

# US WEALTH SHARES, THE DOLLAR AND GLOBAL RISK PREMIA

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## MOTIVATION: EP THEORY

**EP:** *Exorbitant privilege* (EP) theory emphasises a tight connection between the US wealth share, the dollar, the global economy and global risk premia:

1. **US wealth share** is *procyclical* w.r.t global economy
2. **Dollar strength** is *procyclical* w.r.t global economy

**Risk Sharing:** Underpinning these joint dynamics is a *risk sharing mechanism*: as the world's most risk tolerant nation, the US insures the ROW during global recessions (Gourinchas et al, 2017; Maggiori, 2017)

**Challenge:** Whilst the prediction of a procyclical dollar is well known to be counterfactual, *little is known about the US wealth share and its link with the global economy*. I shed light on this using portfolio holdings data.

## MECHANISM

**Question:** What is the underlying mechanism driving the countercyclical US wealth share?

**Mechanism:** I establish two crucial ingredients to the underlying mechanism:

1. **Valuation Channel:** *Valuation forces*, not flow forces drive US relative wealth changes
2. **Risky Asset Markets:** US equity outperformance during global recessions drives countercyclical US wealth share

## RISK PREMIUM CHANNEL

**Mechanism:** If US loads less on the global factor structure in equity prices, *US risk premia rises relatively less vis--vie the ROW during global recessions*

1. **Wealth Share:**  $r_t^{US} - r_t^{ROW} \uparrow$  due to lower relative US risk premia. This maps directly into a *rising US wealth share* due to home biased wealth portfolios.
2. **Dollar:** *Rising US wealth share* increases relative demand for US goods, generating a powerful *dollar appreciation* force during global recessions.

