

Macro Playbook: Transition to a Reflationary Growth Cycle

Executive Summary

The macroeconomic outlook is shifting from a late-cycle, disinflationary mindset toward an early-cycle reflationary growth phase. In contrast to earlier recession-focused expectations, recent developments indicate that a downturn is unlikely – the economy remains resilient, fiscal policy stays expansive, and inflation is proving sticky above target. Central banks have started to normalize policy with tentative rate cuts, but robust real economy strength and fiscal inertia are preventing the full disinflation that many had anticipated. This marks a transition away from recession fears and toward a scenario of sustained growth with moderate inflation.

In this new regime, the brief period of bull steepening in the yield curve – driven by markets pricing in aggressive front-loaded rate cuts – is seen as transitory. Going forward, long-term interest rates are poised to rise again on the back of resilient nominal GDP growth and persistent inflation pressures, shifting the curve toward a bear steepening. Short-term yields fell rapidly in anticipation of easier Fed policy, but markets likely overshot; with economic data consistently outperforming expectations, investors should brace for an upward repricing of the forward curve as growth surprises to the upside. Meanwhile, policy rates are merely being downshifted from restrictive levels to more neutral ones, leaving central banks behind the curve if inflation revives. This dynamic implies lower real yields, boosting demand for inflation hedges and risk assets.

Key market implications: The U.S. and Eurozone economies, while diverging in the very short term, are both entering a phase where fiscal dominance, secular investment booms, and tight labor markets keep inflation from returning fully to 2%. The U.S. dollar's recent softness is expected to give way to renewed strength as U.S. growth re-accelerates and yield differentials widen once more in America's favor. Gold stands to benefit in this reflationary environment – as growth and inflation run above the Fed's stance, real interest rates will be suppressed and investors will seek gold as an inflation hedge. Equities can continue their “melt-up”, but leadership should rotate toward cyclicals such as industrials

and value stocks as the market's driver shifts from excess liquidity to tangible growth. In fixed income, a bearish re-steepening of the curve and rising term premiums will pressure long-duration bonds, warranting a cautious view on Treasuries even as short rates come down. Overall, we are moving from a disinflationary late-cycle mindset to an early-cycle reflationary expansion, fueled by policy normalization, ongoing fiscal support, and real economy momentum.

Reframing the Yield Curve: From Bull Steepening to Bear Steepening

Recent months witnessed a **bull steepening** of yield curves, with short-term interest rates falling much faster than long-term rates. This was primarily driven by markets pricing in a series of front-loaded central bank rate cuts – essentially a prelude to an expected easing cycle. For example, in mid-2024 the U.S. 2-year Treasury yield plunged as investors anticipated multiple Fed rate cuts, narrowing the 2s/10s yield inversion by over 30 basis points. Such bull steepening is typical ahead of recessions or Fed easing, reflecting hopes that policy rates will be cut rapidly.

However, we now view this bull steepening as a temporary phase rather than the start of a sustained trend. The steepening driven by falling short rates is unlikely to persist because the underlying catalyst – a sharp economic downturn – has not materialized. Indeed, earlier steepener bets were quickly unwound when the economy proved more durable and inflation more stubborn than expected. As growth held up and price pressures lingered, the yield curve re-flattened and even re-inverted at times, undercutting the bull steepening narrative. This experience underscores that without a true recession or credit crisis, short-term yields will not keep falling in a one-way slide. Markets had to recalibrate from an overly dovish view once it became clear that rate cuts might be shallower or delayed due to resilient activity and inflation.

Looking ahead, we anticipate the yield curve will transition toward a **bear steepening regime**. In a bear steepener, it is long-term yields that rise faster than short-term yields, often reflecting an uptick in inflation expectations, term premia, or stronger growth outlook. As the recession fails to arrive, long-end rates should resume climbing, steepening the curve from the back end. The logic is twofold: First, nominal growth is proving robust – with real activity solid and inflation settling above 2% – which puts upward pressure on long-term yields. Second, the market's initial pricing of aggressive rate cuts at the short end will likely moderate (or even partially reverse) as investors accept that policy won't ease

dramatically into a non-recessionary environment. The result is a curve that could flatten back or steepen in a “bear” manner – i.e. higher yields across the board, but especially in 10+ year maturities.

