THE RED BULL MARKET IN US EXCEPTIONALISM

LIKE ALL GREAT BULL MARKETS, US EXCEPTIONALISM WAS BORN AND RAISED ON A DIET OF REAL FUNDAMENTAL STRENGTHS. But now, like all great market tops, the behaviour owes more to Red Bull than to Benjamin Graham, the father of value investing. We see extreme valuations and sentiment, combined with AI-enabled optimistic long-term projections – just as the fundamentals have started to decay. Against this fin de siècle backdrop enters a new US administration with a popular mandate to reshape both the domestic and the global economic orders. Add a little vodka to that Red Bull!

NEIL MCLEISH
Co-CIO

DONALD TRUMP'S FIRST ADMINISTRATION WAS SURPRISINGLY SUCCESSFUL, THANKS PRIMARILY TO THE MACROECONOMIC AND MARKET BACKDROP IN LATE 2016. This time around, he has been emboldened by subsequent success to pursue the same objectives with greater vigour. But the starting point today is diametrically opposed to the post-austerity world that allowed markets to thrive under Trump I. As a result, we believe the new administration will be a destabilising force for markets and the global economy.

Our conviction on the outcome (higher volatility) and the timing (2025, likely sooner rather than later) still leaves uncertainty over how it will play out. That will be determined by the sequencing of disinflationary and inflationary policies under Trump II and others' responses to them. Ruffer portfolios reflect both our conviction on the destination and the inevitable uncertainty over the path towards it, whilst keeping a steady eye on what will follow over the structural horizon.

HOW DID WE GET HERE?

Sitting, as we believe we do, close to the peak of a bull market in US exceptionalism, I want to start by looking back before looking forward. The cycle that propelled the S&P 500 Index above 6,000 for the first time in November 2024 also began with a 6-handle – the 666 intraday low in March 2009. You can justifiably argue that the starting point for the current bull cycle was as late as 2020 or as early as 1982. But we favour 2009 because it links two distinct sub-cycles featuring excess, the first monetary and the more recent one fiscal. This is more than just semantics, because the last vestiges of the first, quantitative easing (QE) powered sub-cycle provided rocket fuel for the second, fiscal-driven overshoot.

In his classic study of bubbles, Charles Kindleberger describes the start of any boom as featuring a displacement – a change in the macroeconomic system that creates the potential for new sources of profit.[1] In other words, investment booms and manias don't appear out of the blue based on speculation alone; they invariably have a fundamental basis derived from a shift in underlying conditions. Similarly, JK Galbraith notes that 'in all speculative episodes there is always an element of pride in discovering what is seemingly new.'[2]

Born out of the asset price collapse and consequent deleveraging that followed the global financial crisis (GFC), the bull market in US exceptionalism grew on American technology leadership, energy

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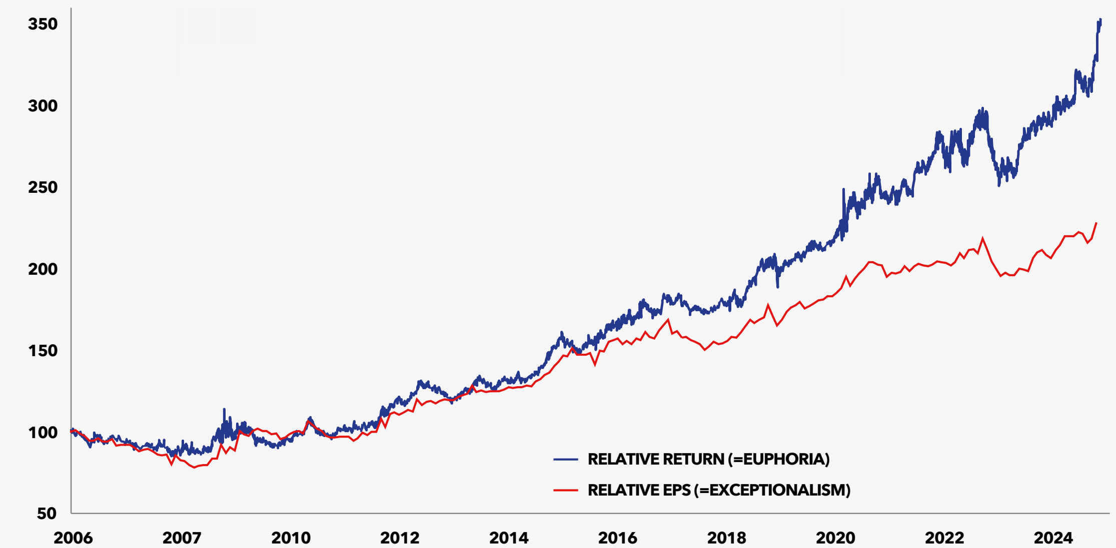
1 Kindleberger, CP (1978), *Manias, Panics, and Crashes*
2 Galbraith, JK (1994), *A Short History of Financial Euphoria*

