Exorbitant Privilege

Louis XIV, the Sun King, died in 1715 after a 72-year reign. It was long enough to see his son predecease him, as well as his grandson and his eldest and next eldest great-grandsons. This left succession to his five-year old great-grandson, who became Louis XV and ruled for the next 59 years.

Louis XV was known as *Le Bien Aimé*, the Beloved, but discontent grew over the years with endemic corruption in his government and the disastrous Seven Years War (1756-1762)[1]. In that war, France lost all of its North American territories, including Canada to the British and New Orleans to the Spanish, and it nearly bankrupted the French treasury.

When his son died, succession fell to his grandson, who became Louis XVI in 1774. To seal an alliance with Austria, he married the youngest daughter of the Empress Maria Theresa, Maria Antonia, or Marie-Antoinette as she was known in France. Louis embraced some Enlightenment ideas, such as tolerance for non-Catholics, but such nonsense (reforms) were blocked by the nobility. His decision to support the American revolutionaries gave decisive support to the rebels, but nearly broke his treasury. Lavish spending by the court further incurred debt and stoked resentment, directed mostly at his foreign queen.

Debt, corruption and weak leadership pushed the elites to oppose Louis' monarchy. Likewise, massive economic inequality stirred discontent among the masses. The clergy, known as the First Estate, were 1% of the population but controlled 10% of the land. The nobility, the Second Estate, was 2% of the population, and controlled another 30% of the land. Neither

[1] Known and the French and Indian War in North America.

group paid any taxes. That burden fell entirely on the remaining 97%, the Third Estate.

The great French philosophers of the Enlightenment, Voltaire, Rousseau and Montesquieu, advocated for democracy and individual rights. And so brewing in France in the late 18th century was a toxic mixture of discontent, mismanagement and new ideas to breed a revolution.

The leading voice of this revolution came from a member of the Third Estate. He was the son of a lawyer from the small town of Arras, near the Belgian border. He received a scholarship to study law at the prestigious Lycée Louis-le-Grand in Paris and dedicated himself to defending the rights of the poor. When Louis XVI was forced to call the Estates-General (National Assembly) in May 1789, he was elected as a representative of the Third Estate, calling for abolishing the monarchy, limiting the power and privileges of the clergy and nobility, for universal male suffrage and for rights for the poor. He quickly became the leader of the Jacobin Club, and was known as "The Incorruptible" for his firm dedication to these revolutionary ideals.

On 14 July 1789, crowds stormed the Bastille,[2] the fortress prison that was a symbol of monarchical oppression. It fell to the mob in a bloody battle, marking the beginning of the French Revolution. The small-town lawyer who exemplified the revolution's motto of *Liberté, Égalité, Fraternité* became a leader of the new government.

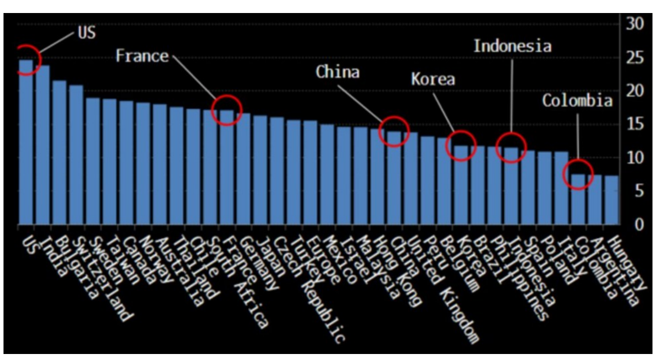
On the heels of the American Revolution, the French Revolution marked a new era of government by the consent of the governed, of "self-evident" truths, and respect for the "inalienable" Rights of Man.[3]

A new era is brewing in the world today. Not another French Revolution, but one in which there are lessons to be drawn from that time, for citizens and investors alike.

Years of outperformance of US equities versus the rest of the world have been justified by superior profit margins and profit growth.[4] It has been led by more than just the handful of the leading, innovative technology companies; American companies have generated superior returns across all sectors, not just in technology. But it has left US equities (Chart 1) and the US dollar (Chart 2) very fully valued.

This is the context in which the United States has embarked on a new direction in economic and foreign policy. These shifts mark significant inflection points, breaks from the past, that have significant implications for investors.

