January 31, 2024

Dear Partners:

We begin 2024 with a set of three high conviction ideas that are based on what the Key Square investment team perceives as anomalies, erroneous conventional wisdom or variant perceptions on our part.

Traditionally, these themes have offered some of the most significant opportunities when our analysis proves correct and the market adjusts to our view. Past examples of this would be that Abenomics would reflate Japanese assets and depreciate the yen; that Greece would not leave the Euro and European assets would recover; that a newly elected Argentine government would pay off its defaulted debt; a positive view following the mini crash on election night after Donald Trump's surprising election win in November 2016; that the market was mistakenly pricing in a victory for populist Front National candidate Marine Le Pen in the 2017 French election; that the Federal Reserve would not hesitate to pursue a Volcker-like hiking cycle.

These are not contrarian views; rather, we believe that market participants are anchored to flawed narratives, giving us attractive entry points or creating underpriced option opportunities. Macro investing is a strategy that typically rewards the ability to sift through imperfect information and create asymmetric payoffs. Such ideas don't always work, but these set-ups traditionally shift the odds in our favor.

The three ideas discussed in greater detail below can be summarized as follows.

1. We believe that equity markets are in the midst of a "Trump Rally" that will last as long as he remains ahead of Biden in the polls. The Key Square view also posits that both political and market analysts are incorrect in their assessment of a Trump second term. It is likely that he would seek rejuvenation/redemption rather than revenge if elected this November. A second term would be expected to embrace Calvin Coolidge-style Roaring Twenties policies over a Herbert Hoover outcome.

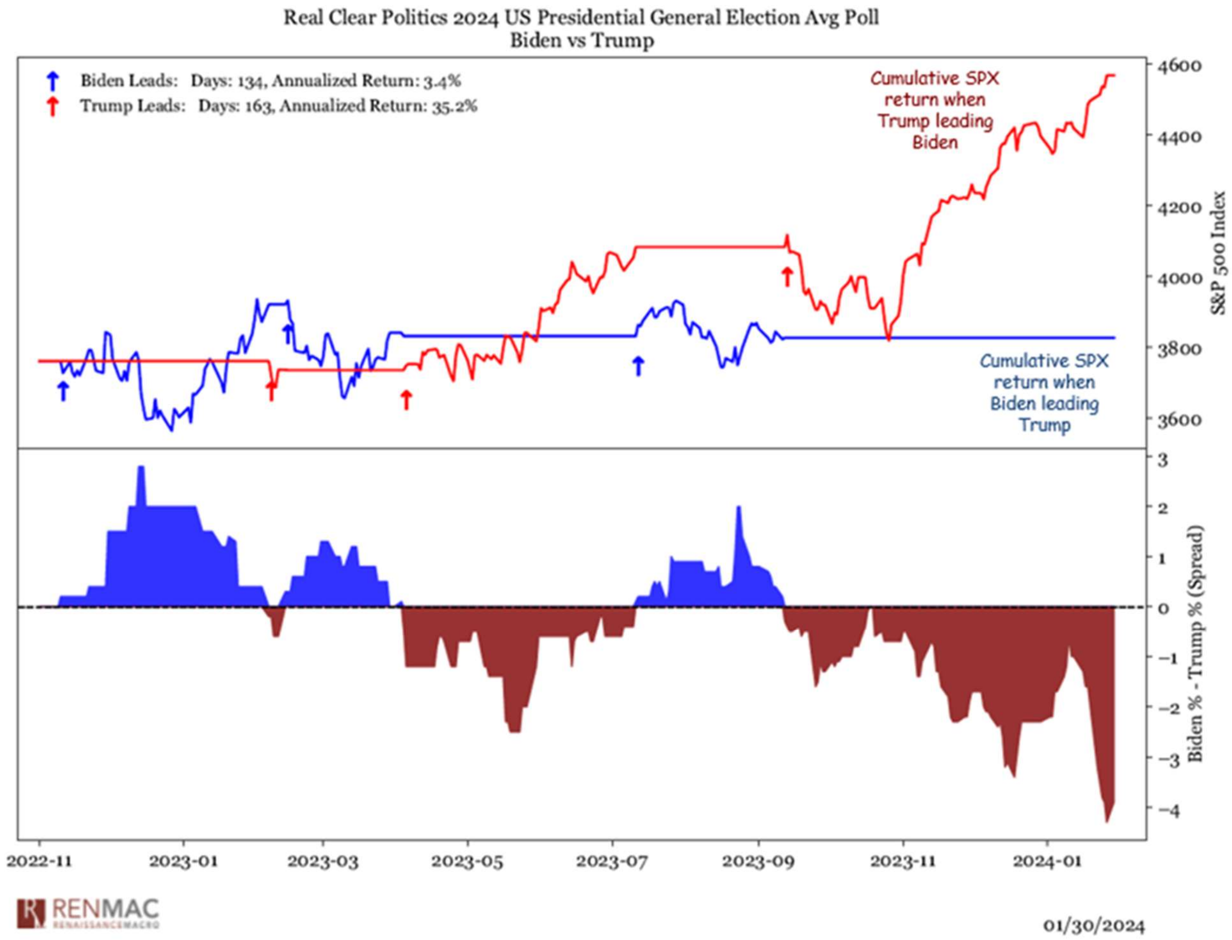
2. There has been much hand-wringing over the reordering of supply chains from optimal to secure/strategic. The conventional wisdom puts forth the idea that duplicative supply chains are inflationary as they are less efficient. We believe the onshoring and prioritizing of strategic manufacturing did create an inflationary wave, but now this impulse has passed. The duplicative excess capacity is without commensurate new demand; therefore, it will depress global capital goods pricing. Disinflation or deflation will be the order of the day going forward.

