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Geopolitics, Mar-a-Lago Accord and Investing in the New World Order

Recent months have seen an upending of the economic and geopolitical system. The investment community has, rightly, focussed on the impact of tariffs but the changes are deeper than that. They amount to a questioning of trust in the US.

This note examines the interlinked issues of debt, the dollar and defense. The abrupt change in US policy seems likely to be driven, at least in part, by these issues. However, in the process we suggest that global investors now view US assets and the dollar in a different light.

Volatility is likely to remain elevated, driven by extreme policy uncertainty. However, investors cannot afford to completely retreat from taking risk. In a lower-growth/higher-inflation world, investors need to have a strategic allocation that plausibly offers a path to positive real returns.

But what is a defensive asset? We have been underweight duration for some time, but we think a higher term premium is now likely to be priced into US government bonds. Moreover, global investors should increase the proportion of US assets that are hedged. The dollar will not suddenly lose its reserve currency status, as there is no viable alternative. However, expect an acceleration in attempts to de-dollarize.

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The first few months of 2025 have witnessed a generational shift in the geopolitical and economic frame of reference. Tariff policy has understandably been the subject of the immediate focus of the investment industry, but the change goes much deeper than this. Investors might be leery about addressing this, individuals may well have very different personal views about the pros and cons of what is happening, and markets find it incredibly hard to price geopolitics, anyway. In addition, the sheer intensity and pace of geopolitical news right now might lead one to conclude that trying to allocate on that basis is simply too hard. We think this would be a mistake. What is happening is momentous and will matter for a long time. This shift doesn't matter only for setting return expectations, but will also likely have implications for the types of return that investors require and perceptions of risk. This note is written while on the road in Asia, and questions about the risk of US assets have dominated queries from clients in meetings; we think that this will continue to be a dominant issue.

Regular readers will know that we have maintained for some time the view that investors face a "new regime," different from the norms of the last 40 years, i.e., a time spanning the entire investment careers of most people reading this research. However, the geopolitical shift taking place now accelerates that process. A new regime is no longer some far-off-seeming place five years hence. The new regime is now.

We by no means intend to cover every aspect of the current upheaval. Instead, this note is intended as a tour d'horizon that allows us to then focus attention on a few specific areas. At its core, this narrative has the role of the US dollar and defense as two linked topics from which other aspects flow. In terms of economic variables, this in turn has implications for growth, inflation and debt. Changes to these variables necessarily lead to questions of asset allocation. There is now an additional complication: the need to consider possibly different conclusions for US versus non-US based investors. It would be of no utility at all to conclude that the world looks riskier, and hence to reduce risk in the allocation of portfolios. That might end up being one possible and logical tactical response to what is going on, but strategically investors need to take more—not less—risk in a low-real-return world. Anyway, it is no longer entirely obvious what "reducing risk" even means and what counts as a defensive asset. The better question is how best to allocate risk. More specifically, we think there remains a case for risk assets, for equities, private assets and active return streams. However, there are new near-term risks to the growth and inflation outlook. More strategically, there are urgent questions to be answered about the appropriate hedging asset to offset these pro-risk positions and whether it has changed.

The waves of tariff announcements over the last month have clearly ushered in a new economic order fundamentally different from the neo-liberal global system of recent decades. Moreover, the capricious nature of changes to those announcements with the possibility of pauses and carve-outs means that the ability for businesses to plan in the current climate has fundamentally shifted. The complaint from the left was that neoliberalism failed to distribute the benefits of globalization equally enough, while the complaint from the right was that it had left governments too powerful (even as the share of gross domestic product accounted for by profits had risen). What is replacing the neoliberal global order, so far, seems to be doing nothing to improve the distribution of outcomes. Whether it reduces the power of governments remains to be seen.

Ultimately, though, there is more at stake than tariffs. A geopolitical realignment is taking place that ends the US-led post-WWII order. As it stands today, it is not obvious at all that NATO's Article Five still stands. In fact, it seems very likely that it does not, especially in the context of threats to the sovereignty of Canada and Greenland. The role of other multilateral institutions is also in doubt, and assumptions about the relative ordering of US allies versus adversaries have been upended. Some of this might not sound new: after all, has not deglobalization been a theme for years? Well yes, but does anyone remember that ugly neologism coined only a few years ago of "friendshoring"? The word was always horrible from an aesthetic point of view, but it seems antediluvian (literally) as a concept now. More broadly, the US, in standing back from the promotion of democracy (e.g., in some of the administration's seemingly more positive statements about Putin and Erdogan versus negative comments about the democratic process in Europe) upends fundamental assumptions about the basis of international relations. The animus for this change seems to be multifaceted. As has been broadly discussed, it seems to stem in part from a view of international agreements as transactional and zero sum. It also seems to reflect a belief that, by supporting multilateral institutions and often acting through them rather than unilaterally, the US was not realizing the full potential of its power.

If this note has an underpinning theme, it is the concept of trust—the last two months have seen it erode. Trust in the US has been tested. This is most acute from a diplomatic perspective, with European and Canadian views of the US changed in a way that seems unlikely to be easily repaired, given the lead time for making changes to critical infrastructure. For most readers of this note, probably the most critical aspect of trust is the view that global investors take on US assets. Other aspects of this loss of trust stem from the move against certain US law firms that appear to have taken up cases that displease the US

administration. Yet another aspect is raised in the questioning of whether corporate CEOs and analysts are self-censoring.[1] Later in this note, we will come back to the question of the degree to which US government bonds and the dollar can be regarded as defensive assets anymore. But a shift seems to have occurred.

In 2022, when equities and bonds both fell, the US dollar acted as a defensive asset, arguably the only really liquid asset that protected global portfolios that year. However, its fall over the last month implies that this is no longer the case. Likewise, US government bonds have not behaved like defensive assets in a traditional way. There could be technical factors at work here in the unwinding of positions by levered investors, but also it raises the question of whether global investors have changed their attitude to such assets.

The move up in US bond yields in a risk-off environment has prompted questions of whether Trump has faced a "Liz Truss moment," referring to the former UK prime minister. At a big picture level, sovereign risk was always going to be questioned at *some* point. Yes, the debt/gross domestic product (GDP) ratio has been rising for decades in G7 economies, but post-COVID, the long-term decline in interest rates came to an end, prompting questions of debt affordability. We have found that the topic has come up with increasing frequency over the last two years. What is happening seems to be more acute than simply the question of how to price sovereign risk when there is no longer a structural decline in interest rates; instead, the shift is driven by worries about how investors in such assets might be treated.

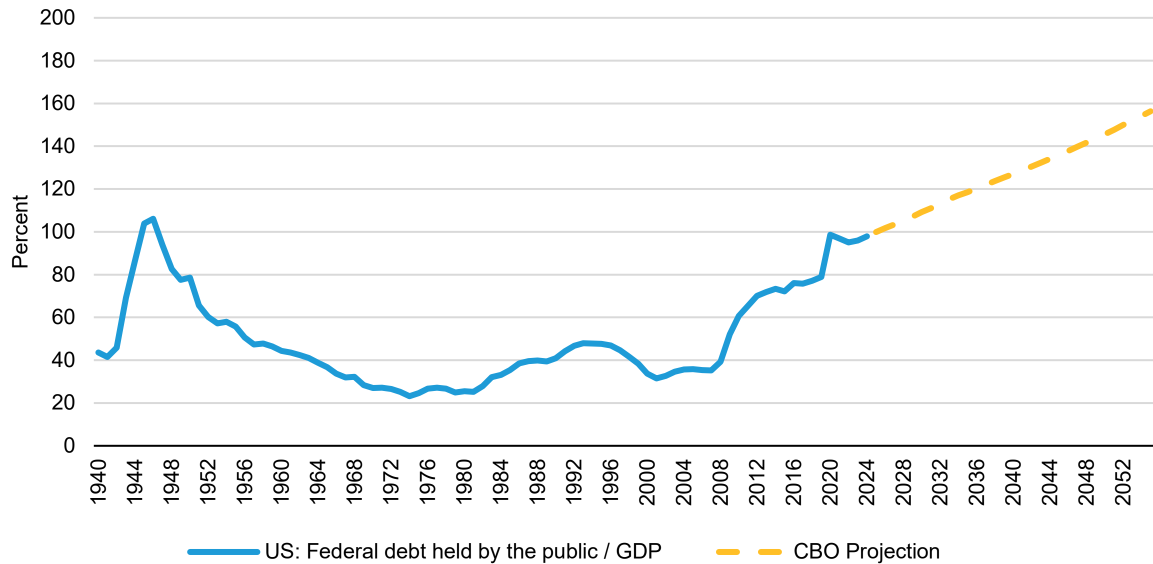
Coverage in the investment industry has been very much focused on tariff policy, which is understandable from a tactical perspective. However, when we look at this through a more strategic lens, we think that the topics of defense, the dollar, trade and debt are all very much linked. Hard military power and the dollar as the basis for international finance are two areas where the US has preeminence, from which the Trump administration seems keen to extract direct value. Debt is the potential limit to this effort. In our meetings with investors over the last year, the question of fiscal sustainability and whether sovereign risk needs to be priced into US bonds has surfaced many times. It is an important topic but does not lend itself readily to quantitative analysis, and so it does not tend to lead to an explicit call for action. Despite episodes in recent years when sovereign risk has been priced in for UK and French government securities, until recently the demand for liquid US bonds has kept any attempt to price sovereign risk more aggressively in that market at bay. This is possibly undergoing a change.

