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Global Equities in an America First World

January 2025

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This document is intended to support the research process of institutional clients, with our survey across key themes and challenges facing global equities in the second Trump administration. This piece is organized into sections synthesizing our views and analysis across key policy themes.

Trump is about to take office with, at the time of writing, US valuations arguably excessively stretched on the basis of "American Exceptionalism" and most other major developed and emerging market equities at relatively cheaper valuations (with the notable exception of India, amid optimism in the pricing of Japan and a few others). Yet key elements of the policy platform point to offsetting positive and negative influences at macro, sectoral and firm levels. Although Trump was forthright, even blunt, in an aggressive campaign stance on radical domestic reform, unilateralist and protectionist foreign policies, etc., much uncertainty surrounds the specifics – timing, extent, sequencing – of his key threats on immigration and trade.

Therefore, we choose not to model or otherwise quantify the effects of such policies, but to interpret the broad policy stance and its likely impact in the domestic and global economy, and the consequences for global equities directly and indirectly via currencies and bonds. We would appreciate any feedback and are happy to discuss our ideas and views on request.

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To summarize our views:

- **We expect Trump to try to enact his campaign pledges, despite much-discussed contradictions of agenda items, empowered by a significantly stronger mandate than in 2016.**

- **This mandate we believe reflects Four I's – Immigration, Inflation, Inequality, and Identity – four key issues on which he laid out a crystal-clear policy agenda. We would emphasize that this mandate consists of a "Red Sweep" in which the (red party colour) Republican Party now controls all three key houses of US government – the White House, the House of Representatives, the Senate – and has significant influence on the Supreme Court. It also includes the first peacetime Republican Party popular vote majority since the first President Bush in 1988.**

- **US presidents have greater autonomy in foreign policy than domestic policy, which requires Congressional cooperation on most key issues.**

- **We expect that being partly in legacy mode, with just one term and just two years before Congressional Mid-Term elections might reduce Republican congressional majorities, constraining reform and intending to entrench his "Make America Great Again" goals, we expect Trump to lead an "America First" approach to foreign policy.**

Table of Contents

1. *Introduction: An America First World Order and Global Markets* 2
2. *Trumpism's Challenges: Inflation, Immigration, Inequality and Identity* 3
3. *Immigration, the Federal Workforce and US Labor Markets* 4
4. *Deregulation, "Drill Baby, Drill!" and Inflation Pressures* 5
5. *US Federal Fiscal Policy, the Debt, the Deficit and the Federal Reserve* 6
6. *Foreign Economic Policies: Trade Deficits and Trade Barriers* 7
7. *Geopolitics, Geoeconomics, Balance of Power and Market Access* 11
8. *Conclusion: Portfolio Diversification in America-First Global Equity Markets* 12

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1. Introduction: An America-First World Order and Global Markets

We expect Trump to enter his second term turbocharged by a clearer, stronger mandate than in his first, more eager and better prepared to enact radical reform, and to try to establish an America-First World Order, welcoming disruption. Yet, it is uncertain which policy pledges he can implement, when and how. Several involve offsetting or conflicting macro implications. The net effect could be reflation, inflation or stagflation depending on implementation. Immigration and trade curbs may cut potential growth or boost inflation. Tariff threats may improve export market access, but deregulation could boost investment; jobs and immigration; capital inflows; and thus, the trade deficit. Given the tradeoffs and contradictions, we expect Trump to be partly constrained and guided by US financial markets – stocks as a metric highly visible to the public; bonds due to US debt and deficits; and the dollar due to its impact on inflation, bonds and stocks.

Promises made, promises kept: “Should one take Trump seriously or literally?” was a refrain in his 2016 campaign. The first term argues literally; Trump tried to enact his pledges. Events since the election also call for a literal interpretation: His victory speech salvo “Promise made, promises kept”; the speed and character of nominees; drivers of his victory offer pointers for governing style, policies and their macro and financial market effects.

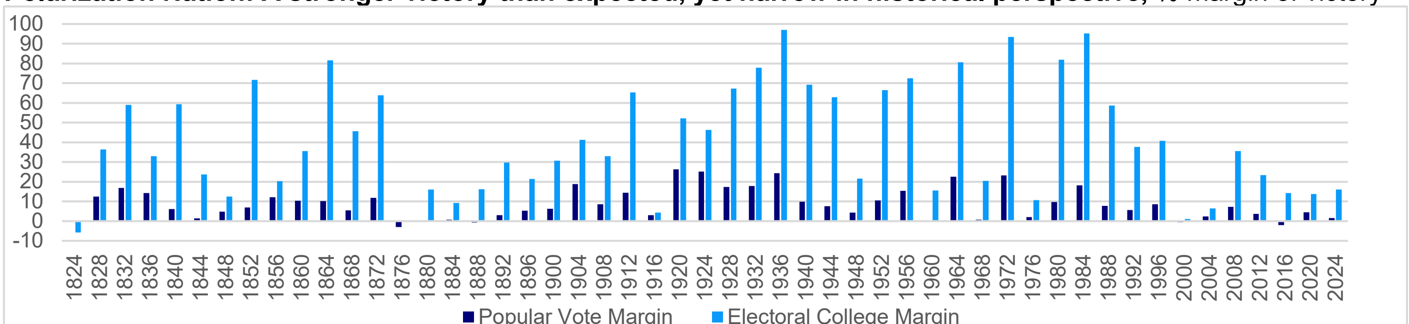
Trump’s Mandates: We think legitimacy and authority are crucial to Trump. Doubts about his mandate bookmarked his first term. His 2016 swing-state margin was only some 77,000 votes and he lost the national popular vote. Yet he insisted it was landslide, and that far larger crowds attended his inauguration than Obama’s, in our view to instill legitimacy by shifting political perceptions of the facts on the ground. In 2020, he lost the swing-states by just some 44,000 votes, a margin so narrow that it likely emboldened him to reject the result and stir up support in the court of public opinion. Now, he brandishes the first Republican peacetime popular-vote majority since 1988; a “red sweep” control of the White House, the House and Senate; possible opportunities to further shape the Supreme Court and reshape the Fed. Plus, we think it worth bearing in mind that Trump is perhaps the most unconventional politician in US history: He is set to be the first to have had only two jobs in politics, both as President and only the second ever to have returned after having lost a reelection bid. His governing style may well be more aggressive than before because he has won such a second mandate, even though in historical terms it is narrow.

Governing … Personnel as Policy: To simplify, presidents need Congress to change domestic policy, especially fiscal policy, but enjoy more autonomy in foreign policy. Personnel choices point to muscular hawkishness on national security, trade, China, confrontation on domestic reform. Trump’s domestic agenda will likely be constrained by narrow Republican majorities, and this may translate into greater aggressiveness on foreign policy and trade.

An America First World Order: We see Trump as more unilateralist than isolationist per se. The world economy is arguably multipolar: China, the EZ, Japan and India (the third largest national economy by PPP) along with the US account for the lion’s share of global GDP and growth. Yet, macro, financial and geopolitical heft is still concentrated. The US is by far the world’s largest importer of goods, services and capital at almost US$1 trillion per year. Most other major economies – China, the EZ, Japan are net exporters, and so collectively need access to US markets. US stocks, bonds and the dollar still dominate global markets. The US has 124 overseas military bases, 4x Russia’s 28 or the UK’s 32; 10x France’s or India’s 12; or 30x China’s 4. With no alternative to the US, many governments are likely to negotiate rather than retaliate. For his part, Trump is already moving to directly link – not compartmentalize – trade and investment with immigration, NATO and other trading partners’ defense contributions and global security.

Policy, Economy, Markets and Equities: We expect urgency in the radical reform agenda given a one-term limit, constrained by narrow Republican control of Congress, which may be challenged in the 2026 midterms, and a desire to secure the legacy and future of MAGA. On net, we expect efforts to moderate US inflation and bond yields and support stock markets as critical real-time metrics for Trump. Yet, we expect high volatility across currencies, bonds and stocks given the blunt radicalism of Trump’s ideas and style. We expect strategic country and sector selection to add value in an America-First world order and global markets, as US policy shifts cut across economies and sectors.

