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"We're running roughly a 7% fiscal gap and probably a 3% gap is what's sustainable. The further you drift from that, the closer you get to the point where it becomes uncontrollable. It's a job I don't want, but it's a job that needs to be done."

Warren Buffett on DOGE & the US deficit in his final Berkshire meeting

"The US no longer represents a rock such as anchored the West for so many decades, but more like sand, shifting underfoot."
Max Hastings

The second quarter of 2025 started in dramatic fashion with the announcement by President Trump of his tariff proposals, described by him as Liberation Day. This precipitated the largest three-day decline in the S&P since the 1987 crash, leading to the temporary easing and suspension of the tariffs till July 8th while further negotiations take place. The quarter ended equally dramatically with the US engaging in the first official military action against Iran since 1979, when the Shah was deposed. The scale of the tariffs was shocking with countries facing double, treble or more of what they had expected, and the announcement was delivered with unusually undiplomatic aggression. At the end of May Elon Musk, who had led the cost cutting DOGE initiative, departed having fallen far short of the original targets set in the post-election euphoria. However, despite all these upheavals, by the end of the quarter most stock markets had advanced, and bond yields were barely changed. The only significant impact was on the dollar which fell by 10.7%, recording the worst first six months start to the year since 1973. Gold rose by 6%, and bitcoin by 30%. So, despite the chaotic political and military news flow financial markets enjoyed a good quarter.

The final level of US tariffs is still unknown, but on current indications the likelihood is that they will settle around 14-15%, a far higher amount than has prevailed for decades, but lower than threatened in early April. At one point Trump imposed a 145% rate on China. For comparison the effective tariff rate was 2.4% last year. It hasn't been clear whether the primary purpose of these tariffs is to raise revenue or encourage industries to reshore, but their inflationary potential and the uncertainty that they cause for many industries has caused considerable alarm for businesses. Politically though they have worked for Trump. They exhibit a clear preference for labour over capital, making them popular in the swing states which secured his election victory last November, and given the electoral importance of these states these policies are likely to be durable. Yet with China Trump appears to have overplayed his hand. China depends on little from the US beyond semi-conductors, and even here the technological gap is closing, whereas the US imports hundreds of products from China, many of them of critical importance, hence the enormous trade deficit. Even the US defence industry depends on Chinese-processed rare earths to keep going. With so many American businesses dependent on Chinese supply chains the US was forced to back down from its initial position. By contrast, China is well prepared for this trade war having been adjusting to American aggression on trade policy since 2017. Given how intertwined the two economies have become after thirty years of integration, a face-saving resolution is in both sides interest.

Longer-term the impact may fall on the US dollar and US interest rates. Trump's 'Big Beautiful Bill' proposes to cut tax and extends previous tax cuts, creating a $300 billion boost for consumers and businesses, but also expanding the budget deficit yet further. Estimates calculate that it will add $3.3 trillion to the US debt burden over the next ten years. The fiscal deficit is running at 6-7% of GDP already, so this puts further pressure on US Government finances. These deficits have to be funded, and the erratic US policy has made this more difficult by making the US a less attractive destination for investors outside America. In some ways the US situation is analogous to Brexit; there is a divided population, the volatility and uncertainty make it hard for business to make long term decisions, and with the risks so complicated investors start to withdraw. Equally as US Government debt balloons more questions arise about its sustainability. Rising interest rates have led to the cost of interest on the debt spiralling higher, and now the annual interest bill exceeds one trillion dollars, approximately the same amount as the Federal Government spends on each of defence or health. As with most other western economies reducing this debt is extremely difficult because so much of the deficit is welfare payments which has become electoral suicide for any politician to challenge. It has led to an investment environment where US Treasury bonds, which are supposed to be the risk-free asset, becoming a potential source of risk. The problem with this is that since the end of World War II the world's investment infrastructure has been built on the basis that the US Treasury bonds are risk free. Following the confiscation of Russian assets by American edict as punishment for the invasion of Ukraine, there has been more caution by overseas investors to purchase US assets. This has been most evident in fixed income markets, which adds further pressure on how the US funds its twin deficits. The scale of the problem can be seen in the context that the US Treasury needs to issue approximately $2 trillion of bonds this year and roll over $8 trillion of maturing bonds. Every basis point rise in yields costs the US Government $1 billion. On top of this many companies will need to roll over the debt that is maturing five years after the orgy of issuance that followed interest rates falling to zero in the wake of the Covid in the second half of 2020 and first half of 2021.