Ferguson's Limit

There is no hard or theoretical limit to government debt/GDP that becomes unsustainable. The latest update from the Congressional Budget Office suggests that US debt will exceed 150% of GDP by 2050 (*Display 1*). But Japan sailed past that level in 2000. True, much of the stock of Japanese debt is held domestically (which is relevant to the national security aspect of the debt question) so it is not directly comparable, but it is a can that policymakers have some ability to kick down the road, perhaps. We also point out that this is far from being uniquely a US problem. For the G7 overall, debt/GDP is at the level it reached at the end of WWII.

[1] Please see: https://www.bloomberg.com/news/articles/2025-04-10/jpmorgan-analyst-highlights-wall-street-fears-over-criticizing-trump

DISPLAY 1: US GOVERNMENT DEBT-TO-GDP RATIO IS RISING



Current analysis does not guarantee future results.

The Congressional Budget Office (CBO) projection represents data that supplement the CBO's March 2025 report, *The Long-Term Budget Outlook: 2025 to 2055*.

As of April 3, 2025

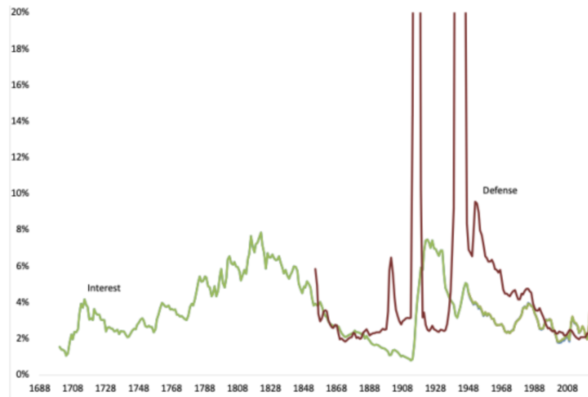
Source: CBO and AllianceBernstein (AB)

However, there is another possible limit. Niall Ferguson recently proposed Ferguson's limit (named, it seems, after Adam Ferguson, the eighteenth-century Scottish philosopher of the Enlightenment rather than Niall himself). The law states that a great power that spends more on debt servicing than on defense will not remain a great power for long. This is relevant because in 2024, US debt-service cost exceeded the defense budget ($882 billion vs. $874 billion) for the first time. Ferguson cites Habsburg Spain, Bourbon France, the Ottoman Empire and Austria-Hungary as a list of unhappy examples where the cost of debt service exceeded defense spending with deleterious consequences for these states to retain the ability to project power. This was especially dangerous in times of more rapid technological change, when this need to service debt meant it was not possible to catch up with rivals.

The country that was most like the US in this regard was the UK, especially in the wake of WWI. Defense spending for the UK was greater than the interest-service cost of debt in the late nineteenth century. In 1913, on the eve of WWI, interest payments were at an all-time low of 0.8% of GDP; defense spending accounted for 3.2%. As the war concluded, defense spending fell but interest-servicing costs soared to 7% of GDP in the early 1920's (*Display 2*). This led to a significant contraction in the ability of the UK to project hard power. It was also the period during which sterling began to lose its global reserve currency status, at first shared with the US dollar and then lost altogether after WWII.

An interesting aspect of the UK case is that it managed to cross back over the Ferguson limit. For the whole of the Cold War, the UK spent more on defense than on interest-servicing charge. In 1982, the time of the Falklands War, the UK was still spending 4.4% of GDP on defense, a level above the share of GDP that the US spends on defense today. However, this crossing back over the Ferguson limit required a policy of allowing the debt to be inflated away and, with that, a very significant devaluation of sterling (from $5 per pound on the eve of WWII to $2 by the early 80s). This is an uncomfortable parallel to the US.

DISPLAY 2: UK INTEREST AND DEFENSE EXPENDITURE (1688–2023)

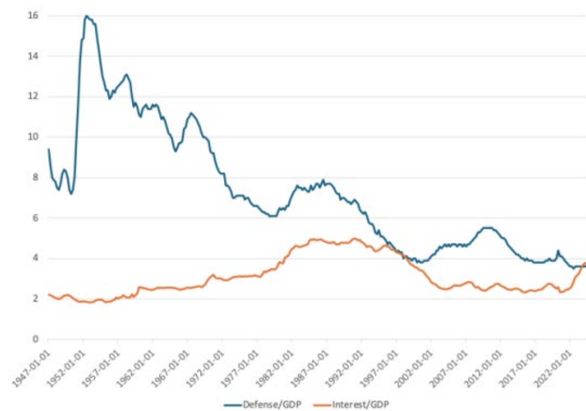


Historical analysis does not guarantee future results.

As of February 21, 2025

Source: Niall Ferguson (2025), Ferguson's Law: Debt Service, Military Spending, and the Fiscal Limits of Power, Hoover Institution History Working Paper 202502)

DISPLAY 3: US INTEREST AND DEFENSE EXPENDITURE (1947–2023)



Historical analysis does not guarantee future results.

As of February 21, 2025

Source: Niall Ferguson (2025), Ferguson's Law: Debt Service, Military Spending, and the Fiscal Limits of Power, Hoover Institution History Working Paper 202502

Based on this view, the level of debt is, bluntly, a national security concern. If we accept this as a notion, then it perhaps casts some light on why this upending of the geopolitical environment is taking place. It is possible that the animus of the US administration's change in policy is not born of US strength. Far from it, it could be the result of a perception of US weakness, especially vis a vis China. This might perhaps be a contributing factor to sudden questioning of US defense guarantees, and also the use of defense as a justification to raise seemingly outlandish questions about the sovereignty of Canada and Greenland.

If debt service costs are a limit to the maintenance of hard power, then the other possible ways out are to grow more or cut other areas of spending through austerity. Neither seem promising prospects. They would have to overcome a change in the demographic trajectory that implies lower growth, albeit with the US still having an advantage over other major economies.

One simple way to decompose GDP growth is to write it as:

*GDP growth= number of workers * productivity of each worker*

The number of workers has grown at an unusually strong pace since 1980, with the Baby Boomer cohort fully joining the workforce, an increase in the female labor participation rate and also a favorable (from an economic perspective) immigration picture. This is no longer the case, Display 4.

To be clear, the US is still in a very favorable relative position vis-à-vis Europe and China. The size of the US working-age population is still expected to grow over the next decade. This is one element forming the basis of our view that US exceptionalism is alive and well. However, this population growth is a smaller number than has seemed normal in the last four decades. In Europe and China, the working-age population is expected to be in outright decline (*Display 4*).

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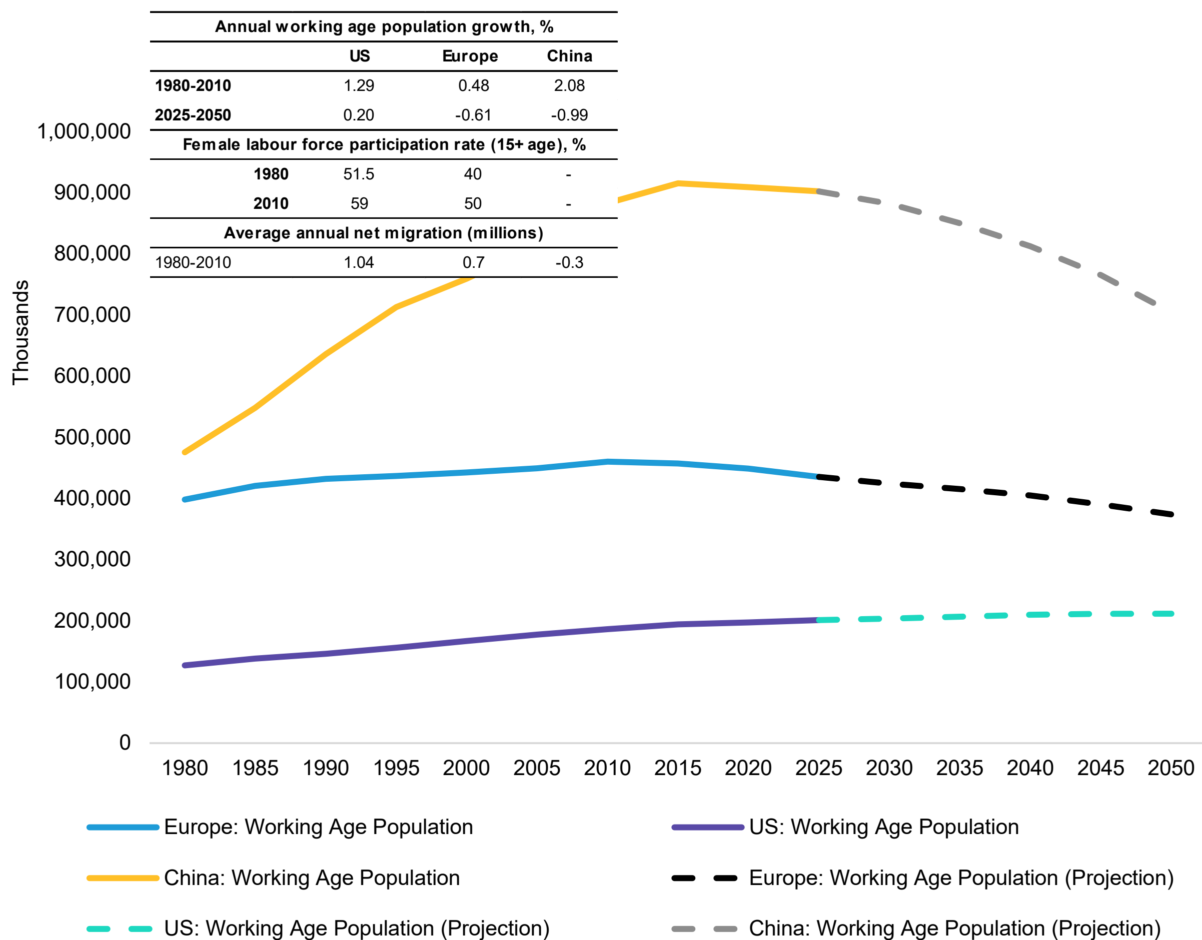
DISPLAY 4: THE US IS STILL DEMOGRAPHICALLY EXCEPTIONAL AMONG LARGE ECONOMIES—JUST LESS SO



