



Quarterly Economic Update

September 4, 2025



MACROECONOMIC COMMENTARY

Economic Outlook

By Michael Broadwater

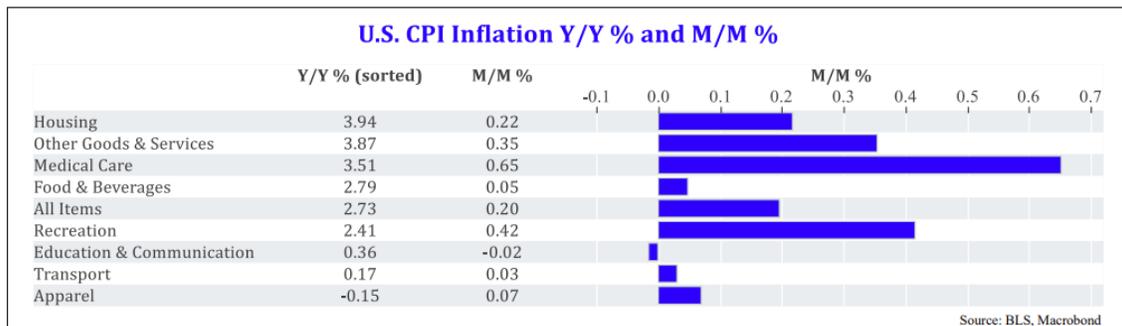
Inflation:

Inflation, when measured by consumer price index, or CPI, has come down significantly from its 2022 peak but is still somewhat elevated. For the month of July, CPI inflation was 2.7% annualized, and Core CPI (taking out food and energy) came in at 3.1%. These were both slightly lower than expected.



Annual CPI inflation from 2021 to today. The horizontal line shows 2%.

Looking more closely at specific components of inflation, services inflation was higher than goods inflation. Within services, shelter and medical care services were particularly elevated. Inflation for recreation services was also high. Goods inflation was more muted, coming in at 1.17% year-over-year. A few of the biggest contributors to goods inflation were used vehicles and furniture. Some goods, such as apparel, have seen deflation (price declines) from this time last year.

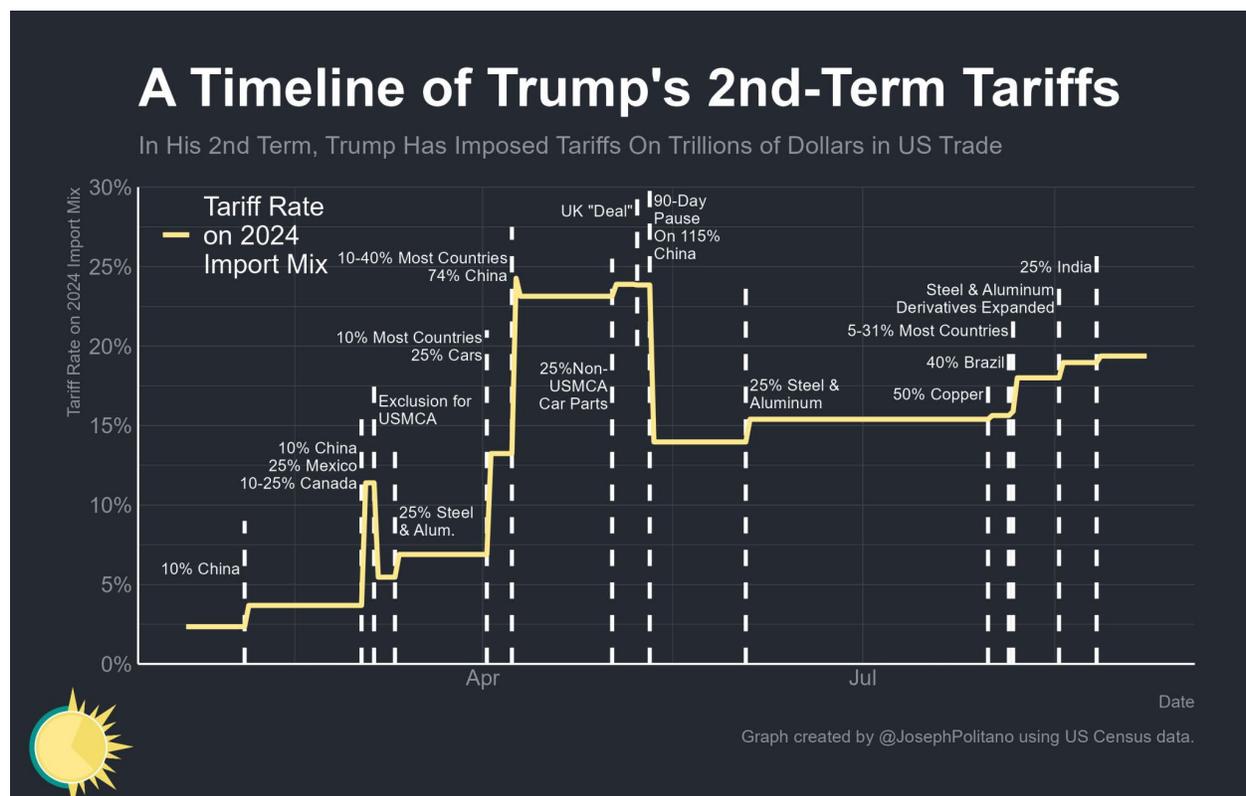


Source: Strategas

PPI, or producer price index, inflation for the month of July came in much higher than expected (0.9% monthly vs. 0.2% expected). Much of this impact can be attributed to price increases in financial services, although raw foods such as produce and meat also increased 12.8% month-over-month.

Many economists and pundits worry that the Trump administration's tariff policy will be inflationary. While this is a legitimate concern, we have not yet seen strong evidence of broad-based elevated prices. Goods inflation has been on an upward trajectory, but this trend began over a year ago. Will goods inflation continue or even accelerate, or will it level off? There are reasons to believe either case could materialize.

Tariffs are the highest they've been in a century. A tariff is essentially a tax on imports and is paid by the importer. All else equal, higher tariffs should lead to reduced profits for domestic companies that sell foreign goods, higher prices for consumers of foreign goods, or a mix of both. Many economists take the view that tariffs will result in a slower economy and higher inflation. This is far from the only take, however. A competing view sees tariffs as disinflationary, as they are an additional tax. Tariffs take money out of the private sector, so households and firms ultimately have less to spend. If this additional tax revenue is spent on reducing the debt rather than fiscal stimulus, the effect of tariffs could theoretically be lower prices and slower growth.



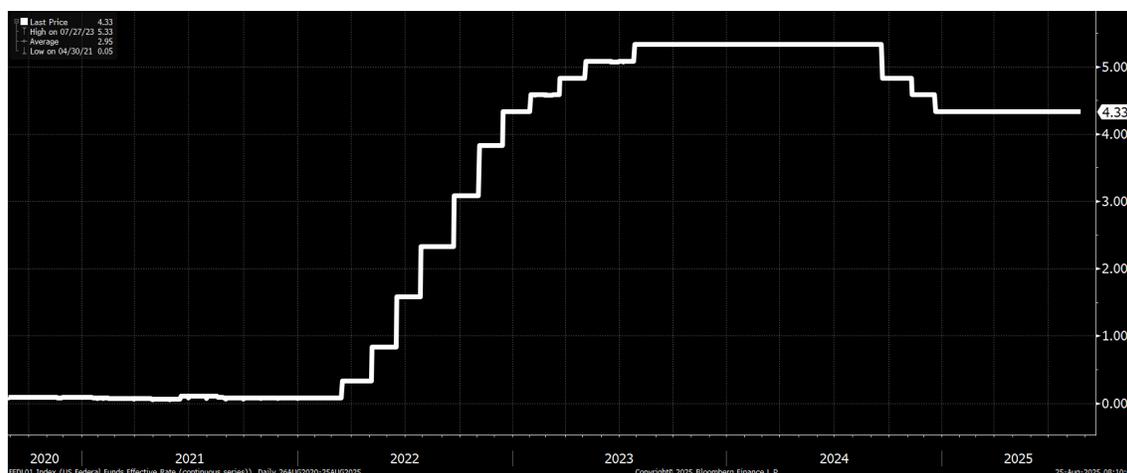
The effective tariff rate is now roughly 19.4%, compared to 2.3% at the beginning of the year.

A recent paper from the National Bureau of Economic Research (Schmitt-Grohé & Uribe, 2025) examined previous bouts of inflation, and the authors found that the ultimate impact on prices and growth depended on both the permanence of the tariffs and the Fed's response. More transitory tariffs did not lead to higher prices, whereas longer-lasting tariffs did. More permanent tariffs resulted in a one-time jump to the inflation rate, which usually prompted the Fed to raise interest rates to combat the higher inflation. In most cases, the Fed cut rates again before long, shifting monetary policy from restrictive back to neutral.

Why did the difference matter? One explanation is that if people think the tariffs are going to be temporary, they're more likely to put off unnecessary spending until the tariffs are gone. This depresses prices, as aggregate demand is lower, and often prompts the Fed to cut rates. This is a key takeaway from the paper. If firms and households see tariffs are temporary, the impact of tariffs could be deflation and lower rates. The recent slowdown in hiring in the labor market may suggest that businesses are pausing activity, waiting for tariffs to subside. Further, the Fed is expected to cut rates in their September meeting. Multiple signs point to us being in the "temporary tariff" scenario.

What about the alternative? We haven't yet seen a one-time price jump from the higher tariffs, but what if they persist for the next 3 ½ years? Maybe corporations are largely eating the tariff costs themselves, lowering profits in the short term. If that's the case, we should see an impact soon in corporate earnings. Are corporations willing to accept lower profits indefinitely, or will they reach a point where they start to pass on higher costs to consumers? If tariffs continue at the same level, we think that corporations will eventually fold and start passing costs along. This would result in an inflationary shock.

The Fed is likely anticipating this shock. Despite a weakening labor market, the Fed has kept the policy rate moderately restrictive. One of their justifications for doing so is uncertainty surrounding tariff-induced inflation. Even if the Fed doesn't hike, not cutting as early or as deeply as they otherwise would at this stage has the same effect. Monetary policy is probably overly restrictive in response to tariffs right now. It's possible the Fed sees tariffs as longer lasting, whereas firms and households assume they will be more temporary. Time will tell who is ultimately correct.



Source: Bloomberg. Federal funds rate since mid-2020.

In either case, the long-term economic impact of tariffs may be the same. Though the NBER paper found short-term impacts on monetary policy and inflation depended on the longevity of the tariffs, they found tariff shocks did not have a meaningful impact on the U.S. business cycle. In other words, we can't tariff ourselves into a recession. However, if a recession is already going to occur, high tariffs certainly don't help.

The administration is adamant about tariffs being both a boon to domestic manufacturers and a way to raise revenue to pay off the debt. Tariffs should increase the price of imports, making U.S. goods more attractive to U.S. consumers. All else equal, this would reduce our trade deficit and spur domestic producers to increase their production capacity. The tariffs as implemented, however, have led to an uncertain business environment and higher input costs. These at least partially offset the benefit from lower demand for imports.

The federal government has generated \$131 billion in tariff revenue so far in 2025, significantly higher than the \$56 billion collected to this point in 2024. This tax is being collected from someone, however. If businesses are eating the tariffs, they have less profit dollars with which to invest in the economy and hire workers. If consumers are paying for the tariffs by paying higher prices, this will make most Americans worse off, as their paychecks will rise slower than prices. If foreign corporations are paying for the tariffs via lower prices on imported goods, this harms our relationship with critical trade partners and leaves them with less money to buy our goods and services or invest in our financial markets.



Source: Bloomberg. Monthly tariff revenue in billions. This revenue is being paid by someone.

And for what? As stated previously, tariff revenue is \$75 billion higher than last year. Extrapolating to the full year, and assuming no further increase in the tariff rates, we would generate roughly \$113 billion more in government revenue from the tariffs than last year. Our national debt is a staggering \$37 trillion, so this incremental revenue only pays for 0.31% of our debt in a single year. Assuming we make \$200 billion in tariff revenue for the full year, it would take nearly 190 years to pay off our debt entirely, and that's *if* our debt doesn't grow in the meantime.



Source: usdebtclock.org

Given their relatively small impact on our debt, tariffs seem to have a high risk of hurting U.S. firms, households, and long-term trade relationships with allies in exchange for very little upside. If the administration were serious about paying off the national debt, they would focus on increasing tax revenue from all sources and reducing spending. Instead, the recently passed H.R. 1, also known as the One Big Beautiful Bill Act, is estimated by the nonpartisan Congressional Budget Office to add \$2.7 trillion to the federal deficit over the next decade. While this deficit spending is good for growth, offsetting one downside of tariffs, it also directly defeats the point of raising additional revenue. Economic policies have inherent trade-offs, and any policy that can help reduce the debt will also likely be

bad for the economy in the short term. Touting tariffs as good for both growth and deficit reduction ignores this trade-off.

H.R. 1's additional deficit spending is indicative of a larger issue plaguing federal politics. Short-term thinking and the need to be reelected win out over sensible fiscal policy. As a result, no one is willing to seriously address our growing debt. More so than tariffs, ballooning government debt remains the biggest risk to long-term inflation.

Unemployment:

If there's one phrase that highlights the current job market, it's "Slow to Hire, Slow to Fire." The unemployment rate has held steady at just over 4% for the past few months, and layoffs look stable as well. Continuing jobless claims are climbing, indicating that those who do lose their jobs are taking longer to find new work. New entrants to the labor market, a group comprised mostly of recent graduates, make up 13.4% of the unemployed population.

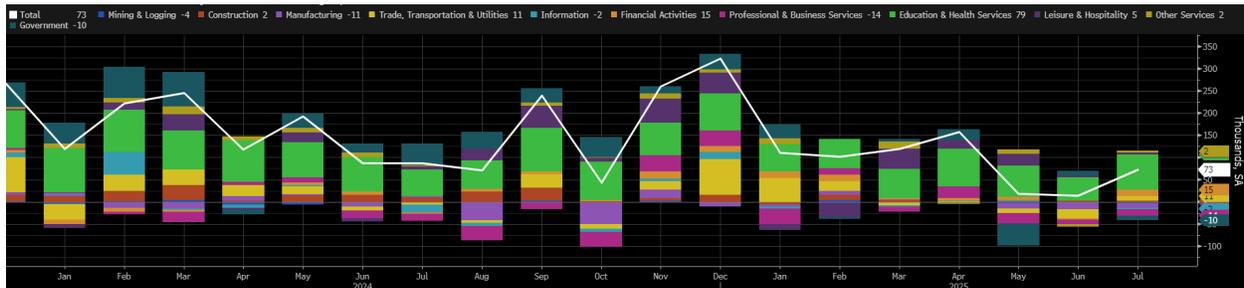


Source: Bloomberg. New entrants as a % of the unemployed population since 2000. The average over that period was 8.8%.

At 13.4%, this number is much higher than the average of 8.8% since 2000, and one of the highest on record, indicating that businesses are slowing hiring for fresh college and high school grads. Overall, these data show that the labor market is not necessarily weak, but stagnating. That was our view until July's nonfarm payroll survey from the Bureau of Labor Statistics (BLS) was released.

July's payroll data was a huge negative surprise. The headline number of jobs added for July was 73,000, decently below the expected 105,000 but not terrible. However, the revisions to prior months' numbers set off alarm bells. June payrolls were revised down from 147,000 to just 14,000, and May was revised an additional -125,000. All in, the prior two months added 258,000 fewer jobs than we had previously believed. This brought the 3-month average payroll number down to just 35,000 vs. the 2-year average of around 200,000. This report paints a much dimmer picture of the labor market: not just stagnating, but possibly close to decline. The print also drew criticism to the BLS, with some claiming the agency was politically biased, tried to help the previous administration win reelection, and is seeking to harm the current administration. These criticisms culminated with the

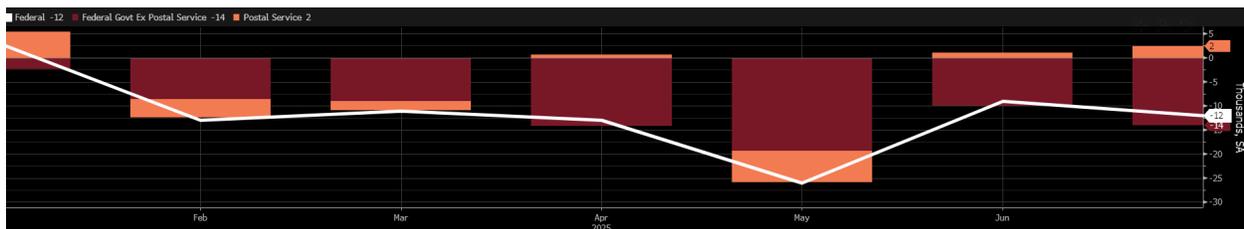
firing of BLS commissioner Dr. Erika McEntarfer. We view this firing as mostly unwarranted.



Source: Bloomberg. Monthly nonfarm payrolls, with May and June being the weakest months since the pandemic.

First, it might help to understand how the BLS payroll survey works, and why seeing revisions months after the initial report isn't uncommon. The BLS surveys 120,000 businesses across the country to ask if they added or reduced headcount in the first half of the month. About two-thirds (68%, on average) of the businesses surveyed respond before the initial print. Over the next two months, answers from slower respondents trickle in, and the payroll number is revised to be more accurate. All in, the response rate winds up at roughly 93% after two months. Though July's revisions were sizable and negative, they were far from the largest ever recorded. We also think they have a rational, economic explanation. The answer lies in the composition of late respondents.

Of the ~25% of respondents who don't answer the survey until the latter two months, both small businesses and the federal government are overrepresented. Taking the latter first, we can see good reasons for why the federal government may be reducing headcount: DOGE. Budget cuts across the federal government have empirically led to higher unemployment month after month, with every single month since February having negative federal government payrolls. An average of 14,000 federal government jobs have been lost over the past 6 months, for a total of 84,000 jobs lost.



Source: Bloomberg. Federal government employment since February 2025.

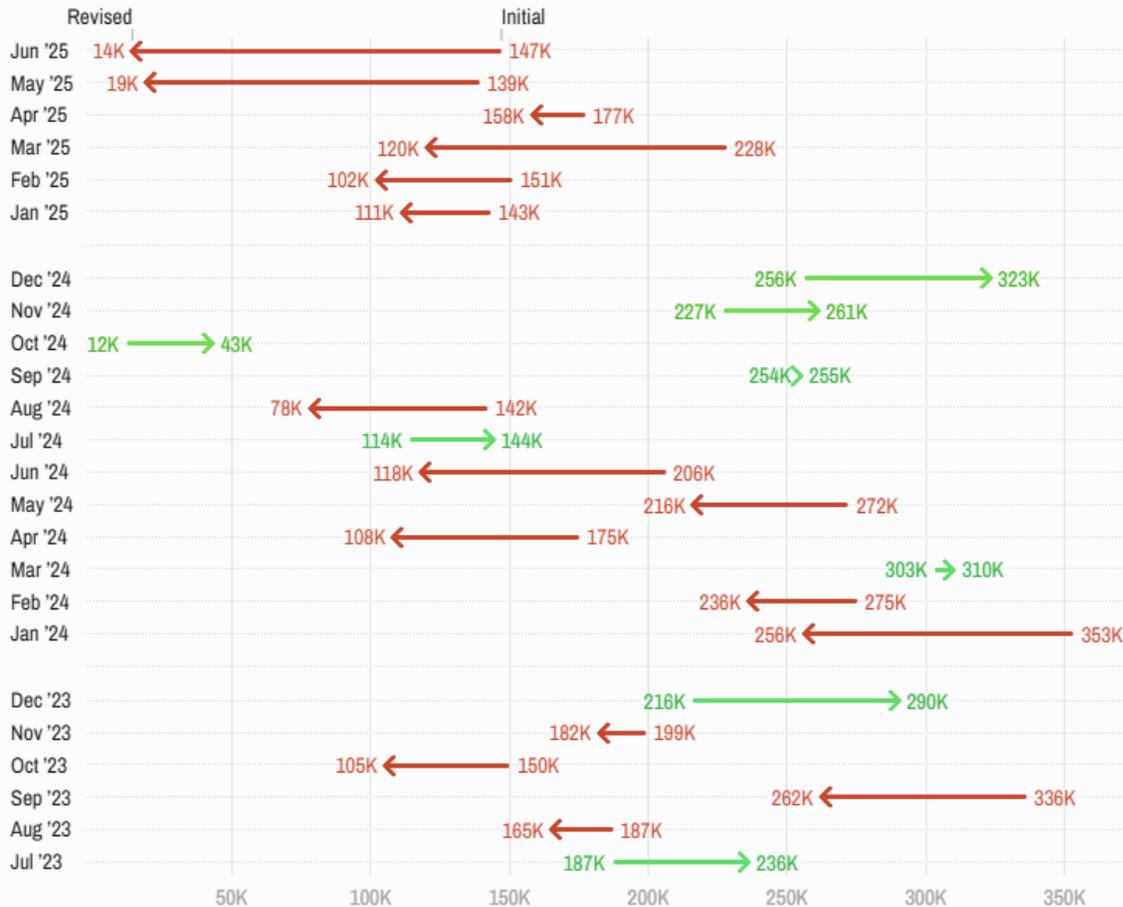
Moving to small businesses, we also see some good explanations for why they may be cutting back on hiring. First, small businesses are less likely to be able to respond to tariffs, as larger businesses have more sway with suppliers and end customers as well as higher profits to tap if needed. Small businesses, on the other hand, are more likely to need to scale back any way they can to weather the higher costs associated with tariffs. This is especially true for small businesses that import foreign goods to sell in the US. Second, small businesses hire more immigrants (documented and undocumented.) The Trump administration's trade and immigration policies have naturally led to decreased

hiring from small businesses, either through the deportation of their workforce or making business owners less certain about the future.

