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Investment Strategy & Research Highlights

- ▶ **U.S. Economic Stability & Federal Reserve Policy:** The United States maintains modest gross domestic product (GDP) growth and strong employment, with inflation gradually receding. In response to economic conditions, the Federal Reserve (the Fed) has implemented recent rate cuts, followed by a decision to hold its target rate at 4.50%, signaling its readiness to ease further if economic conditions weaken.
- ▶ **Stretched Valuations & AI-Driven Earnings:** U.S. equity valuations are elevated amid expectations of enhanced earnings growth driven by artificial intelligence (AI). In contrast, international markets offer more reasonable valuations, particularly for value stocks.
- ▶ **Diversification as a Strategic Imperative:** Given the disparate economic cycles and market phases globally, broad portfolio diversification—including investment-grade-bonds and alternative diversifiers—remains essential to mitigating volatility.
- ▶ **Market Dynamics & Big Tech Evolution:** Historical trends reveal unprecedented S&P 500 outperformance, a strong U.S. dollar and a dramatic concentration in Big Tech. The rapid evolution in AI capabilities and shifting industry leadership, exemplified by Microsoft's resilient performance, highlights both opportunities and risks.
- ▶ **Fiscal & Geopolitical Considerations:** Political shifts, notably the current administration's ambitious reforms under constrained fiscal conditions—characterized by high deficits and interest costs—along with persistent geopolitical risks, signal a challenging environment where a vigilant reassessment of valuations is crucial.

Intro

Most measures of economic activity suggest the U.S. economy is stable with modest GDP growth and strong employment, while inflation is coming back under control—albeit still above the Fed's 2% target. The environment allowed the Fed to reduce rates by 50 basis points in September, followed by an additional 25 basis points in November and another 25 basis points in December. However, it recently decided to hold its target rate at 4.50%.

The Fed is attempting to maintain its ability to either stimulate the economy by further reducing interest rates or curb inflation by increasing them.

However, equity valuations in the U.S. are stretched, implying continued earnings increases, likely driven by expected productivity gains from advances in AI. Market expectations currently reflect the potential for higher earnings growth in the U.S. over the next decade. However, there is no guarantee that these expectations will materialize, and of course future earnings depend on evolving economic conditions, corporate performance and regulatory changes.

Outside of the U.S., international markets present a mixed picture across countries, with Europe, Japan and emerging markets generally coping with their own challenges and opportunities. In general, their economies currently aren't as strong as the U.S., but their equity valuations are generally more reasonable, especially for value stocks.

We think broad portfolio diversification is critical because companies and countries are in different phases of their economic and market cycles. Given current equity market pricing, we expect portfolio tailwinds from value stocks and non-U.S. equities over the next decade.

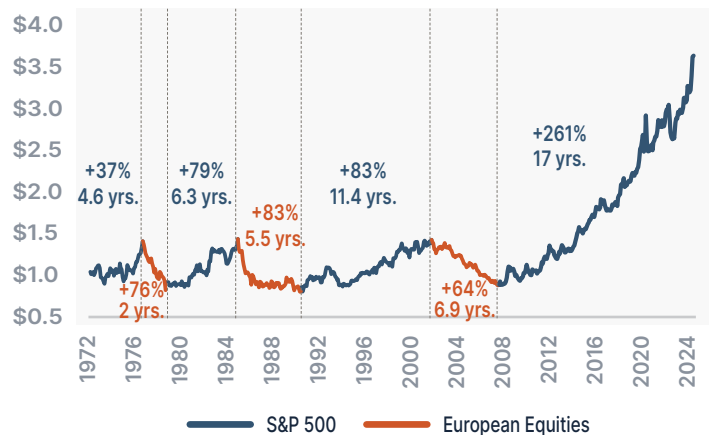
Turning to fixed income, core or investment-grade bonds are generally priced to deliver better returns than they have over past several years. Additionally, bonds could offer more stability, acting as a ballast in portfolios if—and when—equities hit rough patches in the years ahead.

Although not all portfolios hold diversifiers, for those that do, we expect them to continue offering enhanced diversification with exposure to long/short strategies, relative value, global macro, and gold, among others.