Notably, we have empirical evidence of this pattern unfolding. After the Fed began cutting rates in late 2024, instead of rallying, Treasury yields climbed – a highly unusual occurrence that reveals the market’s growing focus on long-run risks. From mid-September 2024 (when the Fed delivered its first cut) to mid-January 2025, the 10-year Treasury yield jumped from about 3.65% to 4.79%, even as short rates declined. Historically, rate-cutting cycles see bond yields fall, but not this time: the combination of a robust economy and rekindled inflation fears pushed long-term rates over 100 bps higher despite Fed easing. In effect, the bull steepening was swiftly overtaken by a bear steepening driven by rising term premiums and inflation expectations. By January 2025, the estimated 10-year term premium had surged to its highest level since 2011 (above 0.8%), accounting for more than half of the 10-year yield’s rise. This reflects investors demanding greater compensation for holding long-term bonds amid uncertainties around inflation, debt and fiscal policy. In short, the yield curve’s steepening is flipping from “bull” to “bear” – an early signal that markets are bracing for stronger nominal growth and lingering price pressures rather than a deep recession.

Short-End vs. Economic Reality: Repricing Imminent

The swift decline in short-term yields that accompanied bull steepening now appears excessive relative to the actual economic data. Markets effectively raced ahead of the fundamentals – baking in substantial Fed rate cuts that implied a deteriorating economy – yet the incoming data have not corroborated a sharp downturn. On the contrary, key economic indicators remain resilient. In the U.S., over two million jobs were created in 2024, the unemployment rate ended the year around 4.1% (well below historical averages ~6%), and real GDP growth is estimated near 3% for 2024, roughly matching its 20-year average. Consumer spending has held up strongly (retail sales +3.8% YoY as of late 2024) and personal incomes continue to rise solidly. Such figures hardly justify the degree of easing that bond markets had been pricing in. In effect, the front end of the yield curve “fell in love” with a recession narrative that hasn’t played out.

We expect a repricing at the short end as investors align rate expectations with the stronger growth reality. At one point, futures markets were anticipating roughly 3–4 Fed rate cuts within a year, far more than the Fed’s own guidance of perhaps one cut in 2024. This dovish outlook is now being reevaluated. For instance, by April 2024, after a string of upside inflation surprises, traders had reduced expected 2024 Fed cuts from 150 bps to about 50

bps, recognizing the Fed may need to **hold rates “higher for longer” given persistent inflation. As the Fed pushed back on premature easing and data stayed firm, the market began pricing out the most aggressive cut scenarios.

Going forward, if growth continues to surprise to the upside, markets will likely mark short-term yields back up. We see two mechanisms for this: one, the Fed itself may signal fewer cuts (or even pause the cutting cycle) in response to strong activity, anchoring the short end at a higher level. Indeed, by early 2025 the Fed had halted its rate-cutting campaign after 100 bps of easing, explicitly citing renewed inflationary risks ahead. And two, even without Fed action, investors might demand more yield to compensate for the possibility that policy will have to reverse course later. In essence, the curve’s inversion could lessen not by short rates collapsing, but by short rates staying relatively elevated while long rates climb. This is a classic “no landing” scenario – the economy doesn’t contract as expected, so rate cuts are shallower and the policy trajectory reprices upward.

To put it succinctly, short-term yields fell too far, too fast given the economic backdrop. We anticipate a partial unwinding of that move as the forward curve adjusts to a world where growth remains above trend and inflation above target. In practical terms, 2-year and 5-year yields may rebound from recent lows as investors realize the Fed won’t be able to aggressively ease into such resilient conditions. Already in mid-2024, a similar dynamic played out: as “surprisingly durable” growth and “pesky” inflation emerged, earlier steepener bets unraveled and short-dated yields jumped back above long yields. A repeat of that pattern is plausible in 2025 – front-end rates finding a floor or drifting higher – as the data continue to defy recessionist predictions. In short, markets will likely correct their overly dovish bets, steepening the curve via rising short yields relative to prior expectations (even as the long end also rises).

U.S. vs Eurozone: Divergence and Convergence in a Higher-Inflation World

The United States and Eurozone economies have been on slightly divergent tracks in the near term, but both are ultimately converging toward a regime of resilient growth and constrained disinflation. In the U.S., economic momentum has remained robust through late 2024 and early 2025, whereas Europe saw a softer patch with near-stagnant growth in some countries. For example, Euro area real GDP grew only ~0.7% in 2024 (with Germany around 0% for much of the year), while the U.S. grew closer to 3%. This created a temporary divergence: U.S. inflation and activity running hotter, Europe flirting with recession. Consequently, the policy outlook diverged as well – the Fed began cutting rates in late 2024 (from very restrictive levels) whereas the European Central Bank was more

cautious, given inflation was still above target and growth weak. In FX terms, this contributed to some USD softness in late 2024 as markets expected relatively larger U.S. rate cuts versus Europe.

