

Outlook

December 2025

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History

Over the past five years we have been adamant on a number of factors and issued warnings on the potential impact on financial asset markets. As a conservative asset manager, with the first priority of capital preservation, we would prefer to have been prepared for the worst and then be pleasantly surprised to have been too pessimistic.

In the 4th quarter of 2019, the decline in US imports was a signal that the US and global economy was at risk of entering a recession. There were other forward indicators that also supported a recessionary outlook, but the pandemic lockdowns that commenced in the March quarter of 2020 made them redundant. This was a very important period in recent economic history because it revealed how government fiscal and central bank monetary policy would be utilised to avert a prolonged economic crisis caused by an event like the pandemic or a war.

In late 2020 we released an inflation outlook paper that correctly forecast the surge in inflation. When it occurred, the RBA labelled it transitory inflation initially, only to capitulate subsequently, and belatedly begin to raise rates. It would be **substantially** incorrect to give the RBA actions any credit, at all, for the subsequent fall of inflation. Unlike the ECB and the US Federal Reserve, the RBA failed to achieve any time period of negative monetary growth. This revealed that the RBA has no understanding of monetary or frankly Keynesian theory with regard to inflation. **Its strategy and approach were hope and prayer.**

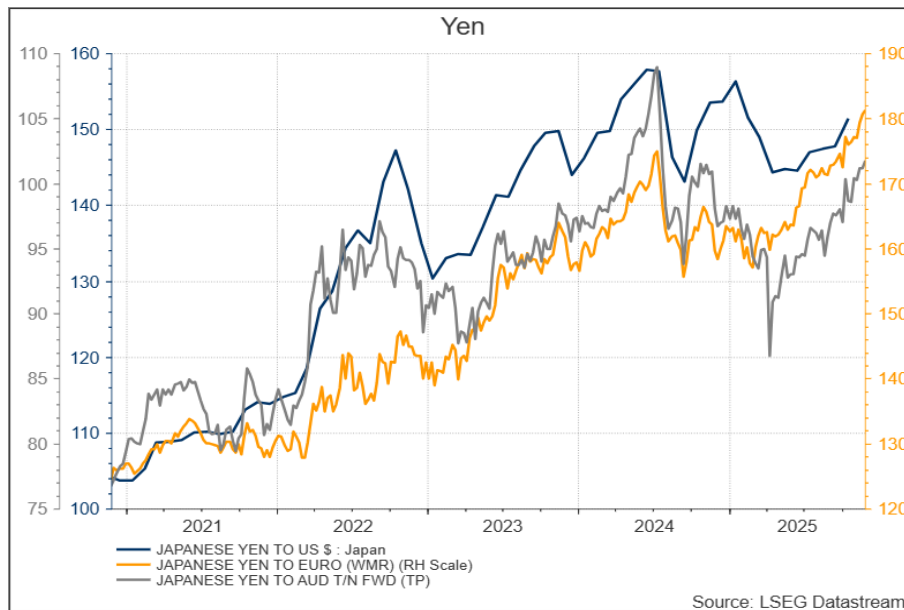
We did not predict the UK Truss budget meltdown in November 2022, but we did acknowledge the risks that this type of event posed to subordinated bonds issued by global banks. Just as note here, we would not be surprised, in the slightest, to see another UK budget meltdown in the life of the current UK government that don't appear at all capable of running even a school raffle, let alone a country.

We did not predict the Credit Suisse event and shotgun marriage to UBS in early 2023. It was and remains a matter contained within the regulatory responsibilities of the Swiss banking system. We did acknowledge at the time that there were no systemic implications for the global financial system. In fact, it has resulted in the Euro Area adopting consistent terms for Bank Tier 1 securities that no longer allows for a write off but only a conversion into ordinary equity if capital adequacy level minimums are breached. It was subsequently very disappointing to see APRA phase out Tier 1 securities in our banking system. In the days that followed the CS crisis we fielded a lot of questions from global investors about the Australian banking capital adequacy fragility and our response was that unlike in other jurisdictions, APRA was a 'hands on' regulator that was actively monitoring the system and that in Australia all Tier 1 securities had a conversion into equity if regulatory risk capital fell below minimum levels.

By mid-2023 the US markets were convinced that the US would move into recession by the first quarter of 2024. This was due to the ISM PMI ratings falling below 50, indicating an economic contraction 6-9 months ahead and the inverse benchmark US yield curve. Historically this combination had predicted a recession with 100% accuracy. At the time we forecast that the US economy would not begin a contraction in 2024 because:

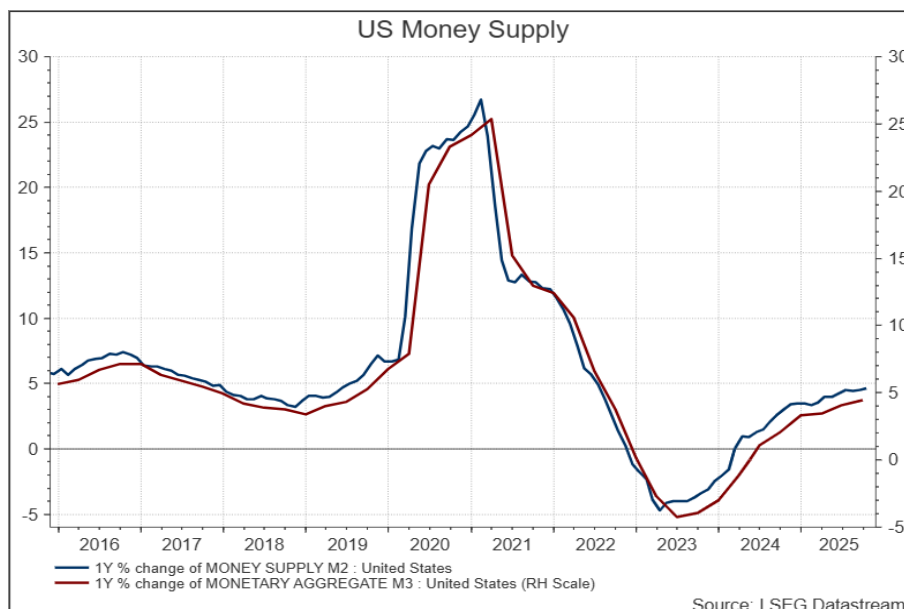
- The PMI data had been distorted by the pandemic lockdowns that brought about a rapid and larger than normal inventory buildup in the year to June 2023.
- The US inverse yield curve was not predicting a recession, but that inflation was transitory and when it fell the US Federal Reserve would lower rates at the short end of the curve.
- Other forward indicators were all showing positive signs.

In July 2023 we forecast that Japanese inflation would continue to rise and that the Bank of Japan would be too slow to tighten monetary policy, abandon yield curve control and raise rates. This would result in the yen declining. In time the weak Yen would then make Japanese equities an attractive investment opportunity.

