Quarterly Economic Update

March 5, 2025

MACROECONOMIC COMMENTARY

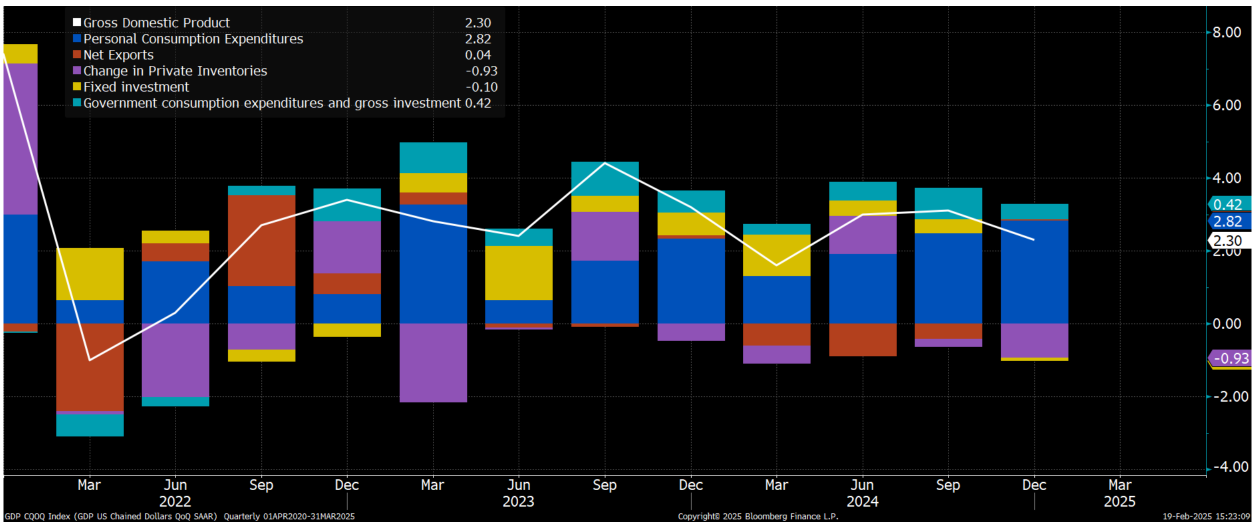
Economic Outlook

By Michael Broadwater

Since our last economic update in December, the U.S. economy has remained relatively healthy, but there are a growing number of reasons to be worried. In the following report, we will discuss multiple economic releases and highlight potential areas of strength and concern.

GDP

Real GDP growth slowed to 2.3% in the fourth quarter of 2024 from an annual rate of 3.1% in the third quarter. Personal consumption expenditures and government spending ticked higher, but this was offset by a decrease in private inventories. Fixed investment was also a negative for the quarter.

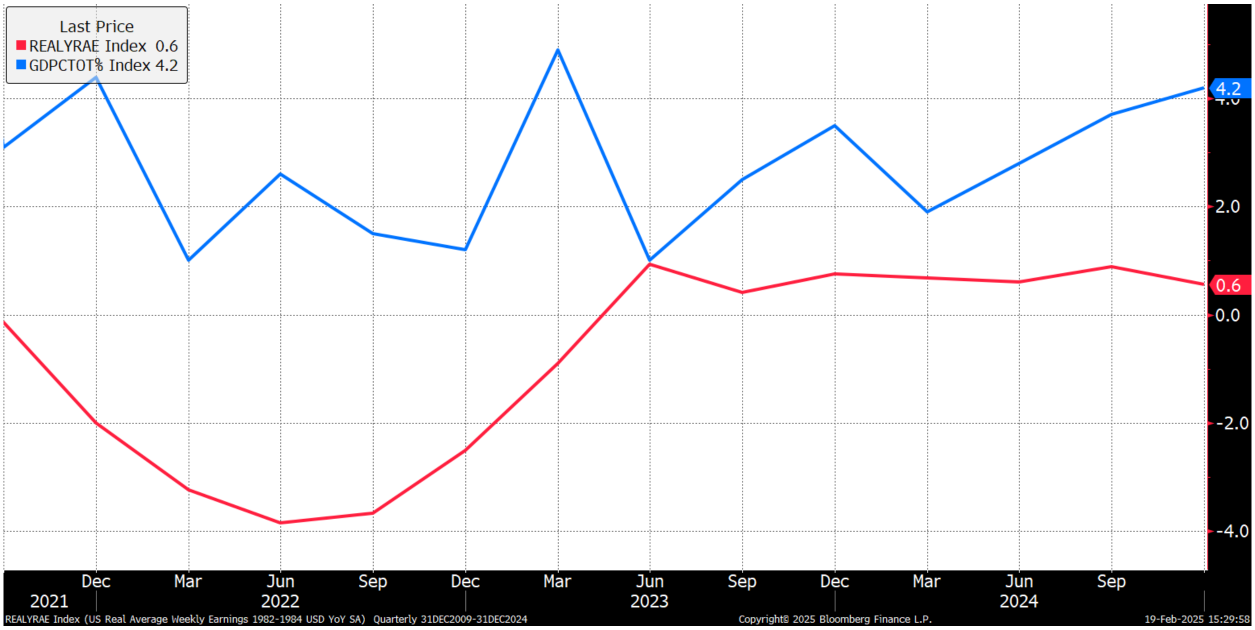


Source: Bloomberg

For the fourth quarter, consumer spending increased by 4.2%. Personal consumption contributed 2.82%, the largest contribution of consumer spending to GDP growth since Q1 of 2023. Spending on goods and services both increased. For services, increased spending on healthcare was the primary contributor.

Durable goods (including motor vehicles) rose at an annual rate of 12% from the prior quarter. One possible explanation for the strong growth is a pull forward of electric vehicle demand. Many consumers likely expect the Trump administration to eventually roll back the current EV consumer tax credit, and as such, may have accelerated their purchases of new EVs. If this contributed to the strength here, we would expect a reversal in subsequent quarters. We also saw an increase in other recreational durable goods, especially information processing equipment (i.e., personal computers.)

Real weekly earnings have been growing more slowly than consumer spending over the past couple of years.



Source: Bloomberg

Real weekly earnings (red) have grown at an average rate of just 0.2%, compared to personal consumption (blue), which has grown at an average rate of almost 3%.

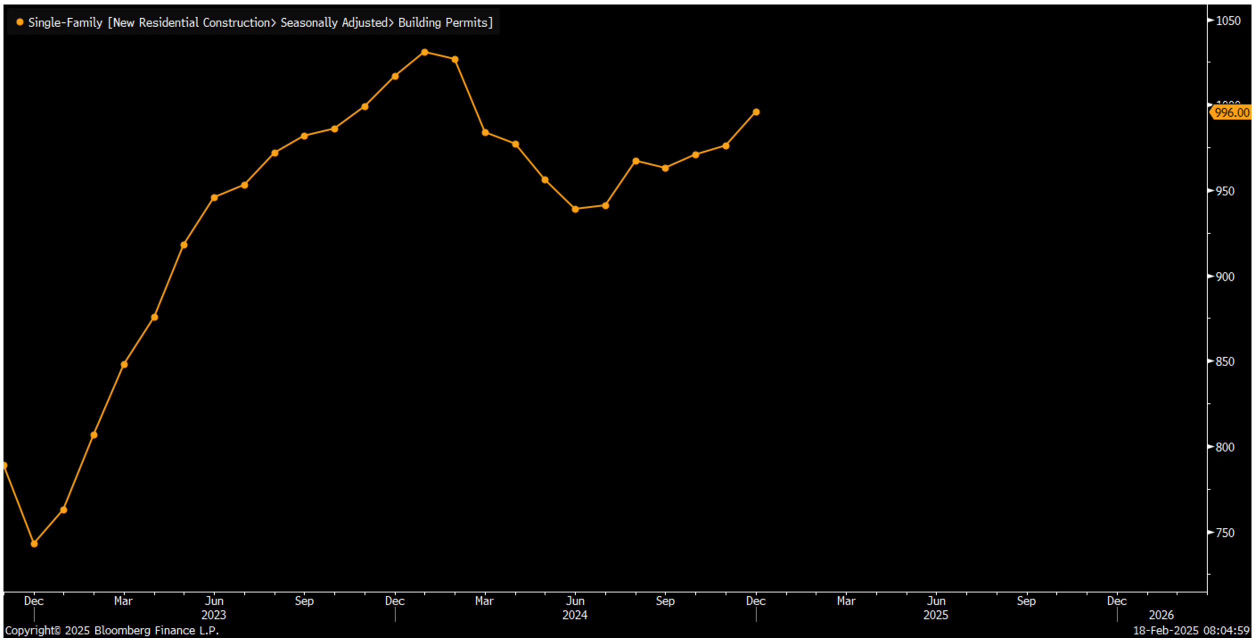
We expect the consumption component of GDP to begin to decelerate. Inflation-adjusted wages have grown only modestly over the past two years, the most recent release in January showing 0.6% annualized growth. Compare this to the most recent quarter's 4.2% growth in consumer spending. When consumer spending grows faster than income, as we see here, that can only be due to consumers taking on debt or spending down savings. Neither of these can continue forever.

Government spending increases were seen at both the local and federal levels. For state and local governments, employee compensation increased. Federal spending primarily increased due to stepped-up defense spending.

The government spending component of GDP is perhaps one of the most uncertain moving forward. The current administration's "Department of Government Efficiency," or DOGE, is a quasi-governmental agency tasked with eliminating wasteful spending from the federal budget. DOGE has already been highlighting what they believe to be wasteful spending at USAID, the NIH, and the Departments of Health and Human Services and Agriculture. In addition, over 65,000 federal workers had agreed to resign in exchange for eight months of severance pay, an unprecedented federal employee buyout program. We expect the impact of these changes to negatively impact government spending's contribution to GDP, but an increase in other areas of spending may offset DOGE's cuts.

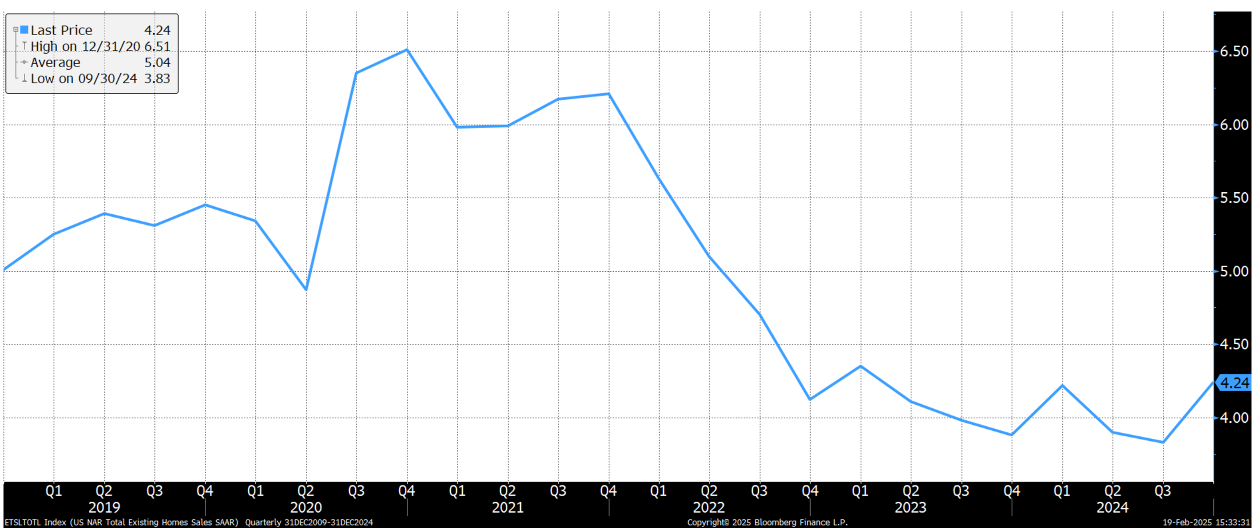
Fixed investment, which had been a positive contributor to GDP growth since Q1 of 2023, was slightly negative last quarter. This segment may continue to contribute negatively, given our higher interest rate environment and slower residential construction. Single-family housing starts fell 1.8% year-over-year in January, and single-family permits fell

3.4%. The homebuilder companies have mostly been giving dour sales projections compared to recent years, and their stocks have been underperforming the market. The outlook for new home construction is poor. The National Association of Realtors' index of pending home sales, which leads actual sales by about 1 to 2 months, has fallen 4.1% and 4.6% in the past 2 months. The index is now at 70.6, its lowest level ever recorded.



Source: Bloomberg

Building permits have been moving higher but still noticeably lower than the beginning of last year.



Source: Bloomberg

Also notable, existing home sales are still at extremely low levels but possibly starting to improve.

A lot of private investment from corporations has been focused on AI for the past several years. Specifically, many of the big tech companies have been spending billions of dollars to build data centers and train large language models (such as ChatGPT). We expect this trend to largely continue, with Meta and Google projecting $60 billion and $75 billion in capital expenditures this year, with a big chunk going towards servers and data centers.

One threat to this trend is recent technological innovation that makes AI models more efficient. Specifically, a Chinese company named DeepSeek recently came out with a large language model called R1 that performed comparably to or better than ChatGPT, as well as Meta's and Google's models, but was developed at a fraction of the cost and requires drastically less compute (fewer graphics processing units, or GPUs.) Although Meta's and Google's capital expenditure projections were given after R1 was released, it's possible that widespread adoption of these new, more efficient models would reduce the amount spent on servers and data centers, either due to efficiency gains or more competition, causing larger players to shift strategies.

Further, tariffs may have an impact on corporate investment in domestic manufacturing. The Trump administration has consistently outlined its intent to lessen the US's reliance on trade partners and produce more at home. Targeted tariffs, especially when used in conjunction with incentives for domestic manufacturers, might make U.S. businesses want to invest in more onshore manufacturing. This would have a positive impact on the investment component of real GDP.

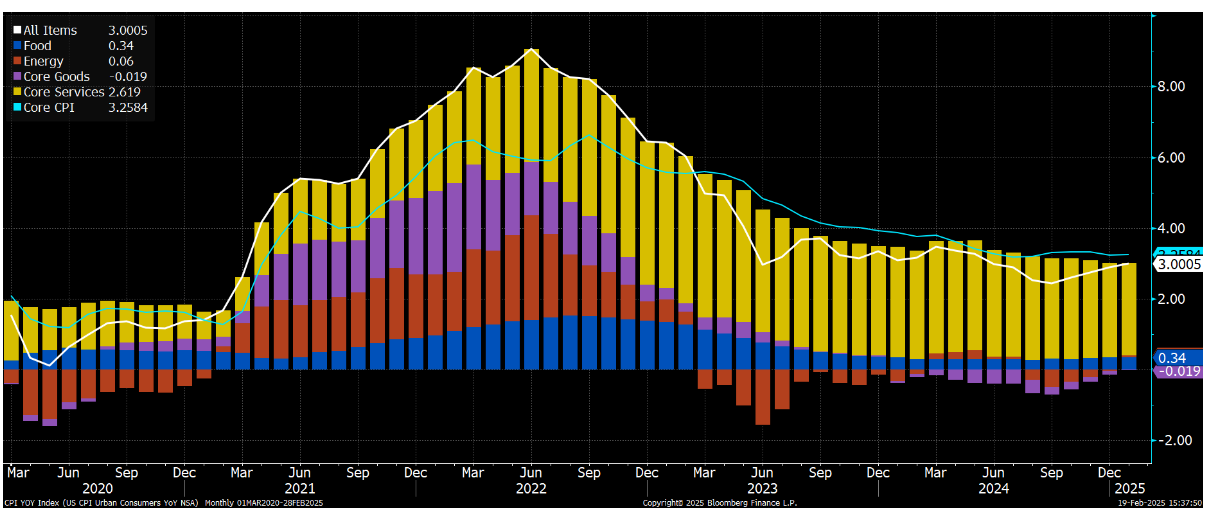
We also expect tariffs to impact net exports (exports minus imports) in the near-term, at the very least by reducing imports. This effect, in isolation, would increase net exports' contribution to GDP, but any reciprocal tariffs from trade partners may weigh down our exports as well, making the overall effect uncertain.

The real GDP growth rate for 2024 was 2.8%, a slight decline from 2023's 2.9% increase. Wall Street's current average expectation for 2025 real GDP is 2.2%, followed by continued deceleration in 2026 and 2027 (2.0% and 1.9%.) There are a multitude of unknowable factors to consider when trying to forecast real GDP growth. As we are not economists, we won't even attempt to give a hard number. However, we do agree with the Street that the growth rate likely continues to decelerate over the next year, as consumer spending, government spending, and private investment all give U.S. more reasons to worry than to be optimistic.

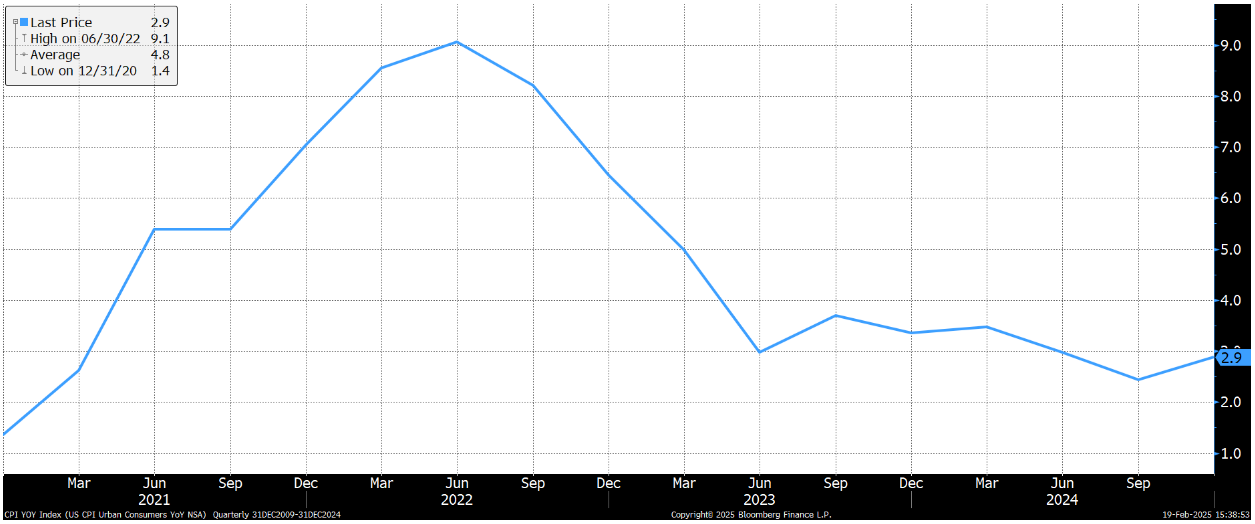
CPI Inflation	Monthly Change	Annual Change
November	0.3%	2.7%
December	0.4%	2.9%
January	0.5%	3.0%

Inflation

The Consumer Price Index for November grew 2.7% YoY and 0.3% from the previous month. For December, CPI grew at an annual rate of 2.9%, or 0.4% month-over-month. Real hourly earnings (adjusted for inflation) increased 1.0%. For January, CPI rose 0.5% over the previous month and 3.0% YoY, exceeding expectations of 0.3% and 2.9%. This was the largest monthly increase in CPI since August of 2023, and it marks the second consecutive month of accelerating CPI inflation (0.3% → 0.4% → 0.5%.) The annual increase in Core CPI was 3.3% in January.