However, we see this divergence as short-lived. Both economies are poised to shift into a similar phase: one characterized by fiscal tailwinds, ongoing investment booms, and labor market tightness that prevent full disinflation. In other words, the U.S. and Eurozone are entering a regime of higher nominal growth and only gradual inflation moderation, even if the timing is offset by a few quarters. The concept of “fiscal dominance” is instructive here – massive government deficits and spending needs are effectively overpowering central banks’ efforts to curb inflation. In the U.S., despite the Fed’s aggressive hikes, inflation only fell to ~3% core by late 2024 and then stuck there, as federal deficits (on the order of 7% of GDP) and stimulus programs (infrastructure, IRA, etc.) kept demand high. Fiscal policy is not pulling back; in fact, projections show U.S. debt and interest costs exploding over coming years without major reform. This means the Fed’s job is much harder – expansive fiscal policy feeds into persistent inflation, requiring higher rates for longer (or an acceptance of higher inflation). Similarly in Europe, pandemic-era fiscal support (e.g. NextGenerationEU funds) and new priorities like energy security and defense are keeping government spending elevated, even as the EU reinstates budget rules slowly. For now, European fiscal policy was modestly contractionary in 2024 at the aggregate level, but looking ahead political pressure to spend remains and investment outlays continue under EU programs. Fiscal inertia – the reluctance or inability to tighten budgets – means inflation will likely settle above 2% on both sides of the Atlantic.

Another common factor is the tight labor market and rising wages. The Eurozone unemployment rate sits at a record low ~6.3%, and wage growth, while down from peaks, was still 4.4% YoY in Q3 2024 – well above the rate consistent with 2% inflation. In the U.S., unemployment around 4% and persistent wage gains (4–5% YoY for private workers through 2024) indicate labor market-driven inflation pressure. Neither region has seen a surge in joblessness that typically accompanies recessions; instead labor shortages and demographic constraints are keeping employment high. Europe in particular faces structural labor supply limits (aging populations, lower participation in places, plus potential impacts from policies like reduced immigration as hinted by U.S. proposals). Tight labor markets mean services inflation is stickier – indeed, Eurozone and U.K. services inflation is still running ~4–5%. As Rothschild & Co noted, services are now the “stickiest part of the inflation equation,” driven by above-trend wage growth on both sides of the Atlantic. This dynamic won’t fade quickly, implying only gradual disinflation at best. In fact, their analysis concludes inflation will stay above target through 2025 in a 2–4% range, rather than returning to 2%.

Crucially, **both the U.S. and Eurozone are entering this next phase with significant investment cycles underway. In the U.S., large-scale public investments in infrastructure, manufacturing (chip fabs, EV plants), and energy transition are ramping up. Corporations too are investing in capacity after years of underinvestment, encouraged by tax incentives and strong demand. Europe is likewise deploying *NextGenerationEU* recovery funds into green and digital projects, and countries like Germany are attempting to kick-start investment to overcome energy bottlenecks. These investment booms support growth (even if productivity gains take time) and add demand for labor and materials, again making it hard for inflation to simply melt away. The end result: while the U.S. and Eurozone may differ in near-term cyclical position (with Europe lagging slightly), both are gravitating toward a milieu of modest growth with inflation stuck somewhat above target – a quasi-reflationary environment spurred by fiscal impetus, capex cycles, and supply constraints.

In practical terms, we expect U.S. policy rates and Eurozone rates to eventually converge in direction – the ECB, which was slower to tighten, will also be slower to ease, but by late 2025 both central banks will likely be navigating the same challenge of how to respond if inflation stays ~3% without choking off growth. The temporary U.S.-Europe divergence (U.S. cutting sooner, dollar weakening for a time) should give way to renewed synchronization, with both regions biased toward higher yields than the market had assumed. Indeed, the U.S. dollar's path – discussed next – encapsulates this story of divergence giving way to convergence in growth and yields.

FX Outlook: Dollar Doldrums to Dollar Revival

The foreign exchange outlook is for a turn in the dollar's fortunes: after a period of short-term softness, the USD is likely to regain strength as U.S. growth outpaces and yield differentials widen in favor of the dollar once again. Earlier in the cycle, the dollar's rally stalled and partially reversed as markets bet on Fed rate cuts and as non-U.S. growth showed signs of life. From late 2023 into early 2024, many expected the Fed to be among the first central banks to ease policy, which helped drive the dollar lower against currencies like the euro. However, that narrative is shifting. The U.S. economy's resilience, coupled with sticky inflation, is leading investors to believe the Fed will need to keep rates higher for longer relative to its peers. This is a classic recipe for dollar strength: wider interest rate spreads and outperformance of the U.S. economy attract capital into dollar assets.