Figure 1
MSCI US VERSUS MSCI WORLD EX-US, RELATIVE RETURNS AND EARNINGS



Source: Minack Advisors, relative returns are in USD, relative EPS is one year ahead forecast, indexed at 100 in 2010. Shaded areas are NBER-defined US recessions

independence and superior demographics. These were important real sources of absolute and relative advantage, helping to explain superior US earnings per share (EPS) and cash flow growth over much of the time since 2009 (Figure 1). Monetary policy played an important supporting role globally. But, during the era of QE and zero interest rates, US monetary policy was far from exceptional – policy rates and bond yields actually remaining positive throughout.

A SHOT IN THE ARM

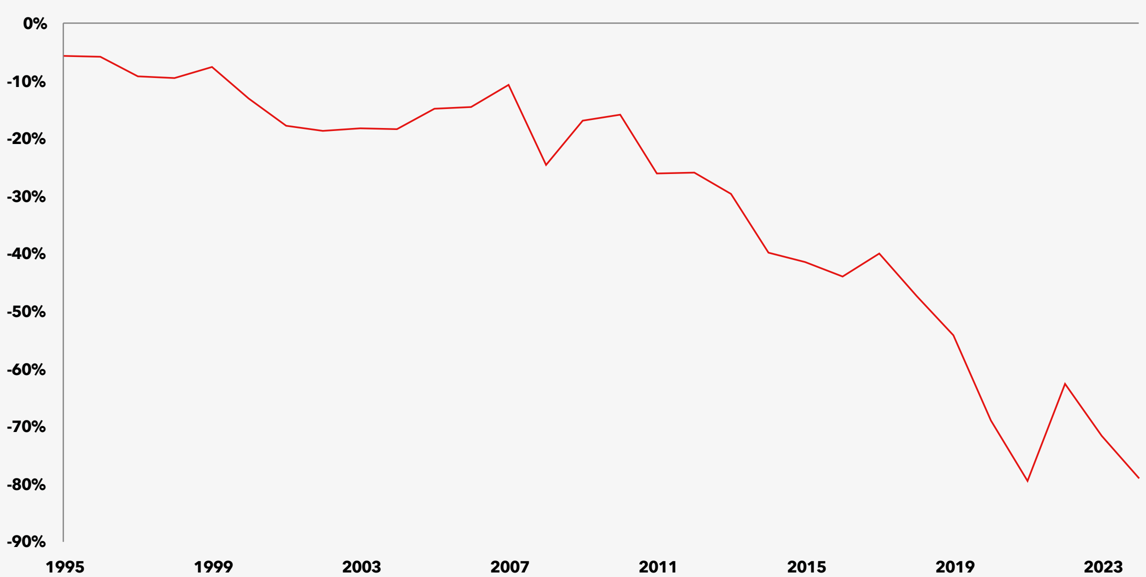
The US exceptionalism bull market only became extreme after the pandemic. The US continued to benefit from tech, energy and demographics, but it also exploited an additional source of exceptionalism – fiscal policy featuring deficits of unprecedented size during the pandemic and, since 2023, still exceptionally large.