Source: Bloomberg



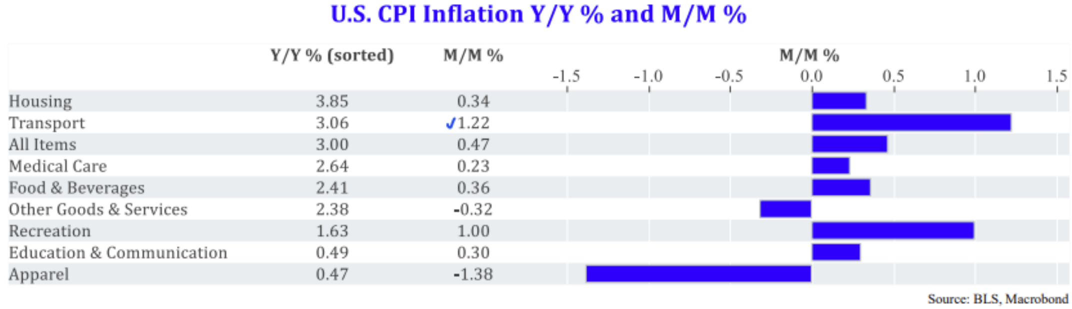
Source: Bloomberg

Annual CPI has moderated from 2022 highs but remains persistently above the Fed's 2% target.

The prices of goods overall saw some deflation in January, but notably, used vehicle prices were up 2%, and egg prices were up 15.2% from the prior month. One key factor influencing January's CPI reading is the impact of weather. A combination of wildfires in California and unusual winter weather in many parts of the country likely contributed to the higher-than-expected inflation.

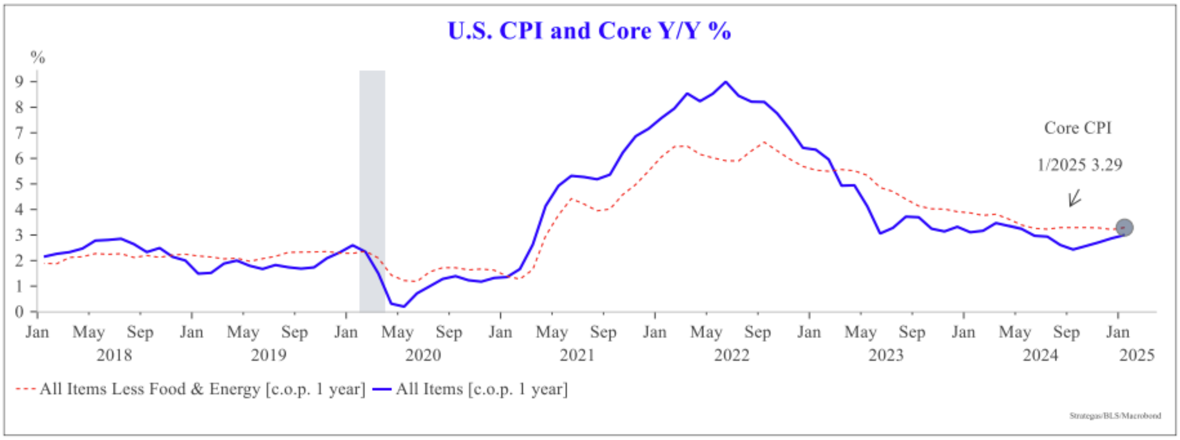
A major contributor to inflation over the past few years has been an increase in housing costs. The total cost of shelter now makes up over a third of the CPI basket. Rent inflation has come down significantly since its peak in 2022/2023.

For January, shelter and transportation (including autos) had the largest annual increases. There are reasons to believe that auto inflation may continue, as many of Trump's tariffs disproportionately affect the auto industry, especially targeting Mexico and Canada. Apparel was an area of deflation MoM and has the lowest YoY level of inflation. We see this as an area of potential acceleration in inflation due to tariffs, as much of the world's apparel is made abroad, especially in China. Housing may get cheaper if more existing homes hit the market, but also could get more expensive if the costs of various inputs increase (particularly lumber and labor.)


U.S. CPI Inflation Y/Y % and M/M %

	Y/Y % (sorted)	M/M %
Housing	3.85	0.34
Transport	3.06	1.22
All Items	3.00	0.47
Medical Care	2.64	0.23
Food & Beverages	2.41	0.36
Other Goods & Services	2.38	-0.32
Recreation	1.63	1.00
Education & Communication	0.49	0.30
Apparel	0.47	-1.38

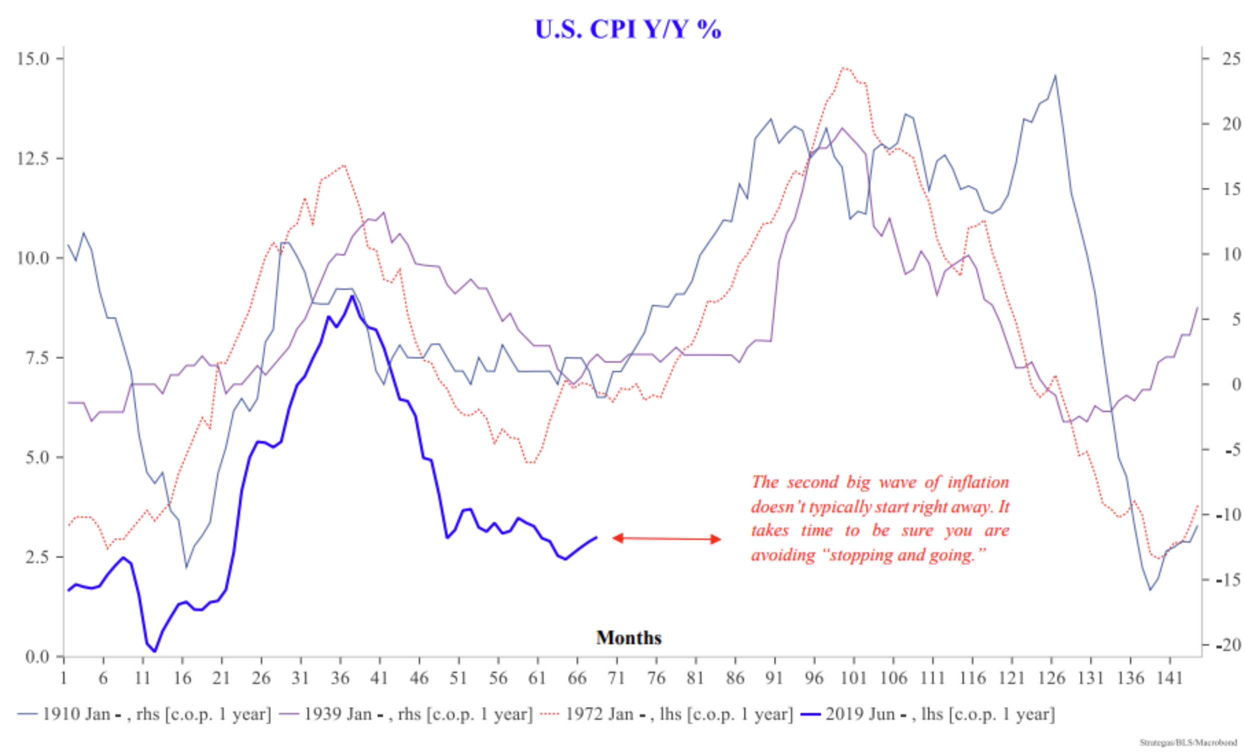
Source: BLS, Macrobond



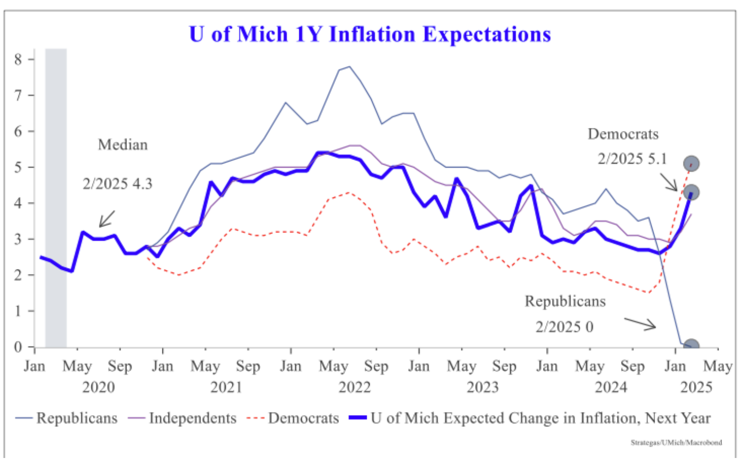
Source: BLS, Macrobond

Several previous periods of high inflation (1910, 1939, and 1972) came in two waves, with a lull between. It's certainly possible that this period of inflation will follow a similar pattern.

Ultimately, it's difficult to tell where inflation will go from here. We've been relatively stable at around 3%, and although this is above the Fed's long-term target, it's manageable. Monetary and fiscal policy both complicate things, as these are challenging to forecast. Even if we knew them with complete clarity, their net effects on the overall inflation rate are uncertain.



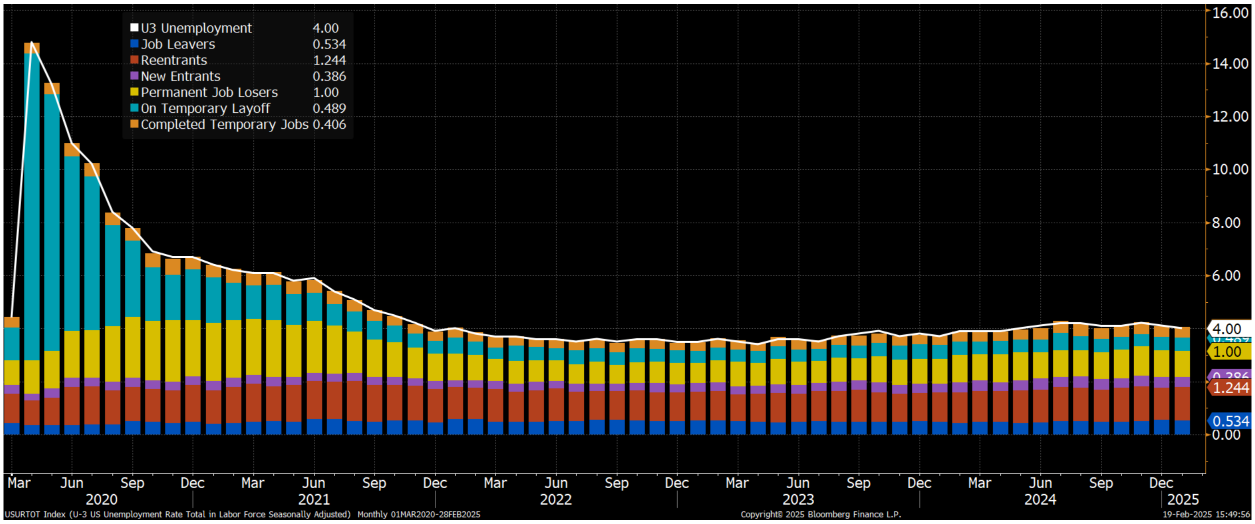
Source: BLS, Macrobond



Wall Street consensus for 2025 CPI currently sits at 2.7%, below 2024's 3.0% rate. 2026 CPI is even lower at 2.5%. This is in stark contrast to the University of Michigan's January consumer survey, in which 1-year inflation expectations spiked from 2.60% to 4.30%. However, one important caveat to this data is that respondents were extremely politically polarized. Republicans reported 1-year inflation expectations of 0%, whereas Democrats expected 5.1%.

Unemployment

The unemployment rate has been improving sequentially over the past several months, going from 4.2% in November to 4.1% in December to 4.0% in January. Underemployment, or the percentage of workers in jobs that don't utilize their education or expertise, has also ticked down from 7.8% to 7.5%. The labor force participation rate was unchanged from November to December at 62.5%, and January increased slightly to 62.6%.



Headline unemployment has remained relatively stable post-COVID, staying around 3-4%.

Source: Bloomberg

Payrolls MoM

	1/31/2025	12/31/2024	11/30/2024
Total NonFarm	**143**	**307**	**261**
Total Private	**111**	**273**	**244**
Goods Producing	0	-2	28
Mining and Logging	-7	-3	2
Construction	4	13	6
Manufacturing	3	-12	20
Private Service-providing	111	275	216
Wholesale Trade	2	13	5
Retail Trade	34	36	-14
Transportation	1	22	28
Utilities	0	-1	0
Information	2	16	5
Financial Activities	7	19	16
Professional and Business Services	-11	31	37
Health Care	44	55	64
Social Assistance	22	26	15
Private Educational Services	-4	1	-6
Leisure and Hospitality	-3	49	54
Other Services	17	9	12
Government	**32**	**34**	**17**

Source: Wolfe Research, Haver Analytics, as of Jan 31, 2025

Change in nonfarm payrolls, or the number of non-agricultural U.S. workers, was lower than expected in January, coming in at 143,000 versus the consensus estimate of 175,000. This was also considerably lower than December's nonfarm payroll additions of 307,000, as well as November's 261,000. Looking by sector, education and health services added the most jobs (which is not uncommon). Retail trade also added 34,000 jobs, and government payrolls increased by 32,000. The average month in 2024 saw an increase in government payrolls of over 37,000. This comprised 22% of the average total nonfarm payroll increase of ~166,000. Given the federal employee buyout program discussed earlier, as well as state and local governments possibly receiving less funding, we would expect the average government payroll number in 2025 to be quite a bit lower than 37,000, possibly even negative. This will weigh on the headline nonfarm payroll number throughout the course of the year unless weakness in government hiring is offset by strength in other areas of the economy.

Average hourly earnings rose 0.5% in January compared to the prior month and 4.1% compared to the prior year. Average weekly hours worked decreased slightly from 34.3 at the end of last year to 34.1 hours in January. The JOLTS Quits rate increased slightly, from 1.9% in December to 2.0% in January. This is a positive signal, as more people willing to quit shows that it is likely easier to find work, and thus the labor market is stronger.

The job openings rate fell from 4.9% in December to 4.5% in January, signaling less demand for labor. There were 7.6 million job openings compared to 6.9 million unemployed people, meaning there is more than 1 available job for every unemployed member of the labor force. Most job openings are in Professional and Business Services and Education and Health Services sectors.

We see the U.S. employment situation as another area where policy changes make prediction challenging. A sizable portion of nonfarm payroll growth has been sourced from immigration over the past decade, so shifts in immigration policy, especially deportations, may shrink the size of the labor force and detract from nonfarm payrolls. Conversely, policy seeking to reignite domestic production may boost some of the manufacturing-related sectors that have seen stagnant payrolls.

Wall Street consensus for unemployment is 4.2% in 2025 (vs. 4.0% in 2024), and 128,000 for average monthly nonfarm payroll additions (vs. 166,000 in 2024.) In other words, the market is currently expecting both unemployment to rise and the pace of job additions to slow in the coming year.

Overall, the U.S. economy was strong in 2024. Inflation, GDP, and unemployment were all relatively stable and healthy; the economy grew in real terms, and real wages increased. There are multiple areas of concern moving forward, including a shaky housing market, the effect of persistently high interest rates on domestic investment, and the potential for a second wave of inflation.

The biggest source of uncertainty is the new presidential administration, as new trade and immigration policies would likely impact inflation, economic growth, and the labor market significantly. Natural fluctuations in the business cycle impact all these areas as well. Besides a brief period in Q2 and Q3 of 2020 (caused by COVID), the United States has not experienced a real recession since the Great Financial Crisis. An economic downturn will occur again at some point, but as to whether new government policies exacerbate or postpone that downturn, we will have to wait and see.