We already have a playbook for this dynamic. By April 2024, as U.S. inflation came in hotter and the Fed's cutting path looked less aggressive, the dollar index (DXY) rallied to its highest levels since late 2023. Traders went from expecting ~150 bps of Fed cuts to only

~50 bps that year, while expecting other central banks (ECB, BoC, Riksbank) to ease more freely. In other words, the perceived policy gap flipped: previously the Fed was seen as leading the easing race, but now others might cut sooner. This rate outlook divergence fueled a significant dollar bounce. Notably, yield differentials between the U.S. and Germany (2-year spread) widened to their most U.S.-favorable level since 2022, following signals that the ECB could cut rates even as the Fed stayed hawkish. As one market strategist observed in April, “*We have the strongest economy right now... yields are going up, whereas Europe is struggling in terms of growth,*” which are obvious reasons the dollar could strengthen further.

Looking ahead, we expect this renewed dollar strength trend to continue. In the near term, the dollar may still exhibit some choppiness – especially if U.S. inflation data surprises on the downside or if risk sentiment remains high, prompting flows into other currencies. There’s also the consideration that positioning had turned long USD, meaning occasional pullbacks can happen. But the fundamental backdrop favors the dollar: U.S. growth is re-accelerating at a time when Europe and others are only stabilizing, and U.S. yields (both real and nominal) are rising whereas many other central banks are at or near their peak and likely to cut sooner. As the yield curve bear-steepens on U.S. inflation/growth dynamics, the relative yield pickup in the USD should expand. We already saw speculators increase net long dollar positions to the highest since 2022 in anticipation of this shift. The Fed’s balance sheet policy (QT ongoing) and a potentially more hawkish stance relative to dovish-leaning peers add more fuel – it tightens global dollar liquidity, often a USD-positive factor.

One scenario to consider is short-term USD softness if markets temporarily refocus on the Fed’s rate cuts already done – for instance, if U.S. data hit a soft patch, the dollar could slip as investors re-price cuts. However, we would view that as temporary, since any cooling in the U.S. will likely be met by even more pronounced policy easing bets elsewhere (given Europe’s weaker trajectory and emerging markets’ sensitivity). Ultimately, as the U.S. proves it can sustain growth above trend while others lag, capital should flow back to the higher-return U.S. markets, lifting the dollar. Another tailwind for the dollar is geopolitical or market stress: the dollar tends to outperform during global uncertainty, and while our base case is a growth story, any flare-up (e.g. a commodity price shock or conflict) could boost the dollar’s safe-haven appeal.

In summary, expect the recent dip in the dollar to reverse into a dollar resurgence. The USD’s cyclical upswing will be underpinned by widening interest rate differentials and superior U.S. economic performance. Already by early 2024 the market narrative had flipped to a “higher-for-longer” Fed versus easing abroad – supercharging the greenback’s rally. As we progress, the U.S. re-acceleration and stickier inflation should keep the Fed more hawkish than the ECB, BOJ, etc., which in turn points to further upside for the dollar

after its brief hiatus. We project the euro's recent strength will fade, with EUR/USD likely rolling over as U.S.-EU yield spreads widen once more in the dollar's favor.

Commodities and Gold: Inflation Hedge Appeal in a Reflationary Expansion

Gold and related inflation-hedge assets stand to benefit in the environment we foresee, where growth is solid but inflation runs above central bank targets. The key reason is that real interest rates are likely to fall in relative terms, even as nominal yields rise. If the Fed and other central banks are slow to respond to resurgent inflation (either because they believe it will be temporary or due to political constraints), inflation expectations can climb faster than policy rates – compressing real yields. Gold historically thrives on declining or negative real yields, as its opportunity cost drops and investors seek protection. Over the past decades, changes in inflation-adjusted yields have been the single most important driver of gold prices.

In the late-cycle period of 2023–24, gold already demonstrated its role as a hedge. With central banks starting to cut rates while core inflation was still ~3%, gold prices surged – up roughly 28% in 2024, reaching all-time highs in many currencies. Investors anticipated that monetary policy might ease faster than inflation falls, and they piled into gold. Indeed, western investors flocked back to gold as soon as central banks began cutting interest rates in 2024, highlighting the sensitivity of gold to any perceived policy slippage on inflation. Moreover, central banks themselves have been large gold buyers (a record >\$100bn in Q3 2024), indicating a desire to diversify reserves in a time of heightened inflation and fiscal strains.