3. When the Bank of Japan finally raises interest rates--likely at its March or April meeting-- the effect should be stimulative rather than restrictive. The transition from a negative/zero interest rate regime should provide a positive shock for cash-laden Japanese households and corporates. Paying interest on deposits will in effect be a Bernanke-style helicopter cash drop from the Bank of Japan to the flush bank accounts of households and corporates.

1. Make US Equities Great Again: The Trump Rally

Former President Donald Trump is now the odds-on-favorite to become the Republican presidential nominee in the next 3-8 weeks. We strongly believe that a significant impetus for the recent rally in equity markets is the commanding lead that he holds over President Biden in early polling on both a national basis and in the key battleground states. Liquid asset markets are priced on future probabilities-- earning projections, interest rate curves, commodity forward prices to name a few--and, in our opinion, markets are now anchoring on the potential market friendly policies of a Trump victory on November 5, 2024.

Our research partners at RenMac (Renaissance Macro) constructed the chart below that shows the cumulative returns since November 2022 when Trump is leading in the polls versus when Biden is leading in the polls.

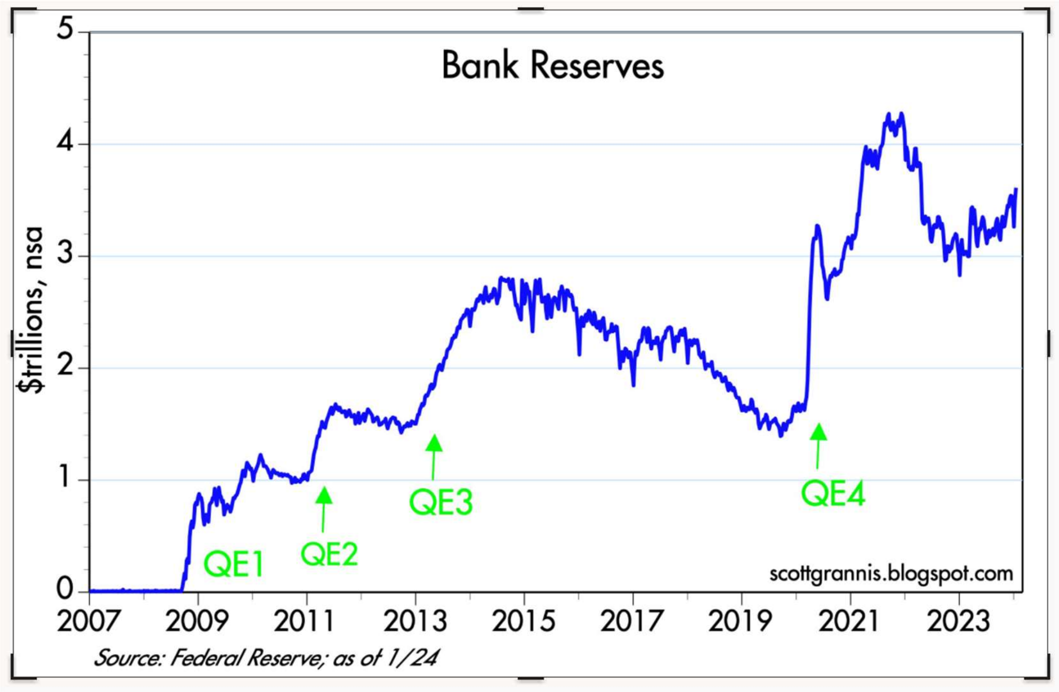


Taking into account all of the usual caveats of causal/coincident, the paucity of observations for statistical relevance and multicollinearity, we do find the linkage between positive market returns and Trump's polling to be directionally interesting.

We believe that the Trump Rally is based on three different factors.

First, as described above, investors looking at polls and anticipating an extended, market friendly economic, tax and regulatory environment.

Second is the response from policymakers in response to Trump's lead. Our belief is that for the time being a positive self-reinforcing cycle has been created. As Trump's lead persists, the Biden administration, led by Treasury Secretary Janet Yellen, would be expected to continue to follow, and perhaps accelerate policies, to keep the economy buoyant, provide ample liquidity, contain interest rates and avoid any more blowups like Silicon Valley Bank. All are extremely equity market positive. The chart below shows that even while the Federal Reserve has been raising rates and shrinking the balance sheet via quantitative tightening, bank reserves as seen in the chart below, turned up in early 2023.



Third and finally, we have a highly differentiated view of what a second Trump term would look like. It is our belief that the prognosticators are wide of the mark in how another administration would run. Our analysis leads us to believe that it would look much more like the period 2017-18 in the first Trump presidency than the more tumultuous 2019-20 period – more Calvin Coolidge than Herbert Hoover.

MR. MARKET'S FRIEND AT 1600 RETURNS

The night of Trump's first victory on November 8, 2016 and into the early morning hours of November 9, US equities crashed, trading limit down with futures locking at the circuit breaker levels. The initial shock of Hillary Clinton's loss--most political analysts were predicting a +95 percent chance of her winning--sent shock waves through capital markets. That Secretary Clinton refused to appear and to concede the night of the election also raised the specter of a heavily contested recount similar to Bush-Gore in 2000.