RSA PORTFOLIO STRATEGY
Fixed Income Strategy

By Nick Prillaman

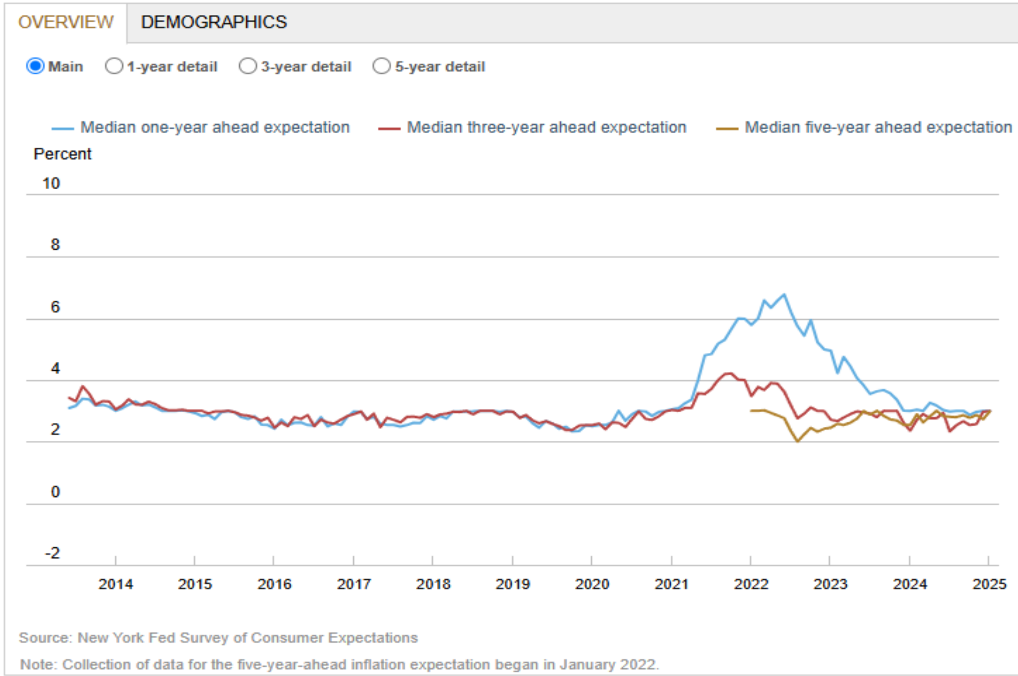
At the time of our previous meeting in mid-December, interest rates had declined for multiple weeks on the back of marginally weaker data as well as the selection of various market-friendly cabinet prospects. The back half was notably different as “Treasury yields soared across the curve going into year-end due to accelerating inflation data, deficit concerns, and uncertainty around economic policies from the incoming administration,” per CreditSights. The Federal Reserve also contributed to the interest rate volatility. While the Fed lowered the fed funds target range by a quarter point on December 18th, the commentary and outlook were of the hawkish variety. Chair Jerome Powell said, “I think from here it’s a new phase, and we’re going to be cautious about further cuts.” The Fed’s dot plot showed only two 25 bp cuts in 2025, which was down from four in September. From the low on December 6th, the 10-year Treasury yield rose 44 bps to end the month at 4.569%. The curve bear steepened as the 2-year Treasury yield only rose by roughly 14 bps during this time frame. From a performance perspective, long-duration bonds were acutely affected in December by the long end sell-off in interest rates. For example, 25+ year Treasuries were down 6.32%, while 1-3-year Treasuries posted a positive 22 bp total return.

As the new year began, the long end of the Treasury curve continued to rise as strong economic data indicated a growing economy. The ISM services PMI for December came in higher-than-expected while nonfarm payroll data from the Bureau of Labor Statistics showed a gain of 256K jobs versus an expected 165K. Hotter inflation, as evidenced by the ISM services prices paid, which Reuters said was the highest reading since February 2023, also contributed to the move higher. The trend in yields for securities further out the curve abruptly changed mid-month when core CPI for December came in at .2% versus.3%. Krishna Guha at Evercore said, “It reinforces the base case for two Fed cuts and keeps open the possibility of a March cut.” The 10-year yield fell 14 bps on the news and then further declined as the month went along.

The Federal Reserve kept the federal funds target range unchanged at its meeting in late January. The Fed statement said, “The unemployment rate has stabilized at a low level in recent months, and labor market conditions remain solid. Inflation remains somewhat elevated.” This verbiage was slightly hawkish but was offset by more dovish commentary from Chairman Powell at the press conference, who said, “With our policy stance significantly less restrictive than it had been and the economy remaining strong, we do not need to be in a hurry to adjust our policy stance.” With a strong economy, declining inflation as seen in the core CPI data, and a Federal Reserve on-hold from a monetary policy standpoint, it is hardly surprising that yields were not materially different at the end of the month than from the beginning as the 10-year Treasury yield only fell 3 bps while the 12-month Treasury was unchanged in January.

The first half of February was a mostly range-bound market for yields, though the general calm was punctuated by large moves in response to various data points. The surge in average hourly earnings of .5% m-o-m versus an expected .3%, the unemployment rate dropping to 4.0% from 4.1%, and the University of Michigan 1-year inflation expectations coming in at 4.3% versus 3.3% produced a bearish move for bonds on February 7th. Increased volatility was also seen surrounding the CPI/PPI releases. January's CPI was incredibly hot at .5% m-o-m versus an expected .3%. The core CPI beat expectations as well. Interest rates popped higher on the news as market participants pushed out their timing for rate cuts. This move was then countered the following day by the PPI data. While the headline PPI number was elevated, underlying parts of the data showed inflation to be less significant. Economic growth concerns have crept into yields in the second half of the month, with the 2-year breaking down to 4.08% at the time of writing from a high of 4.38% mid-month.

Going forward, our base outlook is that the Federal Reserve remains in an interest rate-cutting cycle but is currently on pause until the summer. Markets are predicting two cuts in 2025. This pause gives them time to further evaluate the progress on containing inflation while also giving themselves enough flexibility to respond to the effects of new policies like tariffs and government layoffs enacted by the new administration. On the inflation front, a tremendous amount of improvement has occurred since CPI peaked at 9.1% y-o-y basis in 2022. CPI bottomed last September at 2.4%, but recently, there have been indications of rising price pressures, as seen in the January CPI print as well as the rise in hourly earnings related to nonfarm payrolls. We are of the opinion that this move higher in inflation is a countertrend as the chart below from the New York Fed shows 1-year ahead inflation expectations to be very anchored. Housing rents, which make up a sizable portion of the CPI basket, continue to trend lower which also indicates the lack of a sustained impulse higher in inflation. If the rate of inflation resumes lower, the Fed will be able to lower interest rates which should drive growth higher in the economy.



Source: Federal Reserve Bank of New York

While the scenario laid out above is our base case, there is a considerable amount of uncertainty with regards to how current and future policy actions from the Trump administration will affect the economy. Fed Chair Powell described the situation very well saying, “The range of possibilities is very, very wide.” He further added, “We don’t know what is going to be a tariff; we don’t know for how long, how much, what countries, and we don’t know about retaliation or how it will transmit through the economy to consumers.” What we do know are the expressed intentions of the Trump administration which gives U.S. a roadmap for the future. Overall, President Trump wants to rebalance global trade away from the U.S. running persistent trade deficits while other countries are allowed to run persistent trade surpluses. So far, the primary method of reorganizing the trade map is through the use of tariffs. A 10% across-the-board tariff on imports from China has already been enacted, while 25% tariffs have been proposed on goods from Canada and Mexico. According to the Peterson Institute, “the direct cost of these actions to the typical, or median U.S. household would be a tax increase of more than $1,200 a year.” Inflation should rise at least in the short term, which is why President Trump said, “Americans should prepare for some short-term pain.”

This elevated inflation should be temporary and is planned to be offset by other measures. Treasury Secretary Bessent said in early February that Trump is of the opinion that “if we deregulate the economy, if we get this tax bill done, if we get energy down, then rates will take care of themselves, and the dollar will take care of itself.” He also said, “We cut the spending, we cut the size of the government, we get more efficiency in government, and we’re going to go into a good interest rate cycle.” The administration clearly does not expect inflation to be a long-term problem. If all of this works, the United States will be in a much better position from a trade perspective as more production will occur in the United

States. At the same time, foreign countries will consume more U.S. goods, moving GDP in a positive direction.

Will it work? That is the big question. If part of the plan fails, other areas might not deliver. For example, the administration wants a 3 million barrels per day equivalent increase in energy production. That is a wonderful economic goal but ultimately, the government will be at the mercy of the economics of the oil patch. Energy companies might not be interested in increasing output if it is not in their economic best interest. If this happens, lower energy prices will not be realized and won't provide a buffer against tariff inflation, which will then keep interest rates higher. There are so many systems in our modern economy that are interconnected that making large-scale economic adjustments can introduce an incredible amount of risk to the economy.

Due to this high level of macroeconomic uncertainty, we are of the opinion that bonds are a compelling investment at this juncture. They offer relative safety combined with healthy yields. As the chart below shows, the 2-year Treasury offers some of the highest yields in the past 15+ years. Fixed income investments can perform well in a variety of scenarios ranging from a recessionary downturn brought on by reduced federal spending at the hands of DOGE while also producing strong returns if President Trump's plan reduces the deficit causing the interest rates to drop. Flexibility is key going forward as investors will need to adjust positions depending on whether these government policies are helping or hurting growth. Prudency is also important as it is unwise to take aggressive stances when the outlook is murky.

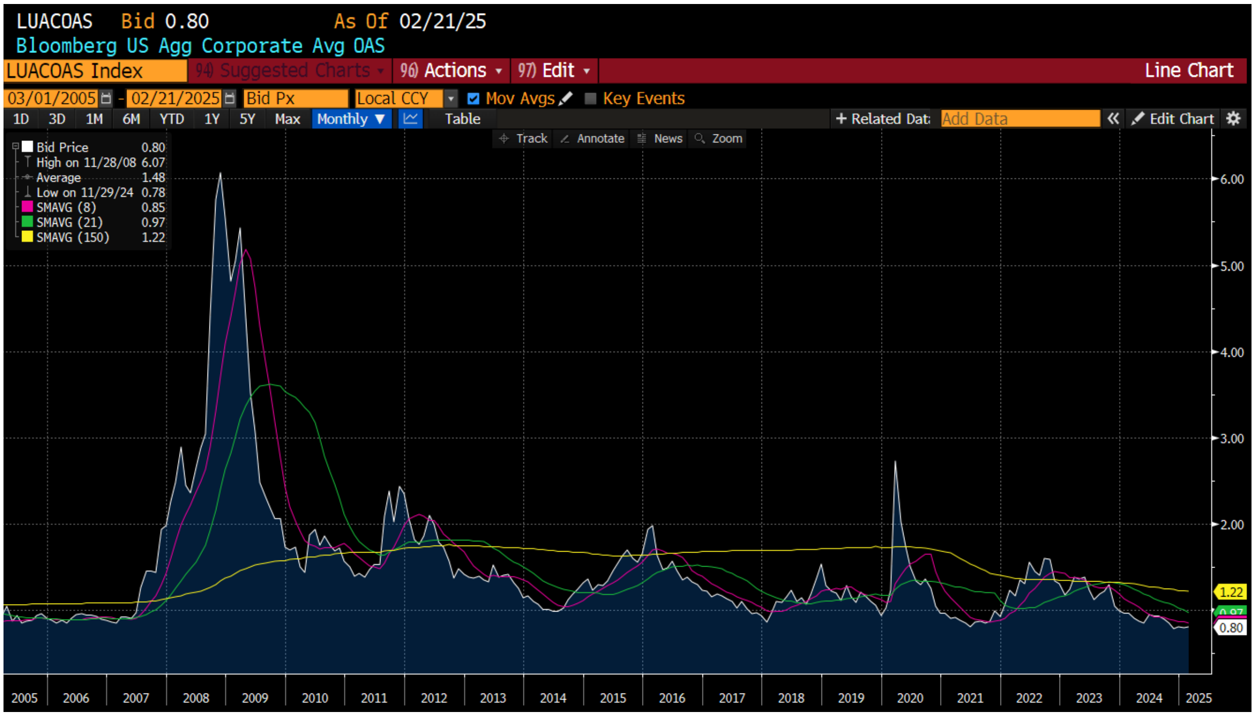
Source: Bloomberg

In terms of recent activity in RSA's fixed income portfolio, we purchased multiple Treasury securities to better position the portfolio. For example, we added to our position in the 4.625% September 2030 Treasury while also establishing a position in the 4.00% February 2034 Treasury to lock in attractive yields of 4.43% and 4.53%. We were looking to add exposure to the sector and add a little duration after the large rise in yields since the beginning of the fiscal year. Another example was the purchase of 2050 Treasury with a yield 5.046%. The long end of the curve materially sold off from December to early January, and we wanted to take advantage of that opportunity. The fund remains underweight Treasuries and short duration versus the index, but we are willing to add to our holdings and increase duration should yields climb.

We also purchased mortgages during this time. One was a 30-year 5.0% in December to reinvest prepayments while also investing additional funds to take advantage of the back up in interest rates. The trade slightly reduced duration which appeared prudent to hedge against interest rates continuing pushing higher. Another was a 30-year 6.0% which was very attractive on a total yield basis and was completed for a similar rationale as the 5.0% pool. Relative to other fixed income investments, mortgages continue to offer a balance of high quality along with decent spreads, which makes this an area where we will continue to add exposure.

For corporates, the fund had multiple maturities in the last few months. Given where corporate spreads were trading, we were very selective in what names to acquire. One example was a January 2036 11nc10 American Express bond with a spread of 90 bps and an approximate yield of 5.45%. American Express was a great name to add as it is a defensive company among A-rate financials that has shown it is capable of managing its business in various economic environments. A second was a new 5-year Valero Energy bond with a spread of 87 bps and a yield of 5.19%. A company with strong free cash flow, a healthy liquidity position, and a yield above 5% was very attractive.

Investment grade corporate spreads continue to be extremely tight, as seen in the chart on the next page. At 80 bps, corporate credit is priced to perfection. Any upheaval in the macroeconomic landscape should pressure spreads to widen, with spreads tied to the riskiest names underperforming the most. The fund will be very selective in adding names in the future and will focus on higher-quality borrowers at this point in the credit cycle. This is not the time to dig through the junk bin when the new economic rules of the road are being written daily.



Source: Bloomberg

Domestic Equity Strategy

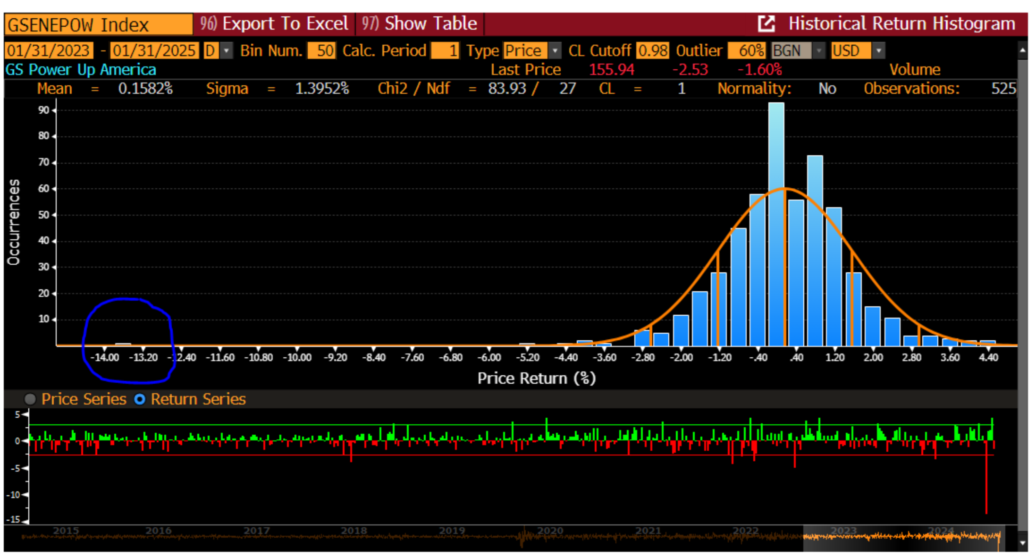
By Allan Carr

After hitting a new record high just two days before our last update, a hawkish Fed meeting on December 18 roiled markets as they moved their dot plot to predict only two rate cuts in 2025. Stickier inflation and policy uncertainty regarding tariffs were the culprits given by the Fed, and risk assets did not take the news well with the S&P 500 selling off -3%, the Nasdaq -3.6%, and small-cap stocks -4%. After getting as low as 3.62% in September, the 10-year yield surged to 4.79% in the following weeks, with Fed Funds futures pricing in only one 25bps Fed rate cut in 2025.

This was a dramatic change from earlier in 2024 when markets were predicting six rate cuts in 2025, while the Fed's dot plot predicted four. This Fed shift and market reaction felt like a clearing of the deck moment for the market at a minimum, with some calling for a correction that hadn't occurred since the Fall of 2023. But in yet another sign of resiliency, stocks clawed back nearly all the Fed-induced losses by the close on Christmas Eve.

January started strong, with the S&P up 4% in the first three weeks, with the Stargate announcement on January 21 providing yet another boost to red hot AI-related names. Less than a week later, a Chinese AI company called DeepSeek set off a massive selloff in AI-related names. A company that most people had never heard of stoked fears that they had an application that could rival US-based apps which had been superior thus far and at a fraction of the cost. In one trading day, tech stocks in the S&P lost nearly $1TLN of market capitalization, with $600BLN coming from NVDA. Tech stocks did not catch the worst of it either; Goldman's U.S. Power basket posted what looked like a fat-finger error (exhibit 1, GS).

EXHIBIT 1



Looking at the blue circle on the far left of the two-year return distribution, the power basket fell -13.7% on DeepSeek Monday. Even with 15 index names down over 10%, including bellwethers NVDA, Broadcom, and Oracle, which were down -17%, -17%, and -14% respectively, the S&P 500 index only closed down -1.46%.

This was a theme in January as index volatility mainly stayed in check, and the VIX didn’t seem to tell the story of the volatility being seen in single names. During a five-day stretch that included the Stargate and DeepSeek news, the realized vol for the S&P Index was a mundane 15, which to people in our seats would suggest not much happened. However, looking under the hood during those 5 days, the realized vol for the average single stock in the index was 3x that of the index at 45. According to Goldman, that was the highest vol spread between index/names since November 2020 and one of the top 10 highest spreads in the last 25 years. It was easy to see the disconnect as our active portfolios in January were as volatile as I can recall in otherwise normal daily moves for the S&P 500. Despite all the noise and volatility in January, the S&P 500 posted a healthy 2.8% return for the month.

As we moved through February, the second weakest month historically, the focus shifted to the nonstop headlines from the new administration and macroeconomic news. Refer to the fiscal and economic portions of this piece for more details, but a string of economic releases came in softer than expected, including housing, sentiment, and government job layoffs. After robust GDP growth in 2023 and 2024, the February economic data has a growing camp of economists and market participants worried about a growth scare. It was risk-off with the 10-year rallying back to 4.23% and futures pricing in a 50% chance of getting three rate cuts in 2025.

The last big event for February was the earnings report of NVDA, which loomed large after the DeepSeek scare in late January. Initially, their results allayed fears of the U.S. AI story being derailed, and both NVDA and the S&P were up when markets opened on February 27. But roughly 15 minutes into trading, headlines hit that tariffs on Canada and Mexico were going into effect on March 4, along with an additional 10% tariff on China. The S&P hovered around flat for most of the day before selling off sharply in the last 90 minutes of trading to end up down 1.6% on the day. With one trading day left in February, the S&P is off 4.6% from the 6144 all-time closing high set just a week earlier.

