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Will investors keep shunning away from the U.S.?

23 May 2025

- U.S. stocks have almost returned to the pre-tariff announcement levels, but the dollar is taking its time to follow. Expectations of a rate cut by the Federal Reserve, speculation about the U.S. administration's guidance towards a weaker dollar, and investors having second thoughts about the U.S. market are some of the factors behind this diversion.
- Since the Global Financial Crisis, the greenback had strengthened on the back of relatively strong U.S. economy and positive flows into the U.S. stock market. Even as investors are trying to diversify away from the U.S., there seem to be no alternative sectors or regions with commensurate medium- to long-term growth expectations outside of this market.

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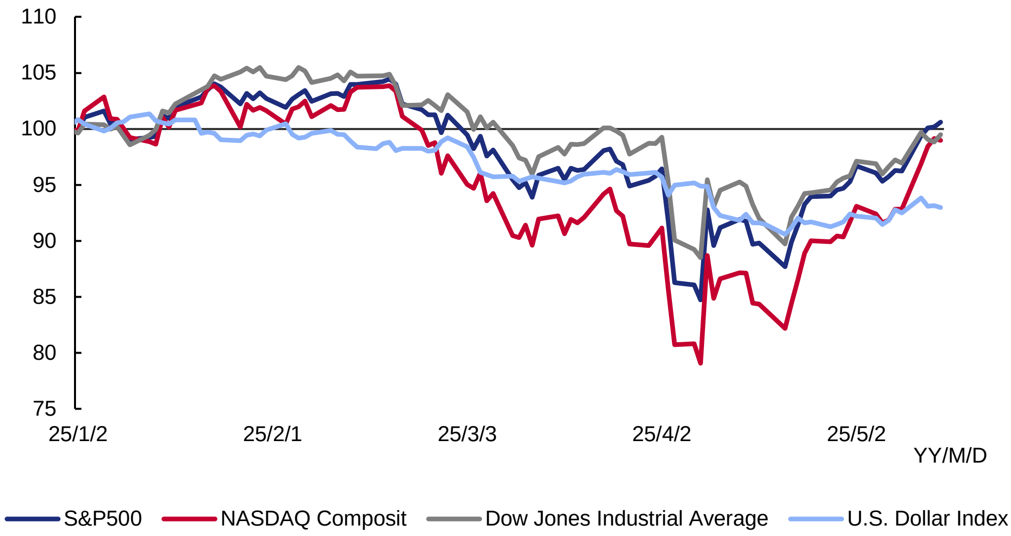
U.S. stocks almost back to the pre-plunge levels, but not the dollar

In early April, the Trump administration announced reciprocal tariffs, causing significant fluctuations in global financial markets. During this period, U.S. stocks, bonds, and the dollar all weakened, resulting in what can be described as a "triple dip." Subsequently, the U.S. administration took steps to ease tensions, and the U.S. stocks recovered to the pre-plunge levels, while the dollar index has not yet reached its late-March reading and traded at about 7% lower year-to-date as of mid-May (Figure 1). The dollar's depreciation appears to be driven by several factors: (1) expectations of a rate cut by the Federal Reserve (FRB), (2) possibility that the U.S. administration may push for a weaker dollar in trade negotiations, and (3) institutional investors' uneasiness about reinvesting in the U.S. capital markets.

Factors (2) and (3) can be considered medium- to long-term themes. Regarding (2), there are concerns that the U.S. administration might demand dollar depreciation in trade negotiations with other countries. As seen in the "Mar-a-Lago Accord" proposal, Stephen Milan, Chairman of the Council of Economic Advisers (CEA), authored a paper last year suggesting (albeit as a thought experiment) putting pressure on other countries to sell dollar in tariffs and economic security negotiations.

However, the prevailing market consensus is that guiding dollar depreciation through policy coordination among major countries is considerably more challenging compared to the Plaza Accord of the 1980s. It appears that Treasury Secretary Bessent, who is seen as the main negotiator for currency policy with other countries, fully understands this challenge, and so far, his public statements on exchange rates have been limited.

