



Since 2024, the fundamentals of the U.S. balance of payments have been shifting towards higher dependency on far less reliable and far more price sensitive foreign capital inflows than in the past



The U.S. is much more reliant on private rather than public officialⁱ creditors, with a far larger share of capital inflows going into inherently more risky equity rather than bond markets



The dollar is more tied to AI's success than recognized, and no longer a reliable backstop

THE LOSS OF U.S. EXCEPTIONALISM

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The recent sell-off in U.S. Treasuries, which pushed the 10-year yield above 5% for the first time since 2007, exposes a structural shift in how the country finances its external deficit. Private capital now drives U.S. financing 10 times more than public official creditors, and over half of recent private inflows have gone into equities rather than the bonds that traditionally anchored foreign demand, leaving both the dollar and U.S. stock markets more exposed to a rapid change in trends. Public official creditors, including those linked to longstanding allies, have already trimmed their Treasury holdings by hundreds of billions since the war with Iran began, in a context additionally marked by the political tensions surrounding tariffs, NATO, and Federal Reserve independence. Without a credible alternative reserve asset to the U.S. dollar, coordinated central bank intervention remains the likely backstop in the event of a crisis, but the need for such intervention would itself confirm that U.S. exceptionalism is fading. European bond markets have already begun to feel the spillover, with French, Italian, and Spanish yields widening meaningfully over the past three months, and further steepening of sovereign bond yield curves and currency pressure are likely over the coming six months.

Introduction

While there are a number of credible theories explaining the recent sell-off in the U.S. Treasury market, the sharpness of the move over the autumn, and its implications for real interest rates and the U.S. dollar highlight fragilities in U.S. as well as global

i. Includes foreign central banks and monetary authorities plus foreign governments, foreign public entities including sovereign wealth funds and multilateral institutions.

financial markets. One way of assessing these fragilities is by closely examining the U.S. Balance of Payments, and more specifically the financial account. The financial account of an economy records transactions resulting in a change of ownership of international financial assets and liabilities between a nation's residents and non-residents. Because the U.S. has been running a structural current account deficit for decades, representing a shortfall in domestic savings compared to investment, it must run a financial account surplus, all else being equal.

Many economists have argued that balance of payments analysis does not apply in the case of a reserve currency economy, as there will presumably always be net demand for that currency, while G7 central banks have the ability to create reserve money without limits. The “exorbitant privilege” of the U.S. dollar is a reflection of long-standing formal and informal demand for dollars globally; at present, dollar assets make up 57% of allocated international reserve holdings compared to the U.S. share (in PPP) of global GDP of 14.5%, according to IMF data. Moreover, despite rising competition from other currencies, the U.S. dollar continues to dominate international trade invoicing, foreign exchange turnover, international debt issuance, and banking and wealth management. These advantages are well-established; and they provide international capital markets with enormous efficiency gains that would be difficult to replace in the absence of U.S. dollar exceptionalism.

Nevertheless, the fundamentals of the U.S. balance of payments have since 2024 been shifting in a way that signifies a much higher dependency on far less reliable and far more price sensitive capital inflows than in the past. Such a dependency is generally not the hallmark of a provider of risk-free assets.

At present, private sector capital inflows into dollar assets outpace public official inflows by a factor of 10 to 1: amounting to \$1.60 trillion (or over 5% of U.S. GDP) out of the \$1.75 trillion financial account surplus that the U.S. posted in the twelve months to July 2026

Compared to the past, the U.S. is far more reliant on private rather than public official creditors. At present, private sector capital inflows into dollar assets outpace public official inflows by a factor of 10 to 1: amounting to \$1.60 trillion (or over 5% of U.S. GDP) out of the \$1.75 trillion financial account surplus that the U.S. posted in the twelve months to July 2026.