Deeper Dive: Continued U.S. Equity Outperformance?

Investors often use history, and specifically historical patterns, to help guide decisions. While the future does not always mirror the past, it often bears a close resemblance—especially when viewed over long periods. Unfortunately, history has not been as reliable a guide for making decisions in financial markets over the last several years as illustrated by **Figure 1**.

FIGURE 1
S&P 500 vs. European Equities
Cumulative Relative Wealth



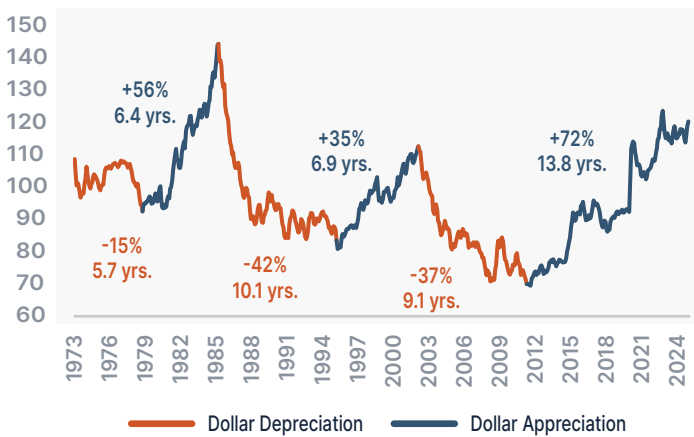
Data as of 12/31/24. Source: Aspiriant analysis. Data from Bloomberg. S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. European Equities represented by the MSCI Europe, Australasia, and Far East (EAFE) ex Japan Index. Past performance is not indicative of future results. All investments can lose value. The performance and volatility of an investor's portfolio will not be the same as the index. Indices are unmanaged and have no fees. An investment may not be made directly in an index. This information alone is not sufficient and should not be used for the development or implementation of an investment strategy or be construed as investment advice. Please see additional disclosures regarding third-party data and other considerations.

Figure 1 compares the performance of the S&P 500 against European equities. Historically, outperformance periods have averaged six years, peaking at 80%-85%, cumulative differences, with both regions delivering similar returns over 40 years. However, since the 2009 financial crisis, the S&P 500 has experienced an unprecedented 17-year run, outpacing European equities by 261%—far exceeding the typical 70% difference. This sustained outperformance is unmatched in the past 50 years.

U.S. Dollar Dominance

After reviewing historical relationships within global equities, **Figure 2** examines the U.S. dollar versus a trade-weighted basket of major currencies. Currency cycles typically span six to 10 years, with cumulative moves of 40%-50%. Notably, the latest period shows the dollar appreciating by 72% over an extended timeframe—an anomaly compared to past trends.

FIGURE 2
U.S. Dollar Major Trade-Weighted Exchange Rate



Data as of 12/31/24. Source: Aspiriant analysis. Data from Morningstar, Bloomberg. A weighted average of USD against a subset of currencies composed of the Euro Area, Canada, Japan, the United Kingdom, Switzerland, Australia, and Sweden. Index March 1973 = 100. Please see additional disclosures regarding third-party data and other considerations.

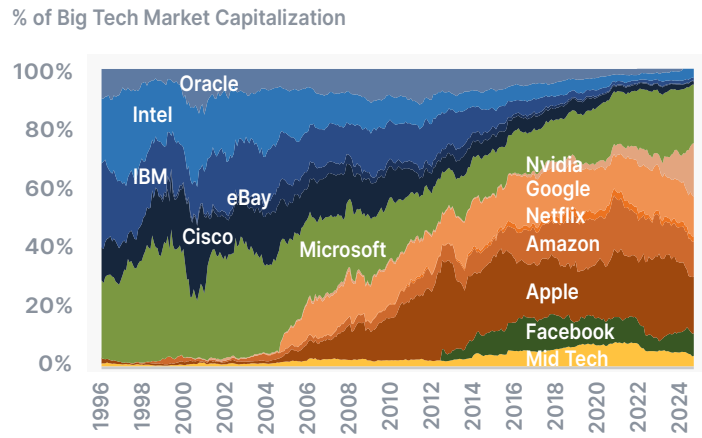
There is some overlap between S&P 500 outperformance and a stronger U.S. dollar, reflecting robust U.S. economic fundamentals that attract foreign capital. However, this relationship isn't consistent; for example, from 1985 to 1995, the dollar weakened even as both European equities and the S&P 500 performed well.