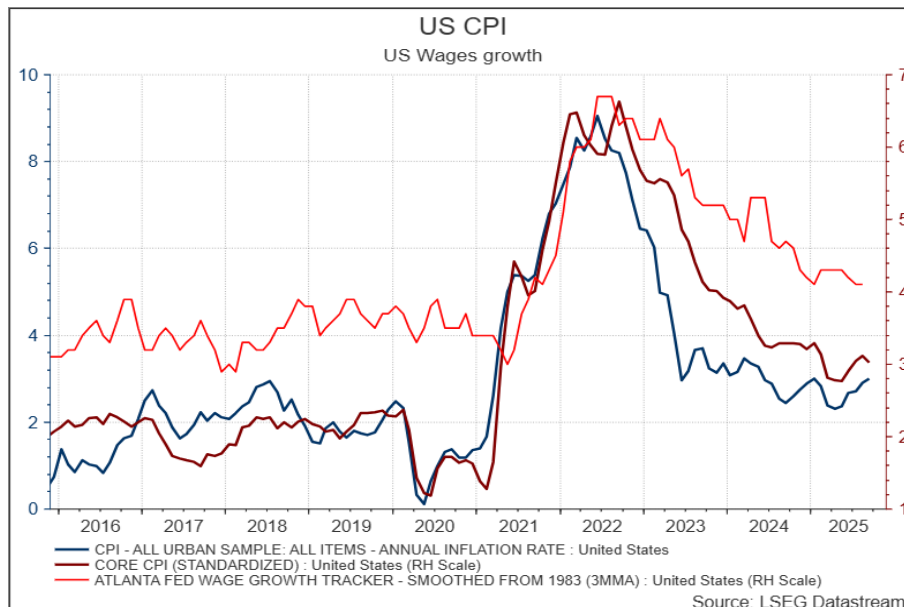


Although we had predicted the Yen weakness we were surprised by the rapid unwinding of the US-Yen carry trade in July 2024 when the US dollar peaked at 157.90 Yen, the AUD at 108.99 Yen & the Euro at 174.97 Yen. At the time we did not see any global systemic risk implications so although credit margins widened initially, they subsequently tightened back to previous levels quite quickly.

In October 2023 we recognized that the rise in US 10-year bond yields to 5% was at risk of triggering a global financial meltdown. The financing of the pandemic link spending by the government had been funded by the US Federal Reserve QE programme. The \$4 trillion of extra government spending was funded by the Federal Reserve printing cash and buying these bonds from the US treasury. This brought about an enormous spike in US money supply growth.

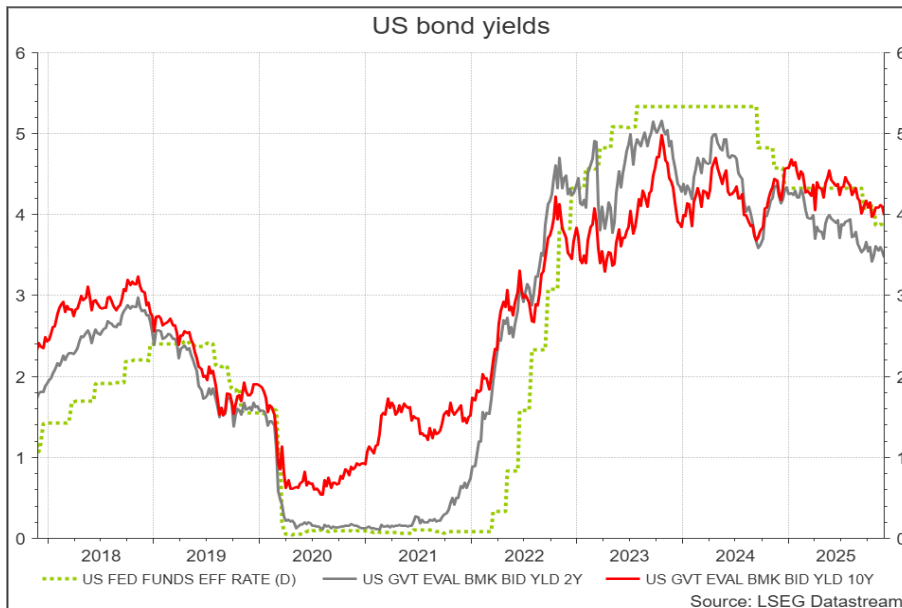


When inflation surged in 2021, the Federal Reserve could no longer be buying US treasury's as this would have undermined their monetary tightening policy necessary to fight inflation. Reading the chart and the below chart we can see that there is a 12-month lag between the peak in money growth (above) and the peak in inflation and wages growth (chart below). It is then apparent that since money growth bottomed in mid-2023 and began to rise, that inflation first stabilised and is only now beginning to rise.



In November 2023 2- & 10-year bond yields fell sharply away from the 5% point after Treasury Secretary Yellen announced a shift away from issuing 10-year bonds to finance the growing fiscal deficit and into 2-year bonds (subsequently discovered to be 30–90-day Treasury bills). At the time this combined with an extraordinary simultaneous very dovish statements from the US Federal Reserve and the ECB with the release of a dot point chart. The “dot plot” of individual members’ expectations released following the November meeting showed that participants expect cuts over the coming three years to bring the overnight borrowing rate back down near the long-run range of 2%. The markets reacted to this and priced up to 8 interest rate cuts in 2024. The market was wrong.

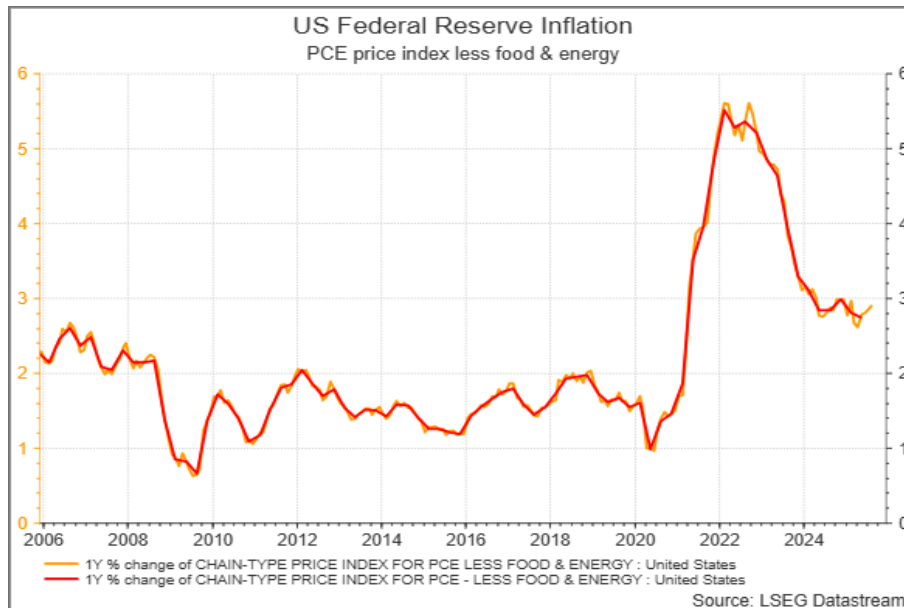
So, the combination of Yellen switching away from deficit funding using 10-year bonds to short-dated securities triggered a fall in 2- & 10-year bond yields from the 5% level. Disaster averted.



In hindsight there has been a lot of commentary written about the fact that Yellen did not dramatically increase long term bond issuance when rates were near zero. This they claim would have meant that the US governments interest costs were much lower for much longer. This is a false narrative. If the US Treasury had increased the supply of 10-, 20- & 30-year bonds when rates were low in 2020-21 then it would have undermined the QE program of the Federal Reserve.