Chart 1 **P/E Ratio of MSCI TR Indices**



Source: Bloomberg

Chart 2 **10-year Z-score of Real Effective Exchange Rate**

[2] See cover painting: *La prise de la Bastille*, Jean-Baptiste Lalleland, 1789, Musée Carnavalet.

[3] The Declaration of Independence (1776) and the Declaration of the Rights of Man and of the Citizen (1789).

[4] We have written about this frequently; most recently last quarter: https://www.angelesinvestments.com/insights/investment-insights/4th-quarter-2024-the-colbert-show.

President Trump has been consistent throughout his public career in favoring high tariffs. His position seems to be based on the belief that a trade deficit is harmful to the economy, a sign of economic weakness in which other countries "take advantage" of the US. Consequently, the imposition of tariffs should be seen not as a bargaining chip to induce lower tariffs worldwide, but rather as a tool to reduce the trade deficit. Should other countries raise tariffs in response, logic dictates that the US raise tariffs further because US tariffs rates must be higher than other countries' in order to have an impact on the trade deficit. An escalation of global tariffs characterized the early 1930s,[5] leading to a collapse in world trade, and contributing to the magnitude of the economic depression the world subsequently suffered.

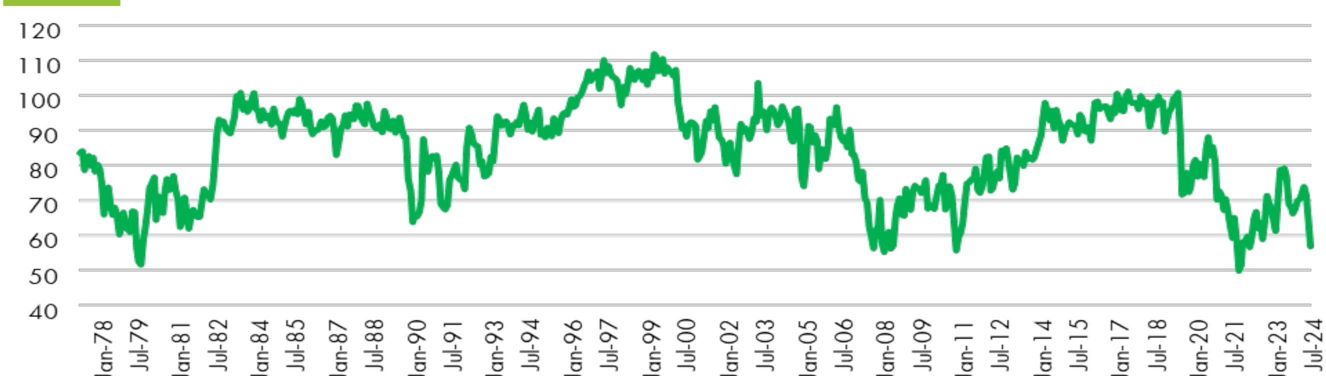
A trade deficit is neither good nor bad, and is certainly not a sign of economic weakness. It reflects simply that the United States consumes more than it produces and invests more than it saves. It enables the US to import cheap goods and capital and invest in higher value-added areas which make the US economy more productive than it otherwise would be.

The immediate consequences of raising tariffs are slower economic growth and higher inflation, and economists are beginning to adjust their forecasts accordingly. This occurs at a time when some economic data are slowing already. Housing starts, for example, are still below pre-pandemic levels (and well below pre-GFC trends—Chart 3). The survey data are weaker still, with consumer confidence below the COVID months and nearing the nadir of the GFC and brutal 1980 recession (Chart 4)

Chart 3 Housing Starts, 1959-2025

Source: US Census Bureau and Department of Housing and Urban Development

Chart 4 Consumer Sentiment, 1978-2025



Source: University of Michigan

[5] The infamous Smoot-Hawley Tariff Act of 1930.

The direction of tariff policy seems clear (higher), but its implementation has been fragmented and contradictory, leading to high levels of economic uncertainty (approaching the COVID month and the GFC—Chart 5). Lower economic activity is one consequence of policy uncertainty. Trade policy, and its inconsistencies, also raise the risk premia (lower valuation) for US assets, one reason for the poor performance of US equities this year.

