

A Muted Celebration

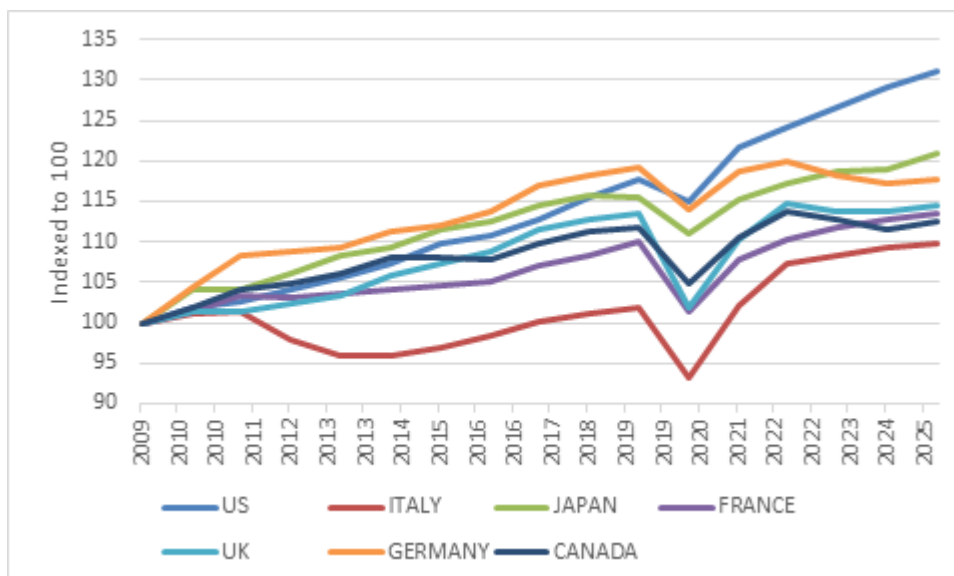
Izak Odendaal, Investment Strategist at Old Mutual Wealth

The United States commemorated its semiquincentennial on Saturday, the 250th anniversary of the signing of the Declaration of Independence. As usual, the 4th of July was celebrated with fanfare, fireworks and festivities, but this time there was also quite a bit of introspection. A nation that was founded (imperfectly) on principles of democracy, freedom and the rule of law is questioning whether those still hold. It seems more divided along political lines than at any time since the Civil War. People are stuck in social media echo chambers in other countries too, but the rigid two-party political system makes it worse in America.

Donald Trump, the 47th president, is both a cause and symptom of the unease. Unlike his predecessors, he has delighted in breaking with long-established norms and rewriting the rulebook. His political genius was tapping into deep-seated economic, social and cultural anxieties, including rising inequality, declining social mobility, deindustrialisation, “deaths of despair” from drug abuse and suicide, and immigration. Like most populists, however, he has been long on scapegoating and attacking opponents, while short on materially helping his ordinary supporters, though close associates have done well. While Trump is unique in background and character, it doesn't mean Trumpism will go away when he eventually moves on (he turned 80 a few weeks ago).

However, there is also still so much to applaud. The US remains the world's most powerful country, a leader in technology and innovation, including artificial intelligence, while its film, TV and music industries are unrivalled in their worldwide reach. For global investors, it is still the one market no one can ignore, not only because of its size and liquidity, but also the way its ups and downs influence the rest of the world. Indeed, for most international investors, understanding the direction of the US economy, interest rates and currency matters more than developments in their own countries. There has always been an irony in Trump's “Make America Great Again” mantra: the US was already doing much better than other advanced countries based on purely economic metrics since the 2008 financial crisis, and especially since the pandemic.

Chart 1: Real GDP per head of G7 countries



Source: OECD

The one area where the US lags other advanced countries is a comprehensive social safety net. However, the Republican Party, including under Trump, continue to undermine what little, relatively speaking, there is.

Wall Street party

In terms of the equity market, probably Trump's favourite barometer of success, there is also little need for greatness to be restored.