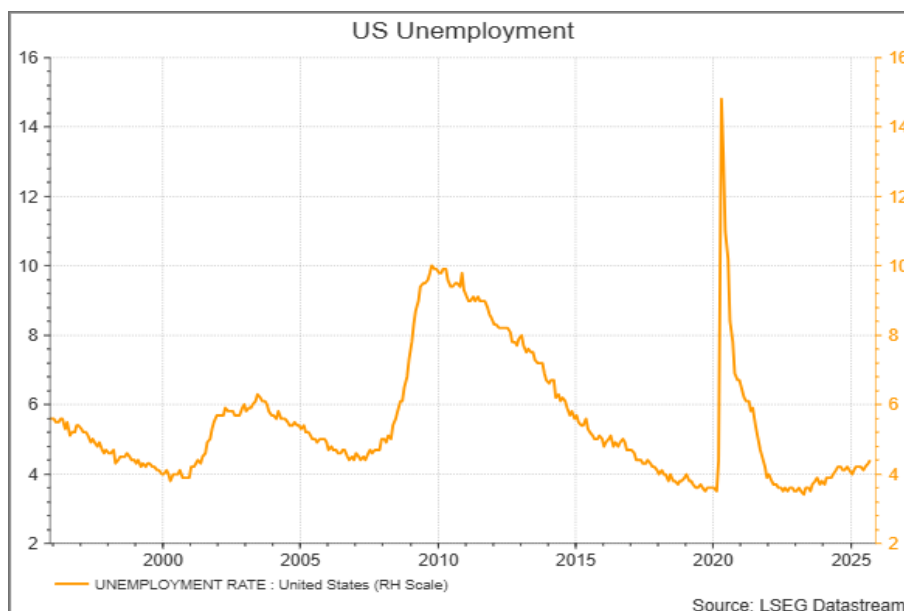
Since Scott Bessant became US Treasury secretary there has been a massive increase in 30–90-day Treasury Bill issuance and a tempered issuance of long dated treasuries. The reported reasoning for this is that he expects rates to fall and so has kept borrowing short dated. This is false. The truth is that demand for US 10-, 20- & 30-year bonds is now much lower than it was prior to the pandemic because emerging market central banks, the Chinese and Russian central banks severally reduced holding their foreign exchange reserves in USD's and US treasuries after the US seized all the Russian US treasuries held on the SWIFT platform after the invasion of the Ukraine. These central banks no longer rely on the USD as the reserve currency and have switched into holding other currencies, assets but principally gold bullion.

The US Treasury has, so far, been able to rely on the US banking system buying the increased volume of short-dated treasury bills, but it only a matter of time before supply rises to a level where US 30–90-day bill rates begin to rise and in doing so undermine the US Federal Reserve's monetary settings. Since September we have seen the overnight repo rising and it now sits at 4.05% (just above the US Federal Reserve upper overnight range of 3.75% to 4.0%). This is indicating that that there is a liquidity problem in the US financial system. While this is being primarily driven by the US Treasury using Treasury bills to finance the growing deficit, we need to be conscious if the fact that we are now quickly approaching a point where the corporate borrowing taken out in the midst of the pandemic at very low rates must be rolled over into new 5-year facilities. Not only will US corporates be forced into paying higher interest rate costs, but they may also find it difficult to find buyers for their debt. It is then no surprise that Governor Powell recently announced the curtailment of QT and hinted at QE being possible. Make no mistake, if the Federal Reserve is forced to go back to printing dollars to fund the growing US fiscal deficit, then money supply growth will accelerate, and inflation will once again explode upwards.



In the US we already had an inflation problem building before the Trump Tariffs. The tariffs have then disrupted the global supply chain since April. So far, this has not had a big impact on final prices. The lag between the Liberation Day tariff announcement and impact on final prices is due partly to Trump continually changing or pausing the tariffs, but mostly due to the build-up of business inventories in anticipation of the tariffs. The inventory cycle is normally 90 days so we expect that only in the November or December CPI numbers will we begin to see the August final tariff announcement show up in final prices.

Even without the tariffs the unemployment rate is still very low, indicating that there is very little spare capacity in the US economy.



US Economic Outlook

A fundamental misunderstanding of basic economics is pervading the financial markets currently. It is not the absolute rate of interest that brings the inflation outcome but the volume of money in supply and its velocity (the money multiplier). After a long period of very low asset volatility that has lulled investors and nearly universally the professional investment community into expecting nothing to change. This is the reason passive index funds have been preferred over active managers. There has been a lot of reporting what has happened and very little on why. Understanding the why will be critical to avoiding what is shaping up to be an extremely bad year in 2026 for investors in all asset classes.

Firstly it is important to understand and separate the actions of the Federal Reserve in December into:

1. The decision to cut rates by 25 basis points
2. The decision to engage in quantitative easing at \$40 billion a month

The decision to cut rates by 25 basis points

The FOMC has left the door open to the idea that they may not be cutting again, with only one rate cut in the dot point chart in all of 2026 where there are 7 meetings. Heading into this meeting 10 of the 12 voting members of the FOMC had made speeches that were hawkish so it was with some surprise that there were only two (Chicago and Kansas governors) that did not vote for a rate cut. The same thing votes on the right cut. Clearly a number of governors were convinced in the meeting the right cut was an affordable form of insurance at this time.

Even though the FOMC has failed to get the Federal Reserve's preferred measure of inflation sustainably below 3% since the pandemic they may have taken the view that with gasoline prices falling below \$3.00/gal for the first time in many years that this would depress inflation readings in the December quarter. The oil price in the US impacts about 30% of the CPI basket as it is pivotal in logistics, food production, transport and just about everything. The fall in the gasoline price is the delayed reaction to the fall in WTI oil over the past month and would impact food and logistics price outcomes with a short lag.

The second reason for cutting was clearly the foggy outlook for the US employment outlook. The markets and the Federal Reserve don't appear to understand that both demand and supply make a market. They are concentrating on the demand side of the equation and ignoring the supply side.

Demand Side

The fall in jobs growth from above 180,000 a month in 2023-24, to below 100,000 a month can be explained, or at least understood as a business reaction to the uncertainty that has become a hallmark of the Trump Administration. What will have troubled the FOMC is that the fog over the data due to the government shutdown has created a vacuum of uncertainty into which private data is flowing that points to employment outcomes something like 10-30,000 a month employment growth. While the private payrolls data is always informative it is a poor substitute for the Non Farm Payrolls report.

