

## The Limits of US Exceptionalism

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A central theme of the last two years has been how the US economy has outperformed the rest of the world. Both cyclical and structural factors help explain the resilient performance in the face of higher inflation and interest rates.

Year-over-year growth in the US is 3.0% versus only 0.5% in the eurozone. Germany and the UK have experienced mild technical recessions, while China's recovery from the pandemic has been anaemic.

The market expects this gap in the growth rate to continue, with forecasts of 2.4% in the US this year, versus 0.6% in the Eurozone. However, it has historically been difficult for the US to maintain such a wide margin. It is quite possible that we are now at peak divergence for this cycle.

When considering whether this divergence will continue, it is helpful to think about what has driven the gap in the growth rate. The global manufacturing cycle has been in a downturn for the past couple of years as a pronounced inventory cycle has been a drag on growth. The US is more of a services-oriented economy and this has helped insulate the region. Exports account for 18.9% of GDP in the Eurozone compared to 10.4% in the US, while the industrial sector accounts for 15.0% of gross value added in Europe compared to 10.3% in the US.

Economic support from government spending (fiscal policy) has also helped support US growth. The IMF estimates that the change in government spending subtracted 0.4% from growth in the eurozone in 2023, while contributing 1.6% to growth in the US. After adjusting for the accounting treatment of student loans, this support was even greater in the US than generally acknowledged.

Another supportive factor for the US has been the willingness of consumers to run down the savings they built up during the pandemic. US households have also benefitted from the structure of their balance sheets, with a higher percentage of long-term fixed rate mortgages versus many other countries.

Finally, the Energy shock from the Russia-Ukraine war and the associated economic sanctions hit Europe harder than the US. This was both a headwind for manufacturing and for consumers to varying degrees. The US has benefited from a vibrant energy sector. According to the Energy Information Administration, the US has produced more crude oil than any other nation for the past six years in a row and US production averaged 12.9 million barrels per day in 2023, breaking the previous US and global record of 12.3 million set in 2019.

However, the global manufacturing cycle is now improving which should help to boost the growth rate in the rest of the world. Furthermore, the IMF estimates that support from the (change in) government spending will go from a tailwind to a headwind of around 2.1% this year. This compares with a headwind of 1.0% in the eurozone.

According to calculations by BCA Research, US consumers have now depleted excess savings, whereas Eurozone consumers still hold excess savings equal to 12% of GDP. It is true that consumers outside the US have a lower propensity to spend, but this tailwind for the US has now largely played out. There are some tentative signs of weakness in the US labour market, so this is something to watch now that growth is more reliant on incomes.



Energy prices have been relatively well behaved which will help importers such as Europe, Japan and India. Geopolitical risk will continue to hang over energy prices, but the UK has benefitted from falling energy inflation and growth has picked up. The Bank of England has said the recession last year was the mildest it has seen on record.

The dollar remains the world's reserve currency, so divergent monetary policy can cause challenges. We have seen this in Japan and a number of Emerging Markets. Higher US interest rates and US dollar strength causing problems for other countries is by no means a new phenomenon. Back in 1971 when the US abandoned the gold standard and allowed the US dollar to float freely against other currencies, then Treasury Secretary John Connally famously said at a meeting of G-10 countries "the dollar is our currency, but it's your problem".

Gold is back in the headlines as the relationship between US real yields and gold broke down after the sanctions placed on Russia's foreign exchange reserves. This made gold more attractive. This has helped to weaken the negative feedback loop where higher US interest rates lead to a stronger US dollar, which tightens financial conditions in the rest of the world, which leads to further dollar strength as investors look for safety.

A convergence of growth, where the US slows a little but avoids recession and the rest of the world picks up, is therefore a very favourable backdrop for global markets.

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