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Global Watch

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2025 - A YEAR OF CAPITAL DESTRUCTION?

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US stagflation risk

In our bedrock analysis on inflation and yields, we identified the nasty "Rising volatile regime", where investors should simply go to their safe space, wherever that is. On this page, we keep tabs on the main triggers for a switch to this negative supply shock-dominated regime. These are our Live-Alpha Threads (LATs) on this topic, as set out in our new framework for investment amid chaos.

In order of likelihood, the regime triggers are

1. Tariffs = increasingly likely
2. Deportations = not likely, at this point
3. Energy and shipping shocks = not likely

Red tiles below indicate potential triggers for regime switch, taking the economy into stagflation, and flipping bond equity correlations to positive. This narrative is already knocking at the door for markets. The question is whether it is a robust or fragile narrative. Our LATs monitor the key metrics and charts to answer just this.

Finally, we are also monitoring triggers for a more serious shift, not merely at the level of short-term regime, but at the level of the paradigm of the international monetary system. At the moment, we continue to think some form of shift on this front will materialize, but at this stage it is very hard to say when. In the below Live-Alpha Thread, we monitor the key charts on one of the critical triggers - the balance of growth between the US and China.

For more on the implications of a shift to the Rising-volatile regime, please check out our bedrock analysis on the 10-year yield and CAPE anchors.

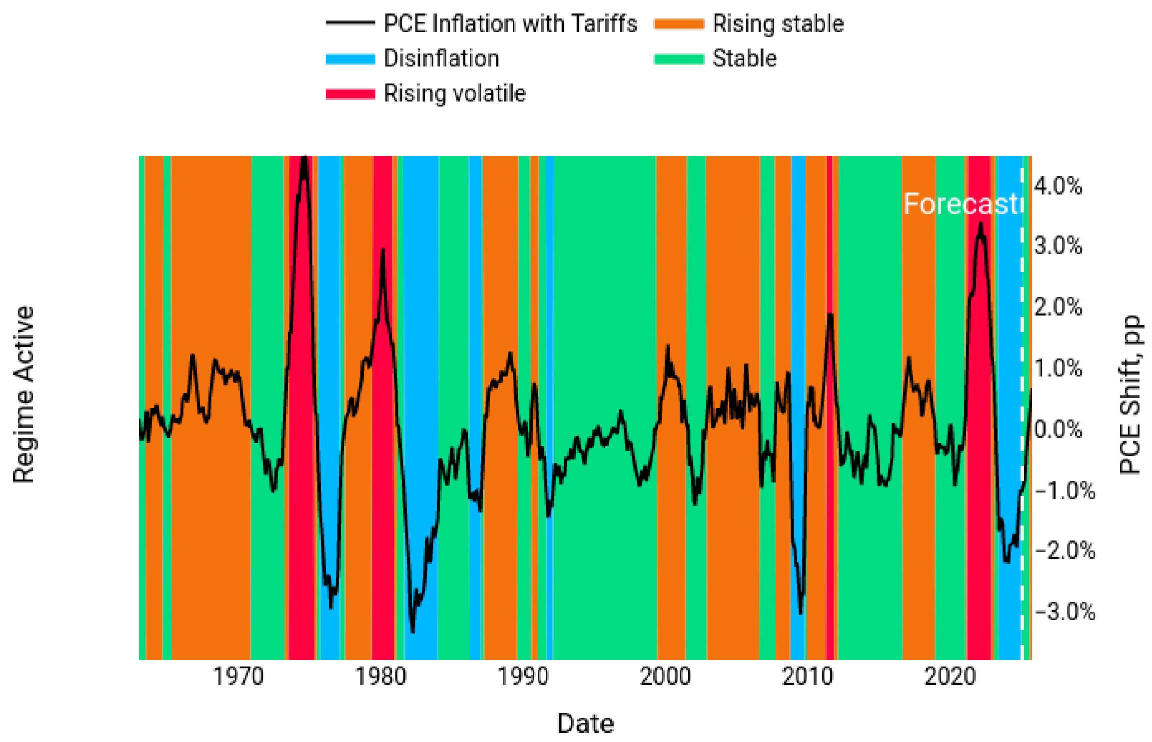
Regime switch triggers

At this stage, our inflation forecast assumes an 8% across-the-board tariff but with carve outs for energy and food, and some Trumpian deals. That assumption does not trigger the "Rising volatile" regime. The threshold is at around 4% inflation - note that the chart below shows change in inflation. The volatility with which this comes through also matters in the triggering of the regime. But at this rate, volatility seems like a given. A combination of tariff shock and deportations kicking in late in the year significantly raises the probability of switching on the unwanted regime. Energy shocks cannot be ruled out, particularly if retaliation from other countries involves energy supply. But we remain relatively sanguine on this front.

Even though the regime is not likely to be triggered in the real economy until the end of the year at the earliest, markets are forward-looking. We continue to see the stock market as a guard rail, despite the tough talk coming from the new administration. So a more reconciliatory tone seems likely to kick in at some point. But we continue to think some level of across the board tariffs will be implemented, in keeping with the wider fiscal agenda. For now, we look for the guard rails to kick in and monitor the threads on tariffs and deportations in particular. We aren't seeing red yet, but we are getting closer. In short, while the outlook is getting more cyclically stagflationary, it is not yet serious enough to trigger the "Rising volatile" regime in the real economy, meaning that we can still fade the chaos at this stage. In the background, we look out for that destructive regime to be triggered as this could be the thing that finally brings about a day of reckoning for expensive US equity valuations and pushes up term premium towards its higher anchor. See our bedrock analysis on the 10-year yield and CAPE anchors.

PCE REGIME CHANGES WITH ADDED TARIFFS

18 MAR 2025



PCE Regime changes with added tariffs

TARIFFS

ENERGY & SHIPPING SHOCKS

DEPORTATIONS

Paradigm shift triggers

INTERNATIONAL MONETARY SYSTEM PARADIGM SHIFT TRIGGERS

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