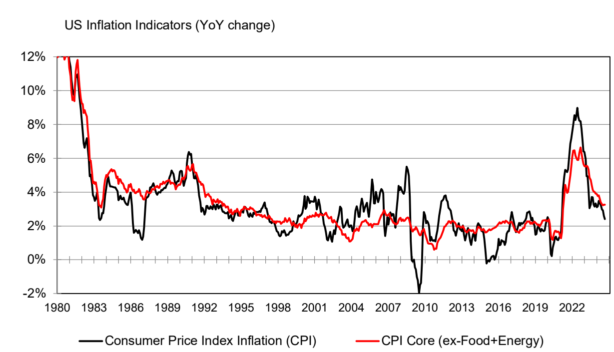
Saddled with the high cost of green energy policies, energy costs have risen 31.8% since January 2021. The IRA also modified Medicare Part D (prescription drugs), which will result in significant increases in insurance premium so the government can claim they lowered the cost of prescriptions. So, the Administration carved out a subsidy of $5 billion to reimburse insurance companies to delay premium increases until after the election. The ways IRA increased inflation, are insidious, although it was pitched as critical infrastructure investment.

Many rules and executive orders have been challenged in court, but the process was/remains excruciating, and the damage was done even if common sense and rule of law eventually prevail. Such aggressive use of non-legislative change can also backfire. Consider now the reversal of Chevron deference, which had enabled federal agency public rulemaking on a range of healthcare, financial services, workplace safety, energy, transportation, and environmental policies. In June 2024, the Supreme Court overturned *Chevron* and held that *courts may not defer to agency interpretation of the law simply because a statute is ambiguous.* Administrative overreach backfired, as this ruling has profound impact curtailing unconstitutional extracurricular rule-making and regulations that reside with Congress or otherwise must be judiciously interpreted by the Courts.

The policies adopted by the Biden Administration had broad adverse effects on the economy, reversing nearly every constructive policy of Trump's Administration from domestic to foreign policy, criminal justice to immigration policy, fiscal to economic and trade reforms, as well as free market and regulatory policy reforms. These policies also compromised rule of law, liberty, free speech, and equal opportunity, in pursuit of *equity*. They drove up inflation to the highest level in over 40 years, and knocked > 1% off potential growth. Consider that Gallup's July Survey recorded 78% believe the U.S. Economy under Biden-Harris is Fair or Poor (vs. 22% Good–Excellent), and 70% believe the economy is "getting worse'. Unleashed inflation expectations and wrong-track evidenced by weaker consumer sentiment suggests a more dismal future continuing down this path.

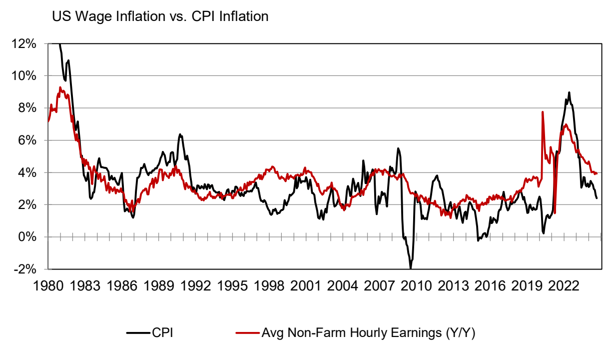
The Democratic Platform was never re-formulated when President Biden stepped aside, thus still implies further action on inflationary policies, including regulation, price controls, and more subsidies. The *Opportunity Economy* seeks greater *equity* at the expense of *equal opportunity* and *right to happiness (property rights)*. Candidate Kamala Harris seeks to raise corporate tax rates and boost share buyback taxes (IRA introduced 1% tax), which will be inflationary and slow potential growth. She also proposed increasing individual taxes on capital gains, and taxing unrealized capital gains, if not impose a wealth tax so the *rich pay their fair share*. There is little that seems to change relative to prior misguided policies, extending Progressive Socialist values.

Socialism has failed everywhere it has been tried without exception over the last 100 years. State control of the means of production or prices, and other insidious policies, attempted to redistribute income and wealth under ever more *progressive fiscal control,* yet failed to subvert economic principles. Socialism's greatest flaw is its incompatibility with the *Rule of Law,* individual liberty, and property rights. In contrast, *Free Market Capitalism*, governed by market-determined prices driving allocation of goods and services (supply-demand), is credited with higher economic growth, greater average income, and improving living standards for over a century. Modern *Progressive Socialism*, rooted in *equity redistribution* and *social justice,* is as doomed to failure with depressed economic potential just as *Democratic Socialism*, yet requires similar command and control of media, free speech, and educational institutions. Haven't we run enough experiments to understand the consequences? This U.S. election is about material policy choices.



