

Seismic *Month*

Insights

On the 2nd of April, at 11:04pm local time, off the eastern part of the Osumi Peninsula, located on the Southern part of the island of Kyushu, an earthquake of magnitude 6.0 occurred at a depth of 40 km. Most medias, except local Japanese newspaper, did not cover this event. Another earthquake, or more like a man-made earth-shaking moment, happened roughly at the same time, 11'700 kilometres away, precisely at the Rose Garden located along the West Wing, near the Oval Office and the Cabinet Room of the White House in Washington.

President Trump, so called Liberation Day, did not disappoint, even the most hawkish forecasters. The historical responses to this historical announcement, will continue shaking the world economy longer than the earthquake in Osumi.

Financial markets initially sold off very dramatically, the S&P500 lost more than 13% over the next 4 trading sessions following Liberation Day. Volatility, the best measure of risk, increased during these 4 days from around 22% to briefly touch above 60%. 10years US Treasury yield initially went down, touching below 3.90% at the high of the sell off, before rebounding to 4.50% roughly 1week later. 5years US High Yield credit spreads widened by almost 100bps, trading briefly close to 500bps intraday. The dollar index, even though volatility increased massively, was initially moving sideline before collapsing, which is a very unusual behaviour for the greenback to sell off during times of turmoil. Even though many forecasters burned their fingers in the past saying that "this time it is different", it really looks like "this time, it is indeed different".

Overall, it was a seismic month for markets, as the announcement of reciprocal tariffs led to a huge global selloff that was historic in its speed. That included the 5th worst two-day decline for the S&P 500 since WWII, moreover, we saw incredible volatility, including the S&P 500's best day since October 2008, and its worst day since March 2020. Meanwhile, the dollar index has posted its worst two-month performance since June 2002, whilst gold has seen its strongest start to a year since 2006.

Exactly one week after the Liberation Day announcements, the US administration, probably surprised by the magnitude of the volatility of financial assets, executed a massive U-turn and announced a 90-day suspension of additional tariffs beyond the "base" 10% tariff applicable to all countries, except for China. What followed next was a fast and furious recovery of most risky assets. The illustration of that is the S&P500, which only lost 0.75% during the Month of April. That late turnaround was partly supported by the latest tariff headlines, as US Trade Representative Greer said "we have deals that are close", suggesting that initial deals would be announced in the coming weeks. We also saw Chinese media reporting that the US government had reached out to China through various channels to initiate tariff talks, though Greer said there were no officials talks yet with China. In addition, Bloomberg reported that the EU is planning to share new trade proposals with the US next week.

The announced U.S. tariffs aimed at revitalizing domestic manufacturing in the long run could first weaken the U.S. economy and rekindle inflation, casting a shadow over the U.S. investment outlook. As trade barriers rise, longstanding partners are reconsidering their economic ties with the U.S. and contemplating alternative alliances.

With its protectionist policy pivots, the U.S. is giving investors worldwide an occasion to rethink long-held assumptions about the U.S. investment landscape. **Witness the recent parallel slides of the U.S. dollar, U.S. equities, and U.S. Treasuries, a combination more often associated with emerging market economies.** Fortunately for the U.S., most of their borrowing is happening in USD, otherwise the big picture would look a lot scarier than now.

The U.S. has long enjoyed a privileged position, with the dollar serving as the global reserve currency and Treasuries as the go-to reserve asset. **However, this status is not guaranteed.** If global capital flows into U.S. assets dwindle, it could point toward a more multipolar world with a diminished reliance on a singular reserve currency.