There were both positive and negative reasons why such fiscal largesse was possible at such a manageable cost.

The positive reasons were the real fundamental drivers and related private sector resilience that allowed the US expansion to run on higher real rates. At the same time, the rest of the world faced challenges – a Chinese balance sheet recession and the eurozone's political fragmentation – that drove capital towards America, causing the US net international investment position to deteriorate dramatically since 2017 (Figure 2). The US now owes foreigners over $20 trillion net, amounting to 80% of GDP.

Figure 2

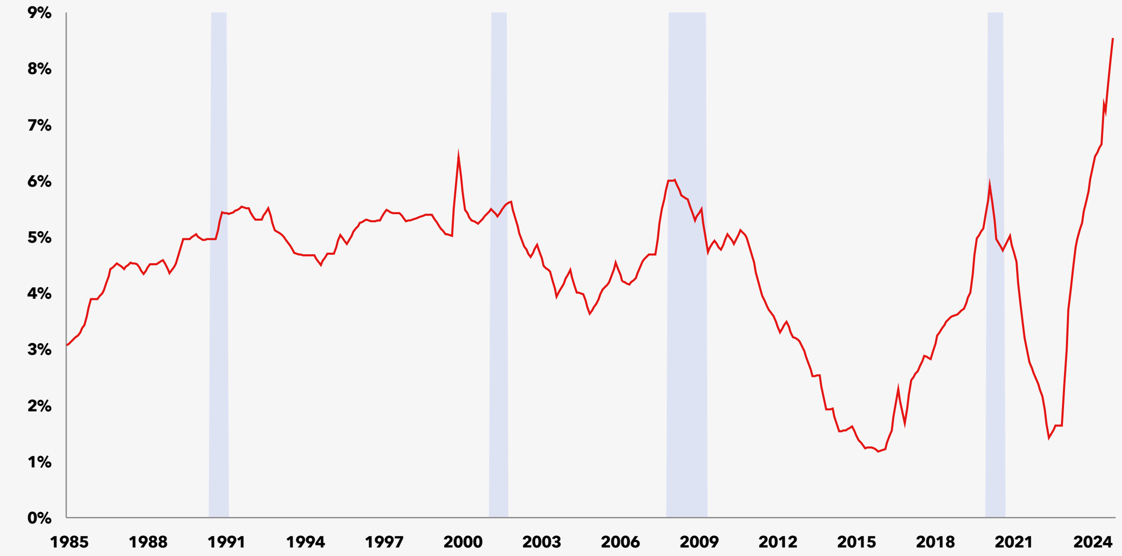
US NET INTERNATIONAL INVESTMENT POSITION, % OF GDP



Source: BEA, NIIP = US residents' foreign assets less rest of the world assets in the US. Data to 2024