As market participants rushed to examine Trump's stimulative economic policies and Clinton made a belated concession speech on November 9, equities staged a strong rebound that continued for weeks. The upward bias in US stocks continued until the third quarter of 2018.

Today, the market is focused on whether the Trump tax cuts, due to expire in 2025, will be extended or made permanent. The Biden White House economic team has already thrown cold water on a renewal of most Trump-era tax cuts and called for higher taxes on corporates and upper income Americans.

Again, market participants initially tend to extrapolate past events, and in our opinion, this simplified view of a Trump victory is the focus of investors at the moment.

POWELL AND YELLEN CALL TIME ON TIGHT FINANCIAL CONDITIONS

Most investors do not realize that more important than their focus on a potential Trump victory are the intense efforts from within the Biden administration to obtain a second term. Since having her position threatened in June of 2022, Yellen moved from dutiful public servant to political apparatchik in short order. The risk-averse Federal Reserve Chair who famously liked to arrive at airport two hours early seems willing to throw caution to the wind to aid Biden's re-election, and markets like the new, racier Treasury Secretary.

Financial conditions have eased materially over the last three months, and we think this easing will likely continue well into 2024. Why the continuation? Simply put, we think the easing was a conscious policy choice made by Treasury Secretary Yellen and Fed Chair Powell ahead of this year's elections, and we think the market has yet to fully absorb the message. Below we explain our reasoning.

GS US Financial Conditions Index

Starting first with the Treasury, we believe the November 1 Quarterly Refunding Announcement (QRA) was intended to send an important signal to markets. Going into the announcement, long end rates had been rising in a nearly straight line as the bond market struggled to absorb the deluge of issuance generated by the ~6% fiscal deficit. Ahead of the announcement, the Treasury Borrowing Advisory Committee had recommended yet another increase in longer-dated coupon issuance, and the market expected scheduled Treasury issuance to follow in kind. Unexpectedly, however, on November 1 the Treasury announced that they would increase coupon issuance only slightly and would instead fund more of the deficit with shorter dated Treasury bills.

Why the change of plans? We believe that the Treasury had become uncomfortable with the bond market sell-off to date and the tightening of financial conditions that resulted. As such, even though it would be more expensive to fund via Treasury bills given the deeply inverted yield curve, the Treasury decided it was a price worth paying. Over the short-term, this change in issuance strategy has had the desired effect, with financial conditions easing materially since the November 1 announcement. However, over a medium-term horizon, we believe this is a risky strategy, and it comes with significant costs. In addition to a higher interest expense, concentrating issuance in short tenors exposes the Treasury to greater volatility via refinancing risks and creates the potential for a financial accident.

Turning next to the Federal Reserve, we believe that Chair Powell intentionally made a dovish pivot at the December 13 meeting and effectively abandoned the "higher for longer" strategy. Importantly, with wage growth still running above 5% and unemployment near all-time lows, the Fed projected 75bps of rate cuts in 2024, even as they marked down their inflation forecasts only slightly and the inflation forecast remained above target both next year and in 2025. (See the excerpt from Fed's Dec 13th SEP below.)

Percent

Variable	Median[1]				
	2023	2024	2025	2026	Longer run
Change in real GDP	2.6	1.4	1.8	1.9	1.8
September projection	2.1	1.5	1.8	1.8	1.8
Unemployment rate	3.8	4.1	4.1	4.1	4.1
September projection	3.8	4.1	4.1	4.0	4.0
PCE inflation	2.8	2.4	2.1	2.0	2.0
September projection	3.3	2.5	2.2	2.0	2.0
Core PCE inflation[4]	3.2	2.4	2.2	2.0	
September projection	3.7	2.6	2.3	2.0	
Memo: Projected appropriate policy path					
Federal funds rate	5.4	4.6	3.6	2.9	2.5
September projection	5.6	5.1	3.9	2.9	2.5

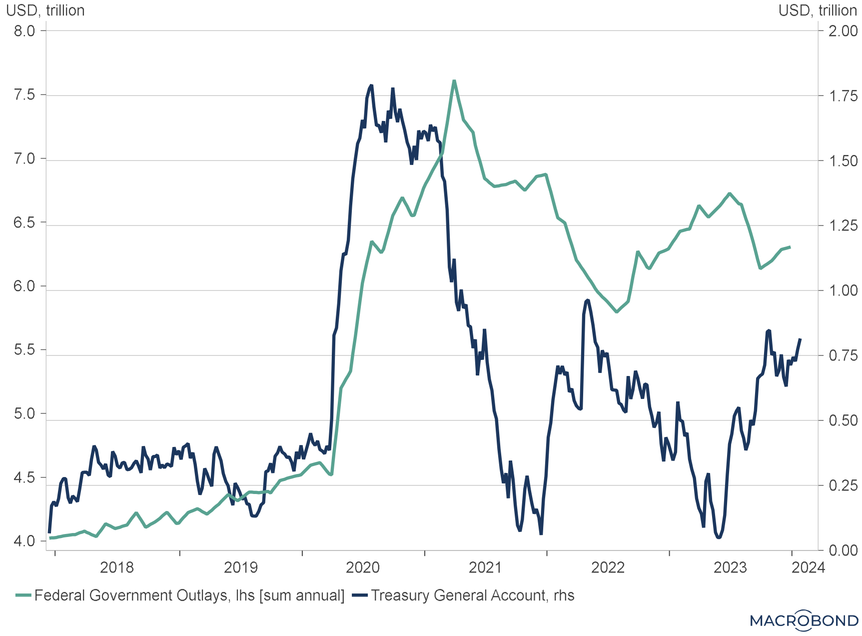
Why signal a more dovish reaction function ahead? We think the Fed decided that they would rather risk an inflation resurgence than a recession, particularly ahead of the 2024 elections. While we don't think the Fed is an explicitly political institution, we think nearly all of Washington, DC is united in wanting to prevent the return of Donald Trump. Indeed, DC (where the bulk of Fed staffers reside) went 93-5 for Biden in the last election. Moreover, it is hard to forget the 2019 Bloomberg Op-ed in which former Fed Vice Chair Bill Dudley explicitly called on the Fed engineer a recession to thwart Trump's reelection. Away from the political angle, we also believe that Biden's appointees to the Board of Governors have likely tilted the balance in a more dovish direction given their past research agendas:

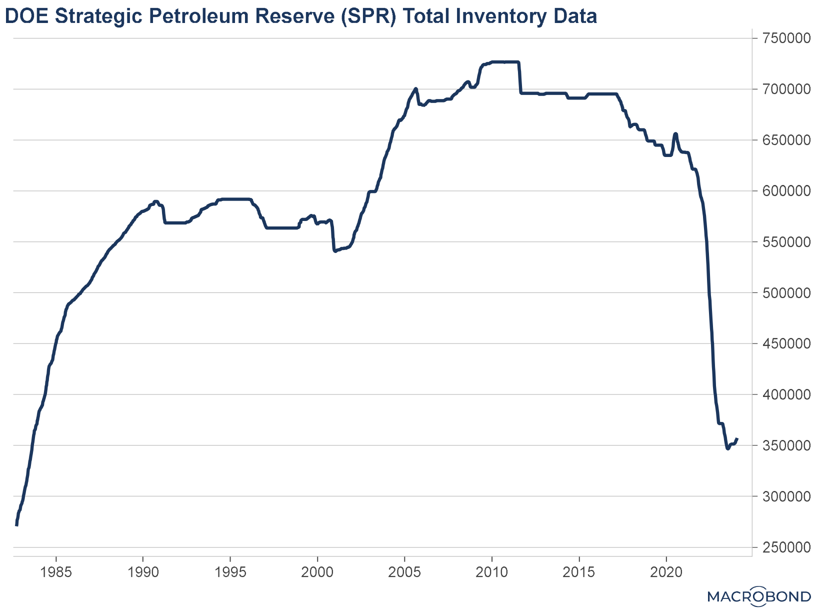
- Lisa Cook: Labor market, inequality/racial disparities, innovation
- Philip Jefferson: Labor market, inequality/poverty, monetary policy
- Adriana Kugler: Labor market, inequality, immigration

What does this Fed pivot mean for markets? Following the Treasury QRA, longer dated real rates reacted immediately with the 4Y1Y real rate dropping nearly 100bps. This decline in rates rippled through to the equity market, with multiples expanding in kind.

The incumbent team is pushing as hard as they can to turn Bidenomics into a compliment. We don't know if they will succeed, but their efforts form an extremely bullish liquidity and economic background for the US stock market.

We will be closely monitoring Secretary Yellen's use of the Treasury General Account (TGA) at the Federal Reserve as the election approaches. Since the pandemic, the Treasury has preferred to keep a larger precautionary cash balance, given the substantial increase in the pace of government spending. However, the Treasury's cash buffer at the Fed comes with a cost, as the bonds issued to fund this buffer drain liquidity from the market on net. Going into the election, Secretary Yellen may wish to raid the TGA and reverse this liquidity drain, similar to how the Strategic Petroleum Reserve was used in 2022. If so, we think this will be an important signal for the equity market. Simply put, it will mean that Secretary Yellen wants to goose it into the election.