Annual working age population growth, %			
	US	Europe	China
1980-2010	1.29	0.48	2.08
2025-2050	0.20	-0.61	-0.99
Female labour force participation rate (15+ age), %			
1980	51.5	40	-
2010	59	50	-
Average annual net migration (millions)			
1980-2010	1.04	0.7	-0.3

Current analysis does not guarantee future results.

As of January 17, 2025

Source: UN, LSEG Data & Analytics and AB

The other moving part in this equation is productivity. We would be very wary of assuming higher productivity in the future as a way to boost growth. We discussed this at length in our recent note on the aggregate impact of AI. Predicting productivity has been very difficult, and assuming it will be higher gives the appearance of putting hope over economic evidence. True, AI is a transformational technology, but the open question is what share of tasks will see a significant increase in productivity as a result. Daron Acemoglu recently predicted it would lead to a 0.11 percentage-point-per-annum increase in the level of US GDP over the next decade. That's certainly helpful, but possibly not enough to compensate for slower population growth.

A discussion of long-term potential GDP growth today might also want to ponder Elon Musk's proposal that the definition of GDP growth be redefined to remove government expenditure. At one level, one can raise eyebrows at such a ploy to omit from statistics the thing that is set to be cut. Surely, wouldn't investors look through such a move? Examples abound of emerging-market countries that tried to improve their apparent economic standing through the expedient of redefining national statistics. We cannot think of a case where this went well. It clearly reflects a deeper fundamental belief in the role of corporates versus governments.

However, this does touch on a bigger point: the definition of aggregate growth is open to debate. Not seriously, in the way that Musk suggested, but the concatenation of all economic activity into one number that is then the focus of policy has many

problems associated with it. The definition of GDP was only formalized in the 1940s. Both Susskind[2] and Wolf[3] have recently discussed how the metric might need to be re-worked to address uneven distribution of the benefits of growth, and also how it might need to be changed to reflect planetary limits. There is also the long-standing issue about activities, such as work done in the home, that are excluded from GDP. This has been the longstanding feminist critique of the GDP metric, which we think will gain renewed prominence in a world with aging populations. That is because more people of working ages may need to cut hours devoted to productive work (from a GDP perspective) in order to care for family members. These are not paths to increasing expected growth rates at all—quite the opposite. Even rejecting the de-growth movement as not morally justifiable, recognizing broader issues implies a downward force on measured growth.

Mar-a-Lago Accord?

This brings us to another possible intersection of geopolitics and investment that ties together many themes discussed in this note: debt, transaction-type relationships with other countries, the role of the dollar, and directly applying threats and the possibility of removing those threats to seek policy goals. There has been much discussion over the last month about whether the new geopolitical and economic reality might lead to a putative "Mar-a-Lago accord" as a successor to the 1985 Plaza accords—the international agreement that devalued the dollar. The idea[4] could address various perceived problems. There seems to be a belief within the administration that the dollar's role as a reserve currency has made it too strong and hence puts US exporters at a disadvantage; recently announced tariff policy creates more potential dollar strength. When trying to pin down the source of the dollar's reserve status and what could threaten it, the role of the US as the only superpower is also frequently cited. How much this is critical to dollar-reserve status is debatable, but if it is the case then it is another "cost" of the dollar. At the same time, Trump has clearly stated that he wants to keep the dollar's reserve status and has even suggested punishing countries that try to move away from it as a basis for international payments.

There is at some level a kind of internal inconsistency in this. Part of the benefit of having the world's reserve currency is that access to it can be cut to punish enemies, as was done when Russia invaded the Ukraine. However, the more that a reserve currency is "weaponized" in this way, the more it creates an even greater incentive for foreigners to find alternatives. Linked to this is the observation that foreigners own a significant share of the US debt, and that the debt service costs alluded to elsewhere in this note that potentially limit defense spending are, to some extent, going overseas. How to address all these issues?

There has been no official policy announcement of what a Mar-a-Lago accord might look like. Indeed, the abrupt weakening of the dollar through the recent period of turbulence arguably takes the pressure off an explicit intervention to devalue the dollar. However, if a more concerted approach was adopted, several routes are possible with the core policy goal of devaluing the dollar but preserving its reserve-currency status.

One route might be to seek international agreement to devalue the dollar, as was the case with the original Plaza accord. Why would other countries agree to such a move, especially after the antagonistic turn in international deliberations? Presumably, tying such an agreement to tariff exemptions or defense guarantees could encourage other countries to accept such an agreement. It would also fit with the transactional nature of international agreement seemingly favored by the administration in recent months. Over the year following the Plaza accords, the dollar fell by 23% based on the DXY US Dollar Index against major currencies.

A parallel potential policy move that is often discussed in conjunction with this would be to convert US bonds held by foreigners into longer-dated instruments. One example of ideas floated so far has been 100-year low-coupon bonds.[5] There has been no official announcement on this front, so it is not clear how much weight to give to this suggestion. Why would holders of these instruments agree to this? Again, presumably they might do so in exchange for tariff exemptions or defense guarantees. Foreigners hold 30% of US government debt, with the largest holders Japan, China and the UK (*Display 5*). To make a meaningful impact on debt payments, any conversion would have to be broader than just China and have a material impact on allies as well.

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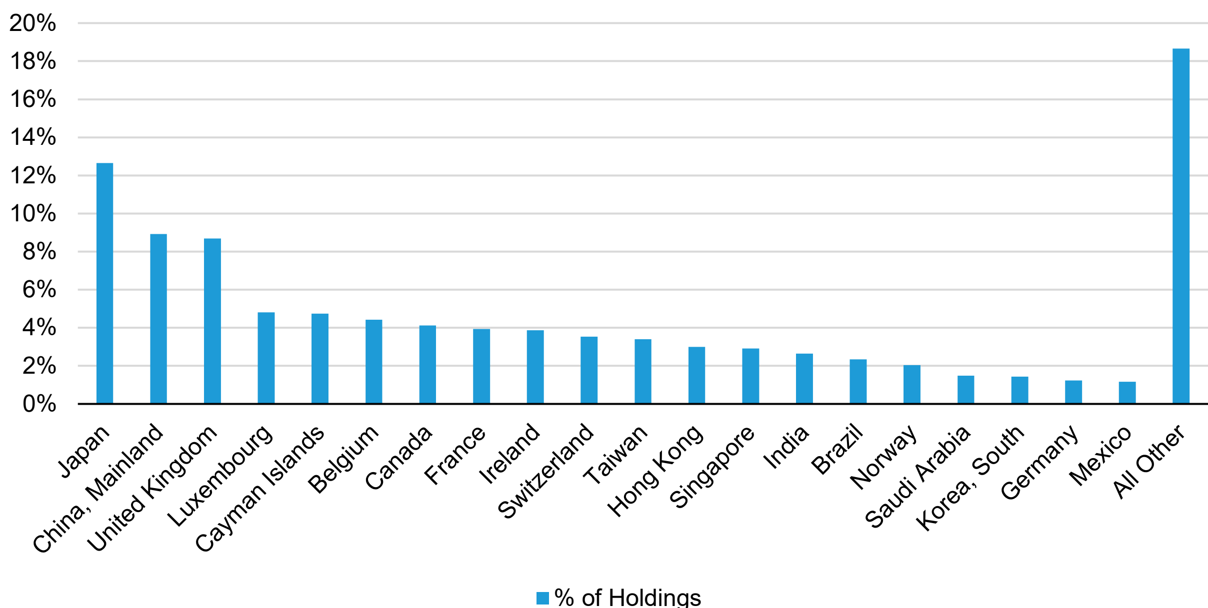
[2] Please see: https://www.imf.org/en/Publications/fandd/issues/2024/09/we-must-change-the-nature-of-growth-daniel-susskind

[3] Wolf, Martin. *The Crisis of Democratic Capitalism*. Penguin Books, 2023.