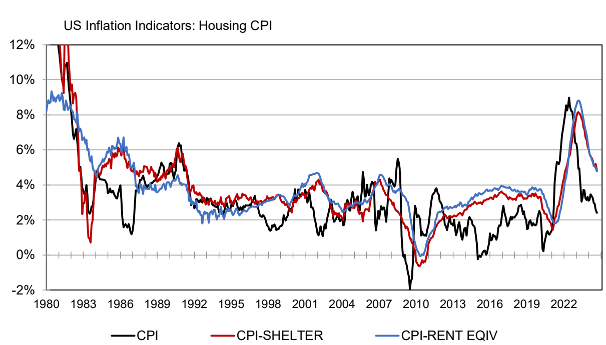
We know the last decade was unusual, characterized by globalization and disinflation during the *Fourth Industrial Revolution.* However, we expect lower productivity with increased regulation, taxes, and labor costs boosting inflation expectations. Two decades of disinflationary forces are moderating, even if *Artificial Intelligence* innovations extend productivity gains a bit longer.

Labor, Resource, and Energy intensity have declined, but further progress will be more challenging with increasing competitive threats. If real potential growth declined to 1.8%, and CPI inflation settles at 3%, as we expect, this new regime implies a normal policy interest rate of 3.5%, not 2.9% expected by the FOMC. Core CPI (ex-food, energy) has bottomed out at 4%, but cyclical energy prices could head higher again. The Strategic Petroleum Reserve was depleted, increasing America's dependency on the OPEC cartel. Labor costs stabilized around 4%, much higher than 2% implicit inflation target, so the continued decline in CPI should revert toward 3%.



Is this so surprising given the policies of the last 3 years, that inflation is behaving more like 1970-1990 then 2001-2021? Poor U.S. policy decisions boosted prices of everything by mid-2022 from basic resources, energy, and transportation to goods and services. Higher inflation expectations, coinciding with lower productivity and potential growth, crippled US competitiveness and increased potential for stagflation. The inflation rate moderated, but ***higher inflation expectations*** will likely settle at a higher level and take time to ease.

There is also still a housing shortage keeping inventory low and prices higher, even as household formation surges. Housing affordability remains challenging as average mortgage rates exceeded 7½%—the highest rate since 2000. However, this chart suggests housing costs are likely to keep inflation from settling lower too.



Benign inflation is not assured with unleashed higher inflation expectations for reasons we've discussed. Labor cost inflation will be slow to recede as workers, lagging behind inflation, seek to maintain purchasing power, particularly in union contract negotiations that spill over into wages generally. Utilities are raising prices after lags in regulatory approval. Pricing power was restored as consumers no longer expect relatively constant prices, so inflation expectations will be difficult to contain. Sticky inflation will limit retreat to the Fed's implicit target—we expect inflation to settle higher based on the trends of various key inflation elements above.

Higher-for-longer inflation will result in higher-for-longer interest rates. US CPI inflation averaged 2.5% over the last decade, but over the last 60 years it has averaged 3.9%. Diminishing comparative advantage in labor, energy, and material costs with greater automation has increased reshoring. We expect limited labor market slack with low unemployment, plus tight housing, will force CPI inflation to settle closer to 3% longer-term.

Interest Rates

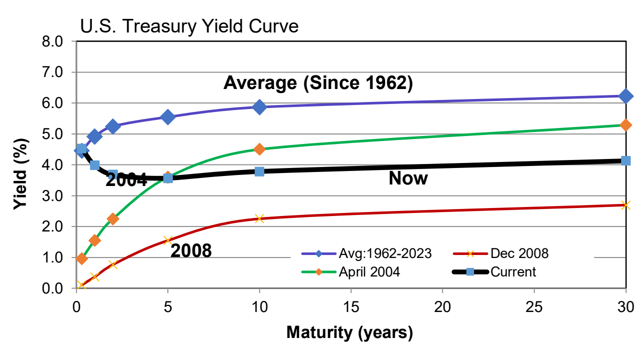
The Federal Reserve raised interest rates by 5¼% since March 16, 2022, yet the US 10-year Treasury rose just 2% from 1.85% to 3.85%. The yield curve remains unusually inverted given economic conditions. The Fed's long-term equilibrium Fed Funds target of 2.9% is low vs. 3.5%, assuming CPI inflation averages 3.0%.

Median Forecast U.S. Fed %	2020	2021	2022	2023	2024e	2025e	2026e	2026e	LongRun Forecast Fed	SFM
GDP	-2.40	5.90	0.50	2.60	2.00	2.00	2.00	2.00	1.80	1.80
U.Rate	6.70	4.80	3.70	3.80	4.40	4.40	4.30	4.20	4.10	4.50
PCE	3.40	4.20	5.60	2.30	2.10	2.00	2.00	2.00	2.00	2.50
Core PCE	3.00	3.70	4.80	2.60	2.20	2.00	2.00	2.00	2.00	2.50
Implied CPI	1.50	3.50	6.10	2.80	2.60	2.50	2.50	2.50	2.50	3.00
Federal Funds Avg.	0.09	0.13	4.38	5.38	4.51	3.09	3.06	2.99	2.91	3.50