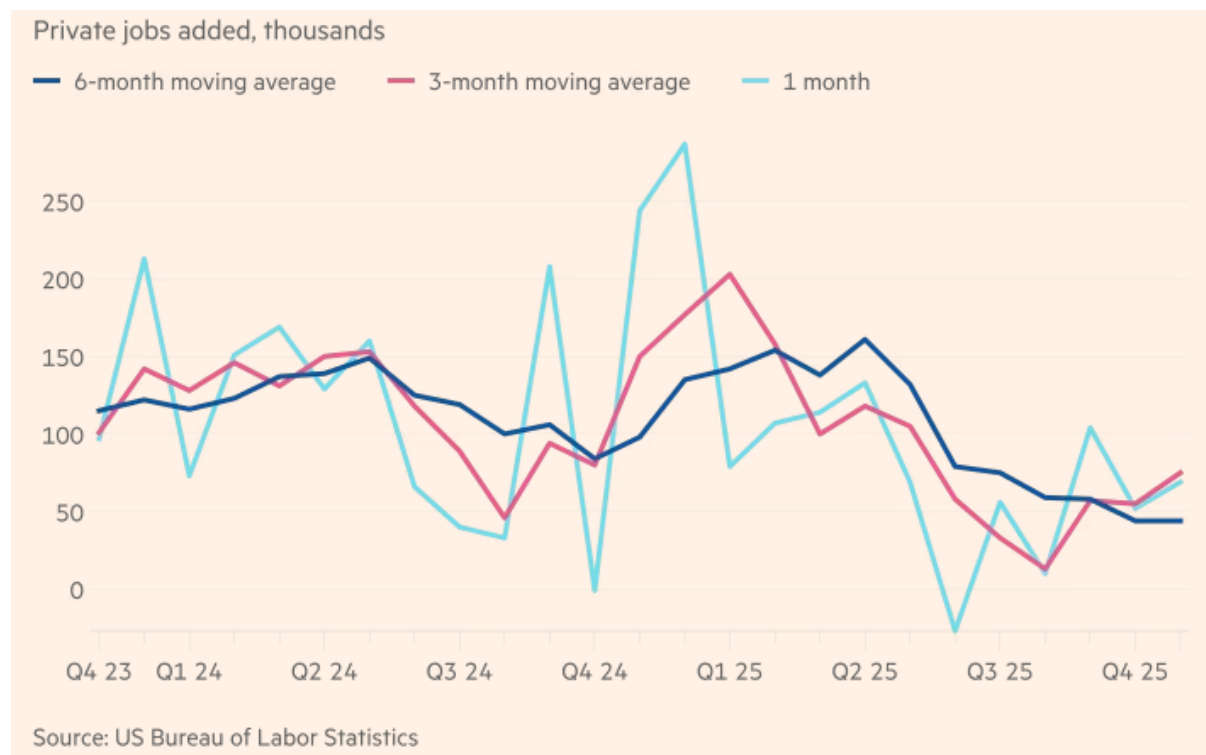
It must also be remembered that the employment data is very much a lagged indicator as it relates to business decisions made 6-9 months in the past. Since then the forward looking data like the PMI, the equity market and the bond yield curve are all telling us that the US economy remains buoyant. The Federal Reserve understands this lag but too many market participants and the hapless media are too fond of using monthly changes to employment as a live signal reflecting business decisions in that month.

Supply Side

Firstly, a look at the most recent labour market data. The belated release of the US non farm payrolls data showed the expected decline in the government sector employment but a surprising strength in

the private sector. The decline in the government sector is not so much related to the shutdown as the Trump Administrations cuts to the size of the government sector that were announced in March but are only now coming into effect. The strength in the private sector may also be due to the private market anticipation of the Big Beautiful Tax Bill stimulus and here we expect a further positive impact in the March quarter of 2026 when consumers will make the decision to either save or spend the \$20bn of stimulus.

It is important to not focus on the rise in the unemployment rate in November. The increase in the unemployment rate to 4.6% was primarily due to a sharp rise in the participation rate with workers returning to the market. The OECD forecasts estimates of the participation showed a rise from 65% to 67% over the past two months and importantly they forecast a rise to 69% in 2026. Even though we consider this forecast as highly unreliable given its track record, the FOMC may have factored it into its analysis.

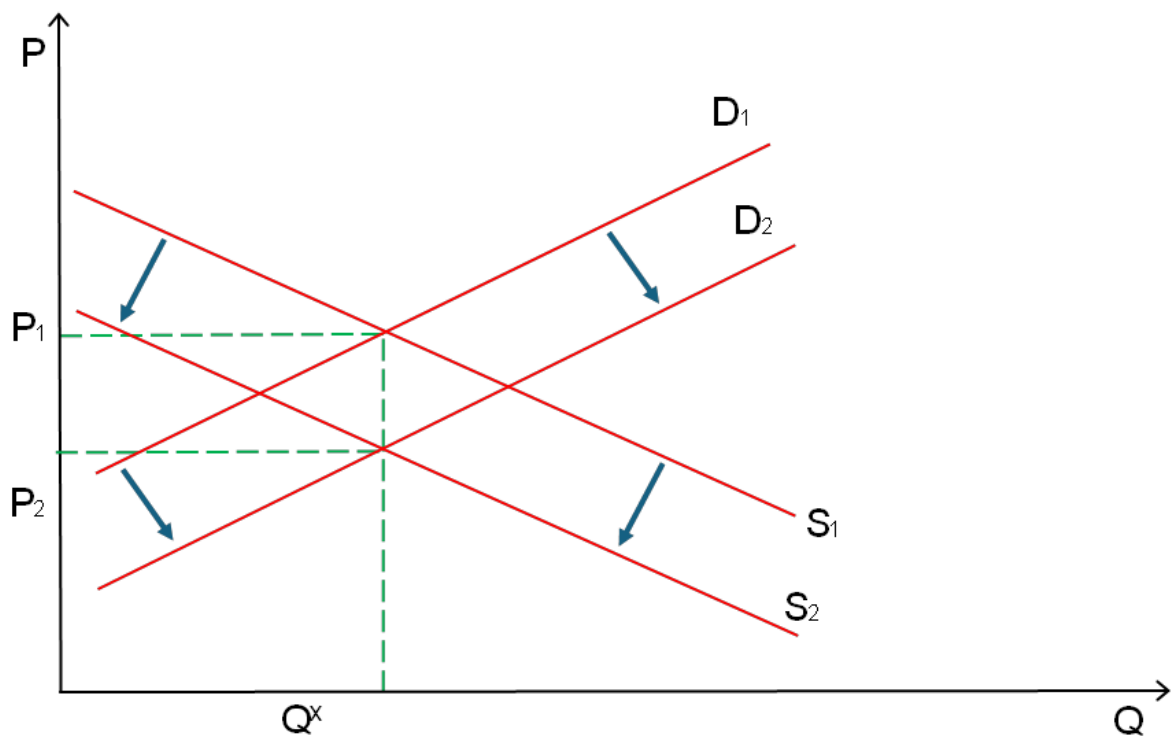


Snipped from FT 18/12/25 [The economy is fine and everyone hates it](#)

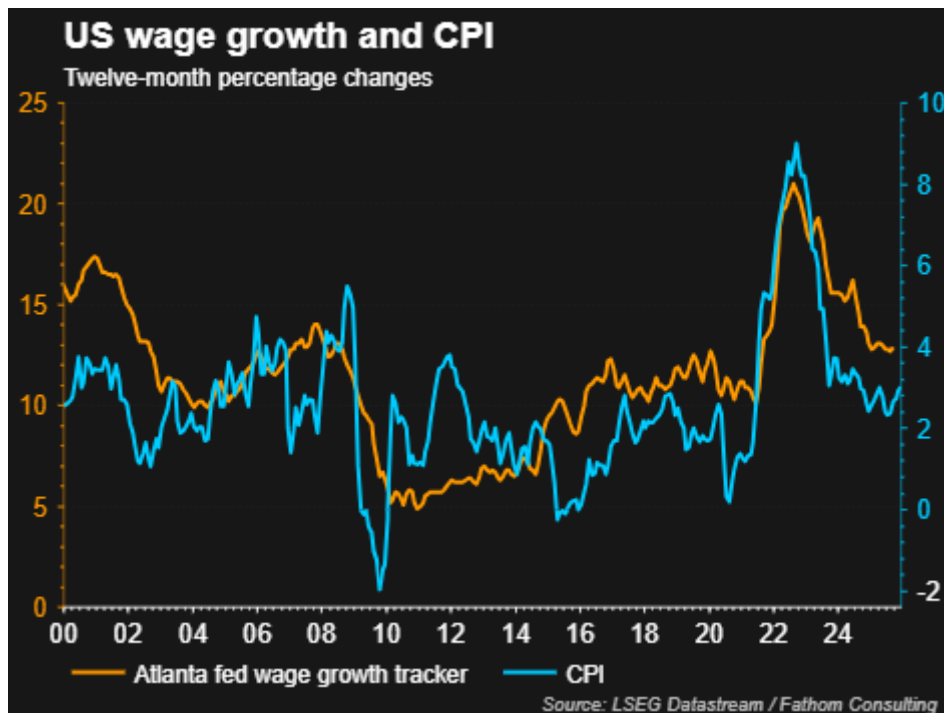
Before the pandemic the US economy needed 125,000 per month employment growth to match out against the supply increase such that there was no impact on the unemployment rate. Post the pandemic the US employment growth was running at 200,000 plus per month but it needed to achieve this level of growth to match the surge in legal migration to catch up after the lockdowns and then there was the 3 million illegal immigrants that came in in 2023 that surged the population growth by 1%.