[4] Stephen Miran: A Users Guide to Restructuring the Global Trading System

[5] For more details please see: https://www.ft.com/content/8a71dceb-806f-4681-80f9-416aa4c366ca

DISPLAY 5: FOREIGN OWNERSHIP OF US DEBT



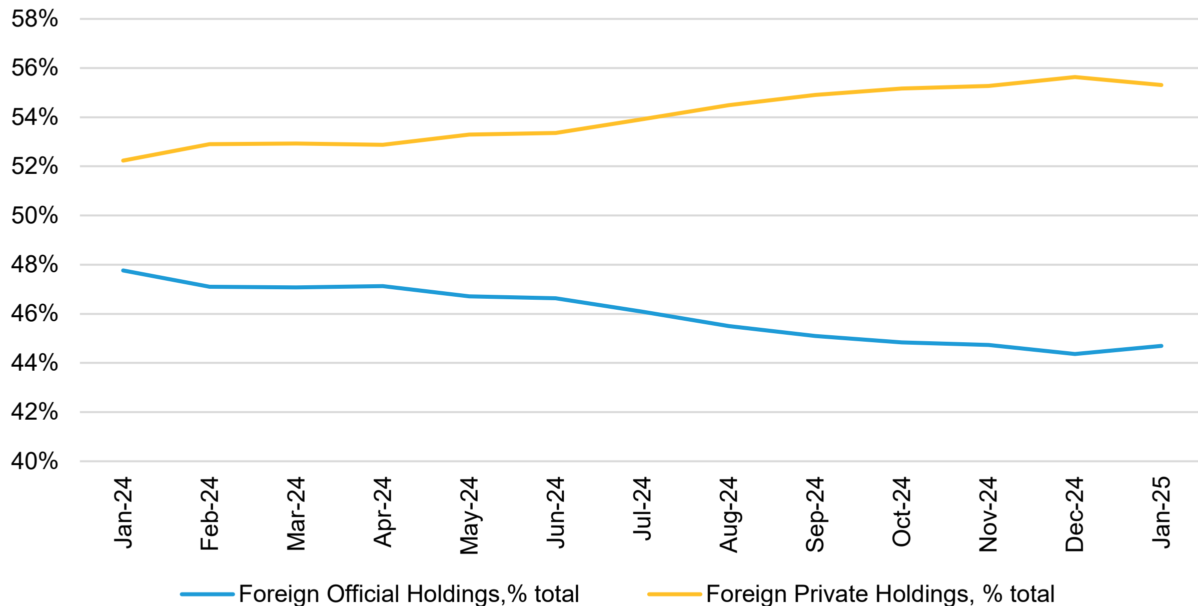
Current analysis does not guarantee future results.

As of January 30, 2025

Source: US Treasury and AB

While foreign holders of US-issued public-sector debt, such as government entities of central banks, might conceivably agree to such a swap as part of achieving some broader policy objective, it is very unclear (to say the least) where this would leave private sector holders of debt such as European and Japanese insurance companies and pension funds, which have grown in share of debt ownership (*Display 6)*.

DISPLAY 6: FOREIGN PRIVATE HOLDERS OF US DEBT HAVE GROWN IN SHARE OF TOTAL HOLDINGS



Current analysis does not guarantee future results.

As of January 30, 2025

Source: US Treasury and AB

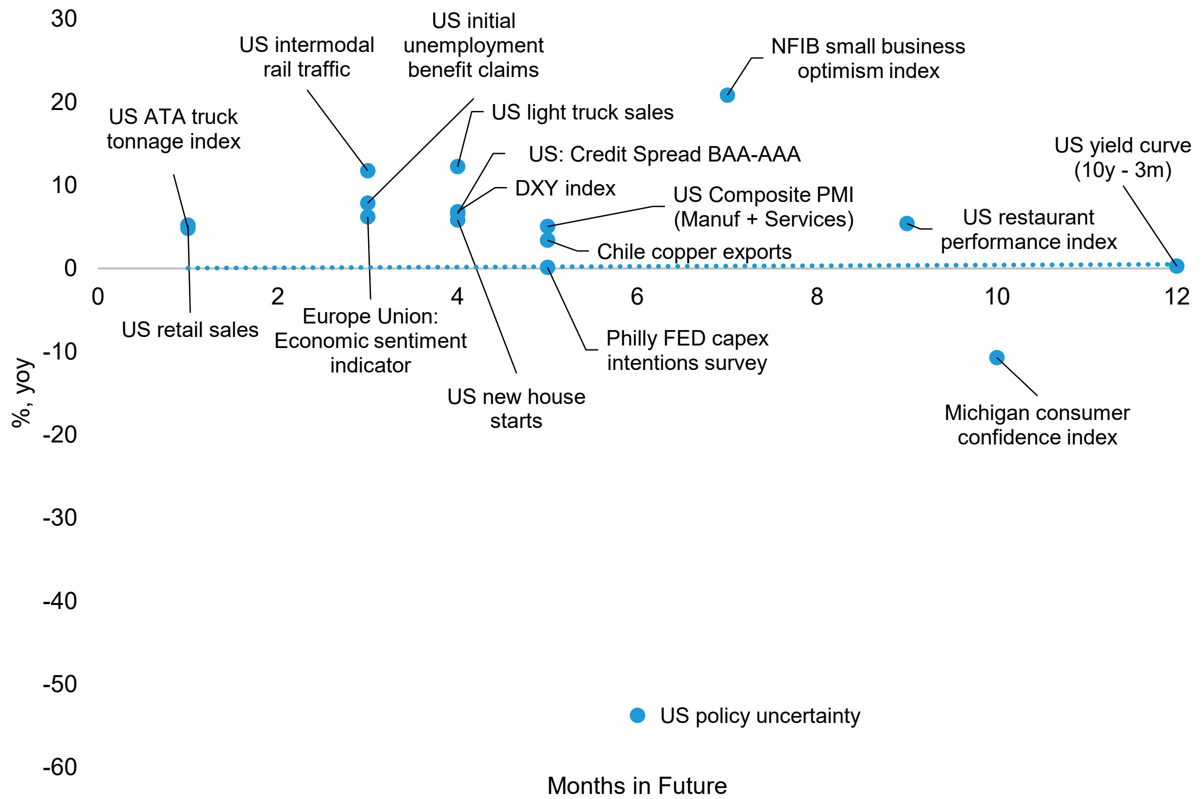
If this were to work in achieving its aims, how effective could it be and what would it mean for investors? The clearest implications are for non-US investors. There is always a debate about how much currency exposure to hedge, with a range of views expressed across the industry. As a rule of thumb, a larger portion of bond portfolios is hedged and a smaller portion of equity portfolios. One way of thinking about this is that bonds tend to be less volatile than developed-market cross rates, whereas equities are generally more volatile. The other observation is that the dollar has appreciated against most currencies in recent decades, so non-US investors have mainly been paid to be underhedged. Whatever one's approach to currency hedging is, if an accord such as this is a possibility, then it implies that non-US investors should consider increasing the proportion of US assets that they hedge, even if this is expensive in the near term.

Growth, corporate profit share and oligarchy

In the near-to-medium term, the seeming chaos of US policy announcements and the front-loading of the focus of economic policy around tariffs has significantly lowered expectations of earnings growth. It is open to debate as to whether the flow of policy announcements, especially around tariffs and the speed at which they are changed, is indeed chaotic. It could instead reflect tensions between different views as to what MAGA means when applied to economic policy, or it could be a calculated tool to seek negotiating advantage. It is not in the scope of this note to opine on the driving animus. What is clear, though, is that the combination of tariffs and the uncertainty around them has lowered expectations for earnings growth and upset the ability to make corporate investment plans.

At the beginning of the year, our indicator for US corporate earnings growth (*Display 7*), which models the level of earnings growth consistent with a broad range of activity stats and other macro variables, was suggesting that 12-month forward earnings growth would be 15%, i.e., an acceleration in growth. This indicator has now materially declined to 0.5%, driven by the extreme spike in policy uncertainty and material weakening in consumer confidence; given lags in some of the inputs it likely has further to fall. The evident risk that policy uncertainty remains high and, with it, uncertainty about corporate investment plans, implies that the risks to earnings are on the downside. Thus, the odds of seeing a profits recession in 2025 are probably a coin toss. This rapid move to essentially a zero-earnings-growth forecast makes the tactical equity outlook incredibly hard to call.