## US WEALTH SHARE, THE DOLLAR AND GLOBAL ECONOMY

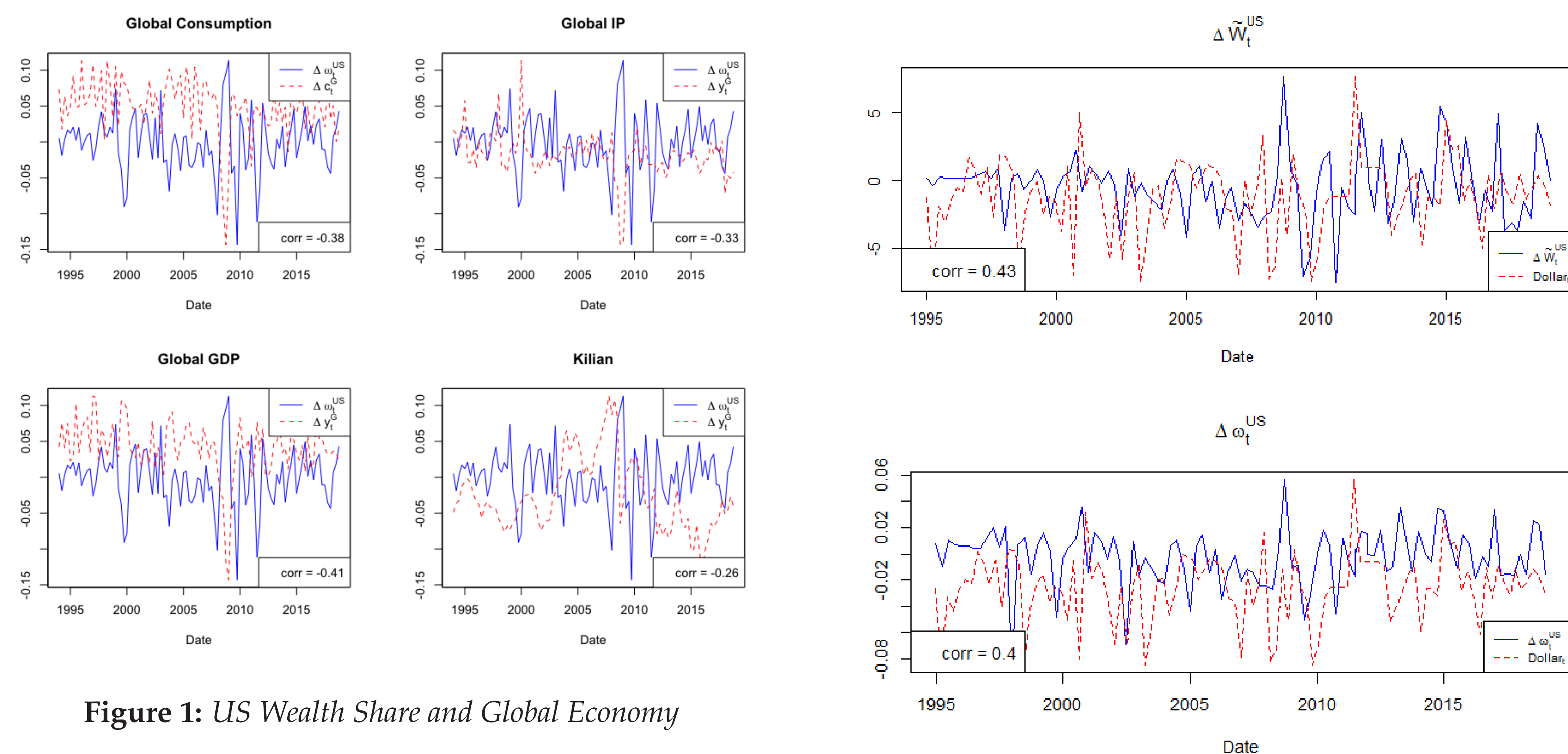


Figure 1: US Wealth Share and Global Economy

**Description:** This figure plots US wealth share growth  $\Delta\omega_t^{US}$  (blue) against various measures of the global economy (red) from 1994Q1 - 2018Q4.

**Description:** This figure plots US wealth share growth and US relative wealth growth:  $\Delta\omega_t^{US}$ ,  $\Delta\tilde{W}_t$  (blue) against the dollar carry trade return (red).