A further look at what private creditors are actually buying raises concerns about the stickiness of foreign investments into the United States, and hence the future stability of the U.S. dollar, and—over the longer term—its reserve currency status. This is because since mid-2024, over one half of the assets being acquired by the non-resident private sector (\$802bn during the twelve months to July 2026) are equity securities, a figure completely at odds with the historical bond-to-equity purchase ratio of around 13 to 1. In other words, the current composition of foreign purchases of U.S. assets is unusually geared towards U.S. stock markets, which are inherently more volatile than bonds. That is particularly the case now given the concentration of tech and semiconductor companies in the S&P 500—and their increasing dependency on the success or failure of AI business models to justify rich valuations and price-to-earnings ratios. At the very least, foreign private investors have accumulated substantial exposure to both U.S. equities and the dollar. This

leaves the dollar in a vulnerable technical position: given the size of these existing holdings, particularly in highly valued technology stocks, a deterioration in market sentiment could prompt foreign investors to reduce their U.S. equity exposure and repatriate the proceeds, adding selling pressure on the dollar rather than generating fresh demand for it.

While there is no Treasury data for cross border financial flows since end July, 2026, and while much of the pressure on U.S. government bonds is coming via short selling, rising U.S. yields also suggest that like their public official peers, private sector non-residents may also be cutting back their holdings of U.S. government bonds even as the large long U.S. stock market position remains in place. Indeed, the monthly data for July confirms large net selling of Treasuries by foreign private accounts for the first time since the autumn of 2025. Given the enormity of foreign private holdings of U.S. bonded debt up until now (through end July 2026, the private foreign sector was a net buyer of U.S. government, agency, and corporate bonds worth just under \$800bn on a 12m rolling basis), there is likely more of a selloff anticipated.

On top of this, the widening and steepening of U.S. rates would—if historical patterns hold—tend to trigger a correction in U.S. equity markets, as customers of U.S. tech companies face higher refinancing costs. A sell-off on U.S. equities and Treasuries would, under this scenario, feed off of each other unless there were an improvement in underlying macroeconomic and fiscal fundamentals.

A sell-off in U.S. equities and Treasuries would feed off itself unless underlying macroeconomic and fiscal fundamentals improve, but in an election year, there appears to be little chance of a re-think by U.S. authorities on fiscal, trade, or immigration policies

When financial vulnerability meets policy risk

However, in an election year, there appears to be little chance of a re-think by U.S. authorities on fiscal, trade, or immigration policies. The recurrent budgetary deficits and high debt of the United States, the persistence of underlying inflationary pressures, and the rise in disagreements between the U.S. and its traditional allies over tariffs, NATO, and Greenland, not to mention the conflict in Ukraine, all pre-date the war with Iran. These tensions come on top of questions around Federal Reserve independence, the politicized 2025 firing of Bureau of Labor Statistics (BLS) Commissioner Erika McEntarfer, and the November 2024 publication of “A User’s Guide to Restructuring the Global Trading System,” in which the author (former chair of the Council of Economic Advisers and Federal Reserve Board of Governors member Stephen Miran) proposes that the U.S. reschedule its longer duration Treasury bonds held by those public official foreign creditors which benefit from a U.S. security guarantee.

Despite tensions between the U.S. and its traditional allies were there really to be a balance of payments shock on the financing side, foreign central banks would likely coordinate actions with the Fed to stabilize the dollar and U.S. financial markets. This is the case despite the decision of public official creditors of the United States to cut their holdings of U.S. Treasuries by a cumulative \$1.59 trillion since 2015. More recently, since the onset of the U.S. war with Iran in February, 13 out of the 20 largest public official creditors of the U.S. government—including longstanding U.S. allies Japan, Taiwan, Saudi Arabia, South Korea, the UAE, Switzerland, and Norway - have