Polarization Nation: A stronger victory than expected, yet narrow in historical perspective, % margin of victory



Note: Victor’s popular and Electoral College votes vs. the next candidate. Source: Gerhard Peters, "Presidential Election Margins of Victory," The American Presidency Project, University of California, Santa Barbara; Invesco. Data as at 20 December 2024.

2. Trumpism's Issues: Inflation, Immigration, Inequality, Identity

We see four "I's" – Inflation; Inequality; Immigration; and Identity (including cancel culture and "woke" in general) – as major political drivers for Trump's unexpectedly strong performance in the election, and his rhetoric and personnel choices since. We expect these issues to feature in domestic and foreign policy as Trump seeks to deliver on platform pledges, maintain momentum in the MAGA movement, and define his legacy, which implies navigating underlying tensions and contradictions – and sustained market volatility.

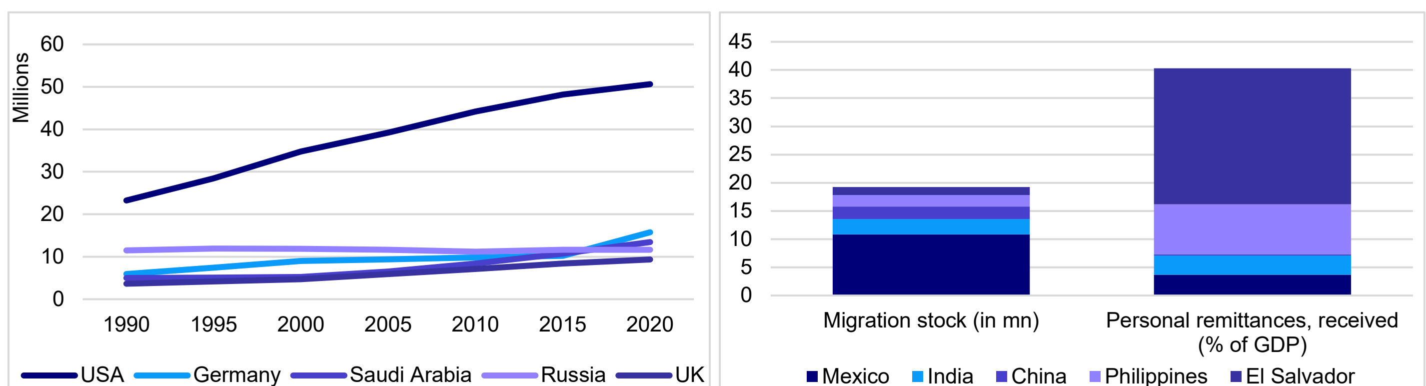
The big four "I's" are perhaps where the tensions and internal contradictions of the Trump platform will come to a head. For example, falling inflation has probably been assisted by high immigration, but at a cost to social stability and public services, as well as doubts about personal safety and diversion of public spending, which the Trump campaign arguably fanned up. We would therefore expect Team Trump to tread carefully to navigate trade-offs between specific campaign goals, such as lower immigration, and other contradictory goals, such as lower inflation.

Identity and Inequality: Identity we expect to have the least direct macro, sectoral and financial market impact, yet is an important socioeconomic and sociopolitical signifier, for it represents a backlash against the preferences of globalized elites and centrist political groups, such as cancelling "cancel culture", political correctness, "woke" and the like. This implies that the Trump Administration will reverse or sideline key elements of associated policy agenda items, spanning climate change, regulatory restrictions on the economic and financial freedom of businesses and individuals and corrective public policies such as redistribution, affirmative action etc. The most direct market impact is likely to be a stronger aversion to "ESG" writ large in financial, real investment, hiring and access decisions (such as federal jobs or college admissions criteria, perhaps via federal education and research grant funding).

Immigration, Inequality and Inflation: Immigration arguably contributed to the "immaculate disinflation" of recent years, in which there has been no major sacrifice of growth or employment, by keeping wages in check and the US labour market well-supplied in the face of a surge in demand for labor that accompanied post-COVID reopening. The US is the largest recipient of immigration in absolute numbers and among the largest proportionally among the world's top-five destinations, which also include Germany, Saudi Arabia, Russia and the UK. By 2020, before the collapse of migration that accompanied COVID-19 lockdowns, the stock of immigrants in the US had exceeded 50mn and is thought to have increased by another 15mn or more (including illegal immigration) in the Biden era. As a result, migrants likely account for over 20% of the US population. We would expect Team Trump to move fast to reduce illegal, uncontrolled immigration; hard and fast to deport illegals, especially those with criminal records; yet gradually to maintain meaningful access for legal immigrants based on skills, education, possibly demand in US labor markets (to help prevent wage pressures from driving up CPI inflation).

Inflation, High Consumer Prices, High Asset Prices and Inequality: We see the high level of prices as a major problem that is only partly relieved by declining inflation, a tight labor market and rising real-terms wages. Inflation and immigration have contributed to inequality, as did the easy money response to the Global Financial Crisis and COVID, driving up asset prices but holding down real wages – while the severe inflation shock causes a real wage shock. Crucial prices like rents, groceries, dining out and other services remain at elevated levels vs. median or low incomes and are still rising, albeit at a more manageable pace now that inflation is close to target. Yet keeping asset prices high is crucial not only to Trump's most visible metric of the quality of his actions, but also to sustaining growth, investment and by extension jobs. Again, these are reasons to expect high volatility, but also constraints on excessively radical policies that destabilize domestic financial markets, though we expect far less if any concern about financial stability overseas, given an America First policy stance. Some countries benefit from large migrant remittances from the US – Mexico, Philippines, El Salvador, India to an extent. Some of these may see slower migration to the US, and hence a tailing off in remittances, which in turn may raise pressure on other sources of external financing, and hence show up in financial asset risk premia across currency, bonds and stocks.

US is by the largest host country for immigrants and source of sizeable remittances for some emerging markets



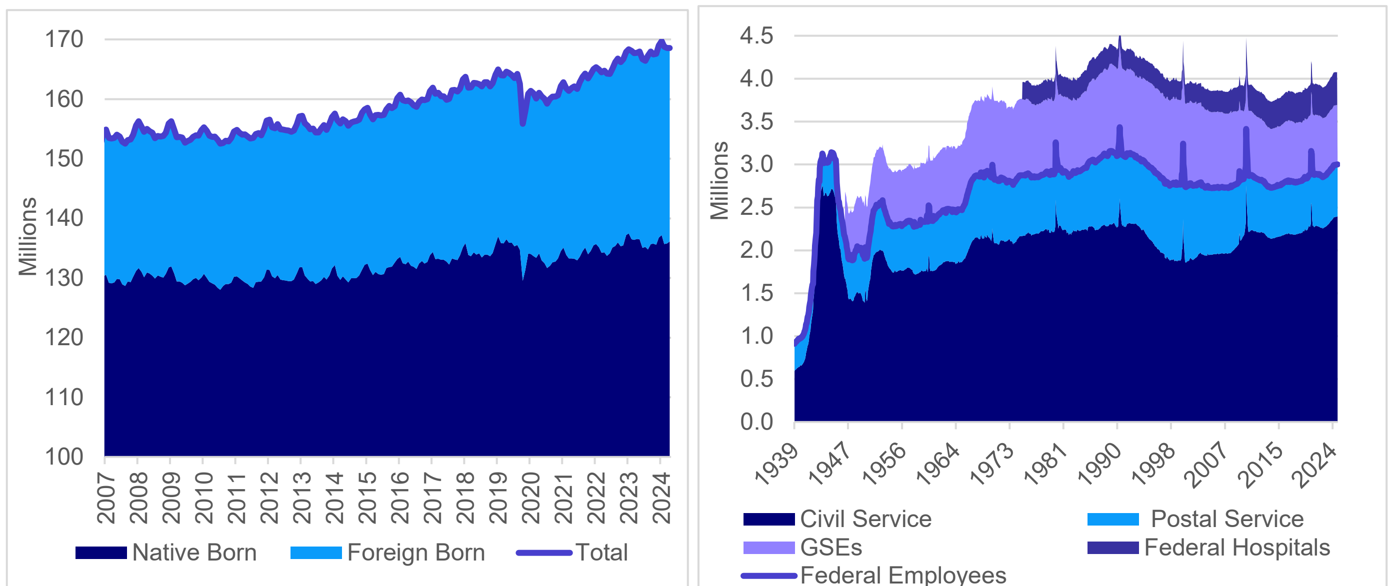
Source: IOM World Migration Report 2024, UN Department of Economic and Social Affairs, Invesco. 2020 data, latest available, as at 18 Dec 2024.

