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US exceptionalism revisited

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Summary

- US exceptionalism has a strong foundation but faces challenges
- Innovation and productivity advantages are unlikely to fade quickly
- But declining openness to trade and immigration is a concern …
- … as well as fiscal proliferation and inflation persistence
- US financial markets and the USD at pole position but victory not assured

The US economy has performed exceptionally well over the last five years despite massive disruptions caused by the COVID pandemic as well as the rise of inflation and interest rates. The extent of US exceptionalism is most evident in the performance of US real GDP versus other major economies (see Table 1).

Table 1: Real GDP performances

% change latest quarter

	Versus pre-COVID	Versus potential real GDP*
US	11.4	+2.5
Canada	5.7	-2.7
Euro-area	4.2	-2.4
Germany	0.3	-4.9
UK	2.6	-3.2
Japan	0.7	-1.6
China	24.1	-3.8

* See footnote 2.

Source: US Bureau of Economic Analysis, IMF[1]

US real GDP exceeds the pre-COVID level by more than 11%, while most major industrialized economies have barely reached the levels last seen before the pandemic.[2] Furthermore, US real GDP exceeds its potential, while real GDP in all other major industrialized economies has fallen short of potential (see Table 1).[3]

China's economy has grown more than the US economy since the outbreak of COVID, but it has fallen behind its potential as well.[4] Moreover, China's economy in USD terms has dropped from a peak of 75% of nominal US GDP in 2021 to less than 65% in 2024.[5]

In our view, US exceptionalism is the result of US strength as well as weakness of the other major economies.[6] We believe that many factors behind the strengths of the US and the weaknesses of other economies are institutional and structural and unlikely to reverse quickly.

However, we also see the US facing more and new challenges, especially from policy, which will threaten US exceptionalism over time.

The best of both

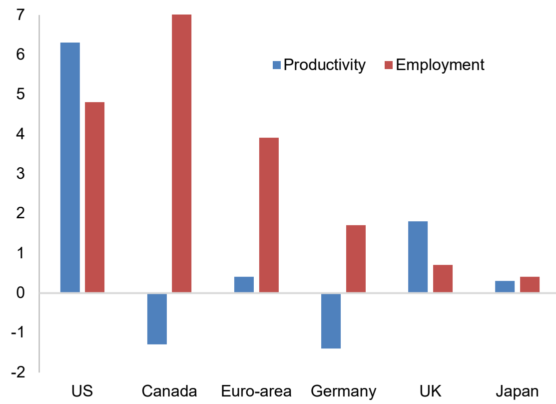
Dividing real GDP growth into employment and productivity growth is helpful for identifying the supply drivers of the US outperformance.[7] Chart 1 shows employment growth and productivity growth for the US and other major industrialized economies since the end of 2019.[8]

The US stands out as having both strong employment and productivity growth. Especially productivity growth is exceptional. Of course, behind the aggregated figures are significant differences by employment sources and economic sectors.

The rise of US employment over the last 5 years was primarily driven by the immigration surge (see Chart 2). The foreign-born labor force is less than 20% of the total US labor force but accounted for about 80% of the labor force increase over the last 5 years.[9]

Chart 1: Employment & productivity growth

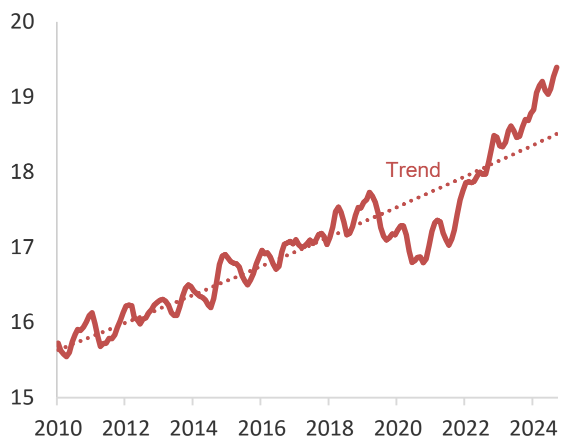
% change 2019 to 2024



Source: US Bureau of Labor Statistics, OECD[10]