Overall, these signals suggest the current market cycle is stretched, and historical patterns imply a reversal is more likely than a continuation of these trends.

Big Impact of Big Tech

The following charts, **Figure 3** and **Figure 4**, illustrate the impact of Big Tech stocks on equity markets more broadly. While they represent a small fraction of the S&P 500, these firms now account for a growing share of market capitalization due to high profit margins and elevated valuations.

FIGURE 3
Big Tech Market Leadership Over Time



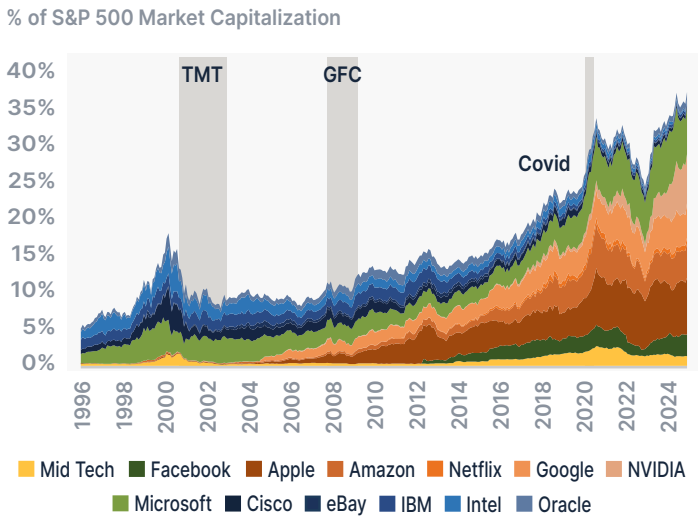
Data as of 12/31/24. Source: Aspiriant analysis. Data from Bloomberg. Big Tech represents market-capitalization weighted portfolio including Adobe, Alphabet, Amazon, Apple, Cisco, eBay, IBM, Intel, Microsoft, Netflix, NVIDIA, Oracle, and Salesforce.com. Month end re-weight of each stock's initial public offering from 3/31/93-3/31/00 and 3/31/00-3/31/07. S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. Please see additional disclosures regarding third-party data and other considerations.

Over time, the composition of Big Tech has shifted as innovation, competition and consumer trends have evolved. In the mid-1990s, companies like Oracle, Intel, IBM, Cisco and eBay comprised roughly 68% of Big Tech's market cap. Today, they represent only 5%, having ceded leadership to firms such as Nvidia, Google, Netflix, Amazon, Apple and Meta. The former group's market cap has declined from \$1.5 trillion in 2000 to \$1.0 trillion—a loss of \$467 billion over 24 years.

This evolution highlights the volatility of industry leadership, where market dominance can shift significantly over time. Today's frontrunners may become tomorrow's laggards, complicating long-term investment strategies.

A notable exception is Microsoft, the Big Tech bellwether. By diversifying from core operating systems and software into gaming, entertainment, cloud services, and, more recently, artificial intelligence, Microsoft has adeptly navigated shifting consumer demands and technology disruptions. It now rivals Apple in value, with a market cap of roughly \$3.3 trillion.