As for the claims that Dr. McEntarfer was politically biased, we point to several facts. First, October's payroll data was absurdly weak. The initial headline number was 12,000, much lower than this May's and June's revised 19,000 and 14,000, respectively.

What recent job report revisions look like

Initially reported nonfarm payrolls gains or losses and revisions after two months



Note: The figure for June 2025 is based on one month's worth of revisions.

Source: BLS • [Get the data](#)

**SILVER
BULLETIN**

Source: Nate Silver. October '24 number was days before the election.

October's report was way below expectations of 100,000 and came with a 2-month revision of -112,000. Though the revisions weren't as bad, the headline miss was much worse than July's, and this was published four days before the presidential election. If Dr. McEntarfer's goal was to inflate numbers to help Trump's opponent win, she wouldn't have presented such a negative report the Friday before the election.

Further, the headline payroll number is usually much more widely reported than the revisions. Looking at the BLS's recent history of reports and revisions, we see a mix of

upward and downward revisions since July of 2023, with a strong trend of downward revisions since January of this year. If the BLS commissioner wanted to help an incumbent president win reelection, we would likely see a strong trend of high headline numbers revised downward after the fact. This would “mask” a weaker labor market initially, reporting the true (lower) number months later and without as much press. While there are months like this during Biden’s term, there are also months revised higher after the fact (and likely without much fanfare). In Trump’s term, so far, every single month has been followed by a negative revision. The more likely explanation for the pattern in revisions is that they tend to be serially correlated. Weak revisions tend to follow weak revisions, and strong follow strong, given underlying dynamics in the types of companies who report late. Again, we see a perfectly rational explanation for the recent weak revisions.

The two-month revisions dominated headlines, but July’s nonfarm payroll number was weak as well. Besides the headline number being 32,000 below expectations, the composition of jobs added was troubling. Of the 73,000 jobs added in July, 79,000 came from healthcare and education. This means that the entire rest of the economy had negative growth in hiring, on average. Areas that shrunk include manufacturing (-11,000), professional and business services (-14,000), and, as discussed previously, government (-10,000).

| Series | Ticker | May-25 | Jun-25 | Jul-25 |
|-------------------------------------|----------------|--------|--------|--------|
| ▼ Total | NFP TCH Index | 19 | 14 | 73 |
| ▶ Mining & Logging | ECANMAYU Index | -4 | -1 | -4 |
| ▶ Construction | ECANRXTD Index | 2 | 3 | 2 |
| ▶ Manufacturing | ECANX8NS Index | -11 | -15 | -11 |
| ▶ Trade, Transportation & Utilit... | ECAN4GFL Index | -11 | -22 | 11 |
| ▶ Information | ECANQ9RK Index | 2 | 0 | -2 |
| ▶ Financial Activities | ECAN9C4V Index | 7 | -2 | 15 |
| ▶ Professional & Business Serv... | ECANLLKT Index | -23 | -11 | -14 |
| ▶ Education & Health Services | ECANF05T Index | 70 | 52 | 79 |
| ▶ Leisure & Hospitality | ECANYZH7 Index | 27 | 4 | 5 |
| ▶ Other Services | ECANH9RY Index | 10 | -5 | 2 |
| ▶ Government | ECAN56JA Index | -50 | 11 | -10 |

Source: Bloomberg. May through July, change in employment by sector.

We haven’t seen a negative payroll survey since 2020, and before that, the Great Financial Crisis. October of 2024 was an example of a nearly flat payroll number followed by several months of strong adds. We hope that July’s nonfarm payroll print will ultimately be the same. There are reasons to think the worst is behind us, as tariff uncertainty recedes, and businesses can better plan and hire. One important caveat to payroll weakness is the trend in population growth.

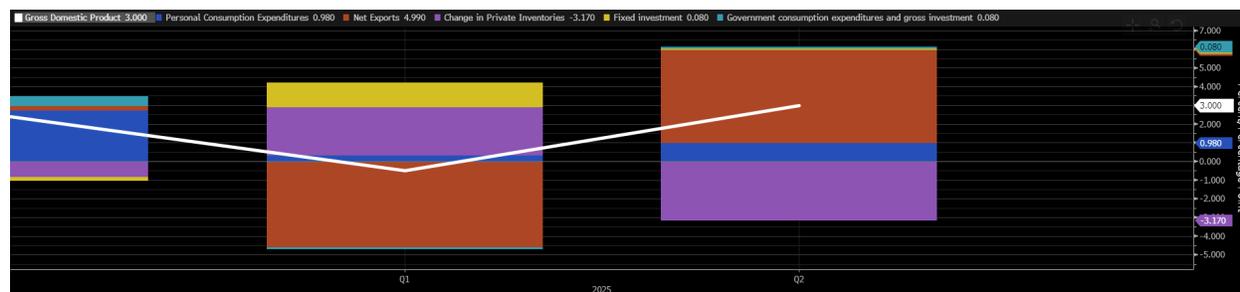
We should expect lower payrolls if our population is growing more slowly, which could be happening now due to the administration’s immigration policies. If this is the case,

weakness in payrolls would indicate a lower supply of workers, not necessarily problems with labor demand. In this scenario, flat or even negative payrolls would not serve as a strong recession indicator like they did when we had robust population growth. Instead, we would view the unemployment rate as a better signal of the health of the labor market, as a drop in population growth would not affect this rate as it would payrolls. As long as layoffs are muted, and the unemployment rate is low, slow payroll growth isn't necessarily a concern.

GDP:

Over the long term, the main driver of a country's stock market returns is growth in real GDP. Multiple quarters in a row of negative real GDP growth usually indicate a recession. Real GDP isn't perfect, but it's one of the best statistics we have for measuring the health of the economy. Recent quarters have been noisy, but we find value in breaking the results down by component.

Real GDP growth for Q2 of 2025 grew at a 3.3% annualized rate compared to Q1. Q1's growth rate was -0.5%, and expectations for Q2 were 2.6%. Looking at the chart, the largest contributors to both quarters' volatility are inventories (purple) and net exports (red). The impact on both can be explained by tariffs.



Source: Bloomberg

Inventories:

Change in inventories contributed 2.60 percentage points (pp) to Q1's real GDP, much higher than last year's average contribution of -0.4 pp. One likely explanation is that businesses knew tariffs were probably coming later in the year, so they increased purchases before their costs went up from the tariff implementation. Q2 saw a -3.29 pp impact from inventories, meaning businesses were selling off their built-up inventory from Q1. This might help explain tariffs' muted impact on inflation so far. Once employers run out of this lower-cost inventory and must purchase newer (tariffed) inventory, we could see more of a tariff impact show up in prices. It's something to watch.

Net Exports:

Since about 1970, the U.S. has run persistent trade deficits, meaning that we buy more goods and services from our trade partners than we sell to them. As a result, net exports (exports minus imports) usually reduce real GDP, although the quarterly contribution to growth can depend on relative changes quarter to quarter. In the second quarter of this year, net exports contributed nearly 5 pp to real GDP. Both exports and imports fell

relative to last quarter, but imports had a much sharper decline. This massive contribution is essentially a reversal from Q1's huge surge in imports driven by businesses' desire to get ahead of tariffs.



Source: Bloomberg. U.S. trade balance since 1992, quarterly (in billions).

One eventual goal of tariffs is to increase manufacturing in the U.S. and improve our trade balance. This takes time, however, so the short-term impact so far has been a reduction in trade. We buy fewer goods from our trade partners, and in return, they buy fewer of our goods. The real test will be how the investment component of GDP changes over time. If tariffs (in conjunction with other policies) are effective at inducing companies to invest in the U.S. and reshore manufacturing, we should see a big contribution from investment to real GDP.

Investment:

Fixed investment contributed 0.59 pp to real GDP in the second quarter. This is after a 1.3 pp contribution in the first quarter, and last year's average contribution of 0.29 pp. Digging deeper, investment in nonresidential structures fell 8.9% at an annual rate compared to Q1. Within structures, manufacturing fell 6.6% and mining fell 42.8%. Nonresidential equipment, on the other hand, grew at an annual rate of 7.4% compared to first quarter, with the biggest contributor being computers and peripheral equipment, which grew a baffling 61.2%. Residential investment fell 4.7%, with both single family and multifamily structures declining, as well as a 7.7% decline in residential equipment.

The types of private investment we need to increase domestic manufacturing haven't increased yet and, in fact, are heading in the wrong direction. Strength in AI investment, unrelated to tariff policy, is helping to mask this weakness. Certain incentives in the One Big Beautiful Bill, such as bonus depreciation, may help to motivate investment in manufacturing in the latter half of this year and in years to come. For now, however, economic data does not yet show that these tariffs incentivize domestic manufacturing.

Input prices are increasing. Usually, this happens in an expansionary environment where the prices of finished goods are increasing as well. As a result, input prices usually coincide with higher business investment, also called capital expenditure or capex. As shown in the following graph, the historical relationship is currently not holding. Input prices are increasing due to tariffs rather than general expansion in the economy, so capex is declining as businesses see costs going up without a corresponding bump in demand.

Regional Fed manufacturing survey results (diffusion indices, averages of z-scores)



Source: Federal Reserve Bank of Dallas, Federal Reserve Bank of Kansas City, Federal Reserve Bank of New York, Federal Reserve Bank of Philadelphia, Federal Reserve bank of Richmond, Matthew Klein's calculations

It's still too early to see the ultimate effects of the administration's various policies to induce domestic investment. Foreign direct investment could pick up, as multiple countries have promised to invest in the U.S. in exchange for lower tariffs. Also notable, the weakness in investment could be a sign we're entering a downturn in the business cycle. Maybe businesses wouldn't be investing right now regardless of tariff policy and are making their decisions based more on consumer demand and interest rates. Even if not the main cause of weak investment, tariffs are having a negative impact on input costs, which doesn't help businesses that want to manufacture more in America.

Consumption:

Strong consumer spending has been the primary explanation for strong economic growth in the U.S. for decades. Weakness in consumer spending often presages a recession. Right now, the consumer is decently strong.

The annualized contribution from consumption to real GDP was 1.07 pp in Q2, vs. 0.31 pp in Q1. This puts the average contribution from consumption for the year at 0.69 pp, compared to the average from the first two quarters of last year of 1.6 pp. Consumer spending looks weaker than last year, but given the weakness in the labor market and uncertainty surrounding inflation, things are holding up surprisingly well.



Auto sales have been especially strong. Consumers are likely trying to buy before prices increase due to tariffs. There are also expiring incentives related to electric vehicles that may induce buyers to act now. These strong auto sales account for some of the strength in consumer spending we've seen, but retail sales ex-auto have been stable as well. This number grew 0.3% MoM in July, after a 0.8% bump in June.

One explanation for strong consumer spending is high wage growth. Growth in average hourly earnings has come down in recent months, but the most recent month was still 3.9% higher than the same month last year. Notably, this means people's earnings are outpacing inflation, enabling them to spend more. Another explanation for high spending is the recent stock market performance. When people's net worth increases, it usually induces them to spend more even if their income is unchanged. This is known as the wealth effect and likely explains at least a part of recent consumer strength. The impact of the wealth effect has been more significant for higher earners who have more of their net worth in financial assets, such as stocks and bonds, rather than personal assets like cars and homes. If higher earners have been propping up consumer spending, a stock market correction may not merely be a sign of economic weakness but could induce economic weakness itself via the wealth effect.



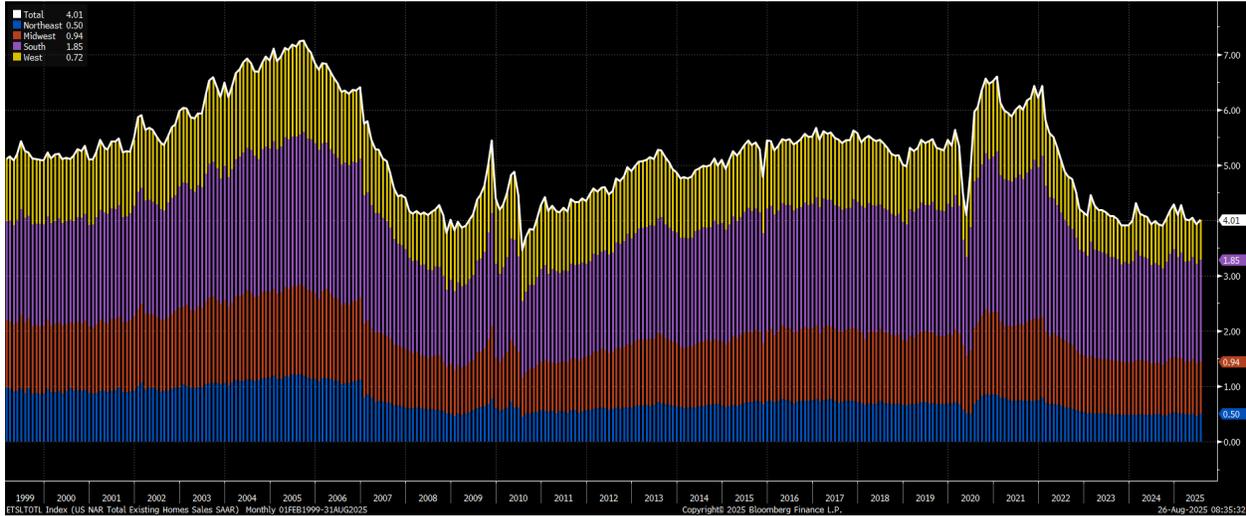
Source: Bloomberg. Retail sales ex-auto is holding steady.



Source: Bloomberg. Hourly earnings (white) have been higher than CPI inflation (red) since roughly June of 2023.

Another avenue for the wealth effect to influence consumer spending is via housing. The housing situation has been poor recently, with some economists even describing the U.S. as in a “housing recession.” A combination of high mortgage rates and persistently high prices have led to some of the lowest home sales volumes since the Great Financial Crisis. Existing home sales are hovering around a 4 million annualized rate, roughly on-par with the worst month of the pandemic but above the 3.45 million rate that marked the worst month of the financial crisis. Monthly new home sales are also stagnant around a 650,000 annualized rate. Further, the FHFA House Price Index has been negative for the past 2 months, showing the average home price falling recently. Even if we don’t see high rates and low demand sending home values lower, higher mortgage costs associated

with high prices and high mortgage rates will increasingly eat into the discretionary incomes of homeowners across the country.



Source: Bloomberg. Existing home sales are worse than the pandemic and not far from Great Financial Crisis lows.

Government Spending:

Government spending has contributed an average of -0.02 pp to real GDP over the past 2 quarters, with Q1's contribution being slightly negative and Q2's slightly positive. This is compared to an average contribution of 0.55 pp in 2024, in which all 4 quarters had a positive contribution. It's impossible to predict exactly how government spending will contribute to real GDP moving forward, but on balance, we lean negative. State and local government spending have been contributing positively so far this year, while federal spending has been a drag. There has been particularly weak nondefense federal spending, with Q2 notching a -5 pp contribution. Given the continued effects of federal headcount reductions earlier in the year, we would expect this trend to continue.

Ultimately, our outlook for GDP going forward is mixed. Investment outside of AI-related projects looks weak. The consumer has been surprisingly resilient in the face of a troubling housing market and macroeconomic uncertainty. These two accounts will likely drive GDP performance for the rest of the year. If we can successfully induce investment through bonus depreciation and other policies, we may see stronger GDP growth for the year. Conversely, if we see home prices continue to fall or the stock market corrects, weaker consumer spending may offset this strength in investment.

RSA PORTFOLIO STRATEGY

Fixed Income Strategy

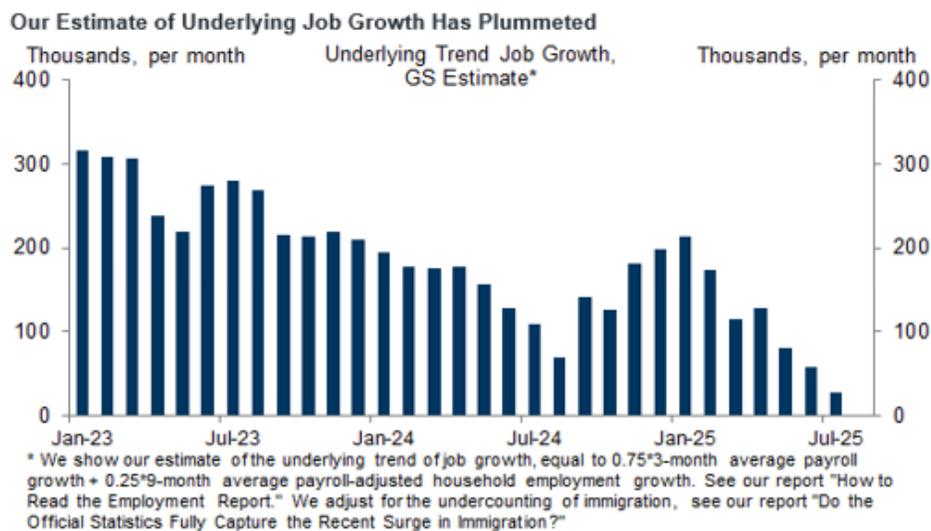
By Nick Prillaman

At our prior meeting on June 11, long-dated interest rates had come down off their local highs from late May but traded in a range in early June as economic data points presented conflicting views, with ADP private payrolls coming in much weaker than expected, while the nonfarm payroll numbers were stronger. The Federal Reserve met mid-month and maintained the target range for the federal funds rate at 4.25%-4.5% for the fourth time in a row. At the press conference, Fed Chair Powell expressed concern over tariff inflation but was taking a wait-and-see approach saying, "We think it is appropriate to hold where we are as we learn more." Interest rates were largely unchanged on the day, which reflected a lack of new information from the Federal Reserve. As the month progressed, dovish commentary from Federal Reserve Governor Michelle Bowman and Governor Christopher Waller put downward pressure on yields. Bowman said, "Should inflation pressures remain contained, I would support lowering the policy rate as soon as our next meeting in order to bring it closer to its neutral setting and to sustain a healthy labor market." Waller said, "Any tariff inflation....I don't think is going to be that big, and we should just look through it in terms of setting policy." In total for June, Treasuries posted a healthy 1.254% return with 20+ year Treasuries leading the way with a 2.67% total return. The 2s/10s curve stayed stable at 50 bps, reflecting the parallel move lower in yields.

As we moved into July, the economy appeared on solid ground as nonfarm payrolls increased by 147,000 in June versus an expectation of 106,000. The unemployment rate fell to 4.1% from 4.2%. This data drove interest rates higher as investors pushed out the timing of rate cuts. The Federal Reserve met on July 30 and maintained their previous target range though Governors, Bowman and Waller voted against the monetary policy action as they preferred a quarter percentage point cut. According to BofA, "the market heard a data dependent Fed that is in no hurry to cut. The assessment was driven by Powell's comments that the labor market is strong & at target, inflation is still running above target, and the 'economy is not performing as if restrictive policy were holding it back inappropriately.'" Overall for the month, Treasuries lost 39 bps due to the selloff at the beginning of July with the 25+ year maturity bucket posting the worst return at -1.15%. The 2s/10s curve bear flattened by 9 bps over the month.