Figure 3

US NET REPO LEVERAGE (ESTIMATED), % GDP



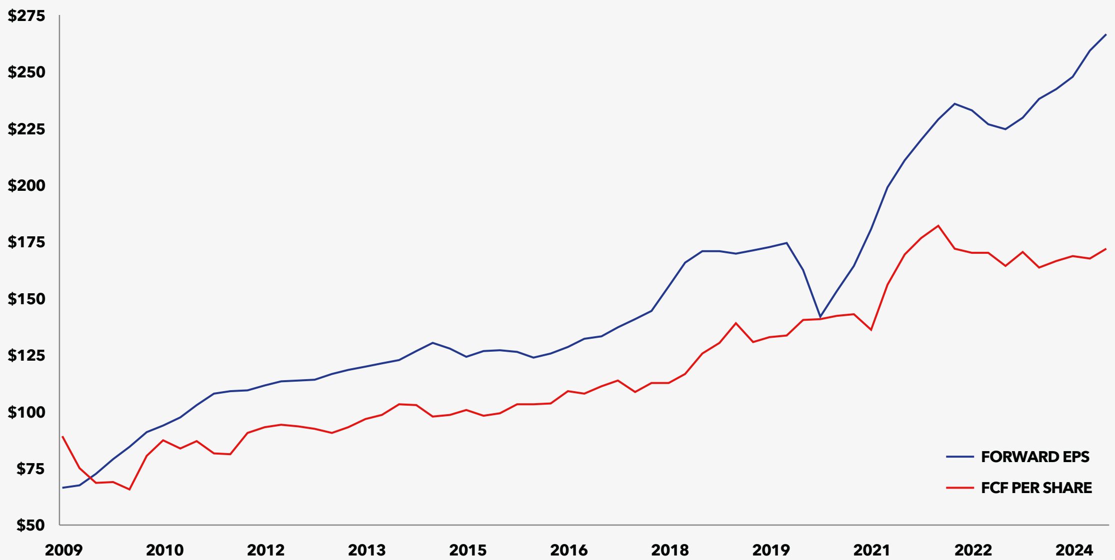
Source: Totem Macro, OFR, NY Fed, Federal Reserve Board, Bloomberg. Leverage taken on by net funders only, without double-counting bank intermediation

However, there were also less sustainable forces at work. Although the Federal Reserve (Fed) was forced to abandon QE in 2022, the residual presence of $2 trillion plus in its QE-era reverse repurchase programme facility (RRP) mitigated the impact of quantitative tightening in 2023-2024. Furthermore, the US Treasury's willingness to skew deficit funding to short-dated debt facilitated the release of this residual liquidity to both fund the deficit and drive private sector re-leveraging.

Remember: leverage is never found in the same place in successive cycles. The dot.com bust centred on high yield credit markets, the GFC on household and bank leverage. In this cycle, leverage is concentrated in the non-bank financial sector (proxied by net repo leverage in Figure 3), as well as large cap companies and the government.

> **"REMEMBER: LEVERAGE IS NEVER FOUND IN THE SAME PLACE IN SUCCESSIVE CYCLES."**

Figure 4
S&P 500 EARNINGS AND FREE CASH FLOWS



Source: FactSet, S&P Global, Bloomberg. Forward EPS is 12 month forward, all other measures are 12 month trailing

FADING FUNDAMENTALS

Although largesse in the post-2020 leg of the cycle has been concentrated in QE-supported fiscal policy, recent corporate performance has been far more mixed than current valuations imply. Whilst the market focuses slavishly on analysts' estimates of forward EPS, trailing measures of corporate performance have diverged significantly over the last few years and now look far less impressive (Figure 4). Most notably, free cash flow per share remains below the peak in 2021, having moved sideways ever since.

Of course, the reason for deteriorating cash generation is also the source of the forward-looking market optimism: AI-related capital expenditure. We understand and believe in the long-term benefits of AI.

But we expect that, just like internet-related benefits pre 2000, they will simply not arrive quickly enough to support current valuation excesses. Research from Goldman Sachs notes that a meagre 5.9% of US companies are currently using AI to produce goods and services, up only modestly from 4% a year ago.[3] And AI is not expected to have a noticeable aggregate impact on the US economy until 2028-2030.