3. Immigration, the Federal Workforce and US Labor Markets

Team Trump, especially the newfangled "Department of Government Efficiency", aims both to curb immigration and to trim what they see as a gargantuan US federal government in terms of workforce, share of national output and regulatory overreach. Yet the data show that immigration drives US labor force growth; the federal workforce is small vs. history, population growth and especially other countries. Still, we would expect the dynamic US economy and markets to respond favorably to significant deregulation and improved government efficiency. That said, we believe serious immigration restrictions or reversals would limit potential growth through both the supply and demand sides of the economy – key strengths of the US compared to other large, high-income countries, so we would expect significant efforts to turn the tide of illegal immigration, but not so much legal immigration.

Immigration has driven almost all US labor force growth in recent decades, which implies that reaching 3% real growth would require remarkable, sustained increases in productivity unless legal immigration is allowed to continue. Meanwhile, US direct federal primary (non-interest) spending is only about 15% of GDP, with another 5% in federal-state fiscal transfers (plus another 10% of GDP in separately funded state/local government spending).

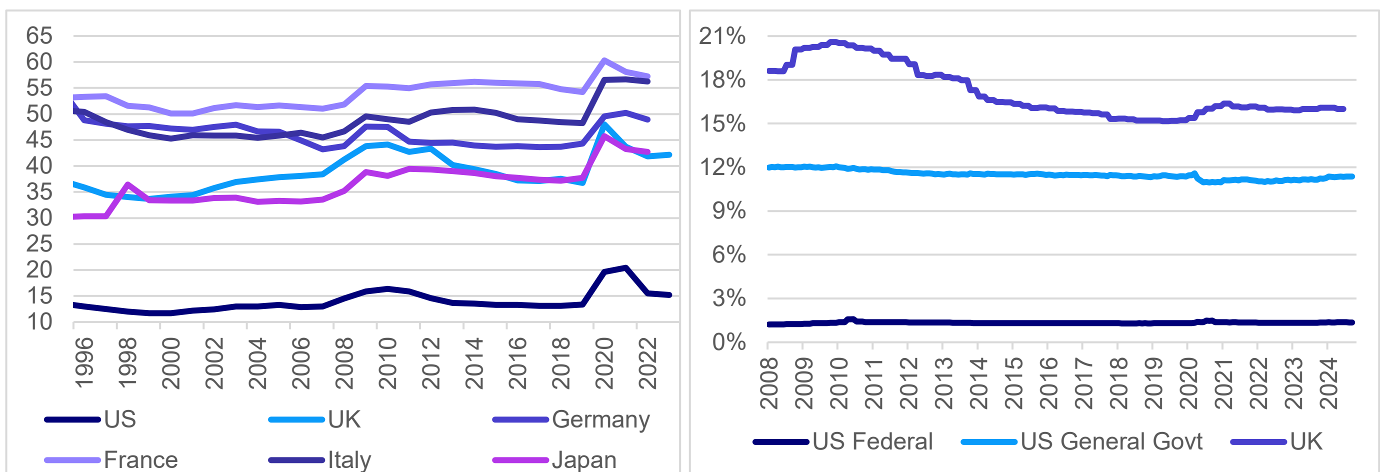
US labor force grows largely through immigration (left). The federal workforce has hardly grown since WWII.



Note: GSEs = Government Sponsored Enterprises. Data spikes, despite seasonal adjustment, reflect hiring for the census in part. Excludes armed forces. Source: US Bureau of Labor Statistics, Macrobond, Invesco. Monthly data to October 2024, as at 15 November 2024.

The small share of federal spending in GDP and federal employees in the civilian workforce likely will limit the radicalism of reform that could disrupt the labor market. Still, there is in our view always room to improve efficiency and productivity. Even limited success may well mean higher equity prices with possibly somewhat higher interest rates and bond yields.

US direct federal spending is a fraction of peers (left), and federal share of the workforce a fraction of peers, %



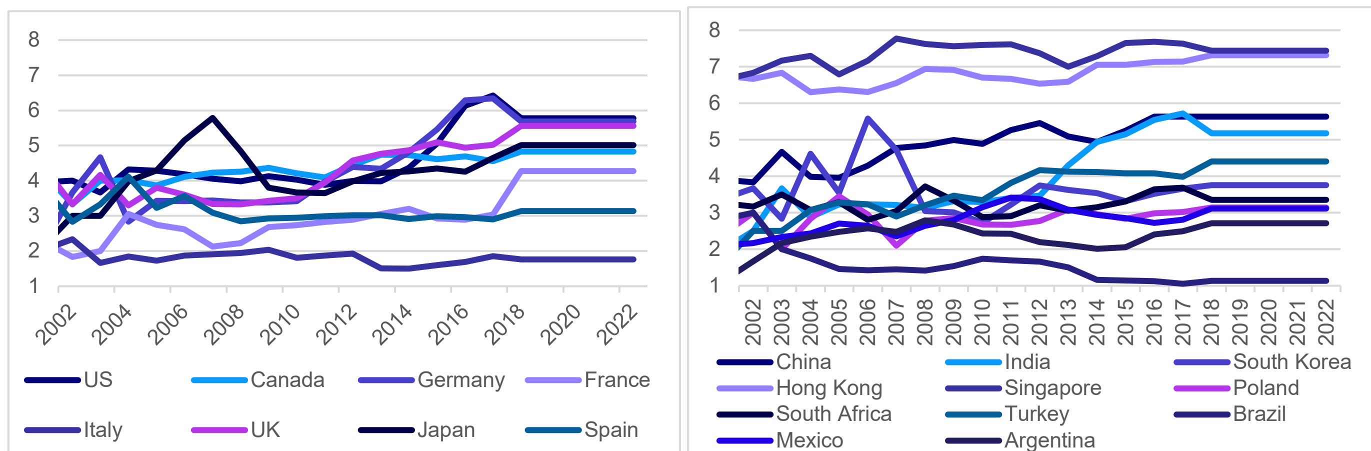
Note: Left – US federal and UK central government; others, general government (including state/regional/local). Central governments dominate public spending in other rich countries. Sources: IMF Global Financial Statistics, US Bureau of Labor Statistics, UK Office of National Statistics, Macrobond, Invesco. Annual (left); quarterly (UK, right); monthly (US, right) to September 2024, as at 15 November 2024.

4. Deregulation, “Drill, Baby Drill!” and Inflationary Pressures

A pro-business deregulation fever for corporates, financials and energy seems to grip Trump. US administrations can deliver by easing enforcement and interpretation, without legislation: The EU and UK, though debating, seem to be doing the opposite, but some EMs (e.g., Argentina) are delivering. Deregulation can cut operating costs, boost investment, productivity and growth, and often has. We are more dubious that “Drill, Baby, Drill!” can raise energy output and cut inflation: US Big Oil has opted for high cash flow/low investment business models. If anything, higher oil prices are normally needed to induce higher output, given the long-cycle nature of production. Plus, there’s no free lunch; a low-regulation, high-carbon growth model may raise tail risks of financial or climate crises, which could boost the value of tail-risk hedging/insurance strategies and cash/bond buffers.

Deregulation? Yes! The US is already among the least regulated of major economies, though there clearly has been re-regulation of financials since the GFC; and more generally for the climate transition. Yet the incoming Trump administration intends to deregulate the US to help make it more competitive, productive, profitable and reduce inflationary pressures. Many mainstream economists doubt there is much room to deregulate, but we think deregulation could induce competition and investment, piling on pressure for productivity gains despite protectionism. Some regulatory indices suggest that the US has significant room to move to a “Singapore model” as espoused by some Brexiters, but which the UK has failed to adopt, at least so far. (NB: the UK Labour government campaigned on planning deregulation, which it continues to push, but has also reregulated labor markets and raised payroll taxes in a blow to investment hopes).