Chart 2: US foreign-born labor force

% of total labor force



Source: US Bureau of Labor Statistics[11]

The ability to continuously innovate

When it comes to productivity, the concentration is even larger. As Table 2 (following page) shows, more than half of the total US productivity growth over the last five years comes from four sectors that together account for less than 5% of the total employment. Not surprisingly, three of the four sectors are IT related.

Table 2: US productivity drivers

Percent

	Employment share	Productivity growth[1]	Share of US productivity growth[2]
Data processing & internet	0.2	53.9	20.1
Computer systems design	0.6	39.8	10.5
Publishing incl. software	1.6	38.7	13.5
Management services	1.6	25.9	8.6
All 4 sectors	4.1	43.1	52.7

1) 2019-24; 2) Share of US economy-wide productivity growth 2019-24.

Source: US Bureau of Economic Analysis, US Bureau of Labor Statistics [12]

The IT concentration bears risks and could lead to excesses as in the dot.com bubble. The current AI boom, for example, could lead to a bubble with negative implications for the economy. However, the ability of the US to persistently innovate and put new technologies and products to broader use reveals key institutional and structural advantages compared to other major economies. In our view, these are:

- First-class universities and research institutions that attract top talents from around the world
- Dedicated government support for research and development
- Good funding access thanks to a huge, integrated and efficient financial system
- Effective legal and regulatory infrastructure
- Flexible and open labor market
- Huge and competitive domestic market for goods and services

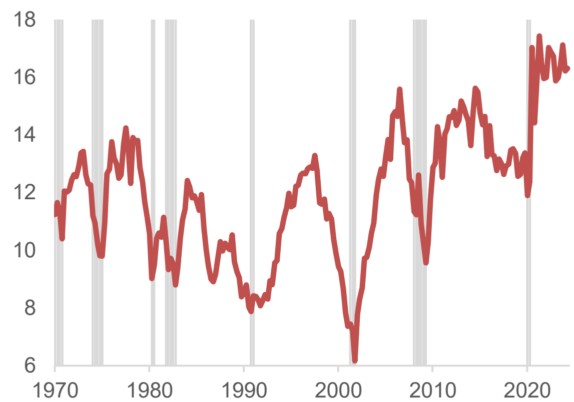
Supported by sound business and household fundamentals

Of course, economic growth is not just about supply factors such as employment and productivity. Demand matters as well and depends largely on business and household sector health.

Chart 3 shows the profit margin of the US corporate sector, which is currently much higher than it has been for the last 60 years.[13] Not every firm is doing well, but the overall strength of profits is supportive for business investment and employment.

Chart 3: Corporate profit margins

% of gross value added

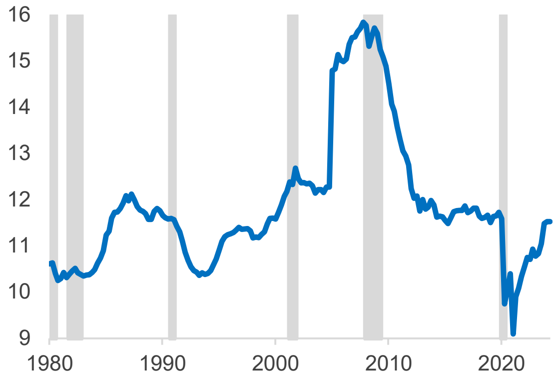


Source: US Bureau of Economic Analysis[14]

Businesses doing well and hiring are also good for household incomes and spending. Households have also done a good job since the financial crisis putting their balance sheets in order and locking in low mortgage rates before the Fed started to tighten policy.[15] The result is visible in relatively low debt-service payments for the US household sector (see Chart 4 on next page).