The US employment market remains roughly in balance because the US has suffered a substantial population decline not seen since the Spanish flu in 1918. The actual decline in the population is hard to determine but we can see from the immigration statistics that 500,000 of these illegals have left the US and Trump is claiming that another \$2m have left under their own volition.

The below chart is intended to demonstrate simply that the labour market may still be in equilibrium because the fall in demand has been matched by a fall in supply.



There is a push-pull relationship between the CPI and wages growth in the US (in fact in any economy). Rises in the CPI explain most of the increase in wages with a one quarter lag, however, falls in the CPI explain very little of the change in wages. This is because wages growth is inherently sticky such that it is very slow to contract in a slowdown.



The Federal Reserve may have seen the moderating wages growth over the past 5 months as providing some room to cut rates in December.

It is probable that the US Federal Reserve has made an error with at least the December rate cut. To make this judgement we need to take a look at not at the lagging indicators - unemployment and inflation - but the forward indicators.

The biggest & most obvious is the Trump Big Beautiful Tax Bill that will only begin to impact on the economy in the March quarter of 2026.

In essence, Trump's *Big Beautiful Bill*:

- Permanently locks in 2017 tax cuts and lower rate structure
- Expands or creates new deductions and credits (standard, SALT, child, senior)
- Provides temporary tax exemptions on certain income categories
- Benefits many businesses and higher earners, while critics say it shifts burdens in ways that disadvantage low-income households via cuts to social programs
- Has broad economic and political implications beyond just tax rates and assets because they impact consumption activity.

Just to refresh:

$$\text{Agg Demand} = C + I + G + X - M$$

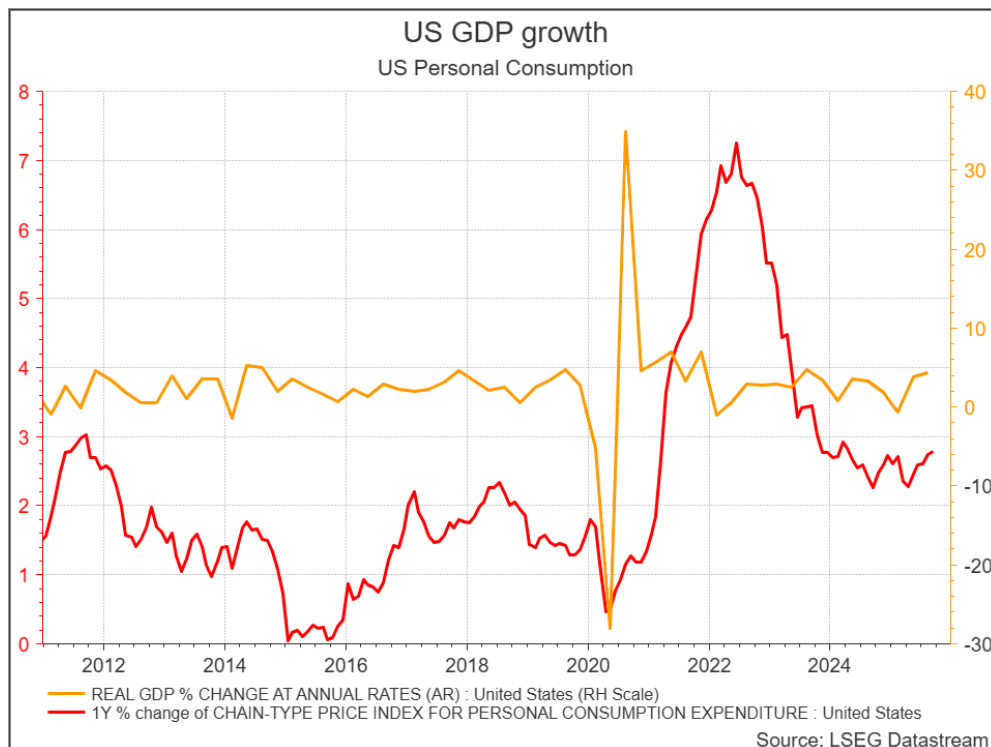
- X-M, or net exports in the US is about 4% of GDP. The focus here needs to be on both exports and imports for the net change. Actions taken by the Trump Administration with Tariffs to shift production back to the US and replace imports will only be successful if other countries don't act to reduce US exports.
- G, or government spending/share of economic output was expanded rapidly in response to the pandemic lockdowns that disrupted the economy but have not been wound back post the pandemic;
- Investment activity by the private sector. Surged post the pandemic with the excess savings from the lockdown periods driving an expansion of smaller to medium sized businesses. These same businesses are highly susceptible to a rise in interest rates, so private business investment began to fall as rates rose and has not begun to recover with rates falling, perhaps, because of the uncertainty of the Trump Administrations policy actions. To be clear, the US economy will not be able to record real economic growth without a big and sustained increase in private business investment. An increasing number of economists and investors are hoping that AI investment will be the source of increased private investment and increased labour productivity. To date the rise in private investment has not materialised but the AI sector have expected to boost borrowing by \$300bn in 2026. This has many hopeful that a boost to economic activity will follow, however, it must be noted that the companies in the AI sector already have \$1.2 trillion of debt. The inconvenient truth may be that the AI sector does not have the earnings to support this level of debt.

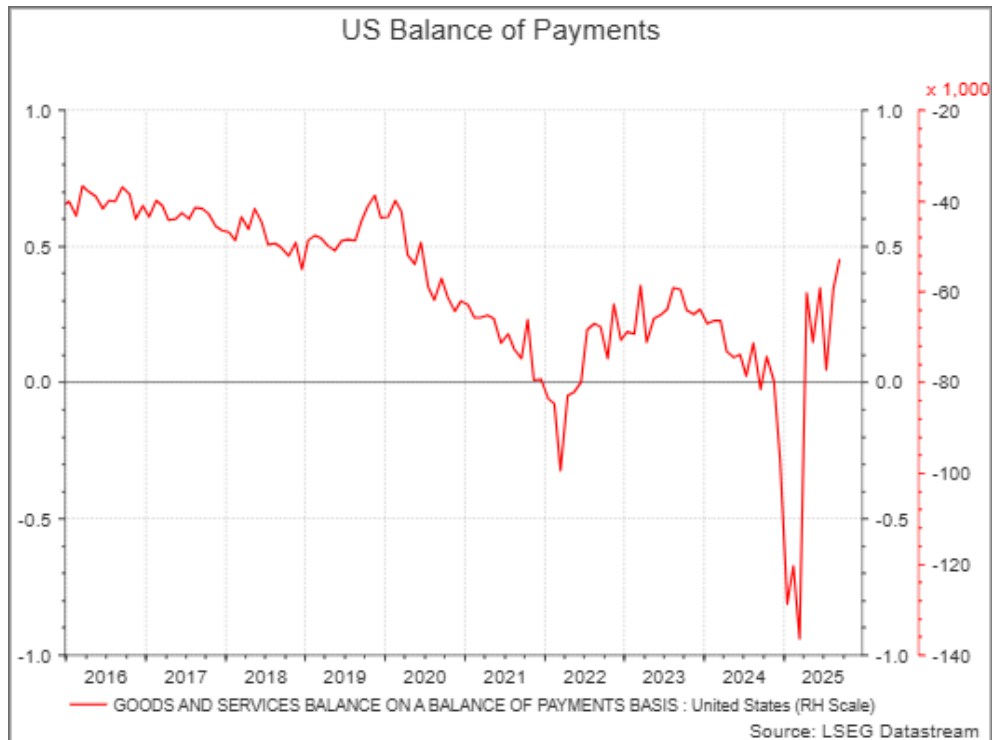


- C - consumption activity has been the rock upon which the US economy has been able to stumble forward over the past 17 years. The US economy has developed into two stage