On the first day of August, markets received a shock from the July nonfarm payrolls report as payrolls grew less than expected at 73,000 versus 105,000. While this was not a good number, the most distressing part of the report was the revisions. In June, the growth in payrolls was only 14,000 versus the originally reported 147,000 and for May, payrolls dropped to 19,000 from 125,000. The revisions were so extreme that President Trump fired the head of the Bureau of Labor Statistics. The economy looked much weaker after the report, and rate markets reacted with vigor. The 2-year yield fell 27 bps that day, while the 10-year fell almost 16 bps. Since then, interest rates have largely moved sideways.

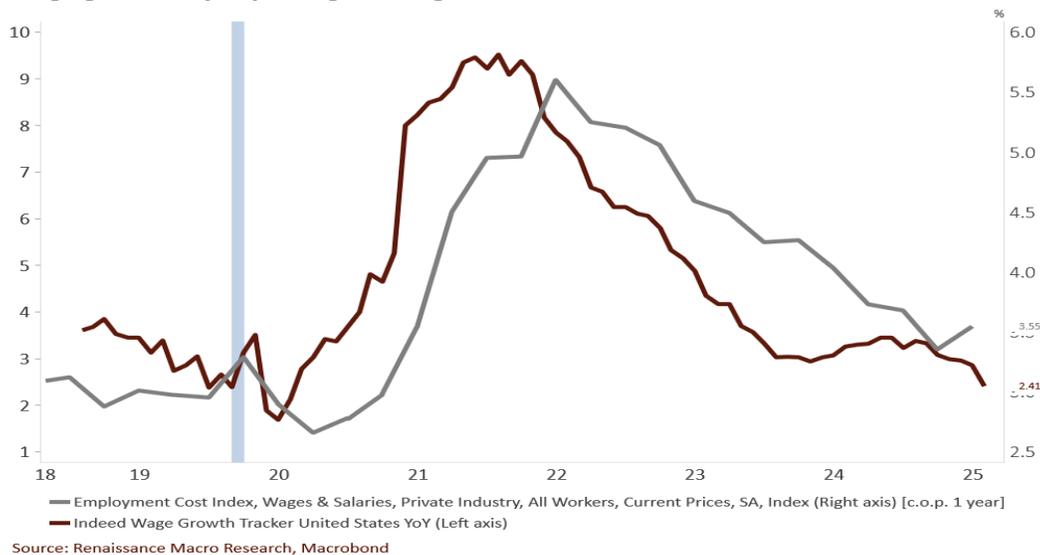
In the terms of our current view of the fixed income market, we are of the opinion that front-end interest rates should continue to move lower as the risks in the labor market outweigh the price stability issues generated from tariffs. The Federal Reserve has a dual mandate of maximum employment and price stability. It makes sense that in the first half of the year the Fed focused on the inflation side given the propensity for tariffs to raise prices. Also, the unemployment rate was bouncing along the low 4% range, indicating a full employment economy. The environment has changed as cracks have developed in the labor market. This can be clearly seen in the July nonfarm payrolls report with the negative labor market revisions. What was thought to be an economy generating over 100k new jobs a month is now one that is barely creating jobs. The chart below from Goldman Sachs shows that underlying job growth has essentially stalled. Additionally, Neil Dutta, RenMac's economist, has pointed to other measures indicating weakness in the labor market such as discouraged worker counts being up as well as rising college-educated unemployment. It is critical at this juncture to start supporting the labor market through looser monetary policy because if job losses start piling up, unemployment often moves higher in a non-linear fashion meaning that once the firing train gets moving, it usually picks up speed unless it is arrested by policy changes.



Source: Goldman Sachs Global Investment Research

While tariff-induced inflation pressures are still a concern, they don't appear to be the most pressing issue for the economy. U.S. CPI rose .2% m/m and 2.7% y/y for July while core CPI, which excludes food and energy, was up .3% m/m. These are manageable numbers. On the producer front, PPI did come in hotter than CPI as July prices increased .9% m/m and 3.3% y/y versus an expected .2% and 3.5%. Considering both data sets, producers are not passing along the full extent of the tariffs to consumers which should help keep inflation from becoming more entrenched in the economy. Inflation is also not presenting a problem in wages as seen in the chart below from RenMac. If inflation were about to materially move higher, like in 2020, the Indeed Wage Growth Tracker would be surging. It is not and is actually declining which gives cover to the Fed to support full employment more than fighting inflation.

Wage growth in job postings cooling off



Source: Renaissance Macro Research

Changing monetary policy from moderately restrictive to neutral is the best way for the Fed to aid growth in the broad economy. According to Don Rissmiller at Strategas Research, a neutral level for interest rates is between 3.0-3.5%, so the Fed has 75-125 bps of cuts to enact to get to a non-restrictive fed funds rate. Market participants see the Fed cutting 25 bps in September and 25 bps in December with the remainder of cuts coming in 2026. Fed Chair Powell’s remarks from Jackson Hole in late August increased the odds that the Fed will cut at the September meeting by saying, “the shifting balance of risks may warrant adjusting our policy stance.”

In addition to the view that the Fed will be cutting rates, there are two potential catalysts to support a bullish move in bonds. One is the end of quantitative tightening (QT) which has been discussed recently by markets observers as the Reverse Repo facility (RRP) approaches zero. If this does happen, the Fed will probably reinvest their MBS paydowns which have been running around \$17 billion a month into Treasuries. Second, the potential easing of the supplementary leverage ratio (SLR) rule would allow banks to hold more Treasuries. In an interview on Bloomberg addressing the topic of how much the change would affect yields, Treasury Secretary Bessent said, “I’ve seen estimates that it could bring yields down by tens of basis points.” Finally, the bond market stands to benefit from investors hedging their equity risk with fixed income products. As stock markets continue to move higher and higher, capital allocators might find it increasingly necessary to rebalance some of their equity gains into bonds which will place downward pressure on yields.

While we are bullish on the front-end of the Treasury curve, the outlook for the long end is decidedly more opaque. Persistent fiscal deficits domestically and abroad continue weigh heavily on the minds of fixed income investors. Treasury Secretary Bessent has tried to relieve the pressure on the back end of the curve by shifting Treasury issuance to short-term bills, but it remains to be seen how effective this will be. Nevertheless, since the Federal Reserve looks to be on the cusp of restarting its cutting cycle and the

probabilities favor a steeper curve. As seen in the chart from the St. Louis Fed, there is a propensity for the curve to steepen after a period where the 2s/10s curve had been negative. With the curve finally ending its inverted position a year ago, one would expect it to keep moving higher until growth picks up materially in the economy.

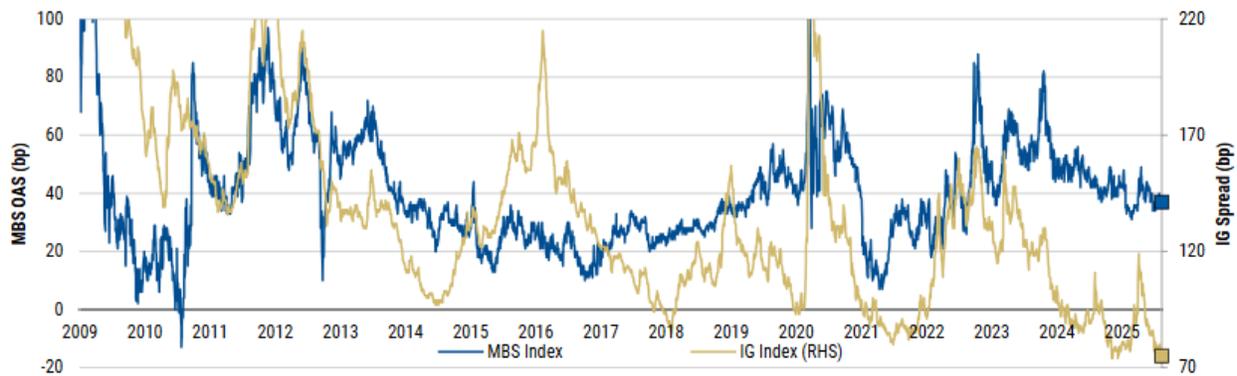


Source: Federal Reserve Bank of St. Louis

Regardless of the outlook, bond investors still need to remain aware of the inflation risk lurking in the background even if its currently not a major problem. The 2022 experience of 9.1% CPI teaches us that policy mistakes can occur, so we must be vigilant about responding to any significant future changes in the macro economy.

Over the last few months, activity in the Treasury portion of the fixed income portfolio has been muted reflecting the somewhat range-bound movement in interest rates. We did sell some March 2026 notes and purchase a block of November 2032s. The trade extended duration at the margin to help hedge a duration-led move lower in interest rates.

In the mortgage-backed securities space, we deployed fresh capital into the asset class beyond our typical reinvestment of prepayments to raise our weighting in the portfolio. We purchased three 30-year Fannie Mae 5.0% coupon pools with yields above 5.3%. These bonds offered healthy spreads combined with a high level of quality as well as excellent liquidity. Relative to corporates bonds, mortgages continue to look more attractive at this stage of the cycle. As one can see in the chart below, agency mortgage bond spreads are well off their lows of 2021, while corporate spreads are essentially the tightest since prior to 2009. In the terms of liquidity, the mortgage market is much better than the corporate bond market as one can reliably invest sizable amounts of money into the asset class. Gone are the days when we could get consistently large allocations in new corporate bond issues. The RSA will continue to invest funds in agency mortgage-backed securities because of these reasons.

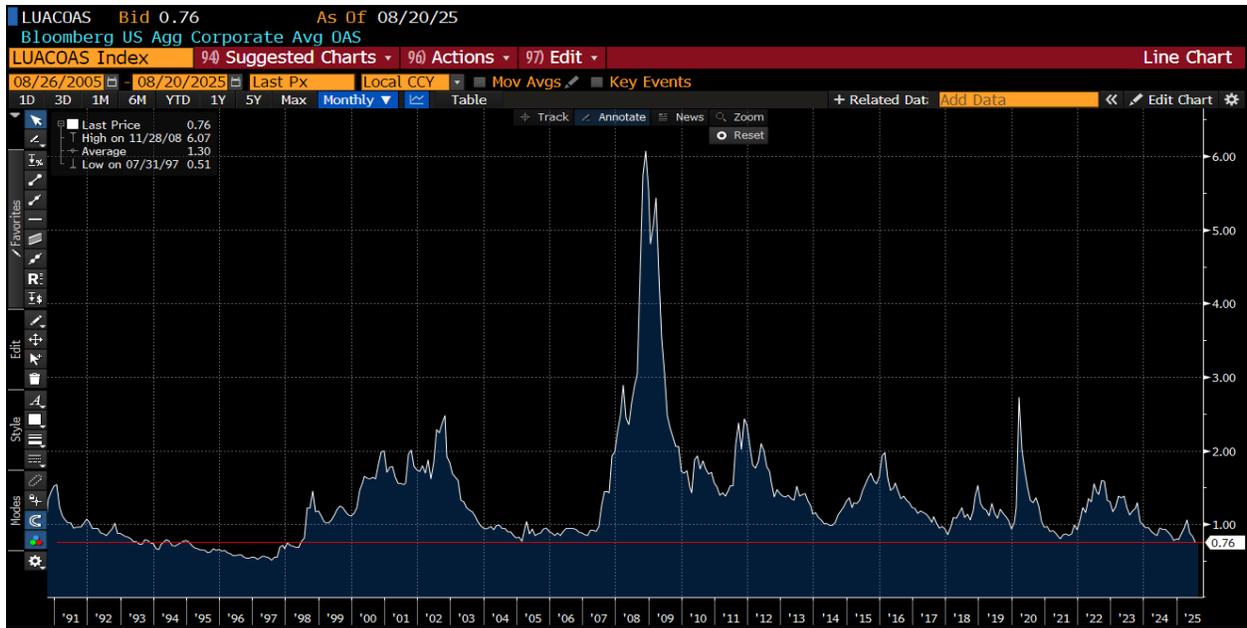


Source: Morgan Stanley Research, Bloomberg

While mortgages are appealing, we are cognizant of prepayment risk which is high at this stage of the cycle. If the Fed resumes its cutting cycle and the belly of the Treasury curve moves lower, recent home buyers will have the opportunity to refinance into lower rate mortgages which will impact MBS holders. We have stayed out of buying ultra-high coupon pools well above par to help combat this risk and will aim to reinvest prepayments into pools priced below par, so each prepayment will provide an enhancement in yield.

In corporates, we purchased multiple bonds to help maintain our weighting in the asset class. For example, we bought a 10-year Packaging Corporation of America note with a yield 5.20% and a spread of 93 bps. A second was a 30-year first mortgage bond of Kentucky Utilities which is part of PPL Corp. at a yield of 5.852% and a spread of 105 bps. Given the uncertain economic outlook, we believed that accumulating safe assets with a touch of duration made sense.

Investment grade corporate bond spreads are currently very tight at 76 bps. The next major move from these levels is usually wider as seen in the chart below, though timing the move can be difficult as spreads in the short run can chop sideways like in the mid-2000s or even can grind tighter like in the mid-1990s. On a relative basis, corporate bonds should underperform Treasuries in a real economic slowdown given their rich valuations. If the economy continues to hold up, corporate bond performance will be fine even if spreads leak wider from here. It seems prudent to focus on higher quality borrowers which will help limit spread widening. On an absolute basis, investors are still receiving attractive all-in yields even with the tight spreads, as the underlying Treasury yields are still decently high, which is why we continue to make purchases in the space.



Source: Bloomberg

Domestic Equity Strategy

By Kevin Gamble

With less than a month remaining in our current fiscal year, the U.S. equity market has continued its resilient march higher to set new all-time highs of just over 6500 on the S&P 500 (reached at the end of August). Of course, we all know that September can be a volatile month in both directions, and nothing is over for the fiscal year until the closing bell rings on September 30. Largecap equities have continued to set the overall pace for this fiscal year with the S&P 500 gaining 13.53%, the midcap S&P 400 a distant second place with a 5.65% return, and the Smallcap S&P 600 serving as the caboose with a modest 3% gain FYTD.

Exhibit 1: S&P 500/400/600 Performance Fiscal Year-to-Date



Source: Bloomberg

Volatility has continued to stay compressed since our last meeting, falling 18% this calendar year as the OBBB Act has now passed Congress. Additionally, the Fed appears ready to embark on further monetary easing at its meeting later this month, following its recent dovish Jackson Hole summit.

Exhibit 2: VIX Index (Volatility) Fiscal Year-to-Date



Source: Bloomberg

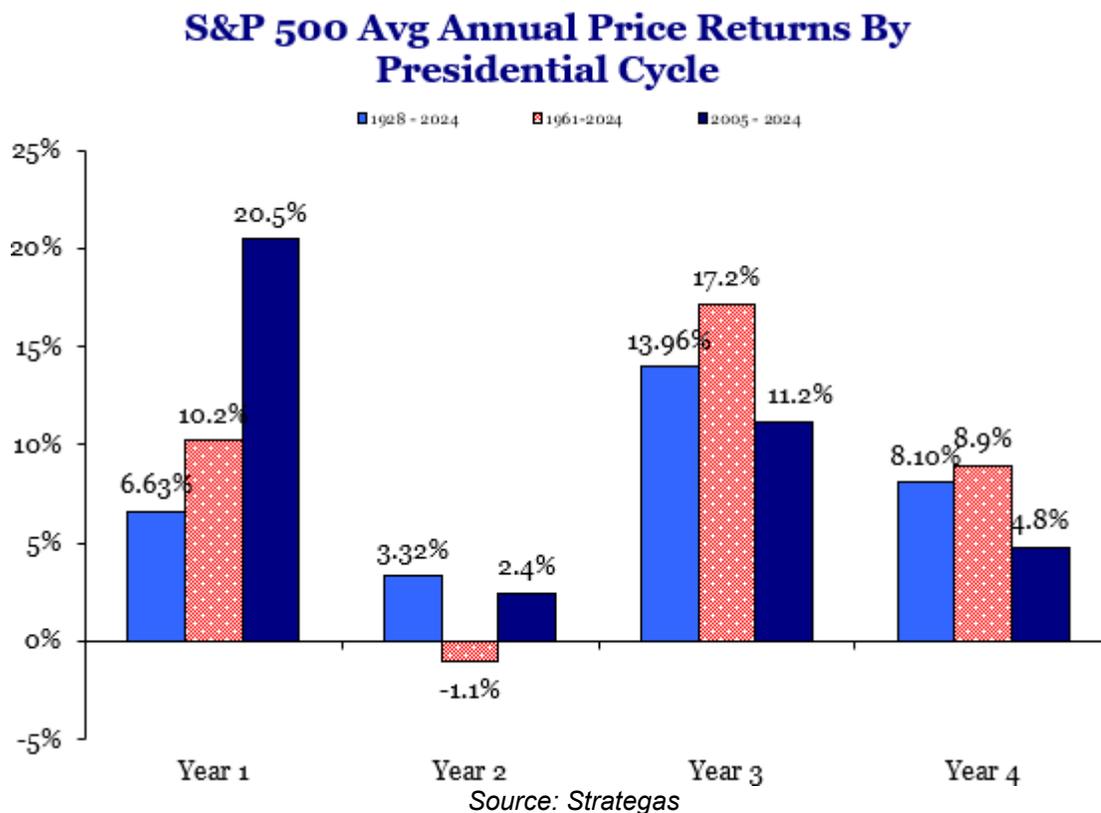
Given the U.S. equity market has been relatively calm during the summer months since our last strategy update, we would like to simply provide 10 very macro-oriented observations/updates about the current state of the U.S. equity market as we approach the finish line for this fiscal year and the start of a new one.

10 Important Observations/Updates

- 1) The first half of the Presidential cycle has historically been the most challenging for U.S. equity markets, but Year 1 has shown significant improvement in the more recent history - We appear to be tracking recent history!**

Since 1928, the S&P 500 has averaged 6.6% in post-election years compared to 14% in pre-election of Year 3 years and 8.1% in election or Year 4 years. Year 2 of the presidential cycle has continued to be by far the biggest outlier to the downside, as it has shown the weakest historical performance across all time periods. In review, President Trump's first term saw 22% gains in the S&P 500 during his first year in office, a slight negative return of down 4% in Year 2, a very strong 32% in Year 3, and a solid 18% in Year 4.

Exhibit 3: Historical U.S. Presidential Cycle Returns



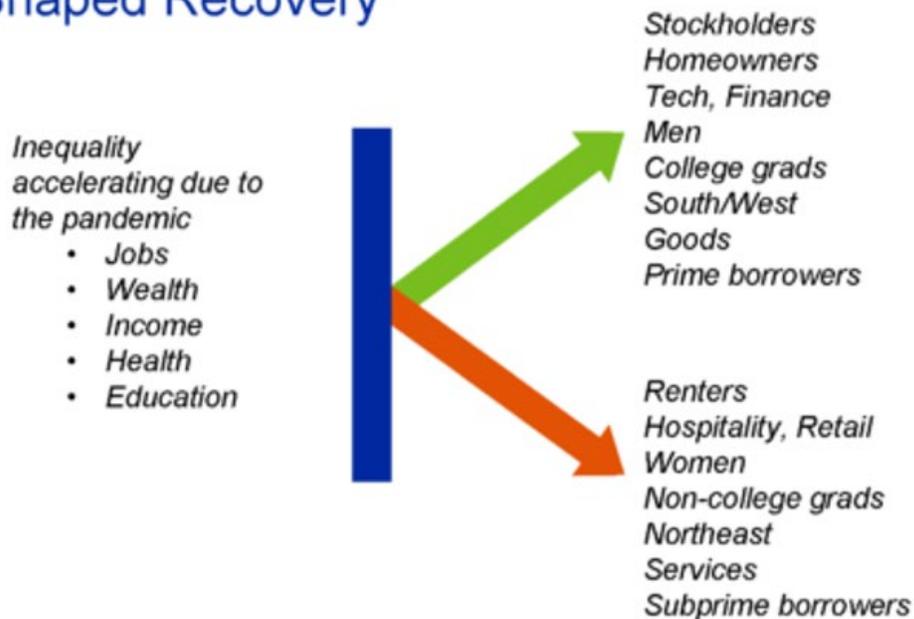
The positive update here is that the U.S. equity market appears to be tracking the more recent time frame results as far as much more positive returns in year 1 of the presidential cycle. This is perhaps due to the more aggressive measures in recent first years such as passing large reconciliation bills along party lines prior to the midterm elections (which often go against the party in power). If recent history holds form, we have further to go on the upside followed by a more challenging environment as we move into the Year 2 midterm election cycle.