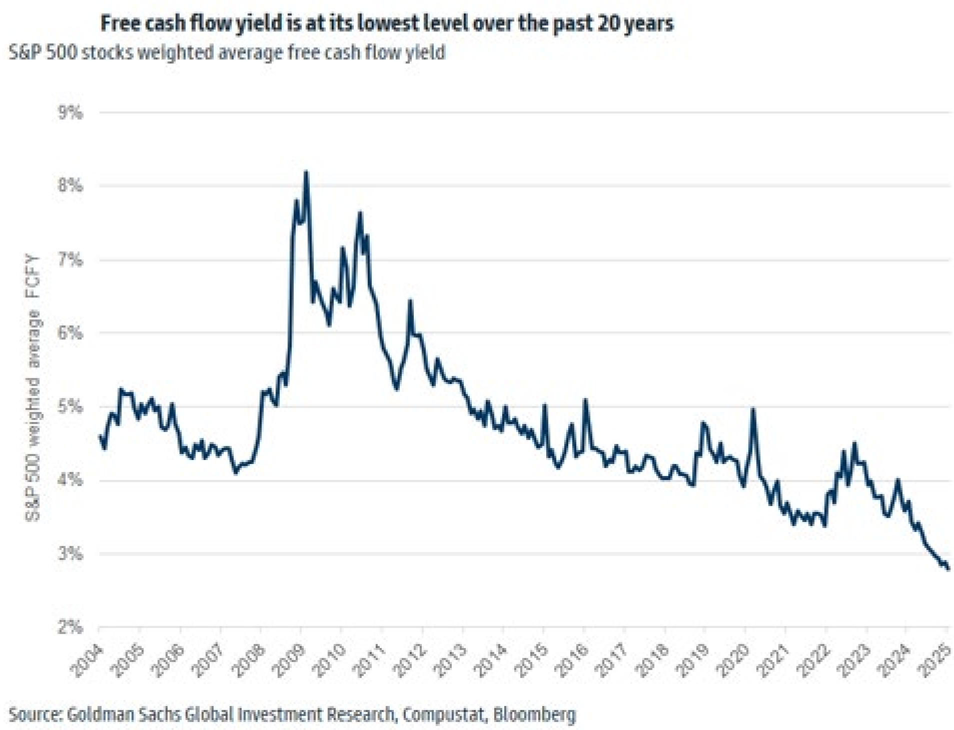
As we assess where we stand and what lies ahead, it is difficult to say with a lot of certainty what will happen with a litany of things: tariffs, taxes, DOGE, deportations, Russia/Ukraine, the Middle East, etc. It’s hard to envision headline risks dissipating anytime soon. We expect more market volatility as investors grapple with policy outcomes and their effects on jobs, inflation, sentiment, GDP, earnings, capex, etc. The one thing we will mention in speaking with our D.C. specialists is they think investors have been dismissive of tariffs as simply being negotiating tactics, and they think the administration is much more serious about tariffs.

What we can say with certainty is it has been a remarkable run for stocks over the last 2+ years: the S&P was up 21.62% for our fiscal 2023, 36.35% for fiscal 2024, and was up 5.26% through the end of January to start fiscal 2025. Combining the strength in risk assets with all the uncertainties that lie ahead, a more cautious tone should not come as a surprise. Simply put, the opportunity set has changed.

A recent WSJ article stated, “Warren Buffett is known for picking stocks. These days, he is increasingly picking cash.” Buffett is holding the largest percentage of cash ever at over 25% and recently stated, “We only swing at pitches we like…it’s just that things aren’t attractive.”

The word “attractive” is synonymous with valuations, which look stretched on most historical measures, including Free Cash Flow yield (exhibit 2, GS) which is at 20-year lows. We have said many times that timing inflection points in valuations is an inexact science as they tend to overshoot, but at a minimum, it suggests less downside support and less likely odds of outsized gains like we have seen in recent years.

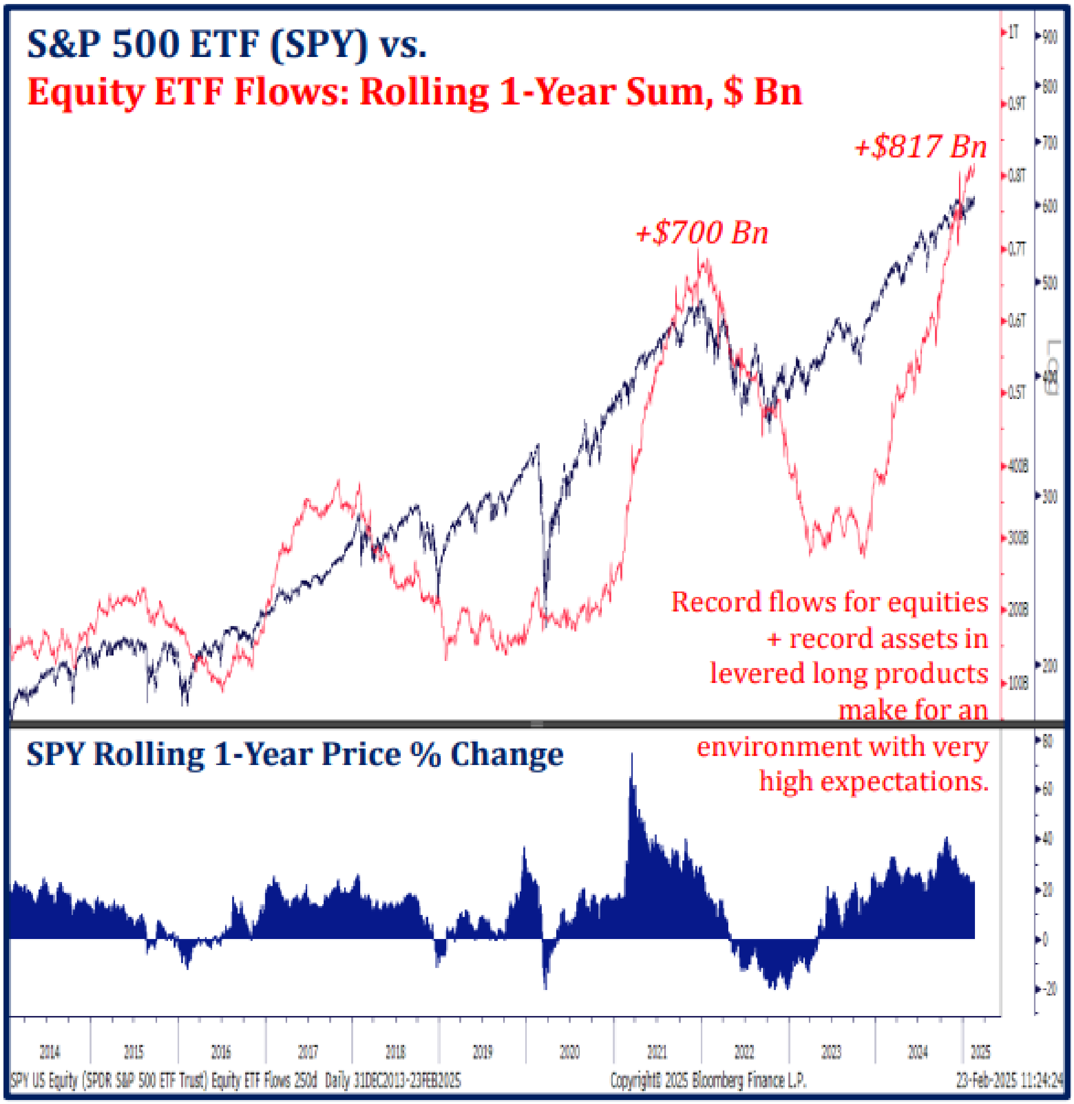
EXHIBIT 2



Market internals have softened as well. After seeing breadth improve in the second half of 2024, it has slipped recently with just 53% of names above the 50-day and 60% above 200-day. Additionally, put/call data is showing signs of complacency, and the NYSE advance/declines failed to make new highs alongside the all-time S&P closing high in February.

Unlike many of the bull markets post the GFC, retail investors have been more active and involved in this latest run (exhibit 3, Strategas). Also, flows into ETFs levered to stocks going up have been outnumbered the flows into ETFs levered to the market going down by a factor of 10.

EXHIBIT 3



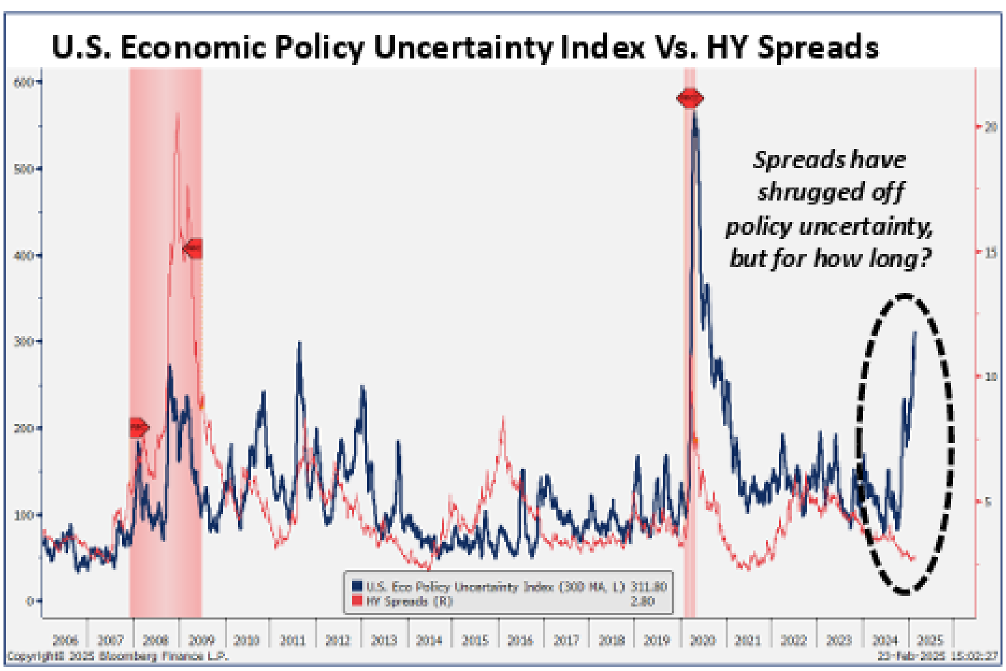
While short interest has risen off post-Covid lows (exhibit 4, GS), it remains well below levels seen post the tech bubble. Digging deeper into sectors, the only ones with short interest above their 30-year averages are healthcare, staples, and utilities.

EXHIBIT 4

Source: FactSet, Goldman Sachs Global Investment Research

A metric that has kept investors constructive on risk assets over the past two years has been tight credit spreads. This has popped up as a new area of concern as spreads remain at 20-year lows despite all the recent volatility in economic data and policy uncertainty (exhibit 5, Piper).

EXHIBIT 5



On the positive side, we are just wrapping up 4Q'24 earnings, and Corporate America continues to deliver. The finals haven't been tallied but it appears that earnings will be up north of 15% on 5% revenue growth. It's encouraging that all sectors, outside of energy, posted earnings growth, and it was not concentrated in a handful of mega-cap names (exhibit 6). We have yet to see the normal ratcheting down of forward earnings estimates in large cap as 2025 estimates imply 9-10% earnings growth, and early 2026 estimates are for mid-teens EPS growth. This is something to keep a close eye on.

Exhibit 6

S&P 500 4th Quarter Earnings Scorecard

	Sales Growth (Y/Y%)			Earnings Growth (Y/Y%)			# Reported
	Oct. 1	Jan. 1	Today	Oct. 1	Jan. 1	Today	
S&P 500	4.8%	4.1%	4.9%	12.8%	9.6%	15.7%	425/500
Discretionary	4.6%	3.9%	5.9%	13.2%	13.0%	26.2%	39/50
Staples	1.8%	1.0%	1.5%	3.1%	-1.4%	1.1%	28/38
Energy	-0.1%	-3.0%	-2.1%	-15.6%	-27.0%	-29.6%	15/22
Financials	4.3%	3.4%	4.9%	20.2%	17.4%	30.0%	70/73
Health Care	6.9%	7.8%	9.2%	21.8%	12.8%	14.3%	54/61
Industrials	-0.2%	-3.0%	-3.0%	2.3%	-3.5%	7.9%	76/78
Materials	2.3%	-0.8%	-1.7%	13.8%	-0.3%	2.5%	27/28
Real Estate	7.6%	7.7%	8.6%	10.5%	10.7%	12.8%	24/31
Technology	12.2%	11.1%	11.8%	15.6%	15.4%	18.0%	54/69
Communications	6.4%	6.7%	7.4%	18.7%	22.6%	32.8%	17/19
Utilities	5.7%	7.9%	3.1%	13.1%	9.5%	12.5%	21/31

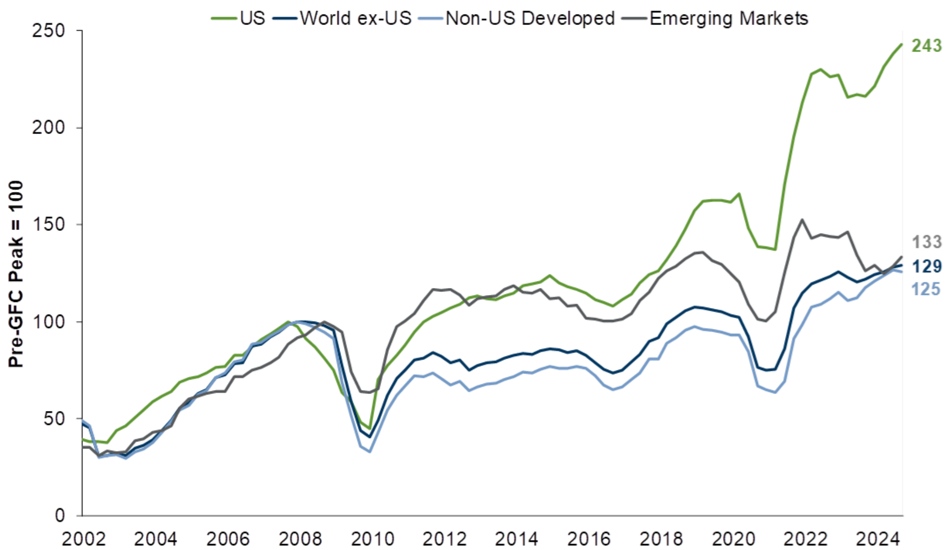
Source: Strategas, I/B/E/S data from Refinitiv (Current Reading Is Highlighted If Greater Than January 1st Estimated)

As for catalysts to keeping a floor on the recent dip, the window is now opening up for corporate buybacks after reporting season, the 10-year yield has come down below the psychological 4.5% level, and over $8TLN is on the sidelines in money markets.

We remain hopeful that deregulation will lead to an increase in capital markets activity, with IPOs and M&A coiled and ready after a couple of lackluster years. We are always encouraged when we see the market holding relatively well, and at the same time, some areas of froth are being recalibrated. Tesla, which nearly doubled in a roughly six-week period on nothing fundamental starting around election day, has given much of it back. Bitcoin is down 25% from its January high, and many other momentum and meme stocks are well off their parabolic post-election highs.

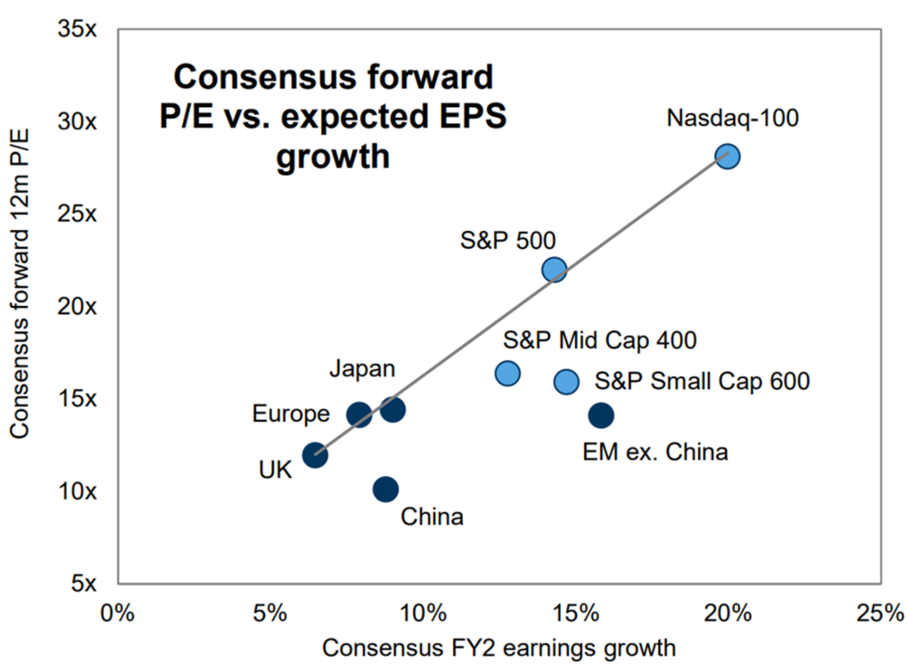
There has been a lot of focus on valuation metrics being rich versus history and the outperformance of U.S. large-cap stocks, especially since COVID (exhibit 7).

EXHIBIT 7



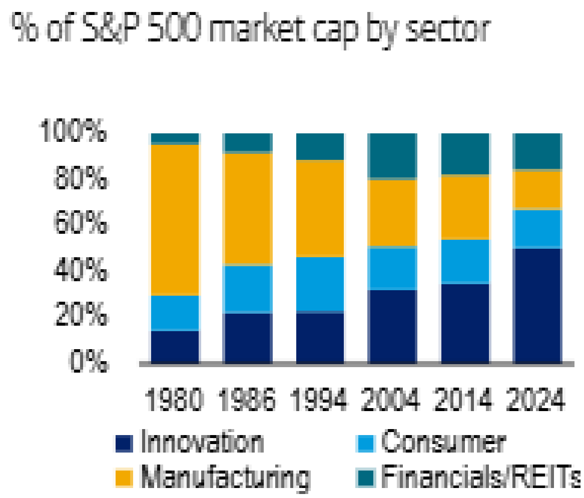
There have been calls to move away from U.S. large cap in favor of other foreign and small cap as this outperformance should mean a revert. However, look at a few of the following charts for some context. Perhaps you have rightly been getting what you pay for (exhibit 8, GS)?