DISPLAY 7: US TACTICAL EARNINGS INDICATOR (CURRENT PROJECTION 0.5%)



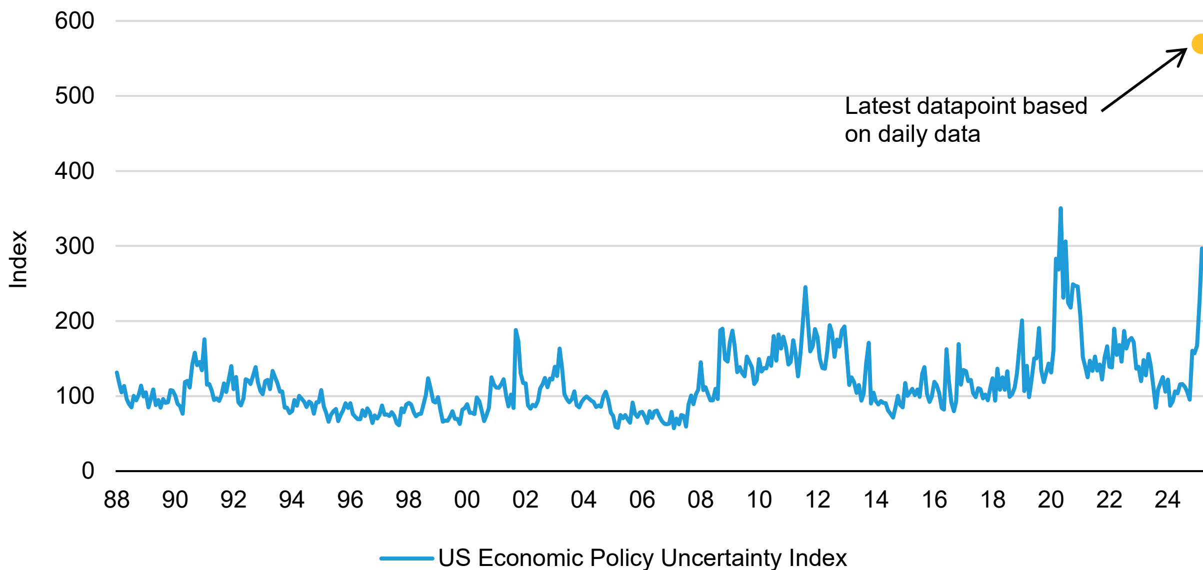
Current analysis and forecasts do not guarantee future results.

As of April 14, 2025

Source: Bloomberg, FRED, LSEG Data & Analytics and AB

Among the inputs into our earnings indicator, the largest single change has been the leap in policy uncertainty (*Display 8*). It is hard to compare the current juncture to anything that has gone before, but usually the Baker, Bloom and Davis Economic Policy Uncertainty Index has short, sharp spikes around periods of uncertainty about the business cycle. The risk now is that policy uncertainty remains elevated, which would have negative implications for earnings.

DISPLAY 8: US POLICY UNCERTAINTY INDICATOR



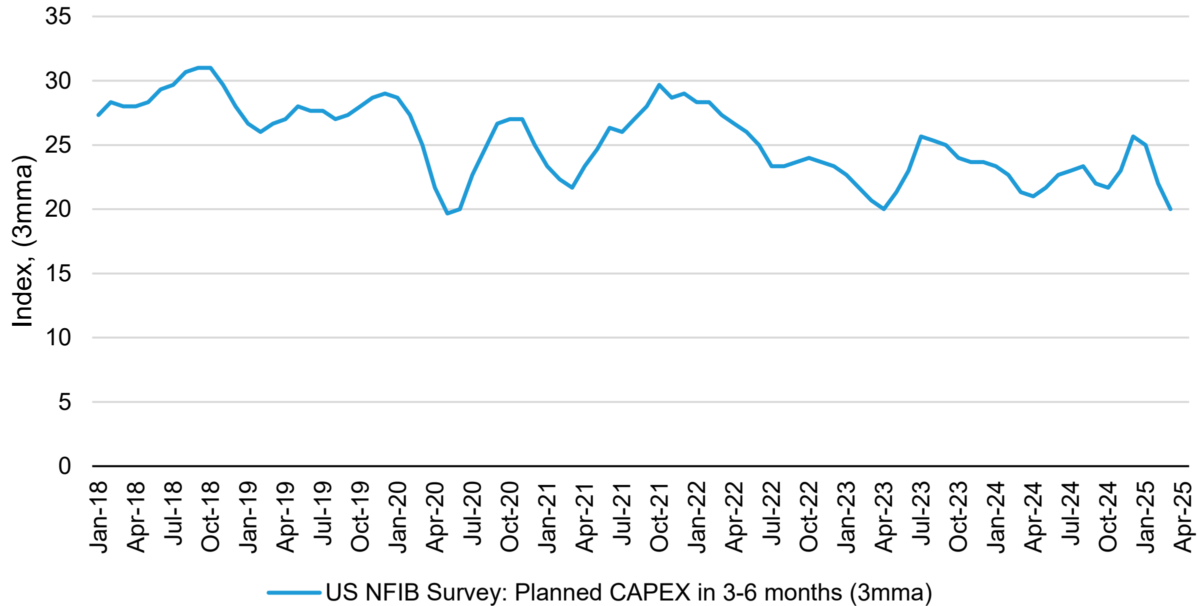
Current analysis does not guarantee future results.

As of April 8, 2025

Source: LSEG Data & Analytics and AB

One consequence of this increase in policy uncertainty is an abrupt curtailment in the capital spending intentions of corporations, especially small businesses in the US (*Display 9)*. Capex intentions for this group soared after the US election on the hope of deregulation but have been dialed back in response to the policy priorities being tariff-related instead.

DISPLAY 9: NFIB SMALL-BUSINESS CAPITAL-EXPENDITURE PLANS



Current analysis does not guarantee future results.

As of March 31, 2024

Source: LSEG Data & Analytics and AB

The promise (or at least the hope from investors) was that deregulation would boost growth. It is entirely possible that a raft of policy announcements on that front might still come, which would no doubt lead to at least a partial rebound in tactical earnings expectations.

However, the main focus of this note is not the next 12-month earnings outlook; instead, it is longer term. If tariffs act as a threat to growth and if volatile policy announcements are set to be a permanent feature, what does this mean for growth? Growth across the US, other developed economies and China was already set to be lower over the next decade, driven by shrinking working-age populations and possible risks from more extreme climate events. A sharp reduction in global trade creates a risk that growth will fall even more.

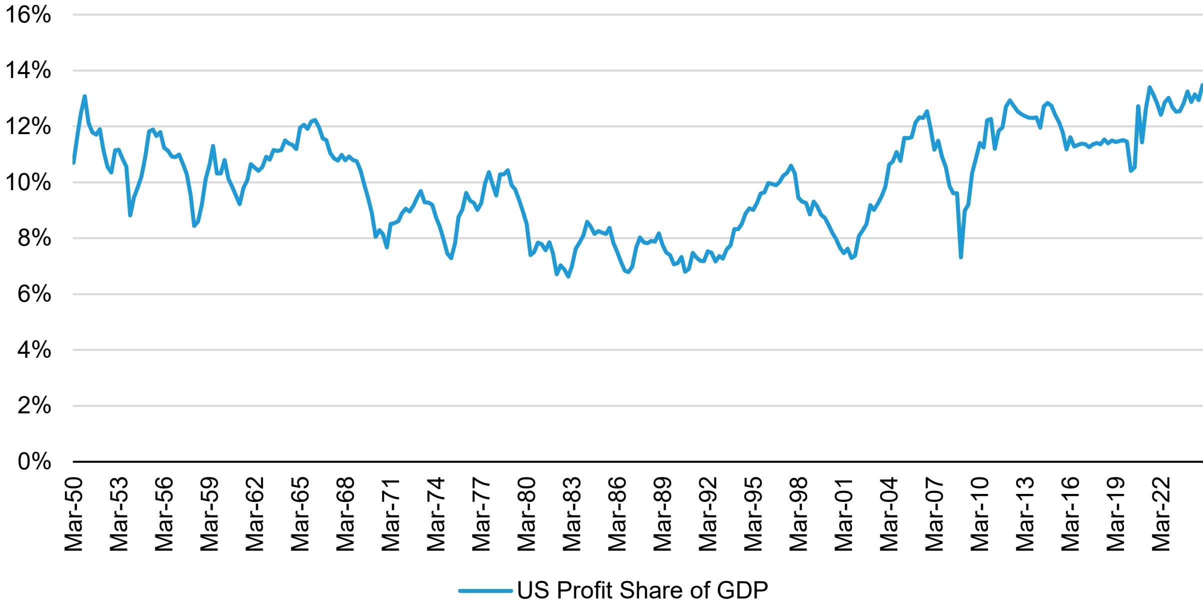
One promise that Trump made on the campaign trail which has not yet been fully acted on is deregulation. Could this help corporations offset lower GDP growth? And if so, how much deregulation would be required? One way to quantify that amount is with the profit share of GDP. The high share of US national production accounted for by corporations is an outlier compared with other countries and compared with longer-run US history. The profit share of GDP in the US has averaged 11.2% since 2000 but was 9.2% for the five decades before that (*Display 10*). The positive case for this (from an equity shareholder perspective) is that it is a symbol of the vigor of US companies.