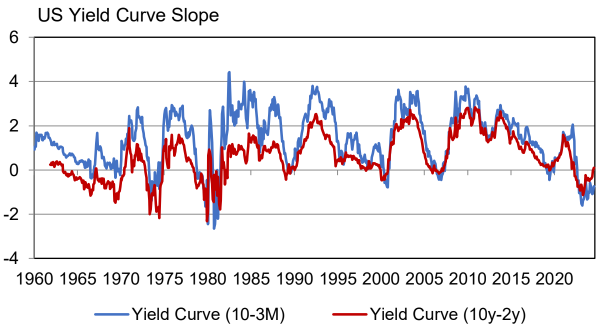
Interest Rates	2020	2021	2022	2023	2024e	2025e	2026e	2026e	Longer Run
FOMC Avg.	0.13%	0.13%	4.38%	5.38%	4.51%	3.09%	3.06%	2.99%	2.91%
Forecast[1]	0.25%	0.25%	4.50%	5.50%	4.75%	3.75%	3.50%	3.50%	3.50%
Rate Change	-1.50%	0.00%	4.25%	1.00%	-0.75%	-1.00%	-0.25%	0.00%	

1. Top-end of indicated Fed Funds range

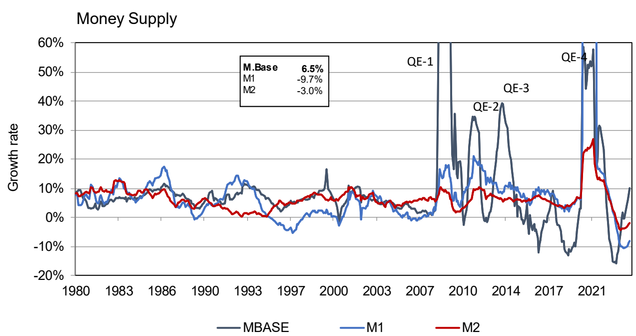
The historical yield curve relationship to the economy is critical to understand. We observe that the shape of the yield curve is very unusual given current economic conditions, likely due to the Fed manipulating market interest rates for a decade—as we've deemed this *explicit moral hazard*. Persistent upward sloping yield curves are necessary to compensate investors for term risk premium of longer duration bonds. We expect 10-year Treasury yields should rise above 5.0%. The chart below highlights unusual yield curve behavior recently.



Economists often associate yield curve inversions with recessions, but yield curve inversions also seem to anticipate equity corrections with greater predictability. Consider timing of the last six yield curve inversions. Is the latest trough a spectre of an imminent correction?

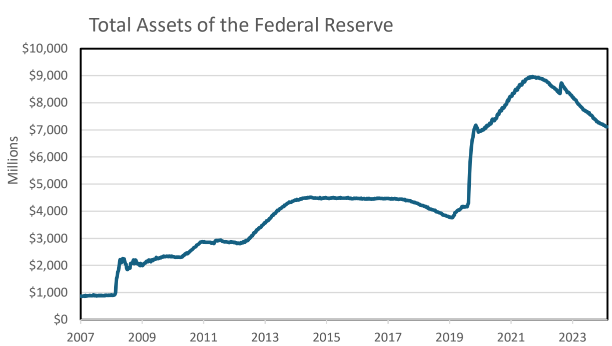


There are similarities today vs. 1999-2001 (Dot.com bubble). Money supply also was extremely volatile, but now is likely to expand below the normal pace of nominal growth for the foreseeable future as the Fed reduces its bond holdings by $5 trillion. Still restrictive monetary policy will limit economic activity.



Source: Federal Reserve

Low-to-negative money growth are a consequence of extending emergency monetary stimulus well beyond needed. Tightening monetary policy, including reducing QE holdings, will limit potential growth and liquidity needed for sufficient income growth to drive tax revenue.



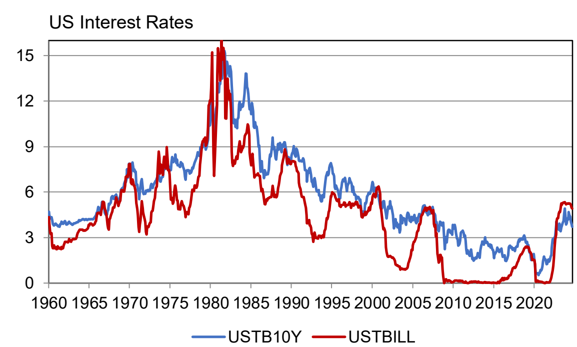
Source: Federal Reserve

The Federal Reserve's QE bond holdings have declined just over $1.8 trillion after peaking in 2022, yet the reduction in accumulated holdings has only begun. The Fed must sell or run-off $5 trillion to get to a now normal level of just $2 Trillion needed to manage monetary operations. The 6-8% fiscal deficit/GDP, exceeding $2 trillion in FY 2024, increases excess bond supply bond.

Foreign US Treasury holders reduced their financing share of outstanding U.S. debt plunging to 22.4% from 33% in 2015. Japan and China remain the largest foreign holders of US Treasuries, although China's holdings peaked in 2015 and Japan peaked in 2021. This source of bond supply can force long yields higher.

