Bretton Woods 2.0

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-Gray Howard, Senior Portfolio Manager

We published a piece last October titled The Chessboard where we discussed the global monetary system, our major trading partners, and why the overall system is likely to be reformed. Much has happened since last October and while it seems very chaotic, it's important to slow down and examine the overall chess game. My role is not to advocate for one particular policy but to simply try and understand how the game is being played and position portfolios accordingly.

Here is an excerpt from our October note that illustrates how we arrived here:

Our current situation began as WWII was winding down and the Allied nations came together in 1944 to create what was known as the Bretton Woods Agreement. This created the International Monetary Fund (IMF), the World Bank, and the global monetary system we have today. As a result, the U.S. dollar became the global reserve currency and other member countries were required to guarantee the convertibility of their currency. In return, they had the ability to convert U.S. dollars into gold. This was key, as it insured that countries could not meaningfully devalue or manipulate their currency, which had been the case leading up WWII.4 For countries to trade freely around the world, it was imperative to have strong treaties and alliances to preserve, protect, and promote this system, or the International Rules Based Order as referred to today. As a result, the United Nation's Charter was signed in 1945 and the North Atlantic Treaty Organization(NATO) was created in 1949. Since then, there have been many regional wars but one could argue these alliances have prevented another major global conflict like WWII.

However, the U.S. dollar has been a fiat currency since Nixon ended the gold standard in 1971. Therefore, the only thing backing the U.S. dollar is the full faith and credit of the United States. But given the large structural deficits and currency devaluations, the U.S. dollar system has been put into question. For example, during the early days of Covid-19 when financial markets were getting crushed, U.S. Treasury yields spiked as foreign buyers no longer viewed U.S. treasuries as a safe haven asset due to the amount of money the U.S. would soon print.7

There are many benefits to being the reserve country such as lower borrowing cost, financial stability, geopolitical influence, cheaper imports, and attractiveness for foreign investment. But there are drawbacks as well. 2

Since the US dollar is the global reserve currency, a large portion of global trade, foreign borrowing, and foreign currency exchange occurs in US dollars(USD), regardless of whether the US is involved. Therefore, most foreign central banks hold a significant amount of USD and US treasuries to support their own economy and currency.3

There is term in economics called the "Triffin Dilemma", coined after Robert Triffin in the 1960s. While I'm oversimplifying, the Triffin Dilemma suggest that if the global financial system runs on one reserve currency, then foreign nations will be in constant need of this currency to satisfy their own trade and balance of payments. Therefore, the only way for the world to continue to get a fresh supply of USD, is for the US to run large structural trade deficits with the rest of the world, meaning we import more goods than we export.4 For example, China is second largest economy and needs a significant amount of USD. Therefore, it's not surprising that the US ran a $295 Billion dollar trade deficit with China in 2024, the largest bilateral trade deficit with any country.5

The US also has benefited from this trade deficit through the ability to access cheaper goods. Also, foreign countries tend to invest their dollars in dollar denominate assets, such as US treasuries, stocks, bonds, and US real estate.[3] Hence, why the US stock market has outperformed international markets over the past 20 years. [6]

However, there are major drawbacks to running persistently large trade deficits:

1. Eventually the domestic industrial base declines to a point that the US becomes overly reliant on other countries for critical parts of its supply chains. As we learned during Covid, this creates a huge national security risk. 4 One of the reasons why the US prevailed in WWII is their large industrial base was able to be converted from peace time to war time production. [4]

2. Trade deficits over time lead to massive wealth inequity. As the economy transitions to a more service and financially driven economy, the working class and younger generations are left behind, while those with financial assets tend to do very well. Hence, the polarity between the coasts and the middle of America.[4]

3. In order to run structural trade deficits, the US must also run large budget deficits. But eventually the debt and deficits in the US become so large that the safety of US debt comes into question. Again, this is exactly what happened in the early days of Covid when treasury yields spiked as foreign buyers dumped US treasuries.[4]

   The US will never default on its debt as it can always print more USD, but whoever bought US treasury debt in 2020 has had a negative return, net of inflation. So why would foreign nations continue to buy US treasury debt when it's a bad investment? They have to because the world runs on US Dollars and US treasuries are the most liquid asset to hold in reserve to support their own currency. President Trump talks about how China is ripping off the US but in reality, the US is also ripping off China and the rest of the world by running large budget deficits. [3]

So where do we go from here?

While everyone seems to focus on President Trump and tariffs, I feel they are missing the forest for the trees. The real issue is the global financial system that was created 81 years ago in Bretton Woods is unsustainable and needs reform, particular for China and the US.4 In fact, the Treasury Secretary Scott Bessett gave a speech at the Institute of International Finance where he called out the IMF and World Bank for not adhering to the Bretton Woods original purpose and thus laid out a blueprint to restore equilibrium to the global financial system. I would encourage you to read the full speech. https://home.treasury.gov/news/press-releases/sb0094

Regardless of one's opinion of President Trump, Treasury Secretary Scott Bessent is a seasoned global macro investor which gives him a unique role as Treasury Secretary. In fact, Bessent was one of the brains behind the trade that broke the bank of England in 1992. The British pound was being artificially propped up and they invested their entire hedge fund 200% short the British pound. This turned out to be one of the greatest macro trades of all time as they had uncovered what is called a one-way bet - a bet where you know you hold all the leverage. That said, I can't imagine Besset would have supported putting 145% tariffs on our largest trading partner without knowing they hold a ton of leverage. [8]

Rebalancing the entire global economy is no small feat and it's going to be very interesting to see how all this plays out. But the fact that the consensus on Wall Street seems to believe this approach is chaotic, dangerous, and will likely lead to inflation or recession, gives me solace that a successful solution is on the horizon and the consensus will be wrong once again.9 And over the past two weeks the markets have been confirming this view. [6]

This reminds me very much of the early days of Covid. People forget that the market bottomed on March 24th 2020, which was peak uncertainly and hysteria. Even though the economy was still locked down and companies were pulling their guidance, the market continued to recover.6 Keep in mind that markets do not live in the present as they have already discounted it. They live in the future and only care about the rate of change- are things getting better or are things getting worse.10

In my judgment the market bottomed on April 7th with peak uncertainty around Tariffs. And even though there is still not a lot of visibility around these trade deals, there is more than there was a few weeks ago, which is likely why the market has rallied 20% since April 7th.6 I think it will remain two steps forward, one step back from here. But as I said, in our March update: *I think we will look back a few months from now and realize this was a great buying opportunity, especially, in U.S. companies that could benefit from deregulation, lower taxes and artificial intelligence.*

So far so good! Especially after the news over weekend regarding China and the US.11

Please feel free to reach out if you have any specific question or comments.

All the best,

Gray

Please note: If you do not have assets under management with our group and would like more information on our process and performance, please let us know.

Sources;

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