Presumably, from a social perspective, there are in fact limits to this, as a very high profit share of GDP is in essence just an outright oligarchy. We strongly suspect that at some level this creates a social and political backlash, which in the US is possible in the form of left-wing populism. However, that is a story for another day, as there is very little sign of a curtailment of corporate power anytime soon. Indeed, as we have noted, with corporations firmly in the driving seat of AI development, it is likely that profit share increases in the near term, because presumably the decision about what kind of AI is developed and released will be to augment profits rather than to achieve other social goals. Moreover, this view of corporations leading growth fits with Musk's recent suggestion that government spending is even eliminated from the calculation of GDP (more on this below).

A deregulation-driven increase in profit share could offset slower GDP growth, but this is not an easy thing to achieve. Plotting a history of GDP growth and corporate earnings shows that the two have a strong tendency to co-move over the business cycle. However, regulatory-driven shifts in profit share could conceivably be significant enough to raise profit share to an extent that it

offsets the decline in GDP growth. The profit share of GDP is already at an all-time high (*Display 10)*; to compensate for lower GDP growth, it would have to rise even higher to leave earnings growth unchanged. That would be in uncharted territory, but perhaps conceivable given a very pro-corporate administration. We suggest that there are social limits to how high the profit share of GDP can go before there is a popular backlash, but as yet this limit is untested in the US.

DISPLAY 10: US PROFIT SHARE OF GDP



Current analysis does not guarantee future results.

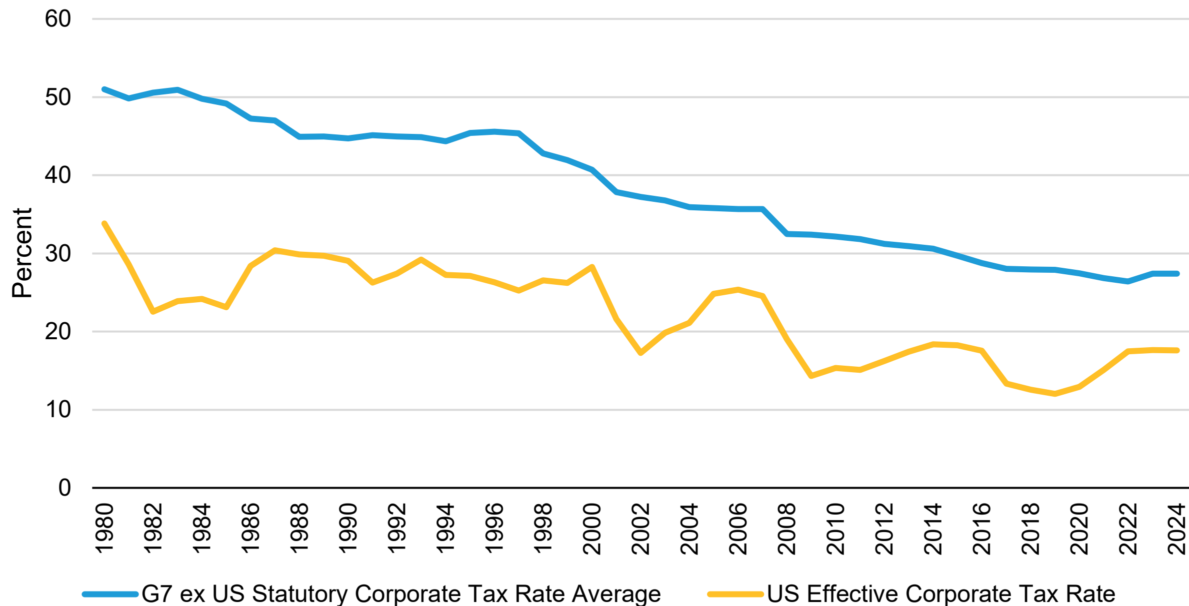
As of December 31, 2024

Source: LSEG Data & Analytics and AB

One specific area where US companies have had an advantage is their effective tax rate, which has fallen from 28% to 17.5% over the last 25 years. This advantage has been especially large for the US tech sector. We don't want to belittle how successful this sector has been, but it does need to be recognized that at least part of the success was a game of tax arbitrage. This seems to be a clear example of a change in the willingness of the US to exploit its power. Pre-Trump, there was a discussion about global tax cooperation and a possible minimum level of corporate tax proposed by the OECD. Such talk now seems out the window. Thus, the favorable tax treatment of US corporate earnings seems intact for now, and potentially partly offsets lower GDP growth. However, we note that the president of the European Commission, Ursula von de Leyen, has proposed taxing US services and digital advertising revenue in particular as a potential response to US tariffs,[6] This could put upward pressure on the US effective corporate tax rate.

[6] https://www.euronews.com/my-europe/2025/04/11/von-der-leyen-ready-to-hit-tech-and-services-in-useu-trade-war

DISPLAY 11: US EFFECTIVE CORPORATE TAX RATE VS G7 EX-US AVERAGE



Current analysis does not guarantee future results.

Note: US effective tax rate is calculated from aggregate US corporate profits before and after tax.

As of April 11, 2025

Source: Tax Foundation (www.taxfoundation.org), FRED, LSEG Data & Analytics and AB

We have heard the opinion voiced several times this year that "US exceptionalism is dead." We disagree, and we think that this reaction betrays a misunderstanding of the phrase. Any exceptionalism of the US should not be understood as a tactical proposition that can indeed change with sentiment, the cycle and policy pronouncements. The real exceptionalism of the US is a strategic one founded on:

1. A relatively favorable demographic outlook versus other developed economies and China; growth in the US working-age population is set to decline but remain positive, whereas in those other regions it is in outright contraction

2. A structurally higher level of profitability for US companies and a successful tech sector that imply an ongoing ability to earn higher margins

3. Stronger geographic security of supply chains than other regions

4. Benefits from the scale of its home market

5. The dollar's reserve-currency status. The recent episode probably hastens the time when the dollar is no longer the reserve currency, but in the absence of credible alternatives, it is set to remain in place for the foreseeable future

Despite the policy shocks of recent months, these structural forces remain in place, so our strategic (we stress *strategic*) position remains overweight US equities within a global equity portfolio.

Investment Conclusions

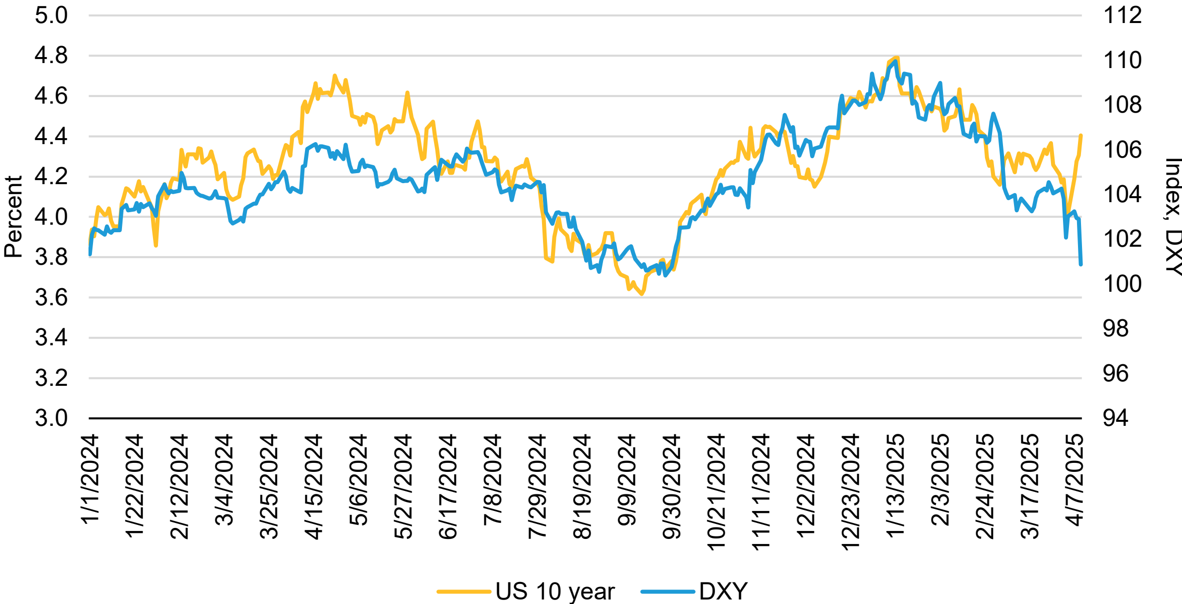
Given the scale and pace of the changes to the global economy implied by policy announcements over the last month, investors could be forgiven for paralysis. But that is not an option. Strategically, investors face a global outlook of lower growth and, we

would argue, higher inflation. The premium demanded for taking risk, be that in equities or bonds, should be higher too. More tactically, the growth outlook is sharply lower, with a meaningful chance of negative earnings-per-share growth this year.