As we enter 2025, the case for gold's upside remains strong. We are in a scenario where growth and inflation could both exceed the Fed's current stance – essentially a policy mismatch that erodes real yields. For example, the Fed's policy rate might plateau around 4–4.5% after cuts, but if inflation only falls to ~3% or even turns back up toward 4%, the real fed funds rate would slip toward zero. Longer-term real yields could also decline if inflation expectations rise faster than nominal yields. In fact, forecasts by some analysts see US inflation rising above 3% in late 2025, possibly up to ~4%, as the second-round effects of growth and commodity prices feed through. If the Fed does not react with renewed hikes (which it might be hesitant to do quickly), inflation-adjusted yields would head lower, which is bullish for gold. It's a replay of the classic story: when the market suspects the Fed is “behind the curve,” gold shines.

At the same time, demand for inflation hedges and safe assets is increasing. Not only gold, but commodities broadly could catch a bid if nominal growth is surprising to the upside. A scenario of commodity-driven growth upside – say a resurgence in industrial activity or infrastructure spending that boosts demand for energy and metals – would reinforce the reflation narrative. Oil and other commodities might rise in price, contributing to higher headline inflation and prompting investors to further hedge that risk. Gold, as an uncorrelated asset and inflation hedge, would be a prime beneficiary. We note that gold often also benefits from financial repression: if policymakers tolerate higher inflation to support growth or debt burdens (a form of fiscal dominance), real rates remain subdued and currency confidence can be tested – a fertile backdrop for gold to outperform.

It's worth acknowledging that if nominal yields rise extremely fast (outpacing inflation expectations), real yields could temporarily rise and pressure gold. Indeed, during late 2024 when the 10-year Treasury yield spiked above 4.5% and real yields (10y TIPS) rose to ~2.2%, gold had a brief pullback. But those periods were short-lived and tied to sudden shifts (like tariff announcements). The overarching trend we anticipate is central banks erring on the side of growth, not wanting to choke it off – meaning they'll likely be late in tightening if inflation flares up again. That would cause real yields to lag behind inflation, a positive for precious metals. Additionally, continued geopolitical risks (trade tensions, conflicts) and currency volatility support gold demand from both central banks and investors seeking stability.

In conclusion, we maintain a constructive outlook on gold in this early reflationary cycle. The metal already proved its worth by outperforming in 2024 amid initial Fed easing and inflation uncertainty. Going forward, as inflation remains above target and policy only tiptoes toward normalization, gold's role as an effective hedge against inflation and policy credibility risk comes to the forefront. We could see gold testing new highs if our scenario of sticky inflation and policy hesitation plays out, especially since investor allocations to gold often increase in late-cycle or regime-shift periods. Commodities more broadly may also join the rally – any “second wave” of inflation, perhaps driven by commodity supply tightness or a demand surge, is a tail-risk that would send hard assets higher. For now, the base case is gold grinding higher on lower real yields, while oil/commodities provide an upside risk skew to the inflation outlook.

Equities: Melt-Up Continues, but Rotation to Cyclical and Value

Global equity markets have weathered the past year remarkably well, even as interest rates soared. We anticipate that equities can continue their gradual “melt-up” – a steady grind

higher fueled by improving growth prospects and abundant liquidity – but with a crucial change in leadership. The next phase should see a rotation out of the defensive, duration-sensitive growth stocks that led earlier, and into more cyclical and value-oriented sectors that benefit from reflation and real economic expansion.

In 2024, much of the equity upside was concentrated in a handful of mega-cap tech and growth names, driven by falling yields and hype over themes like AI. The “Magnificent Seven” tech giants propelled the S&P 500’s gains, contributing an outsized share of returns. This was a liquidity-driven rally: as soon as the market smelled Fed rate cuts (i.e. easier financial conditions), long-duration growth stocks – whose valuations hinge on low discount rates – took off. By late 2024, however, breadth was improving and other sectors started catching up. Now, with the cycle turning toward actual growth (as opposed to just hopes of policy easing), fundamentals will matter more and interest rate sensitivity a bit less. We expect economically sensitive sectors to take the baton from hyper-growth.

