

The Two faces of American Exceptionalism

Executive Summary

- In the 1990s, the United States' openness to immigration and financial deregulation facilitated the extension of its neoliberal model that had been revitalised a decade earlier. The ensuing surge in demand and productivity has since been the driving force behind its sustained economic performance.
- However, the dynamics of this model are inherently divergent. Maintaining the confidence necessary for its functioning increases its reliance on financial markets. While the American model remains superior, it simultaneously nurtures imbalances that may occasionally precipitate disruptions.
- Confidence in the US economy remains robust and the outlook for productivity growth and real wage gains should support output expansion in the coming year. The new administration, with its ambitious agenda, should be pragmatic enough to leverage these strengths.
- The financial markets generally align with this optimistic outlook, though their conclusions are inconsistent. The US dollar, interest rates, and equities cannot all appreciate simultaneously. Depending on the policy priorities of the Trump administration and the resulting reactions of trading partners, at least one of these asset classes will need to adjust.
- In contrast to the past four years, imbalances are becoming prevalent as key growth drivers lose momentum:
 - Very tight valuations and concentrated investor positioning are affecting the resilience of the US equity market, leaving it more vulnerable to shocks.
 - Key economic drivers such as government expenditure, the spending of post-COVID savings, immigration, and falling inflation are gradually fading. Moreover, the Federal Reserve may face constraints in its capacity to steer monetary policy due to resilient inflation, leaving fewer sources of support in the event of an economic shock.
 - The ambitious and occasionally risky nature of the new administration's policy agenda increases uncertainty, heightening the risk of missteps, secondary effects, and negative reactions from trading partners. This raises the likelihood of financial market surprises.
- The risk of a shock, along with the likelihood of a broader impact, are rising. Should investor optimism persist, the probability of a market correction will become material, especially given the market's high sensitivity to financial conditions.

From economic liberalism to interventionism

The 1970s in the United States were characterised by erratic economic growth and rampant inflation, which stifled business investment and eroded household confidence. Periods of robust expansion were followed by recessions, exacting significant economic and social costs.

By the early 1980s, like many developed nations, the US adopted a revised economic model under the Reagan administration. This era was marked by economic liberalisation and price stabilisation. The aggressive monetary policy of Federal Reserve Chairman Paul Volcker subdued inflation at the cost of double-digit interest rates and a third recession in 10 years. Following three years of monetary warfare, inflation dropped below 3% by 1982, providing the foundation for enduring price stability. This newfound stability encouraged investment and enabled households to rebuild savings, which became critical to the economy's resilience. Deregulation further stimulated business activity, while tax cuts bolstered consumer demand. A virtuous cycle emerged: rising demand fuelled corporate profits, enabling wage growth which further sustained consumption. The result was a return to stronger, more resilient economic growth.

A decade later, the United States extended along this model by embracing further deregulation and immigration reforms. The Immigration Act of 1990 facilitated the influx of labour, fostering demand, competitiveness, and innovation. Talent drawn by the thriving economy enhanced productivity and technological progress. Meanwhile, deepening capital markets enabled businesses to secure financing more efficiently, fuelling innovation and allowing the US to outpace foreign competitors (chart 1). Households also benefited from expanded financial opportunities, finding ways to optimise returns on their growing savings while supporting the economy. Added to the first, this second virtuous cycle of market dynamics further amplified growth (chart 2). By the 1990s, the US economy consistently outperformed its developed peers, establishing itself as a model of dynamism and flexibility.