## US EQUITY OUTPERFORMANCE

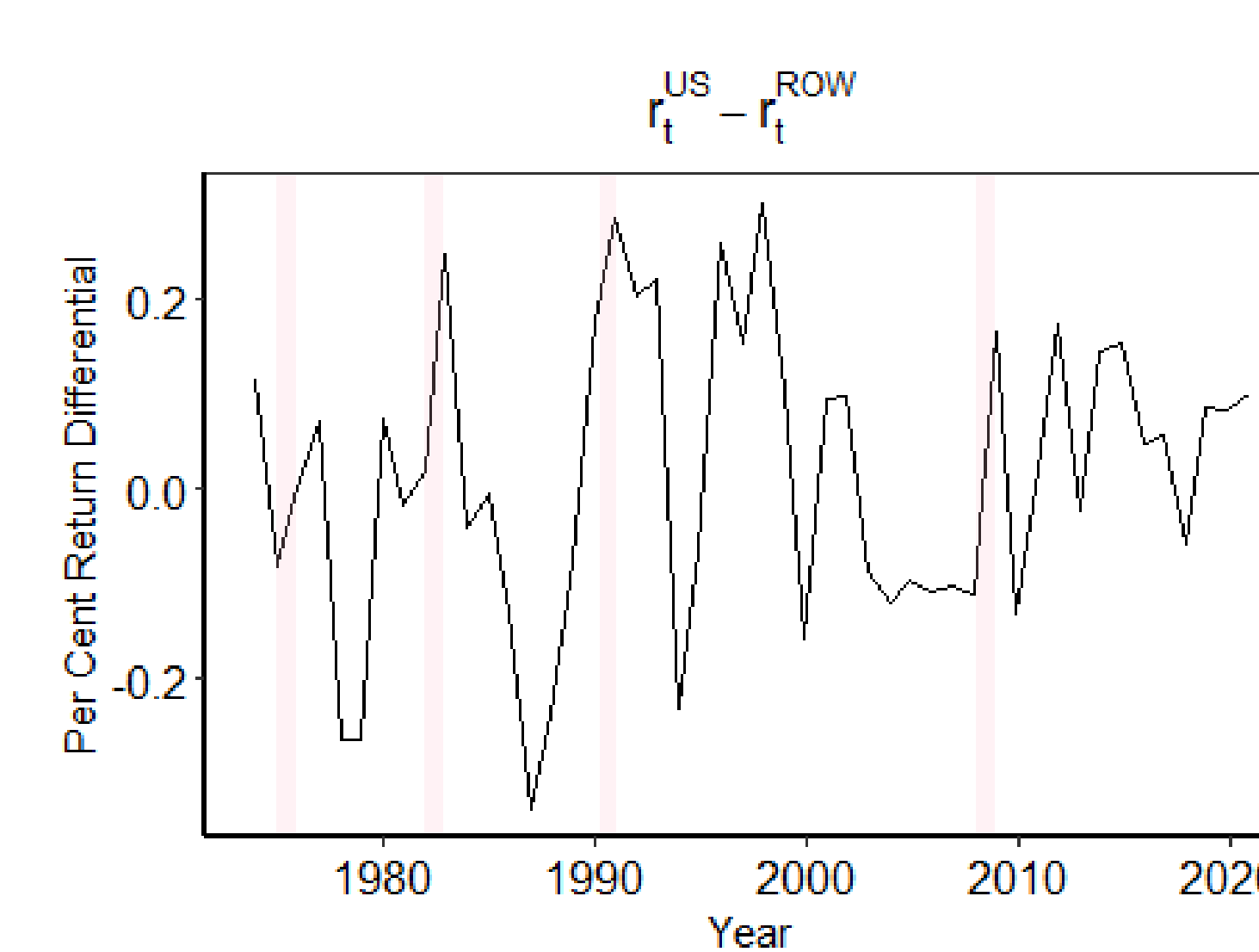


Figure 3: Countercyclical US Equity Outperformance

**Description:** Pink bands corresponds to four global recessions: 1974Q1-1975Q1, 1981Q4-1982Q4, 1990Q4-1991Q1, and 2008Q3-2009Q1.