Another interesting twist is that international equities and emerging markets have joined the rally after years of underperformance. The weaker dollar and the rotation into cyclical/value (of which many non-U.S. markets have plenty) spurred a catch-up. Europe’s indexes, heavy in banks, oil, and industrials, have done well. The MSCI EAFE’s 11% gain in early 2025 outpacing the S&P 500 indicates a broadening of the bull market. While U.S. equities still look expensive at ~22x forward earnings (rich vs history and other markets), many foreign markets trade at discounts and are benefiting from similar themes (e.g., Europe’s value rotation, China’s stimulus efforts, etc.). So the melt-up is becoming more global and more value-centric.

As the market moves from “liquidity-driven” to “growth-driven,” we should also see small-cap and cyclical subsets perk up. Thus far, small-caps have lagged (Russell 2000 underperformed in 2024’s latter half). Part of that was recession fear (small firms hit hardest in downturns) and part was high interest costs. If nominal growth is accelerating, smaller companies and cyclicals should enjoy better top-line growth and pricing power, aiding their earnings. We note that in early 2025, small-caps hadn’t yet fully participated in the rotation – possibly due to lingering concerns – but this presents an opportunity if the economy avoids recession. Industrials, materials, and certain consumer sectors tied to economic momentum are primed to lead. We expect sector leadership to tilt toward industrials, financials, energy, basic materials, and select consumer cyclicals (like autos, travel) as the cycle enters a reflationary phase. Meanwhile, the prior leaders – e.g. mega-cap tech, utilities, other bond-proxy stocks – may lag or see range-bound performance. They aren’t likely to crash given decent fundamentals, but their valuation multiples could compress if long-term yields rise and if investors find better growth elsewhere.

It's important to emphasize that equities overall can still grind higher even with rising yields, so long as those yields are rising for "good" reasons (growth). Historically, bear steepening with growth has often coincided with stock gains, as improved earnings prospects outweigh the drag of higher discount rates. Corporate earnings in this scenario should beat previous pessimistic forecasts. For instance, sectors like energy and mining might see earnings upgrades on higher commodity prices; banks on better loan growth and margins; industrials on new orders from fiscal projects. The "reflation trade" tends to favor value stocks, commodities, and non-U.S. markets – a mix that has been out of favor for a long time, indicating potential for substantial upside as capital reallocates.

Investors should thus position for continued equity upside but with a rotation. One should tilt exposure toward value/cyclical sectors and regions, and perhaps trim some overweight positions in long-duration growth equities. The market melt-up is likely to broaden out. As a case in point, by late 2024 all 11 S&P 500 sectors had positive yearly returns, and more sectors (like communications and financials) actually beat tech in H2 2024, signaling a healthier, broader rally. We expect that broadening to strengthen in 2025. Industrials and energy stocks could emerge as new leaders, given tailwinds from infrastructure spending and commodity trends. Value stocks have historically outperformed when inflation and rates rise, which aligns with our macro outlook.

In summary, equities remain on an upward trajectory, but it's a different market under the surface. The leadership rotation into industrials and value is underway, echoing the shift from a liquidity-fueled rally to a growth-and-inflation-fueled rally. Portfolios should adapt to this changing playbook: continue to ride the equity uptrend, but favor the segments that thrive in a reflationary, early-cycle expansion (while de-emphasizing those that led in the disinflationary, late-cycle phase).

Tactical Outlook and Asset Allocation Implications

With the macro regime evolving, our tactical positioning also shifts to reflect the new realities. The expectation that the yield curve will not bull-steepen for long (due to the absence of a recession) but may instead re-flatten or bear-steepen has direct implications for fixed income and equity allocations in the near term.

Fixed Income: We maintain a defensive stance on longer-duration bonds. The likely rise in long-term yields as nominal growth surprises higher means bond prices (especially long-dated Treasuries) face downside risk. The unusual episode following the Fed's late-2024 cuts – when 10-year yields climbed over 100 bps instead of falling – serves as a cautionary tale. It showed that in a non-recession easing cycle, longer-term bonds may

underperform even as short rates come down, because the market starts worrying about future inflation and supply (deficits) – i.e., a rising term premium. We expect this pattern to persist: any further bull steepening (short-rate declines) is likely to be countered by bear steepening (long-rate increases), keeping the curve from steepening too far on a sustained basis. In practical terms, we prefer short-to-intermediate duration where yields are still attractive but interest rate risk is lower. Yields in the 2–5 year range have already fallen significantly (pricing in cuts), so there is some risk they back up – but even so, the carry in short maturities is decent and will absorb some price volatility. In contrast, the 10-year+ segment has less cushion and more vulnerability to a reflation shock.