REJUVENATION AND THE ROARING TWENTIES

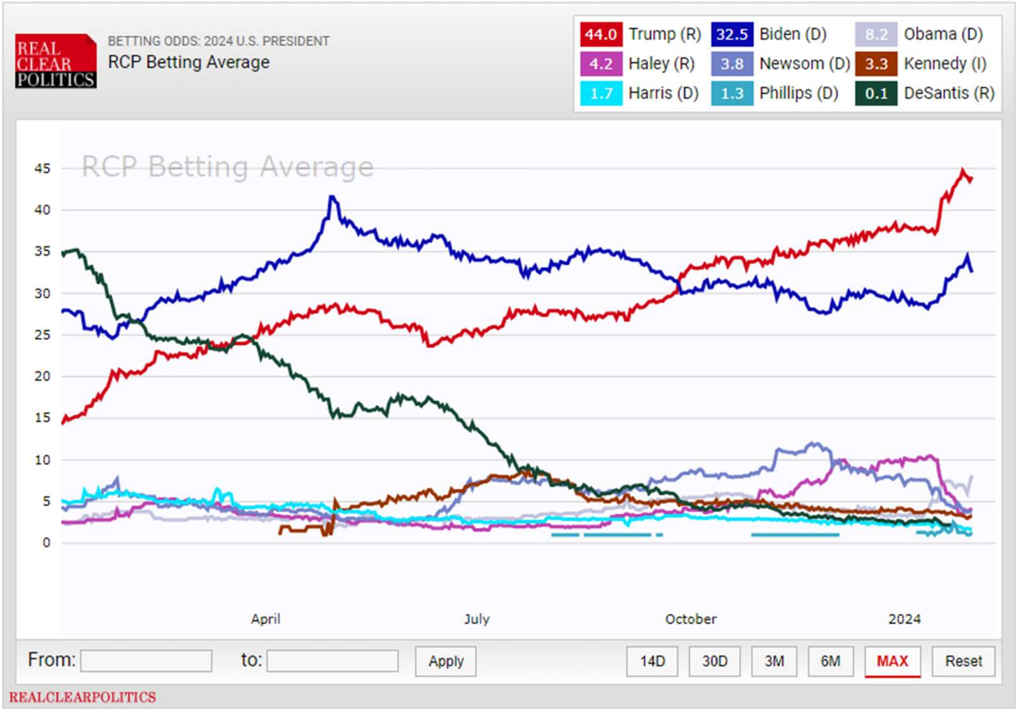
This week, Christine Lagarde, the president of the European Central Bank, announced in a CNN interview that she expects Donald Trump to make harsh decisions that may hurt Europe, apply tariffs and jeopardize global trade. We believe that she and others have much about the second term wrong. Lagarde makes our point for us – the threat of tariffs will mean a stronger negotiating position for the US. In essence, a second Trump administration would be expected to embrace a "Peace Through Strength" trade policy. Of course, in the case of recalcitrant trade partners, Trump can always offer them a negotiating session with former US Trade Representative Robert Lighthizer who will likely play a prominent role in his second term.

Our base case is that a re-elected Donald Trump will want to create an economic lollapalooza and engineer what he will likely call "the greatest four years in American history." Economist Ed Yardeni believes that post-Covid America has the potential to have a boom similar to the "Roaring Twenties" of a century ago. We believe that a returning President Trump would like this to be his legacy. In this scenario, the greatest risk factor, in our opinion, would be a sudden rise in long-end rates.

The talk of revenge will likely be limited to a small group of political enemies, and the wider policies of the administration will be oriented toward de-regulation, energy independence, reviving U.S. manufacturing and extending the tax cuts. We find it unlikely that across-the-board tariffs, as currently reported by the media, would be enacted at the same time as he moves to fix the immigration crisis. The tariff gun will always be loaded and on the table but rarely discharged. Of course, strategic and national security issues around China will remain.

Another differentiated view that we have is that Trump will pursue a weak dollar policy rather than implementing tariffs. Tariffs are inflationary and would strengthen the dollar--hardly a good starting point for a US industrial renaissance. Weakening the dollar early in his second administration would make U.S manufacturing competitive. A weak dollar and plentiful, cheap energy could power a boom. The current Wall Street consensus is for a strong dollar based on the tariffs. We strongly disagree. A strong dollar should emerge by the end of his term if the US reshoring effort is successful.

ELECTION DAY IS A LONG WAY OFF



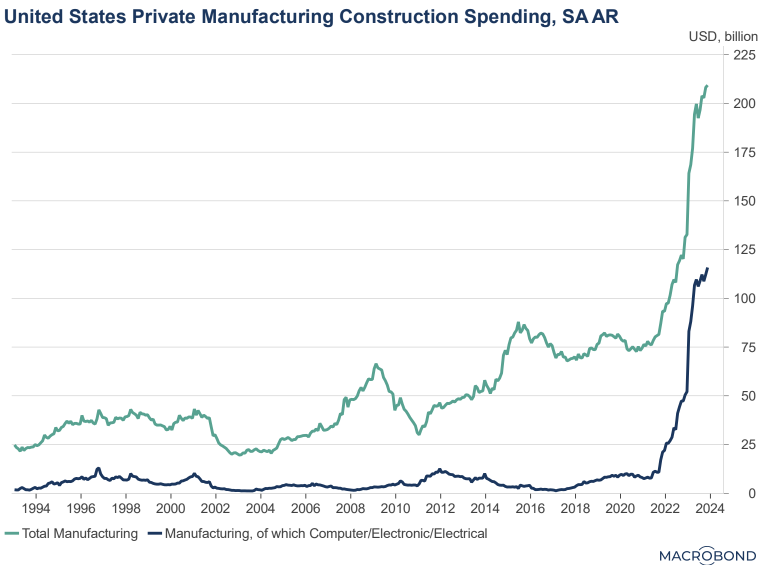
In conclusion, we believe that as long as Trump remains ahead in the polls or the race is close, the Trump Rally can run right up to the election. The apparatus inside the administration will be constantly priming the pump. If Biden were to move ahead, the market will start to focus on tax hikes and even more regulation in the second term. The market would pull back but not substantially until after Election Day due to the large amount of stimulus in the system. Of course, the downside for Trump in this rally could be that the market rally brightens the voters' mood and Biden gets credit, helping carry him back into office. On the other side, in the event of a Trump win, the markets could be at very high levels on Election Day. At that point, our Rejuvenation and Roaring Twenties thesis would have to be made clear or there could be a substantial setback.

We are expecting an upward trajectory in the US equity markets. Barring Biden pulling ahead in substantial fashion, all pullbacks should be bought.