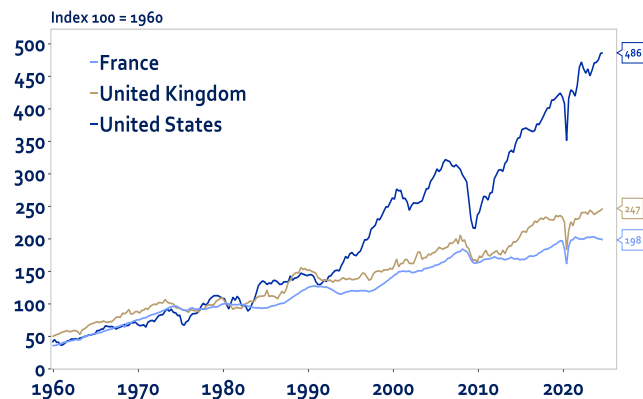


Chart 1: fixed capital expenditure
Sources: H2O AM & Macrobond, Q3 2024



Chart 2: double demand loop
Sources: H2O AM, November 2024

However, the model has a significant flaw: it is divergent. Both households and corporations are incentivised to take on more debt to fully benefit from it to the point of destabilising the structure. By 1999, household debt soared as Americans speculated on rising asset prices, while some companies resorted to financial misreporting to satisfy shareholder expectations. This instability culminated in a recession two years later, mitigated only by the joint intervention of the Federal Reserve (400-basis-point rate cut) and government (property market liberalisation). The cycle repeated in 2008. Banks, emboldened by prior interventions, over-leveraged and amplified systemic risks, compounding the economic downturn triggered by surging energy prices. Massive government and central bank interventions were required to restore stability and confidence in the system. While Europe has opted for more regulated economic frameworks, accepting lower growth in exchange for greater stability, the US remains committed to preserving confidence in its neoliberal model at all costs. This strategy necessitates increasingly frequent and expansive interventionism, which, while sustaining the system, also heightens its fragility.

The trajectory of the past years highlights the latest chapter of this American exceptionalism. Like other nations, the US responded aggressively to the COVID-19 crisis with liquidity injections, tax relief, and rate cuts. However, unlike others, the US sustained these measures well beyond the crisis, using extensive fiscal stimulus to maintain confidence and fuel demand. Households, supported financially during a period of rising interest rates, regained confidence. They drew on excess savings accumulated during COVID and invested in markets, driving remarkable market performance and sustaining economic optimism. This cycle of spending, investing, and renewed confidence has underscored the United States' exceptionally strong growth over the past two years (chart 3).

Today, the model's dependence on financial markets has reached precarious levels. Nearly three-quarters of US economic growth hinges on consumer spending. Additionally, 42% of American financial wealth is tied to highly valued equity markets, and foreign investors hold unprecedented amounts of US assets. Investment by key trading partners is also accelerating (chart 4). These factors are all underpinned by confidence in the US economic model, a confidence increasingly threatened by surging debt and the extreme valuations of equity markets. An important market correction would inevitably have far-reaching repercussions on the economy.

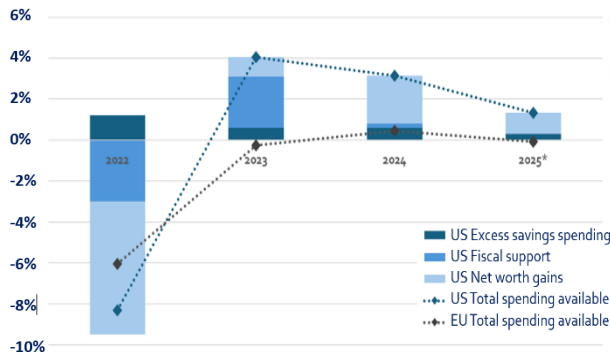


Chart 3: Exogenous support for the economy (% of GDP)
Sources: IMF, July 2024

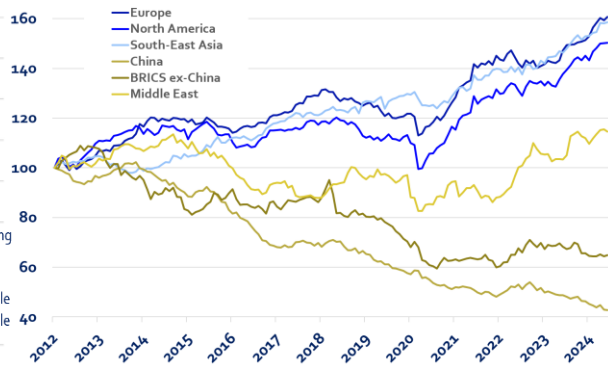


Chart 4: Financial flows to the US, net of market effect
Sources: H2O AM & Bloomberg, November 2024

Remaining pragmatic...

At first glance, the US economy is approaching 2025 under the best possible conditions. The initial context is sound: low unemployment, low private sector debt, and absence of significant imbalances in corporate balance sheets or markets. Additionally, the momentum is positive: consumer confidence is at its highest and real wages are rising given the recent decline in inflation (chart 5). This outlook gives grounds for optimism: productivity gains thanks to artificial intelligence (chart 6), and innovation thanks to the deregulation envisaged by the Trump administration.