Chart 4: Household debt-service payments

% of disposable income



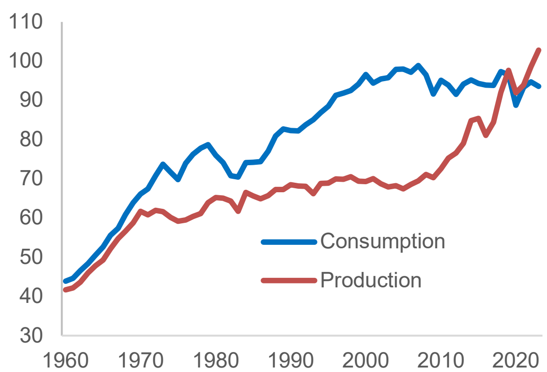
Source: Board of Governors of the Federal Reserve System.[16] The drop in debt-service payments in % of disposable income in 2020/21 were due to the temporary surge in disposable income caused by government transfer payments.[17]

Important support for both supply and demand conditions in the US economy came in recent years from the energy sector. Chart 5 shows that domestic energy production has matched and even exceeded consumption since 2019.

The energy independence of the US stands in sharp contrast to most other major economies. Especially Europe suffered badly when energy supply tightened and prices soared with the beginning of the Ukraine war.

Chart 5: US primary energy

exajoules



Source: Energy Intelligence Agency.[18]

Policy is the main risk

In our view, the institutional and structural advantages of the US are unlikely to fade quickly, while the other major economies will probably not overcome their structural problems soon.[19] As a result, we think US exceptionalism has a chance to last a while longer. However, we see new challenges, especially from the policy side, that put US outperformance at risk.

One concern is trade protectionism, especially if across the board tariff proposals get implemented. We fear this will result in retaliation and ultimately reduce growth and raise inflation. In our view, the evidence that tariffs work is weak. The US current account deficit has increased from less than 2% of GDP in 2017 before the introduction of new tariffs in the first Trump administration to over 3% this year.[20]

However, while we think that protectionism is generally harmful, we expect other countries, especially those that rely more on trade, to fare worse than the US, which has a larger domestic market. As a result, US outperformance may continue under increased protectionism in spite of its expected negative effects on the economy.

Another policy concern relates to immigration. As outlined before, immigration has been a key driver of recent employment and economic growth. Thus, plans to block immigration and to deport illegal immigrants are likely to undermine growth and fuel inflation, in our view. This could be potentially very harmful for US outperformance, but we also note that most other major economies face bigger demographic problems than the US and also struggle to implement efficient immigration policies.

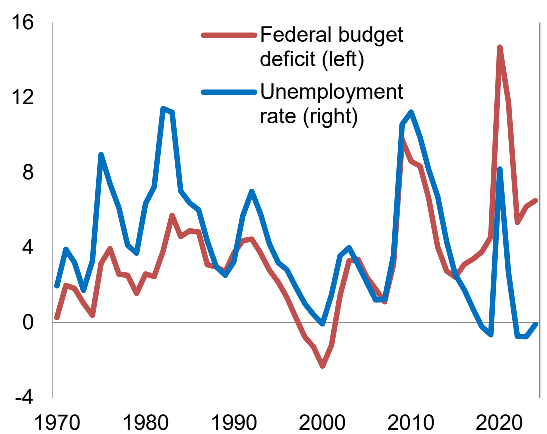
Fiscal proliferation

Our last policy concern relates to fiscal policy. We believe the swift and large-scale response of US fiscal policy to the COVID pandemic was an important factor behind US outperformance over the last few years.[21] However, there have been no attempts to scale back the fiscal deficit as the economy recovered.