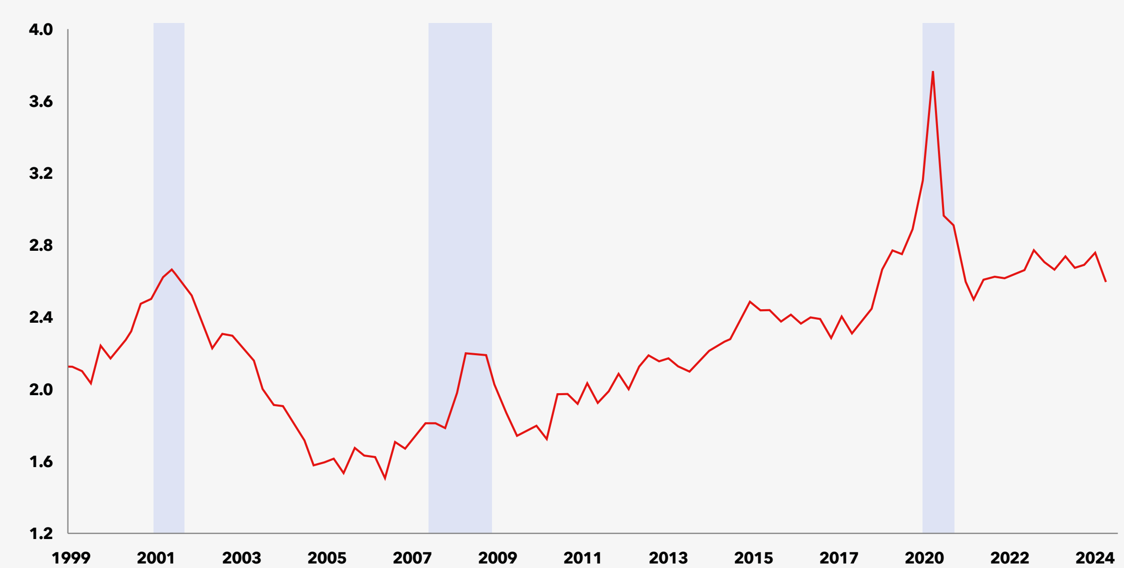
Despite a consensus view that balance sheets are pristine, US large cap companies are in reality close to their highest levels of leverage over the past quarter century, excepting the short-lived earnings collapse during the pandemic (see Figure 5). And the currently elevated leverage metric is of course flattered by record-high profit margins – the historical leverage peaks in 2001, 2009 and 2020 were all associated with margin collapses driven by recessions (the shaded areas).

STANDING AT THE PEAK

So we are approaching the sixteenth anniversary of a bull market founded on genuine US exceptionalism but latterly marked by deteriorating corporate performance and a dependence on unsustainable fiscal policy. Fraying fundamentals ironically coincide with the onset of truly extreme valuations. But what stands out most starkly to us is the confidence that accompanies these valuations.

Aggregate cash levels are lower than at any point in modern market history,

Figure 5
NET DEBT TO EBITDA RATIO, INVESTMENT GRADE ISSUERS



Source: Goldman Sachs, median value for IG-rated non-financial corporations

3 AI Adoption Tracker, October 2024

Figure 6

GLOBAL CASH HOLDINGS OF NON-BANK INVESTORS

Source: Bloomberg, JPMorgan. Percentage of total holdings of equities, bonds, cash and equivalents

including the peak of the dot.com boom in 2000 (Figure 6). In addition, the market-implied correlation between stocks is priced to remain the lowest since data became available in 1990. In other words, market participants are highly confident that the current benign conditions will persist. Perhaps not surprisingly, there is a record degree of confidence among US consumers that stock prices will appreciate over the next year (Figure 7). The last five times this relationship was nearly as extreme were not good moments to embrace risk.

WHERE ARE WE GOING?