Trade policy, tariffs in particular, has been the primary driver of economic and investor uncertainty. The US economy is less dependent on trade than any other developed country, but trade still plays an important role in the economic supply chain. Imports make up about 14% of US GDP, a far higher percentage than the less than 4% in 1930 when the Smoot-Hawley tariffs were enacted (Chart 6).

Chart 5 **US Economic Policy Uncertainty Index, 2005-2025**

Source: Baker, Bloom and Davis

Chart 6 **Imports as Pct. Of US GDP, 1947-2024**

Source: US Bureau of Economic Analysis

Tariff levels will be set (and re-set) at the whim of the president, and investors should expect tariff policy to be volatile regardless of what is first announced. Should the president follow through on his stated positions (a dubious assumption), tariff levels could rise to their highest since the 19th century (Chart 7).

Regardless of where tariff levels settle, the effects will be significant, well beyond an immediate, and permanent, reduction in wealth. The US is the largest, most robust economy in the world. When Canada and Mexico are added to the US economy, with an immeasurable increase in natural resources and an expanded labor pool, both skilled and unskilled, of another 165 million people, the integrated North American economy, as a whole, possesses unequaled economic power and potential. This economic structure is now being unilaterally dismantled in pursuit of misguided policies.

An important implication of this shift in policies is the impact on the role and value of the US dollar. The Bretton Woods agreement of 1944 established the dollar as the official linchpin, the reserve currency, of the world economy. This role necessitated that the US provide dollars freely to the rest of world, facilitating international trade and capital flows and ensuring that the majority of these flows would be denominated in dollars. The US could run a current account surplus or deficit, and the value of the dollar could rise or fall, but never would the US, alone among countries, face a balance of payments crisis since imports are priced in dollars.

Chart 7 US Average Tariff Rates on Goods, 1890-2025 (proj.)

Note: March 2025 figure includes tariffs on China, aluminum, steel, and non-USMCA-compliant Mexico and Canada. Bloomberg Economics' maximal reciprocal tariff estimate includes non-trade barriers, VAT and other grievances. Estimates based on 2024 trade composition.

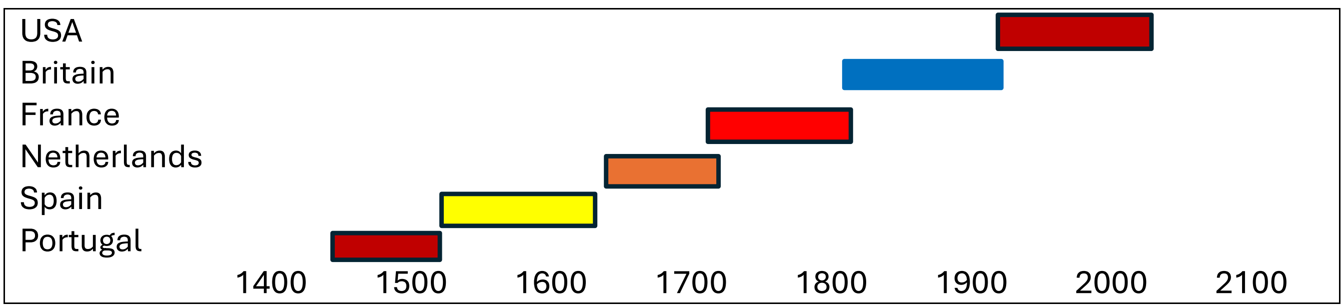
Source: US ITC, Customs, Census Bureau, Bloomberg Economics

The world economy almost demands a reserve currency to facilitate capital flows. Historically, that reserve currency has been provided by the dominant political and economic power of the era (Chart 8). Even before Bretton Woods, in the aftermath of the First World War, the US economy became globally predominant, and the dollar became the world's de facto reserve currency.

Interestingly, each era of currency dominance lasted about 100 years. Perhaps there is a natural lifespan of a reserve currency. If we trace the US dollar's preeminence from 1920, that era may be coming to its natural end.

At present though, the US dollar remains the world's reserve currency. Its dominance is diminishing, however, from over a 70% share of world reserves in 2000 to under 60% today (Chart 9). Nontraditional currencies, such as the Australian and Canadian dollars and the Chinese renminbi, have seen their shares increase, as has gold (Chart 10).