Chart 6 shows the relationship between the unemployment rate and the federal budget deficit (rising unemployment corresponds to an eroding budget deficit and vice versa) and highlights the extent of fiscal proliferation in recent years. With unemployment around 4%, the federal budget should be roughly balanced based on past standards and not reach a deficit of 6.5% of GDP (trend rising).[22]

Chart 6: Federal deficit and unemployment

% of GDP (left) and % (right)

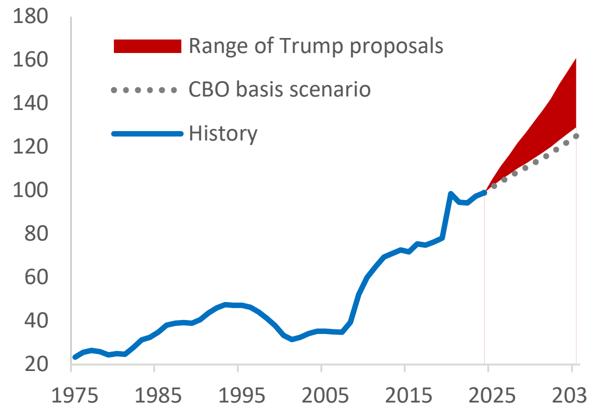


Source: : Office of Management and Budget and Bureau of Labor Statistics [23]

The upshot of the fiscal proliferation is rapidly rising government debt (see Chart 7). The Congressional Budget Office (CBO) estimates that the public debt/GDP ratio will increase by a quarter over the next ten years to 125% and the Committee for a Responsible Federal Budget forecasts that the debt burden will rise even further under the plans of the incoming Trump administration.

Chart 7: Federal government debt

% of GDP



Source: : CBO and CRFB [24]

We do not expect the US government to face a funding crisis soon, but we view fiscal proliferation as bearing several negatives.

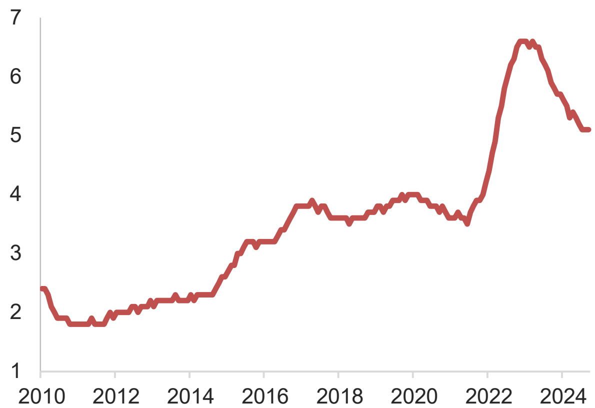
First, we see it as inherently inflationary. Second, it has a bias to crowd out private investment. Third, it risks leading to a debt spiral through rising interest payments. Fourth, it constraints the government's ability to react to future shocks swiftly and with scale.

Inflation and overheating pressures

The mix of trade and immigration restrictions and loose fiscal policy is inherently inflationary in our view. Trade tariffs and immigration crack-downs curtail the supply of goods, services and labor, while tax cuts boost overall demand. And that is happening in an environment in which the economy is already running above its potential and at risk to overheat.[25] In particular, wage pressure remains firm (see Chart 8 on next page). Against that background, we are skeptical whether inflation will move sustainably toward 2%. Instead, we fear that the economy could overheat and inflation reaccelerate.

Chart 8: Wage growth pressure

% over 12 months



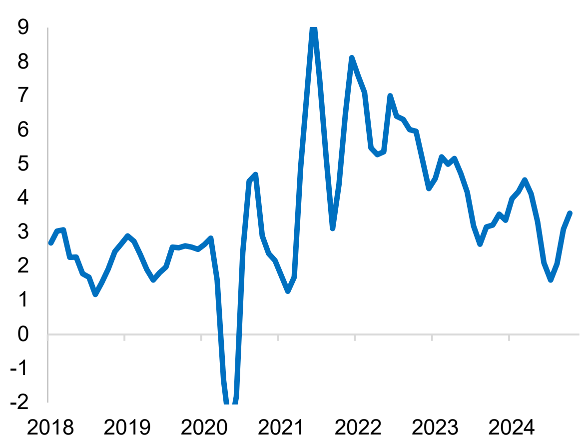
Source: Atlanta Fed[26]