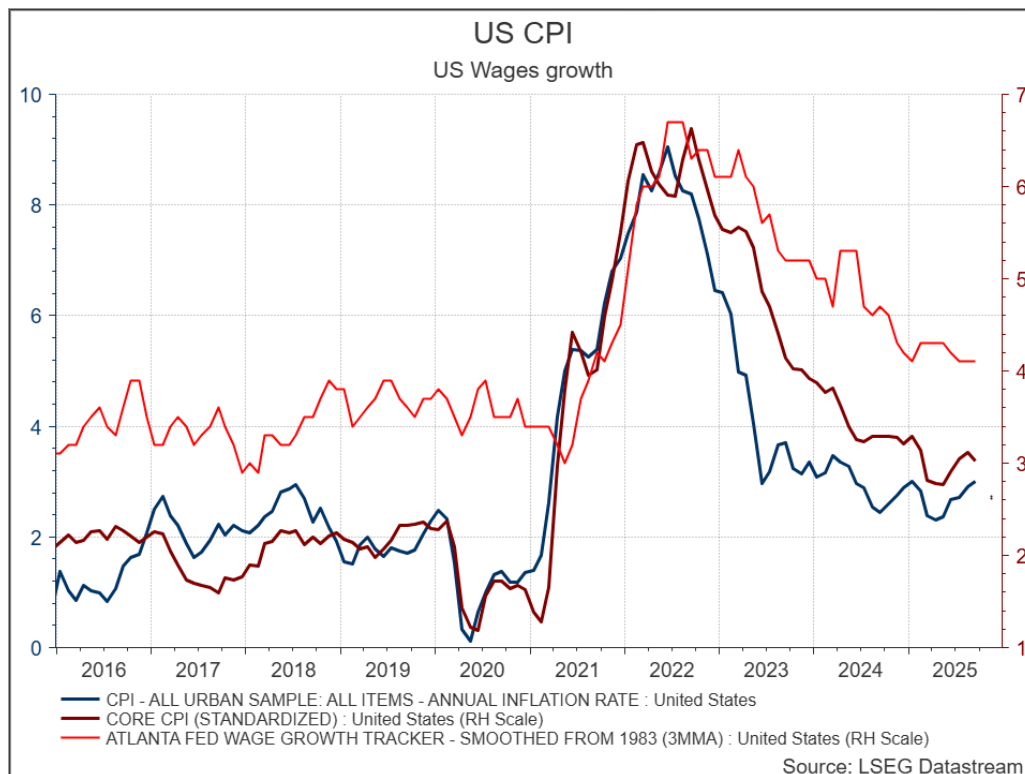
economy. Income growth was during the pandemic higher for low income households but since then has been much higher for high income households while low income households income growth has been undermined by inflation. The other related factor is that strong asset growth is also supporting consumption activity by high income households. This was explained in the following FT article, [Happy K-shaped Christmas](#) . Understanding which households are driving consumption explains why the Big Beautiful Tax Bill is aimed at these households.

The 3.8% September quarter surge in GDP was due to a combination of Consumption, Investment and net Exports. This context is important because consumption is likely to remain strong and government expenditure (G) increase in the March quarter with the impact of the Big Beautiful Tax Bill in a new financial year.





Given the obvious stimulus from the Trump Tax bill in the March Quarter, it is hard to see inflation moderating. Supported by nominal wages growth above 4% and the money supply still growing at a healthy rate (that will not slow and may increase after the December rate cut), we see only an outlook of higher US inflation in the year ahead. There is some hope that US labour productivity, which is currently hovering near 1.5%, will get a huge AI boost at some point.

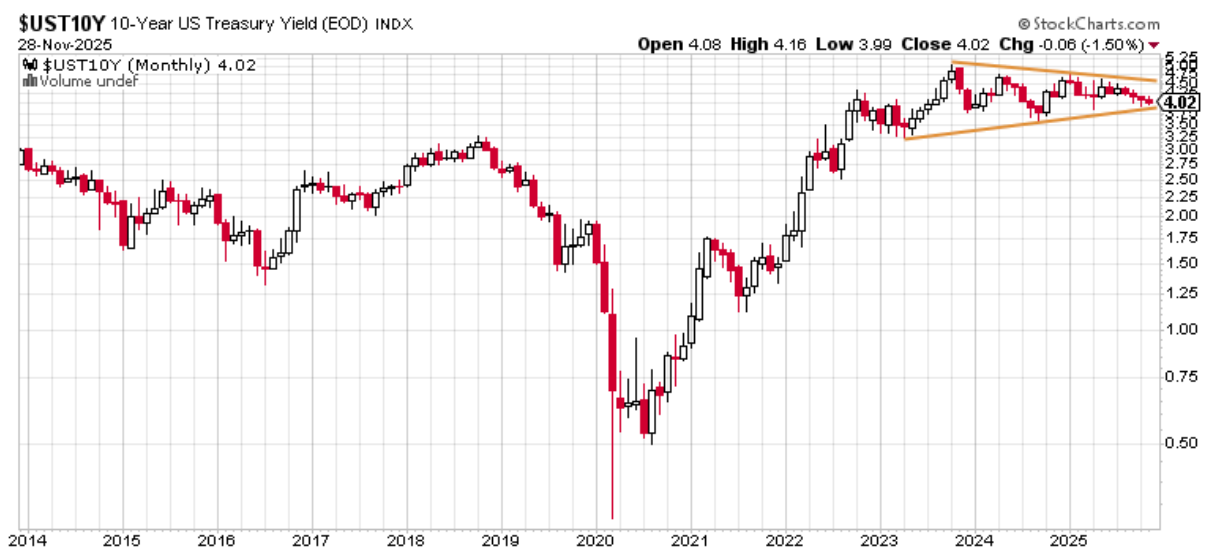


Rates Outlook in the US

We don't believe that the US Federal Reserve should be cutting rates again and is more likely to need to raise rates for several reasons:

1. The financing of the US fiscal deficit requires higher rates to clear the supply of US bonds issued by the treasury.
2. If the general country tariffs are blocked by the US Supreme court, then the budget deficit deal will collapse, and even greater bond issuance is needed.
3. If the general country tariffs are not blocked, there is still the inflationary impact of the tariffs increasing final prices. It is not true that tariffs will only have a short-term impact on final prices. The impact in 2017 when Trump first increased tariffs was minimal only because the USD rose to offset their impact. This will not occur this time.
4. If the US Federal Reserve does cut rates in December, then the market will signal this as an error by selling down the US Dollar and pushing the 10-year bond yield higher.