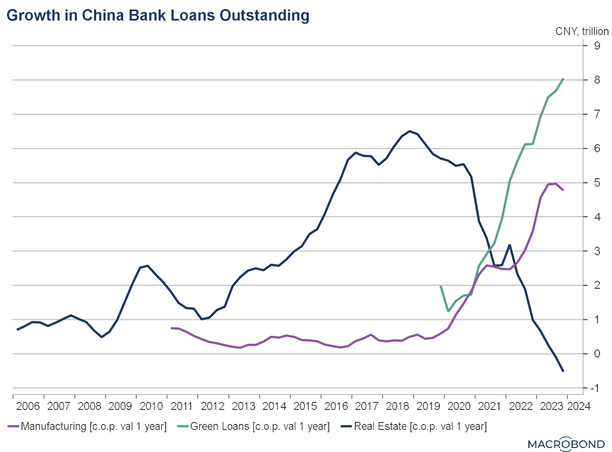
2. Fire Then Ice

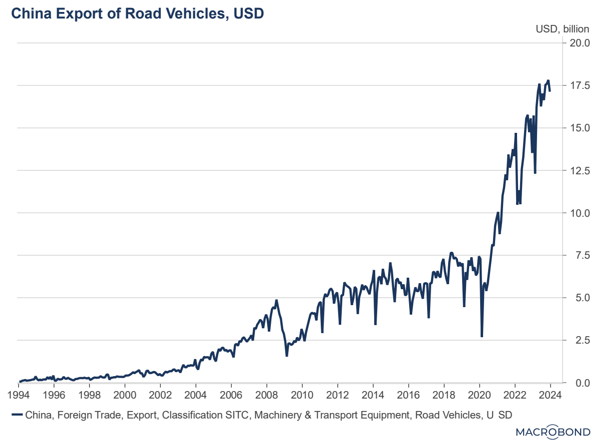
After the rolling wave of supply chain disruptions caused by Covid, combined with a desire to reduce reliance on a strategic adversary (China), the Biden administration has overturned 40+ years of neoliberal economic thought (the "Washington Consensus"). Instead, US policymakers have embraced a much larger government role in resource allocation, as well as the much bigger budget deficits that this role entails.

Thus far, this move towards big government has brought the “fire” of inflation as resources were directed towards duplicating supply chains, especially in strategic sectors like semiconductors (CHIPS Act) and green technologies (Inflation Reduction Act). Indeed, since the CHIPS and Inflation Reduction Acts were passed into law, manufacturing investment in the US has surged, as has employment in nonresidential construction. At first, this turbocharged investment exacerbated the inflation fire sparked by the pandemic’s disruptions. However, we believe the US economy will soon start to experience the “ice” of goods price deflation as the world grapples with substantial excess capacity in the products to which big government directed its investment.

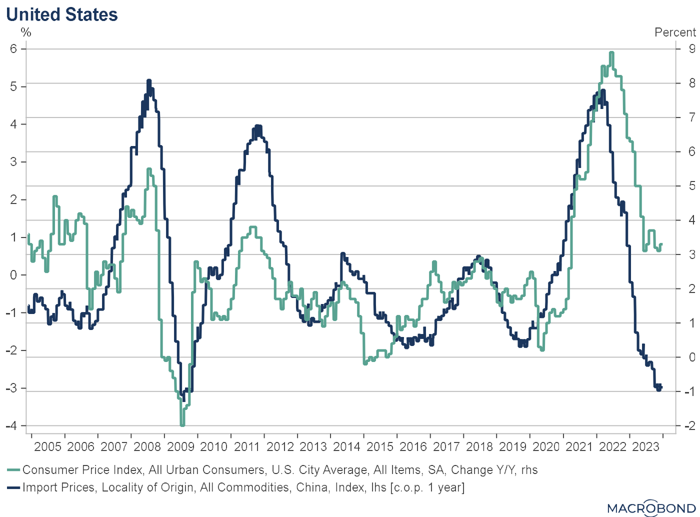


We believe this problem of excess capacity will be exacerbated by China’s own misguided investment boom. Following Xi Jinping’s ill-timed crackdown on the property sector in 2020 and the disastrous Zero Covid policies that followed, China has attempted to revive animal spirits with a surge of directed bank lending to “green industries” (e.g., EVs, solar panels, batteries) and to the high-tech manufacturing sector (e.g., semiconductors). Not coincidentally, these are many of the same sectors targeted for investment by the US. As shown in the chart below, the pace of lending to China’s green sectors has been so brisk that it now surpasses the boom in property lending at its 2018 peak.

