for multi-year fiscal consolidation and for resorting to financial repression as a way of coping with the unpleasant arithmetic. America looks like it will be at the top of that list.

Along with negative real rates, we think a multi-year period of U.S. dollar weakness could also result from America's fiscal exceptionalism. Of course, textbook economics suggests that expansive fiscal policy combined with tight monetary policy is a recipe for currency strength. And U.S. nominal bond yields remain higher than those in many other DM nations, a situation supported for the moment by the expansive stance of America's fiscal policy.

However, textbook economics also suggests that the U.S. trade deficit is likely to widen as national savings declines relative to investment thanks to America's uniquely expansive fiscal policy. Indeed, America's monthly trade deficit has expanded by nearly $20 billion since February as imports have fallen much less than exports (Chart 3). If the trend to wider trade deficits continues, as we expect it will, America's dependence on foreign capital inflows will rise substantially. Without higher interest rates to attract those flows, we would expect to see a weaker U.S. dollar as the key adjustment mechanism.

Interestingly, some of the most pointed criticisms we have seen of America's fiscal response to the pandemic have come from China, the nation's largest creditor. As a recent article in the South China Morning Post noted:

> *"Chinese officials have recently taken aim at the unprecedented coronavirus stimulus in the United States, which has seen American debt levels balloon and stoked concern in Beijing about the devaluation of the U.S. dollar assets held by Chinese financial institutions."* [2]

This type of criticism is somewhat ironic, since China's focus on supply-side stimulus for its economy appears designed to take advantage of demand-side stimulus in the U.S. to increase its trade surplus.

Watch the Trade Data and Consider Higher Non-U.S. Equity Exposure

In conclusion, the potential for widening trade imbalances to help trigger a prolonged slide in the U.S. dollar is a clear implication of America's fiscal exceptionalism. For that reason, monthly trade data should receive increased scrutiny by investors.

If we are correct, a material widening of trade imbalances could usher in a significant regime shift in global equity markets in the post-pandemic world. History shows that when the dollar strengthens, U.S. equities tend to outperform non-U.S. equities – and vice versa (Chart 4).

If this history is a guide, investors can hedge their portfolios against a multi-year slide in the U.S. dollar by increasing their exposure to non-U.S. equities.

William Sterling

GW&K Global Perspectives

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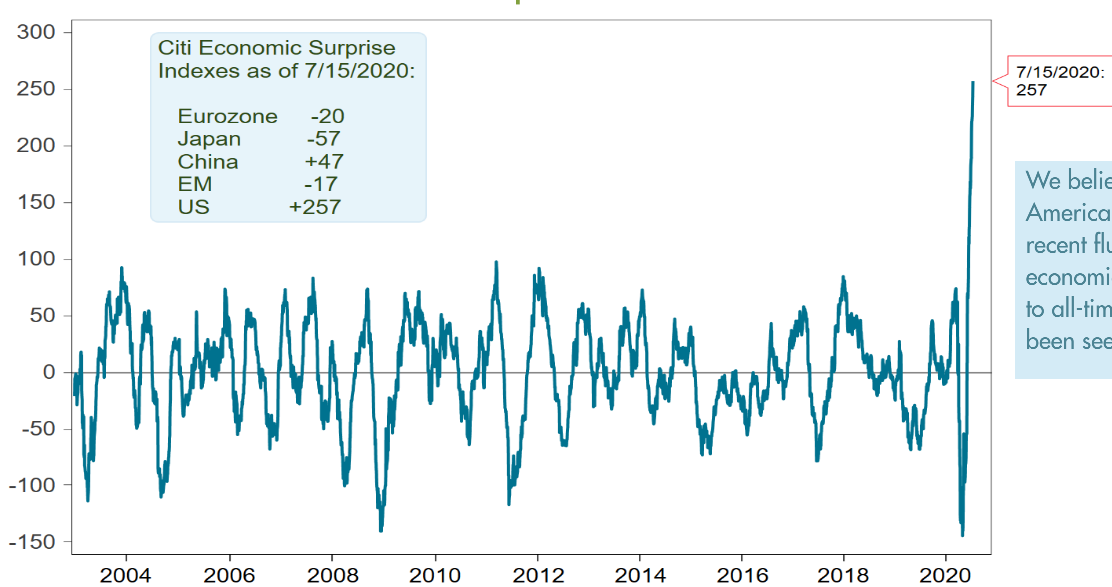
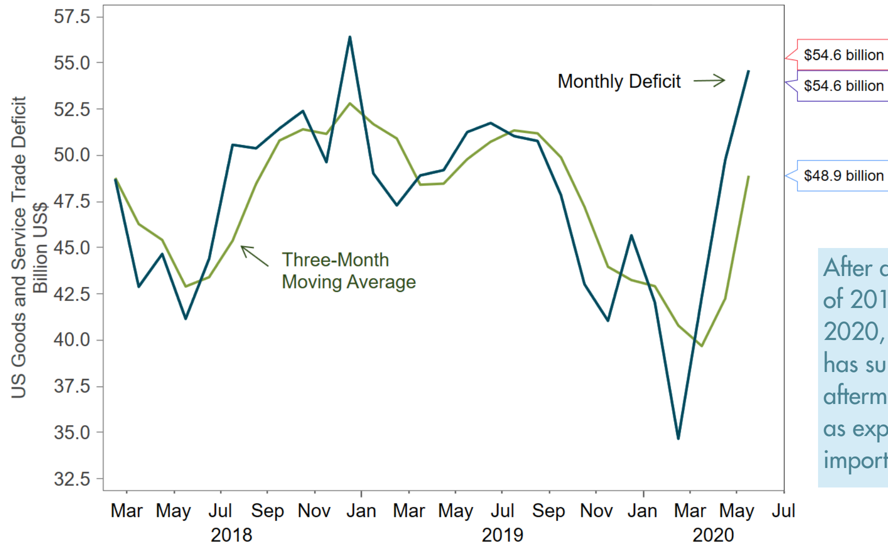
CHART 2: Off the Charts: Citi Economic Surprise Index - United States