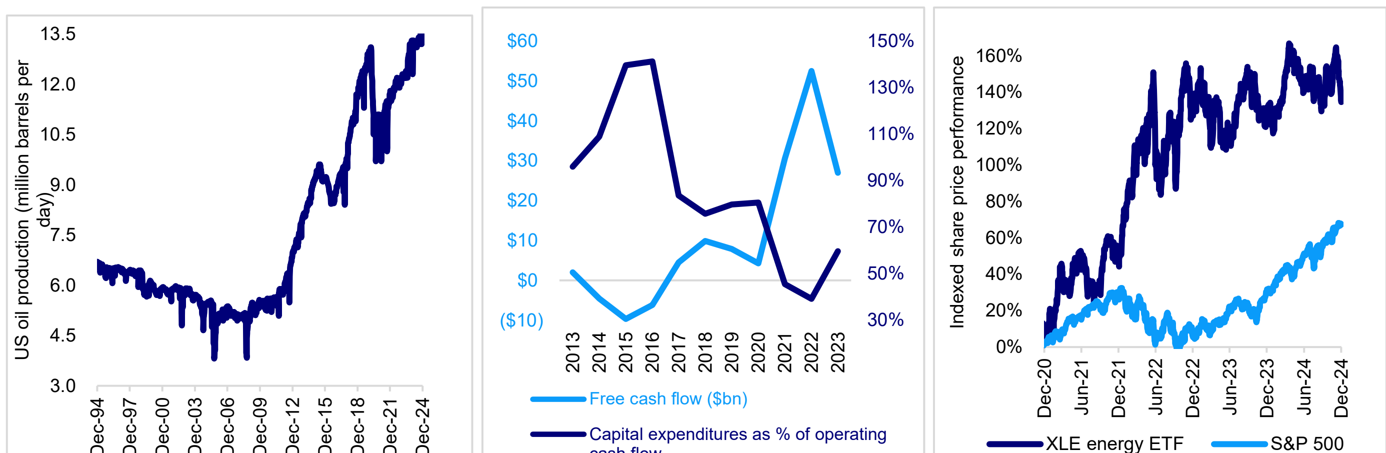
Can the US, already the least regulated of major economies, get to Hong Kong/Singapore levels? (index)



Source: Fraser Institute Regulatory Burden index; 10 is lowest burden; Macrobond, Invesco. Annual data to 2022, latest available, at 19 Dec 2024.

“Drill Baby, Drill!"? – No So Fast: Treasury-Secretary nominee Bessent has outlined a rule of 3s: 3% growth; 3% fiscal deficits; 3mn bbl/day higher oil output. In contrast to deregulation, we see less room for major oil output increases, though permitting reform and opening up more federal lands for drilling might help. US Big Oil is arguably already a paragon of free enterprise, generating record output with a low-capital/high-cashflow model, and is handily outperforming the stock market. Furthermore, geopolitics might be mixed at best: Returning to Trump’s policy of sanctions on Venezuela and maximum pressure on Iran (which Biden reversed, while sanctioning Russia) would not help, at least vis a vis Western oil markets.

“Drill Baby, Drill!"? Record output (left), Big Oil in low investment/high cashflow mode, which markets are rewarding (right)



Note: Free cash flow defined as operating cash flow less capital expenditures. Right, equity price performance reindexed, Dec 2020=100.
Source: Company filings; Bloomberg; CNBC; Invesco. Monthly and annual (middle) data all as at 19 December 2024.

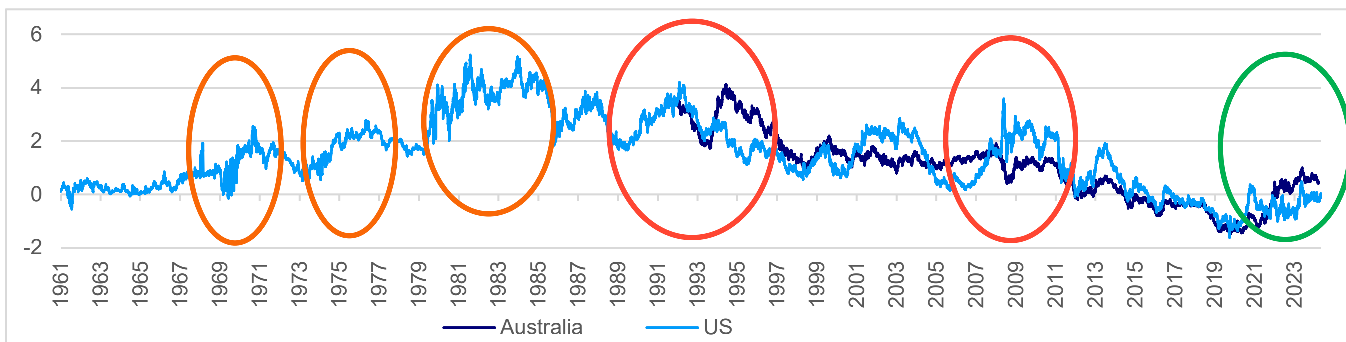
5. Federal Fiscal Deficits, Treasury Debt and the Federal Reserve

We share investors' deep concerns that the US is on an unsustainable fiscal trajectory with outsized deficits at or above full employment and possibly above trend GDP growth. Such worries reflect a lack of political constituents for cutting US federal debt, and Trump's desire to cut taxes despite difficulties in cutting federal spending or the workforce. Yet we think the direct trigger for a sharp rise in bond yields and term premia would be a loss of control of inflation, in turn driven by the independence of the Fed – or challenges to its ability to carry out its price stability mandate. We therefore see Trump's occasional attacks on the Fed or the Chair as a greater source of jump risk in bonds with knock on consequences for the dollar and US and global equities than federal deficits or debt per se.

An enduring mystery in the US bond market is the placidity of the so-called "bond vigilantes", who used to punish profligate governments with sharp selloffs that would force monetary tightening or crowd-out non-interest spending. Arguably, the US is already there, for the interest bill already exceeds defense spending. Yet despite Congressional Budget Office projections of an explosive debt trajectory on current policies, the yield curve is well-behaved and the term premium low.

In our view, the real danger for bond investors, and by extension for dollar and US equity exposures, would come from threats to Fed independence and credibility. US term premia rose sharply amid high volatility in the late-1960-early-1980s when US debt and deficits were only about a third of current levels – but when the Fed had been repeatedly and severely undermined by Presidents Johnson and Nixon. We think drastic, repeated inflation surprises and sharp rises in bond yields and term premia, which severely punish bondholders during a loss of institutional credibility, are far worse than bond yields rising due to fiscal pressure, which allows for a gentler rebalancing of bond and risk-asset portfolios. We believe the 2022 UK Gilt crisis fits this bill: PM Truss fired top civil servants; prevented the Office of Budget Responsibility from scoring her unfunded tax cuts; and threatened to blame the BoE for inflation fallout from fiscal expansionism. Gilts have adjusted far more smoothly despite major increases in deficits and borrowing by a leftist Labour government in 2024, at least so far.