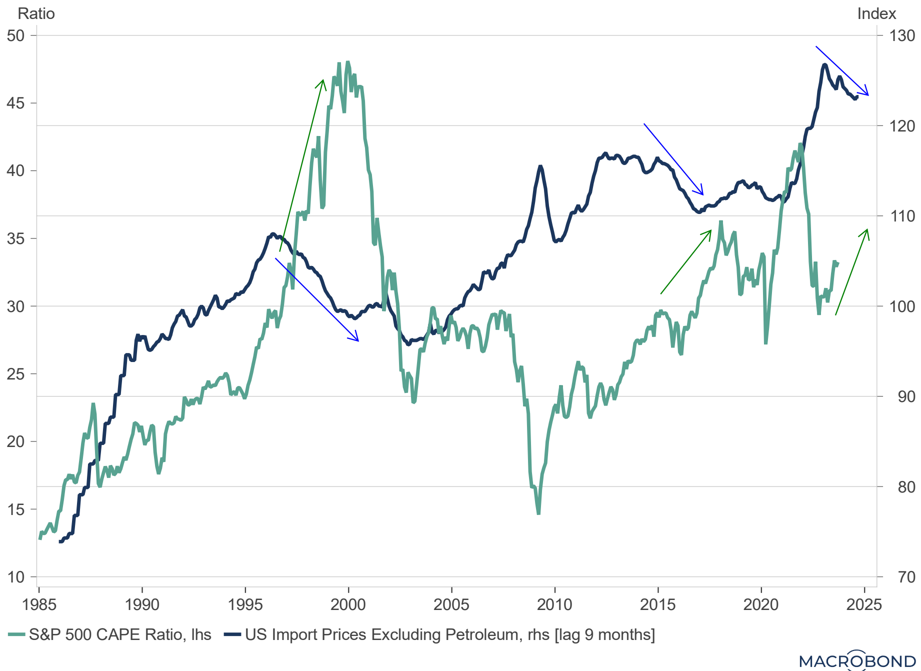




Already, we are seeing signs that the world is unwilling to absorb the excess capacity that this investment boom has created. Indeed, Europe is actively discussing tariffs on Chinese autos as China has now become the world's largest auto exporter. Likewise, the US is considering ways to limit a coming Chinese flood of low-end semiconductors. Regardless of whether these export restrictions are effective, we believe that the US duplication of supply chains and China's doubling down on manufacturing investment will unleash a broad deflationary impulse on global goods pricing.



What impact will this have on markets? Paradoxically, we think this could be very positive for US equities. Indeed, we think the coming few years could look very similar to the late 1990s. Back then, a series of EM crises (Mexico, Russia, Asia) spurred a prolonged period of US Import Price deflation. This allowed the Federal Reserve to begin cutting policy rates in 1995, and it enabled them to keep rates relatively low even as the domestic economy boomed. We believe that this inappropriately easy policy inflated the dot-com equity bubble, proxied below by the late '90s surge in the Shiller CAPE ratio. While we are not forecasting a similar wave of EM crisis in the decade ahead, we think a number of manufacturing exporters will be severely pressured by China's coming export tsunami. However, we think this will likely prove very beneficial for US equities, as the "ice" of falling goods prices allows the Fed to ease policy just as the AI mania reaches escape velocity.



How are we expressing this view in the portfolio? We think the best way to capitalize on this rapidly unfolding theme is via upside optionality in the US equity market, and long the raw materials, such as copper, that will go into the oversupplied finished goods. Receiving rates in Germany and Korea also looks interesting. We are also closely monitoring the Korean and German economies as we believe they will be hit the hardest.

3. The Case for the Reverse, Reversal Rate

Having visited Japan dozens of times since an initial trip in 1990, one is reminded that both Japanese households and financial markets can respond in ways that are difficult for Westerners to grasp. The three decade debt binge by the Japanese government was supposed to cause substantially higher rates; instead, Japan experienced some of the lowest nominal rates in the world for many years.

We think that the impending rate rises by the Bank of Japan from a negative overnight rate to a positive call rate will have the unintended consequence of stimulating growth both via an increased propensity for banks to lend, and cash rich households receiving a positive income shock from upwardly repriced interest income. We believe that a positive interest rate will be a government transfer from the Bank of Japan to

Japanese households. This is not a dissimilar transfer to the one that Ben Bernanke suggested when he referenced Milton Friedman's notion of money being dropped out of a helicopter. While the yen will not be falling from the sky, it will be credited to Japanese savers' bank accounts for the first time in almost a decade.

In 2016, Princeton economics professor Markus Brunnermeier was the lead author on a BIS paper that attempted to identify an unexplored central banking conundrum: Is there a rate at which accommodative monetary policy reverses and becomes contractionary for lending, i.e. is there a there a liquidity trap near or below the zero bound? He concluded that such a rate does exist and designated it the "Reversal Rate."

This reversal rate exists for two reasons. First, there is a time and price when banks have exhausted the excess capital from their bond portfolios generated by monetary easing. Once this capital surplus begins to dwindle due to the compressed or negative margins generated by the artificially low prices at which they are lending, credit availability shrinks. Second, rates below the zero-bound serve as a tax on savers. Unlike U.S. households, Japanese households did not follow the standard quantitative easing model and switch to riskier assets. They just accepted negative or ultra-low rates or hoarded physical cash.

In our opinion, the main asset channel adjustment caused by quantitative easing and negative interest rates in Japan was the exchange rate. This benefited multinational companies' earnings and equity prices, created import inflation and spurred a mini resurgence of reshoring in Japan.