The U.S. Treasury also needs to increase the average issuance maturity to extend outstanding debt. The current average maturity of outstanding debt is just 71 months, despite an inverted yield curve. This is a missed opportunity as Congress compounded debt at higher interest rates with imprudent appropriations driving 6-8% fiscal deficits since 2020—initially to offset recessionary effects of the global pandemic, which quickly subsided.

The last bit of *Risky Business of Regime Change* is how debt is compounding faster with higher interest rates. The U.S. Government will spend $1.16 trillion on interest alone in FY 2024 on $35.3 trillion debt. Interest expense exceeded the Defense budget by 41%, and is equivalent to 4% of GDP—this is unsustainable, and are past a tipping point in recovering. No wonder the Federal Reserve must believe it needs to reduce interest rates as soon as possible. Unfortunately, the bond market won't provide much relief if the U.S. is now on credit watch and could see its debt downgraded further.

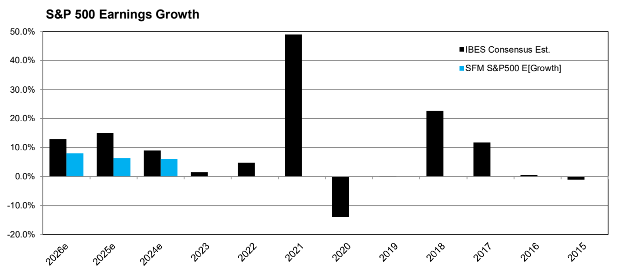


We think the bizarre behavior of Treasury bond yields recently is in part a consequence of experimental monetary policies that induced *explicit moral hazard* for over a decade, including exceptionally low interest rates, successive periods of quantitative easing, and extended forward guidance since the Financial Crisis of 2008.

Earnings

We observed volatility in S&P 500 earnings growth, as well as general absence of growth recently. In 2021, earnings rebounded as the pandemic receded. We are entering a period of declining margins as growth slows with lower productivity and higher inflation expectations.

Operating Earnings	2026e	2025e	2024e	2023	2022	2021	2020	2019
IBES Consensus Est.	12.9%	14.9%	9.0%	1.5%	4.8%	49.0%	-13.8%	0.1%
SFM S&P500 E[Growth]	8.0%	6.4%	6.2%					
SFM S&P500 Target	5800	5300	5000	4770	3840	4766	3756	3231
Index Return (no Div)	9.4%	6.0%	4.8%	24.2%	-19.4%	26.9%	16.3%	28.9%
Dividend Yield %	1.33	1.34	1.34	1.47	1.75	1.29	1.48	1.85
Total Return	10.8%	7.3%	6.2%	26.3%	12.6%	16.6%	13.9%	13.6%
S&P 500 @18x SFM TE	4860	4500	4230	3984	3926	3746	2515	2919
S&P 500 P/F12 (SFM)	17.7	16.9	18.0	14.5	17.3	21.9	18.0	23.1



Source: LSEG I/B/E/S vs. Strategic Frontier Management Estimates

More realistic long-term earnings growth of 5-7% may be challenging but won't be enough to correct extended valuations. If the economy slows and margins decline, earnings growth must be limited. Analysts are chronically overly optimistic, but we expect just 6.4% earnings growth or just 2/3rds of 2024 consensus and 43% of 2025 consensus.

Artificial Intelligence Grows UP

We've highlighted since 2022 that disinflation effects of the *Fourth Industrial Revolution* were sunsetting. Artificial Intelligence (AI) involves the creation of processes, systems, or machines that can mimic human intelligence executing tasks or driving systematic processes. It is evolving rapidly, and likely will bolster productivity growth a few more years, but can't alter the secular trend of diminishing productivity gains observed.

We have long championed Artificial Intelligence in our future themes. Yet, we expect growth in related profits will be slower than anticipated, even if the economy gets a boost from productivity. The drive to invest in *anything-AI* across private and public markets, particularly *Generative AI,* is still speculative. Where AI will have the greatest impact has been and will continue to be in automation and systematic workflows, or quantitative analytical work. AI expanded our thinking and what is realistically possible, tapping unstructured data and natural language, which increased public visibility and accessibility. Commercialization potential increased.

AI is a creative application of mathematics and statistics, including use of decision-making optimizers and data science. AI research for decades reached a tipping point recently with the consumer releases of Generative AI capabilities, which captured our imaginations. I've often discussed its promise in *Future Themes* work updated every couple of years since 2004, as well as in these commentaries. Indeed, speculative enthusiasm reached a fevered pitch driving the *Magnificent Seven* and other technology companies to risky valuations, in our opinion. Yet, we still have yet to see much broad payoff in economic or earnings growth—AI has become a ubiquitous tool needed to succeed, but not a giant maker with high barriers to entry.