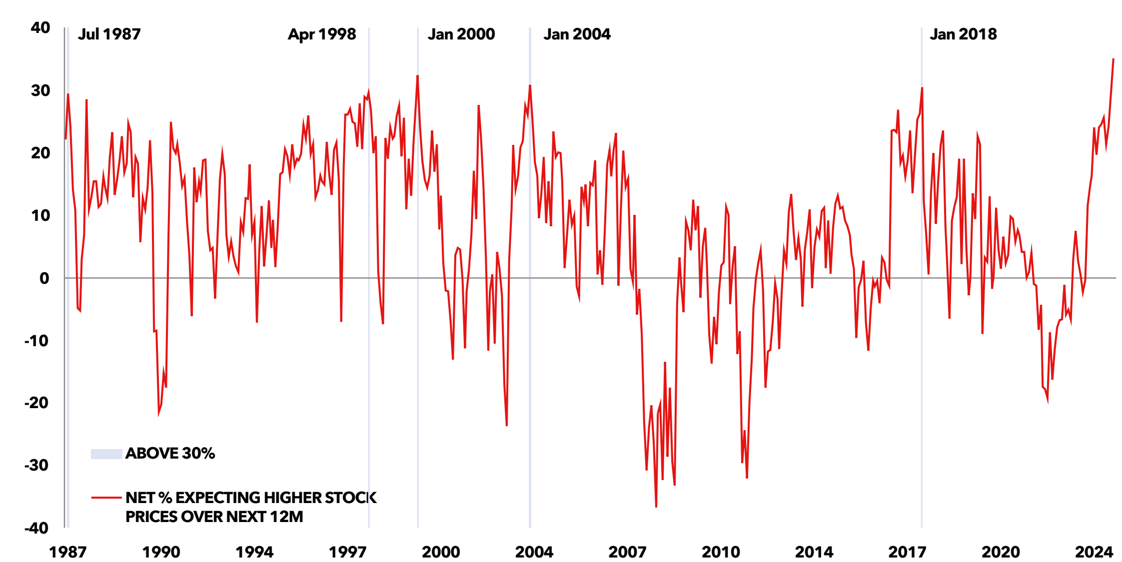
It's debatable how far US policymakers across the Fed, the Treasury and other arms of government actively coordinated to reinforce the confidence that drove the post-2020 leg of the US exceptionalism bull market. But there is no doubt the QE-enabled fiscal largesse contributed significantly. The result is a tightly coupled and highly leveraged market system that has now largely exhausted the post-QE dividend represented by the RRP. Into this heady mix throw the re-election of Donald Trump, which was greeted with renewed market enthusiasm, bordering on euphoria in some asset classes. That was based on the assumption that Trump II will reinforce and extend US exceptionalism, a process my Co-CIO Henry Maxey has termed hyper-exceptionalism.

To state our conclusion upfront, we expect Trump's blend of populist economic nationalism to fare much less well than during his first term. In fact, we think it will be a destabilising force that increases volatility. Combining this insight with the starting point for market valuations, we see trouble ahead. But the precise nature of the trouble will depend on the order in which the administration implements its policy initiatives, several of which have contradictory objectives.

To help plot the course for Trump II, we need to start by understanding why Trump I worked. Most importantly, Trump I followed seven years of post-GFC austerity, featuring private sector deleveraging, modest fiscal deficits and funding requirements, disinflation and easy monetary conditions. And hence modest asset valuations. In 2016, the US economy, facing secular stagnation, was crying out for easier fiscal policy. And, with inflation-linked bonds yielding almost zero on the eve of the 2016 election, the market was happy to provide low-cost funding – aided and abetted by central banks across the globe eagerly buying up bonds to stave off said stagnation.

Figure 7

US CONSUMER EXPECTATIONS FOR US STOCK PRICES OVER THE NEXT 12 MONTHS



Source: Conference Board, net % of respondents expecting US stock prices to rise/fall over next 12m, vertical lines mark when the index rose above 30%

CHALK AND CHEESE

Fast forward to 2024, and the conditions facing Trump II could scarcely be more different (Figure 8). The US government already runs a budget deficit that is uniquely large outside recessions, and the economy has little spare capacity – in economic parlance, it runs a positive output gap. Central banks globally – now even the Bank of Japan – are shrinking their balance sheets at varying speeds, and US inflation-linked bonds yield close on 2%. Partly as a result of this policy mix, US equities and corporate bonds have rarely been more expensive than on the eve of Trump II. Technical market indicators reveal an extremely overbought market – again, the opposite of late 2016.