EXHIBIT 8



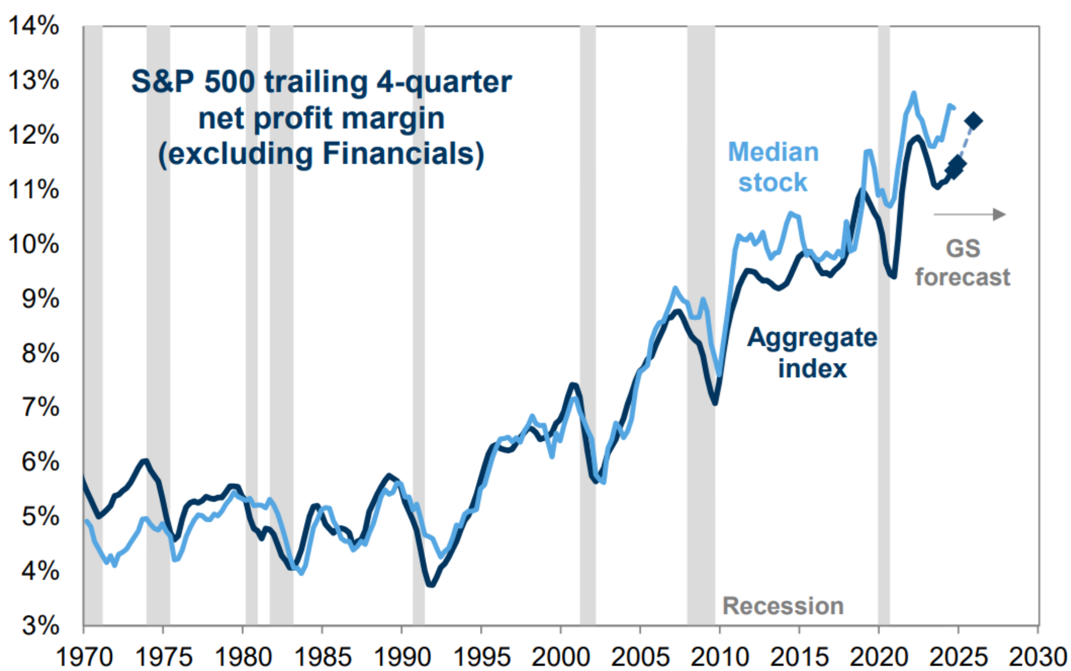
Valuation seems like a headwind when looking at multiples through a historical lens, but should investors consider a re-rating higher given how much the index composition has changed over the past 30-40 years (exhibit 9)?

EXHIBIT 9



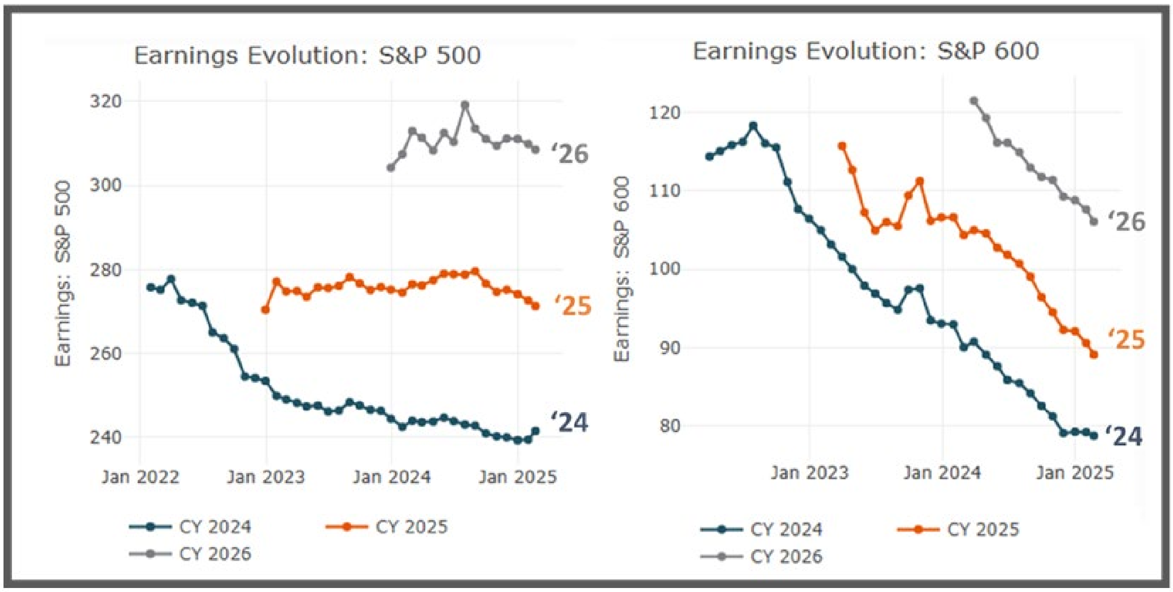
Comparing a market that was 2/3 manufacturing (which is both highly capital and labor-intensive) to a market dominated by technological innovation (which is asset and employee-light) does not seem like an apples-to-apples comparison. Additionally, look at what margins have done since the 90's tech innovation (exhibit 10, GS). What if AI continues this trend?

EXHIBIT 10

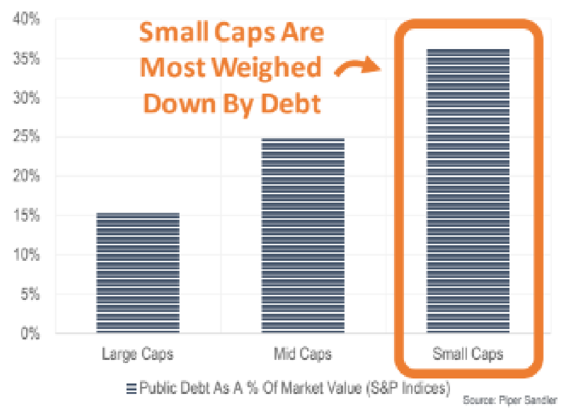


Regarding large versus small, here are two charts that do not need much explanation (exhibits 11 & 12, Piper).

S&P 500 CY Earnings Estimates **S&P 600 CY Earnings Estimates**



Debt To Market Value In S&P Size Indices



In closing, while the last month has brought about a growth scare, recession odds remain quite low, and solid growth should continue, albeit at a slower pace. It's worth noting that 2% growth has historically been a solid spot for equities to work. We remain cautious in the near term due to all the policy uncertainties and given the outsized gains realized in the last few years. The next few weeks and months should provide U.S. with a better sense as to what tariffs, inflation, employment, and the Fed's path will look like. As we wait for the above to play out, our best guess is that we will continue to see choppiness and a rangebound market with 5700 being a critical level for support.

International Equity Strategy

By Steve Lambdin

The global equity markets fizzled out in the fourth quarter as trade concerns post Trump's U.S. presidential victory, sluggish economic activity, political upheaval across Europe, and continued concerns surrounding the Chinese economy came together to push equity markets significantly lower outside of the U.S. Stocks in developed markets as well as emerging markets were hit equally as bad in the quarter. The U.S. dollar was very strong on the rhetoric surrounding Trump's pro-America policies, especially the potential for much higher tariffs on Chinese, European, Mexican, and Canadian imports. This dollar strength hurts returns in global stocks. The major global central banks continued to be in easing mode as the European Central Bank (ECB) cut interest rates twice. Inflation was a bit sticky during the quarter as investors were surprised by core CPI readings in Japan and the United Kingdom (U.K.). Japan's government approved a massive stimulus. program targeted at helping low-income consumers with various forms of aid to help them absorb the shock of rising prices. In Europe, the governing coalitions in France and Germany fell apart as these leaders received votes of no-confidence. Leadership in these regions remains a mess. Global Purchasing Managers Indices (PMIs) outside the U.S. remained generally weak in the quarter. This was especially so in the Eurozone economy, as expansionary levels in early 2024 gave way to contractionary levels at the end of the year. The economies of Germany, Italy, and France were all struggling as we exited 2024.

The Chinese equity market fell nearly -8% in the quarter on new potential tariffs from President Trump, a lackluster reception from the recent government stimulus package, softer economic activity in the region, and the ongoing real estate bubble. Unfinished apartment dwellings are rampant across the country, leading to a collapse in fresh starts and, therefore, loan growth. Over the last several years, wealth destruction in Chinese real estate has passed the losses suffered during the U.S. financial crisis 15 years ago. It will take years to restore health in the real estate sector.

Even though the Japanese equity markets fell -3.6% during the fourth quarter, this market fared much better than the overall MSCI Pacific region. We believe this relatively better performance was due to the approval of a $250 billion economic stimulus plan in addition to the continuing efforts of corporate governance reform. Many investors expect developments from these initiatives to continue to provide more positive momentum in the coming year.

Equity index returns (%)	December 2024 U.S. dollar	December 2024 Local currency	4Q 2024 U.S. dollar	4Q 2024 Local currency	YTD 2024 U.S. dollar	YTD 2024 Local currency
S&P 500	–2.4	–2.4	2.4	2.4	25.0	25.0
MSCI ACWI	–2.4	–1.6	–1.0	1.3	17.5	20.2
MSCI ACWI ex USA	–1.9	0.3	–7.6	–1.4	5.5	12.6
MSCI World	–2.6	–1.9	–0.2	1.9	18.7	21.0
MSCI Emerging Markets	–0.1	1.2	–8.0	–4.4	7.5	13.1
MSCI EAFE	–2.3	0.4	–8.1	–0.6	3.8	11.3
MSCI Europe	–2.4	–0.5	–9.7	–2.9	1.8	7.8
MSCI Pacific	–2.1	2.1	–5.5	3.5	7.0	17.8

Source: RIMES; Capital Group

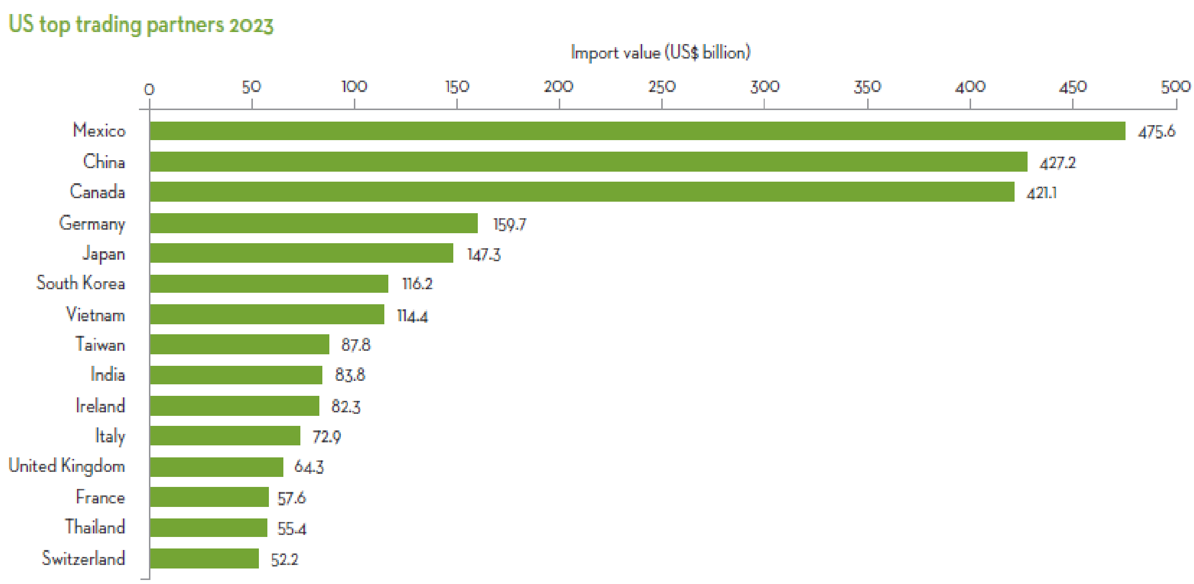
The MSCI EAFE Index (net dividend) and the MSCI Emerging Markets Index returned -8.1% and -8.0%, respectively, during the fourth quarter of 2024 vs. +2.4% for the S&P 500 Index. President Trump's reelection victory was the primary catalyst behind the significant out-performance of U.S. equities vs. equities outside of the U.S. His proposals of sharply higher tariffs on goods imported into the U.S. sent global markets sharply downward in the period. It's too early to tell how much of this is "gamesmanship" by President Trump to secure slightly better terms with our trading partners. News flow from the U.S. administration seems to change daily on this issue. This is introducing a lot of volatility into the global equity markets. The U.S. dollar index rose +7.65% in the period. This hurt returns for unhedged U.S. investors in the MSCI EAFE Index and the Emerging Markets Index. For the fourth quarter, the Asian region was stronger than the European region, as equity markets in Singapore and Japan were stronger than most in the period. All eleven sectors of the MSCI EAFE Index posted negative returns, with financials and consumer discretionary being the best house in a bad neighborhood. The basic materials and healthcare sectors performed the worst during this period. The Bloomberg Commodity Index was a mixed bag and was nearly flat in the quarter, as WTI crude oil rose +7.1%. In comparison, copper and nickel fell –12.6% and -13.8% respectively.

After a slow start in January for the global equity markets, we have seen a nice rally in the equity markets outside of the U.S. Anticipated tariff implementation dates by the U.S. administration have been pushed outward, which have brought some relief to investors in global equities. This has provided a nice relief rally in these markets. Overall, major economic reports continue to be a mixed bag with a negative tilt toward them, especially in Europe. So far in the first quarter of 2025, the MSCI EAFE Index and the MSCI Emerging Markets Index are up +8.4% and +4.5%, respectively, while the S&P 500 Index is up +1.4%. However, we recognize that things can change in a hurry in the current environment.

The following pages provide an update on what we see as relevant concerns for investors in the marketplace at present. Many of these are the same issues that were present during Trump's election in early November. We will see how these issues play out in the coming months.

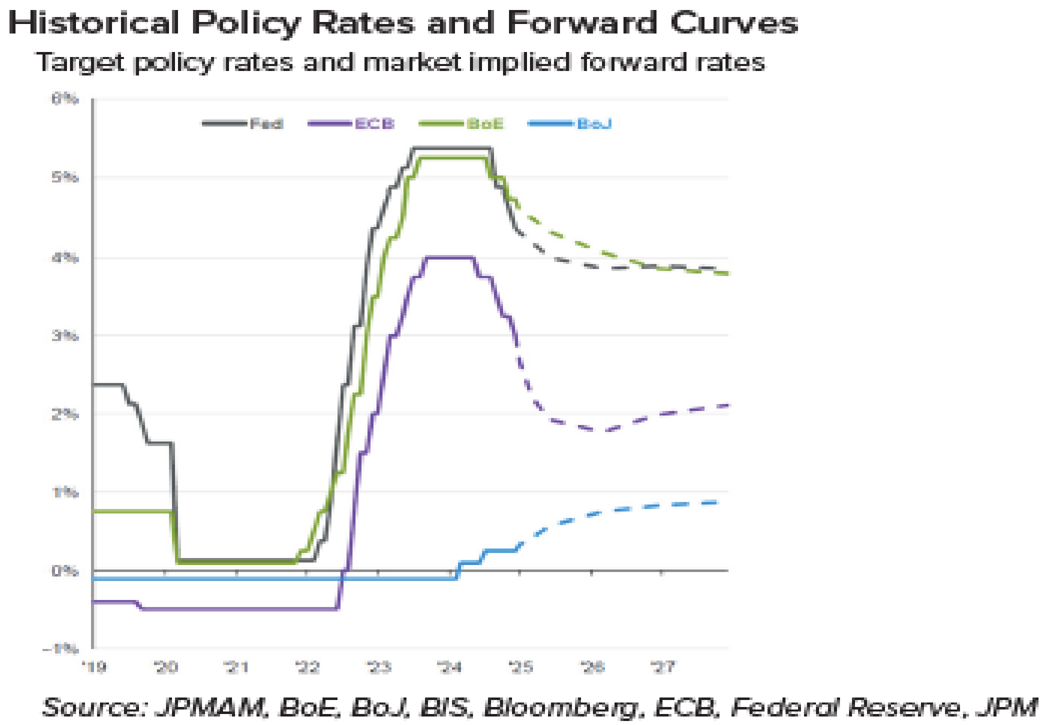
<u>Issues/Points:</u>

Tariffs – Gauging the daily swings surrounding tariff chatter from world leaders is a very taxing exercise. We see a wide range of possibilities and outcomes on this matter. So far, major tariff implementation announcements made by President Trump have later been rescinded or pushed out to "down the road." Whether this is political posturing to gain just marginally better trading terms or a complete watershed moment to re-write U.S. trade policy with the world is hard to tell. However, this surely makes for some volatile equity markets as investors digest the daily swings in tariff rhetoric. We will see how this proceeds, and we caution you that plenty could change in the coming weeks.



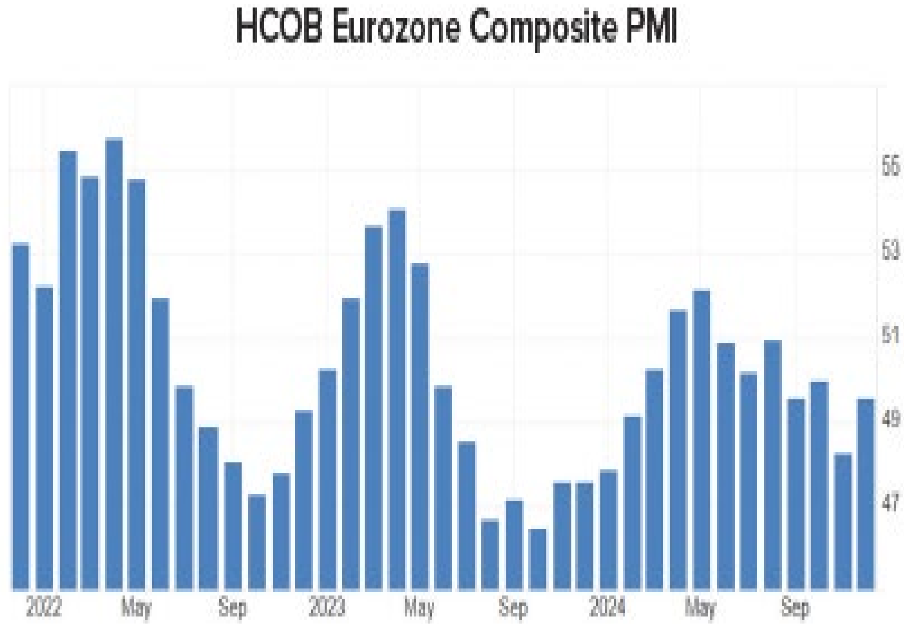
Source: Statista, US Census Bureau and US Department of Commerce as at February 2024.