Consumer prices are volatile on a monthly basis and produce short-term inflation swings (see Chart 9). In the third quarter of this year, consumer prices have reaccelerated after a pause in the second quarter.[27]

Looking through the volatility, the optimistic view is that the disinflation trend towards 2% is still intact. We observe, however, that the inflation dynamic is back where it was a year ago, namely above 3%. Thus, we think inflation is more likely to persist around 3% with a risk of reacceleration if the economy overheats.

Chart 9: Core consumer prices

% 3-months change s.a. annualized



Source: Bureau of Labor Statistics[28]

The Fed has limited room to ease

We are not in a position to rule out an economic downturn next year or the year after. In that case, we expect the Fed to ease at least as much as it currently projects or more.[29] But the Fed faces a challenge if the economy holds up, as we expect, and if inflation fails to fall sustainably to 2%.

One possibility in that case is that the Fed will tighten again if inflation fails to reach 2%.

We think it more likely that the Fed will be prepared to tolerate moderately higher inflation as long as it does not spiral up again. In that scenario, however, we believe that the Fed has very little room to cut interest rates if any at all.

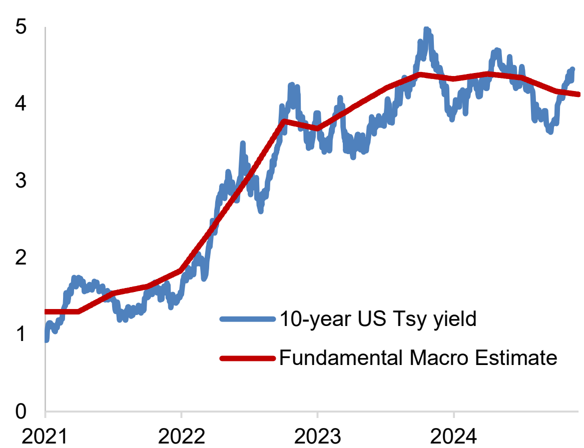
Higher for longer

If we are right on growth and inflation, that implies that the Fed is unlikely to pull long-term interest rates much lower.

Our fundamental 10-year Treasury model puts the fair-value yield currently slightly above 4% (see Chart 10).[30]

Chart 10: US 10-year Treasury yield

% p.a.



Source: Federal Reserve Board, ZAIS estimates[31]

Actual long-term yields are more volatile and may temporarily move lower, but we see two factors that are likely to prevent a sustained decline below 4%.

- Inflation stabilizing closer to 3% than 2%, implying higher long-term inflation expectations and inflation risk premia.
- Fiscal proliferation and falling voluntary net private savings (demographics) leading to an overall tightening of available funds in the economy.

In addition, we see a risk that foreign capital inflows could slow, if the USD's safe-haven appeal fades, while the Fed keeps offloading its Treasury and mortgage holdings.[32]

US exceptionalism and financial performance

US exceptionalism is also visible in the performance of financial markets. The US equity market has outperformed all equity markets in the other major economies over the last 5 years (see Table 3). In local currency terms, the US equity market has outperformed its major peers on balance by about 100%. In USD terms, the outperformance has been even bigger, which implies that the USD has outperformed as well.

Table 3: Equity market performance

% change 2019-2024

	Local currency terms	USD terms
US	90.5	90.5
Canada	65.9	54.5
Euro-area	43.8	35.9
Germany	34.3	25.3
UK	29.5	25.8
Japan	79.9	28.4
China	-10.1	-13.8

Source: MSCI [33]

Most striking is the contrast with the Chinese equity market. In our view, that highlights China's struggle in overcoming the pandemic as well as the problems created by the housing bubble, overinvestment in state-owned enterprises and the government's growing interventions in private enterprises.