Recent advances in Gen AI brought attention to applications, and enabled non-programmers to enhance or build new systems. Google and OpenAI inspired us opening up potential possibilities, but it is only a slice of what AI can do. The gap between competitors will narrow over time as applications improve dramatically. Don't overlook other ways AI has already and will continue to impact economic and technological progress. Our belief is that economic benefits to broad productivity will be more visible than financial benefits in earnings potential. The greatest differentiation will be for those that ignore AI's potential for their business.

New innovative software tools have reduced coding experience required to build robust application, but begs the question—how to preserve sustainable comparative advantage driving excess margin with lower barriers to entry? The AI phenomenon may boost economic productivity (lower labor cost), but likely lowers margins too, reducing potential earnings growth. Many investors don't seem to understand consequences of ignoring competitive threats in free markets, particularly as companies are stumbling over each other, and have limited ability to protect intellectual property or first mover advantages in an open-source world. Capital expense building out AI infrastructure will depreciate rapidly with innovation, and may yield *low return on capital* this cycle.

Emergence of Gen AI provided Main Street a view into the potential future of AI and Machine Learning (ML) through the lens of Large Language Models (LLMs). Yet, given investment needed to build these models, an oligopoly has emerged among first movers engaged in a competitive arms race. Investors are enthusiastic across the spectrum for industrial, infrastructure, life sciences, banking and financial services, if not everything in between including software development. However, we think this will limit earnings potential as competitive threats emerge and barriers to entry are low. Consider *Mistral*, which in 9 months raised $500 million.

Gen AI access emerged quickly, which allowed people and machines to work together with relatively little effort or programming skill. It made internet search better overnight. The power of these systems is impressive, but also highlighted many commercial risks or malicious activities able to leverage its power for less than noble ventures. Developers' biases emerged, as did the unexpected need to manage prediction errors or hallucinations. Results can be unsettling for users expecting numerical precision of digital computers, but use cases emerged rapidly, including industrial and task automation to analyzing unstructured data, and increasing systematic task efficiency

There is no shortage of consultant opinions, specifically from BCG, McKinsey, Accenture, Gartner, and others.

Their conclusion is that the Gen AI revolution has only begun, and will radically transform work by boosting productivity, thereby increasing worldwide GDP. McKinsey suggests Gen AI could boost productivity, adding $2.6-4.4 trillion annually to global GDP—double that if embedded into existing legacy systems. This forecast may be too optimistic, although we suspect it is directionally correct. Yet, it begs the question will labor intensity decline further, and will it limit labor costs at a time workers expect wage growth to exceed inflation?

In *The Economic potential of Generative AI: The Next Productivity Frontier (June 2023),* McKinsey makes a case that Gen AI will impact the future of work in ways we have only begun to anticipate, while rekindling global productivity. Estimates for boosting potential growth seem unrealistic for Gen AI alone, but we expect AI, in all it forms (inc., Machine Learning, Reinforcement Learning, Neural Networks, Generative AI, Natural Language Processing, computer vision, fuzzy logic, expert systems, and other disciplines) could have that level of impact. Important complementary tangents to AI, including adaptive robotics, advanced sensors, and quantum computing, will enable AI to realize its full potential. AI likely will rival economic impact on the order observed from the Personal Computer (1990s), Internet (2000s), or Mobile & Cloud Computing (2010-Present).

Gen AI is already enabling new capabilities and amazing results, resulting in many new companies leveraging it. However, large companies will struggle to show contribution to earnings for several years, whereas small companies could see more immediate commercial payoff. Gen AI product margins will be limited by high computing and data storage costs, greater open-source access if not expanding competition. Potential copyright/property issues of massive non-public domain datasets, content, and news sources required to train models is limiting the reach and competitive advantage.

The payoff in margin and product solutions will come with and developing proprietary large language models (LLMs) specifically designed and fit for purpose, rather than relying only on publicly available products powering ChatGPT or Gemini. Many companies are filling this gap, not attempting to compete with OpenAI, Google, or Microsoft on their terms, but are developing the tools, applications, engines, and other capabilities to engineer robust proprietary datasets, or more effective and better solutions from first principles.

Y Combinator (YC) is a startup incubator that helped launch over 4,000 companies. YC invests $500,000 in hundreds of pre-seed companies it accepts into its program, funding about ~1% of roughly 32,000 startup applications per year. The YC Summer 2023 Batch was estimated to include ~35% AI-focused startups, according to a Bloomberg interview with CEO Gary Tan. The Winter 2024 Batch included 260 companies, of which we estimate 60% were AI-enabled or AI-focused.

Our concern is that there is little awareness about competition likely to compromise financial performance.

The massive amount of energy needed to power AI computing centers has contributed to a resurgence of interest in nuclear power. Microsoft, Amazon Web Services, and OpenAI sought to secure nuclear power capacity in order to manage the clean electricity demand required by their computing centers. Amazon acquired a data center campus powered by Talen Energy Corp.'s nuclear power plant, while Microsoft announced an agreement with Constellation Energy to restart Three Mile Island’s dormant nuclear power plant to power their AI and cloud data centers. OpenAI CEO Sam Altman backed the nuclear power startup Okio (OKLO). However, what are we to make of electricity cost and grid reliability if companies snatch up so much generation capacity? This increase in demand will be inflationary for some time to come—as energy demand increases, our already strained energy infrastructure, marginalized by Green New Deal, is not prepared to meet future needs.