Within fixed income, we also favor inflation-protected securities (TIPS) and floating-rate exposures as hedges. If we're right that inflation expectations will need to reprice upward, TIPS breakevens (market inflation expectations) could rise, rewarding holders with higher principal adjustments. Moreover, if the Fed were forced to restart hikes later (a tail risk if inflation's second wind is strong), short floating-rate instruments (like bank loans or 3-month T-bill rolls) would reset to higher yields. For now, base case is the Fed holds steady, so floating rates might not see hikes, but they also won't drop as much as was priced in if the Fed stays cautious – again making a case that the front end won't collapse further. Credit-wise, we tilt towards credit spreads tightening in a growth scenario (good for corporate bonds), but given rising yields, prefer shorter corporate bonds to manage duration.

Equities: As discussed, we advocate a pro-cyclical tilt – favoring sectors and factors that benefit from rising nominal growth and pricing power. **Industrials, Energy, Financials, Materials, and select Consumer Discretionary** (e.g., travel, autos, retail tied to strong consumption) are areas to overweight. Many of these also overlap with "value" style. We would underweight the most rate-sensitive, long-duration equity segments: e.g., **Utilities, Staples, and expensive Tech**. Those did well when yields were falling and recession risk was high (investors sought safety and secular growth), but now they may lag. **Small-cap** exposure can be increased a bit from underweight toward neutral or modest overweight – smaller companies typically rally strongly coming out of growth scares, and if credit conditions remain benign (which they should if no recession), small-caps have room to run, especially given their valuation discounts now. Regionally, a slight overweight to **international equities** is warranted, as Europe, UK, Japan all have more value/cyclical composition and could outperform if global growth improves and the dollar eventually peaks. However, we note currency impact: a stronger dollar could eat into unhedged international returns, so one might hedge part of the FX or choose USD-hedged funds until the dollar rally runs its course.

Yield Curve Trades: For more tactical investors, the changing yield curve dynamic opens relative value opportunities. We would *avoid* long-term bond exposure (as noted) and could even position for higher long yields via **curve steepener trades** but *bearish* in nature – for example, short 10-year vs long 2-year Treasuries. In January, many had crowded into bull steepeners (long front end expecting cuts), and those trades are at risk of reversal. Instead, being underweight duration on the long end and neutral or modestly long on the short end aligns with our view. The curve could even re-invert or flatten from current levels if short rates rebound while long rates climb (a possibility if the Fed rethinks cuts). Thus a conditional curve flattener (options positioning) might pay off if the market swings from steepening to flattening in a nonlinear way.

Commodity Exposure: Tactically, a reflationary growth phase supports having some commodity exposure or commodity-linked equities (energy, mining). Even without a full-blown commodity “supercycle,” the risk/reward favors some allocation as an inflation hedge and as play on global capex. Oil prices could rise if demand remains high and OPEC manages supply, and metals could jump on any supply bottlenecks. We especially like gold in the tactical horizon – not just as a long-term hedge but even tactically it could continue its upward momentum. The fact that gold reached record highs in late 2024 suggests strong technicals; any correction is likely shallow given central bank buying and investor interest, so adding on dips is prudent.

In summary of tactical changes: We do not expect a prolonged bull steepening (which would imply clinging to recession trades). Instead, our playbook rotates away from duration and toward growth-centric risk assets. We reprice bonds lower (especially long bonds) and rotate equity exposure toward cyclicals and value. The market is transitioning from a phase dominated by falling yields and defensive positioning to one driven by rising nominal growth and select inflationary tailwinds. Our tactical asset allocation reflects that tilt – still pro-risk (since no recession crash), but oriented to different winners than before.

Evolving Risk Scenarios: New Tail Risks in a No-Recession World

With recession tail-risk greatly diminished in our base case, we turn our focus to new tail risks that could emerge in this reflationary environment. Rather than fearing a collapse in growth, investors should be wary of upside risks and policy credibility challenges. We outline three key risk scenarios:

- **Resurgence of Inflation – a “Second Wave”:** The first risk is that inflation, after easing from its 2022 peak, comes roaring back for a second round. This could

happen due to a combination of factors: re-accelerating wage growth (e.g., if labor markets tighten even more or a wage-price spiral psychology sets in), renewed supply shocks in commodities, or simply the delayed effect of excess money and fiscal stimulus still in the system. Unlike the 1970s, we are not predicting double-digit inflation, but even a rise from ~3% back to, say, 5% would be very destabilizing given current expectations. Some economists warn that U.S. inflation could rise noticeably in late 2025, exceeding 3% and approaching 4%, even without a major shock – basically as the economy runs hot. If such a second wave materializes, it would force a sharp rethink at central banks (potentially aborting easing cycles or even prompting new hikes). Markets would likely react by aggressively selling bonds (yields spiking) and volatility would surge. Equity valuations would be tested as well under higher discount rates, though certain sectors (energy, materials, etc.) might benefit from the cause of the inflation (i.e., commodity boom). This risk is essentially the mirror image of the feared recession – instead of demand collapsing, demand could prove too strong and overheat the economy once more.