US exceptionalism diluted

In sum, we believe that US exceptionalism will prevail for some time longer but in a more diluted form.

In our view, the persistence of US strength as well as the structural problems in most other major economies will depend mostly on policy. The risk is that US outperformance could end faster but chances are probably similar that US outperformance intensifies, at least for some time, partly because of the relative weakness of other major economies.

For financial markets, that means to us that US financial assets and the USD remain in the pole position and have a good chance to stay at least initially in the lead.

However, we also expect financial performance to become more volatile due to external shocks (e.g., geo-political tensions) or policy events. That, we think, creates more downside risks not least because we view both US financial assets and the USD as overvalued, thanks to the long period of outperformance.

A tail risk that we will monitor closely is a loss of market confidence in the independence of the Fed and the sustainability of government debt. Such a scenario could occur if inflation moves higher from 3% and the Fed fails to act decisively, while the fiscal borrowing requirements continue to rise.

Turning to the ZAIS investment activities in US credit-related assets, we think our base scenario of ongoing solid US growth with moderately above-target inflation and only limited Fed easing provides a constructive background. The main risks to our investment universe are the same as for the overall financial market (overheating, inflation and policy credibility).

Furthermore, we believe that credit dispersion will persist and potentially intensify if overall market performance becomes more volatile.

In particular, given our view that interest rates will remain higher for longer, we see re-financing risks for weaker credits, notably in consumer finance, office-related loans and weak high-yield business loans and bonds. On the other hand, we note that our investment universe is well diversified, notably in the loan market and CLO structures, which allows us to manage the inherent credit risks.

More information

As always, we are available to discuss our views with you. Please contact your Client Relations representative at +1 732 978 9722 or zais.clientrelations@zaisgroup.com

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[1] U.S. Bureau of Economic Analysis, Real Gross Domestic Product [GDPC1], retrieved from FRED, Federal Reserve Bank of St. Louis; October 30, 2024.

https://fred.stlouisfed.org/series/GDPC1

U.S. Congressional Budget Office, Real Potential Gross Domestic Product [GDPPOT], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/GDPPOT

International Monetary Fund; National Accounts and Price Statistics; Gross Domestic Product.

https://data.imf.org/regular.aspx?key=61545852

[2] See Table 1.

[3] Potential is an estimate of the sustainable real GDP trend. For the US, potential real GDP is estimated by the Congressional Budget Office (see footnote 8). For all other countries, potential is estimated as the non-cyclical real GDP trend over the span of the business cycle.

[4] See Table 1.

[5] International Monetary Fund; World Economic Outlook Database, October 2024.

https://www.imf.org/en/Publications/WEO/weo-database/2024/October/weo-report?c=924,111,&s=NGDPD,&sy=2020&ey=2024&ssm=0&scsm=1&scc=0&ssd=1&ssc=0&sic=0&sort=country&ds=.&br=1

[6] We discuss the factors we see behind the strength of the US economy in detail in this report. But to complete the comparison, the following provides a short overview of what we view as the main causes of weakness of the other major economies.

Canada: Overheated housing market, leverage problems of the household sector, poor productivity and competitiveness, dependence on oil exports.

Euro-zone: Productivity and competitiveness problems, investment gap, fiscal restraints, bureaucracy, political fragmentation, Germany and France.

Germany: Eroding productivity and competitiveness, investment gap, fiscal restraints, bureaucracy, political fragmentation, public unsettledness.

United Kingdom: BREXIT, productivity and competitiveness problems, investment gap, overheated housing market.

Japan: Demography, poor productivity, closed economy, high public debt, deflation mentality.

China: Demography, housing and investment bubble, debt-deflation, failed growth transition from exports and investment to domestic consumption, misguided government dirigisme.

[7] Defining productivity for the whole economy as real GDP divided by employment implies by

differentiation that real GDP growth is the sum of employment growth and productivity growth.