2) The K-shaped recovery remains very much intact and perhaps has even accelerated with higher tariffs and restrictive interest rates

The economic recovery post-Covid has been very much K-shaped with asset owners, prime borrowers, and corporate executives doing extremely well while a large and growing percentage of the population now lives paycheck to paycheck (close to 70%) and struggles under the continued inflationary pressures post the pandemic.

Exhibit 4: K-Shaped Recovery Still Intact

The K-Shaped Recovery



Source: Moody's Analytics

3) There remain rising signs of consumer stress at the bottom of the K

If there is a solid reason for Jerome "Too Late" Powell to cut rates at the upcoming meeting, this is it! The bottom of the K is struggling mightily under the weight of high interest rates, while rich savers love high rates. In other words, current restrictive monetary policy is arguably driving the massive wealth gulf wider and wider.

Despite the relatively low unemployment rate, there are rising signs of consumer stress as credit card delinquencies have now risen to over 12% of accounts being overdue. In addition, more and more borrowers are simply making the minimum payment on credit cards, which is a worrying sign given the high level of current interest rates being charged. Additionally, the use of BNPL or "buy now, pay later" options has also continued to rise for a variety of different purchases with elevated delinquency levels. The rising use of BNPL loans for daily necessities such as groceries is especially concerning. It should also be noted that student loans have once again entered repayment which is leading to both rising delinquencies and lower consumer credit scores. Last equity update, we showed you the chart of spiking 90+ day delinquencies, so this update will give a few qualitative observations.

Exhibit 5: Rising Costs at the Grocery Store is a Big Problem for Bottom of K



unusual_whales ✓
@unusual_whales

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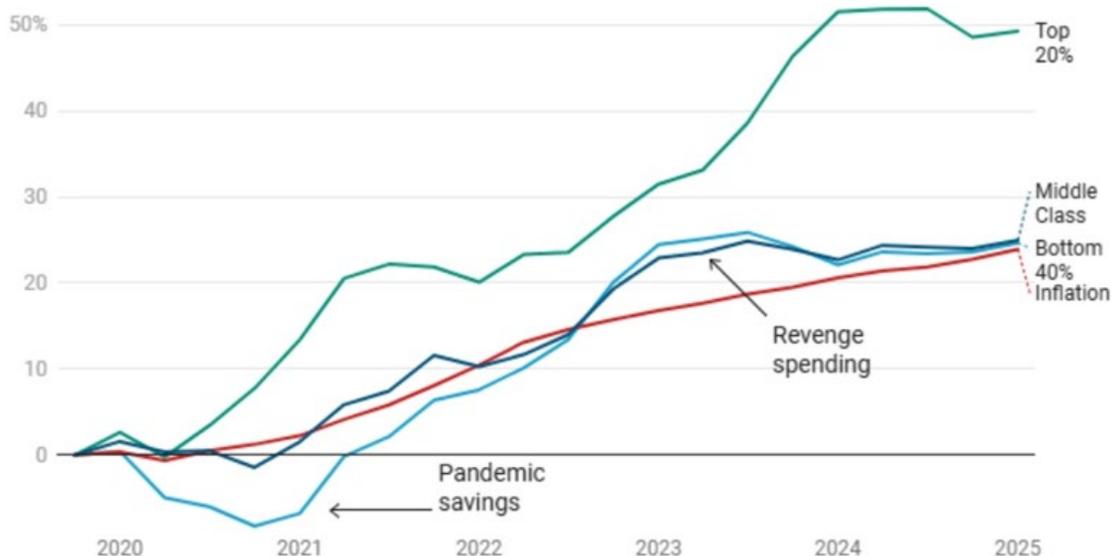
53% of Americans say the cost of groceries is a major source of stress, per Axios.

Source: Unusual whales/Axios

Exhibit 6: Top of the K Loves High Savings Rates and Stocks at All-Time Highs and is Driving Consumption in the U.S.

The U.S. economy depends on consumption by the rich

Wealthy Americans in the top 20 percent continue to grow their spending. Meanwhile, the "revenge spending" era for middle-class and lower-income Americans is over. Their spending is roughly in line with inflation. (Chart shows growth in personal outlays vs. inflation.)



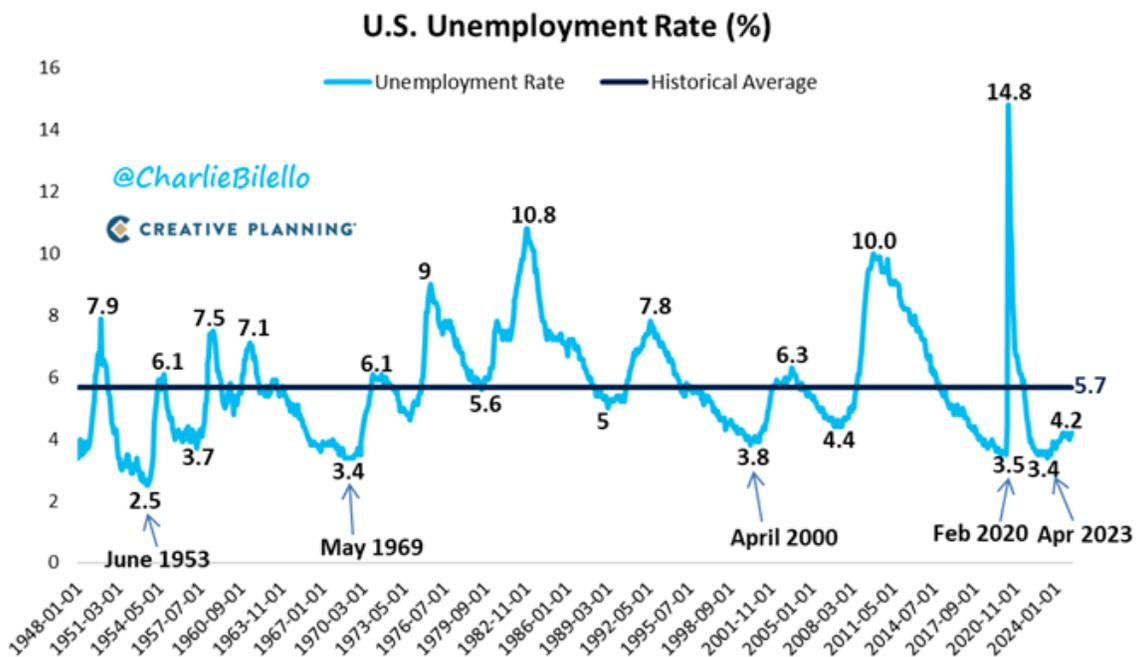
Source: Twitter/X

4) The labor market (unemployment rate) holds the key and is becoming a bigger worry for the Fed post Jackson Hole

At the recent Jackson Hole summit, Chairman Powell made the comment that “nonetheless, with policy in restrictive territory, the baseline outlook and the shifting balance of risks may warrant adjusting our policy stance” indicating the potential for rate cuts to address the building concerns over the maximum employment side of their mandate.

When assessing the various economic scenarios and risks moving forward, the health of the labor market really jumps out as a key level to monitor. As we have written about in past updates, we are approaching a point in the cycle at which labor markets have historically weakened quite a bit. Of course, every period is slightly different, and this period is no exception with retiring baby boomers and immigration issues with which we must contend on the labor front. The Fed would welcome a labor market which stays steady as price levels moderate to their 2% inflation target (goldilocks). A significant weakening in the U.S. labor market would make for a challenging backdrop for the Federal Reserve, introducing both deflationary risks as well as stagflationary risks from the likely aggressive policy response.

Exhibit 7: U.S. Unemployment Rate



Source: Creative Planning

5) Does the Fed risk 1970s style stagflation by cutting interest rates too aggressively?

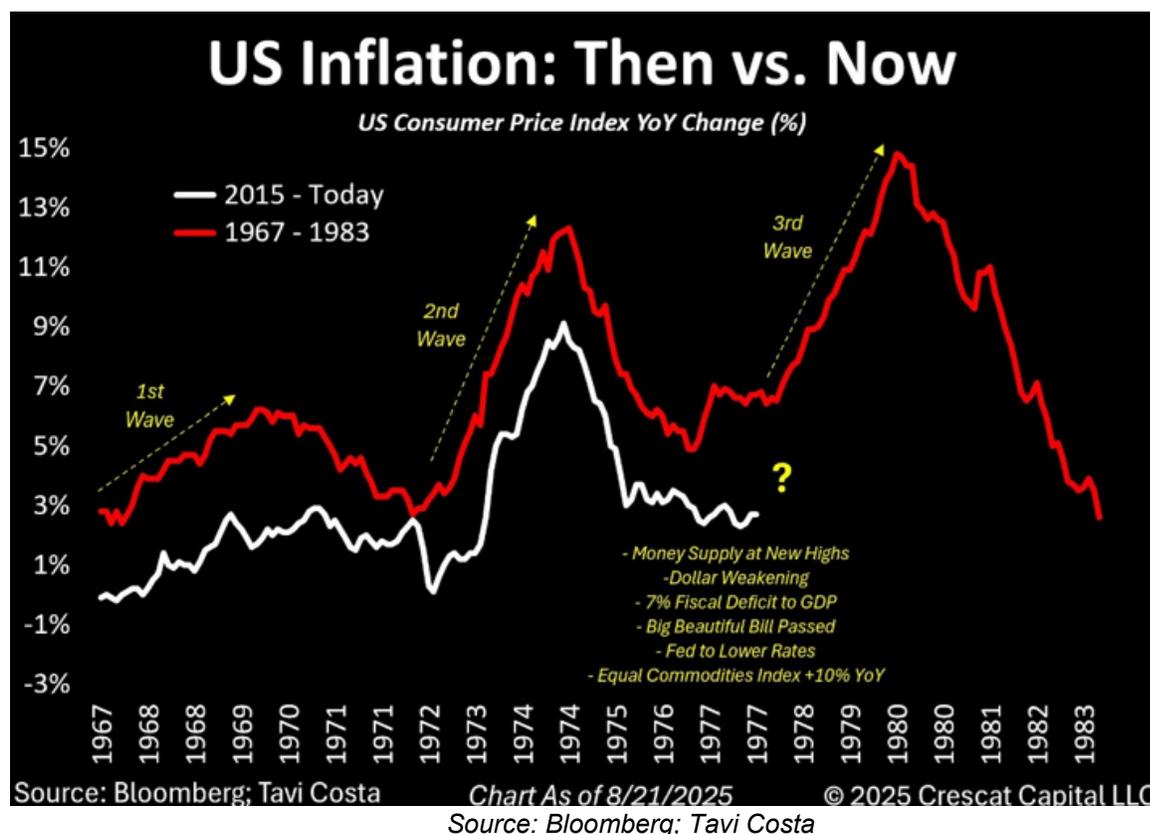
Jay Powell certainly does not want to have the same legacy as Arthur Burns, who is best known for not effectively controlling inflation in the 1970s. What will happen to the \$7 trillion plus currently parked in money-market funds if the Fed pushes these investors/savers out the risk curve? While there are certainly some similarities to the 1970s historical time frame, as far as it being very difficult to put the inflation genie back in the bottle, the fiscal dominance situation of large budget deficits driving the bus today versus a more bank lending cycle of the past seems very different. While there are some important differences, there are undoubtedly some signs of stagflation risk when looking at the PPI rising alongside the growing cost of tariffs. These tariff costs must be absorbed by someone in the system, just a question of who.

Exhibit 8: Jaws of Stagflation Wide Open?



Source: Bloomberg

Exhibit 9: U.S. CPI Inflation (1970s vs Today)

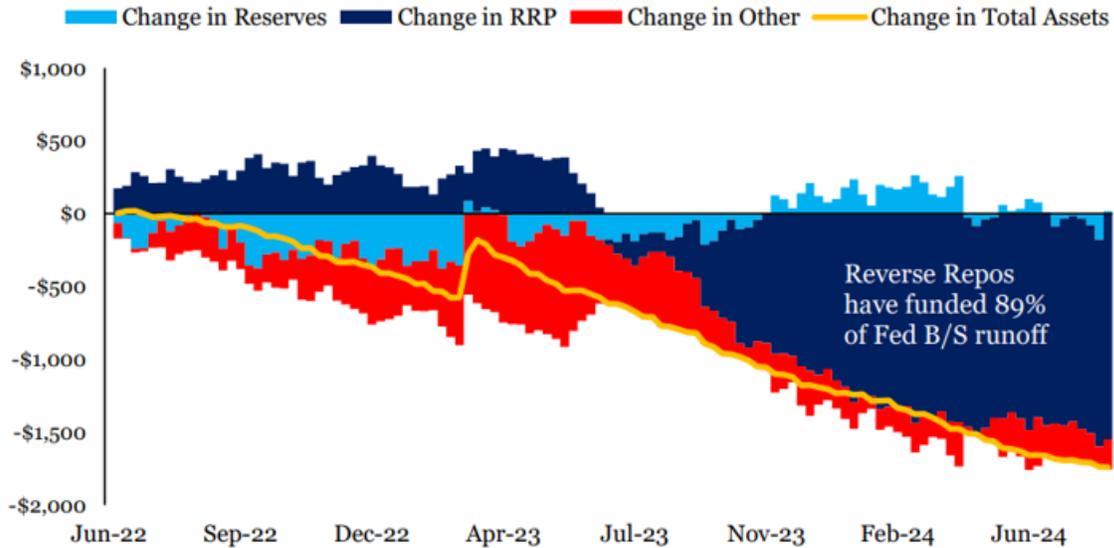


6) The reverse repo facility is now drained....what is going to happen with the Fed's balance sheet moving forward?

While all the focus has been on the Fed cutting interest rates, the Fed's balance sheet is perhaps going to come increasingly into focus as the reverse repo facility, which has provided the demand for 90% of the Fed's QT since inception, is now effectively drained from over \$2 trillion to almost nothing today. In addition, now that the debt ceiling has been lifted by the OBBB, the Treasury general account (U.S. govt checking account at the Fed) is scheduled to be refilled this month to the tune of over \$300 billion to reach its goal of \$850 billion by the end of September of this year.

Exhibit 10: Fed Balance Sheet Runoff – What Funded the QT?

Fed Balance Sheet Runoff - Composition of Change Since QT Began (\$BN)

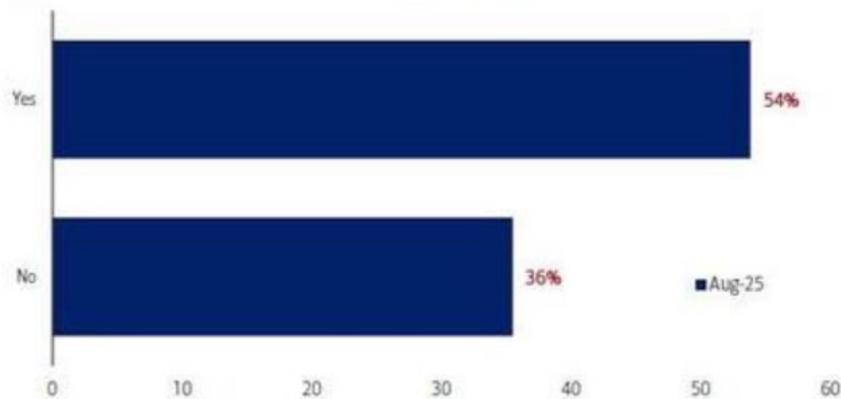


Source: Strategas

Exhibit 11: Will QE or YCC Be Necessary to Fund the U.S. Budget Deficits Moving Forward?

Chart 4: 54% of Aug'25 FMS respondents expect QE/YCC in US

Do you expect the next Fed chair to resort to Quantitative Easing or Yield Curve Control to help alleviate the US debt burden?

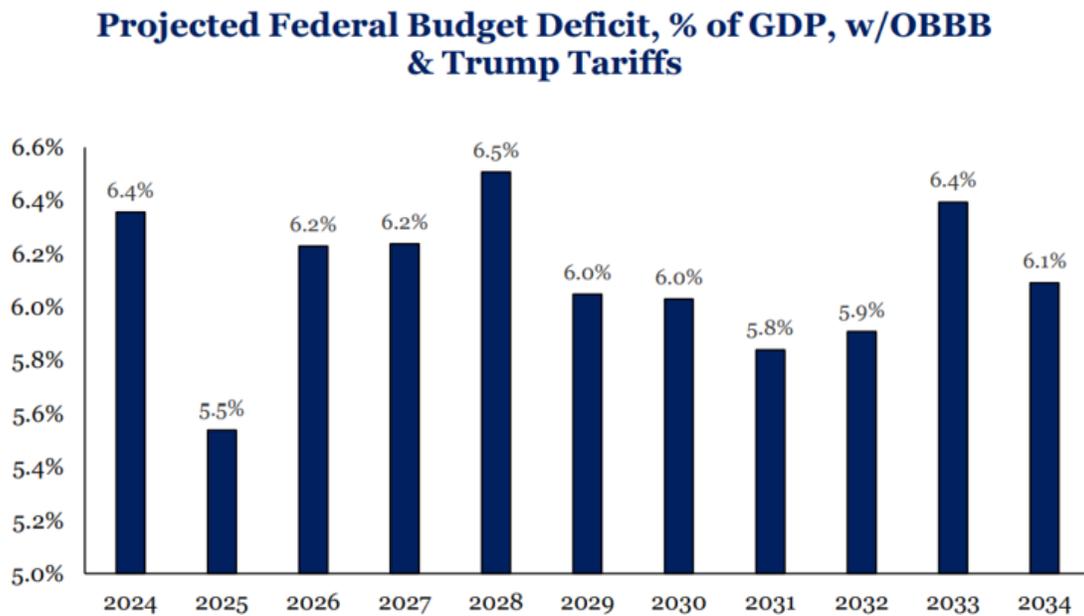


Source: BofA Global Fund Manager Survey

7) The “one, big, beautiful bill” or OBBB Act is now the law of the land

The one, big, beautiful bill became law since our last equity update. While the bill provides an additional layer of certainty on the permanence of the Trump tax cuts and some stimulative measures on bonus depreciation in the coming years, it should be noted that the bill certainly does not address the budget deficit concerns and offloads future costs on to the states to deal with Medicaid spending, the majority of which will take place post the Trump presidency.

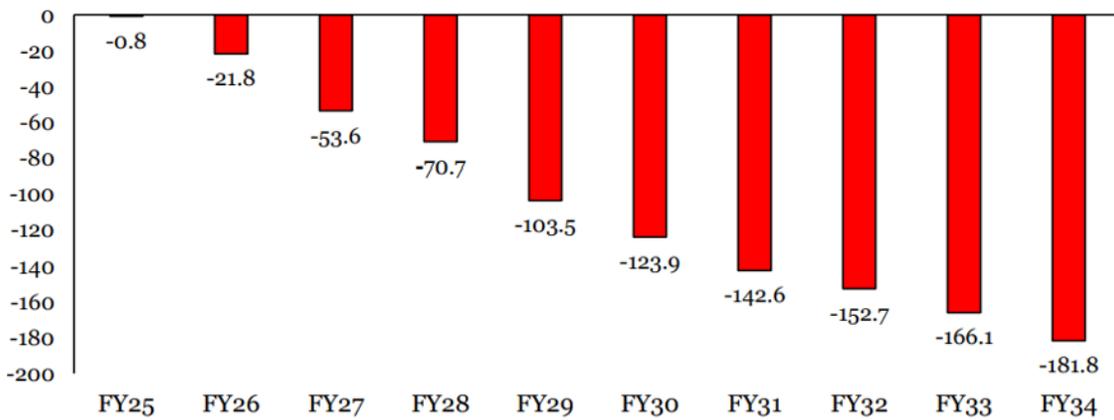
Exhibit 12: Projected Federal Budget Deficit as a % of GDP w/ OBBB and Tariff Revenue Included



Source: Strategas

Exhibit 13: Future Medicaid Cuts Associated with the OBBB Act

Estimated Medicaid Savings in One Big Beautiful Bill Act, by FY (\$Bn)
(CBO, 6/29/25)



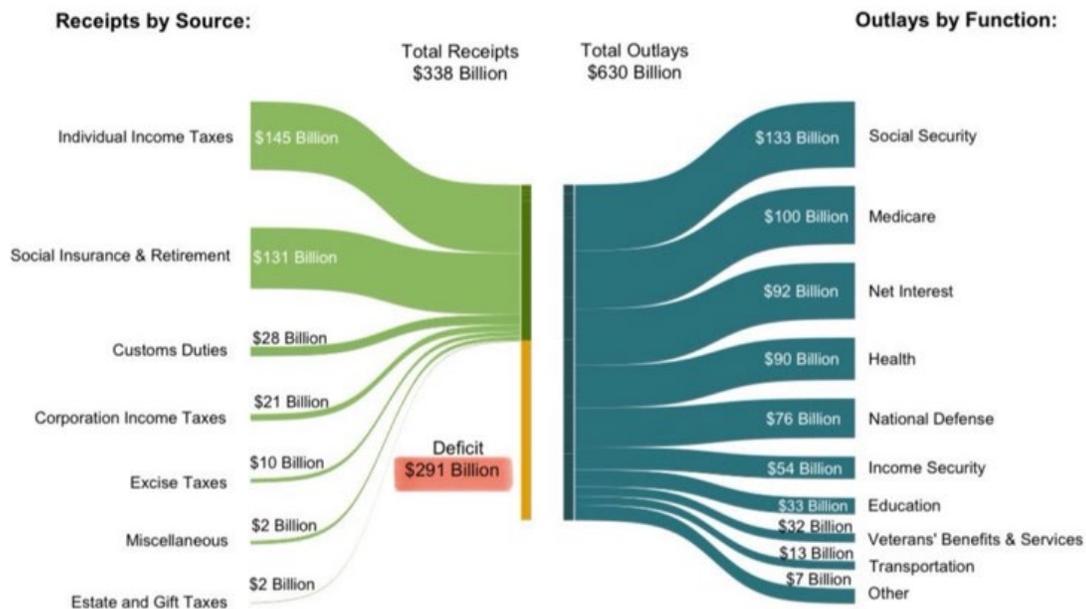
Source: Strategas

8) Nothing Stops the U.S. Budget Deficit Train?