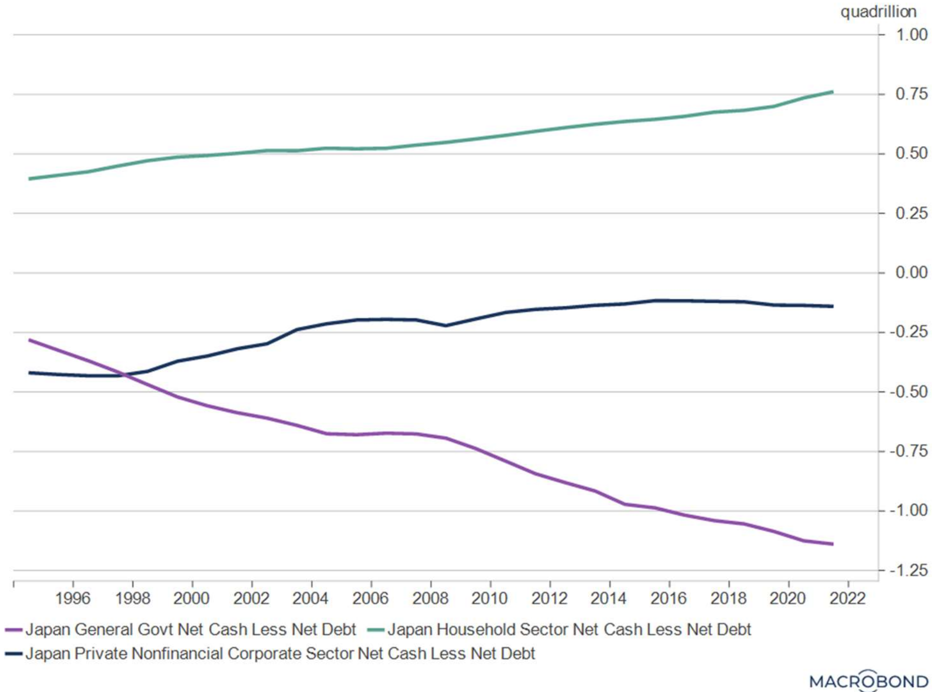
Now, a hike in interest rates will likely strengthen the yen, making imported goods cheaper; create positive cashflow for Japanese households and drive a domestic boom, rather than export led growth. We also suspect that the signaling effects of rate hikes will serve to drive animal spirits, renew confidence in the consumer economy and create a self-reinforcing cycle.

The balance sheet of Japan's household sector is very unusual, as Japanese households have huge savings in the form of "currency and deposits" and relatively low debt. Moreover, the Japanese corporate sector has delevered substantially since the late '90s. As such, rate hikes will not prove too punitive on net.

Who will ultimately bear the cost of higher interest rates? The public sector, i.e. the Ministry of Finance. This sector has long been the biggest borrower in Japan. As described above, the interest rate hikes would be functionally equivalent to a cash handout from the public sector to the household sector, with little net impact on Japanese corporates--although there will likely be distributional consequences among unprofitable "Zombie companies."

Whether this net transfer from the public sector to the household sector turns out to be stimulative over the long run depends on the extent to which households expect the central government to raise taxes in the face of higher fiscal deficits caused by the rate hikes.

For the sake of comparison, it is interesting to look at the US. Here, while the household sector likely is a net beneficiary of interest rate hikes (at least from a flow perspective absent wealth effects), the benefit is overwhelmed by the negative impact rate hikes have on the non-financial corporate sector. As such, Federal Reserve rate hikes are ultimately contractionary.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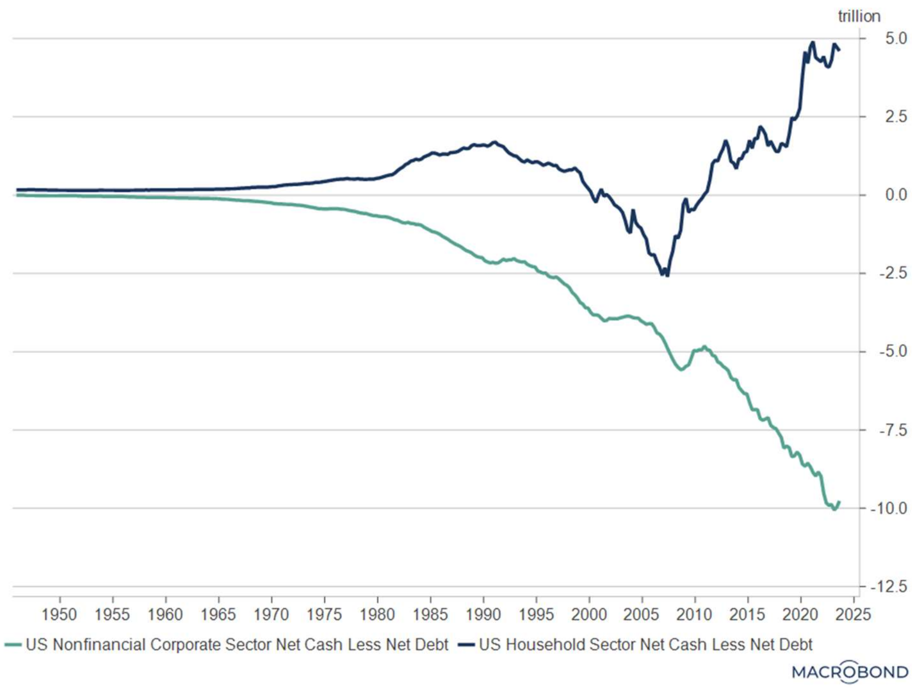
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US Household Sector Net Cash Less Net Debt
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In a Project Syndicate column last month, Abe advisor and distinguished Japanese economist, Takatoshi Ito, writes that the Bank of Japan's upcoming hiking cycle involves a complex calculus, "...the normalization challenge the central bank faces this year extends well beyond deciding when to raise rates." If we are correct, BoJ will have a "Spring Surprise" when their hiking cycle stimulates the economy--perhaps driving the eventual neutral rate to a higher level.

We believe that a portfolio of paid positions in one year and ten-year Japanese rates, long the yen and long select equities are the best expression for our unique view.

As always, thank you for your support. Please feel free to contact us with comments, questions or alternative viewpoints.

Best regards,

Scott Bessent and the Key Square Team

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