[8] Unfortunately, we could not find comparable employment and productivity data for China. Also, comparing productivity data between a fully developed economy like the US and a still developing country like China could lead to misleading results given the developmental and structural differences. Developing countries tend to have higher productivity growth as they employ mostly existing technologies and do not have to innovate as much as developed countries.

[9] Same source as in footnote 10.

[10] Productivity = Real GDP / Employment

Real GDP data same as footnote 8.

U.S. Bureau of Labor Statistics, All Employees, Total Nonfarm [PAYEMS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/PAYEMS, October 29, 2024.

OECD; Main Economic Indicators; OECD Data Explorer; Infra-Annual Labor Statistics: Employment Total: 15 Years or over.

https://data-explorer.oecd.org/vis?lc=en&tm=DF_IALFS_INDIC&pg=0&snb=1&vw=tb&df[ds]=dsDisseminateFinalDMZ&df[id]=DSD_LFS%40DF_IALFS_INDIC&df[ag]=OECD.SDD.TPS&df[vs]=&pd=2010-Q1%2C2024-Q3&dq=.EMP...Y._T.Y_GE15..Q&to[TIME_PERIOD]=false

[11] U.S. Bureau of Labor Statistics, Civilian Labor Force Level - Foreign Born [LNU01073395], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

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U.S. Bureau of Labor Statistics, Civilian Labor Force Level [CLF16OV], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/CLF16OV

[12] U.S. Bureau of Economic Analysis; Interactive Access to Industry Economic Accounts Data; Real Value Added by Industry; October 30, 2024.

https://apps.bea.gov/iTable/?reqid=150&step=2&isuri=1&categories=gdpxind&_gl=1*1hzb2ku*_ga*NzYzODc5NTIyLjE3MjkzNDU0MDM.*_ga_J4698JNNFT*MTcyOTM0OTMyNC4yLjEuMTcyOTM0OTMyNi41OC4wLjA.#eyJhcHBpZCI6MTUwLCJzdGVwcyI6WzEsMiwzLDNdLCJkYXRhIjpbWyJjYXRlZ29yaWVzIiwiR2RweEluZCJdLFsiVGFibGVfTGlzdCIsIjEwIl0sWyJTY2FsZSIsIi05Il0sWyJGaXJzdF9ZZWFyIiwiMjAxOSJdLFsiTGFzdF9ZZWFyIiwiMjAyNCJdLFsiUm93cyIsWyIyMlIiXV0sWyJTZXJpZXMiLCJRIl0sWyJDb2x1bW5zIixbIjIwMjAiXV1dfQ==

U.S. Bureau of Labor Statistics; Establishment Data; Table B-1. Employees on nonfarm payrolls by industry sector and selected industry detail; October 4, 2024.

https://www.bls.gov/news.release/empsit.t17.htm

[13] For more analysis of the high level of corporate profit margins, especially given the rise of inflation and interest rates, see: ZAIS GROUP; News and Insights; Resilient but not invincible; April 2024.

https://www.zaisgroup.com/resilient-but-not-invincible.html

[14] U.S. Bureau of Economic Analysis, Corporate profits with inventory valuation and capital consumption adjustments: Domestic industries: Nonfinancial [A463RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/A463RC1Q027SBEA

U.S. Bureau of Economic Analysis, Gross value added of nonfinancial corporate business [A455RC1Q027SBEA], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/A455RC1Q027SBEA

[15] For more analysis on household sector health, incomes and spending see: ZAIS GROUP; News and Insights; Resilient but not invincible; April 2024.

https://www.zaisgroup.com/resilient-but-not-invincible.html

[16] Board of Governors of the Federal Reserve System (US), Household Debt Service Payments as a Percent of Disposable Personal Income [TDSP], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/TDSP

[17] U.S. Bureau of Economic Analysis, Disposable Personal Income [DSPI], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

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U.S. Bureau of Economic Analysis, Personal Current Transfer Receipts [PCTR], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/PCTR

[18] Energy Information Agency; US energy facts explained; July 15, 2024.

https://www.eia.gov/energyexplained/us-energy-facts/

[19] See also footnote 5.