Expanding nuclear power capacity looks more viable to address energy challenges, but another longstanding Future Theme is coming into focus. *Quantum Computing* has the potential to change the world, and how we think about computing resource and energy needs. Quantum Computing’s potential can be leveraged in conventional computer systems today with *quantum intelligent* or *quantum inspired* algorithms. A leap forward in Quantum Computing would reduce power consumption demand.

New algorithms can solve more complex nonlinear optimization problems more efficiently and effectively in simulated quantum environments on a scale of orders of magnitude. Complex optimization problems are the heart and soul of mathematical decision-making that enables machine learning, reinforcement learning, and even Generative AI algorithms—think faster convergence with better solution outcomes for solving the most difficult problems or previously unimaginable in a fraction of the time on available computer systems. Progress in quantum computing *need not wait for quantum processors to be available before software algorithms can make a leap forward solving more difficult problems with faster convergence to better solutions.*

Eventually, as realization of Quantum computing in new types of processors can be stable with low error rates at room temperature, then an order of magnitude higher computational efficiency reduces energy intensity at an astonishing rate that the power need plunges, particularly if we ditch super cooling requirements, or even the expensive infrastructure many are scrambling to build out today threading conventional processors.

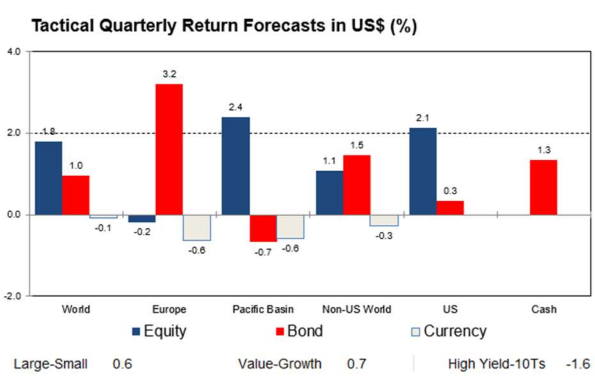
There is also concern about increased job loss due to automation. Research from MIT CSAIL explains, while AI/ML have significant potential, the cost of building and maintaining technology can outweigh the realized benefits. While many jobs will be impacted by automation, it is not yet cost efficient to replace many jobs. Labor intensity has declined for decades with technology innovation—AI has automated many more routine or quantitative tasks, modernized workflows, enabled adaptive robotics, and other control systems, as well as enhanced efficiency of an array of applications, more so than ever imagined.

We have long championed the idea of technology innovation and its impact on society, but we believe mass replacement of individuals on the scale suggested by some consultants is exaggerated and highly speculative. Hurdles of being economically viable is still very high. Given so many new companies imbedding AI at an accelerating rate, we expect a lot of innovation, but also competition that can limit potential profitability. It seems forecasts overlook basic rules of *Competitive Strategy*, well articulated by Michael Porter, as well as certain game theory axioms. No doubt, the nature and future of work is changing, productivity gains will be realized, but we believe numbers consultants toss around seem outlandish.

Global Tactical Asset Allocation Strategy

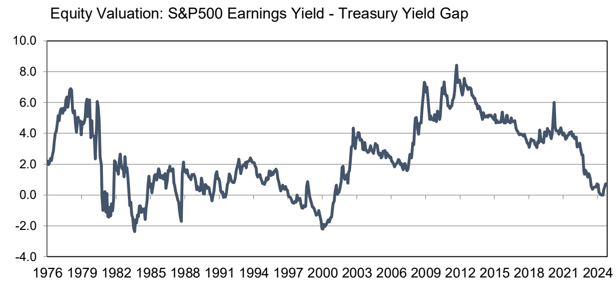
Global asset allocation is the primary determinant of long-run portfolio performance, and thus wealth creation. Tactical Asset Allocation is the discipline of forecasting relative return differentials from asset allocation seeking to maximize risk-adjusted returns. Our outlook reflects mean reversion of bond and equity valuations, both which are stretched. Negligible growth in earnings in 2023 as the S&P 500 index rose over 24%, combined with higher interest rates, suggest downside for US large-cap equities. Investors should expect higher equity, bond, currency, and commodity volatility as monetary policies normalize globally.

Our Global Tactical Asset Allocation forecast model output is summarized below. These quarterly forecasts are designed for tactical use relative to strategic asset allocation with a decade-long horizon.



Source: Strategic Frontier Management

We think US equities will struggle to grow into the current valuation multiple (S&P 500 > 20x) given recent lackluster S&P 500 earnings growth. We believe the equity market is stretched as P/E multiples rose with marginal earnings, even as interest rose. U.S. equity performance was driven by P/E multiple expansion rather than earnings growth. We think the magical thinking of AI growth speculation resembles a *Party like its 1999* proceeding the Dot.com bubble.