FIGURE 4
S&P 500 Market Cap Representation



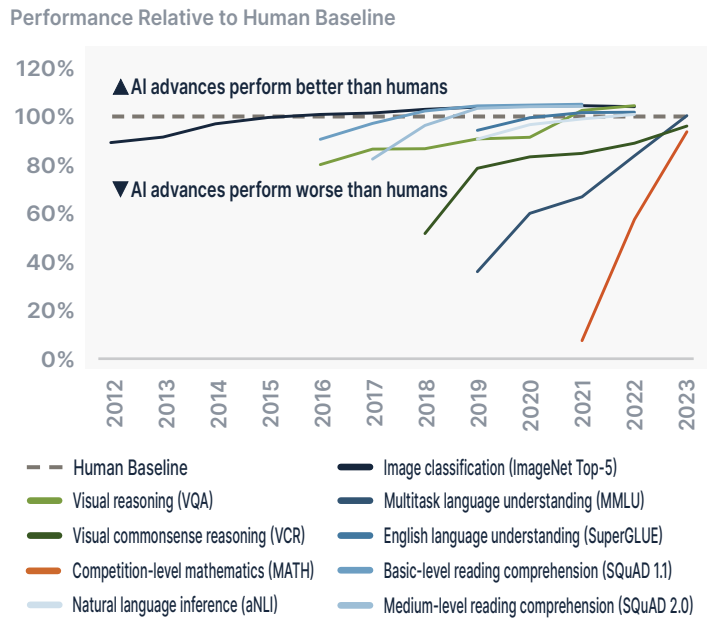
Data as of 12/31/24. Source: Aspiriant analysis. Data from Bloomberg. Big Tech represents market-capitalization weighted portfolio including Adobe, Alphabet, Amazon, Apple, Cisco, eBay, IBM, Intel, Microsoft, Netflix, NVIDIA, Oracle, and Salesforce.com. Month end re-weight of each stock's initial public offering from 3/31/93-3/31/00 and 3/31/00-3/31/07. TMT is Technology, Media and Telecommunications. GFC is the global financial crisis. S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. Please see additional disclosures regarding third-party data and other considerations.

Finally, the concentration in Big Tech has accelerated dramatically. Before the technology, media and telecommunications (TMT) era, these stocks represented about 14% (\$1.9 trillion) of the S&P 500. Following the TMT boom, their share dropped to 7% (\$558 billion) before surging to 37% (\$18.4 trillion). Their high correlation further limits diversification, amplifying portfolio outcomes as these stocks tend to move in unison.

AI vs. Humans

Within Big Tech, the pace of AI advancements is accelerating dramatically. Figure 5 compares AI capabilities against a human baseline (dashed gray line), with performance above the line surpassing human ability and performance below the line indicating remaining gaps.

FIGURE 5
AI Progress vs. Human Performance Benchmarks



Data as of 12/31/24. Source: Aspiriant analysis. Data from Stanford AI Index public database. Please see additional disclosures regarding third-party data and other considerations. Early Systems: Handwriting recognition (not shown, 2000 to 2012), Speech recognition (not shown, 2000 to 2016), and Image classification (ImageNet Top-5). Visual Reasoning: visual reasoning (VQA), visual commonsense reasoning (VCR). Language Reasoning: natural language inference (aNLI), Basic-level reading comprehension (SQuAD 1.1), Medium-level reading comprehension (SQuAD 2.0), English language understanding (SuperGLUE), Multitask language understanding (MMLU). Mathematics: Competition-level mathematics (MATH).

For instance, image classification (black line) started at 89% of human proficiency in 2012, reached parity by 2015, and has since surpassed human performance. The two green lines track improvements in visual reasoning that, while initially below human levels, have closed the gap over five-year periods. The five blue lines demonstrate rapid progress in language reasoning, with some capabilities catching up in just two to four years.

Most remarkable are the gains in mathematical proficiency. The orange line shows AI systems, which in 2021 answered only 6%-7% of competition-level math problems correctly—frequently making basic geometric errors—but improving to about 90% accuracy within two years, with further leaps on the horizon.

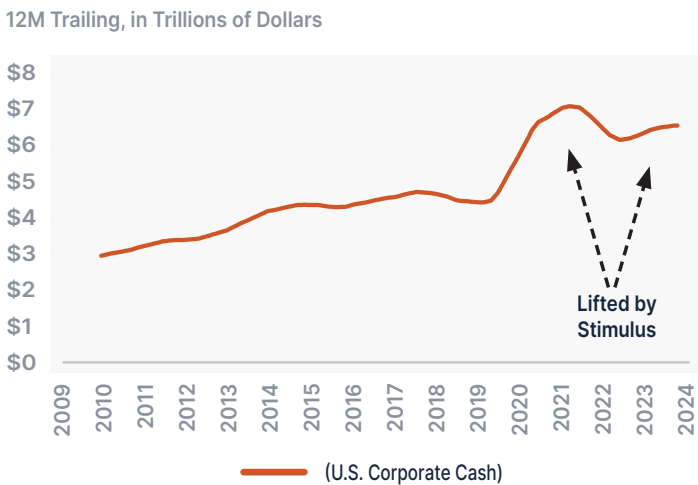
In summary, as task complexity increases, AI is achieving human-level performance at an even faster pace. This trend underscores AI's transformative potential and its profound implications for industries and investment strategies.