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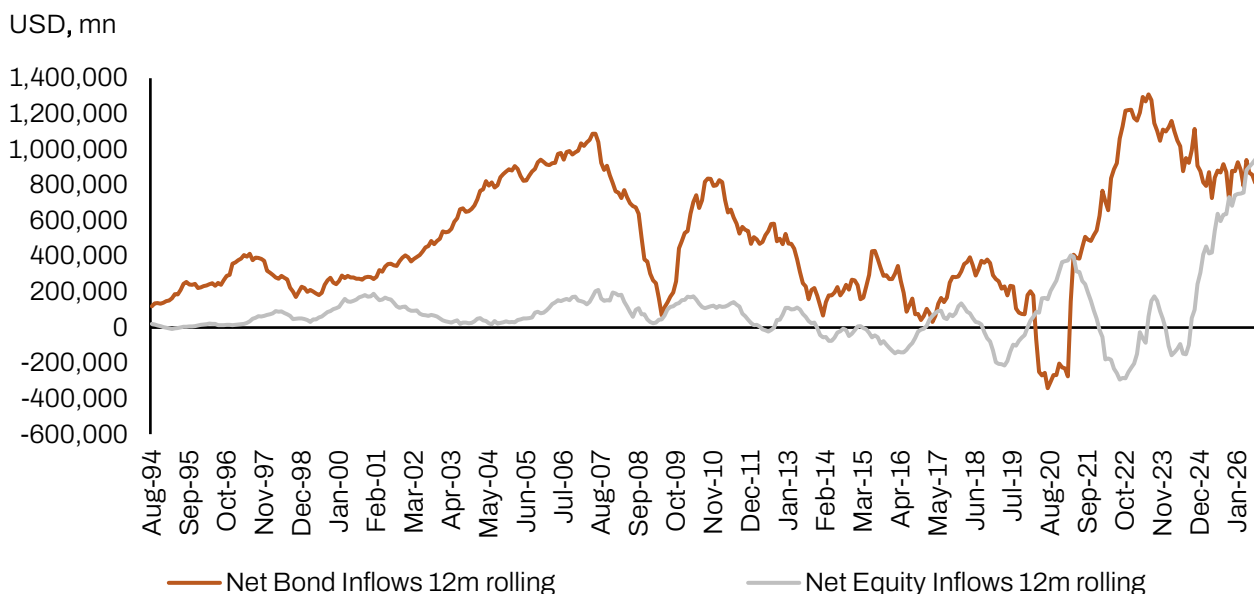
pared back their holdings of Treasuries. Treasury International Capital (TIC) data for end June 2026, shows that the top 20 public official holders of U.S. debt have reduced those holdings by just under 6% or \$233bn since the war started. Faced with a weaker dollar and a weaker U.S. economy, however, U.S. allies and adversaries would likely take steps to coordinate an intervention in currency and financial markets. That they would be forced to do so, however, would tend to reinforce the sense that U.S. exceptionalism is quickly eroding.

It is of course also fair to ask what is the viable alternative to U.S. Treasuries and the U.S. dollar. Neither Europe nor China is keen to operate balance of payments deficits with the rest of the world, nor do they issue sufficient volumes of tradeable, risk-free securities that they could sell to offset those undesired external deficits. After all, that the U.S. runs external—including trade—deficits with the rest of the world largely reflects this demand from trading partners to invest in U.S. bonds, and increasingly equities, as well as the policy choices and structural features that explain the high propensity of private companies and households in Asia, Europe, and the Middle East to save more than they spend. These excess savings must be invested somewhere else, and for decades that somewhere has been the United States.

What does this imply for financial markets over the next six months, particularly in Europe?

Further yield steepening is expected particularly across the 2-5 year section of the U.S. yield curve. There has already been considerable spillover into euro area bond markets, with further spread widening, although not the same degree of steepening. French 10 year yields have backed up by over 100bps during the last three months, with Italian and Spanish yields wider by 65bps and 50bps respectively. Given limited growth prospects in much of Europe, a far higher exposure to market oil prices, amid

Figure 1 - Total 12m rolling Net Equity (gray) vs Total Net Bond (orange)



hydrocarbon import dependency, and generally weak euro area public finances, it seems unlikely that euro area bond market or Gilts will outperform Treasuries. The recent trend of inflows into emerging markets should continue, with depreciation of G7 currencies, including the euro against a basket of EM including Asian currencies. The level of oil prices will influence how much exchange rate appreciation the Chinese will tolerate. Ultimately, U.S. authorities are likely to push for another “Plaza Accord,” in conjunction with domestic policy measures, including possible measures to contain domestic price and wage inflation should the dollar come under severe pressure simultaneous with higher energy prices. U.S. governments of either major political party may be supportive of some price controls, especially of services including housing, in conjunction with maturity transformation of U.S. debt including a swap into longer duration obligations, not excluding a default, albeit this is likely to play out over a longer time horizon. **FI**