- **Commodity Super-Spike and Growth Upside:** A related upside risk is a commodity-driven economic boom – possibly spurred by an exogenous event or policy change. For instance, a large emerging economy like China or India could embark on a big stimulus focusing on infrastructure, lifting global commodity demand. Or supply issues (geopolitical conflict, underinvestment) could drive commodity prices much higher, which initially boosts incomes for producers and investment in extraction (a growth positive for some regions) even as it lifts inflation. We call this a “risk” because it can unanchor inflation while also shifting growth distribution (winners and losers). Energy prices are a wildcard – an escalation of conflict in a major oil-producing region or unexpectedly cold winter could send oil/natgas prices skyrocketing, leading to higher headline inflation and potentially a short-term GDP boost in commodity-exporting economies. Likewise, key industrial metals for the green transition (copper, nickel, lithium) face supply constraints. A scramble or speculation in these could inflate prices sharply, incentivizing new investments (near-term growth pop) but also raising manufacturing costs (inflationary). The net effect of a commodity super-spike scenario is complicated: it can create stagflationary pressures globally, but importantly it represents an upside risk to nominal GDP (and to corporate revenues in commodity sectors). In our playbook, this is a risk because it would likely push inflation well above central bank comfort, and the policy response could be messy – do central banks hike into a supply-driven inflation at the cost of growth? Additionally, rapid commodity moves can strain financial markets (e.g., if some players are caught wrong-footed). So while

not a “tail risk” in the traditional recession sense, a **commodity shock** that boosts nominal growth and inflation is a prominent scenario to watch.

- **Central Bank Credibility Test:** As we pivot to a regime of persistent inflation and fiscal dominance, central banks may face a credibility crisis. In the past couple of years, the Fed and ECB earned some credibility by acting forcefully against the initial inflation surge. But if inflation remains elevated (say 3-4%) and policymakers tolerate it for longer – either to support employment or under political pressure – markets might begin to doubt their resolve. Investors could start questioning: *Will the Fed really do “whatever it takes” to get back to 2%, or will it acquiesce to 3% inflation as the new norm?* Any sign that central banks are wavering in their inflation commitment could unsettle bond markets. The result might be a bondholder revolt – a rapid rise in long-term yields (spiking term premia) as inflation risk is priced in. We saw a mild version of this in late 2023: despite falling inflation, long-term yields spiked, partly on worries about U.S. fiscal profligacy and the Fed’s constraints. A full credibility crisis could be more severe. It ties into fiscal dominance: if markets perceive that central banks can’t raise rates sufficiently without causing a fiscal crisis for governments (due to high debt), they may assume higher inflation in the future to erode debt – again demanding higher yields. In short, the risk is a loss of confidence in central banks’ anti-inflation stance, leading to persistent inflation risk premium across asset classes. This scenario would be negative for most financial assets (except real assets like commodities and possibly certain equities with pricing power) because it implies higher real yields and volatility. Central bank independence might be questioned if political influence is seen as keeping policy too loose. Already, some analysts note that without fiscal reform, the Fed’s independence could be threatened and a future of “prolonged inflation and greater market volatility” looms. We place this as a tail risk because it’s not immediate – credibility erodes over time – but once it reaches a tipping point, the market moves could be abrupt.

Apart from these, other risks include **financial instability episodes** (we can’t fully dismiss that after a massive tightening cycle, some financial accident could still occur) and **geopolitical shocks beyond commodities** (e.g., major conflict escalation, which would have complex effects). However, compared to a year ago, **downside risks like a debt crisis or systemic bank failure have receded in probability**, whereas the risks listed above have risen in relevance.

In sum, instead of a hard-landing recession, our tail risks skew toward higher inflation or nominal growth outcomes and the difficult policy trade-offs they present. Investors should

consider hedges for these scenarios – such as holding some gold (for inflation/credibility risk), some commodity exposure (for a super-spike), and being mindful of duration exposure (which would suffer in a credibility crisis). Also, inflation-linked bonds and assets with real cash flows (like real estate or infrastructure) could hedge against an inflation resurgence, whereas fixed nominal income would fare poorly.

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