AI Investment Frenzy

The hope of realizing the immense potential of these advances—namely in worker productivity and capital efficiency—has led many companies to view AI as an existential threat to their business models. To avoid obsolescence, like the previously mentioned cohort of Big Tech companies, firms feel compelled to invest heavily in AI opportunities and, at the moment, have plenty of capital to do so.

Figure 6 shows corporate cash balances since 2010. During the pandemic, cash reserves surged from approximately \$4.5 trillion to \$6.5 trillion—a 44% increase. Excess cash is typically deployed quickly for share buybacks, dividends, mergers and acquisitions, capital expenditures, and research and development (R&D), especially amid an escalating AI arms race.

FIGURE 6
U.S. Corporate Cash



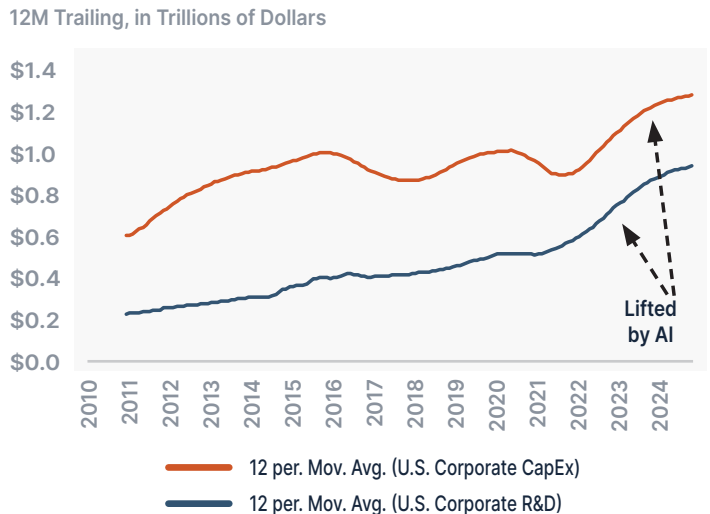
Data as of 12/31/24. Source: Aspiriant analysis. Data from Bloomberg. Please see additional disclosures regarding third-party data and other considerations.

Figure 7 reveals that capital expenditures have more than doubled since 2010, increasing 40% since 2021, while R&D spending has quadrupled since 2010 and risen 60% recently. These increases reflect substantial investments in AI. Notably, Amazon, Alphabet, Microsoft, and Meta now account for roughly 23% of total U.S. capital expenditures (CapEx), compared to just 3% a decade ago.

The payoff from these investments will take years to materialize, and not every dollar will be well spent. As such, investors must remain vigilant in reassessing company valuations. A case in point is DeepSeek, a Chinese AI firm that recently introduced its R1 model. The company claims R1 delivers testing results comparable to ChatGPT and other leading AI systems while using less advanced, lower-cost and energy-efficient chips. If validated, this suggests U.S. competitors may be overspending billions on expensive, energy-intensive Nvidia chips without corresponding benefits.

Following the announcement of DeepSeek's R1 model, Nvidia's stock experienced a significant decline in market capitalization. While competition in AI may impact valuations, other factors such as investor sentiment, broader market conditions and economic data releases can also contribute to price fluctuations. Despite such volatility, robust competition in AI ultimately benefits consumers through enhanced quality and lower costs, ensuring that as AI evolves, winners and losers will emerge.