**Interpretation:** Each global recession is associated with US stock market outperformance vis--vie the ROW

**Theory:** All potential resolutions must explain why the US stock market outperforms ROW during global recessions.

## MODEL OVERVIEW

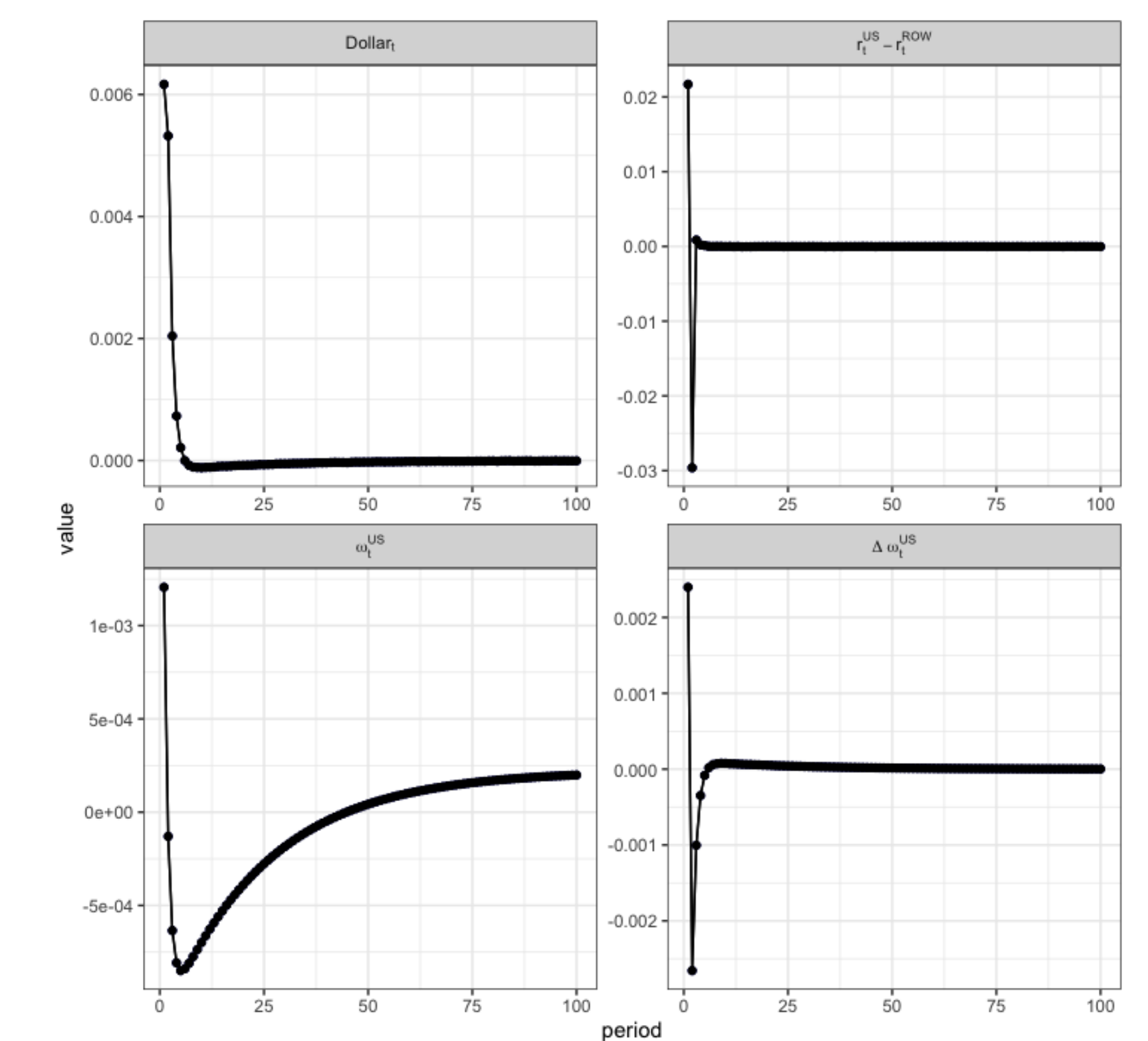


Figure 4: Model IRF to 1 SD bad global shock

**Model:** Frictionless two country, two good model with i) EZ preferences, ii) global SR and global LR shocks that are *positively correlated with each other* iii) US has lower (larger) exposure to the SR (LR) shocks.

**Overview:** Model reproduces both the countercyclical US wealth share and the countercyclical dollar.

## STYLISTED FACTS OVERVIEW

**US Wealth Share:** Using aggregate portfolio holdings data, I uncover a novel stylised fact: the US wealth share is *countercyclical* w.r.t the global economy. Global recessions are associated with *rises, not falls, in US relative wealth vis--vie the ROW*.

**Key Takeaway:** This novel fact challenges EP theory: hard to reconcile the countercyclical US wealth share with the view that US insures ROW (Gourinchas et al, 2017; Maggiori, 2017).

## RISK SHARING VS RISK PREMIA

**Risk Sharing:** EP theory cannot reproduce either the countercyclical US wealth share or the countercyclical dollar

**Risk Premia:** I show that a global *risk premium* story can formally account for both patterns.

## CONCLUDING REMARKS

**Bottom Line:** *risk premia, not risk sharing, is the key economic force driving the joint dynamics between US wealth share, dollar and global economy.*

**Moving Forward:** Enrich model setting to include portfolio choice and richer menu of shocks.