Last September, the Peterson Institute for International Economics published a detailed analysis of the Trump II policy agenda.[4] It concluded: 'The policies examined cause a decline in US production and employment…as well as higher US inflation… The negative impact of a contraction in global trade is significant for countries that trade with the US the most… Ironically…this package of policies does more damage to the US economy than to any other.'

In short, the US current account deficit helps to drive the global economy. And, in this cycle, the US budget deficit played an outsized role in keeping the US economy humming. So any initiative to curtail or significantly reconstitute either deficit – or more likely both – will be inherently destabilising. Not least given that nearly half of S&P 500 earnings comes from overseas.

An optimist might dismiss such concerns, arguing that the Trump II administration will manage policy implementation carefully to avoid discontinuities. We doubt this will happen. The very fact that Trump I succeeded despite widespread scepticism will encourage the new administration – better organised and this time having won the popular vote – to pursue a bold policy path.

4 McKibbin, Hogan and Noland (2024), *The International Economic Implications of a Second Trump Presidency*

Figure 8

MACRO AND MARKET METRICS ON TRUMP'S ELECTIONS

US MACRO FUNDAMENTALS	TRUMP I (NOV 2016)	TRUMP II (NOV 2024)
US output gap	Negative*	Positive†
Primary budget deficit/GDP %	0.9	3.3
Total budget deficit/GDP %	2.7	6.4
Core PCE inflation	1.7	2.7
Net international investment position/GDP	44% deficit	80% deficit
US BOND MARKET		
Net quarterly UST coupon supply	$100bn or 2% GDP	$450bn or 6% GDP
Aggregate G4 central bank balance sheet	Growing steadily	Shrinking steadily
Bond equity correlation	Negative	Positive
MARKET VALUATIONS AND TECHNICALS		
S&P 500 forward PE ratio	17x	22x
S&P 500 versus 200 week moving average	8% above	27% above
Investment grade corporate bond spread	135bps	82bps
10 year inflation-linked bond yield %	0.0	2.0

Source: Ruffer LLP. Output gap is average of CBO and IMF. * Spare capacity † No spare capacity

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SEQUENCING RISK

Where we do acknowledge uncertainty is the sequencing of Trump II policies and consequently the nature of the shock they will present in aggregate. The suite of stated policies includes both positive and negative demand and supply shocks. The policies with potential negative shocks – government cost cutting, tariffs and immigration – can all be pushed through almost immediately.

By contrast, the tax cuts – which would have a positive impact – may take a full year to negotiate. Financial deregulation also requires the agreement of multiple parties, most notably the Fed. Other actors' responses will help to shape the outcome as well. Tariff retaliation by foreign governments will sap corporate confidence, whereas increased fiscal stimulus in places where it is needed (China and Germany most notably) could create global offsets.

Whatever the sequence, the starting point matters. As Trump II plays out, the Red Bull market will break upon the rocks of extreme valuation, high market leverage and an economy that lacks material spare capacity. We can envisage two main scenarios.

Scenario 1 – an earlier, disinflationary shock, where the initial policy steps are those which can be implemented fastest, including aggressive cost cutting, tariffs and immigration. The resulting rise in financial market volatility feeds on itself given extreme valuations and leverage, overwhelming any liquidity benefit from the debt ceiling resolution process.

Scenario 2 – a slightly later, inflation-driven shock as an initial rise in animal spirits, some early financial deregulation and a debt ceiling related rundown of the Treasury General Account combine to act as an unstable bridge across other negative policy shocks. However, this combination soon triggers a cyclical upswing in inflation, reinforced by recent evidence that the disinflationary progress has already stalled. Hence volatility quickly moves higher on this path, too.