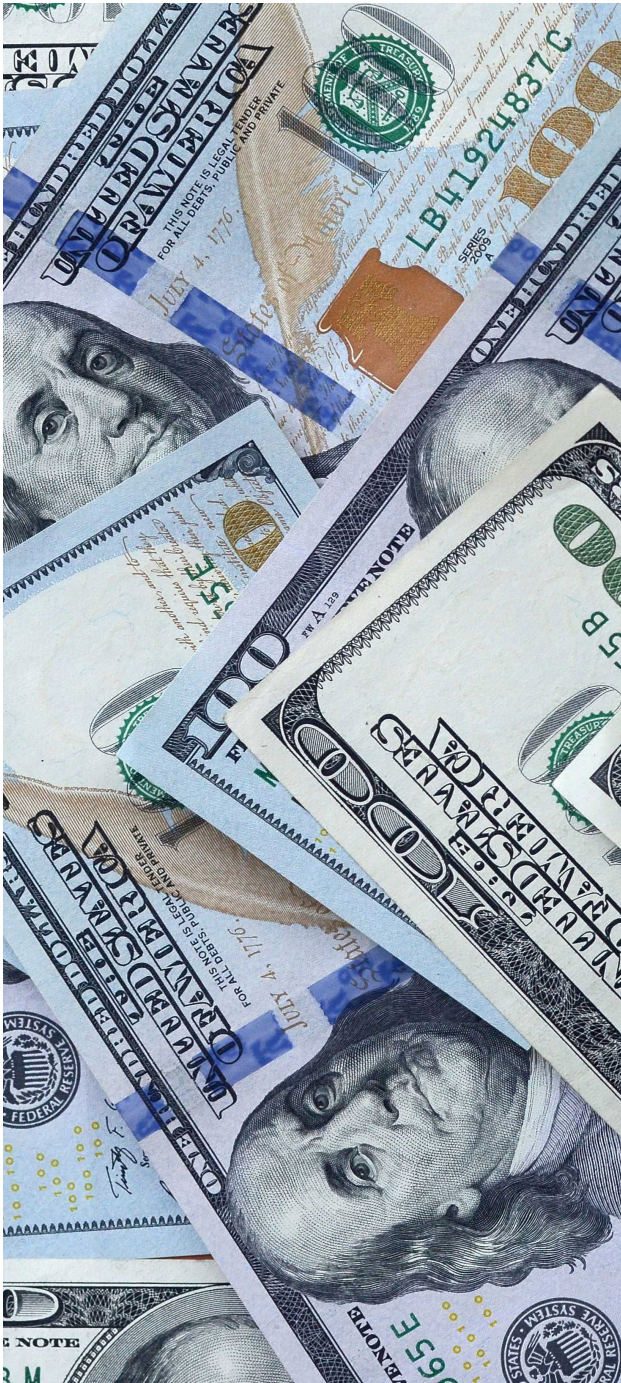


Paradigm shift

For decades, the U.S. has operated on a model of consumption, importing more than it exports. The dynamic of U.S. consumers satiating themselves on an endless supply of cheap foreign goods, and the resulting current account deficit, creates a U.S. capital account surplus.

Nations in the post-Cold-War era, including allies bolstered by NATO security assurances, have been able to prioritize savings and investment over national security spending, often funnelling dollars into American financial assets. These international capital inflows have bolstered the dollar's reserve status, a cornerstone of U.S. economic exceptionalism.

With tariffs disrupting this balance, the financing of America's twin current account and fiscal deficits may become more challenging, unless there is fiscal support, as countries pursue greater economic and military self-reliance. The breakdown of longstanding global correlations could be painful for a global investor, who may be left wondering how many U.S. assets to own.



A diminished policy safety net

The U.S. enters this period with historically high sovereign debt levels and inflation exceeding the Federal Reserve's 2% target. If U.S. companies are compelled to manufacture goods domestically and shift supply chains away from China, production costs will rise, resulting in diminished productivity and higher prices.

The Fed will have to chart an interest rate path that balances resurgent inflation expectations with dimming U.S. growth projections. Conversely, currency appreciation in other regions may alleviate inflationary concerns, allowing the Bank of Japan and the European Central Bank to adopt a more dovish stance.

Investors have come to expect forceful government intervention during economic and market downturns. Today, U.S. fiscal support appears less likely, not by choice, but due to limited capacity for additional debt. This era of strained geopolitical relations could mean far less global policy coordination than during previous crises.

Investment implications

Based on PIMCO analysis, the U.S. markets appear to be mirroring dynamics of the U.K. and EM, characterized by steeper yield curves, a weaker currency, and a structural risk premium, higher compensation for holding a country's assets. A self-inflicted supply-side shock, similar to Brexit, has led to a stagflationary outlook. Lessons from the U.K. suggest that the U.S. economy may need to rebalance toward structurally lower growth and higher inflation in the absence of fiscal capacity.

Having long benefited in many ways from the existing ecosystem, the U.S. may face hurdles as the global order evolves. For investors, the return of equity may soon take precedence over the return on equity, prompting a shift toward diversification and a stronger home-country bias.

In a more multipolar world, there may no longer be a need for a singular reserve currency. Multiple options would be necessary to safeguard national security interests, ensure diversification, and deliver stable returns.

Thus far, this is a self-inflicted wound for the U.S. The dollar has only recently begun to structurally weaken. However, sentiment and market performance could quickly reverse if we see a shift toward less disruptive and more predictable U.S. trade policies.

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