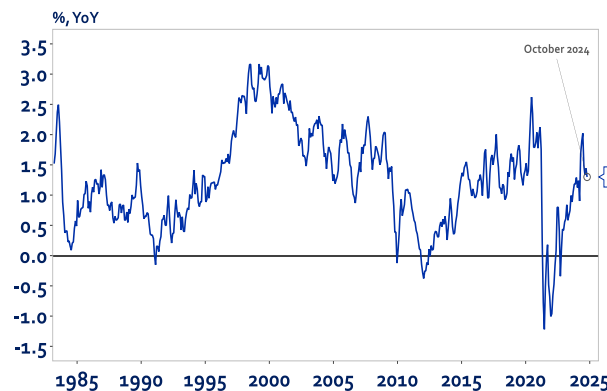


Chart 5: US Real Wages (year-on-year)
Sources: H2O AM & Macrobond, October 2024

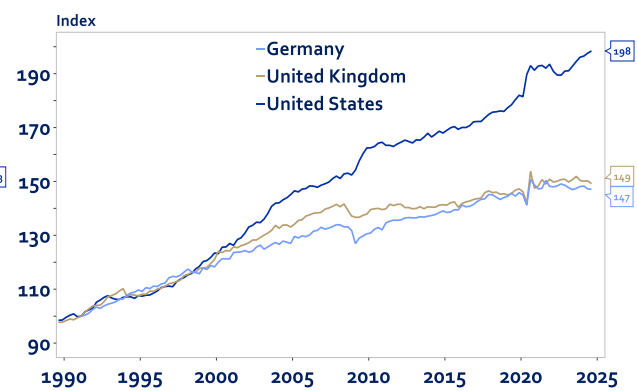


Chart 6: Productivity in the US and EU (Output per Hour)
Sources: H2O AM & Macrobond, Q3 2024

The Trump 2.0 programme is ambitious and sometimes unorthodox. If fully implemented, it could induce significant disruptions. But there are reasons to believe that the new administration will exercise pragmatism, drawing from the experience of the first mandate. There is no point in imposing higher tariffs if the opposing side devalues its currency, as China did previously. Likewise, deporting migrants would have a major recessionary impact and run the risk of triggering inflation, in direct contradiction with stated ambitions. Stimulating consumption and innovation without curbing spending would exacerbate the debt burden, with the risk of higher long-term interest rates and their impact on the housing market. After the announcement effect, the new administration will likely prove more moderate and should, at the margin, support growth over the next two years.

In Europe, any adverse effects from potential tariff hikes should be offset by the delayed but significant rise in real wages and the rebound in manufacturing aided by the recent euro depreciation. China will continue to slowdown, impacted by the US economic programme, but its strong competitiveness and government support should help to absorb the pressure. Besides, the country's weaker links with the global economy should mitigate risks of material contagion. Finally, after a lost generation, Japan has relaunched the virtuous circle of domestic demand, which ought to persist for the foreseeable future.

Geopolitically, the focus appears to be shifting toward resolving conflicts, both in the Middle East and Ukraine, while concentrating on domestic political challenges. **In this context, our 2025 central scenario is an extension of last year's, and remains one of positive but moderate growth, led by the United States.**

... in the face of contradictions

This constructive yet cautious outlook contrasts with the market's upbeat expectations, which appear overly optimistic and based on the unlikely premise of a smooth continuation of American exceptionalism. But the concept of "Making America Great Again", with its implied rise in the US dollar, equities, and interest rates, is increasingly hazardous. Such expectations are fundamentally inconsistent with the new administration's programme.

- If the emphasis were placed on tariffs targeted at China, and the latter responded by devaluing its currency as it did in 2018-2019, there would be no rise in consumer prices, and any gain in American competitiveness would be neutralised. While the US dollar would remain strong in this context, interest rates would likely decline. Alternatively, if the US took steps to prevent a devaluation of the yuan, perhaps by threatening further tariffs, interest rates would stay elevated for longer, but the US dollar would have to depreciate.
- If instead the focus were placed on deregulation and increased spending to drive innovation, equities would continue to perform, but long-term rates would come under pressure as the debt burden worsens. The steepening of the US yield curve by more than 70 basis points this past summer suggests that the market is already on alert.
- Finally, if the emphasis were placed on immigration and/or government spending, as publicised in the media and through appointment announcements, the recessionary effects would be immediate, and the three asset classes would head South.

Interest rates are already discounting the inflationary impact of higher tariffs; the US dollar is already factoring in a less accommodating Fed policy and an unfailing appetite for US assets; while equities are already pricing in major cuts in regulation and taxes. **Yet, none of these factors considers the risks for policy missteps, side-effects, and potential reactions from trading partners and adversaries.**

Besides, history offers a cautionary tale: after the euphoria surrounding the 2016 election, markets corrected sharply over the next two years, first with the US dollar and interest rates in 2017, then with equities in 2018, once the inherent unpredictability of Trump's economic programme became clear.