Chart 8 **World Reserve Currencies, 1450-present**



Source: *Author's calculations*

Chart 9 **Currency Share of FX Reserves, 2000-2022**

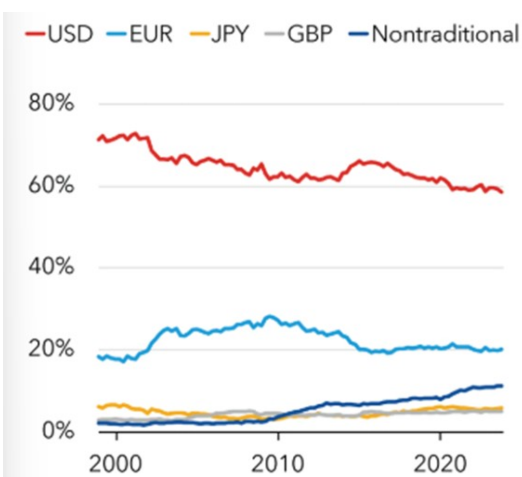


Chart 10 **Gold Holdings in Official Reserve Assets, MM fine troy ounces, 1950-2022**

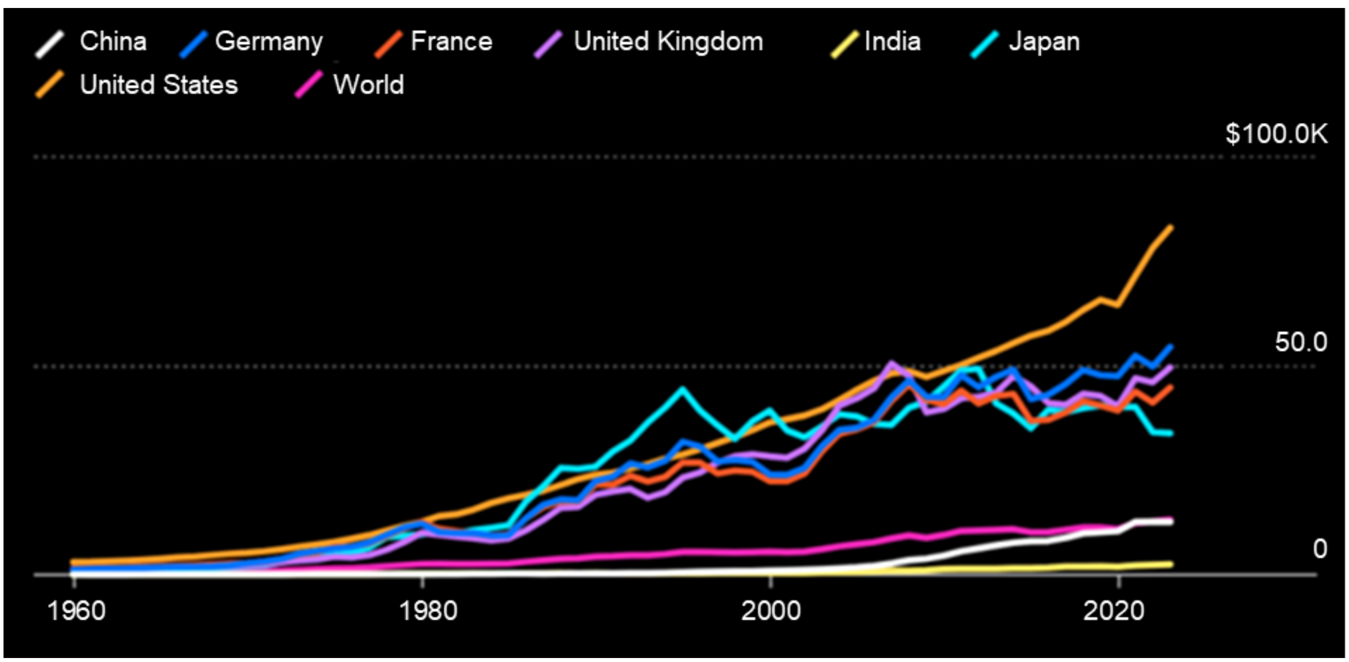
Source: IMF

As goods are denominated in the reserve currency, countries are forced to hold large amounts of US dollars, not because this offers the highest returns, but because it is needed to recycle capital across all currencies. As the US pulls away from global trade and investment, the necessity of foreign central banks to hold dollars lessens, thus weakening the dollar's role as the reserve currency, diminishing one, important, source of economic power.

