Bellwether

Chart FOR Thought

The U.S. Trade Deficit Feedback Loop

Why a Growing U.S. Trade Deficit is Bullish for U.S. Risk Assets

Since the Federal Reserve launched quantitative easing (QE)[1] in November 2008, the U.S. stock market has surged through an era of unprecedented money printing, ultra-low interest rate policy (pre-March 2022), and innovation in the technology industry. However, one overlooked yet powerful relationship has appeared in the data: a meaningful correlation between the year-over-year percentage change in the U.S. trade deficit and S&P 500.[2]

This isn't a coincidence — it's a result of U.S. dollar (USD) capital flows into financial markets. While this relationship is clearly observable, its persistence may be impacted by shifts in global trade, capital preferences, or policy regimes. Importantly, this mechanism offers meaningful insight into how international trade and capital flows can affect U.S. financial market performance.

The Mechanism: U.S. Imports Increase *(more than Exports)* → Export of the USD Increases → USDs are Reinvested into U.S. Assets

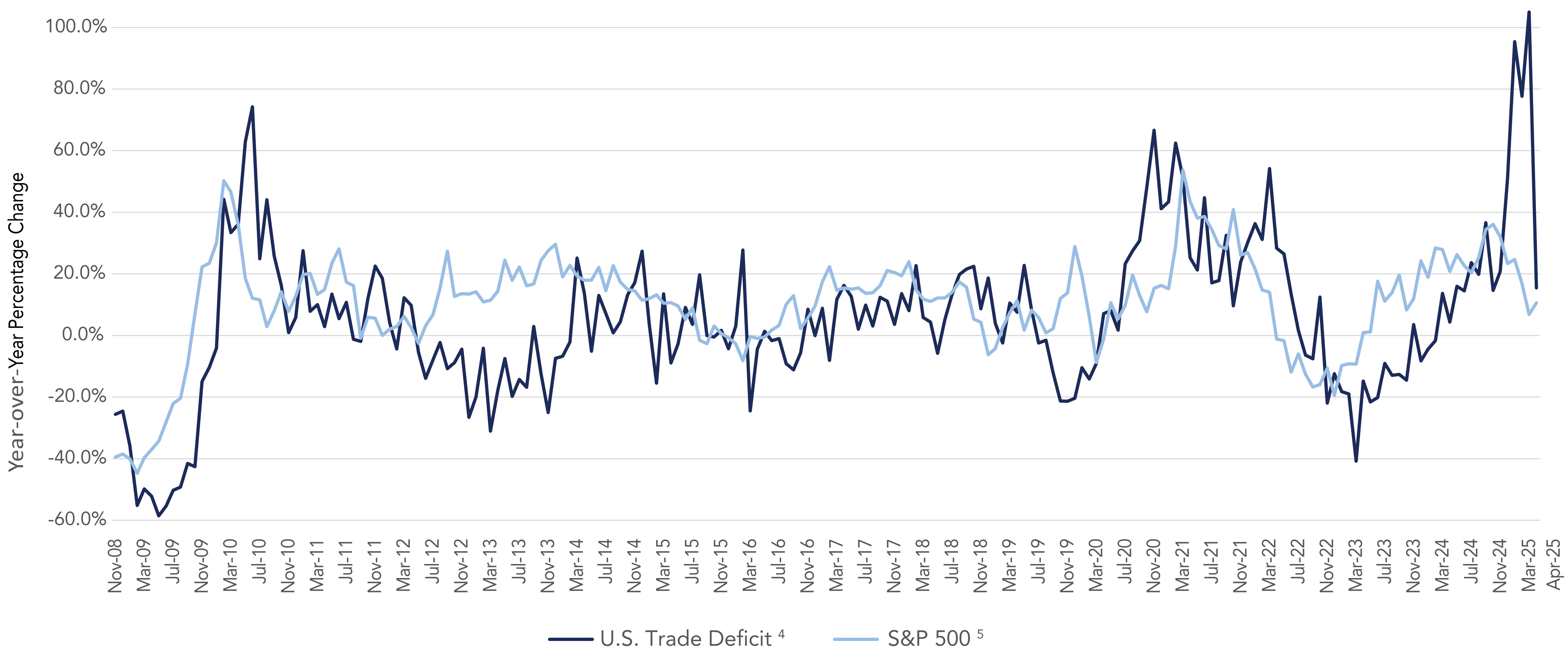
Functionally, a trade deficit occurs when a country imports more goods than it exports. For reference, the U.S. has run a persistent trade deficit since 1975.[3] Since the USD is the primary reserve currency of the world, most internationally traded goods are priced in USDs, creating a constant global demand for USDs. As a result, the U.S. exports USDs to countries around the world in exchange for imported goods. These countries accumulate USD reserves, which predominantly find their way back into U.S. financial markets — often via reinvestment in treasuries, equities, corporate bonds, private alternatives, etc. That capital loop has remained sticky due to:

- The USD's primary reserve currency status, and
- The attractiveness of the U.S. financial markets, which are by far the largest and most liquid globally.

Ultimately, a larger trade deficit increases the pool of USDs available to be recycled back into the U.S. financial markets. The post-2008 world of QE, globalization, and U.S. economic outperformance has further reinforced this loop.

Chart Insight: U.S. Trade Deficit and S&P 500 Relationship

U.S. Trade Deficit vs. S&P 500, Year-over-Year Percentage Change



Since November 2008, the year-over-year percentage change in the U.S. trade deficit and the S&P 500 often moved in tandem, exhibiting a correlation coefficient of +0.50. According to Pearson's Correlation Coefficient,[6] values between 0.50 to 1.00 indicate a strong positive correlation.

Generally, periods of rising U.S. trade deficits have coincided with positive S&P 500 returns, likely driven by increased global reinvestment in U.S. assets, via the aforementioned capital loop. It's worth noting that correlation doesn't imply direct causation, as many variables—such as corporate earnings, monetary and fiscal policy, sentiment, and inflation—simultaneously influence market returns.

Where Do We Go from Here?

Looking ahead, what happens if the U.S. reduces its trade deficit?

One of the central goals of the Trump administration is to reduce the U.S. trade deficit through more protectionist trade policies, including tariffs and incentives for reshoring. While the jury is still out on how successful these policies will be, they could also disrupt the flow of recycled dollars into the U.S. financial markets, as less USDs would be exported globally.

As a result, a reduction in U.S. trade deficits could become a headwind for U.S. financial markets — unless offset by things like: increased productivity, increased domestic savings (used to fund increased domestic investment), a reduced fiscal deficit, long-term foreign direct investment, amended U.S. tax policy, monetary policy, etc. Heightened uncertainty with U.S. trade policy has recently led to increased volatility, which may continue until material trade deals are executed.

Bottom Line

The trade deficit isn't just an economic scoreboard — it's also a liquidity engine for U.S. financial markets. Investors and policymakers should pay close attention to how structural trade dynamics influence cross-border capital flows, U.S. financial market performance, and policy trade-offs in the years ahead.

Endnotes

1. Quantitative easing is a monetary policy tool used by central banks to inject liquidity into the economy and lower interest rates through the purchase of government securities or other financial assets.

2. The S&P 500 is a stock market index tracking the stock performance of the 500 leading U.S. companies.

3. U.S. Census Bureau and U.S. Bureau of Economic Analysis, U.S. International Trade in Goods and Services, https://www.bea.gov/data/intl-trade-investment/international-trade-goods-and-services.

4. Federal Reserve Bank of St. Louis, Trade Balance: Goods and Services, Balance of Payments Basis, Percent Change from Year Ago, Monthly, Seasonally Adjusted, FRED, https://fred.stlouisfed.org.

5. Bloomberg L.P., S&P 500 Index Historical Performance, Bloomberg Terminal.

6. Pearson's Correlation Coefficient is a statistical measure that quantifies the relationship between two variables.