Chart 2: US exceptionalism: S&P 500 Index versus MSCI World ex US Index in dollars



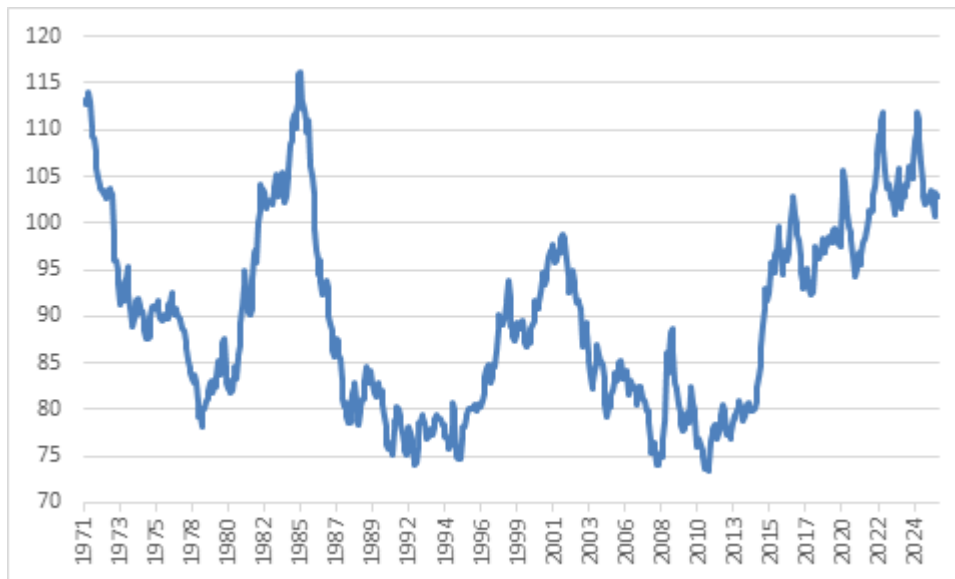
Source: LSEG Datastream

As chart 2 shows, the S&P 500 outperformed non-US markets by 200% since 2009, largely due to a similar outperformance in terms of earnings delivery. Put simply, US companies are more profitable, so no wonder their share prices have risen as much. In the long run, price follows profit. However, chart 2 also shows that the relative valuation has increased. In 2009, the S&P 500 traded at a price: earnings ratio of 12, similar to non-US markets. Today it trades at 20 times forward earnings, while the MSCI World ex US Index trades at 15 times. While US equities probably deserve to trade at a premium, the elevated valuation nonetheless creates a high bar for future outperformance since so much good news is priced in.

The mighty dollar

Part of the equity outperformance in common currency relates to a strong dollar. Since President Nixon abandoned the peg to gold in 1971, there has been three big upcycles for the dollar. The third started after the financial crisis, when the stronger recovery shown in chart 1 led to higher interest rates, attracting capital flows. The outperformance of US equities also attracts foreign capital. There have been a few short-lived "Sell America" moments, notably in April 2025 when Trump announced much higher tariffs than everyone expected.

Chart 3: Real trade-weighted US dollar



Source: LSEG Datastream

It is important to distinguish between the dollar's value in foreign exchange markets, as shown in chart 3, and its role as global reserve currency. The former closely follows cyclical factors like growth and interest rate differentials. The latter is structural, but not necessarily permanent. The dollar remains not only the favoured asset of reserve managers but still forms one side of almost 90% of traded currency pairs while still dominating invoicing and settlement in global commerce. The reason for this dominance is mainly convenience: since the dollar is widely accepted, it is useful. And because it is useful, it is widely accepted. This is what is known as a network effect. The closest analogy is English, the world's most widely spoken second language. A Swedish family visiting Thailand will probably get by speaking English. Similarly, when they exchanged krone for baht, their bank used the dollar as an intermediate step, first swapping krone into dollars and then into baht. The airline that got them would have made some of the onboard announcements in English, but also most likely borrows in dollars. For the financial director of a multinational firm, being able to do business in a single currency is extremely useful. What is even better from their point of view is that they can park excess cash in US markets without having to worry about entry and exit barriers or market liquidity. While the renminbi is often touted as the most likely alternative to the dollar, China imposes strict capital controls. The other potential rival, the euro, lacks a large and liquid bond market since each member country still has its own, relatively small bond market.