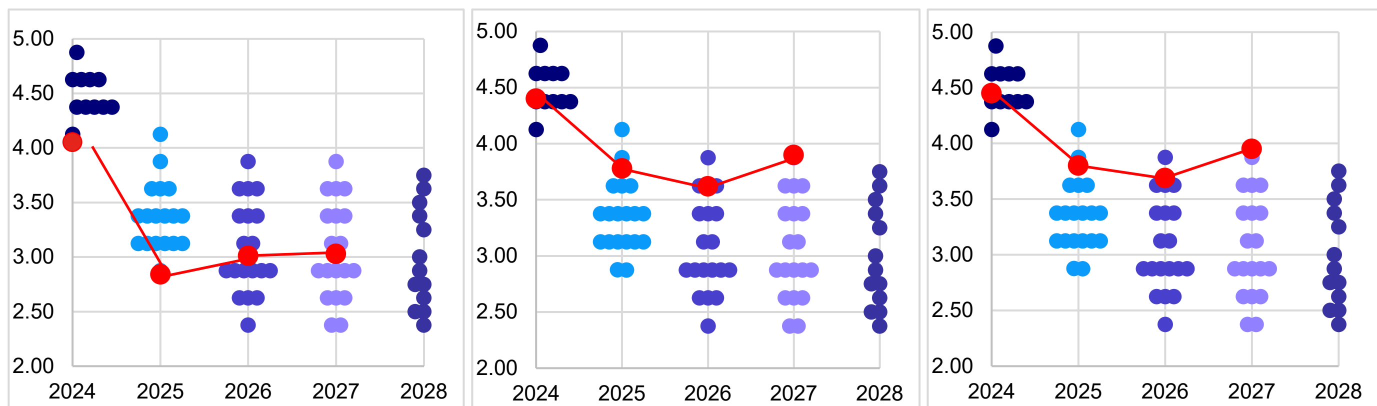
US term premium is lower than Australia's, despite much higher debt and deficits, 10-year government bond, %



Note: Term premium is the excess yield required to extend duration instead of rolling over short-term debt.
Source: Reserve Bank of Australia, NY Federal Reserve, Macrobond, Invesco. Daily data to 07 October 2024.

We worry that cross-asset class risks lurk in potentially inflationary policies (e.g., immigration curbs) may be triggered by Trump's periodic attacks on the Fed. Market pricing has repriced for tighter Fed policy since the election, and this could exacerbate market volatility should Trump really lash out at the Fed. We believe the markets expertise of key nominees like Bessent for Treasury and Congress's support of the Fed in Trump's first term will contain these risks.

The Fed Funds path before, during and after the election: Repriced for tighter policy than the FOMC expects, %



Note: Red – Fed Fund futures-based market pricing for policy path to the last FOMC meetings of 2024-26, and January 2027. Color dots, FOMC members' Fed Funds forecasts for each year-end, as per the 18 September 2024 Summary of Economic Projections. Source: CME Group FedWatch tool, Invesco. Market data for 18 September, and 7 and 22 November 2024, all as at 22 November 2024.

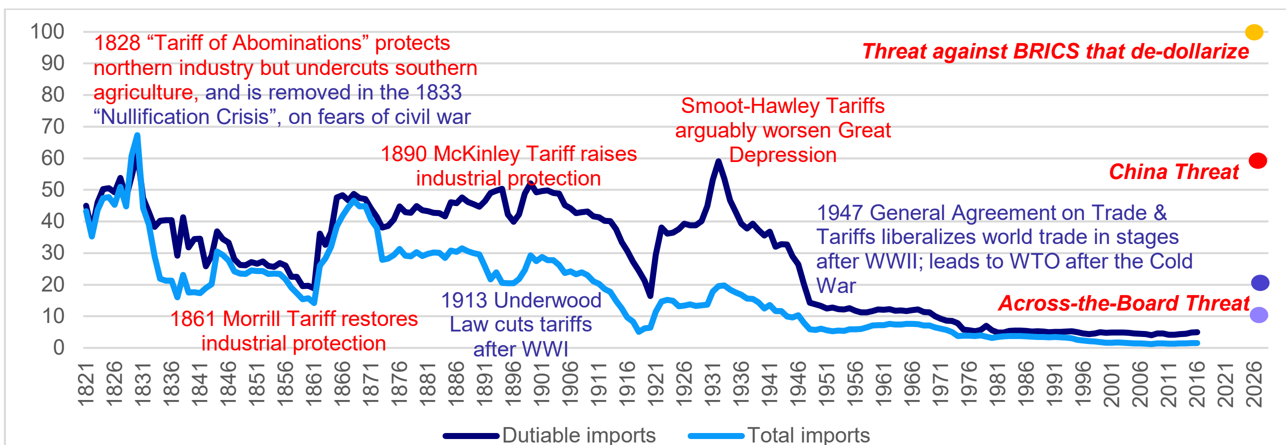
6. Foreign Economic Policy: Trade Barriers and Trade Deficits

We expect Team Trump to follow a long tradition of US economic and financial statecraft with current geopolitical and technological twists. Large US trade deficits and the sharp deterioration in the US Net International Investment Position are becoming major geoeconomic issues with geopolitical overtones. We believe Trump will use tariffs as leverage to increase market access and cooperation on defense funding, immigration restrictions and the war on drugs and fentanyl when it comes to allies, partners and friends; but will aim to reduce US reliance on China.

Protectionism may be Trump's longest, most-deeply held policy conviction: In 1986, he placed a full-page NY Times ad calling for tariffs against Japan. Plans to tariff allies and adversaries alike have raised fears of inflation or stagflation via both final goods and supply chains; worries about effects on corporate pricing power and productivity; other plans to boost investment, sustain consumer purchasing power and cut taxes all point to stronger domestic demand and hence wider trade and current account deficits. How these contradictions are resolved, or at least how trade-offs are managed, could make a major difference across asset classes and economies.

Trump's tariff threats in historical context: US average tariffs were among the lowest of major economies and the lowest in US history before Trump's first term. Even now, many specific tariffs have been raised, yet overall tariffs are below historical highs. Trump's threats to raise across the board tariffs for all trading partners, and sharply for China in particular would likely still leave overall tariff levels below those in the most protectionist episodes in US history.

Trump's tariff threats: Extreme by modern standards but not necessarily relative to US history, %



Source: Federal Reserve Economic Database, St. Louis Fed, Invesco. Annual data to 2016, latest available as at 6 December 2024

Tariffs and Inflation? We doubt that tariff hikes by themselves will have much direct inflation effect. Raising tariffs without reducing trade with quotas or outright regulatory bans (e.g., as with sensitive, "dual-use" or "civ-mil" items) would raise the price of tariffed goods relative to substitutes or other goods. Plus, the dollar would rise against currencies of tariffed trade partners. All these shifts would reduce the impact of tariffs on inflation, especially if the tariffs were imposed all at once or in a few steps, as seems to have happened with tariffs in Trump's first term.

A more conventional inflation risk could rise if tariffs were ratcheted up periodically, affecting both the supply side and final goods, especially if demand were running strong, and more so if other policies were expansionary (e.g., deregulation or unfunded tax cuts). We would expect the Fed to hold monetary policy tighter than otherwise in such a scenario but look through the effect of one-off tariff hikes as a price-level effect, as some Fed officials have indicated.

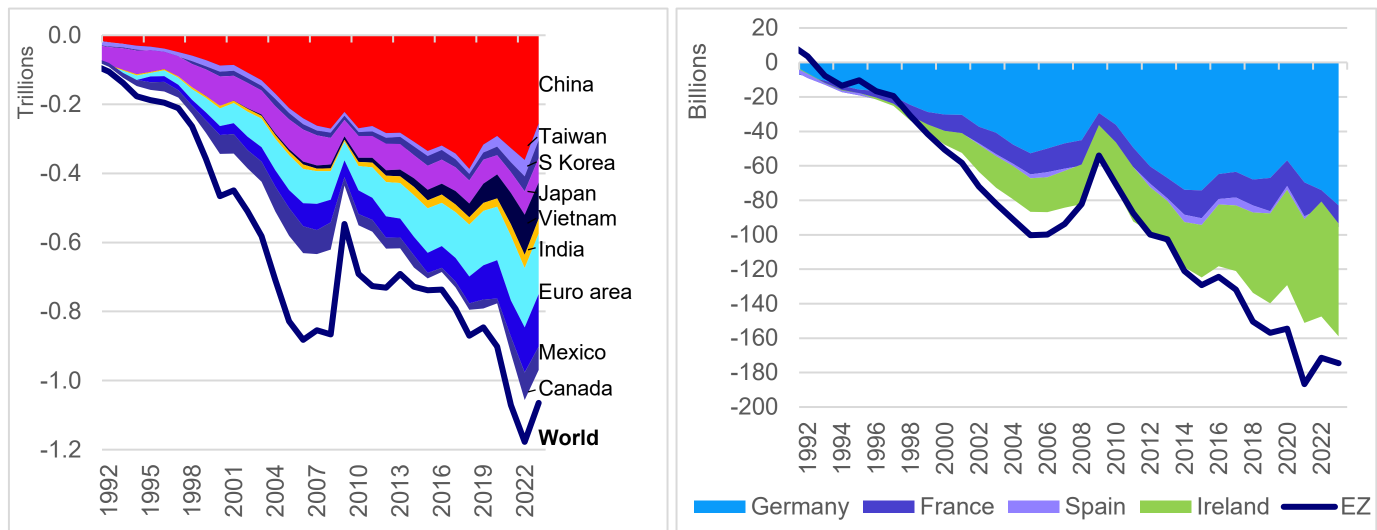
Protectionism and Productivity: "American Exceptionalism" poised to persist? Originally used to convey the idea of a unique society founded on ideals of equality and freedom (especially of expression and enterprise, not nationality or religion), US exceptionalism has come to connote economic and financial market outperformance. These two concepts are arguably complementary: The US is the one major economy to reach and redefine the technological frontier with highly profitable corporates even in long periods of heavy protectionism, we think due to uniquely intense domestic competition despite protection against foreign competition. Trump aims in our view to restore this vision of dynamic US capitalism behind high trade barriers, rejecting Bidenomics by abandoning industrial policy and subsidies in favor of deregulation.