[20] International Monetary Fund; World Economic Outlook Database, October 2024.

https://www.imf.org/en/Publications/WEO/weo-database/2024/October/weo-report?c=111,&s=BCA_NGDPD,&sy=2017&ey=2024&ssm=0&scsm=1&scc=0&ssd=1&ssc=0&sic=0&sort=country&ds=.&br=1

[21] For more analysis of fiscal policy and the impact on the economy see: ZAIS GROUP; News and Insights; Resilient but not invincible; April 2024.

https://www.zaisgroup.com/resilient-but-not-invincible.html

[22] See Chart 6.

[23] U.S. Office of Management and Budget and Federal Reserve Bank of St. Louis, Federal Surplus or Deficit [-] as Percent of Gross Domestic Product [FYFSGDA188S], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

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U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

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[24] U.S. Office of Management and Budget and Federal Reserve Bank of St. Louis, Gross Federal Debt Held by the Public as Percent of Gross Domestic Product [FYPUGDA188S], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/FYPUGDA188S

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https://www.crfb.org/papers/fiscal-impact-harris-and-trump-campaign-plans

[25] See Table 1.

[26] Federal Reserve Bank of Atlanta, 12-Month Moving Average of Weighted Median Hourly Wage Growth: Overall [FRBATLWGT12MMAWMHWGO], retrieved from FRED, Federal Reserve Bank of St. Louis; October 29, 2024.

https://fred.stlouisfed.org/series/FRBATLWGT12MMAWMHWGO

[27] U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; October 24, 2024.

https://fred.stlouisfed.org/series/CPIAUCSL

[28] U.S. Bureau of Labor Statistics, Consumer Price Index for All Urban Consumers: All Items in U.S. City Average [CPIAUCSL], retrieved from FRED, Federal Reserve Bank of St. Louis; November 14, 2024.

https://fred.stlouisfed.org/series/CPIAUCSL

[29] Federal Open market Committee; Summary of Economic Projections; September 18, 2024.

https://www.federalreserve.gov/monetarypolicy/fomcprojtabl20240918.htm

[30] For a detailed analysis of the 10-year Treasury yield drivers see: ZAIS GROUP; News and Insights; Adjusting to higher for longer; June 2024.

https://www.zaisgroup.com/adjusting-to-higher-for-longer.html

[31] Board of Governors of the Federal Reserve System (US), Market Yield on U.S. Treasury

Securities at 10-Year Constant Maturity, Quoted on an Investment Basis [DGS10], retrieved from FRED, Federal Reserve Bank of St. Louis; November 14, 2024.

https://fred.stlouisfed.org/series/DGS10

For a detailed description of the ZAIS fundamental macro estimate of the 10-year US Treasury yield see: ZAIS GROUP; News and Insights; Adjusting to higher for longer; Footnote 9; June 2024.

https://www.zaisgroup.com/adjusting-to-higher-for-longer.html

[32] Board of Governors of the Federal Reserve System (US), Assets: Securities Held Outright: U.S. Treasury Securities: All: Wednesday Level [TREAST], retrieved from FRED, Federal Reserve Bank of St. Louis; October 28, 2024.

https://fred.stlouisfed.org/series/TREAST

Board of Governors of the Federal Reserve System (US), Assets: Securities Held Outright: Mortgage-Backed Securities: Maturing in over 10 Years: Wednesday Level [MBS10Y], retrieved from FRED, Federal Reserve Bank of St. Louis; October 28, 2024.

https://fred.stlouisfed.org/series/MBS10Y

[33] MSCI Indexes; Explore featured equity indexes; View performance details, fact sheets and more; October 28, 2024.

https://www.msci.com/indexes

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