Authorities in Beijing and Brussels would love to dethrone the dollar, but it is not their decision alone. Millions of traders, business executives and investors prefer the status quo. At any rate, reserve currencies are hard to dislodge if history is a guide. It took two world wars to replace the sterling, even though America was already the largest global economy before 1914.

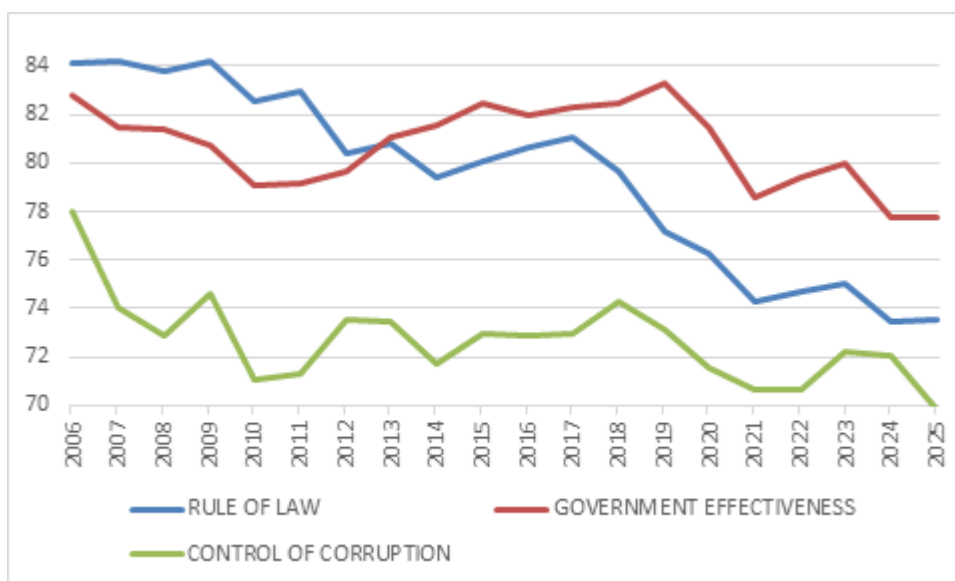
Nonetheless, Trump has probably done more than anyone else to encourage de-dollarisation by forcing a reassessment among reserve managers and large institutions. Apart from wars, foreign policy swings and trade conflicts, his assault on the Federal Reserve's independence is probably the biggest red flag for investors, since the Fed essentially safeguards the purchasing power of the dollar through its inflation mandate. Nothing would see the dollar lose value quicker in foreign exchange markets than a sense that the Fed is keeping interest rates artificially low. It might still be forced to one day if the worrying rise in government debt levels is not arrested. Fortunately, Fed independence remains intact for now.

Trump tried to fire Fed governor Lisa Cook to make way for a lackey, but last week the Supreme Court ruled in her favour, specifically highlighting the importance of shielding the central bank from political interference. Kevin Warsh has also reiterated the importance of Fed independence in the two public engagements since taking over as chair.

In a separate ruling, however, the Supreme Court overturned decades of convention, finding that the President is allowed to fire the heads of other federal agencies at will. This includes two regulatory agencies important for investors, the Commodities Futures Trading Commission and the Securities and Exchange Commission. The concern is not only that the Trump administration will now be able to advance a particular agenda such as crypto-friendly regulations, though it was revealed last week that the Trump family made more than \$1 billion from selling cryptocurrencies. It is also that any future president could now do so, creating a potentially unstable regulatory environment.

Of course, this is but a small slice of the upheaval in Washington. Corruption, political interference in the civil service and erosion of rule of law are problems normally associated with developing countries. It is hard to believe that the US is discussed in similar terms these days, though some of these trends predate Trump. The big question, of course, is whether they will outlast him.