Figure1: Major U.S. Stock Indices and Dollar Index Performance Year-to-Date



Source: Bloomberg, Asset Management One Co. Ltd.
Note: 1. Daily data from 2 January 2025 to 15 May 2025
2. Indices are normalized at a value of 100 at the end of 2024

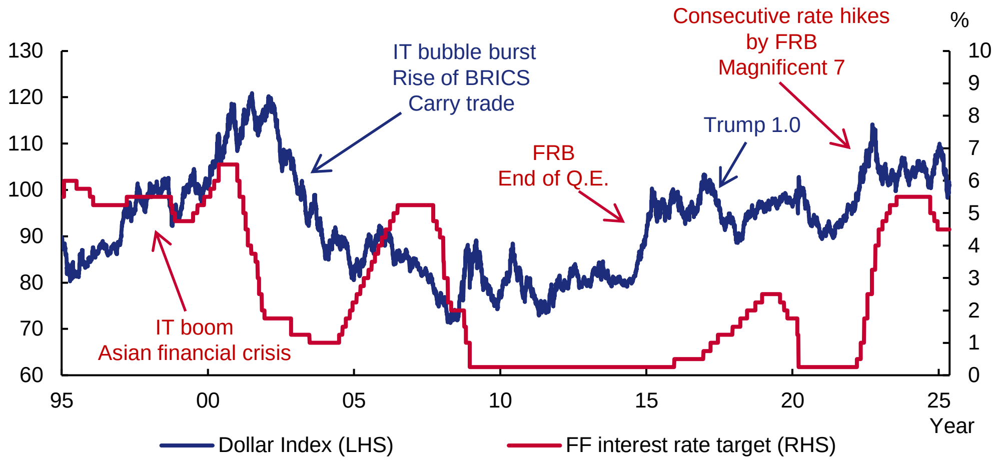
Dollar Strength Since the Global Financial Crisis

Looking at the long-term trend of the dollar index since the 1990s, there was a relatively long period of dollar depreciation in the early 2000s (Figure 2). This period coincided with the IT bubble burst in the U.S., China's accession to the World Trade Organization (WTO) in 2001, and the remarkable economic growth of BRICS countries. We saw expansion of carry trade, which involves procurement of low-interest currencies like the Japanese yen and investment in high-interest currencies of high-growth emerging and resource-rich countries. Thanks to the high growth expectations, emerging markets attracted strong capital inflows, leading to dollar depreciation.

The Global Financial Crisis (GFC) left significant scars on the economies of Europe and emerging markets. As a result, even as the FRB maintained its low-interest-rate policy, the relatively robust U.S. economy supported the dollar. Subsequently, following the end of quantitative easing and zero interest rate policy, as well as a series of interest rate hikes after the COVID-19 pandemic, the dollar has been on a medium-term upward trend, albeit with short-term fluctuations.

We believe it is the relative robustness of the U.S. economy that supported the strong dollar. During the first Trump administration, the dollar depreciated by over 10%, but this did not lead to a sustained medium-term downward trend. So, the Trump administration's criticism of dollar's appreciation since the GFC appears to be valid. However, as explained below, it does not seem that we can expect a shift to a medium- to long-term dollar depreciation trend for the time being.

Figure 2: Dollar Index Trend since 1995



Source: Bloomberg, Asset Management One C., Ltd.
Note:1. Daily data from 2 January 1995 to 15 May 2025
2. Red text indicates periods of a strong dollar, while blue text indicates periods of a weak dollar
3. March 1973=100

Potential alternatives for investment outside of the U.S.

U.S. market's strength becomes more apparent in the context of the trends in other markets' capitalization. U.S. share in the MSCI All Country World Index has been on an upward trend since the GFC, recently exceeding 60% (Figure 3).

The rise in the U.S. stocks during 2023-2024 was driven by the increasing demand for generative AI, with large tech stocks like NVIDIA leading the way. Unlike the obscure growth expectations of the IT Bubble period, this increase was accompanied by actual profit expansion, suggesting it was not a market bubble. However, there were signs of a slowdown in profit growth. It is fair to say that already at the end of 2024 investors were considering diversification away from the U.S. stocks when planning their asset allocation for 2025.

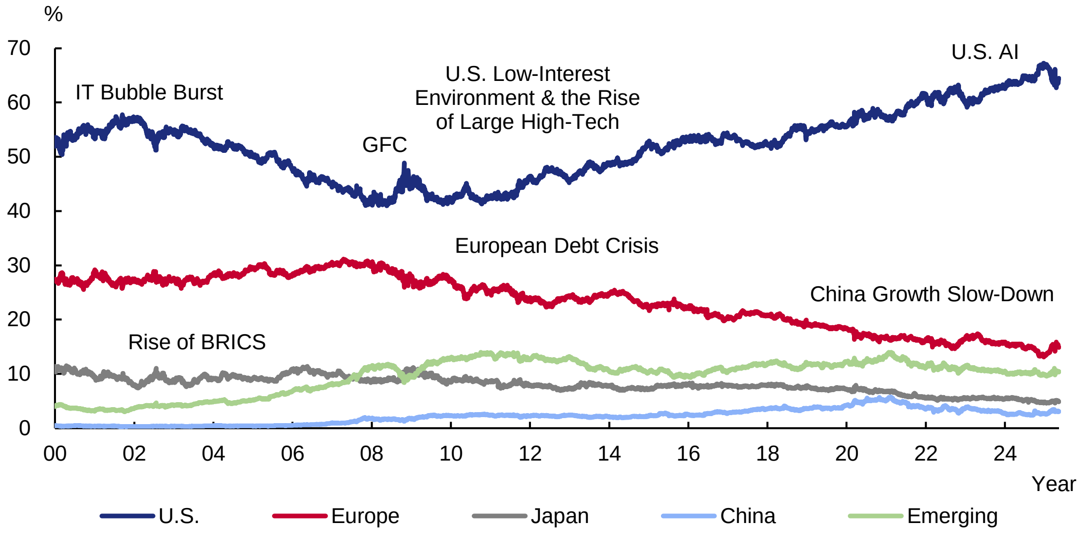
The strong European stocks rally had started in early 2025, before the announcement of Germany's fiscal expansion policy, and likely reflected changes in asset allocation by institutional investors.