Lyn Alden is well known for her stance that “nothing stops this train,” taking a line out of the TV show “Breaking Bad” to describe the U.S. budget deficit situation. The data would certainly back up her thoughts as the U.S. budget situation shows no signs of changing course despite the increase in tariff revenue. As a matter of fact, it seems to be getting worse based on July numbers which showed the U.S. spending \$291 billion more than it collected in revenues!

Exhibit 14: July U.S. Budget Deficit in Visual Form

Figure 1. Receipts, Outlays, and Surplus/Deficit for July 2025



Source: U.S. Govt data

9) Rate Cuts are Restrictive Policy to Passive Income

In this fiscally dominant, post-pandemic world we find ourselves in, it is important to point out that lower short-term interest rates are restrictive in the sense they lower passive income to savers. Chairman Albritton's recent comments about the General Fund in Alabama potentially taking a meaningful income hit in the face of dramatically lower short-term rates is a very good case-in-point that hits close to home. With over \$7 trillion now sitting in money-market funds, lower short-term rates mean significantly lower risk-free passive income to society, and this seems to be a misunderstood aspect of the current situation.

Exhibit 15: Estimated Monthly Income from Money-Market Funds

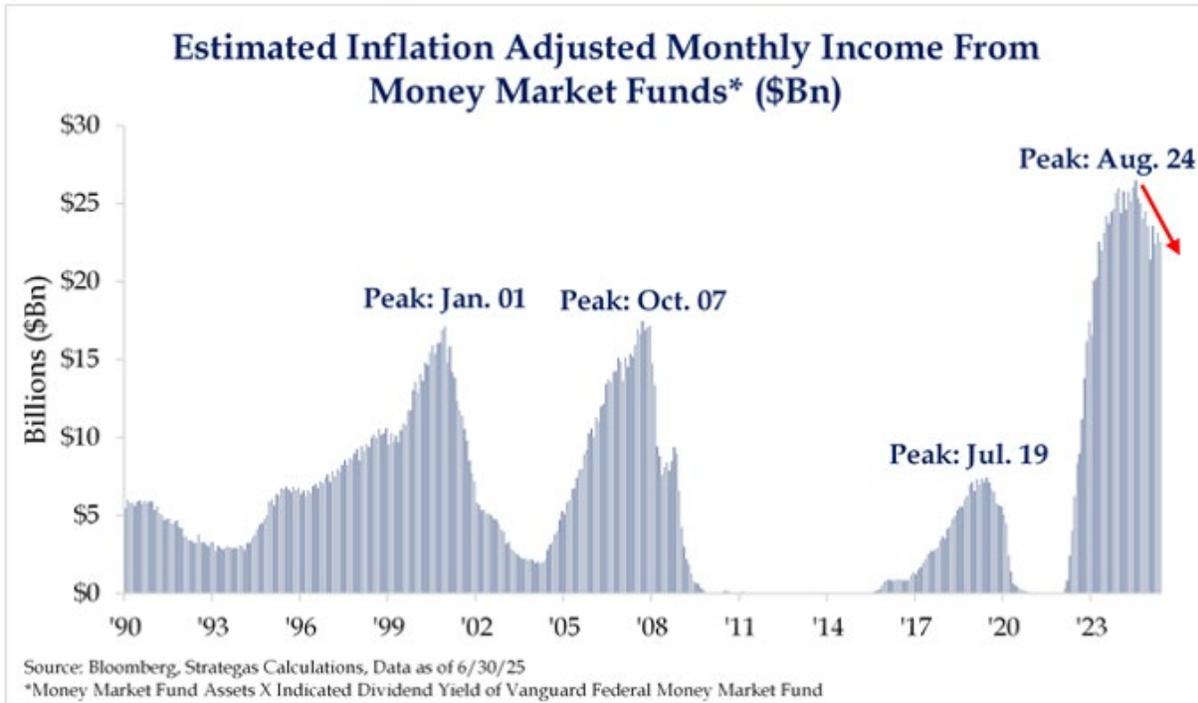
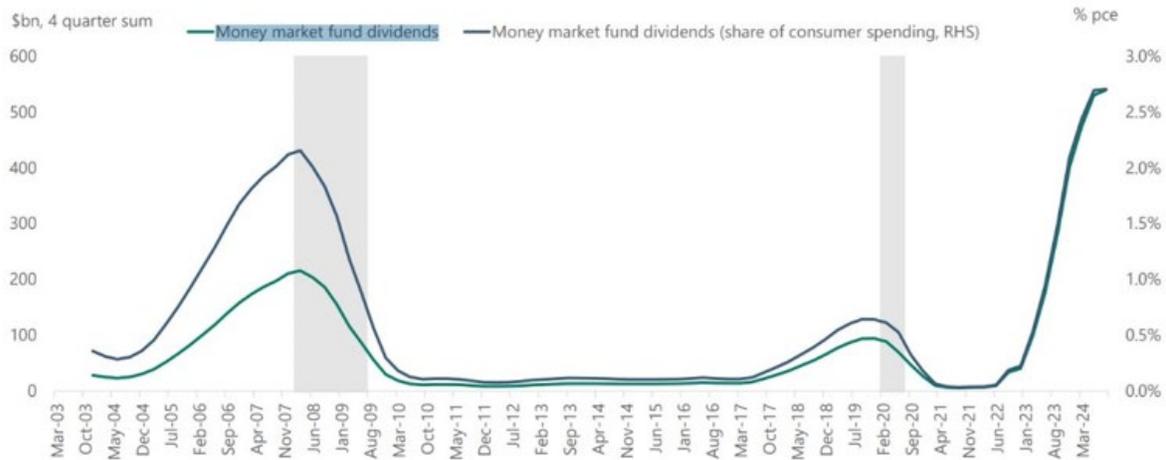


Exhibit 16: Passive Income Relative to Annual Consumer Spending in U.S.

Money market funds currently pay around \$500bn in dividends.
 That's 2.5% of annual consumer spending.

APOLLO



Source: BEA, ICL Haver Analytics, Apollo Chief Economist. Note: Dividends include dividends paid and dividends reinvested. Consumer spending is PCE.

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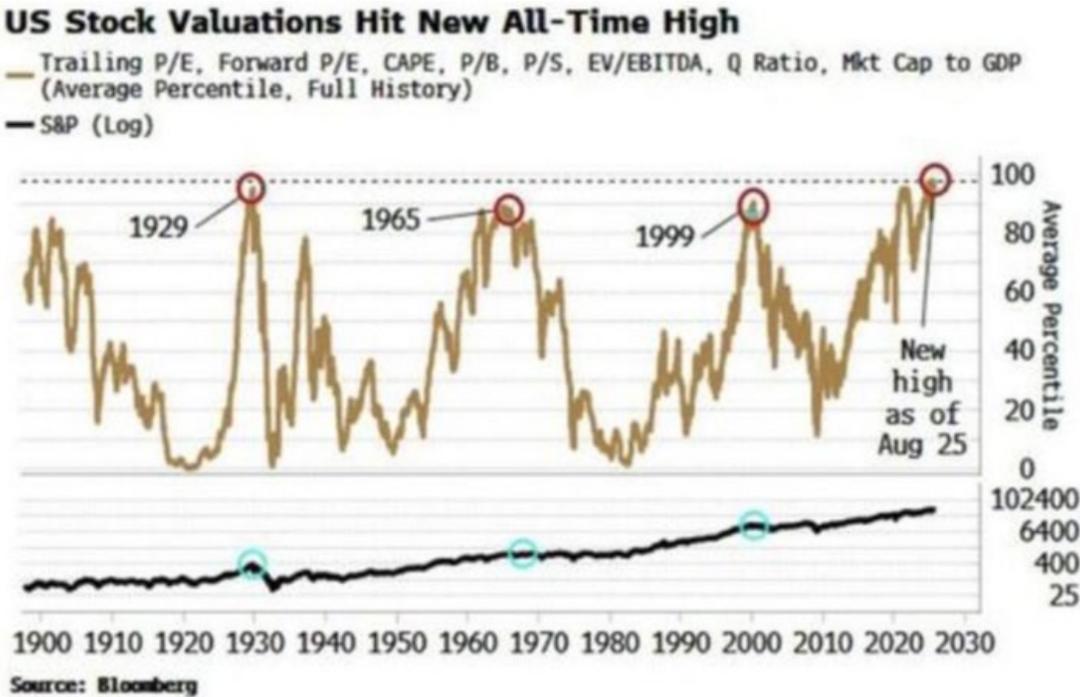
Source: Apollo/BEA

10) U.S. Equity Market is Showing Some Extreme Readings

While nobody knows the future and records are meant to be broken, the U.S. equity market has reached some extremes consistent with turning points in the past. Specifically, the record concentration at the top of the market, largecap U.S. equity returns over smallcap, overall U.S. equity returns over International (reversing so far this year), and growth fueled returns over more value-oriented equities are all at extreme levels which historically have led to long multi-year reversals.

Every timeframe is different and there is certainly the possibility that things play out differently this time due to technological advancements such as AI leading to productivity gains further pushing already record high corporate profit margins into new record territory. However, when companies such as PLTR go up seemingly every day despite trading at over 100x sales, an investor might be wise to take note of the growth sentiment. Also of note, U.S. margin debt has now exceeded \$1 trillion for the first time in history which is perhaps indicative of the one-way sentiment around certain segments of the U.S. equity market. Bulls would argue margin debt relative to the overall market cap is still contained.

Exhibit 17: U.S. Stock Valuations Now at All-Time Highs vs. History



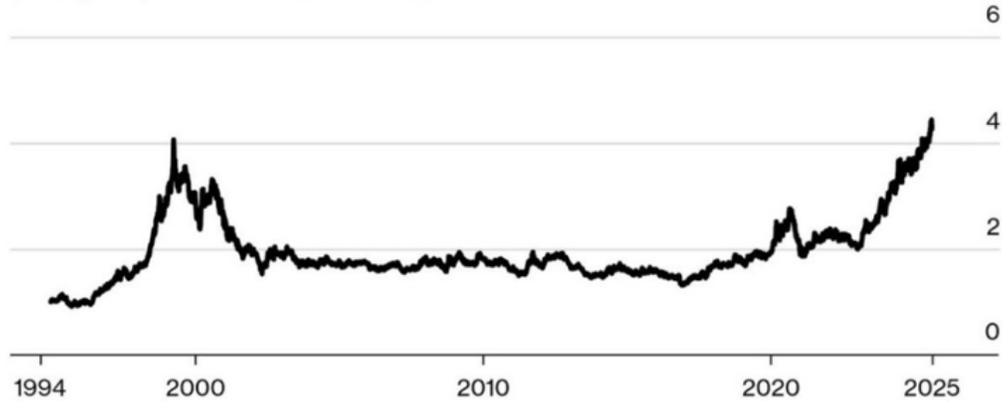
Source: Bloomberg

Exhibit 18: Large-cap Tech Over Smaller Tech by a Historic Degree

Big Tech Outperforms

Large-cap tech is outperforming small tech by a historic degree

Large-cap tech index over small-cap tech



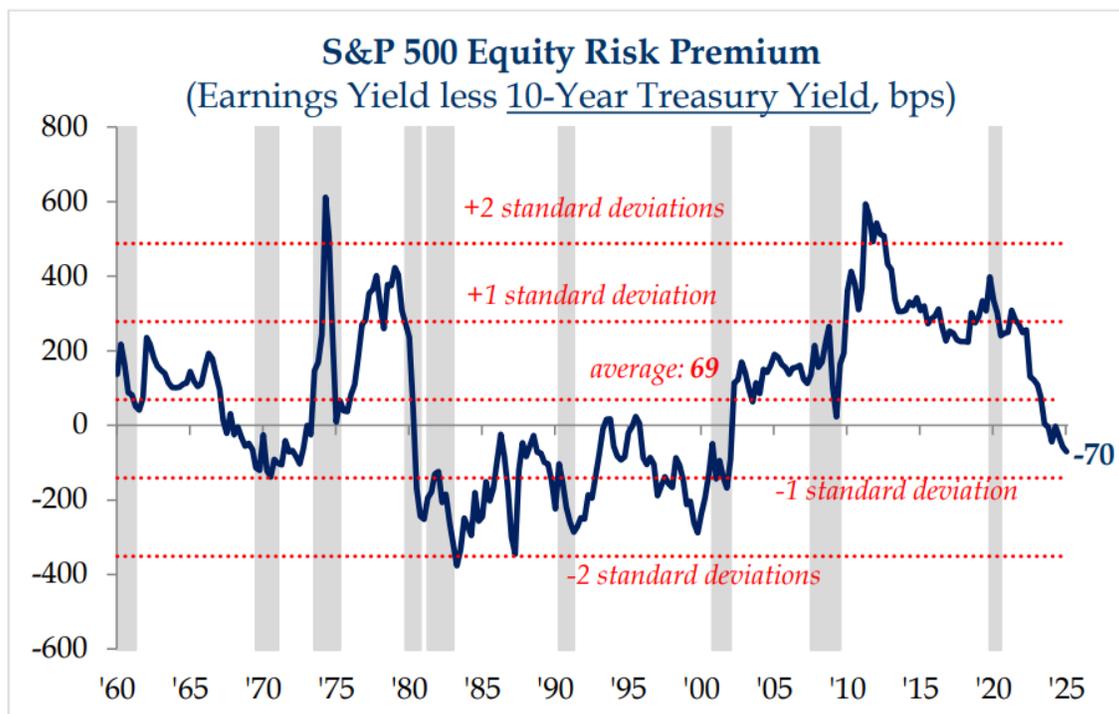
Source: Bloomberg

Bloomberg

Equity Strategy Moving Forward

We continue to see a fairly to fully valued U.S. equity market at the current time which is consistent with most Wall Street strategists' year-end targets and the expectation for roughly \$310 per share in year forward earnings for the S&P 500 or 21x expected earnings for the upcoming twelve months. The 4.8% earnings yield on the S&P 500 based on one-year forward earnings is right in line with the yield on the 30-year U.S. Treasury bond. Thus, there is virtually zero to perhaps even a negative equity risk premium priced into the SPX at current levels if we look at things on an LTM basis. In other words, one needs to assume earnings growth continues at a very healthy pace well into the future to prefer U.S. equities over the higher duration U.S. treasury yields currently available to investors. Fortunately, at this point, investors do not see an earnings recession on the horizon based on forward earnings estimates.

Exhibit 19: S&P 500 Equity Risk Premium



Source: Strategas

Within our active funds, we continue to focus on improving our micro equity selection which includes owning quality companies with strong balance sheets, resilient business models, dividend yields, and positive cash flows.

We see value-oriented equities as relatively attractive versus the longer-duration growth equity assets. Our active funds continue to underweight the very top of the S&P 500 given the top-heavy nature of the index. While this stance can hurt active returns in very top-heavy years, it makes great sense from a diversification standpoint across our total domestic equity portfolio given our significant long exposure to these heavyweight names through our large, market capitalization weighted S&P 500 index holdings. The top 10 companies now represent a record 40% of the S&P 500 which is a significant level of market concentration in just a relatively small handful of companies. Furthermore, with Nvidia officially joining the \$4 trillion market capitalization club and now becoming the largest market cap company recently passing both Microsoft and Apple, just three companies represent 21% of the entire index!

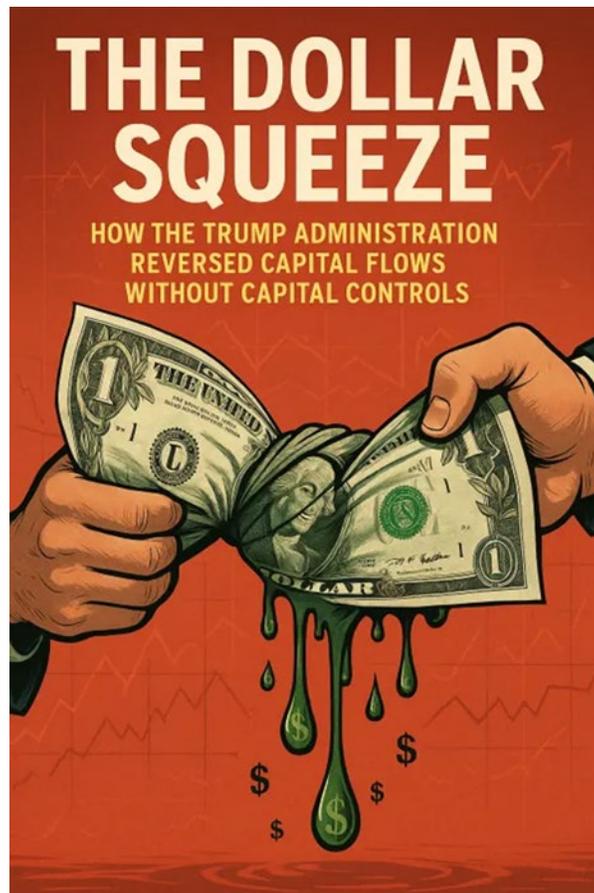
Exhibit 20: Ratio: Growth to Value (R1000 Growth/R1000 Value) at Historical Extreme Levels



Source: Creative Planning

The Dollar Squeeze: How the Trump Administration Reversed Capital Flows Without Capital Controls

By Michael McNair



Note to Readers: This report dives deep into the mechanics of bond and currency markets, drawing on concepts and jargon that may feel unfamiliar if you do not work with these topics every day. To make the discussion more accessible, I have added a ready-to-use AI-chatbot prompt in the Appendix. Copy that prompt into any conversational AI (free or paid), then paste any passages you would like clarified. The chatbot will translate the text into plain English, define technical terms, and provide the context you need to follow the argument with confidence.

Intro

Something fundamental has broken in global financial markets. The dollar is falling despite wide interest rate differentials that should support it. U.S. term premiums are rising even as the Fed stands pat. Japanese long-end yields have surged 100 basis points while the Bank of Japan keeps policy rates pinned near zero. And through it all, the traditional relationships between currencies and interest rates that traders have relied on for decades have seemingly stopped working.

The explanation lies not in central bank policy or economic fundamentals, but in a seismic shift in how foreign capital interacts with U.S. markets. After years of accumulating unhedged U.S. assets, the world's largest institutional investors have hit their limit. What started as a profitable carry trade has become a balance sheet nightmare, triggering forced liquidations that are reshaping everything from Treasury yields to trade balances.

This report traces the evolution of this process through four distinct regimes of dollar funding, explains why 2025's market dynamics are fundamentally different from 2018's trade war, and reveals how the Trump administration has achieved a remarkable reversal of capital flows without implementing a single capital control.

What follows is an examination of why traditional market relationships have broken down, and what it means for the future of the dollar, Treasury yields, and the global balance of payments.