Global Central Banks – We continue to believe global central bank policies will exert a lot of force on the global equity markets over the next several months. Our concern on this issue has not changed since our last update. The European Central Bank (ECB) implemented two interest rate cuts in the fourth quarter as concerns grew over economic weakness in the region. We expect the ECB to focus on future interest cuts to support a weak growth outlook as inflation could continue to fall. The Bank of England (BOE) cut interest rates at its November and February meetings. Like the ECB, we expect more cuts in 2025. Interest rate cut expectations by the U.S. Federal Reserve (FED) may not be as numerous in 2025 as many expect. Investors will be monitoring economic data points as this could instantly change the direction of the FED. We continue to expect that the Bank of Japan (BOJ) will probably have a flat to slight upward bias toward interest rates. As everyone knows, changes in interest rate expectations could push markets significantly higher or lower.

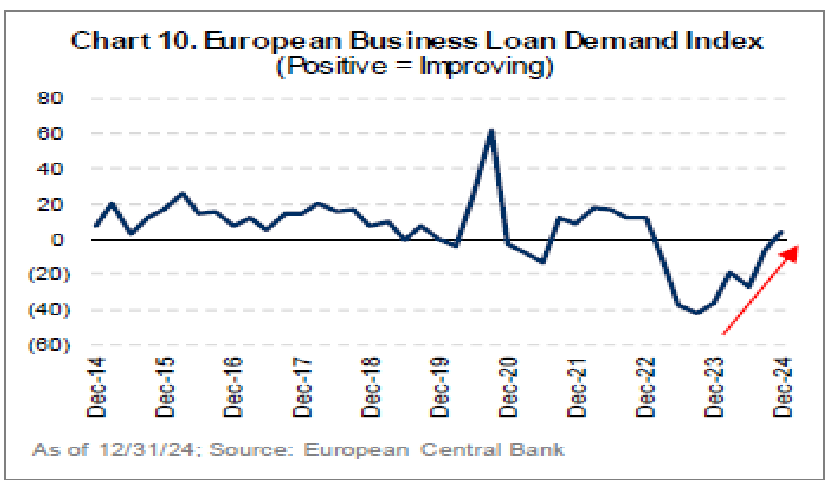


Source: Eagle Global Advisors

Eurozone Economy & Equity Markets – Overall, we view the economy here and the equity markets as a mixed bag with a range of different outcomes. On one hand, European exporters are in the crosshairs for tariff increases by President Trump, which could dampen the region's economy. Also, the Purchasing Managers Index (PMI) has been in a nasty downtrend over the last half of 2024 as manufacturing struggled. The political area has been a complete mess as the French and German governments have faltered with votes of no-confidence. Political instability makes investors very nervous and creates an environment where equities struggle to perform well. However, we could see some near-term strength in manufacturing as importers could look to build inventory ahead of proposed tariff increases. In addition, European banks are starting to loosen lending standards to spur business growth. As we add up the scorecard, we still maintain a downward bias to the region's outlook.

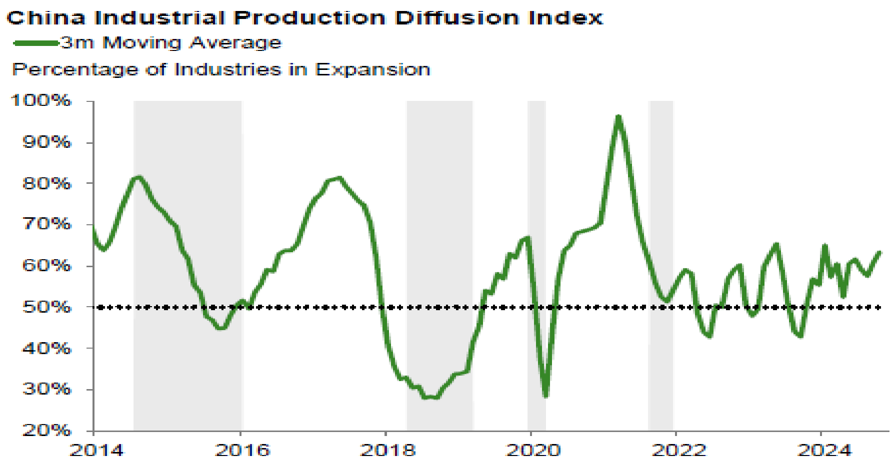


Source: S&P Global, Trading Economics, Eagle Global Advisors



Source: Altrinsic Global Equity Commentary

China – the outlook here continues to be cloudy as some near-term cyclical data points signal some level of stability but are balanced out by longer-term structural issues. Industrial production was stronger than most were expecting, as December production was the strongest reading since April. Recent stimulus measures will be good for household consumption as consumers should be more confident in the coming months. However, CPI remains just above zero, well below targeted levels. Trade issues will be key as the U.S. looks to implement tariff increases on most goods in the coming weeks. At this point, we expect 2025 economic growth in the +4.5% - +5% range.



Source: National Bureau of Statistics, PBOC, Fidelity Investments

China: Economic and Policy Trends

Positive	Negative
Local government support (debt swap)	Structural imbalances (excess capacity, high debt)
Property sector easing (mortgage refinancing)	Property overhang (asset value deterioration)
Equity market support (swap facilities)	Depressed consumer sentiment
Positive messaging for household consumption/social welfare	Geopolitical and trade risk

Source: National Bureau of Statistics, PBOC, Fidelity Investments

Geo-Political Landscape – We continue to see plenty to worry about on this front. The global hotspots mentioned in our previous reports are still present. Global conflicts continue to escalate with each passing month. The war in Ukraine continues to grind forward as casualties and lost economic output are pushing higher. However, President Trump is trying to follow through on his campaign promise to help bring an end to this conflict. Talks have recently started between the U.S. and Russia on how to end this war. However, these talks have not included Europe and Ukraine at the present time. Certainly, these talks will have to include these two regions at some point. So far, all sides seem to be far away from any type of negotiated solution to end the conflict. If President Trump can have a major hand in ending this, his stature would climb among the world's leaders. Also, we believe this would be a significant positive event for global equity markets. In the meantime, global equity markets remain surprisingly strong to U.S. when considering all that is happening around the globe.

Source: Compliance Week

Final Thoughts/Summary

As we look out over the next few months, we see a lot of uncertainty in the global markets. The economic outlook has cooled a bit over the last month as the Eurozone and China are struggling to gain any momentum, while the outlook in the U.S. is better. President Trump's policies pertaining to trade and geopolitical events remain a wildcard and keep most investors guessing what the next move might be. We fear businesses are finding it tough to plan longer-range spending plans in the face of such uncertainty. We expect inflation to continue trickling down over the first half of 2025 and give opportunities for most global central banks to stay in a more dovish monetary policy position. While the geo-political landscape looks risky, if President Trump can bridge some type of negotiated solution in the Ukraine/Russia war, this should be a positive shot in the arm for the global equity markets. However, right now, all sides seem to be far apart, and there is no easy deal at hand. Corporate earnings growth ended 2024 at a better level than many had expected, setting up a decent 2025 outlook. Overall, the outlook for the global equity markets looks mixed and choppy. We would expect some reversion toward equity markets outside of the U.S. after a strong end of 2024 by U.S. stocks.

We continue to sell a few out-of-the-money calls on the Emerging Markets Index to bring in income. Overall, premiums remain attractive in the current equity market. Our current allocation to Emerging Market equities is approximately 2.8% of total assets and 10.7% for MSCI EAFE equities across our TRS, ERS, and JRF portfolios for a total international equity exposure of approximately 13.5%. This is within our target allocation range in our investment policy statement. *(Credit is given to the following entities for charts provided: Compliance Week, National Bureau of Statistics, PBOC, Capital Group, RIMES, S&P Global, Macrobond, Fidelity Investments, Eagle Global Advisors, Trading Economics, Altrinsic Global Equity, U.S. Census Bureau, U.S. Department of Commerce)*

The Sovereign Wealth Effect: America's New Tool for Rebalancing the Global Trading System

By Michael McNair

Intro

President Trump's recent executive order establishing a U.S. Sovereign Wealth Fund has left many observers puzzled. Most analysts have dismissed it as either meaningless political theater or, more cynically, as a vehicle for personal enrichment. These interpretations fundamentally misunderstand both the purpose and significance of this initiative.

We believe the creation of a U.S. Sovereign Wealth Fund (SWF) represents a game-changing development in American economic policy. It provides clear confirmation of the strategy we outlined in our previous report, "The Dollar's Dilemma," that the Trump Administration would move to address persistent trade imbalances by targeting capital flows and dollar overvaluation. The SWF represents a sophisticated tool for restructuring the global financial architecture that has long disadvantaged U.S. manufacturing.

In this report, we will demystify the executive order and demonstrate why it marks a pivotal shift in addressing global economic imbalances. By examining recent statements from key administration figures, particularly CEA Chair Stephen Miran and Treasury Secretary Scott Bessent, we show clear signs of how this tool will be deployed to force reciprocity in global capital markets and restore U.S. manufacturing competitiveness.

Balance of Payments

Most analyses focus solely on the flow of goods and services between countries. However, this view captures only half the picture. International transactions are part of a larger system that includes two types of flows: trade flows (the exchange of goods and services) and capital flows (the exchange of financial assets like stocks, bonds, and property). These two flows are inextricably linked through what economists call the balance of payments, which can be expressed in a simple but powerful equation:

Trade Account* = Capital Account

**The technical BoP identity is: current account = capital account, but we are using "trade account" in place of the "capital account" for simplicity. It should be noted that the current account differs slightly from the trade account, which is a fact we can ignore in our discussion.*

Regardless of their global circulation, all U.S. dollars ultimately purchase either 1) U.S. goods and services or 2) U.S. financial assets. While some might argue that dollars can be used to buy commodities or assets from other countries, this merely transfers the dollars to new holders who face the same fundamental choices.

Regardless of how they circulate globally, U.S. dollars fundamentally represent claims on U.S. assets. When entities engage in international trade, whether for financial assets or physical goods like commodities and receive dollars, they invest them in interest-bearing U.S. financial instruments, such as Treasuries. Even if these dollars are held in foreign banks or circulate within the Eurodollar market, they are reinvested into U.S. assets, maintaining a continuous. link to the U.S. financial system. The number of times these dollars change hands internationally is immaterial; they are invariably invested back into U.S. assets, completing the circular flow.

This circular flow of dollars, always returning to purchase U.S. goods and services or U.S. financial assets, is the fundamental reason why the balance of payments always balances. Every outflow of dollars is ultimately matched by an inflow, whether through the trade account or the capital account, ensuring that the balance of payments sums to zero.

The balance of payments accounting identity tells U.S. that any change in one side of the equation must be matched by an equal and opposite change in the other. For example, when Korean pension funds invest $1 billion in U.S. stocks, all else equal, U.S. net exports must decrease by $1 billion, and Korean net exports must increase by $1 billion, despite this transaction having no direct connection to trade in goods and services (see the FAQ section at the end of this report for a detailed explanation).

This framework helps explain why many conventional approaches to reducing the U.S. trade deficit have failed. When we focus solely on trade flows — through measures like tariffs or export promotion — we ignore the powerful role that capital flows play in driving trade outcomes. In fact, in today's global financial system, it's often capital flows that determine trade flows, rather than the other way around.

One of the fundamental misunderstandings about trade imbalances - particularly why China runs a persistent trade surplus while the U.S. runs a persistent trade deficit - is the assumption that these imbalances are driven by one country's inherent production cost advantage over the other. While production cost advantages do exist, they are not supposed to persist indefinitely in a properly functioning global trading system because persistent imbalances should self-correct. When a trade surplus country experiences excess demand for its goods and services, this should cause either its currency to appreciate or its relative inflation rate to rise (changes in relative productivity can also occur, but this is slower and less directly determined by trade and capital flows). An appreciating currency rebalances trade flows through two channels: it increases the production costs of the surplus country relative to its trading partners while simultaneously raising real household disposable income. Since savings equals production minus consumption, this combination of higher relative production costs and increased household purchasing power naturally reduces the trade surplus.

However, this rebalancing mechanism has failed to operate effectively for the past 30 years due to a fundamental distortion in the demand for currencies.

There are two distinct drivers of currency demand:

1) Demand for goods and services (trade flows) typically reflects the underlying dynamics of comparative advantage and trade balances.
2) Demand for financial assets (capital flows) arises from the preference for holding or investing in a particular country's financial instruments.

In today's financial system, the desire for U.S. financial assets has effectively short-circuited the natural currency adjustment mechanism. Despite decades of large trade deficits, which should have led to dollar depreciation, the U.S. dollar has remained strong because of overwhelming foreign demand for U.S. financial assets.

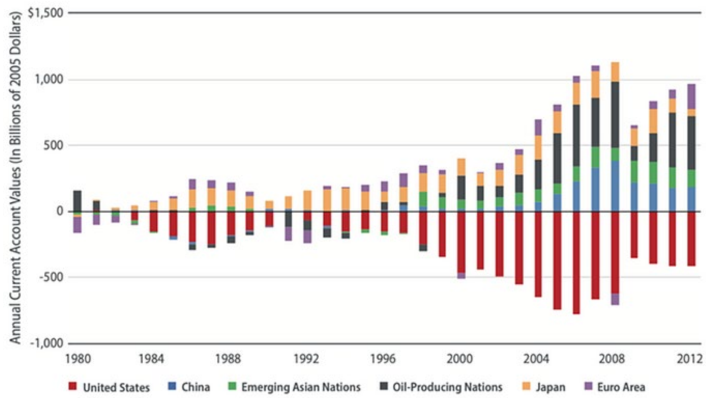
The overwhelming demand for U.S. financial assets reflects structural features of the global economy, particularly policies in surplus countries that generate and export excess savings. These policies systematically suppress household income and consumption, forcing domestic savings rates far above what's needed for domestic investment (in the balance of payments: savings = production — consumption).

A crucial part of the equation is that the United States has long been the only country with sufficient liquidity and unrestricted access to its capital markets. While many nations carefully manage and sometimes restrict foreign investment to maintain control over their economies, the U.S. has embraced an open financial market regime.

We have been highlighting this structural imbalance for well over a decade. In our 2013 report, we published data demonstrating that the United States had become the world's primary destination for excess savings. As we wrote then,

> "The U.S. runs a trade deficit because it has been forced to absorb nearly 100% of the world's excess savings (i.e., net capital flows) due to the fact that the U.S. is the only country that allows the free flow of capital and has a sufficiently large financial system to absorb the capital flows.
>
> The United States needs the rest of the world to purchase more U.S. goods and services and fewer U.S. financial assets. However, as long as the United States remains the only country willing and able to accept the world's excess savings, it will continue to run a trade deficit regardless of trade policy.
>
> The chart shows how capital flows from surplus countries, including China, Japan, oil producers, and other emerging Asian nations, are predominantly directed toward the United States, with few other significant destinations for these flows."

Figure 2: Global Capital Flows



Source: International Monetary Fund, World Economic Outlook Database

Notes: The emerging Asian nations category does not include China. The oil-producing nations are: Algeria, Angola, Canada, Iraq, Kuwait, Libya, Mexico, Nigeria, Norway, Oman, Russia, Saudi Arabia, United Arab Emirates, and Venezuela. The euro area does not include the United Kingdom.

Little has changed in the proceeding decade. If anything, the United States' role as the primary destination for global excess savings has only become more entrenched. This persistent dynamic makes it clear that any meaningful rebalancing of global trade must address the capital side of the balance of payments. Traditional trade measures, like tariffs or export incentives, only tackle one half of the equation. The real leverage lies in capital flows. By regulating or even redirecting these flows, a country can influence its currency value and, in turn, its trade balance. To achieve lasting change, policies must incorporate capital flow measures alongside traditional trade measures, acknowledging that capital is not merely a passive response to trade imbalances but a primary driver of them.

A User's Guide to Restructuring the Global Trading System

Since we published 'The Dollar's Dilemma,' a significant development has reinforced our analysis: President Trump's appointment of Stephen Miran as Chair of his Council of Economic Advisors. Miran has been a leading proponent of addressing global imbalances through the lens of capital flows, having written extensively on how excess foreign savings distort U.S. financial markets and trade patterns. As one of the administration's most influential economic voices, his appointment signals a likely shift toward policies that directly confront these capital flow dynamics in the effort to rebalance the global trading system.

Prior to his appointment, Miran authored "A User's Guide to Restructuring the Global Trading System" at Hudson Bay Capital. This detailed blueprint reveals a framework strikingly aligned with our analysis over the years. Miran, like us, recognizes persistent dollar overvaluation driven by capital flows as one of the most significant drivers of global imbalances. "The root of the economic imbalances," he writes, "lies in persistent dollar overvaluation that prevents the balancing of international trade, and this overvaluation is driven by inelastic demand for reserve assets."

In his "User's Guide," Miran methodically catalogs the tools available to reshape the global trading system. His primary approach mirrors what we termed the "Mar-a-Lago

Accord" scenario in "The Dollar's Dilemma" — a coordinated realignment of global currencies similar to the 1985 Plaza Accord.

Miran recognizes the challenges in securing such an agreement in today's environment. As he notes, neither Europe, facing sub-1% growth, nor China, doubling down on export-led growth amid domestic weakness, appears naturally inclined toward currency appreciation. This leads him to detail unilateral options that could create leverage for eventual multilateral negotiations.

Miran directly challenges the conventional wisdom about U.S. policy options:

> "Consensus on Wall Street is that there is no unilateral approach that the Trump Administration can take for strengthening undervalued currencies. These economists tend to point to the Federal Reserve's policy rate as the main driver of the dollar and then emphasize that the Fed will not cut rates merely because the President wants to achieve a currency outcome. This conclusion is wrong. There is a variety of steps an Administration can take if it is willing to be creative, that do not rely on the Fed cutting rates."

Miran's first unilateral approach leverages the International Emergency Economic Powers Act (IEEPA). Signed into law by President Carter in 1977, IEEPA grants the President broad authority over international transactions in response to foreign-origin threats to U.S. national security, foreign policy, or economy. Miran suggests using these powers to directly address what he identifies as the root cause of dollar overvaluation: excessive foreign demand for U.S. reserve assets.