To be sure, the United States possesses enormous economic advantages and unparalleled power. We remain among the most innovative economies in the world,[6] creating new technologies and global corporate leaders far above any other country. Our economy is the world's largest, and in a remarkable rejection of the law of large numbers, per capita growth in the US outpaces every other large economy (Chart 11).

The global economic system that pulled billions out of poverty, created new technologies that transformed nearly every facet of life in countless ways, was designed and led by the United States. The world's prosperity has not been a zero-sum game, whereby gains for one country can come only from the losses of others. The global economic system, underpinned by the US dollar as its reserve currency, solidified US economic dominance for generations while also producing wealth for every country that joined the US-led framework. Apparently, we now want to blow all this up.

Chart 11 **GDP Per Capita, 1960-2022**



Source: World Bank, Bloomberg

[6] The Global Innovation Index ranks the US behind only Switzerland and Sweden: https://www.wipo.int/pressroom/en/articles/2024/article_0013.html.


Portrait de Robespierre, 1820, Musée Carnavalet

Abolishing the monarchy was one goal of the revolution. One way to accomplish this was to execute the king. In August 1792, a mob overran the Tuileries Palace and captured the king and queen. In January 1793, both were executed by the new, and favorite invention of the French, the guillotine.[7] Following their execution, the Revolution turned on itself, with two factions, the Jacobins and the Girondins, fighting for power. The feud ended in June with the execution (by guillotine, of course) of the leaders of the Girodins, leaving the Jacobins, and its leader, Maximilien Robespierre, the small-town lawyer who fought for the poor, firmly in power.

Robespierre quickly consolidated dictatorial powers, and turned on his own allies in the Jacobins, employing the guillotine on tens of thousands of victims. This was not *Liberté* Day, much less *Égalité* or *Fraternité*. It was the Reign of Terror, and it lasted for a year before Robespierre himself was sent to the guillotine.

The great British historian Arnold Toynbee noted that "Civilizations die from suicide, not by murder." What he meant was that societies generally do not succumb to external factors such as invasion or conquest, but to internal decay: corruption, inequality, cynicism, apathy or despair.

The French monarchy had become corrupt, French society unequal and stagnant. Revolutionaries believed that only by destroying the monarchy could society reform, and perhaps they were right. But the revolution took an ugly turn, self-destructing and coming to an end in 1799 when Napoleon Bonaparte was appointed First Consul. He proclaimed himself Emperor five years later. One tyrant (Louis XVI) was replaced by another (Napoleon), with an interregnum of terror and destruction.

An unequal society with an uncaring, detached elite could characterize today's United States, as it certainly did the France of Louis XVI. But the similarities are overwhelmed by the degrees of differences.

American society is nowhere near as unequal and corrupt as 18th century France with a level of prosperity for the vast majority of people that even the French nobility could not imagine.

The United States faces significant societal challenges, but also possesses the tools to reform and improve, unlike 18th century France did. But we are choosing to be guided not by the principles of the Enlightenment but by placing ourselves in the grip of grievances, both real and imagined. We are choosing to relinquish our global power to adversaries that

7 Named after its inventor, the physician Joseph-Ignace Guillotin.

do not share the values of the Enlightenment: a belief in reason and progress, in the dignity of the individual and of human rights. We no longer wish to bear the burdens of world leadership, forgoing the irreplaceable advantages it confers.

A French finance minister, Valéry Giscard d'Estaing, later a prime minister, decried in 1965 the "exorbitant privilege" that accrued to the United States for possessing the world's reserve currency. We will regret deliberately relinquishing this privilege.

Investors must adapt to this new era. The strategies we previously deployed will be ineffective in this new environment. We must, and can, seek opportunities in new areas, new approaches because new opportunities will certainly arise for those astute enough to be searching for them. *Vive l'avenir*![8]

La Liberté guidant le peuple, Eugène Delacroix, 1830, Musée du Louvre.

[8] "Long live the future!"

Michael A. Rosen

Principal & Chief Investment Officer

April 2025

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