We believe the exceptional size of America's stimulus helps explain the recent flurry of strong U.S. data as economic surprises have skyrocketed to all-time highs. This pattern has not been seen elsewhere.

Source: GW&K Investment Management, Citi Research, Bloomberg, and Macrobond

CHART 3: U.S. Trade Deficit Surges as Pandemic Hits the Economy

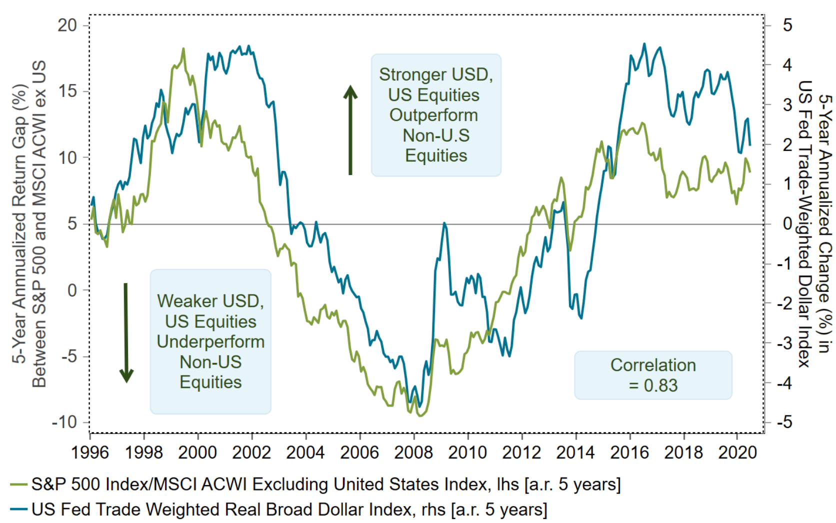


After declining through most of 2019 and through early 2020, America's trade deficit has surged in the immediate aftermath of the pandemic, as exports fell by more than imports.

Source: GW&K Investment Management and Macrobond

CHART 4: 5-Year Annualized Rolling Returns of USD versus S&P 500/MSCI ACWI ex. U.S.

Historically, when the U.S. dollar has been strengthening, U.S. equities have tended to outperform non-U.S. equities by a significant margin. Conversely, a weakening U.S. dollar favors non-U.S. equities.



Source: GW&K Investment Management, MSCI, Bloomberg, and Macrobond

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Endnotes:

[1] Carmen M. Reinhart, M. Belen Sbrancia, "The Liquidation of Government Debt," National Bureau of Economic Research, Working Paper No. 16893, March 2011

[2] Harry Pearl and Karen Yeung, "US coronavirus stimulus reignites China's criticism of dollar hegemony, but no alternative seen any time soon," South China Morning Post, July 7, 2020