Chart 4: World Bank Governance score for the US



Source: World Bank

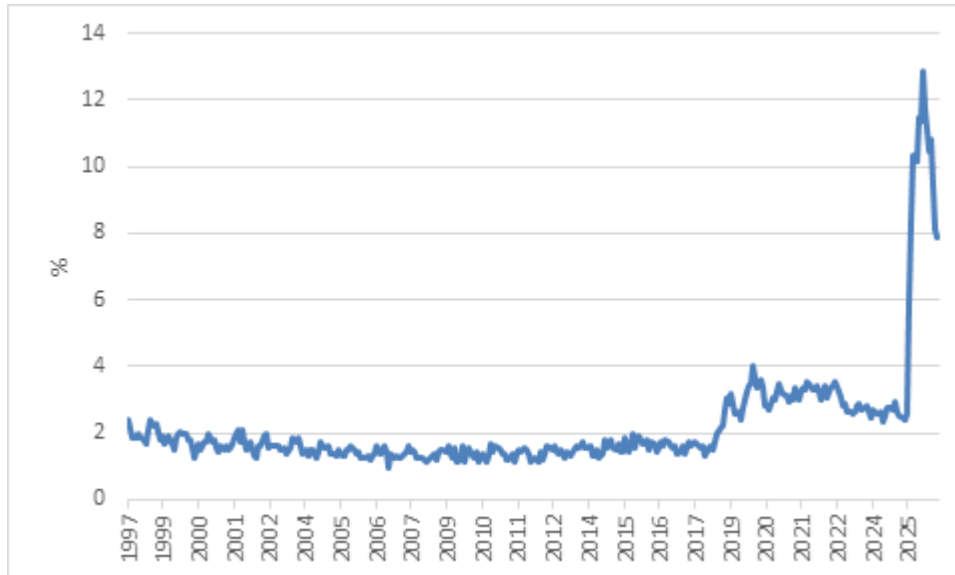
Fortunately, while some of the institutional guardrails that limit executive power have been bulldozed aside, other checks and balances remain in place. The country will hold midterm elections in November, while the media, for all its faults, continues to hold up the mirror to politicians. Democratic participation is deeply ingrained in society, and the federal system means there is only so much influence one politician can ever have. Markets are also a mechanism that limits political power, captured in the idea of the TACO (Trump always chickens out) argument, namely that a market wobble has forced him to reverse course every time he pushed policy in an extreme direction. This idea was first articulated three decades ago when James Carville, an adviser to President Clinton, mused about wanting to be reincarnated as the bond market since it can “intimidate everybody” and force a change in policy.

A lot of ruin

Three final points on science, immigration and trade. The US has long been a leader in science, technology and innovation. It has world class universities (13 of the top 20 in the latest Times rankings) and scientific research institutes that are supported by government funding private and venture capital to form a unique ecosystem for turning ideas into breakthroughs and ultimately, useful products. The Trump administration has taken an axe to federal government funding for scientific agencies and universities. It has also made it much more difficult to attract the best and brightest from other countries. Around 40% of the American winners of science Nobel Prizes since 2000 were born elsewhere. This will not have an immediate impact on the US economy, but will

make a difference in years to come. If sustained, the crackdown on unskilled immigrants will likely also contribute to lower economic growth over time, since artificial intelligence is unlikely to solve a labour shortage on construction sites, farms, and care facilities.

Chart 5: Effective US tariff rate



Source: LSEG Datastream

Similarly, the US economy showed resilience in the face of the large increase in trade barriers last year. But over time, these barriers will act as sand in the gears of the US economy, including by creating uncertainty. Yes, the next president might cut Trump's tariffs, but his or her successor could reinstate them. For decades, US economic policy was largely predictable. No more.

Perhaps the best shoot-yourself-in-the-foot analogy is Brexit. The feared post-referendum recession never arrived after the UK voted to leave the European Union. However, a decade later, and few doubt that the UK economy is less prosperous and less dynamic than it would have been otherwise. In our lifetimes, the US will remain the dominant economic, financial, technological and military power, rivalled only by China. However, the foundations of this success are being undermined, and it is not clear that bond, currency and equity markets discount this. It is always dangerous to bet against the US, but there is reason to circumspect about future returns.

On the other hand, we can turn to the wisdom of Adam Smith, the Scottish philosopher and father of modern economics. As the American War of Independence raged 250 years ago, an acquaintance noted his fear that it would ruin Britain. Smith replied, "Be assured, my young friend, that there is a great deal of ruin in a nation." In other words, it takes a lot to wreck a country, particularly if that country happens to be the richest and most powerful on earth.