From market instability to the real economy

Unlike in recent years, downside risks are beginning to emerge around our scenario.

First, the trajectory of risky assets is becoming less linear. Current valuation levels, while not yet extreme, leave little margin for error (chart 7). The exposure of the most active but also least stable investors, such as hedge funds, asset managers, and households, is notably high, encouraged by low volatility and strong performances (chart 8). Historically, whenever these levels have been surpassed, corrections proved swift and severe. Additionally, asset allocators, whose positions are less visible and harder to measure, also hold elevated levels of such assets, driven by the complacency of their risk models. Over the past two years, exceptionally low volatility and correlations have incentivised investors to maintain allocation exposures well above historical averages. Even more concerning, these increasingly standardised models are promoting a heavy overweight over US assets, which have recently delivered superior returns: the divergence of the US model also extends to asset allocation.

The experience of 2017, often regarded as the most complacent year on record, is instructive: volatility in allocations averaged just 3%, yet the following year (2018) proved disastrous for equities, despite solid economic fundamentals and robust growth. Today's equity market, characterised by tight valuations and concentrated investor positioning, is more prone to sharp corrections when a disruption occurs. The barrel is full, and the wick is short.

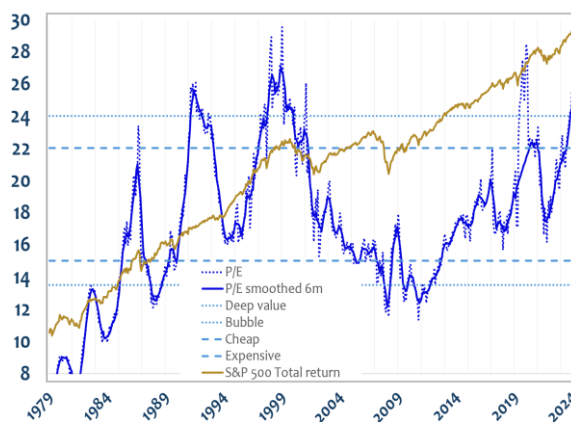


Chart 7: S&P500 Index (total excess return & P/E)
Sources: H2O AM & Bloomberg, Q3 2024

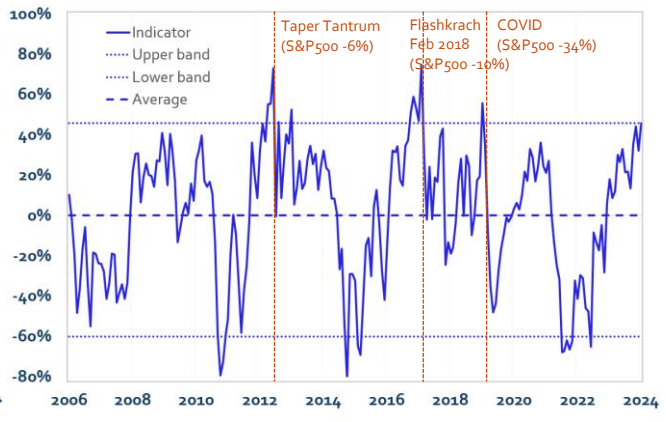


Chart 8: S&P500 Investor positioning Indicator
Sources: H2O AM & Bloomberg & CS, Q3 2024

Second, the key drivers of the economy have essentially been exhausted. Fiscal stimulus measures and excess savings have run their course. Disinflation is struggling in the last mile, with the rate of price increase stagnating at around 3%, limiting the demand potential from real wage gains. The Federal Reserve may also find itself constrained in its capacity to steer monetary policy due to stickier inflation. For now, the US economy is riding on its final supports: the confidence generated by its recent performance as well as the hope of a new programme that will restore some of its momentum. However, this optimism comes with heightened risks of disappointment, as elevated expectations leave little room for error. History shows that when markets no longer feel protected, they can quickly lose steam.

Finally, the new administration's policy agenda, while ambitious, remains arguably vague and occasionally risky. This increases the likelihood of unintended consequences and adverse reactions from trading partners or the central bank. At present, equity markets and consumers are focusing almost exclusively on the programme's upsides, while downplaying the uncertainty and potential negative repercussions for US assets. Given the narrow margin for mistakes, this overly optimistic narrative could unravel at the first signs of surprise or even simple misinterpretation, potentially disrupting the market's current trajectory. Consequently, heightened volatility seems inevitable, and the probability of a correction in US equities exceeding 10% in 2025 is important.

