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AMERICAN CAPITAL MARKETS ENTER AN AGE OF UNCERTAINTY

Investors are starting to consider what the end of U.S. dollar hegemony might mean for American capital markets. The developments that are currently taking place could have enormous ramifications for every country with extensive economic and financial ties to the United States.

The turmoil started after the "Liberation Day" tariff announcement on April 2, 2025. After an extremely negative market reaction, the Trump administration announced that most of the reciprocal tariffs would be frozen for ninety days. The immediate market reaction to the freezing of the tariffs was positive, and many investors hoped that the markets would now return to normal. By late June, the S&P 500 appeared to have completely recovered, and in recent days it has passed its pre-Liberation Day peak.

Figure 1. *An America First High for the S&P 500*

Despite this, however, more sophisticated investors are beginning to realize that there are new dynamics to consider when judging American financial markets. In U.S. dollar terms, the S&P 500 has fully recovered. But when looked at in most other currencies, the market still appears to be struggling. As Figure 1 shows, especially when looked at in terms of euros, the S&P 500 has not performed particularly well in the last few months. This is starting to greatly worry investors who have become used to dollar-denominated stocks being the "gold standard" for international investment. Investors, especially American investors, are starting to wonder whether they might have stop relying so heavily on American stocks and look at investing more heavily in other countries.

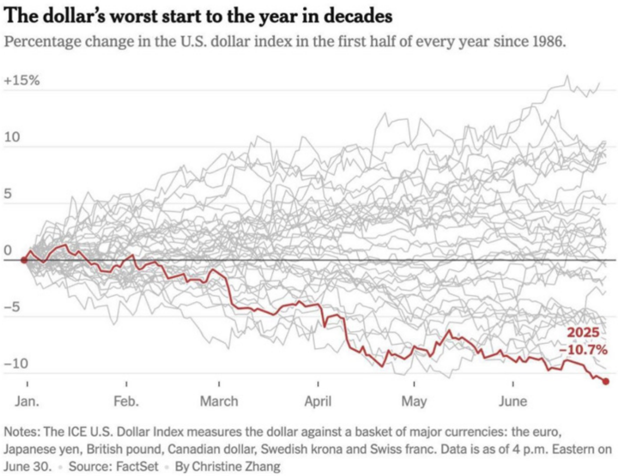

Figure 2. *The Dollar's Worst Start to the Year in Decades*

The reason for this underperformance is that the U.S. dollar is declining at an alarming rate. As Figure 2 shows, the U.S. dollar has had its worst year so far since 1986. Even comparing the current decline of the U.S. dollar to the decline in 1986 is misleading, however. In September 1985, the United States and Japan signed the Plaza Accords with the aim of a managed decline of the U.S. dollar against the Japanese yen, the German deutsche mark, the French franc, and the British pound sterling by intervening directly in the foreign currency markets. The weakening dollar in

1986 should therefore be viewed as a managed intervention in the foreign exchange markets. The fact that the U.S. dollar decline that we have seen so far in 2025 is comparable to this managed decline but is not a result of direct intervention means that we are seeing unprecedented negative market activity.

These could be the first signs that the U.S. dollar is losing its status as the world's reserve currency. This status as world reserve currency allows the dollar to remain strong even though the United States runs large trade deficits with the rest of the world. If the dollar is losing its status as the reserve currency, what we might be seeing in the dollar market is that the dollar is starting to adjust to its "natural" state—that is, its state as a normal currency not propped up by its reserve status. If this is the case, we can read the disappointing performance of American stocks when measured in non-dollar terms as being due to American capital markets losing their "special" status.

European economic policymakers are starting to wake up to the ramifications of these developments. In late May, it was reported that American companies were fleeing American capital markets because borrowing costs were too high and were instead tapping European debt markets. These deals have become known in financial markets as "Reverse Yankee" deals. President of the European Central Bank Christine Lagarde has stated that this is Europe's "global euro" moment saying:

> *We are witnessing a profound shift in the global order: Open markets and multilateral rules are fracturing, and even the dominant role of the US dollar, the cornerstone of the system, is no longer certain.*

There is no doubt that this is an enormous opening for alternative currencies like the euro, but there are also potential downsides. As the dollar loses value, the American market becomes smaller. ECB officials sounded a note of caution, saying that too much euro strength could hamper European export growth. In reality, though, European policymakers have no real control over these fundamental global economic shifts.

Because the forint is a small currency, however, Hungarian policymakers likely have more latitude in trying to mitigate the currency's strength to maintain international competitiveness. They could do this by dramatically lowering interest rates, which would also boost the economy in the run up to the election.

It is now widely known that the American industrial base has been hollowed out in the past three decades—in part due to the overvaluation of the U.S. dollar due to its reserve currency status. Because of this, the United States has not really been able to offer other countries the sort of foreign direct investment it could offer when the country was a major industrial power. During this period, the United States has effectively used the special status of the dollar to maintain its relevance in the global economy. The country could do this by offering other countries like Hungary access to its capital markets. In recent years, this has offer has increasingly been tilted toward access to America's extensive private equity market.

Investors are already worrying about the continued global economic relevance of the United States. If the U.S. dollar continues to decline, the American market will become substantially smaller. American capital markets will lose their "special" status, and inward U.S. dollar flows will become less attractive, especially considering the much higher borrowing costs in the United States.

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