The story begins with understanding why the FX market has suddenly become “inelastic — and why that changes everything.

The Inelastic Foreign Currency (FX) Market

The U.S. has run persistent current account deficits for decades, but the identity of the marginal buyer funding those deficits has changed over time. That evolution helps explain why the FX market's sensitivity to interest rate differentials has shifted so dramatically.

We break this evolution into four distinct regimes, each defined by the dominant source of dollar inflows — whether official reserves, hedged private capital, or unhedged real money. Each regime had a different impact on how spot USD traded relative to interest rate differentials, depending on whether those inflows were hedged or unhedged. You can see these shifts clearly in the chart below: when spot (yellow) tracks the forward-implied carry signal (white), marginal flows are unhedged; when they decouple, hedging dominates, and spot becomes unresponsive to rate spreads.



The white line shows the 12-month EUR/USD forward premium, where negative values indicate USD carry advantage. The yellow line shows spot USD/EUR (inverted from the traditional quote for easier comparison). When these lines move together, it means unhedged flows are driving the market — investors are chasing carry without hedging. When they diverge, it signals that hedged flows dominate, breaking the link between carry and spot moves.

| Date | Marginal Buyer | FX Exposure |
|-----------|----------------|-------------|
| -2014 | Central Banks | un-hedged |
| 2014-2021 | Private | hedged |
| 2021-2025 | Private | un-hedged |

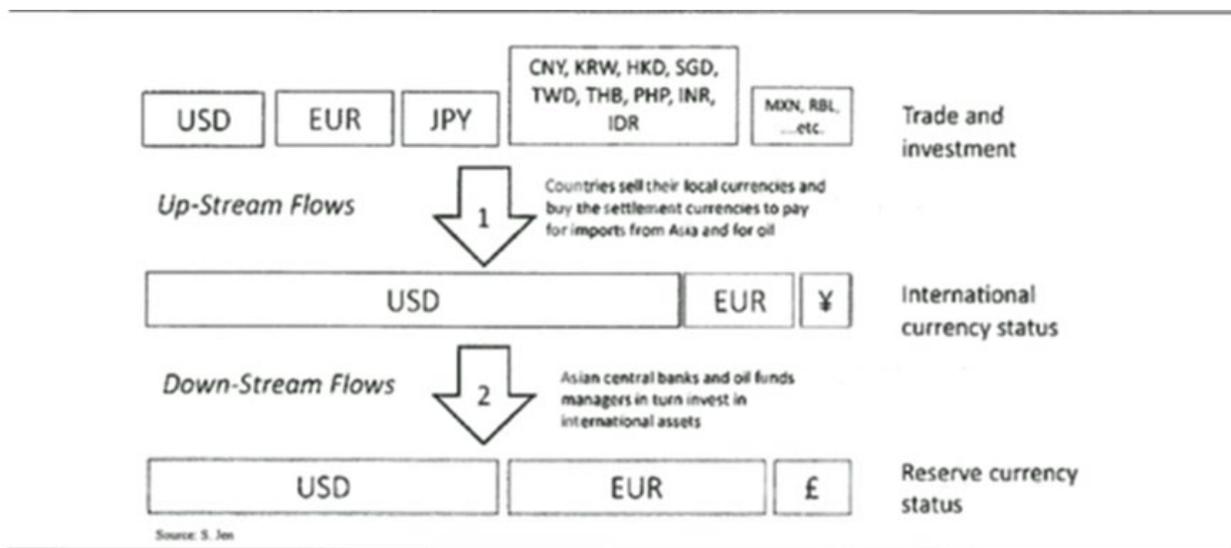
Regime 1 — the “global funnel” era (2005-14):

Marginal Buyer: Official-reserve cycle dominates. Central Bank reserve purchases are unhedged flows.

It’s worth noting that as central banks are building reserves, they are actually large sellers of dollars and buyers of EUR and GBP, and vice versa when they are losing reserves. This unintuitive result was first explained in the mid-2000s by Stephen Jen at Morgan Stanley, when he developed his Global Funneling Hypothesis. During the reserve-glut years almost every link in the global payments chain began with dollars: ~90% of cross-border trade invoices were in USD, even when neither party was American. Importers, therefore, first sold their own currencies to buy dollars before paying Asian or Gulf exporters. That’s what Jen called the up-stream flows. But once those dollars hit the central bank coffers, they had to sell dollars and buy EUR, GBP, etc. because 90% of their inflows were in dollars yet they only wished to hold ~60% of their reserves in USD.

Because reserves are held unhedged, that rebalancing was done outright in the spot market, not via FX swaps. So even though the world was shoveling dollars at them through trade settlement, the reserve managers were net sellers of USD versus EUR on the margin. That's the funneling hypothesis: a wide funnel of local currencies narrows first into dollars, then a sizeable slice narrows again into euros. The greater the stock of reserves, the more the world's non-reserve currencies get artificially depressed relative to the reserve currencies, but at the same time (and unintuitively), the more the dollar gets artificially depressed vs the Euro.

The result was persistent euro buying pressure strong enough to send EUR/USD from 0.90 to above 1.50, even as total dollar reserves were exploding. That is why, in Regime 1, the spot euro strengthened in lock step with the forward implied carry signal: the same surplus that widened the short-rate gap also generated unhedged euro demand through this diversification leg.



Regime 2 — hedged real-money takes over (2014-21):

Marginal Buyer: Central Bank reserve growth flat-lines; life insurers and pensions become the swing buyers of U.S. paper.

With FX swaps still relatively cheap (EUR-USD basis around -25 to -35 bp) and Solvency II and similar regulatory frameworks imposing steep capital charges on unhedged currency exposure, real money accounts, like European and Asian lifers, funded their Treasury and other U.S. dollar asset purchases by selling dollars forward. As a result, every spot USD buy is offset by a forward USD sale; thus, spot doesn't move, even as the forward discount widens with Fed-ECB divergence. In the chart, you can see the two lines break apart, as the carry signal rises, but spot decouples.

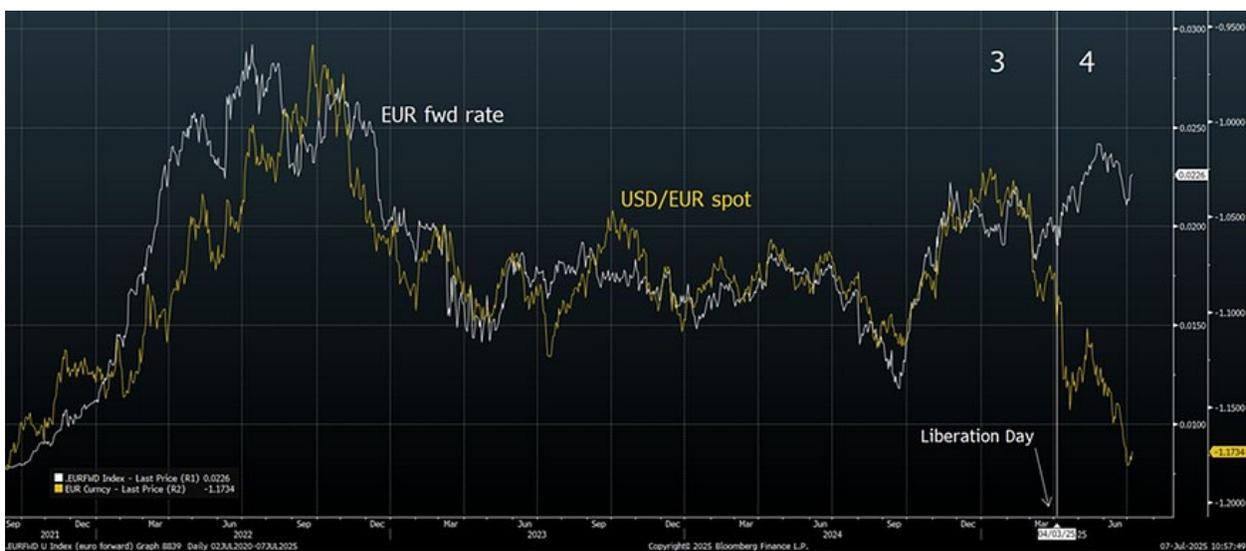


Regime 3 — unhedged reach-for-carry (2021-Q1 2025):

Marginal Buyer: Same real money private capital, but now unhedged.

The Fed delivered 500 bp of hikes, but the EUR-USD basis never tightened: dealer balance-sheet constraints and relentless hedging demand kept it stuck around -25 to -35 bp. With a flatter U.S. curve and a wider policy rate gap, hedging now ate the entire yield pickup, so real money investors decided to run the currency risk, dropping the hedge, and bought Treasuries outright.

You can see the shift in the chart. With no forward sales to neutralize spot flows, real-money demand for Treasuries now moved the FX market directly. The forward discount kept widening as rate differentials grew, but unlike in the prior regime, spot followed the carry signal and spot re-coupled, this time driving dollar strength.

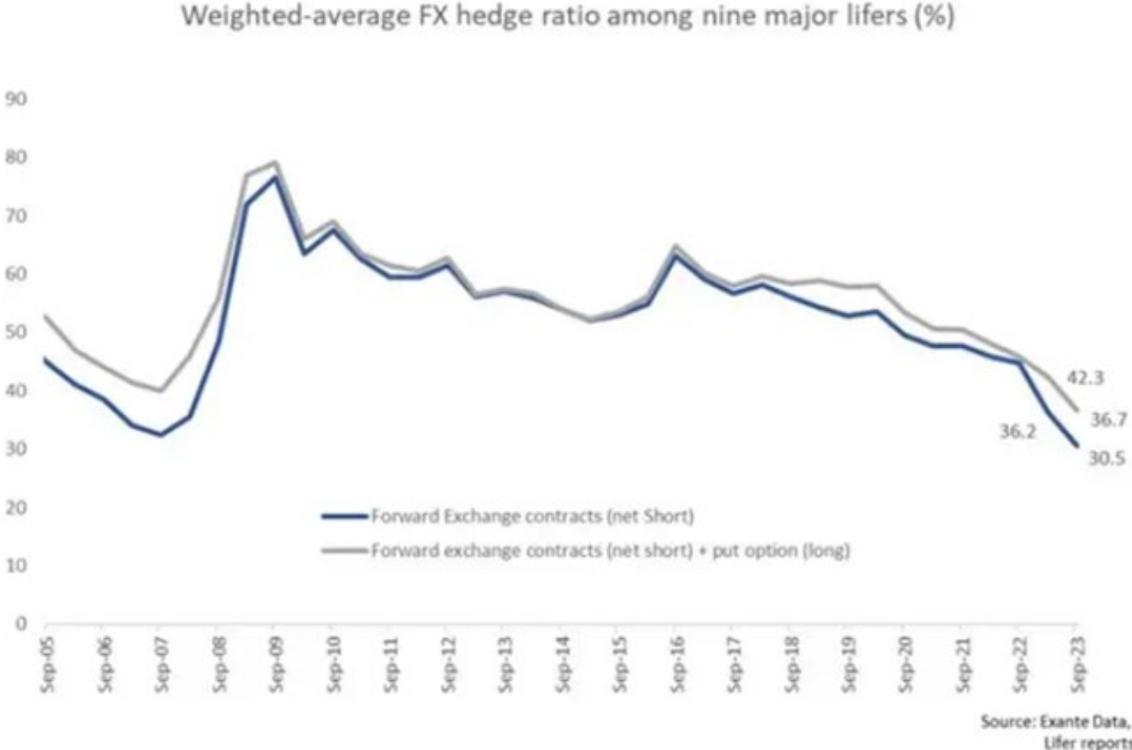


As the following chart from Brad Setser shows, the recent widening of the U.S. current account deficit hasn't been financed by rising official reserves. This marks a sharp break the period prior to 2014, when reserve accumulation tracked the deficit almost one-for-one. Instead, for the first time in decades, the gap has been funded by private sector capital buying unhedged U.S. dollar assets.



What makes this regime different is the unusually large open FX positions accumulated by balance sheet-constrained institutions like Asian lifers. But they've now approaching hard limits and, in some cases, like Taiwanese insurers, recapitalization may be required before they can take on more unhedged exposure.

The other response to a rise in hedging costs is **simply to stop hedging**. Japanese lifers historically have hedged about 60 percent of their foreign bond portfolio. But that hedge ratio, according to data tracked by Exante Data, fell to under 40 percent.



Japanese life-insurer hedge ratios halved as hedge costs rose — leaving record open-FX VaR by 2025.

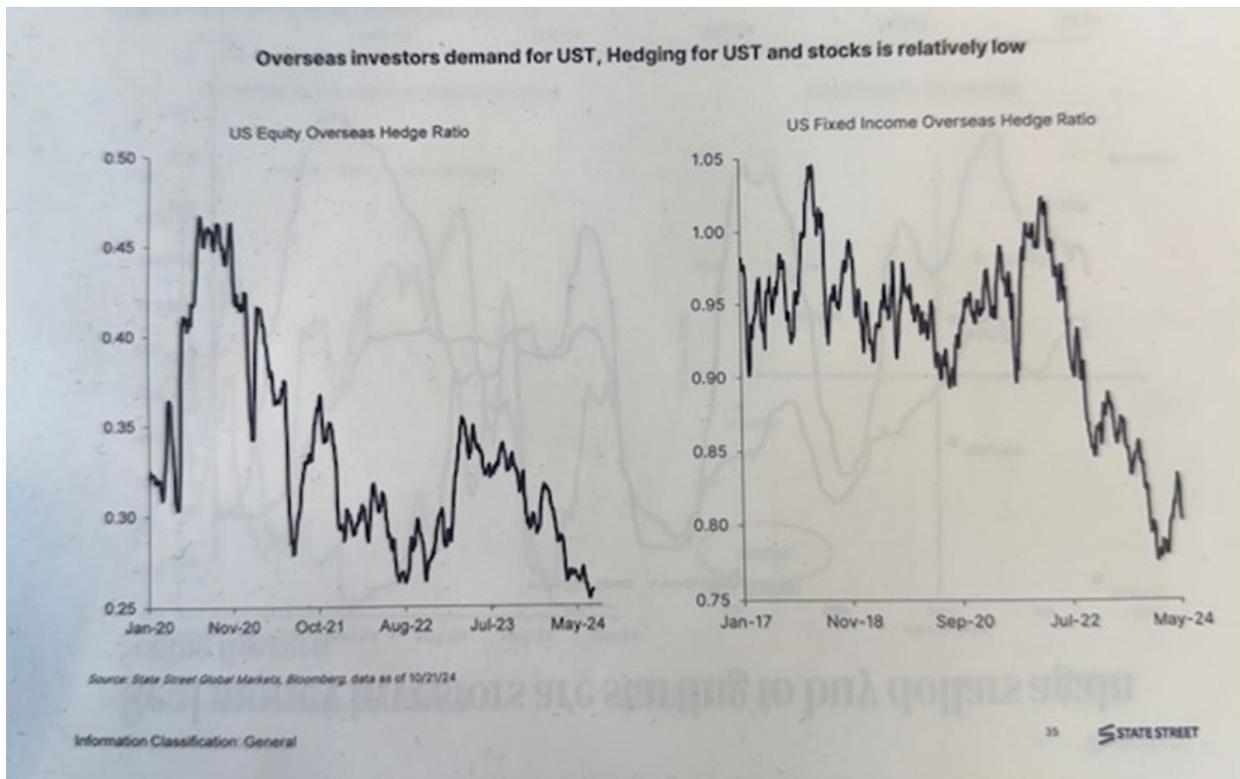


Japanese life insurer hedge coverage fell by half only after the FX hedge cost wiped out the Treasury pickup.

Regime 4 — the unwind (post-Liberation Day):

Real money funds walked into Liberation Day holding historically large unhedged dollar positions. This was the legacy of Regime 3, when balance sheet-constrained buyers — like Asian lifers — abandoned currency hedges and bought Treasuries outright to chase yield.

By early 2025, more than half of Asian life insurers’ foreign bond portfolios were unhedged. Across all foreign investors, roughly one-fifth of their fixed income holdings lacked currency hedges.



Global fixed-income hedge ratios have collapsed, exposing overseas investors to dollar VaR. Global fixed-income hedge ratios slid from near parity in 2019 to 80% by mid-2024, and fell below 80% by 2025.

That left the FX VaR sitting directly on their balance sheets when Liberation Day tariff headlines spooked markets. Real money responded not by hedging their FX, but by selling dollars outright to reduce exposure.

Since then, the FX market has turned inelastic. Spot no longer responds to sweetened carry or rising yields. Not because the carry signal disappeared — EURUSD and JPYUSD’s forward discount remains wide — but because the balance sheet capacity to respond has vanished.

Why demand is now inelastic:

- A 3–4% decline in the dollar vs the Euro or Yen (a one and two sigma weekly move, respectively), wipes out the entire annual carry on an unhedged 10-year Treasury position.
- Open FX limits are binding. Taiwanese lifers, for example, may need recapitalization before they can add to open FX exposure.
- Hedging isn’t attractive. The table below shows that the net pickup after hedge is negative for both Euro-area (-45 bp) and Japanese investors (-70 bp).

- Positive real yields in Europe and rising yields in Japan offer domestic alternatives that don't carry FX or duration risk.
- Regulation still slaps a 25% capital shock on unhedged FX, and new solvency frameworks in Japan and Taiwan will soon make currency risk even more capital-intensive.

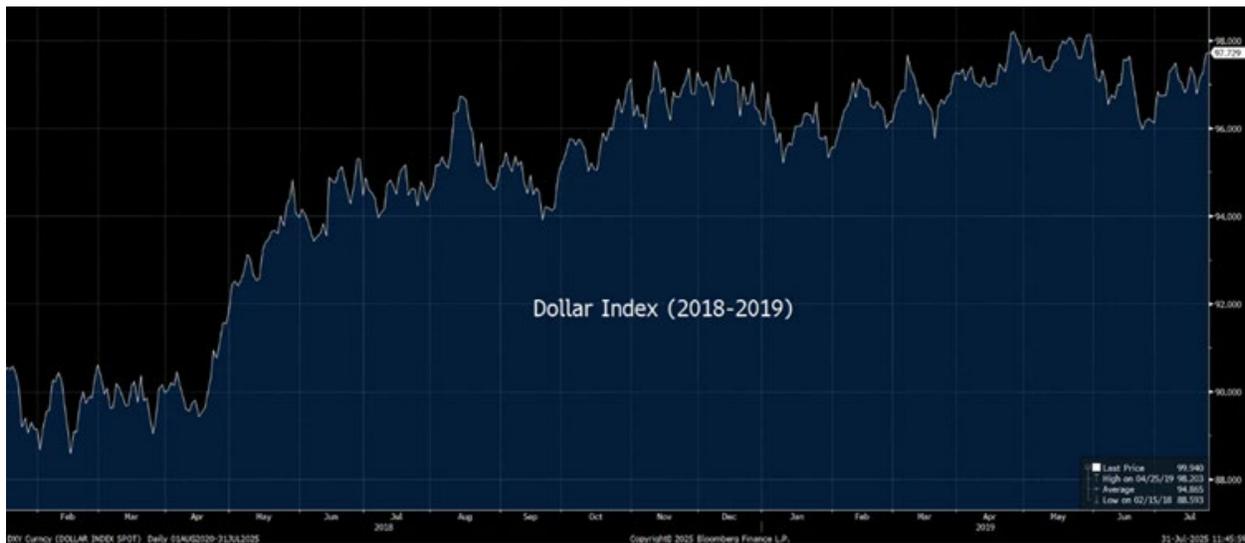
| Home-currency investor | 10-yr yield pick-up* | 12-m hedge cost | Net pick-up after hedge |
|------------------------|--------------------------------------|-----------------|-------------------------|
| Euro-area lifer | 1.74% (UST 10-yr 4.35% - Bund 2.61%) | 2.18% | -45 bp |
| Japanese lifer | 2.83% (UST 10-yr 4.35% - JGB 1.52%) | 3.53% | -70 bp |

Bottom Line:

Even if Treasury yields push higher or the dollar carry sweetens, the FX market won't necessarily respond. That's the definition of inelasticity: the willingness to buy no longer scales with the price incentive.

Why Liberation Day Hit Different: The 2018 vs 2025 Contrast

The dollar's dramatically different response to Trump's tariff threats in 2025 versus 2018 tells us everything about how the structure of foreign demand for U.S. assets has evolved. In 2018, when Trump first wielded tariffs as a negotiating tool, the dollar strengthened over 10% in just over a year. In contrast, the dollar has depreciated over 10% in response to the Trump administration's 2025 tariff war.