FIGURE 7
U.S. Corporate CapEx and R&D



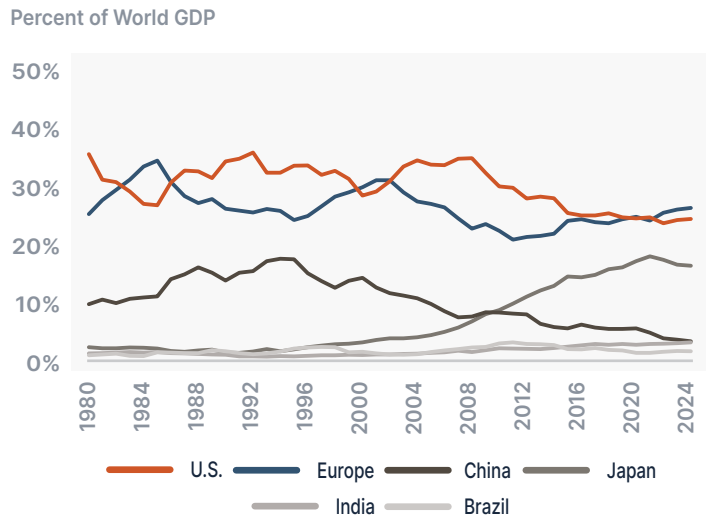
Data as of 12/31/24. Source: Aspiriant analysis. Data from Bloomberg. CapEx stands for capital expenditures. R&D stands for research and development. Please see additional disclosures regarding third-party data and other considerations.

World Economies & Market Capitalizations

Figure 8 illustrates the exceptional performance of U.S. equities by comparing regional market capitalization to real GDP across major economic zones. Over the past 45 years, the U.S. (orange line) and Europe (blue line) have each consistently represented about 25% of global GDP. In contrast, China (dark gray line) has surged from 3% to nearly 17% of global GDP in recent decades—a gain largely at Japan’s expense, as Japan’s share fell from a peak of 18% in the early 1990s to just 4% as of year-end 2024 (light gray line).

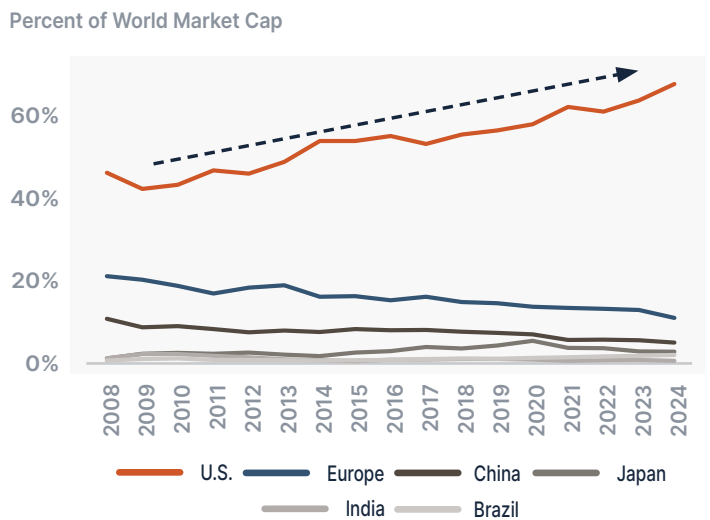
Among these four regions, market capitalization relative to GDP varies. Europe’s market cap stands at 80% of its real GDP, while China’s is approximately 55%. Although Japan’s market cap exceeds its GDP, its economy is considerably smaller than those of China or the U.S. Notably, the U.S. market cap currently stands at \$62 trillion—more than double its GDP of \$29 trillion—and now accounts for two-thirds of global market capitalization, as shown in Figure 9.

FIGURE 8
World GDP by Region



Data as of 12/31/24. Source: Aspiriant analysis. Data from International Monetary Fund database, Bloomberg and Morningstar. Please see additional disclosures regarding third-party data and other considerations. Please see additional disclosures regarding third-party data and other considerations.

FIGURE 9
World Market Cap by Region



Data as of 12/31/24. Source: Aspiriant analysis. Data from International Monetary Fund database, Bloomberg and Morningstar. World Market Cap data approximated using the regional exposure of the iShares MSCI ACWI ETF (ACWI). Please see additional disclosures regarding third-party data and other considerations.