Specifically, Miran proposes using IEEPA to impose a "user fee" on foreign official holders of Treasury securities by withholding a portion of interest payments. This approach would make reserve accumulation less attractive while helping recoup some of the costs these holdings impose on the U.S. export sector. Miran notes that while some bondholders might protest, most governments already tax interest income. The U.S. itself taxes domestic holders of Treasury securities.

This strategy aligns precisely with our prediction in "The Dollar's Dilemma," writing that

> "If negotiations fail to produce meaningful adjustment, we expect the administration to move toward direct measures targeting capital inflows. There is clear historical precedent for such action — until 1984, the U.S. maintained a 30% withholding tax on foreign interest income. The elimination of this tax played a crucial role in enabling the explosion of global capital flows we've witnessed since".

Return of the Foreign Withholding Tax: Killing Two Birds with One Stone

Secretary Bessent's first interview as Treasury Secretary may have provided an early signal of how the administration plans to implement this strategy. He emphasized the urgency of making the 2017 Tax Cuts and Jobs Act permanent, warning that "if we do not get this tax bill done…then we will have the largest tax hike in history." While this might seem unrelated to trade policy, it potentially creates the political opening for reimposing measures targeting capital inflows.

The challenge facing the administration is that making the Trump tax cuts permanent would cost an estimated $4 trillion over ten years, and many Republicans are unwilling to support this without offsetting revenue increases or spending cuts. Traditional tax increases face significant political hurdles. However, one solution could address both the fiscal and trade objectives: reinstating the 30% foreign withholding tax on interest income.

The scale of potential revenue from such a measure is substantial. As of June 30, 2023, foreign portfolio holdings of U.S. securities totaled $26.9 trillion, with current estimates around $30 trillion, split roughly evenly between the foreign private sector and foreign official institutions. Conservative, back-of-the-envelope estimates suggest a 30% withholding tax on interest income would generate approximately $360 billion annually in tax revenue, or $3.6 trillion over the ten-year window used by the Congressional Budget Office.

Crucially, this revenue would come entirely from foreign holders of U.S. securities, not domestic taxpayers. For private foreign investors, this wouldn't necessarily increase their total tax burden. For example, Europe's average statutory top personal income tax rate is 42.8%. Therefore, European holders of U.S. securities would simply pay 30% to the U.S. government and the remaining 12.8% to their home country. The lost revenue would be borne by foreign governments. Most foreign jurisdictions already impose similar withholding taxes on their securities, so they would have limited grounds for retaliation. The U.S.'s large negative net international investment position further constrains potential retaliatory measures.

Private vs Official Flows: The Channel Changes, The Challenge Remains

The shift from official reserve accumulation to private capital flows as the primary driver of dollar demand represents a change in tactics rather than fundamentals. When U.S. returns are attractive (as with current higher rates), private capital flows from surplus countries into U.S. markets, and their central banks have no need to accumulate reserves. However, if private flows reverse, we typically see these central banks step in with reserve accumulation, a pattern that has repeated over decades. The specific channel through which surplus countries export their excess savings may change, but the economic impact remains the same: capital flows into U.S. financial markets rather than goods and services, maintaining dollar strength at levels that prevent trade rebalancing. This is why policy must address both private and official capital flows to be effective. Surplus countries will always find ways to maintain their trade advantages by preventing currency adjustment unless both channels are addressed.

The Sovereign Wealth Fund: A Capital Account Tool for Addressing the Trade Account

However, Miran's second unilateral option of reserve accumulation reveals the true purpose behind Trump's creation of a U.S. Sovereign Wealth Fund. "Another unilateral approach to strengthening foreign currencies," Miran writes, "is to mimic the approach taken by some of our trading partners and accumulate foreign exchange reserves. By taking dollars and selling them in the market for other nations' currencies, the government can create additional demand for other currencies and increase their value."

In analyzing implementation paths, Miran states,

> "In terms of implementation, there are two meaningful avenues for doing so: the first is Treasury's own assets, particularly its Exchange Stabilization Fund. The President can direct the Treasury Secretary to use the ESF as he sees fit. However, the ESF is of limited size: its total net position is less than $40 billion, of which $10 billion is already invested in foreign currency instruments."

Miran goes on to examine creative ways to expand this capacity, including leveraging the ESF or using Treasury's gold reserves through careful structuring of forward contracts to comply with statutory requirements.

> "The Gold Reserve Act also authorizes the Secretary to sell gold in a way 'the Secretary considers most advantageous to the public interest,' providing additional potential funds for building foreign exchange reserves. However, the Secretary is statutorily required to use the proceeds from such sales "for the sole purpose of reducing the national debt." This requirement can be reconciled with the goal of building foreign exchange reserves by having the ESF sell dollars forward. If gold sales are used to deliver dollars into the forward contracts, it will likely satisfy the statutory requirement of reducing national debt. There are other means of structuring the ESF transaction as a form of debt contract to comply with the law. While this is probably statutorily permissible, selling national gold reserves to buy foreign exchange instruments could be politically costly, and changes the asset composition of the USG's balance sheet. Still, because gold pays no interest, selling it for positive-yielding foreign debt should result in income for the U.S. Government."

When Treasury Secretary Bessent announced the SWF's creation, his language was striking:

> "We're going to monetize the asset side of the U.S. balance sheet for the American people. There'll be a combination of liquid assets, assets that we have in this country as we work to bring them out for the American people."

It isn't hard to connect the dots between Bessent's announcement and Miran's framework. The fact that the administration's two most influential economic voices converge on using the Treasury's assets for reserve accumulation is no coincidence. As Treasury Secretary and CEA Chair, Bessent and Miran will drive trade policy. **The SWF**

clearly provides the institutional architecture needed to implement Miran's strategy and address trade imbalances through the capital account.

The SWF's intended role as a vehicle for purchasing foreign assets was underscored by President Trump's specific mention of acquiring TikTok. This was no random example. As a foreign financial asset, TikTok represents the type of acquisition that would serve the SWF's strategic purpose of accumulating foreign assets to address capital flow imbalances. Similarly, Trump's previously puzzling comments about purchasing Greenland can now be understood as an early signal of his administration's interest in acquiring foreign assets at scale to address capital flow imbalances.

The White House's own fact sheet on the SWF explicitly states that its purpose is to pursue "President Trump's economic policies — including the pursuit of fair and balanced trade." This direct connection to trade policy alignment strongly suggests the SWF is indeed meant to serve as a tool for addressing trade imbalances through capital flows, as outlined in Miran's framework.

At this point, we have limited information about the specific structure and implementation of the SWF. However, on the day of the announcement of the SWF executive order (2/4/25), Bloomberg reported that one approach under consideration involves converting the U.S. International Development Finance Corp (DFC) into a sovereign wealth fund. A separate Bloomberg report on February 13th, 2025, states that the administration is discussing plans to shift billions in funding from USAID to the U.S. International Development Finance Corp (DFC), transforming it into a more aggressive instrument of U.S. economic power. The plan would reduce humanitarian assistance in favor of strategic project finance initiatives and investments in critical minerals and resource projects, with an expanded role for private equity groups and investors. This restructuring aligns perfectly with the reserve accumulation strategy Miran proposed, as it would create a vehicle capable of making significant foreign investments at scale.

Trump Orders Creation of US Sovereign Wealth Fund, Says It Could Buy TikTok

Treasury Secretary Scott Bessent told reporters the fund would be set up within the next 12 months. **"We're going to monetize the asset side of the U.S. balance sheet for the American people," Bessent said. "There'll be a combination of liquid assets, assets that we have in this country as we work to bring them out for the American people."** One approach would be to convert the U.S. International Development Finance Corp (DFC) to function similar to a sovereign wealth fund, which the Trump administration reportedly considered in recent months, Bloomberg News reported. The DFC is a government agency that currently partners with private parties to finance projects in the developing world.

Reuters, **2/4/2025**

h/t Strategas RP

Potential Scale of the SWF is Significant

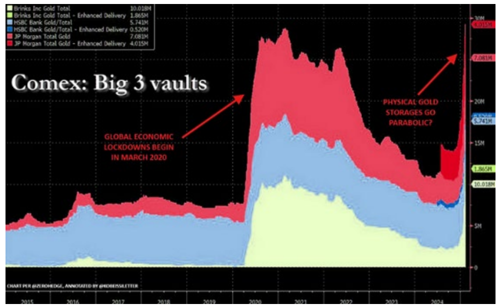
Banks do not simply lend out existing deposits; they create new money through the lending process, expanding the total money supply in the economy. As a financial institution, the DFC could operate with bank-like leverage ratios. Commercial banks typically maintain leverage ratios of 10–20x their equity capital, meaning each dollar of capital supports $10–20 in assets. With Treasury's gold reserves valued at $841 billion at current prices ($2,850/oz), using this gold to capitalize the DFC could create $8.4–16.8 trillion in lending and reserve buying power. It's important to note that this calculation only considers the Treasury's gold reserves. The U.S. government possesses numerous other assets, from land and mineral rights to infrastructure and strategic stockpiles, that could potentially be used to capitalize the SWF. While a more conservative leverage ratio might be employed, the inclusion of these additional assets could still support massive reserve accumulation capacity. We highlight the gold-based calculation to illustrate the potential scale possible under standard bank leverage ratios, as we believe the Trump administration will aim for significant firepower in pursuing its reserve accumulation strategy.

This structure is an elegant solution to the constraints Miran identified with the ESF approach. Rather than selling gold outright, the Treasury could use it as capital backing for the DFC's operations. This would allow for reserve accumulation at a meaningful scale while preserving the nation's gold stock. While this expansion of the money supply would likely require some Fed sterilization (a topic that deserves its own analysis) it provides a more powerful tool for implementing Miran's strategy than existing mechanisms.

Unprecedented Gold Market Activity: Preparation for SWF Capitalization?

Recent developments in physical gold markets have raised intriguing questions about potential preparation for such a strategy. An unprecedented accumulation of physical gold is currently taking place in COMEX vaults. January 2025 alone saw over 19,000 contracts delivered, a scale of physical delivery never before witnessed in the market's history. COMEX data shows combined vault holdings have surged to approximately 35.5 million troy ounces, while London vault inventories are being simultaneously depleted, with withdrawal times extending to eight weeks. Perhaps most notably, the U.S. has switched from being a net gold exporter to a net gold importer during this period.

While we cannot definitively identify the entity behind these massive gold purchases, the timing and scale of this accumulation are curious, to say the least, given the context we've laid out in this report. One plausible scenario is that the Treasury is quietly building its gold holdings to enable larger capitalization of the DFC/SWF. This would be legally permissible under 31 USC 5116, as the Secretary of the Treasury has authority to "buy and sell gold in the way, in amounts, at rates, and on conditions the Secretary considers most advantageous to the public interest" with Presidential approval. While the Treasury hasn't purchased gold since announcing its withdrawal from the private market in March 1968, the legal framework for resuming purchases remains in place.



Fed FX Reserve Accumulation

Miran's second avenue to implement reserve accumulation is for the Fed to purchase foreign exchange reserves:

> "The other means of building a reserve portfolio is to use the Federal Reserve's System Open Market Account, since the Federal Open Market Committee authorizes the New York Fed to do so. Use of SOMA requires cooperation from the Fed — which, to repeat, is not impossible given the Fed defers to Treasury on currency policy, and can be the outcome of any number of agreements between the Fed and Treasury, but must be voluntary to preserve the Fed's inflation fighting credibility. Given the Fed's ability to create money supply at will and operate with any capital position, size constraints do not arise from purchasing power, but rather from available assets to purchase…a reserve fund can buy assets, like longer-term foreign government debt, or other assets"

As Miran notes, a plan for the Fed to purchase FX reserves would require cooperation by the Fed. However, Fed Chairman Powell may be resistant to cooperate with the Trump Administration's plan. Therefore, the administration might initially choose to go the route of the Treasury funded SWF due to Treasury Secretary Bessent's willingness to participate.

Mechanics Behind Traditional and U.S. Sovereign Wealth Funds

To understand how the U.S. SWF differs from traditional sovereign wealth funds, it's worth examining the typical mechanics of foreign reserve accumulation. When domestic companies in surplus countries earn foreign currency through trade, central banks often accumulate these trade-earned dollars, effectively recycling them back into U.S. financial markets as reserves. Similarly, traditional sovereign wealth funds, typically found in commodity-exporting nations, take trade-earned dollars from state entities and reinvest them in foreign assets.

The U.S. SWF operates through a different mechanism: instead of recycling trade-earned dollars, it would create new dollar reserves to purchase foreign assets. However, from a balance of payments perspective, the economic impact is identical to traditional reserve accumulation or sovereign wealth funds. Whether through a central bank converting trade-earned dollars into reserves, a commodity-based SWF reinvesting oil revenues, or the U.S. creating new dollars to purchase foreign assets, all these activities represent capital outflows that must be matched by corresponding trade flows.

Strategic Logic of Reserve Accumulation

To understand how a U.S. SWF could effectively counter surplus countries' strategies, we need to understand the logic of reserve accumulation. When surplus countries build FX reserves, they're ensuring they remain net exporters of capital, which, through the balance of payments, they must be net exporters of goods and services.

Japan provides a perfect example of how this game works. When foreign capital flows into Japan, they immediately push it back out by buying foreign assets at whatever scale necessary to remain net capital exporters (and thus net trade exporters). This strategy works because surplus countries deliberately target their reserve accumulation toward markets like the U.S. that don't respond in kind and allow unrestricted capital inflows. In fact, this is precisely why the U.S. has become the world's primary source of reserve assets. We are unique among major economies in allowing foreign capital to flow freely into our markets without reciprocal access or countervailing measures.

While other countries actively resist and redirect unwanted capital inflows, the U.S. has passively absorbed the world's excess savings, effectively subsidizing the export-led growth strategies of surplus countries. This asymmetry isn't a natural market outcome but rather reflects policy choices, both by surplus countries to restrict capital inflows and by the U.S. to accept them without restriction.

As Miran aptly notes, "It's not even clear what we could buy at scale given capital controls around the Chinese economy." This observation gets to the heart of the asymmetry in global capital markets. While surplus countries enjoy unrestricted access to U.S. financial markets, they maintain extensive controls that limit foreign ownership of their domestic assets. This asymmetry is not accidental; these countries understand that unrestricted capital flows would force domestic adjustments that would erode their trade surpluses.

Critics often miss how these capital flows force domestic economic adjustments. Just as foreign capital inflows have shaped U.S. economic conditions by inflating asset prices and suppressing savings, U.S. capital outflows through the SWF would reshape conditions in recipient economies. Their domestic variables must adjust to accommodate these flows, regardless of local policy preferences.

If surplus countries resist U.S. capital flows while continuing to freely invest in U.S. markets, they expose the mercantilist nature of their policies. This creates a clear justification for implementing reciprocal restrictions through mechanisms like the International Emergency Economic Powers Act (IEEPA). Politically, restricting foreign access to U.S. financial markets becomes far more feasible after countries have demonstrated unwillingness to accept reciprocal capital flows. By forcing surplus countries to either accept reciprocal flows or lose privileged access to U.S. markets, the

SWF creates leverage for restructuring the global financial architecture that has long advantaged surplus countries at U.S. expense.

The SWF provides the administration with powerful leverage in pursuing a multilateral agreement for currency realignment — what we've called a potential "Mar-a-Lago Accord." By demonstrating both the capability and willingness to accumulate foreign reserves at scale, the U.S. gains crucial negotiating leverage with surplus countries. The threat of unilateral reserve creates strong incentives for surplus countries to negotiate a coordinated approach to revaluing their currencies against the dollar. The prospect of U.S. intervention through the SWF makes a negotiated solution more attractive to surplus countries than facing unilateral action. This gives the Administration a credible tool to bring partners to the table for discussions on orderly dollar devaluation and broader reforms to the global financial architecture.

Conclusion

The seemingly chaotic opening days of Trump's second term mask a sophisticated strategy to restructure the global trading system. While markets focus on the threat of tariffs, the administration is quietly assembling an array of unilateral options, ranging from traditional trade measures to more powerful capital flow tools. The creation of the Sovereign Wealth Fund, alongside potential IEEPA restrictions and tariffs, demonstrates the administration is prepared to act independently but crucially hopes it won't have to.

The ultimate goal appears to be a "Mar-a-Lago Accord" that would engineer a coordinated dollar devaluation and establish new rules preventing persistent trade surpluses, echoing Keynes's original vision at Bretton Woods. In this way, the administration seeks to reshape the global trading order as profoundly as Bretton Woods once did rather than merely replicate the more limited scope of the Plaza Accord. The administration's preparation of multiple unilateral tools, including both tariffs and capital flow measures, serves primarily to bring key players to the negotiating table.

As Treasury Secretary Bessent emphasized, "Tariffs are a means to an end." If negotiations succeed, neither tariffs nor capital flow restrictions would be necessary. A coordinated restructuring of the global trading system would benefit not just the U.S. but all deficit countries, including Mexico, with its seventh-largest trade deficit globally. The administration's tough posturing across multiple fronts should be understood not as policy preference but as creating leverage for meaningful reform.

While trade surpluses and deficits are not inherently problematic, the persistent global imbalances that have defined the economic landscape for decades are neither natural nor healthy. These chronic imbalances do not reflect comparative advantage or market forces but rather systematic distortions in how income and demand are distributed within surplus economies. When countries implement policies that suppress domestic consumption and generate excess savings that must be exported, they force corresponding deficits on their trading partners.

The current global trading paradigm has created clear winners and losers. Manufacturing sectors in persistent surplus countries have thrived by maintaining artificially weak currencies and suppressing domestic consumption. In the U.S., these policies have channeled massive capital flows into financial markets, disproportionately benefiting Wall Street and asset owners while hollowing out the manufacturing sector. Given how deeply entrenched these patterns have become, any significant restructuring risks major market disruption, as many investors are poorly positioned for such a dramatic reversal in capital flows. Many skeptics doubt the Trump administration's willingness to challenge Wall Street's interests. Still, Treasury Secretary Bessent's own words suggest otherwise: "Wall Street has had it great. And now under this Administration its Main Street's turn."