Today, China may be pursuing similar ideas with great success in high-tech manufacturing, India in cutting-edge services. China relied on industrial policy throughout its rapid catch-up, most recently in picking favored sectors like solar power, EVs, semiconductors and high-tech in general, as well as subsidizing start-up firms. But beyond that, it has also generated fierce competition in so-called sandboxes. Most other major economies have relied on competition in global markets for technological, managerial and process innovation and competitiveness. India for its part tightly regulated industry but was hands off on services, particularly in new technology and business service

sectors, such as software, business process outsourcing and more recently, medical tourism and AI and other new generation programming – all sectors that have taken off. In stark contrast, most historical European and emerging market performance with protectionism and industrial policies has been poor. Pending major changes, including deregulation and a more generally supportive environment for investment and employment, and for new sectors in Europe and EMs beyond China and India, we would expect investors to remain skeptical of macro and corporate performance prospects despite attractive valuations, vs. the US (and perhaps India).

US Trade Grievances: The US is by far the world's largest continuous deficit country. Some others also run trade deficits continuously – the UK, India, Brazil, Turkey, Australia, etc. But these economies or their deficits are relatively small. On the flip side of the coin are several continuous surplus countries, including the EZ, Japan, China, South Korea, Russia and others – all split across US allies and partners, and adversaries. Team Trump argues that contrary to standard economic and market views, these deficits reflect unfair trade: The US is much more open to exports than trading partners' markets are to US exports. Thus, the US has no chance of moving to balanced trade in line with the original theories of free trade, in which both trading partners become better off by exchanging goods or services with each other, and as a result the US is confined to exporting commodities and exchanging financial assets for manufactured goods (about which, more below) at the expense of investment and jobs in the US itself.

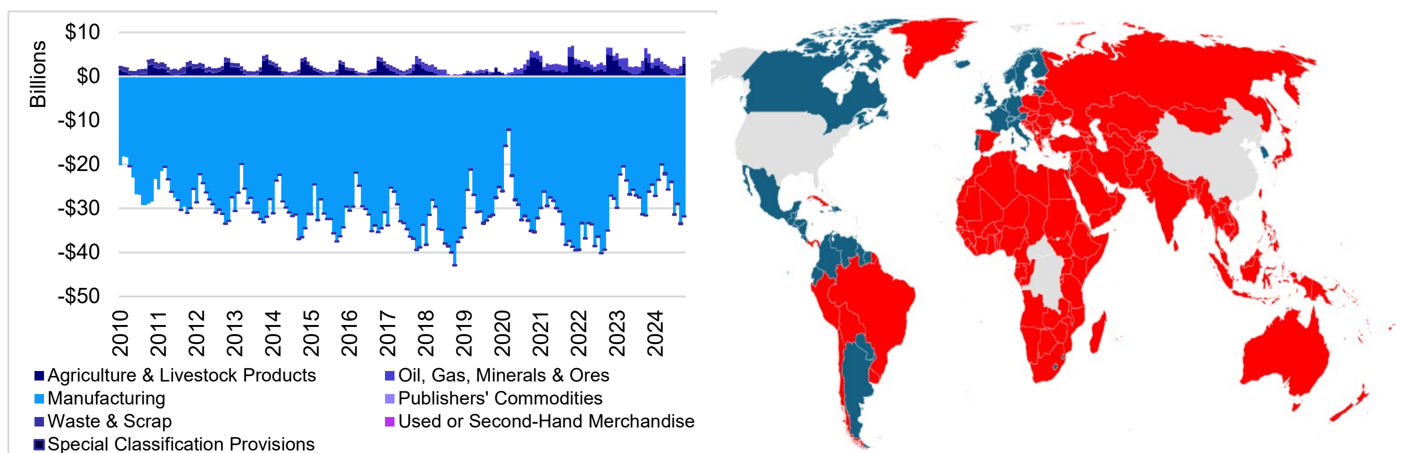
Largest US trade deficits – China, the EZ, Mexico; largest EZ deficits – Germany, Ireland, current US dollars



Source: US Bureau of Labor Statistics, Macrobond, Invesco. Monthly data to October 2024, as at 15 December 2024.

The US China Syndrome: Since China's 2001 accession to the WTO, US-China bilateral trade has become lopsided. The US exports mainly primary commodities to China, in exchange for manufactures, with a massive deficit. China has replaced the US as the dominant trading partner of most countries outside Europe and North and Central America, even as the US remains the most important security partner in the Mid-East and much of Asia.

US exports commodities, imports goods from China, the dominant trading partner for most countries (right)



Note: Right – red, countries whose total trade with China exceeds that with the US in 2023; others, blue. Source: U.S. Census Bureau, China National Bureau of Statistics, Macrobond, Invesco. Left, monthly data, billions of current USD. All latest available, as at 19 December 2024.

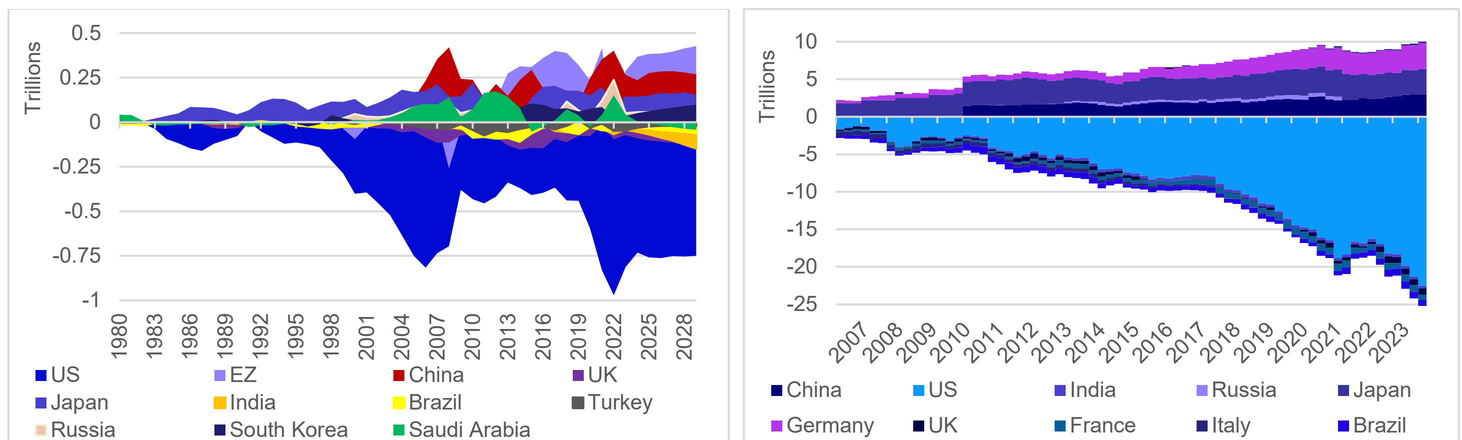
Continuous US External Deficits and the Collapsing NIIP: US trade and current account deficits persisted for decades, yet the US Net International Investment Position – the stock of US assets held by non-residents – was slightly negative but remarkably stable until the GFC. How could large, growing and persistent deficits fail to translate into rising obligations to the rest of the world? The standard explanation for this conundrum was that US claims on trade/investment partners tended to perform better than its partners' claims on the US. This was largely because the

latter were mainly fixed-income claims (Treasuries, Mortgage-Backed Securities, and Investment Grade). In contrast, US claims on other countries were more equity-like direct investments by corporates with higher income, dividends etc., that boosted the value of US foreign assets.