Trump 1.0 vs. Trump 2.0

Closing with a brief political commentary, former President Donald Trump's return—with Republican majorities in both Senate and House—provides unified federal control, setting the stage for sweeping reforms in energy, trade and immigration. While initial regulatory and policy shifts are underway, the current administration faces constraints unlike those of his first term. Inflation remains above target, and elevated interest and mortgage rates require any pro-growth measures to be finely balanced to avoid reigniting inflation and tightening financial conditions.

These challenges are significant as real economic growth nears productive capacity amid robust labor markets, where participation rates are at multi-decade highs and unemployment remains historically low—albeit slightly higher than the 3.4% low of previous years. Additionally, recent population growth, driven by net immigration, is expected to decline in the coming months.

Fiscal constraints further complicate the landscape. Interest costs now exceed \$1 trillion—\$600 billion higher than in 2016—and the federal deficit stands at more than 6.5% of GDP, more than double the 2016 level. Any new tax cuts or extensions of provisions from the 2017 Tax Cuts and Jobs Act will force either spending cuts or the opening of new revenue streams, all while economic stability must be preserved. With mandatory spending on Social Security, Medicare and other entitlements accounting for roughly two-thirds of the \$6.75 trillion fiscal budget—plus an additional 9%-10% allocated to defense—the government's fiscal flexibility is limited.

Trump has often referenced equity markets as a real-time scorecard of economic performance. Since his 2016 victory, the S&P 500 has risen nearly 200%, reflecting a combination of earnings growth and valuation expansion. A significant portion of this increase is attributed to doubled earnings, while the remainder reflects elevated valuations. However, with the index trading around 27 times trailing earnings and 25 times forward earnings—well above historical norms—sustaining such gains in the future may prove challenging.

Economic & Market Indicators

	11/01/2016	11/08/24*
Inflation & Interest Rates (%)		
Consumer Price Index (Core CPI)	2.10	3.30
Fed Funds Rate (Top Range)	0.50	4.75
Treasury Bond Yield (10-Year)	1.83	4.31
Bankrate Mortgage Rate (30-Year)	3.51	7.20
Economic Growth Indicators		
GDP Growth (Real) (%)	2.9	3.1
Labor Force (Millions of Workers)	159.5	168.3
Labor Participation (Ages 25-54) (%)	82	84
Unemployment Rate (%)	4.9	4.1
Worker Productivity (5-Year) (%)	0.8	2.1
Population Growth (% from Net Migration)	10M (45%)	2.7M (83%)
Debt and Debt Service		
Federal Debt to GDP (%)	105	120
Household Debt to GDP (%)	76	71
Federal + Household Debt to GDP (%)	181	191
Federal Budget Deficit to GDP (%)	-3.1	-6.6
Federal Annual Interest Costs (\$ Trillions)	0.5	1.1
U.S. Equity Markets		
S&P 500 Index (Level)	2,126	5,999
Est. S&P 500 TTM Earnings per Share (\$)	109	220
S&P 500 P/E Ratio LTM	19	27
S&P 500 P/E Ratio FTM	17	24

Source: Aspiriant analysis. Data from Bloomberg, Federal Reserve Economic Data (FRED), U.S. Census Bureau and the Congressional Budget Office. *If data as of 11/08/2024 has yet to be released, the closest available data is used. Figures are rounded and calculated as year-over-year percentages unless otherwise noted. Core CPI stands for Core Consumer Price Index and measures the annual change in average consumer prices excluding volatile components like food and energy. Fed Funds Rate Top Range is the upper limit of the Federal Reserve's target interest rate for overnight lending between banks. GDP stands for gross domestic product and measures the total monetary value of all goods and services. Labor Participation 25-54 is the percentage of the population aged 25-54 that is either working or actively seeking work. Unemployment Rate measures the percentage of the labor force that is unemployed and actively seeking work. Worker Productivity measures how efficiently the U.S. converts inputs into the outputs of goods and services. Population Growth (% from Net Migration) shows the percent of population growth attributed to net migrations over the same period. P/E Ratio stands for price-to-earnings ratio, reflecting how much investors are willing to pay per dollar of earnings. The S&P 500 is a market-capitalization weighted index that includes the 500 most widely held companies chosen with respect to market size, liquidity and industry. LTM stands for last twelve months. FTM stands for forward twelve months. Please see additional disclosures regarding third-party data and other considerations.