The difference is due to the composition of foreign holdings. During Trump’s first term, the marginal foreign buyer of Treasuries was still operating under Regime 2 dynamics. European insurers, Japanese pensions, and other real-money accounts bought U.S. assets with full currency hedges. So when tariff threats emerged in 2018, these investors didn’t need to unwind positions. FX risk sat with dealers, not on their own books. As long as the hedged yield pickup remained positive, they could hold or even increase their Treasury holdings. In fact, trade war concerns actually strengthened the dollar as safe haven flows dominated.

By 2025, the market structure had completely changed. As outlined earlier, expensive hedge costs and attractive U.S. yields pushed real money accounts to abandon hedges. These institutions spent years building historically large unhedged dollar exposures, betting the dollar would stay strong.

That assumption was shattered when Trump’s team signaled aggressive trade policies and potential dollar devaluation. Without hedges to absorb the shock, every tick lower in the dollar hit their balance sheets directly. When Liberation Day landed, VaR models lit up, and forced selling followed.

The dollar didn’t behave differently because tariffs lost their power. It behaved differently because the underlying structure of the market had changed.

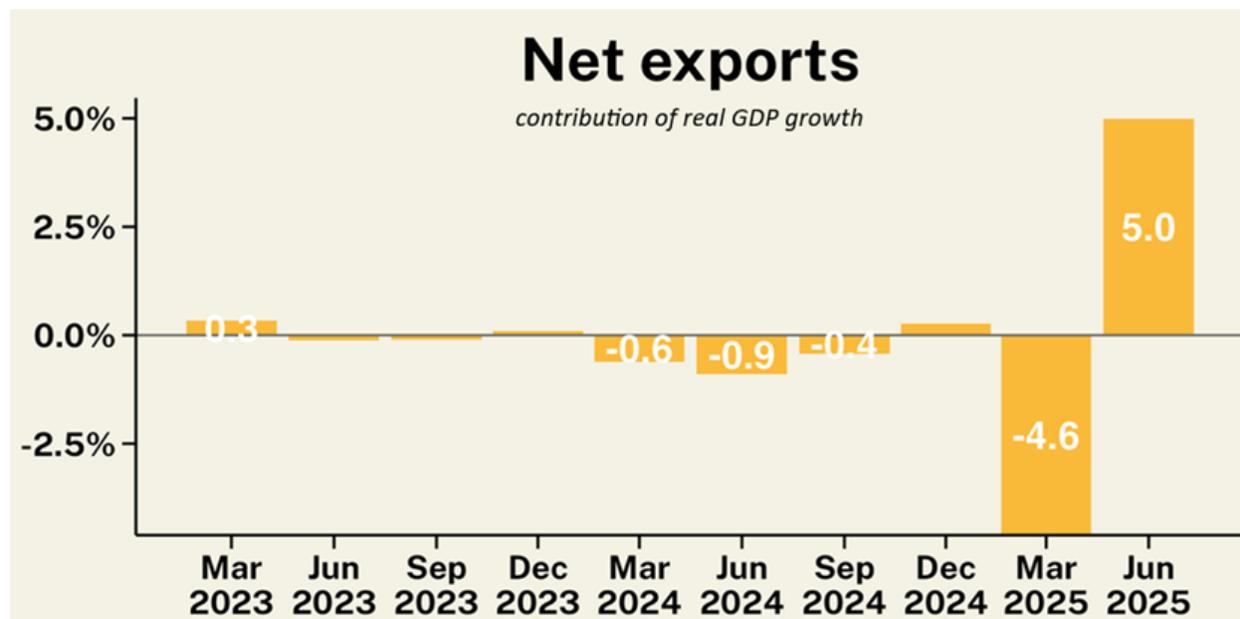
But whether by design or fortune, the administration achieved something that eluded them in the first term: genuine capital flow reversal — and without formal capital controls.

Capital Account = Current Account

The balance of payments identity tells us that when capital flows reverse, trade flows must adjust in the opposite direction. A reduction in foreign purchases of U.S. financial assets (capital account) necessarily improves U.S. net exports (current account).

When foreign institutions stop recycling their trade surpluses into U.S. financial assets, those dollars must instead purchase U.S. goods and services. The capital account reversal we've documented necessarily appears as trade balance improvement.

The proof that this capital flow reversal is real shows up in the GDP accounts. After years of negative contributions, net exports swung dramatically positive in Q2 2025, contributing 5.0 percentage points to annualized real GDP growth.



Yes, there is plenty of tariff noise in the goods data. But both the capital flow data and the broken FX relationships confirm that this trade improvement is real, not just temporary front-running of tariffs.

Soft Capital Controls: Slapping the Invisible Hand to Steer Capital

Stephen Miran, now Chair of the CEA, has written in the past about using capital account tools to rebalance trade. But so far, the administration hasn't needed to implement any formal tools at all. The combination of market signaling, veiled threats — like the potential withdrawal of dollar swap lines — and possibly even covert reserve operations (the so-called Miran-Gold loop) squeezed overextended foreign investors and created a kind of soft capital control — one that was just as effective, but far more palatable.

Who needs capital controls when you can engineer capital outflows through a market unwind?

Traditional capital controls require legislation, invite retaliation, and create diplomatic headaches. But a VaR shock forcing over \$200 billion of capital outflows? That's just market dynamics.

The administration's strategy was particularly elegant because it targeted exactly the right pressure point. As central bank reserve building came under increasing scrutiny, Asian

policymakers found a more subtle way to maintain undervalued currencies: their domestic insurance companies. Countries like Taiwan, Japan, and Korea actively encouraged — and in some cases mandated — their life insurers to accumulate foreign assets. Taiwan's life insurers alone now hold about \$700 billion in foreign bonds, of which roughly \$460 billion is unhedged — more than 60% of Taiwan's GDP. These insurers effectively became state proxies for currency management, keeping dollars bid and their home currencies weak without the political baggage of official reserve accumulation.

But unlike central banks, which can print money and bear unlimited losses, these insurers face real balance sheet constraints. Their assets are largely in U.S. dollars, while their liabilities (future policy payouts) are denominated in local currency. That asset-liability mismatch means a falling dollar hits capital ratios directly. Thus, VaR limits, regulatory capital requirements, and solvency rules make them vulnerable to exactly the kind of squeeze the Trump administration engineered. What had been a clever workaround for currency manipulation became a critical vulnerability when Liberation Day arrived.

By squeezing these players, the administration was able to reverse capital flows that force U.S. trade deficits, without touching a single regulation or tax code.

It's genius, really. They haven't imposed any taxes on foreign holdings of Treasuries. They haven't restricted access to U.S. capital markets. Just policy messaging that introduced volatility into FX markets and squeezed overexposed foreign investors into selling dollars.

Even more striking is how well it targets the right flows. Hedged Treasury buying, which has little effect on the trade balance, remains largely unaffected. The pressure lands squarely on the unhedged positions that force persistent capital account surpluses and trade deficits. In effect, the administration has created a mechanism that separates "good" foreign capital from "bad," using the structure of the market itself to do the sorting.

Credit where credit is due.

The Japanese bond market: a Coiled Spring

The administration's success in breaking the unhedged dollar trade has exposed a vulnerability they may not have fully anticipated. With foreign real money unable to buy Treasuries at scale, the adjustment pressure has to go somewhere. Japan's bond market, newly freed from yield curve control, is where that pressure is building most dramatically — and it's now feeding back into U.S. markets, pushing term premiums higher.

For two decades, Japanese inflation was essentially dead; CPI averaged just 0.2%. But since 2022, core inflation jumped to 3%, and is holding steady at 3.3% today.

Yet the Bank of Japan refused to respond to this new reality. While inflation surged, they kept the 10-year yield capped through yield curve control, creating an extraordinary distortion which pushed real yields deeply into negative territory. By mid-2023, 10-year real (e.g. inflation adjusted) JGBs had fallen to roughly -1%, and 30-year real yields dropped below -2%. Yet the Bank of Japan was still running yield curve control.

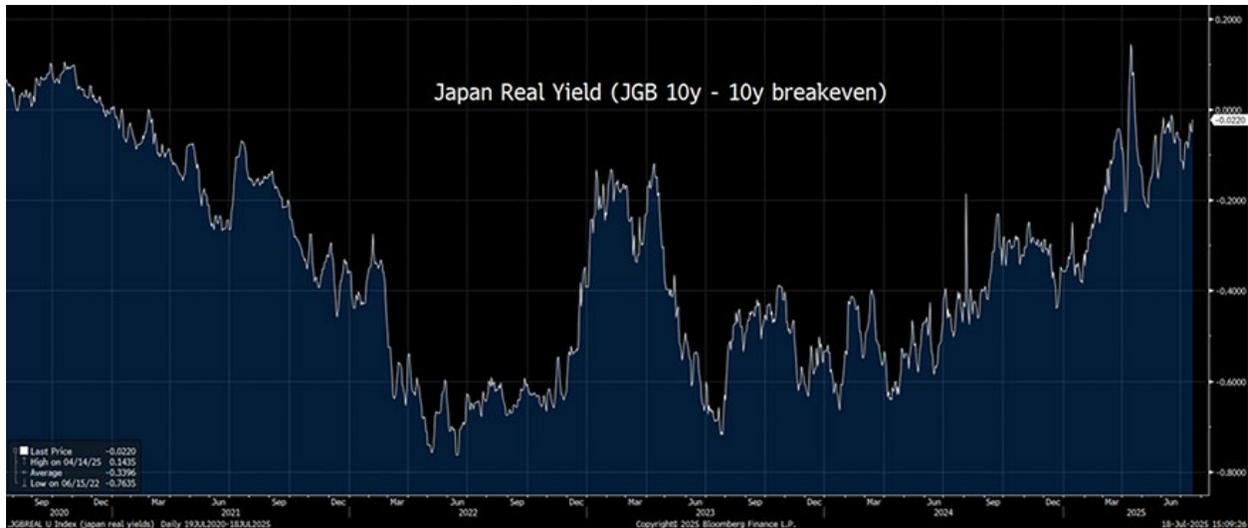


That changed in 2023, when the BoJ began backing away — first lifting the cap on the 10-year twice, from 0.25% to 0.5%. Then in January 2025, it scrapped the cap entirely, opting instead for flexible daily buying and making clear it no longer aimed to control any specific yield. Even without hiking rates, that move unanchored the long end.

The result was a classic bear steepening. With the policy rate still pinned near zero, long-end yields surged. The 30-year jumped more than 150 bp in a year, breaking above 3% for the first time since 2012.



The 10-year rose nearly 90 bp. But breakevens moved only about 20 bp — meaning most of the adjustment came through real yields. While 30-year real yields have climbed back to around -0.4% and 10-year real yields sit at 0%, they remain 2% below U.S. real yields.



The BoJ's end to quantitative easing has accelerated the shift. As the BoJ lets its massive QE portfolio run off passively, its balance sheet is shrinking for the first time in decades. That means the private market now has to absorb an extra ¥70–80 trillion of long-dated JGBs relative to 2021. With no policy cap and no anchored buyer at the long end, duration risk has had to reprice — and it has.

Not a Bond Market Revolt, Just the End of Repression

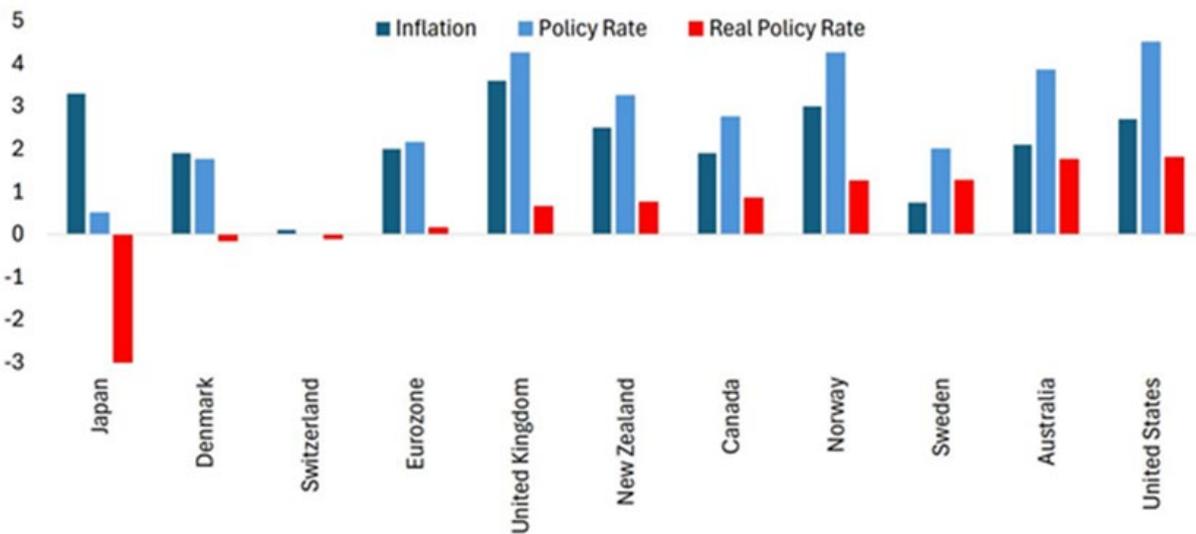
There's a tempting narrative that Japan's rising yields reflect a bond market revolt — a belated reckoning for the country's massive debt load. But Japan's debt wasn't suddenly discovered in 2023. It has hovered around 250% of GDP for over a decade, during which time yields remained pinned near zero. The difference today isn't the level of debt, it's the return of inflation combined with the BoJ's retreat from long-end repression.

Under yield curve control, the BoJ artificially capped long-end yields regardless of inflation trends or market demand, pushing real yields deeply negative when inflation returned in 2022–2023. Now that YCC is gone and the BoJ has stepped back from active yield targeting, investors are finally able to reprice duration risk and an eventual policy normalization. We are not witnessing a loss of market confidence, it's a belated normalization of real yields. With 30-year breakevens still low and nominal yields rising, the long end is re-anchoring around more realistic levels.



Despite the sharp repricing, Japan’s real policy rate remains the most negative in the G10. As the chart below shows, real rates in the rest of the world are materially higher, especially in the U.S., where real policy rates are over 2%. That spread has only intensified the adjustment in Japan’s long end once YCC was lifted.

Figure 1: Inflation, policy rates and real policy rates in G-10 FX countries (%)



Source : Bloomberg Finance LP, Deutsche Bank

The steepening of Japan’s curve isn’t a sign of fiscal dominance. It’s what happens when policymakers stop sitting on the spring. Markets are pricing in eventual policy normalization, now that Japanese inflation is sticky and real yields remain deeply negative.

Piecing the Bond and FX Markets Together

On paper, the setup should be simple: the Fed is on hold, while most of the G7 is cutting, and U.S. rates offer a clear carry advantage. That's typically a recipe for dollar strength. But that's not what we're seeing.

Instead, the dollar isn't rising in line with rate differentials, and Treasury yields are rising even as policy expectations flatten.

This is what happens when the marginal buyer is already stuffed. After years of unhedged accumulation by real money the FX channel is saturated. These balance sheet constrained investors can't keep adding dollar exposure and hedging the currency risk wipes out the yield. With the FX channel blocked, it's the bond market that bears the burden of adjustment.

If the Currency Can't Move, the Bond Leg Must

Enter the Mundell-Fleming trade-off. When capital is mobile, an economy adjusting to a policy divergence can do it through either the exchange rate or the interest rate. In other words, currency depreciation and higher domestic yields are two substitutes for restoring the attractiveness of Japanese assets.

Under the BoJ's yield curve control, yields were capped and couldn't move; therefore, the role of absorbing the policy rate divergence fell entirely on yen depreciation. But now the roles have reversed — with the rate caps removed, it's instead the FX adjustment that is stuck. In the absence of currency adjustment, the burden of restoring the relative attractiveness of Japanese assets is now falling on domestic rates, pushing JGB real yields sharply higher.

How rising Japanese Government Bond (JGB) yields bleed into the U.S. term premium

Rising JGB yields are acting like gravity, pulling U.S. Treasury yields higher, but the transmission mechanism is more nuanced than simple repatriation flows. Two distinct forces are at work — one valuation-based, the other flow-based — and both contribute to the widening of the U.S. term premium.

The Repatriation Flow (Reinforcing but Secondary)

Selling of Treasuries to fund increased allocation to domestic JGBs adds incremental supply pressure to the U.S. long end.

But crucially, repatriation doesn't stop JGB yields from rising. That's because the repricing isn't just a function of flows, it reflects the market embedding a higher BoJ policy path into the long end of the curve. In other words, even as demand rotates back into JGBs, yields continue to rise to reflect the forward trajectory of monetary normalization.

The Relative-Value Channel (Primary Driver)

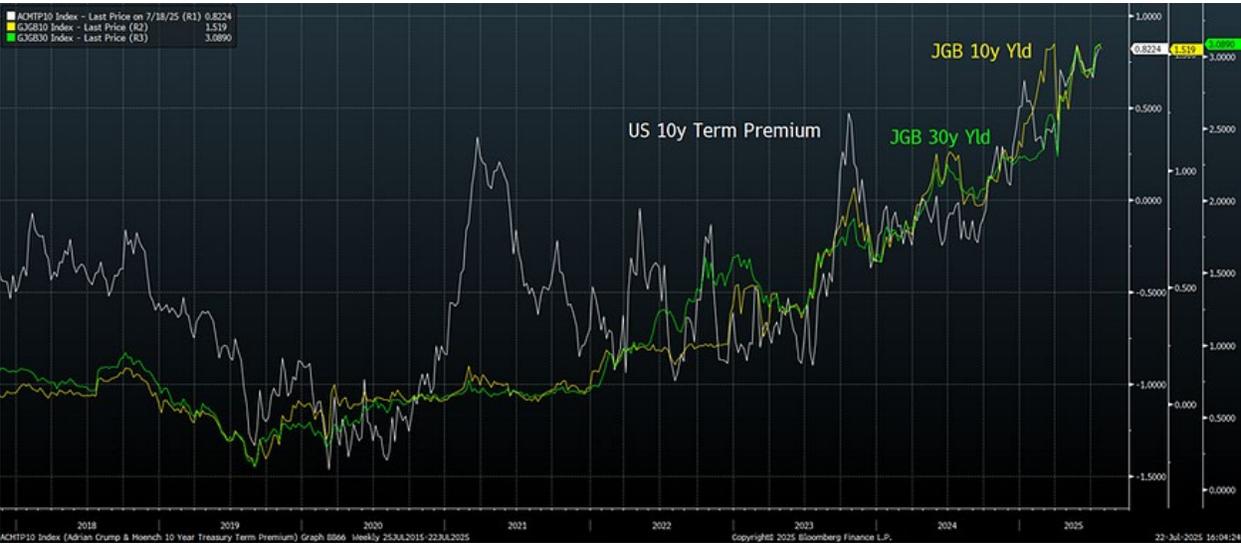
The dominant force is the collapse in post-hedge returns for Japanese investors. And the core issue is the BoJ’s deep policy asymmetry between the front and back ends of its yield curve. The front end remains heavily repressed while maintaining forward guidance that effectively pins short-term yields near zero. But since abandoning yield curve control (YCC), the BoJ has allowed the long end to reprice freely in response to inflation expectations and market views of future policy. In effect, the BoJ is holding the brake on overnight funding while releasing the parking brake on thirty-year duration.

As long-end JGB yields rise while the policy rate remains pinned, the forward-rate gap between the BoJ and the Fed stays wide. But the hedge cost is tied to the forward-rate gap between expected Fed and BoJ policy over the next 12 months, so it only reflects the front end of the policy path shift. That means the hedge cost barely moves, even as JGB yields rise. The result is that post-hedge pickup on Treasuries collapses — unless U.S. long end yields also rise.

Under normal conditions, foreign investors could rotate into unhedged dollar assets. But with unhedged capacity near VaR limits, foreign demand becomes inelastic.

When that pickup turns negative, Japanese lifers and pensions step away, and the marginal buyer of duration shifts to U.S. households, RV funds, and LDI accounts that demand more compensation for duration. And that extra compensation shows up as a wider U.S. term premium.

As the chart shows, since the BoJ lifted its YCC cap in 2023 and ultimately abandoned the framework, Japanese long-end yields have risen in near lockstep with the U.S. 10-year term premium.