Since 2008 the investment world has been dominated by the performance of US assets. US markets, particularly Nasdaq, have been the strongest by far, and the US dollar has been one of the strongest currencies. This so-called US exceptionalism was based on superior earnings, higher interest rates and the US's strong infrastructure of law and property rights, but recent events have cast doubt on the strength of these institutional safeguards. Nonetheless while confidence has been dented the US retains a culture of cutting-edge innovation and entrepreneurial zeal. Despite the political upheaval there is no real challenge to the US dollar as the world's reserve currency. Even after twenty-five years the euro is hardly used outside Europe, and many European countries have debt profiles that are as bad or worse than the US. Fears that the dollar suffers from a disorderly fall require that other currencies rise in an equally disorderly way, and it is not obvious which currency would do this. The US also has an interest in keeping the dollar attractive to international investors. The flows from all corners of the world to the US have been immensely beneficial for both the US Government and US industry, and given the size of the debt that needs to be sold in the next few years to erode the dollar as a store of value would be a self-harming act. Ultimately though investors must understand that the gargantuan debt that the US and other developed nations have built up will be solved by inflation. For reasons of short-term political expediency both sides of the political spectrum are pedalling a fiction that debt doesn't matter (the Left), or that tax cuts will solve it (the Right). Short-term these huge deficits are stimulative for economic growth but ultimately the debt burden will have to be addressed.

As sentiment on the US shifts investors are starting to look at other regions for opportunity. The starting point is one where global allocators are as overweight US assets as they have ever been. Most global equity indices have a 60-70% weighting in the US, the result of Nasdaq and particularly the Mag 7 (the largest technology stocks) having drawn an enormous amount of the world's savings. From this point it will be hard for these stocks to propel portfolios in the same way. By contrast the rest of the world offers a diversification to what may be another three years of a challenging Trump Administration. Europe has started to be the beneficiary of these flows which at the margin can be powerful. One silver lining of Trump is that he has forced quicker decision making in Europe, including spurring a fiscal revolution in Germany, and commitments to greater defence spending. Germany may spend an extra €1 trillion over the next decade, a significant boost following years of austerity. Europe is also benefiting from lower energy prices, lower goods prices courtesy of China, and these disinflationary forces are allowing fiscal and monetary expansion. Investor positioning hasn't acknowledged this. After such a long period of US outperformance investors have forgotten that European companies are capable of excellent performance too. The Italian bank Unicredito has risen ten times in the last five years and still doesn't look expensive. This example shows the potential when ignored assets come back into favour. Banks have been operated much more cautiously since 2008 and have been generating tons of cash and returning these excess profits to shareholders. It leaves them well positioned if the economic cycle does pick up in Europe, and government policy supports this. More generally the opportunity is idiosyncratic. The best returns may come from investing outside the benchmark in companies with solid fundamentals that have been ignored. Japan, Emerging Markets and commodities are attractive areas to explore, particularly Emerging Markets where economic policies have been much more orthodox.

The current environment is so complex that any conclusions have to be tentative. Some valuations remain stretched. However, the strength of markets in the face of so much confusion suggest that investors believe that companies will find a way through the political drama. It may also be the reflective belief that if serious trouble arrives then Central Banks and Governments will pull out all the stops to print their way out of trouble as they have done every time trouble has hit in the last thirty years. The vagaries of President Trump, Iran, Ukraine and debt issues generate considerable volatility. However, companies have continued to perform well, and low energy prices, full employment, and steady global growth provide a supportive environment for company profits. With liquidity still abundant it may be time to start to look further afield than the narrow selection of US technology stocks that have dominated the last few years. Investors should start to focus on where this liquidity will flow next.