However, while the ties between the economy and the market have strengthened, there is currently insufficient evidence to suggest an imminent spillover effect. If a correction were to occur swiftly from current levels, it is unlikely to trigger widespread contagion and might even present an attractive investment opportunity, reminiscent of 2018. **In fact, the prevailing euphoria for risky assets could persist for some time, dismissing potential risks. In this context, the economic cycle could extend further, or even accelerate locally over the next six months, while valuations approach bubble-like levels.**

This would inevitably deepen the connection between the economy and the market, leaving growth more vulnerable to market downturns. History offers no shortage of such episodes in the United States, most notably in 2001 and 2008. Each period of excessive optimism was followed by a recession, and the longer the euphoria, the more severe and global the downturn became (charts 9 & 10).

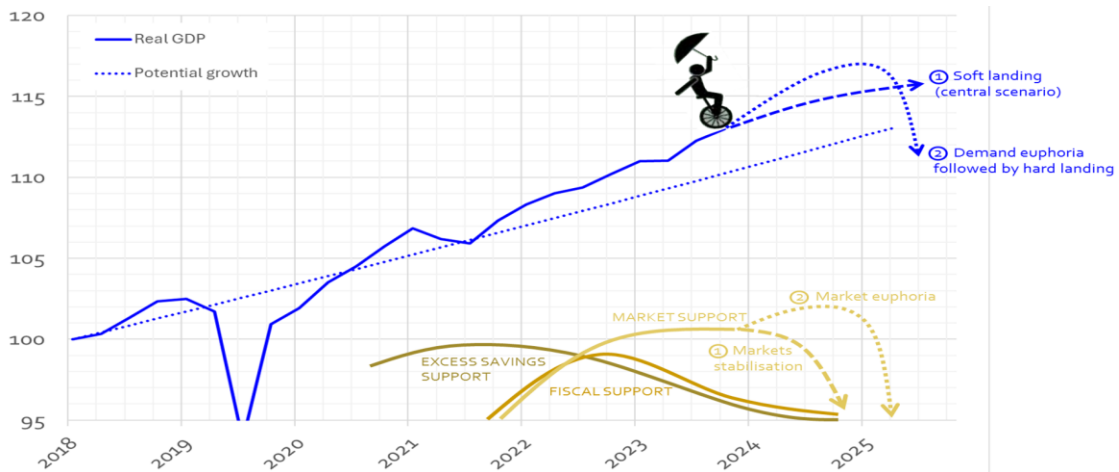


Chart 9: Possible economic trajectories for the United States
Sources: H2O AM, December 2024

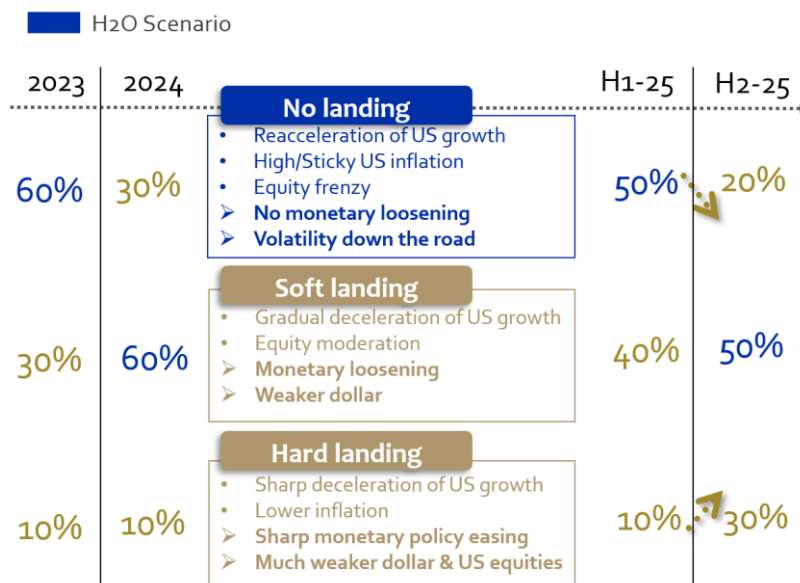


Chart 10: Evolution of the H2O AM scenario over time
Sources: H2O AM, December 2024

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