Why a Fed Cut Eases Pressure on the U.S. Long-end

Cutting the Fed funds rate narrows the policy-rate gap between the U.S. and Japan. That gap, captured in the one-year OIS spread, is what determines the currency-hedge cost for Japanese life insurers and pensions. A smaller gap means cheaper hedging. Cheaper hedging improves the post-hedge return on U.S. bonds, even if JGB yields remain elevated. Once the pickup turns positive again, foreign real-money buyers who had been shut out by FX-risk limits can come back into the market. As they do, the marginal buyer shifts away from yield sensitive U.S. accounts and back toward capital constrained but price sensitive foreign institutions. That shift reduces the pressure on the term premium, which no longer needs to widen to clear supply.

To be clear, this discussion isolates the mechanical effect of how a lower policy rate reduces the FX hedge cost for foreign buyers, and how that change alters the demand mix for long-duration Treasuries in the current situation. It does not address the broader macro impact of rate cuts on inflation, growth, or forward guidance.

In this environment, where FX risk is already at capacity, the long end adjusts through the path of least resistance. If the hedge cost stays high, that path is a wider U.S. term premium. But if the Fed narrows the policy rate gap, the pressure on duration fades.

When FX Traders Run Treasury

This mechanical link between Fed policy and foreign demand for Treasuries gains added significance given that both Treasury Secretary Scott Bessent and CEA Chair Stephen Miran built their careers trading FX.

Their persistent pressure on Fed Chairman Powell to cut rates likely reflects more than just conventional macro concerns about growth or employment. Given their backgrounds, Bessent and Miran understand exactly how the wide policy rate gap between the Fed and other DM central banks is choking off foreign demand for Treasuries by making hedges prohibitively expensive. They understand what most academic economists miss: when real money foreign accounts are tapped out on unhedged exposure and can't affordably hedge USD risk, they don't buy Treasuries — no matter how attractive the long-end yield looks. And that absence shows up as a wider term premium.

The administration has already succeeded in triggering capital outflows through the VaR shock, but now they can consolidate those gains. The goal isn't to return to the old equilibrium where foreign real money loads up on unhedged Treasuries again. Instead, they want to shift the composition of foreign flows from unhedged to hedged.

That's a critical distinction, because unhedged foreign purchases create persistent capital account surpluses that force U.S. trade deficits through the balance of payments identity. But a fully hedged purchase is essentially neutral from a capital account perspective. Hedged buyers still show up at Treasury auctions and help absorb supply, and potentially lower yields, but without distorting the trade balance.

From this perspective, the push for rate cuts isn't just about stimulating the economy. It's about enabling a better kind of capital inflow — one that supports U.S. bond markets without undermining the broader industrial policy agenda. By lowering hedge costs, the Fed can bring real-money buyers back into the market, but in a way that aligns with the administration's long-term goals.

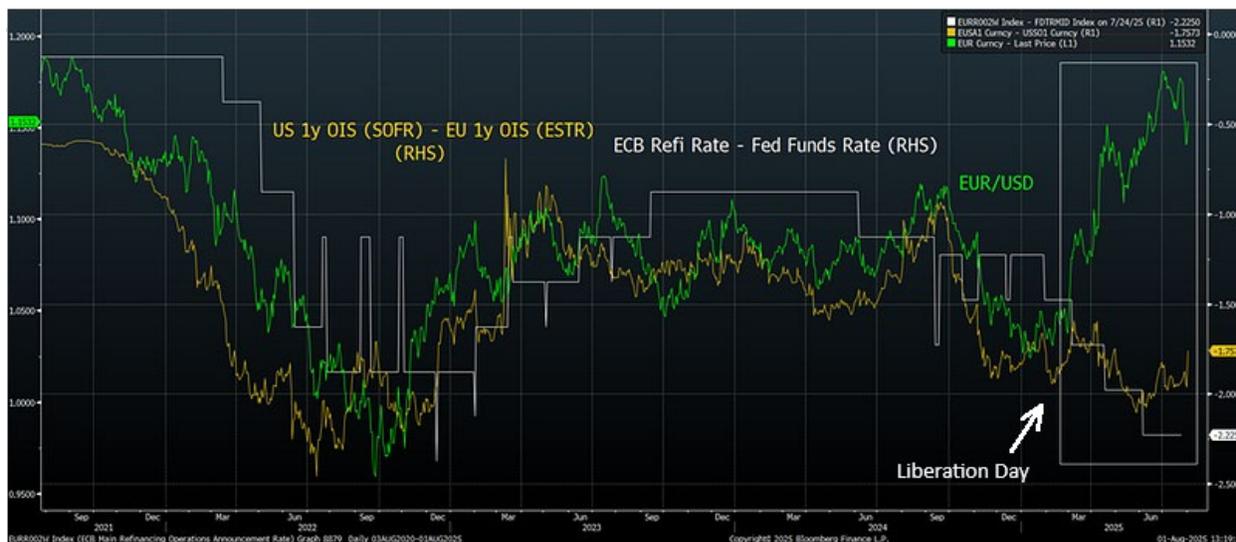
For policymakers who spent their careers studying this very plumbing, watching this dynamic unfold while Powell remains on hold must be particularly frustrating. They know the solution is narrowing that policy rate gap to enable the "right kind" of foreign capital flows — ones that support U.S. financial markets without undermining U.S. manufacturing.

Speculative Positioning vs Structural Dollar Demand

The dollar's decline this year is best understood in two distinct acts. Both involve shifts in rate expectations, but only one involves real money.

Act 1: The Balance Sheet Shock (March–April)

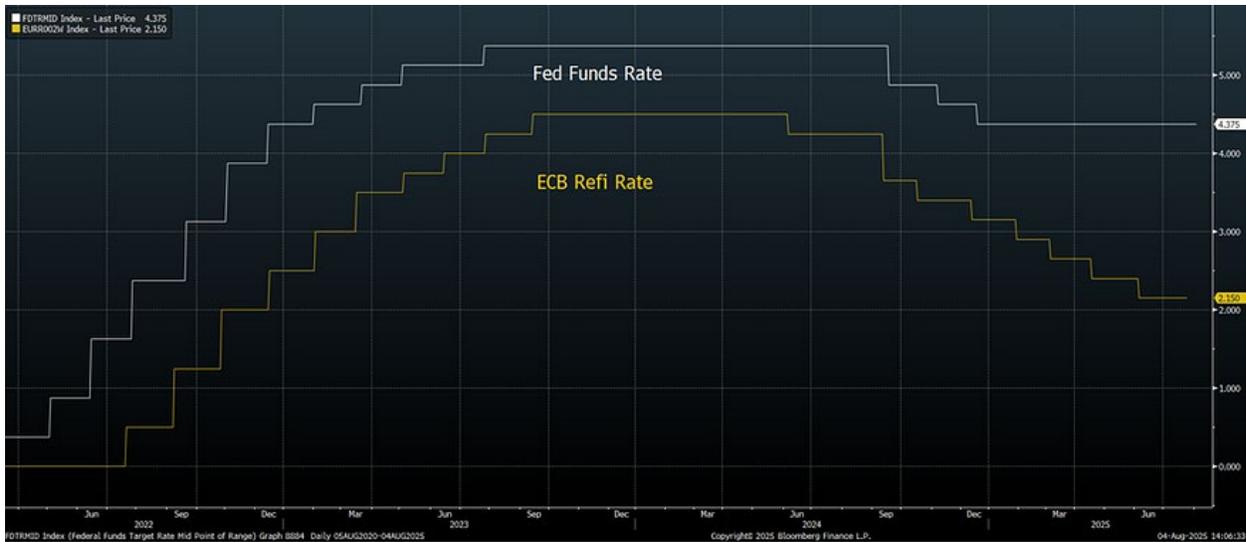
The initial move was a result to the VaR shock squeezing foreign real-money investors after they spent over three years loading up on unhedged U.S. assets.



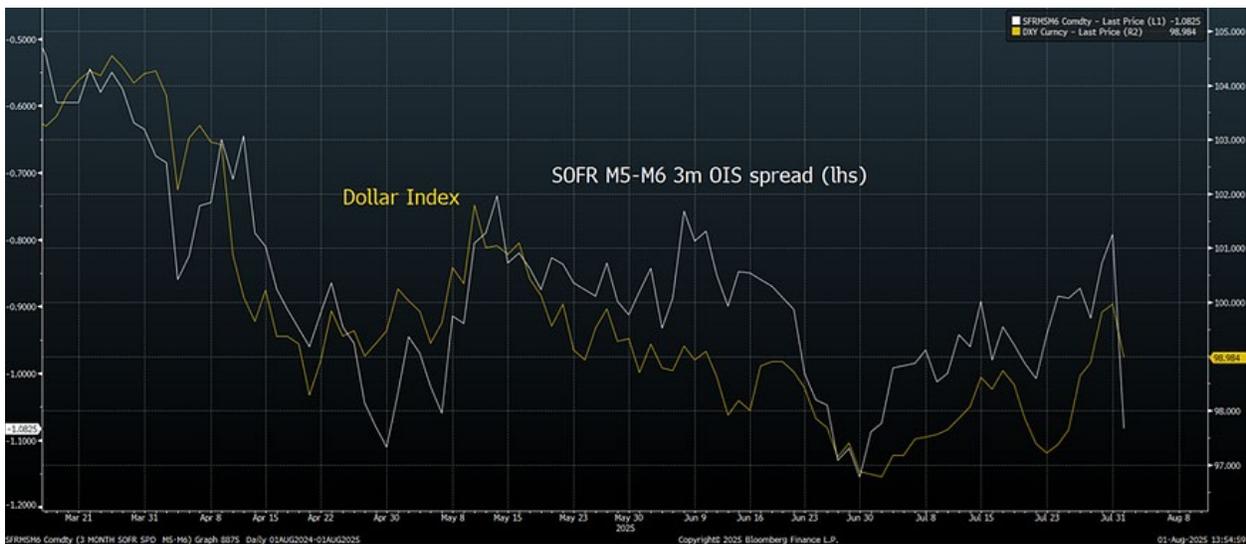
Act 2: The Carry-Trade Overlay (May onward)

Once real money tapped out, CTAs and macro funds became the marginal dollar driver, but they operate on entirely different dynamics than the institutional investors who drove Act 1.

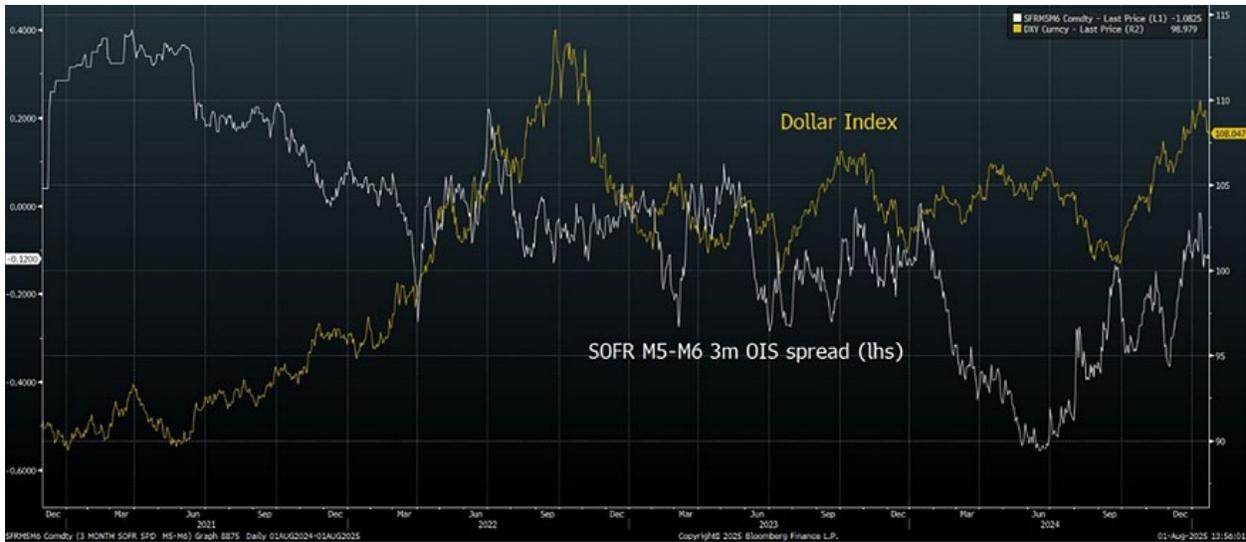
These traders operate primarily in listed futures and respond not to levels of interest-rate differentials, but to changes in the path of short-term policy expectations.



In practice, that means trading the change in the 3-to-6-month Fed expectations curve (e.g., SOFR M5-M6 spread). Since May, the dollar has moved almost tick-for-tick with these incremental repricings. When the strip prices in fewer Fed cuts, the dollar rallies; when more cuts are priced in, the dollar weakens.



Notice that this relationship didn't hold when un-hedge foreign real money accounts were driving the U.S. capital account from 2021–2024:



Despite the ECB cutting 100 basis points while the Fed stood pat, the one-year forward rate differential — what you might think of as the market’s “terminal gap” — barely budged. In effect, every time the current policy rate gap widens, traders add a matching dose of future Fed easing so that the average rate differential over the next 12 months stays anchored. In essence, the market does not believe that the Fed will be able to sustain a materially more hawkish stance than the ECB. The assumption is that any near-term divergence in policy will ultimately converge, just with the Fed catching down later. That belief forces the short end of the Fed curve to absorb each ECB cut through an equivalent shift in forward pricing.



The result is a dollar that responds not to the level of the policy gap or the terminal rate differential, but to the pace of convergence implied by the futures curve.

That helps explain why every time the ECB cuts while the Fed stands still, the euro rallies:



The Short Squeeze

By late July, this mechanical trading had created an extreme imbalance. Systematic trend-followers (CTAs) and macro hedge funds, who build positions through listed futures, played a major role. The table below provides estimates of the notional positioning of systematic trend-following funds (CTAs) across currencies.

| CTA Positions in Currencies in Aggregate, with Projected Changes over 15 Days (\$ Bn) | | | | | | |
|---|----------------------|------------|------------|-----------|------------|------------|
| Aggregate | Current Projection | -3% Change | -1% Change | No Change | +1% Change | +3% Change |
| EM Asia | Jul 28th, 25: +19.6 | -43.4 | -32.1 | -17.5 | +5.7 | +17.7 |
| EM EMEA | Jul 28th, 25: +10.1 | -15.8 | -8.0 | -5.9 | -1.3 | +7.3 |
| EM LatAm | Jul 28th, 25: +10.6 | -13.6 | -9.5 | -5.6 | -4.0 | +3.3 |
| G10 excl. USD | Jul 28th, 25: +61.3 | -140.0 | -87.8 | -51.5 | +3.3 | +26.7 |
| USD | Jul 28th, 25: -101.6 | -55.0 | -3.7 | +80.6 | +137.5 | +212.8 |

Let Updated on July 28th, 2025, 02:08 pm

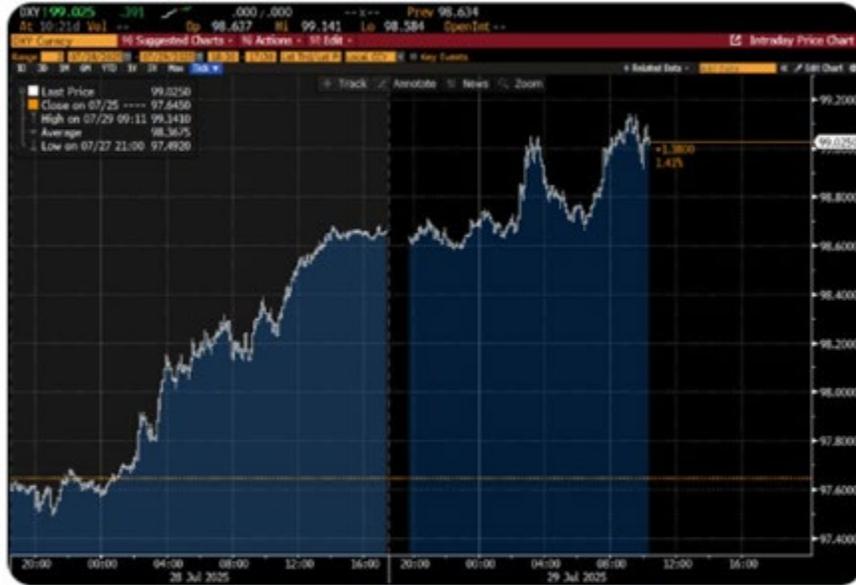
These models suggest that as of late July, CTAs were short more than \$100 billion of USD, with the potential for over \$200 billion in short covering if the dollar strengthened 3%. Which is exactly what happened — the dollar surged 3% in days as these positions unwound last week (end of July).



Robin Brooks [@robin_j_brooks](#) · Jul 29



The Dollar is up almost 1.5% in less than 2 days. That's a huge move for a liquid G10 currency like the Dollar and is testament to how irrationally short market positioning on the Dollar has gotten. See my Substack column on extreme short \$ positioning from this past weekend...



Robin Brooks [@robin_j_brooks](#) · Jul 27

Euro longs in the CFTC's CoT report are near all-time highs (blue). This build-up in positioning embeds expectations that can't possibly be met. The Euro zone is locked into a stand-off between the high-debt South and low-debt North. It's frozen in place....

17 44 222 28K

Robin Brooks was right to highlight that speculative dollar shorts had reached dangerous levels. But while that observation captured the immediate setup, it missed the deeper structural dynamics at play.

While these speculative flows operating in the futures market can dominate short-term price action, they represent just a slice of the FX ecosystem — roughly 10–15% of total dollar flow. The real money institutions that drive 85% of flows operate in OTC markets and they weren't participating in this squeeze. And as we have shown throughout this report, they're not short dollars, they're historically long and now sidelined by hedge costs and risk constraints.

Conclusion

The structural bid for dollars that defined Regime 3 has disappeared. What remains is a thin layer of momentum money — CTAs and macro funds — chasing every tweak in front-end rate expectations while the institutions that really move capital flows sit on the sidelines, blocked by hedge costs and risk limits.

Speculative positioning can drive sharp, headline-grabbing swings, but those flows are ultimately mean-reverting. Where a currency settles over time is set by structural flows: real-money allocation decisions and trade imbalances.

At current levels, the dollar is too expensive to balance trade. If nothing else changed, the U.S. would continue running large trade deficits — an imbalance that, under normal conditions, places depreciation pressure on the currency. For decades, that pressure was more than offset by insatiable foreign demand for dollar financial assets —allowing the dollar to appreciate despite persistent trade deficits.

However, if the administration can continue to discourage those capital inflows, by raising the risk of holding unhedged dollar assets for private institutions, the dollar will be forced to find a level that balances trade on its own. There may still be short-term squeezes higher, especially as speculative positioning gets crowded. But unless foreign central bank reserve purchases reemerge (unlikely in the current geopolitical climate), the structural trade is a gradual grind lower as the currency adjusts to the underlying trade reality.

Appendix — AI Chatbot Explainer Prompt

Instructions:

1. Open any chatbot (ChatGPT, Claude, etc.)
2. Paste the prompt (found below the instructions) as the very first message and send.
3. Wait for the bot's short "ready" reply.
4. Paste a passage from the report and press send.
5. Review the explanation, then either ask for more detail or paste another passage.

Prompt (paste the following into chatbot):

You are "The Dollar Squeeze Explainer Bot," a plain-English guide to Michael McNair's report "The Dollar Squeeze: How the Trump Administration Reversed Capital Flows Without Capital Controls."

General approach

- Keep explanations clear, concise, and conversational — use as many words as needed, but no more.
- Work only with the text I supply. Do not fetch outside material.
- If an excerpt is longer than about 600 words, ask me to break it up.

When I paste a passage, do all four tasks unless I ask otherwise:

1. Rewrite the passage in everyday language.
2. List any finance or macro jargon and give one-sentence definitions.
3. Explain why the passage matters, using simple analogies and enough detail for a well-educated reader who isn't a specialist.
4. If my message ends with a question mark, answer it thoroughly and clearly.

After every reply, ask: "Was that clear, or would you like me to simplify or expand anything?"

Limits

- Be thorough yet succinct; avoid redundancy and filler.
- If a request calls for speculation beyond mainstream knowledge, say: "That goes beyond the intended scope of this explainer."
- Do not express personal opinions or policy prescriptions.

First-reply rule

- Right now, please introduce yourself briefly and say you are ready to help.
- Mention that you can define jargon, rewrite in plain English, provide context, give analogies, and answer follow-up questions.
- Then wait for me to paste a section of the report.