While we tend to agree with this standard explanation of past performance, our view of what has changed to account for the recent collapse in the US NIIP speaks to Team Trump's frustration with trading partners. Since the GFC and the Eurozone Crisis, the US appears to have become a bit of a victim of its own success. Its outperformance in growth, in per capita GDP and productivity gains have all translated into dramatic equity outperformance, not least because of the role of US tech giants in the Fourth Industrial Revolution while US external financing has shifted from fixed-income, including dollar reserve purchases by central banks, to private-sector buying of US stocks.

Team Trump, however, worries that this success will turn into failure on a massive, national scale: On current trends, US industry in general, including the defence-industrial base, will continue to be hollowed out. Domestic assets and their income will keep being sold to surplus countries because of a lack of market access for US exporters, not just because of superior US economic and financial performance. Inequality will continue to rise, as will existential risks to national security. China in particular is already the world's largest economy on a PPP basis. As an industrial producer, China outranks the 10 next largest industrial producers *combined*. If rivalry were ever to come to conflict, it is already unclear if the US and allies could win, but the further this goes, the greater the risk of defeat.

US current account deficits now translate into a collapsing Net International Investment Position, current USD



Note: Current US Dollars.
Source: IMF, Macrobond, Invesco. Annual data to 2023 and IMF WEO forecasts to 2028; all as at 25 October 2024.

Retaliation vs. Negotiation: We believe the various facets of US relationships will prevent a generalized trade war, though some retaliation against US tariffs seems very likely, especially by China. We see no substitute for the US as an export market. The other major, persistent deficit economies – UK, India, Brazil and Turkey, etc. – are not large enough to absorb global export surpluses, if the US were to become truly isolationist. What's more, China aside, most major surplus countries are US treaty allies or friends, so seem likely to negotiate, as Japan did in the 1980s.

Over time, we would expect "like-minded" countries, in a phrase from the Biden era, ideologically similar democracies, to eventually cooperate with the US on trade, as on defense spending. We don't expect renewed trade liberalization, but rather increased purchases of US exports, including military equipment and commodities.

That said, Trump may widen his trade war using high, across-the-board tariffs on China. High direct tariffs along with plans to stop China's indirect exports to the US via third countries in which its firms set up plants (e.g., Mexico, Vietnam) may push Chinese exports into other countries. Their sheer size and low cost (which the US and EU allege is subsidized) could impose severe competitive, even existential pressure in industries they need to sustain for political or national security reasons (i.e., for substantial onshore industrial capacity in case of trade disruption).

Other countries may already be following the US in imposing trade restrictions on China. A key side effect of Biden's 100% China EV tariff might be to divert exports to the EU, overwhelming its auto sector. The EU complained about protectionist US industrial policy but imposed its own EV tariffs on China, albeit significantly lower than the US tariffs. Brazil also put tariffs on steel from China, following the US. India has also raised tariffs and other trade/investment restrictions on China, reflecting border tensions that persist despite recent improvements in relations.

Geopolitical trading blocs may thus be forming already. The US may focus on North America, Europe, Japan, South Korea, India, etc., China more on the Mid-East, Latin America, Africa. Still, we do not expect economic fragmentation on China-US lines because other governments will likely try to avoid picking sides. On one hand, access to US export markets and financial markets, and security partnerships remains crucial for many countries. On the other hand, China's importance as a trading partner for many countries, including those closer to the US, is likely to keep many doors open. As a result, China and the US may have little choice but to compete for influence across the world. Yet such issues suggest that trade and investment is become more geopolitical than macro or cyclically driven. And that in our view calls for active country and sector selection instead of a buy- or sell-the-market investment style.

7. Geopolitics; Geoeconomics; Balance of Power; Market Access

We believe Trump and team will aggressively exploit linkages among national security, geopolitics, geoeconomics and cross-border economic issues – immigration, trade and foreign investment to push an America First agenda. US policymakers used to compartmentalize these issues in the pursuit of free trade, open financial markets, democracy and nation-building. But with Team Trump focused on "Make America Great Again", pressure to raise global defence spending will keep rising across major the world in our view, led by Europe, India and China, with the US revamping and modernizing. National defence industries and tech sectors are likely to benefit, amid stronger, sustained fiscal pressure in bond markets, given other, inescapable demands on fiscal budgets and private funds, including spending for demographic needs, climate change, infrastructure, technology, etc.

Trump seems to be using the transition to nominate personnel to send policy signals and to message a hardening of his negotiating stance, whether it's the threat of tariffs on USMCA partners Mexico and Canada; insistence on direct bilateral quid-pro-quo exchanges to rebalance the EU-US bilateral trade surplus; but also to signal geopolitical linkages, such as upping the share of GDP NATO members should contribute in defense spending.

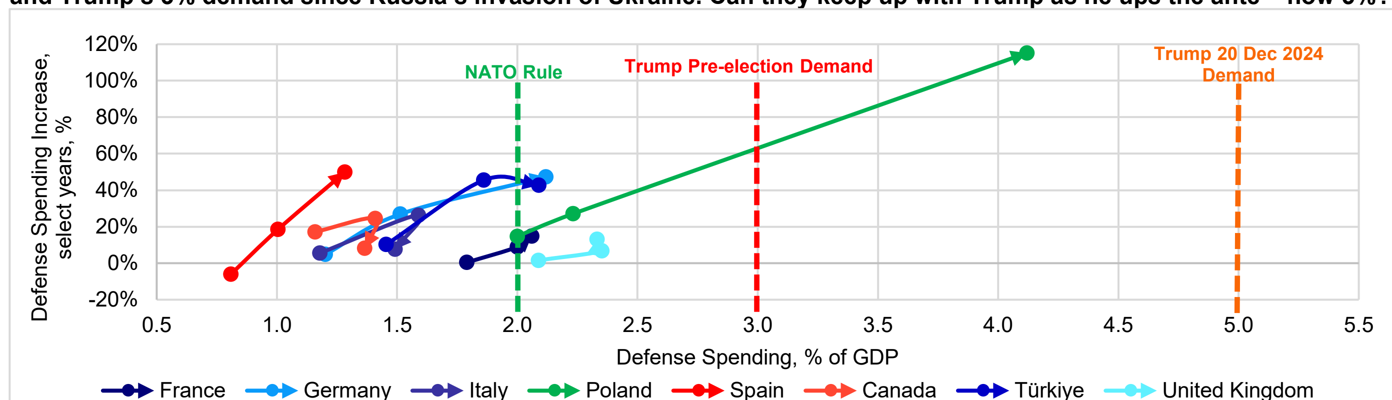
This hardline stance may even be working in some sense with allies and protectorates in Europe. No doubt there is resentment and plans for retaliation are being laid. But Canada, Mexico and to some extent Europe have already signaled willingness to re-engage and negotiate in perhaps more directly, quickly and effectively than in the first Trump term. Yet with China in particular, possibly other great powers that are not beholden to the US for security guarantees, retaliation may be preferred to negotiation – especially if extra-high, across-the-board tariffs are in fact imposed on China (given existential risks to domestic industries posed by China's export capacity, discussed above).