Given the adjustment that has taken place and the need to earn above-inflation returns in a lower growth world, investors have to remain invested in assets that seem able to deliver positive real returns. However, volatility is set to remain a lot higher. It was unusually low for a long time and that has come to an end, so tactically there is a need for more defensive trades as part of a portfolio. But after all this brouhaha what, exactly, is a defensive trade?

The biggest question is around the role of US bonds, and the US dollar in general, as being a defensive asset. US bonds held up well in the initial stages of the recent tariff dispute, but as the tariff war escalated US bonds have fared less well, with yield rising since 4 April. The close association of US bond yields being positively related to the dollar, as measured by the DXY index, has abruptly broken down.

DISPLAY 12: SIGNS OF STRESS: DOLLAR WEAKENING AND YIELDS MOVING HIGHER



Current analysis does not guarantee future results.

As of April 11, 2025

Source: LSEG Data & Analytics and AB

We think that global investors should increase the proportion of US dollar assets that they hedge. For non-US investors, the risks around the dollar have increased. It was always unclear to us whether Trump's announced policy intentions pre-election would be positive or negative for the dollar. Tariffs provide an impetus for dollar strength, but the lower growth outlook pushes the other way. Moreover, there are reasons for believing, as outlined in this note, that a weakening of the dollar might be to the administration's liking. Given the change in priorities in setting US policy and the bluntness with which it can apparently be implemented, we argue that non-dollar investors should view the dollar differently.

Non-US investors also face other risks with US government securities, in that it seems likely that more of a term premium will be priced in and hence a steeper curve.

We have been strategically underweight duration in our recommended asset allocation for some years and have questioned whether government bonds can fulfil their historic de-risking and diversifying role. Thus, investors must look more broadly in portfolio design to achieve diversification: for example, using illiquid assets, factor strategies and active strategies.

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As investors consider the risk around government bonds, in particular, it implies that one possible route is to increase the proportion held in investment-grade credit. The case against investment-grade bonds, and credit in general, is that their spreads started this episode at very tight levels and the deterioration in growth could cause spreads to widen further. However, this is less of a concern if their role is to replace government bonds—not form a relative value spread-trade. We always thought it strange that investors seemed happy to buy credit on the argument that its overall yield was attractive, even while the spread over government bonds was low. There is still business cycle risk that spreads widen. However, viewed specifically through the geopolitical lens of this note and for an investor worried particularly about US government assets, the yield argument for credit is the relevant one; the spread is of less importance.

Indeed, the new geopolitical environment throws the whole established methodology of spreads and risk premia up in the air. As we show in *Display 13*, over the last two years in particular but also over the last 10 years, US investment-grade corporate indices had much better risk-adjusted returns than similar-duration government bonds. The established idea is that credit deserves a spread over government bonds to compensate for default risk and that equity deserves an even larger spread or risk premium because it is lower in the capital structure and bears growth risk. But who says this idea holds any more? We reject the established notion that sovereign risk, credit risk and equity risk are risks that stack on top of each other; they are just different kinds of risk. Or, to put it another way, there is no such thing as a risk-free rate.

DISPLAY 13: RETURN AND VOLATILITY OF US INVESTMENT GRADE VS. SIMILAR-DURATION US GOVERNMENT DEBT VS. GLOBAL GOVERNMENT BONDS: LAST TWO YEARS AND LAST 10 YEARS

	US IG Corporate 7–10-Year Index	US 10-Year Treasury index	Bloomberg Global Treasury Aggregate
Last Two Years			
Return	6.11	1.38	1.17
Risk	6.02	8.22	8.00
Return/Risk	1.01	0.17	0.15
Last 10 Years			
Return	2.79	0.71	-0.13
Risk	5.71	7.20	6.99
Return/Risk	0.49	0.10	-0.02

Past performance does not guarantee future results.

As of April 2, 2025

Source: Bloomberg and AB

In *Display 14*, we show the recent performance of a broader series of return streams that could be considered defensive. They bear very different levels of risk, so the size of the returns can't necessarily be directly compared. However, it is evident that some have worked and some have not. The quality factor in equities has not held up well, while low volatility has generally been more effective. To some extent this reflects valuations, with the quality factor being more expensive than normal in the lead-up to the current episode (*Display 15*), while low volatility was not expensive as a factor. On a spread, rather than total yield, basis, investment-grade debt was also expensive prior to this episode. Thus, we can say that the quality factor in a cross-asset sense is less likely to be defensive.

DISPLAY 14: SINCE THE END OF JANUARY, "QUALITY" HAS FAILED TO BE DEFENSIVE

	Asset	Performance Since January 31, 2025
Quality Equities	MSCI World Quality (Relative)	-0.46
	World ROE (L/S)	-1.85
	World ROE (SN) (L/S)	-3.80
Low-Volatility Equities	World Low Volatility (SN) (L/S)	14.61
	MSCI World Minimum Volatility (Relative)	13.21
	World Low Volatility (L/S)	12.66
High FCF Equities	World FCF Yield (L/S)	12.89
	World FCF Yield (SN) (L/S)	9.56
Other Assets	Gold	6.87
	JPYUSD	6.73
	Global Agg Corporate	1.16
	Global Aggregate	2.16
	iShares Short-Term TIPS	2.17
	iShares Short-Term US Government Bonds	0.76

Past performance does not guarantee future results.

Returns are calculated on a total-return basis in USD. MSCI World Quality and Minimum Volatility factors are market-capitalization-weighted, and the performance is measured relative to the MSCI World Index. The other quality, low-volatility and high free-cash-flow (FCF) yield factors are constructed by dividing the MSCI into quintiles based on a given factor (or a blend of factors for a "composite" style), forming long-short (L/S) portfolios of stocks that are in the top and bottom quintiles, respectively. The stocks in these portfolios are equally weighted and portfolios are rebalanced quarterly. The sector-neutral (SN) factors are constructed in a way that ensures an equal representation of each sector in the factor portfolios. ROE denotes return on equity. As of April 8, 2025
Source: Bloomberg, Factset, LSEG Data & Analytics, MSCI and AB

DISPLAY 15: VALUATION OF POSSIBLE DEFENSIVE TRADES

(Z-SCORE VALUATIONS VS. HISTORY)

	Asset	Z-score (since 2005)
Quality Equities	World ROE (SN) (L/S)	1.54
	World ROE (L/S)	1.31
	MSCI World Quality (Relative)	0.80
Low Vol Equities	World Low Vol (SN) (L/S)	-0.77
	World Low Vol (L/S)	-0.25
	MSCI World Min Vol (Relative)	-1.02
High FCF Equities	World FCF Yield (SN) (L/S)	-0.36
	World FCF Yield (L/S)	-0.60
Other Assets	Global Corporate AGG (OAS)	0.32
	Global AGG YTM	-0.98
	US TIPS (5 year)	-0.89
	US 3m Deposit Rate	-1.18

Current analysis does not guarantee future results.

Note: smaller (or more negative) values indicate a greater discount to historical average. MSCI World Quality and Minimum Volatility factors are market-capitalization-weighted factors, and their valuation is measured as the relative 12-month-forward price/earnings (PE) multiple relative to the MSCI World Index. The other quality, low-volatility and high-free-cash-flow (FCF) yield factors are constructed by dividing the MSCI into quintiles based on a given factor (or a blend of factors for a "composite" style), forming long-short (L/S) portfolios of stocks that are in the top and bottom quintiles, respectively. Factor valuation is calculated as the ratio of the median 12-month forward PE multiple of the long-short portfolios. For the Global Aggregate Index, US TIPS and US 3-month deposit rate, valuation is measured as the yield to maturity. For the Global Corporate Aggregate Index, valuation is measured by the option-adjusted spread (OAS). The sector-neutral (SN) factors are constructed in a way that ensures an equal representation of each sector in the factor portfolios. ROE denotes return on equity. As of April 8, 2025. Source: Bloomberg, Factset, LSEG Data & Analytics, MSCI and AB

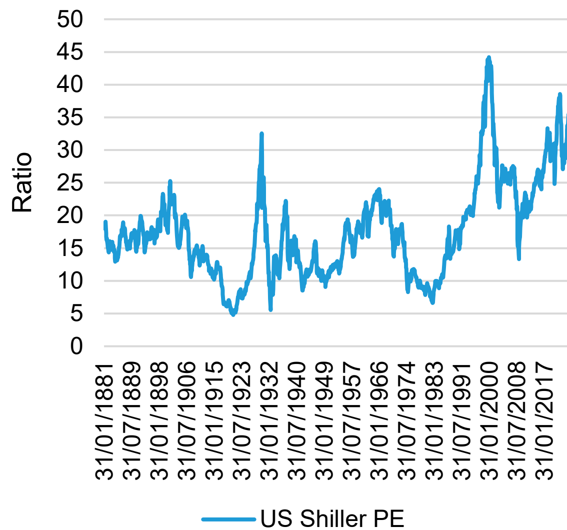
We have made the case for an overweight allocation to gold and non-fiat, zero-duration assets for some time. The performance of gold has been very strong through this episode. We remain positive on it, in the context of an overall portfolio allocation that has an overweight in risky real assets. Some investors we speak to worry about the lack of an ability to set a return target (which is a legitimate concern) and the scale of the recent upward movement. This might give the impression that gold is "expensive," but we think it really just underscores an environment where most asset classes are fully valued. From today's level of bond yields and Shiller PE, gold has tended to perform in line with a 60:40 portfolio five years forward. So, we do not think it is a drag on performance. Several factors give an explicitly positive case for gold: 1) the observation that the correlation of gold with equities remains zero even at higher levels of inflation; 2) central bank demand seems likely to remain strong, which cannot have a time scale attached to it but should provide a tailwind as attempts to de-dollarize continue and; 3) all G7 economies have high levels of debt/GDP, making inflation or depreciation against gold an attractive policy path.