As the administration assembles an array of economic tools, including tariffs, capital controls, and the newly formed SWF, it becomes clear that these moves are not isolated policies but part of a larger strategy to reshape global economic relations. Treasury Secretary Scott Bessent hinted at this in June when he positioned himself for the role, stating:

> "We're also at a unique moment geopolitically, and I could see in the next few years that we are going to have to have some kind of a grand global economic reordering, something on the equivalent of a new Bretton Woods or if you want to go back like something back to the Steel Agreements […] or the Treaty of Versailles, there's a very good chance that we are going to have to have that over the next four years, and I'd like to be a part of it."

Treasury Secretary Bessent has not only acknowledged that a global economic restructuring is likely but has actively positioned himself to help shape it. This is not speculation from an outsider; it is the perspective of one of the most influential policymakers at the center of U.S. economic strategy. His appointment as Treasury Secretary signals that this administration is not only aware of the need for structural change but is intent on pursuing it.

The potential Mar-a-Lago Accord represents more than a mere trade negotiation; it could represent a fundamental restructuring of the global economic order on par with Bretton Woods. Just as the 1944 conference created a new international monetary system that shaped global economic relations for decades, this accord aims to address the structural imbalances that have distorted global trade for generations. Where the Plaza Accord was a temporary adjustment, the Mar-a-Lago approach should seek a more fundamental restructuring, creating a framework that realigns economic incentives, rebalances global demand, and ensures a more equitable distribution of economic opportunity across both surplus and deficit economies.

Buyer Beware: The U.S. Dollar Before and After the 1985 Plaza Accord

Addressing Frequently Asked Questions and Concerns

Won't Reduced Foreign Buying Drive Up U.S. Interest Rates?

Despite common assumptions, foreign capital flows into U.S. markets do not automatically reduce interest rates. Understanding why requires examining how these inflows affect the broader economy.

When foreign capital flows into the U.S., the economy must adjust in one of two ways: rising unemployment or rising debt. In the first scenario, as capital inflows force a higher trade deficit, domestic producers lose demand to foreign competitors and lay off workers. These unemployed workers draw down savings, so foreign savings effectively replace domestic savings rather than adding to the total pool. This means no net increase in demand for U.S. bonds and, thus, no downward pressure on interest rates.

The second adjustment path involves rising debt to prevent unemployment. The government might expand its fiscal deficit, or monetary policy might encourage household borrowing to maintain spending levels. Foreign purchases of U.S. debt are matched by additional debt issued by Americans. With both supply and demand rising together, there's no clear effect on interest rates.

Another helpful way to see why foreign bond purchases do not necessarily lower U.S. interest rates is to look at the broader pattern across countries. In theory, if foreign demand for a nation's bonds reduces its rates, then countries running larger trade deficits (i.e., benefiting from more foreign bond-buying) should have systematically lower rates. Yet, the opposite often holds for those borrowing in their own currency. Major surplus economies, such as the Eurozone, Japan, and China, do not have higher interest rates than the United States despite sending out more capital and receiving less "benefit" from foreign bond-buying. Furthermore, when the Eurozone shifted from balanced trade to a sizable surplus, its interest rates actually declined rather than rose. This pattern undercuts the idea that foreign purchases of U.S. bonds must drive U.S. rates downward.

Moreover, the conventional fear that reduced foreign buying would drive Treasury yields significantly higher fundamentally misunderstands what determines bond yields. Treasury yields primarily reflect market expectations of future Federal Reserve policy rates, not foreign demand dynamics.

Ultimately, foreign capital inflows can either raise or lower interest rates, depending on a range of economic factors. In most cases, however, countries that export capital (i.e., run persistent trade surpluses) see their income grow faster than their debt-servicing costs, steadily increasing their capacity to manage debt. Of course, surplus economies can still misallocate capital (as seen in China), pushing debt-to-GDP higher. That said, if the United States truly wants to reduce its debt-to-GDP ratio in the long run, it needs to reverse its persistent balance of payments imbalance.

Hasn't China been a driver of global growth?

When asking if China has been a driver of global growth, we need to carefully distinguish between global growth and rest-of-world growth.

Yes, China's rapid GDP growth has significantly boosted global GDP growth figures since China is part of the global economy. However, what matters for rest-of-world growth is not China's overall GDP growth but rather the difference between Chinese production and Chinese domestic demand (consumption + investment).

In China's case, production growth has consistently outpaced domestic demand growth. This means that Chinese production has not only met all of China's increased domestic demand but has also captured additional demand from the rest of the world. When a country's output exceeds its domestic demand by this much, you're actually taking more demand from other countries than you're providing through your own consumption growth.

So, while China has certainly driven up global GDP numbers through its own growth, it has actually been a net drain on rest-of-world demand, not a source of it. The fact that Chinese production satisfies more than 100% of Chinese domestic demand means they're effectively absorbing demand from other countries rather than creating it.

There's a common assumption that countries running trade surpluses must have superior productive capabilities or are simply 'better at competing' than other nations. But is this really what a trade surplus tells U.S. about an economy?

This is a common mistake, equating trade surpluses with superior production capabilities, higher productivity, economic strength, and being "better at competing." However, a trade balance simply tells you the gap between what a country produces and domestic demand (consumption + investment). This gap can be driven by factors entirely unrelated to productive capacity:

1. External forces beyond a country's control, like foreign entities buying your financial assets for reserves, keeping your currency strong, and affecting trade flows
2. Domestic policy choices, like when countries implicitly tax consumption and subsidize production, which increases production relative to consumption — as China does.

Moreover, producers are also consumers, so increased productivity should flow back into higher incomes and, thus, higher consumption. People often mistakenly link trade surpluses to low wages, but high-wage countries like Germany run persistent surpluses, too. What matters is wage repression — wages relative to productivity. Both China and Germany maintain surpluses by keeping wages low relative to worker productivity, meaning workers don't receive the full value of their increased output.

If you want to measure a country's actual productive capabilities or economic strength, metrics like GDP per capita or total GDP are far more meaningful indicators than the trade balance, which merely reflects the relationship between domestic production and demand.

How does a SWF help create manufacturing jobs in the US?

The SWF creates manufacturing jobs by affecting capital flows and exchange rates. When foreign capital flows into U.S. financial markets instead of purchasing American goods, it keeps the dollar artificially strong. This overvalued dollar makes U.S. exports too expensive in global markets while making imports artificially cheap, directly undermining American manufacturing competitiveness.

Exporting capital is equivalent to importing demand. Just as surplus countries have "stolen" U.S. demand by exporting capital to us, the SWF would reverse this dynamic. By using the SWF to accumulate foreign assets, the U.S. creates outward capital flows that must be balanced by changes in trade flows. These outward flows reduce upward pressure on the dollar, allowing it to move toward a more competitive level. A weaker dollar makes U.S. manufactured goods more competitive both domestically and in export markets.

Isn't foreign investment good for the US?

Foreign investment in the U.S. would be beneficial if our economy were constrained by a lack of capital. However, this fundamentally misunderstands today's economic reality.

In the 19th century, foreign capital helped fund American industrialization because the U.S. lacked sufficient domestic savings to finance railroads and factories. Today, the constraint on investment isn't lack of capital; its lack of profitable opportunities given current levels of demand.

Even foreign direct investment (FDI), which many view as inherently beneficial, can contribute to this demand problem. While people often point to individual cases where foreign companies create jobs through U.S. investments, this misses the broader economic impact. These same investments could be funded domestically—U.S. banks can expand credit, or foreign companies could raise capital from U.S. investors who would gladly fund projects with attractive returns. The U.S. has deep, sophisticated capital markets and ample domestic savings capacity.

The key point is that the U.S. doesn't lack funding sources for profitable investments. When foreign capital flows in, whether through FDI or portfolio investment in existing financial assets, it typically displaces domestic funding rather than enabling investment that wouldn't otherwise occur. And because these capital inflows must be matched by trade deficits through the balance of payments mechanism, they reduce aggregate demand in the economy, which further reduces the incentive for domestic investment.

This is why economists like Michael Pettis emphasize that for advanced economies like the U.S., excessive foreign capital inflows are harmful rather than helpful. They don't solve an investment funding problem; they create a demand problem.

Foreign central banks are no longer accumulating reserves. U.S. dollar demand is now primarily driven by private investors rather than central bank reserve accumulation. If private capital flows are the dominant driver of U.S. inflows, does that weaken the case for policies aimed at reducing reserve accumulation? Is the U.S. being the "most attractive investment destination" really problematic?

While notable, the shift from central bank reserve accumulation to private capital flows doesn't fundamentally alter the underlying economic dynamics of global imbalances. The core issue isn't the specific channel through which foreign capital enters U.S. markets but rather the persistent structural imbalances that drive these flows.

Surplus countries continue to produce more than they consume and invest domestically, generating excess savings that must find an outlet. Whether these savings flow into U.S. markets through private investors (as we see today) or official reserves (as in 2002–2014), the economic effect remains the same: excess foreign savings flowing into U.S. financial assets rather than goods and services, maintaining dollar strength at levels that prevent trade rebalancing.

The distinction between "market-driven" private flows and "policy-driven" reserve accumulation is somewhat artificial. Both channels stem from policy choices in surplus countries that suppress domestic consumption and generate excess savings. When private flows go to persistent trade surplus countries like China, Korea, and Japan, their central banks build FX reserves by reexporting that private capital to maintain their trade surpluses. When U.S. returns are attractive (as with current higher rates), private capital flows out of those countries and into the US, and their Central Banks have no need to acquire reserves. However, if private flows reverse, we will see a return to reserve accumulation by these Central Banks, a pattern we've observed repeatedly.

Importantly, these capital flows don't primarily fund productive investment in the U.S. Instead, they force domestic adjustments through some combination of higher unemployment, rising household or government debt, and asset bubbles.

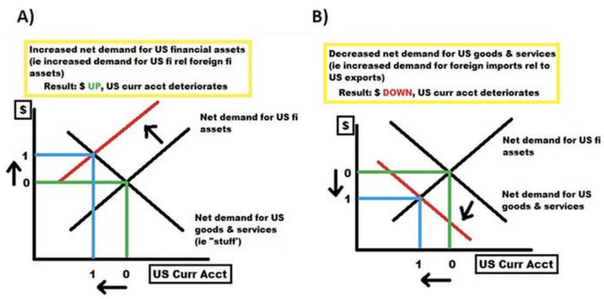
Ultimately, the balance of payments ensures that these capital inflows must be matched by U.S. trade deficits, regardless of whether they come through private or public channels. While the mechanism of capital flows may have shifted, the fundamental challenge remains: surplus countries are exporting their domestic imbalances to the U.S., leading to economic adjustments that can undermine manufacturing and increase financial instability.

How do we know the direction of causality of U.S. trade deficits?

The balance of payments presumes no direction of causality. A trade deficit and its corresponding capital account surplus can result from higher U.S. demand for foreign imports than foreigners have for U.S. exports, or it can be the result of higher foreign demand for U.S. financial assets than American demand for foreign financial assets.

However, changes in currency value tell U.S. the direction of causality.

Starting in equilibrium where foreign demand for U.S. goods and services equals U.S. demand for foreign financial assets (black lines in the chart below).



If Chinese demand for U.S. financial assets rises, the Chinese need to finance that by selling more of their stuff and thus offering it at a lower yuan price per dollar. In this case, the U.S. dollar increases relative to the yuan. Shown in scenario A.

But if Americans now demand more Chinese goods & services, they must offer more U.S. dollars per Chinese Yuan. The dollar depreciates relative to the Yuan. Shown in scenario B.

The current (i.e., trade account) and capital accounts shift by the same amount in both cases, but the exchange rate moves in opposite directions.

The U.S. trade deficits (i.e., current account deficits) have occurred alongside an appreciating currency. This tells U.S. the cause of the U.S. trade deficits has been excessive foreign demand for U.S. financial assets and not the other way around.

This conclusion is further reinforced by examining asset market performance. If the U.S. were truly dependent on attracting foreign capital to fund excessive spending, we would see two clear signs:

1. U.S. financial assets would underperform as we competed for scarce foreign capital
2. The dollar would weaken as our need for external funding grew

Instead, we see the opposite. U.S. financial assets have been among the world's best-performing, and the dollar has remained exceptionally strong despite decades of trade deficits. This pattern is precisely what we'd expect when foreign demand for U.S. financial assets drives trade deficits, not the other way around.

History provides clear examples of countries that genuinely needed to attract foreign capital to fund trade deficits. They invariably faced weak currencies and poor asset returns, having to offer substantial yield premiums to entice foreign investors. The U.S. experience could not be more different.

The U.S. should focus on fiscal discipline and reducing the fiscal deficit, which reduces national savings and contributes to the trade deficit.

It is a common misconception that U.S. fiscal deficits drive capital flows and trade deficits; however, the causality runs the other way, as foreign capital inflows force domestic adjustments, including fiscal deficits. When foreigners use trade-earned dollars to buy U.S. financial assets instead of goods and services, the U.S. must adjust either through higher unemployment, larger fiscal deficits, or increased private sector debt.

The "twin deficits" view misses that fiscal deficits are often a symptom of absorbing excess foreign savings, not the cause. Persistent surplus countries must address policies that generate excess savings and prevent natural rebalancing. U.S. fiscal "discipline" won't fix this when surplus countries need to export their savings somewhere. History shows fiscal tightening often just shifts adjustment to private sector debt or unemployment.

The fact that fiscal deficits don't drive these flows is the dollar's strength despite massive deficits. When countries truly need foreign capital to fund deficits, their currencies weaken, and their financial asset prices fall. Anyone who's studied financial history knows what it looks like when a country needs to "pull" foreign capital to fund deficits: currency collapse, soaring risk premiums, capital flight, plunging asset prices. This was Latin America in the 80s, Asia in the 90s, and the European periphery in 2011.

The U.S. experience is exactly the opposite: U.S. financial assets have been among the world's highest-valued and best-performing, and the dollar has remained exceptionally strong despite decades of trade deficits. This pattern only makes sense if foreign demand for U.S. assets drives flows, not U.S. borrowing needs. U.S. asset prices tell U.S. which way causality runs.

Don't you need to run a trade surplus to have a SWF or accumulate FX reserves?

No. This fundamentally misunderstands the causality. Reserve accumulation actually creates trade surpluses, not the other way around. The Asian Tigers in the 1990s provide a perfect illustration of this principle: these countries weren't in strong financial positions when they began accumulating foreign exchange reserves. Instead, they created domestic currency to purchase foreign assets, and this policy of reserve accumulation was precisely what generated their trade surpluses.

The mechanism is straightforward: When a central bank or sovereign wealth fund creates currency to purchase foreign assets, this represents a capital account deficit that must be matched by a current account surplus. The balance of payments ensures this adjustment must occur. This is how countries like South Korea, Taiwan, and later China built their manufacturing bases — by using reserve accumulation to prevent currency appreciation and maintain export competitiveness.

The U.S. SWF would operate through the same mechanism. Creating dollars to purchase foreign assets generates outward capital flows that necessarily result in improved U.S. trade balances. The resulting economic adjustments, whether through exchange rates or other channels, must produce corresponding changes in trade flows.

You write, "Therefore when foreigners use their dollars to buy more U.S. stocks or bonds, it automatically reduces U.S. net exports of goods and services". Without a currency adjustment, what's the "automatic" mechanism that reduces U.S. net exports?

Consider a simple two-country world (U.S. and China) where initially, no one owns foreign currency.

Chinese entities can acquire U.S. dollars in two ways:

1) Trade Chinese financial assets for U.S. dollars (a purely financial transaction that nets out in the balance of payments)
2) Trade Chinese goods and services for U.S. dollars

When Chinese entities receive dollars from selling goods and services to the U.S., these dollars must return to the U.S. in one of two ways:

1) Buy U.S. goods and services (which would balance trade flows)
2) Buy U.S. financial assets

If they use these trade-earned dollars to buy U.S. financial assets instead of U.S. goods and services, this creates an imbalance: China has exported goods without importing an equivalent amount, creating a trade surplus matched by a capital account deficit (accumulation of U.S. financial assets).

The "automatic" reduction in U.S. net exports occurs because dollars earned from trade but used to buy financial assets are, by definition, not being used to purchase U.S. goods and services.

Do rising asset prices increase a nation's wealth?

Rising asset prices do not inherently increase national wealth. True wealth creation occurs only when an economy enhances its capacity to produce goods and services that improve living standards. Rising asset prices that aren't tied to increased productive capacity merely represent a transfer of wealth between groups rather than net new wealth for the economy.

This distinction between real wealth and nominal gains is crucial. Real wealth comes from productivity improvements, technological innovation, and enhanced infrastructure that sustainably increase income and living standards. In contrast, nominal gains from asset price inflation, whether in stocks, real estate, or other financial assets, often represent speculative value that doesn't expand the economy's productive capabilities.

When asset prices rise without corresponding productivity growth, the gains for sellers come at the expense of buyers. A housing bubble, for instance, enriches current owners but transfers wealth from future buyers who take on greater debt without any improvement in housing quality or infrastructure. Similarly, stock market surges driven by speculation rather than genuine corporate innovation or earnings growth simply redistribute wealth from late investors to early sellers.

The problem becomes even more acute when foreign investors own domestic assets. In such cases, rising asset prices can actually transfer wealth abroad when profits are repatriated, draining purchasing power from the local economy. Furthermore, while borrowing against inflated assets might temporarily boost spending, this creates financial fragility if incomes don't rise due to stagnant productivity.

Asset prices can signal genuine wealth creation, but only when they reflect real economic improvements, such as technological breakthroughs that lower production costs, infrastructure development that enhances trade capacity, or sustainable increases in corporate profits driven by better products and services. Without these fundamental improvements in productive capacity, rising asset prices simply mask wealth transfers rather than create new wealth.

A Special Note:

This analysis owes a profound intellectual debt to Michael Pettis. The thread connecting the Trump administration's three most influential trade policy architects — JD Vance, Scott Bessent, and Stephen Miran — is their deep intellectual grounding in Pettis's work on global economic imbalances. For those who have followed Pettis closely, his intellectual fingerprints are unmistakable: the emphasis on savings, consumption dynamics, and the structural nature of trade imbalances resonates clearly in their rhetoric. Each of these policymakers speaks with a distinctive cadence that reflects their shared intellectual lineage, a testament to Pettis's profound insights into the global economic system that have shaped a new generation of economic thinkers.

Our comprehensive collection of Pettis' writing since 2008