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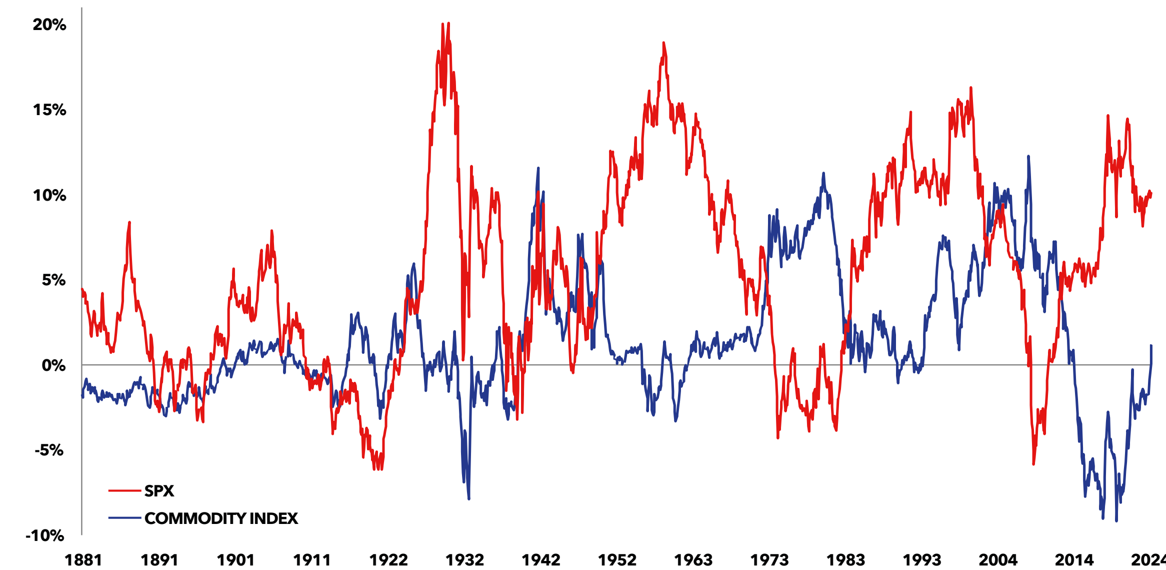
>
> ...BUT A NASTY HANGOVER IS GUARANTEED.”

Either scenario is entirely consistent with our bigger picture roadmap of inflation volatility, which Henry Maxey and Economist Jamie Dannhauser have laid out in prior Ruffer Reviews. And, in either scenario, the populist response to disinflationary market volatility will be more fiscal stimulus and hence inflation. Financial deregulation and the erosion of Fed independence will then open the door to greater financial repression (ie artificially depressing real rates to inflate away debt) down the line as the populists seek additional policy levers to keep the plates spinning.

Figure 9

STOCKS AND COMMODITIES: PERSISTENTLY ROTATING LEADERSHIP, REAL 10 YEAR TRAILING CAGR



Source: S&P 500 Price Return and Warren Pearson USA Commodity Price Index (to Oct 1914). S&P 500 Total Return and Thompson Jefferies CRB Core Commodity Total Return Index (from Nov 1914)

MARKET IMPACT

Stepping back, we see three major portfolio implications. First, expect volatility to rise significantly in 2025 (with the speed and magnitude dictated by policy sequencing), boosting both credit spreads and the VIX. Second, the difference in valuations between the US and non-US equity markets looks set to narrow. An earlier disinflationary shock would narrow the spread primarily via a greater decline in the US market's multiple, whereas a later inflationary shock may first involve some re-rating of cheap markets in other countries that embrace fiscal stimulus. Third, we expect that all versions of the 2025 playbook will eventually lead to more fiscal stimulus. This should provide a tailwind for commodities, which have lagged stocks over the last two years but, in our view, embarked on a new structural bull market in 2020 (Figure 9).

The bottom line: the tails of the distribution are fattening. But markets entered 2025 instead anticipating a euphoric extension of US exceptionalism, with prices in credit and equity markets suggesting the lowest level of macro uncertainty in a generation. The highs of a late night fuelled with caffeine and alcohol can be exhilarating and addictive, much like the new highs that greeted hyper-exceptional US markets. Fun while it lasts, but a nasty hangover is guaranteed.

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