Concerns about valuation and economic growth for equities persist, but the recent rally in bond markets (lower bond yield) offsets that for now. Our greatest tactical concern remains U.S. Bonds. Japanese and Australian equities rank highest for now. What models can't anticipate is when BoJ's equity ETF exposure winds down or bond liquidity struggles with quantitative tightening, higher rates, and interest burden of excessively high fiscal deficits given Debt/GDP.

We still believe that intrinsic fundamental value of earnings yield, dividend yield or book value should drive equity investor decisions. Yet, sentiment and momentum have had immense influence for nearly a decade, although technical analysis shouldn't be so useful if markets are *efficient*. Relative market relationships are behaving more like 1998-2000 (Dot.com) than any time since—consider value vs growth or large vs. small-cap.

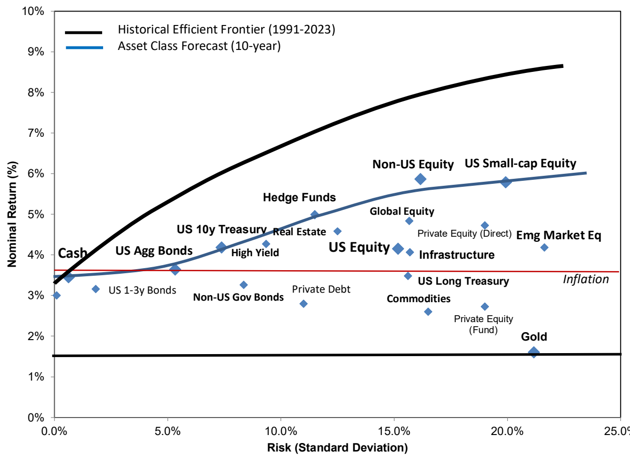
We recommended underweighting US equities since mid-2021, which worked well for 2022, but not so much since October 2023. Valuations should be consistent with slower earnings growth due to withering profit margins and diminished competitive advantage. We continue to favor U.S. value and small-cap, both positions that seem out-of-step with momentum driven and AI/technology centric sentiment.

On October 31, 2023, US monetary policy experienced a dramatic shift in expectations. Stocks soared and the yield curve inverted, but was this rational as the economy has limped along?

Strategic Asset Allocation Forecasts

A consistent, disciplined, and rigorous approach to forecasting risk and returns are an important exercise to develop and maintain robust intermediate-to-long-term *Global Strategic Asset Allocation*. Over longer horizons, economic and financial fundamentals tend to normalize or mean-revert toward equilibrium.

We remain on target with our higher-for-longer thesis regarding inflation and interest rate hikes, which peaked at 5 ¼-5 ½%. We expected the Fed to begin cutting rates in Q4/2024, including a ½% this year and 1% next year. We added a ¼% cut this year, but our normal longer-term equilibrium at 3.5% remains higher than the Federal reserve forecast of 2.9%, consistent with our higher inflation equilibrium.



Source: Strategic Frontier Management (October 2024)

Riskless cash yielding 5%, as short-term bond funds approach 6% yield suggest longer maturity bond funds remain inferior to cash and short-term bonds on a risk-adjusted return basis. Higher short-term interest rates raise the hurdle rate for volatile Cryptocurrencies (0% expected return) and commodities (2.5% expected return). Cash should earn 0.5-1.0% greater return than inflation on average. We favor overweighting cash versus equities and bonds for now.

Total Return	YTD	1-Yr	3-Yr	5-Yr.	10-Y	20-Yr	30-Yr
S&P 500 Index	22.1	22.1	36.4	16.0	13.4	10.7	11.8
NASDAQ Composite	21.4	21.4	38.7	18.6	15.9	13.0	12.6
Russell 2000	11.2	11.2	26.8	9.4	8.8	8.5	8.9
Russell Value-Growth	-7.9	-7.9	-14.4	-9.1	-7.3	-4.1	-1.5
Non-US (World xUS)	13.6	13.6	25.6	8.9	6.2	6.6	6.0
Emerging Markets	17.2	17.2	**26.5**	**6.1**	**4.4**	7.7	5.1
Small-cap Global	11.6	11.6	25.4	9.7	7.4	9.0	
US 10-Year Treasury	3.7	3.7	**10.7**	**0.8**	**1.5**	3.3	4.6
US Aggregate Bonds	4.4	4.4	**11.6**	**0.3**	**1.8**	3.2	4.7
BAML High Yield Bonds	8.0	8.0	**15.7**	**4.5**	**5.0**	6.6	7.0
Short-term Bonds	4.5	4.5	**8.1**	**1.5**	**1.6**	2.2	3.5
JPM Non-US Bonds	1.6	1.6	**12.1**	**-2.9**	**-0.7**	1.7	3.3
Cash (US T-Bills)	3.9	3.9	5.2	2.3	1.6	1.5	2.4
US Dollar (TWI)	1.8	1.8	-1.2	1.3	2.2	0.7	0.5
CRB Commodity Index	12.4	12.4	5.6	13.1	2.0	1.5	5.1
WTI Oil (US$)	-4.4	-4.4	-24.3	4.9	-2.8	1.6	4.5
Gold (US$)	27.5	27.5	41.9	12.3	8.1	9.6	4.5
Bitcoin	50.4	50.4	135.2	50.1	66.3		

Source: Strategic Frontier Mgmt. Returns as of Sept 30, 2024. Performance exceeding 1-year annualized.