Final Thoughts & Portfolio Considerations

We have largely settled into a post-pandemic economy, with many policy and supply dislocations behind us. Inflation remains one of the few exceptions, moving stubbornly toward target. Unemployment is at 4.1%. Real U.S. GDP is growing around 3%, driven primarily by consumer spending. Unlike prior periods of monetary tightening, the growth in consumer spending—which accounts for about 70% of the economy—has been funded largely by rising incomes in recent months and has been less sensitive to changes in the cost of credit.

However, aggregate data mask some potential risks and warning signs, especially among lower-income groups that have been hit hardest by years of inflation. Rising credit card and auto loan delinquencies are just consequences of this financial strain. We are also seeing an increase in corporate bankruptcies as floating-rate loans and higher funding costs squeeze margins and cash flows.

Geopolitical risks—spanning multiple regions—are as high as they have been in the past 30 years.

U.S. equity and dollar outperformance has persisted longer and on a greater scale than in any period over the past 50 years.

Given the assortment of risks facing investors, diversification seems particularly well-advised to help navigate the months and years to ahead.

First quarter 2025 investing outlook and insight provided by:



John Allen, CFA,[®] CAIA
Chief Investment Officer, Partner



Marc Castellani, CFA,[®] CAIA, CIMA[®]
Managing Director, Partner



Stephen Kawasaki, CFA,[®] CAIA, CFP[®]
Senior Manager, Partner

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Glossary of Terms Used in this Issue

Alphabet (Google): The parent company of Google, specializing in internet services, digital advertising, AI and cloud computing.

Amazon: A multinational technology company specializing in e-commerce, cloud computing, digital streaming and artificial intelligence.

Apple: A leading technology company known for its consumer electronics, software and services, including the iPhone, Mac and cloud-based platforms.

Artificial Intelligence (AI): Artificial intelligence, including machine learning and large language models.

Big Tech: A term referring to the largest, most influential technology companies.

Capital Expenditures (CapEx): Funds used by companies to acquire, maintain or upgrade physical assets such as property, buildings or technology.

DeepSeek: A Chinese AI firm that introduced the R1 model, a competitor to ChatGPT, claiming similar performance using lower-cost, energy-efficient chips.

Federal Reserve (the Fed): The central banking system of the United States, responsible for setting monetary policy, including interest rates and the federal funds rate.

Federal Funds Rate: The interest rate at which banks lend reserve balances to other banks overnight, influenced by the Federal Reserve to implement monetary policy.

Gross Domestic Product (GDP): The total value of goods and services produced within a country over a specific period, used as a key measure of economic health.

Investment-Grade Bonds: Bonds that have been assigned a high credit rating, indicating lower risk of default and often used to provide stability in diversified portfolios.

Market-Cap-Weighted Index: An index in which each component is weighted according to its total market capitalization, such as the S&P 500.

Microsoft: A leading technology company recognized for its diversified business model, including operating systems, cloud services and AI-driven innovation.

Net Migration: The difference between the number of immigrants entering and the number of emigrants leaving a country over a specified period, contributing to population growth.

Nvidia: A semiconductor company specializing in graphics processing units (GPUs) and AI chips, which have become critical in artificial intelligence advancements.

S&P 500: A market-capitalization-weighted index of 500 widely held companies, selected based on market size, liquidity, and industry representation.

Technology, Media and Telecommunications (TMT): A sector encompassing companies in tech, digital media and communication services that experienced rapid growth during the early 2000s.

Trade-Weighted U.S. Dollar Index: A measure of the value of the U.S. dollar relative to a basket of foreign currencies, reflecting its strength in global markets.

U.S. Dollar Dominance: A term describing the strength of the U.S. dollar relative to other currencies, driven by economic fundamentals and global demand for U.S. assets.

Valuation: The process of determining the present worth of an asset, company or investment based on various financial metrics.