We believe Trump's aggressive demands that other NATO members as well as allies in Asia step up their defence spend will continue to be met by some success, yet demands that partners do even more of the heavy lifting may continue rising. Trump had raised the stakes during the campaign, suggesting that NATO member defense spending should rise to 3% of GDP. On 20 December 2024, he upped the ante further, signaling that the ask would rise to 5% of GDP. VP-Elect JD Vance had offered an estimate of US$8.6tn as the cumulative shortfall in NATO partner defense contributions relative to the historical 2% of GDP agreement; this represents an implicit taxation without representation on the US voter, which allows Europe to finance larger, more generous welfare states than it could otherwise afford. In effect, US citizens, lacking an EU-style welfare state at home are in effect indirectly funding one in Europe.

One can debate the merit of this backlash – after all, Europe might choose such a welfare state and continue to finance one itself with or without US-dominated collective security. But the backlash has been decades in the making: President Kennedy was the first to charge Europe over its lack of financial contribution to its own security – a complaint repeated by most presidents since, with the key difference that Trump was first to try to capitalize on it in domestic politics. And between Russia's Ukraine War and Trump's weaponization of NATO and trade as geopolitical leverage, it does seem to be working.

We would hope that stronger contributions to their own national security and defense by some of the highest-income countries in the world, including Western Europe, South Korea and Japan will help maintain a relatively open trading relationship with the US; as well as support the US's willingness and capacity to maintain its extensive network of military bases, helping to preserve world peace, freedom of navigation and thereby keeping the world economy functioning relatively well, despite aggressively unilateralist national security, trade, investment and immigration policies.

Some, not all EU NATO members, are raising general defense and equipment spending toward NATO's 2% of GDP target and Trump's 3% demand since Russia's invasion of Ukraine. Can they keep up with Trump as he ups the ante – now 5%?



Note: Change in ratio of defence spending to GDP (y-axis) vs. total defence spending share in GDP; dot 1, 2016 vs. 2014 (year Russia annexed Crimea); 2, 2020 change from 2016; and 3, arrowhead, expected 2024 vs. 2020. Source: NATO, Invesco. Annual data as at 20 December 2024.

8. Portfolio Diversification in America-First Global Equity Markets

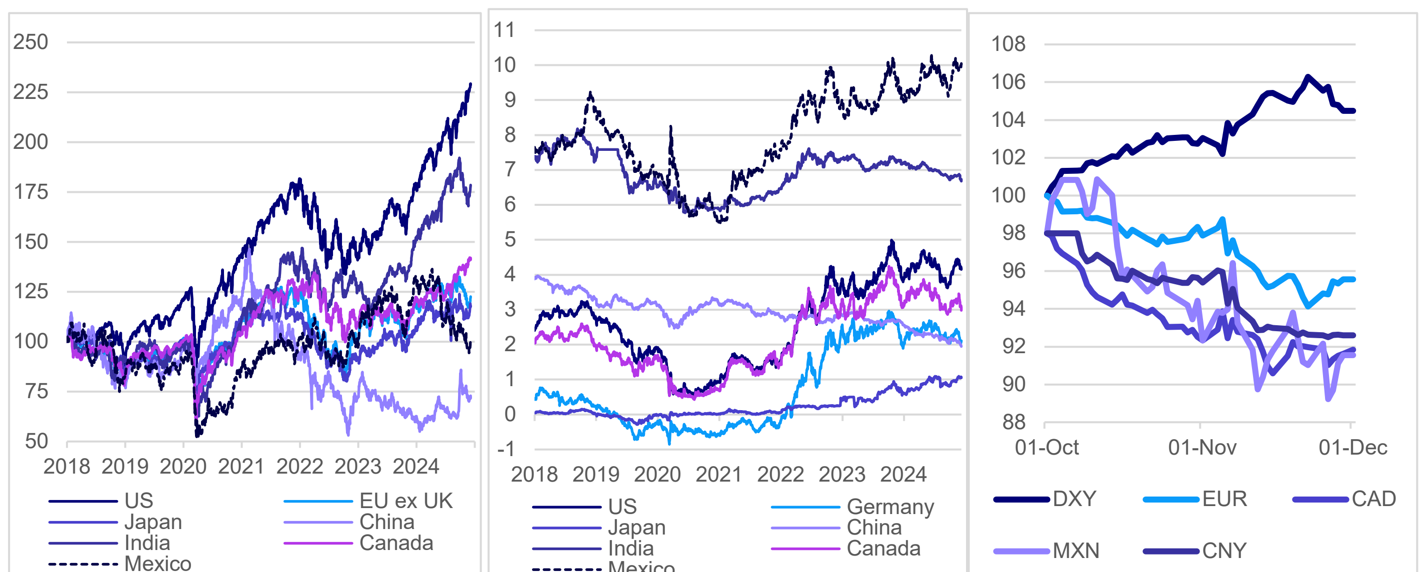
We expect the main channel for the direct transmission of Trump policies to global markets, especially global equities, to be threats or actual effect of high tariffs, potentially across-the-board of all imports, applied to all US trading partners, but singling out China for higher tariffs than the rest of the world. The main policy levers likely to directly affect US equity markets in addition to the tariffs themselves, would be immigration restrictions and deregulation. The raft of policy pledges, spanning tax cuts, immigration curbs and mass deportations, institutional reform and downsizing of the federal government, and heavy oil extraction – are likely to have somewhat offsetting or contradictory effects – including effects that are negative for growth, inflation and in order of importance to Trump, equity and bond markets, and the dollar.

Given the difficulty of radical reform with a narrow margin of Republican Party control in Congress, we expect the reality to be more measured than the domestic policy rhetoric, probably leaning on deemphasizing existing legislation on regulation. Given domestic constraints, Trump may be more aggressive on foreign economic policy, especially tariffs and immigration. Yet we also expect Trump to be somewhat constrained and guided by stock and bond markets as a metric of the economic impact of actual policy decisions. On this basis, we expect a stronger dollar and significant differentiation across global financial markets, even as the US outperforms other countries, based on the experience of the Trump's first trade war.

With this backdrop, we think investors would be well served by pursuing active country selection based on policy responses to what we expect to be America-First unilateralism, somewhat constrained by the performance of US markets with divergent sector- and country-index performance. Current views on select global equity markets:

- ***The US will probably continue to outperform despite the rich valuations of both US equities and the dollar. Much of the world, like us, probably sees no alternative to continued economic and security cooperation with the US.***
- ***Mexico, Canada, Europe will tend to cooperate and negotiate, though there may well be some retaliation, which should put a floor under their currencies and stocks, but the uncertainties are likely to promote volatility in Mexico perhaps more than Canada, where the possible election of a pro-Trump populist might help improve relations;***
- ***India is probably relatively well hedged despite its services surplus with the US, given its role as a counterweight to China – though this benefit is partly offset by cyclical economic slowdown and rich equity valuations;***
- ***Japan and South Korea are likely to cooperate for defense reasons, likely offering concessions on trade and defense contributions. Yet South Korea's recent impeachment of a pro-US/Japan president for trying to impose martial law may lead to a left-leaning government conciliatory to China and North Korea, which could undermine relations with the US and the Quad (US, Japan, Australia and India). Japan seems likely to outperform Korea.***
- ***China seems likely to retaliate, offsetting damage to growth with stimulus, making low valuations more appealing.***

Since Trump's First Trade War: Tariffed country equities underperformed (right); bond yields fell, implying lower growth (middle, %). Now, currencies have fallen vs. the US dollar as markets priced in a Trump victory (left),



Note: Left, MSCI in USD terms as currency movements reflect shifts in the terms of trade driven by changes in tariffs. Middle, 10-year government bond yields; in the absence of a benchmark common bond for the EU (ex UK); German Bunds as a proxy. Right, index of bilateral currency crosses against the USD, 01 October 2024 = 100; currencies whose quoting convention has a higher number for a weaker currency are shown with index values reversed. Source: Bloomberg, Macrobond, Invesco. Right daily 01 Oct to 01 Dec 2024; rest, daily data from 01 Jan 2018, as at 6 Dec 2024.

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Abbreviations:

EZ - Eurozone

DM – Developed Markets

EM – Emerging Markets

GFC – Global Financial Crisis

Risk Warnings

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