We have avoided Emerging Market Equities, and particularly China, for three years, underweighting Emerging Market Equities with further economic and geopolitical concerns about Russia and Brazil too. Only India and South Korea seem to be on a credible path with sufficient potential growth. Marginalization of China's comparative advantages of low-cost labor, energy, and resources with limited regulation as supply chain and transportation costs rise imply challenging margins for exports. Strategic basic resource exports are declining as post-pandemic backlash resets global supply chains.

Dismissing History and Speculative Myopia

The most effective way to destroy people is to deny and obliterate their own understanding of their history.

— George Orwell

The anticipated economic hangover is visible now with fiscal spending and monetary cliffs ahead, as excessive U.S. government hiring should stall. Policy decisions from January 2021 unleashed inflationary forces, undermined US competitiveness, and stalled economic growth in the private sector. Beyond earnings challenges, stretched valuations and slowing growth with higher interest rates are a cruel potion for global equity and bond markets already engaged in *Magical Thinking*.

Benign inflation is not assured with unleashed higher inflation expectations for reasons we've discussed. Rising bankruptcies, debt and interest burdens, leverage, loan delinquencies, and spiraling up bond yields, as we expect, increase risk of a global bond crisis, which also could trigger a U.S. equity correction of stretched valuation.

Treasury yields are well below their long-term historical average with insufficient term risk premium to inflation—this is *Risky Business of Regime Change.* Bond yields will need to rise significantly to clear excess supply. US Treasury hasn't taken advantage of an opportunity to extend debt maturities with yields well below expected long-term Treasury yields of 5-6%. With the inverted yield curve, issuance should be piling on longer-term maturities rather than short-term T-Bills.

Need for tight monetary policy is required to reverse effects of central bank induced explicit moral hazard. We believe risk of a *Global Debt or Liquidity Crisis* is increasing, exacerbated by manipulating free markets (bond yields) for an extended period. Bloated holdings of central banks must wind down, and U.S. Treasury likely recognize losses flowing through fiscal budgets. Massive fiscal deficits increased our debt burden as interest rates increased. Inflation is still not under control, as Japan and China continue to reduce their share of Treasuries, all of which increases bond supply and may limit liquidity.

Real GDP was boosted by unsustainable, government spending and hiring. Inflation came down slower than expected and interest rates rose more than consensus forecast. Recent U.S. Policies undermined global competitiveness, potential growth, and productivity, as higher inflation expectations were unleashed. Slowing economic growth and declining margins have reduced earnings growth. This is a key question for equities—can sufficient earnings growth turn valuations around or will a market correction be required with higher-for-longer interest rates. The equity market may be able to muddle along for a few years, but that doesn't support risk-adjusted return. Income tax revenues will disappoint unless incomes and profits grow. Raising tax rates slow economic activity, driving wider fiscal deficits.

President Biden's innumerable policy mistakes boosted inflation, being rooted in *Magical Thinking* of his progressive advisors, some of them embracing *Modern Monetary Theory*. This shift in Bidenomics can be traced back to the *Biden-Sanders Unity Task Force Agreement*. Ideological wishful thinking, sought to justify a massive expansion of government spending and hiring, reflecting progressive socialist values. The resulting policy agenda unleashed higher inflation expectations after a persistent (not transitory) surge in prices for energy, labor, food, consumer staples, transportation, services, and most basic resources (commodities). Such Magical Thinking assumed that fiscal deficits over 5% and debt exceeding 120% of GDP would be benign—but risk of a global government debt crisis has increased rapidly at a time there is little fiscal flexibility to address any such crisis. The only tool available is to slash interest rates.

The combination of misguided partisan legislation, aggressive overreaching agency rule making, and Presidential Executive Orders with force of law triggered scrutiny of Judiciary (balance of powers) requiring reversals by Appellate and Supreme Court intervention on constitutional grounds. The Democratic response to adverse judicial rulings has been to introduce legislation to add four justices to the Supreme Court and President Biden's call for Court term limits, and other reforms.

New technology innovations can still enhance productivity, and AI potential is becoming more visible. Novel AI applications are not starved for startup capital, but capital costs have increased and wasteful investments were not surprising either when money is too plentiful. Bankruptcies have accelerated, particularly those reliant on cheap financing now that interest rates increased, and venture debt financing is difficult without Silicon Valley Bank, First Republic, and others around. Certainly, the cost of capital has increased.