The tactical equity outlook is very complex, to say the least. The highly volatile policy environment creates a near-term risk of a downturn in earnings growth. We expect earnings forecasts have more downward revisions to come. This could be either directly via the impact of tariffs or because the rapidly changing policy environment deters longer-term investment decisions. The hope post-election was that growth would be given an impetus from deregulation. That could still be forthcoming, but so far has disappointed. While the risk of a decline in growth sufficient to cause an earnings recession certainly exists, it is not yet a foregone conclusion. The tariff delay might possibly be a sign that a so-called "Trump-put" exists. But it has been followed by statements from the US administration that the reprieve is only temporary. The lesson from COVID, the GFC, etc. is that, at some point, authorities step in, but is that possible in the current environment? At some level, marginal extra tariffs become irrelevant,

as trade between the nations involved falls to zero. If the two nations in question are the US and China, then such an eventuality does not appear to be priced into valuations.

Strategically, the case to be overweight equites still stands despite a significantly less supportive investment environment. We need to be clear about the basis for this. It is not because of some bullish outlook: global growth will likely be lower and volatility higher. The decline in equity valuations in the recent turmoil still leaves equities globally at a level that is expensive compared with history (*Displays 16* and *17*). We do not believe that a full mean reversion in valuations needs to occur, but the lower valuation is not sufficient to forecast anything other than a lower return than norms of recent decades. Instead, the reason for an equity overweight is desperation on the part of investors—if there is a need to generate real returns, then the global equity market is the largest real asset there is.

DISPLAY 16: US SHILLER CYCLICALLY ADJUSTED PRICE/EARNINGS (P/E)

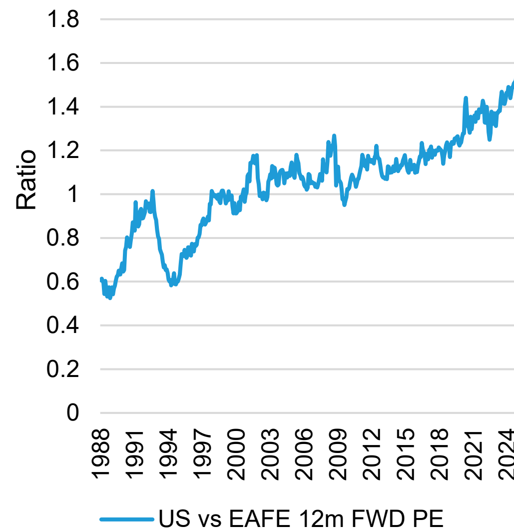


Past performance does not guarantee future results.

As 5 April, 2025

Source: Robert Shiller's database and AB

DISPLAY 17: US VS EAFE 12-MONTH-FORWARD PRICE/EARNINGS (P/E)



Past performance does not guarantee future results.

As of 10 April, 2025

Source: Factset and AB

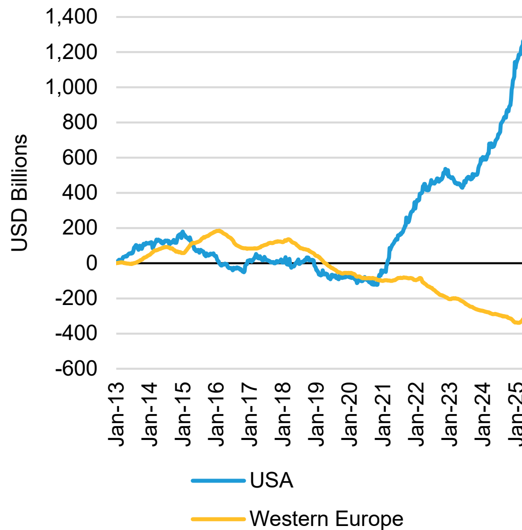
There is considerable uncertainty about what constitutes an equilibrium level of valuation. The setting of capital market forecasts now is, in part, about stripping away layers of recency bias. There is the recency bias of the post-1980 high-growth and quiescent-inflation environment that, we think, has decisively come to an end. One can have a go at trying to "price" this, and we do that in our capital market forecasts. But how should one go about calculating the impact of the removal of the "recency" bias of the last 80 years of a US-led world order?

Within the equity allocation, there is also the question of US concentration. Tactically, we expect to see further outflows from US equities and flows into other regions, unwinding at least some of the extraordinary degree of preference for the US over other regions in recent years (*Display 18*). It is not that the case for other regions is more bullish. Yes, the German fiscal change of heart is a big deal, but there is also a hit to come from tariffs. However, a striking feature of the equity market at the onset of the year was the scale of consensus in favor of the US over other regions (and to be clear, we agreed with that).

At our January CIO forum in New York City, the pro-US/anti-Europe consensus was unanimous. More quantitatively, this viewpoint is demonstrated by the extraordinary and unprecedented $600 billion flow into US equities in the prior 12 months and contemporaneous $60 billion outflow from European equities. In dollar terms, we have simply not seen a disparity of flows of this scale before. Thus, when some exogenous shock (policy changes in this case) disturbs that consensus, the resulting move can be large. So far, we would need to furnish readers with a magnifying glass to see the reversal of relative flows over the last 2 months on the chart. Over that period, there was a $27 billion European inflow and a $54 billion US inflow. Thus, this

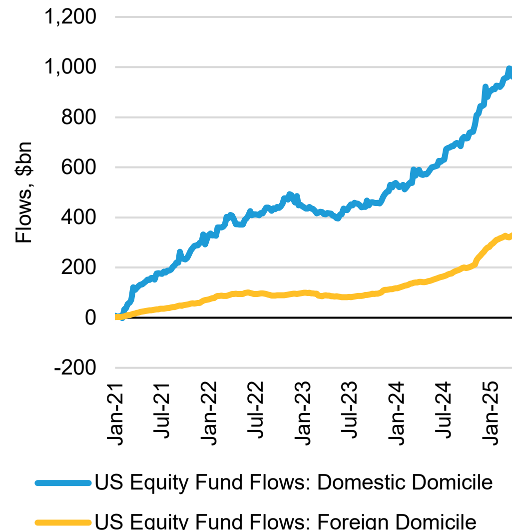
resetting of the consensus position may have further to run. There are also the beginnings of signs that non-US investors have turned more negative on the US equity market, with recent buying supported by US domiciled investors (*Display 19*).

DISPLAY 18: US AND EUROPE CUMULATIVE EQUITY FUND FLOW



Past performance does not guarantee future results.
As of April 2, 2025
Source: EPFR and AB

DISPLAY 19: US VS NON-US INVESTORS' BUYING OF US EQUITIES IS DIVERGING



Past performance does not guarantee future results.
As of April 2, 2025
Source: EPFR and AB

This makes it entirely conceivable that, on a near-term basis, there is further underperformance of the US, given the scale of the flow into the country and out of other regions over the last 12 months (*Display 18*). However, strategically, as noted above, we still think that elements of US exceptionalism stand. To be sure, this is less clear now than it was in the past, but the demographic, size of home-market and energy-supply features still distinguish the US from other major markets. Moreover, as we have discussed in previous research[7] there is a greater degree of persistence in profitability at the individual corporate level in the US, a key element justifying valuation.

Conclusion

Drawing this together, recent policy announcements have rapidly accelerated the transition to a new investment regime with lower growth and greater volatility being key attributes. Fundamentally, this amounts to a new geopolitical and economic order. In the process, there has been a destruction of trust, particularly toward the US. The willingness of global investors to buy US assets is being tested as a result.

Taken in the context of lower growth and likely higher long-run equilibrium inflation, however, investors don't have the option of retreating to a lower-risk portfolio: a strategic allocation is needed that gives a plausible path to positive real returns. However, the topic of what constitutes a diversifying asset is likely in flux.

[7] For more details please see: https://www.alliancebernstein.com/americas/en/institutions/insights/investment-insights/productivity-democracy-power-and-truth-the-influence-of-ai-on-markets-and-investing.html

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