European stocks' (developed markets) share in the global stock index was about 30% before the GFC, but stood at only 15% recently. The fiscal expansion in Europe, particularly in Germany, marks a historical shift from the strict fiscal discipline that characterized European Union (EU) since its establishment. This fiscal expansion is expected to significantly contribute to the recovery of the European economy, which has been beset by low growth following the European debt crisis and the onset of war in Ukraine. As a result, European stocks and the euro may continue to perform well in the near term.

However, to achieve sustainable high economic growth, it is essential that this fiscal expansion leads to productivity gains. Germany once achieved high growth through an export-led growth model, and in the medium term we need to watch whether a switch to a new growth model can be achieved.

Additionally, there is a growing expectation in the market that countries in the Global South, such as India and Indonesia, could drive global economic growth as BRICS used to in the past. However, uncertainty remains whether a high growth economic model that is not reliant on manufacturing and exports can be found, especially as China continues to grapple with excess production capacity.

Figure 3 : Japan, U.S., Europe, China and Emerging Markets – Historical Market Cap Share



Source: FactSet, Asset Management One Co., Ltd.
Note:1. Daily data from 3 January 2000 to 14 May 2025
2. This chart illustrates the trend of each country's and region's share of the dollar-denominated MSCI stock price index within the dollar-denominated market capitalization of the MSCI All Country World Index
3. "Emerging" includes China

U.S. dominance likely to continue against the backdrop of its dynamic economy

U.S. large high-tech sector has grown on the back of entrepreneurship and R&D in the private sector rather than direct government support. This is probably what increased productivity of the entire U.S. economy, supported consumption, and enabled steady growth. Against this background, it is hard to think of any other country or region that could surpass the U.S. in growth and attract the diverted capital over the medium term.

One reason Trump won the U.S. presidential election was the strong support from workers who were once employed in manufacturing. This was due to the growing dissatisfaction among workers left behind by the growth of sectors like high-tech. Does that mean that workers in the U.S. low-productivity sectors did not benefit from the high-tech sector's strong growth?

Realistically, even the population not employed in the high-tech sector did benefit to some degree. The U.S. is known for its comparatively high household stock ownership ratio, partly due to the early introduction of 401(k) (defined contribution pension) plans. In recent years, household financial assets have expanded significantly, providing strong impetus to the U.S. personal consumption.

Additionally, the presence of high-growth sectors in the U.S. supported wages in the low-productivity sectors. Since returns on capital accelerate capital accumulation, the relative scarcity of the workforce versus capital increases nationwide (an environment where labor is relatively scarce compared to capital in terms of stock; simply put, labor shortage). This promoted wage increases for the entire workforce.

The U.S. demands "rebalancing" from China, but China still lacks a system to distribute the benefits of growth to its citizens

U.S. Treasury Secretary Bessent pointed out in April this year that China's economy is heavily dependent on manufacturing, and if the export-led economic system persists, China will maintain imbalances with its trading partners. He emphasized that China needs to rebalance—specifically, to transition from an export-led manufacturing to a consumption-driven economy. The implication is that China should also contribute to global economic growth through its consumer power.

China has pivoted towards strengthening support for private enterprises. There is strong momentum for innovation in the private sector, such as the development of low-cost, high-performance generative AI by companies like DeepSeek. There is a good chance that China may become a formidable competitor to the U.S. tech sector in the future.

On the other hand, China's per capita GDP has not yet reached the level of high-income countries, and its population has begun to decline. Additionally, China has only recently started to implement individual defined contribution pension plans at a national level. Compared to the U.S. the system to broadly benefit from the new high-growth sectors is not yet established. To achieve the U.S. style economic growth driven by technological innovation and consumption, China still needs to profoundly reform its economic model.

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