The US 10 year on the monthly chart looks poised to break upwards from a large symmetrical triangle. The technical upside target from a breakout through 4.50% is 5.86% and the downside target from a support failure at 3.78% is



In December the FOMC cut rates by 25 basis points and the dot chart showed one further rate cut in 2026. There was also an announcement that the Federal Reserve would begin buying up to \$40 billion a month of treasury bills.

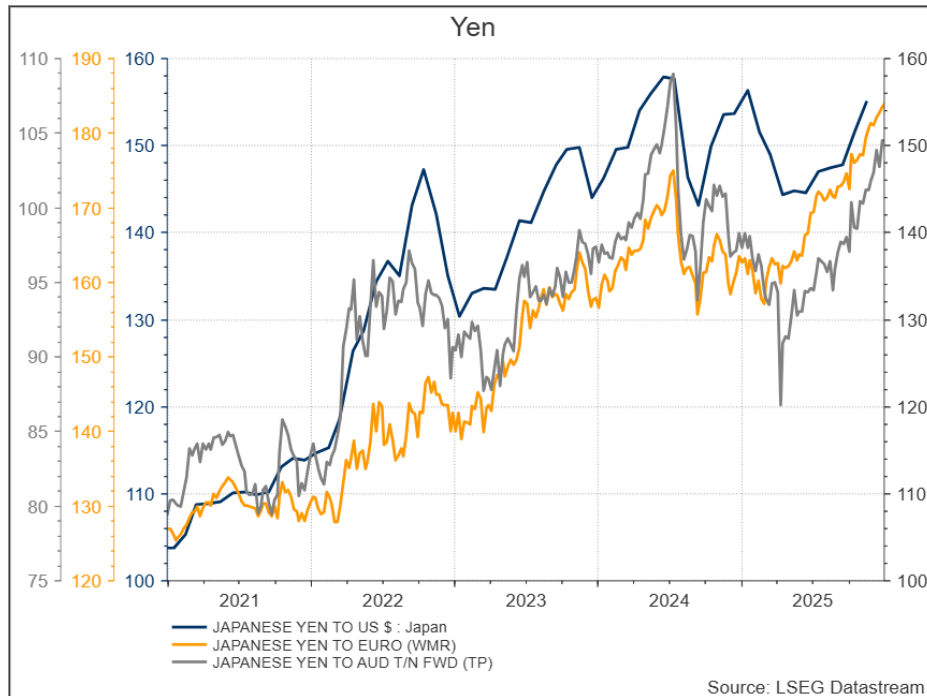
Japanese Yen Carry Trade

The significance of the Yen Carry Trade on global bond markets cannot be easily underestimated. Ongoing Yen weakness will have very important implications for all global investors in 2026. We believe it would be the main underlying explanation for a spike in the 10 year yield through 4.50%. There are two factors at work with the Yen Carry Trade:

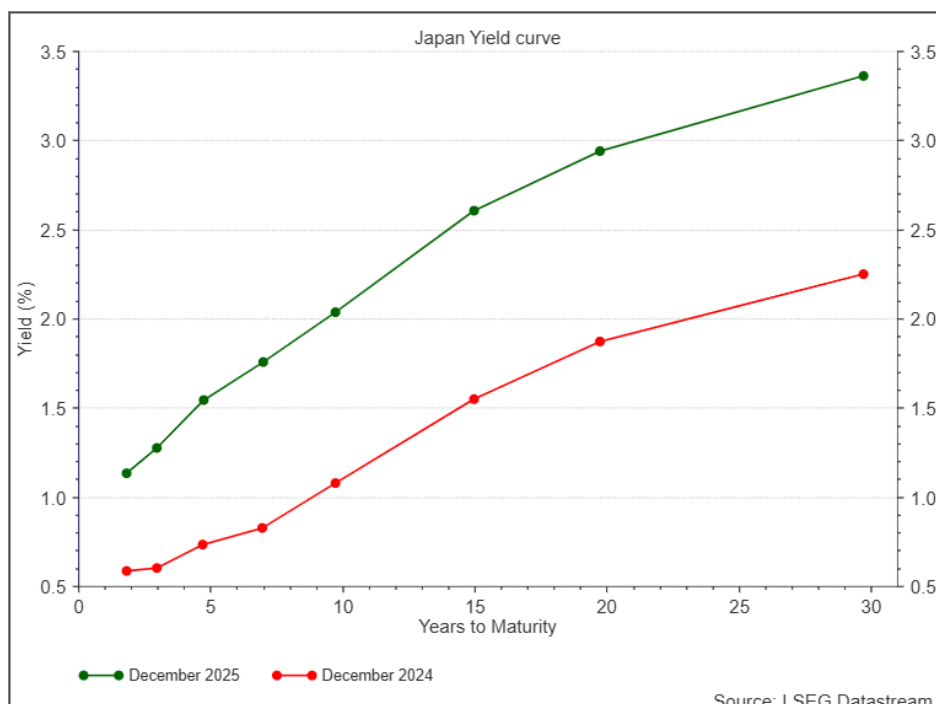
- The falling Yen;
- Rising bond yields in Japan.

The Yen Carry Trade (all currencies) is estimated by the Bank Of International Settlements at US\$22 trillion. Since 1990 Japan had engaged in a modern monetary theory experiment whereby the money supply was expanded and interest rates moved to zero. Japanese and offshore investors then borrowed

in Yen and invested in offshore bonds to gain not just from the interest rate differential but also the change in the currency. In June 2024 the Yen reached a new low point against the USD and this triggered a rapid unwinding of the US/Yen carry trade and sharp rise in US bond yields (investors sold US bonds and the USD to move back into Yen). In 2025 the rise in the Euro against the Yen has triggered an unwinding of the Euro/Yen carry trade



Over 2025 the Japanese yield curve shifted significantly higher with rising inflation triggering a shift out of bonds and the Bank Of Japan (BOJ) raising rates at the short end of the curve. Investors in 10 year Japanese bonds are not concerned with the bonds yield but the change in the yield over the past 12 months. The move from 1.08% in December 2024 to the current 2.08% is a 9% fall in the bonds capital value.



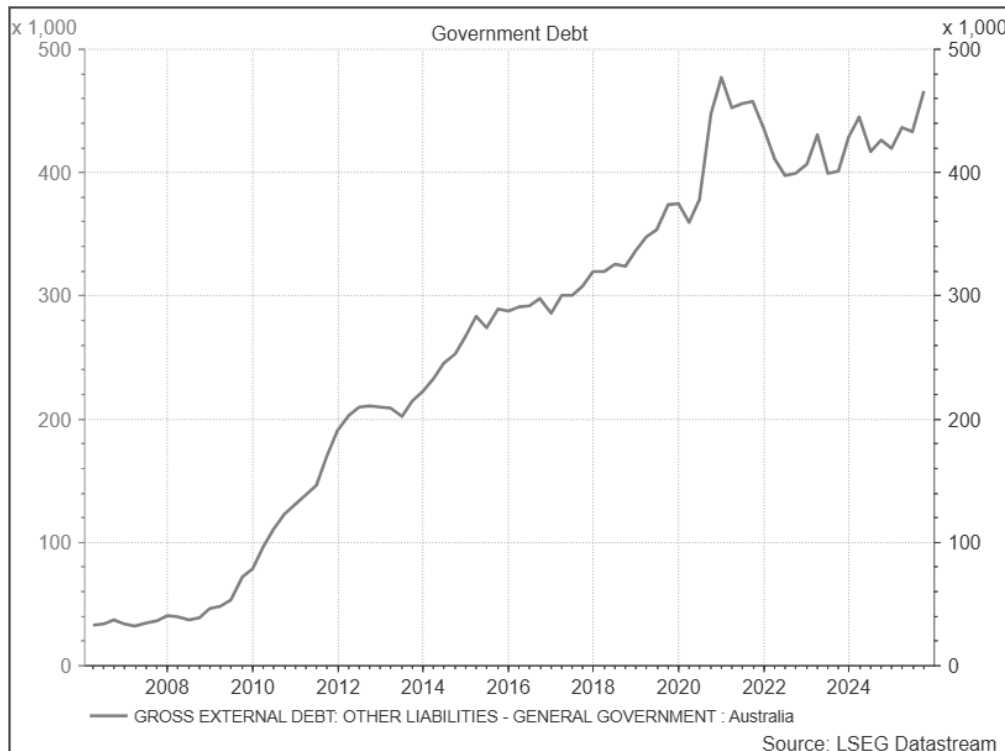
Australian Economic Outlook

The Australian economy is a 3 trick pony:

- Government output;
- Residential linked finance – investment – construction
- Mining & Agricultural exports

$$\text{Aggregate Demand} = C + I + G + (X - M)$$

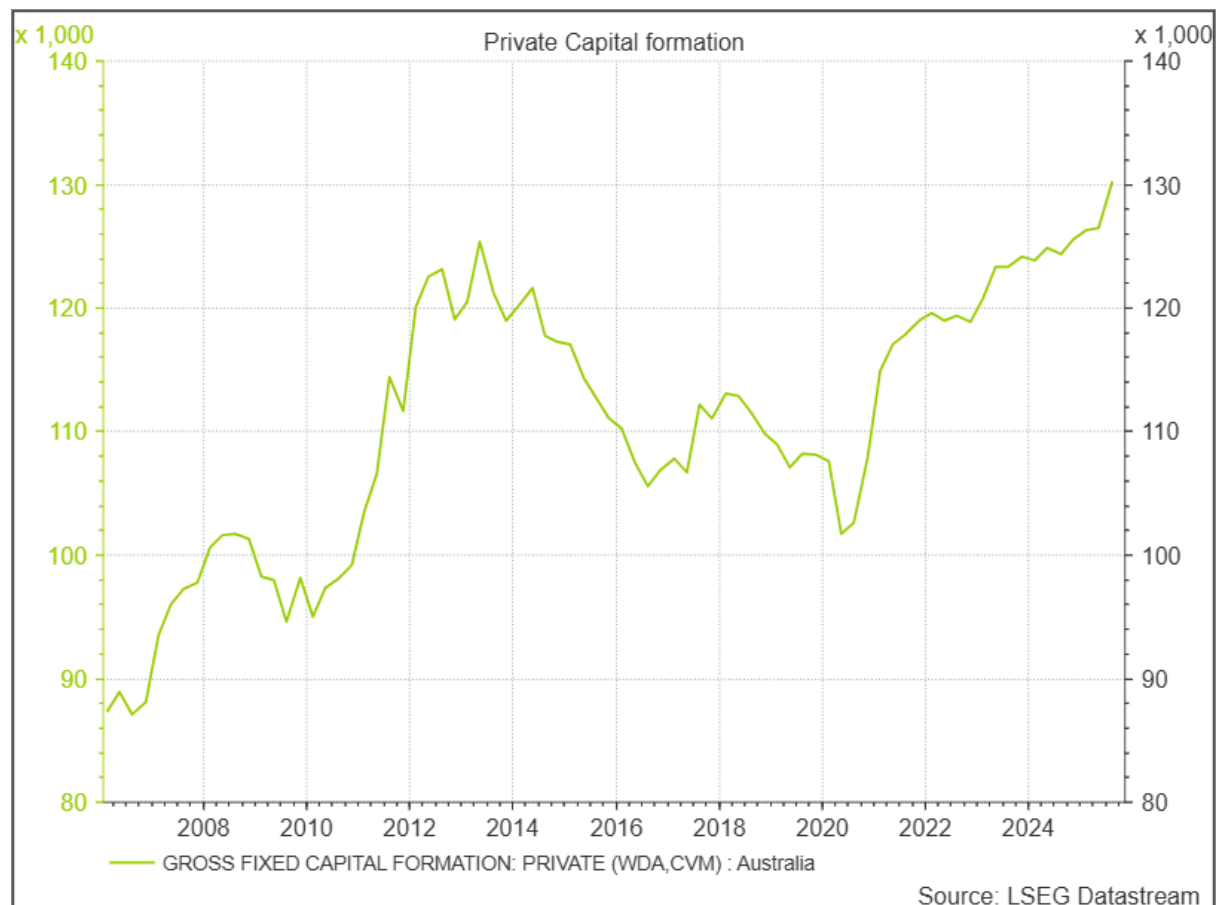
In an Australian context aggregate demand is being increasingly driven and dependant on government. The size of the government is now near 33% of the workforce and then there is all the government spending though government owned corporations, private corporations working on government awarded contracts for very long periods (Infrastructure projects in Victoria and the NSW bus network). Australia has become a welfare state to the extent that over 50% of the workforce is not actually a net tax payer and a large percentage of the total population receives some form of welfare (family disability, hardship etc) to supplement their income needs. What this means is that there is a high degree of dependence between household consumption (C) and Government expenditure (G).



The problem Australia now faces is that falling productivity and low GDP growth cannot pay down the rise in Government debt quickly enough. This has meant that many private sector investments are crowded out of the funding market. While socialist economics always can find a reason for a bigger role of government in the economy, Keynesian economics could only justify increased fiscal expenditure to address an economic contraction that had created a significant amount of spare labour capacity in the economy. When government expenditure (of any kind) increases at a time of full employment the price paid is **rising inflation**. There is no basis for government debt to be once again increasing post the pandemic lockdowns.

Business Investment (I) in an Australian context is a hopeless cause. Outside of Mining & Agricultural there are very few Australian companies that can produce a commercial return even with widespread, politically driven government subsidy programs. Our manufacturing sector is either government owned,

subsidised or has moved its capex, ingenuity and production to Asia. Private business investment based on a profitable commercial outcome is in decline, however, this is not showing up (yet) in the statistical measure of Investment (I). In fact private capital formation is increasing at a rapid rate as can be seen in the following chart.



There are two periods on this chart that deserve some explanation. The first is the mining capex boom post the GFC that began in 2010 and peaked in 2013. The second is the post pandemic lockdowns when small and large businesses rapidly expanded capex to catch up for the lost pandemic days. That leaves us trying to explain why capital formation surged in 2023 and now in 2025. The most logical explanation must be a response to a government policy such as the renewables rollout.

We would argue that the Australian Aggregate Demand function looks more like this:

$$\begin{aligned} \text{Agg Demand} &= (C+G) + (X-M) \\ &= \text{Government} + \text{Trade} \end{aligned}$$

At its most basic level, the outlook for the Australian economy is driven by government activity and the trading outcomes from a few large coal and iron ore mining companies plus the wheat crop outcome. What this means is that the economy is vulnerable to an external shock that triggers both a fall in the demand and more importantly the price of its exports.

The Great Australian Residential real-estate Ponzi scheme remains a clear and present danger to the Australian economy. The asset bubble is now so large the everyone fears it bursting. In our opinion this problem begun when Australia fully adopted the Basel Capital Adequacy requirements in 1991. The Basel Capital adequacy rules required that a bank hold 10% of risk capital for every residential mortgage but 70% for every business loan. This created a distortion in bank lending away from business investment and towards financing of homes. Our banks have turned into great big building societies

because the capital adequacy rules allowed them to grow faster with lending to home buyers. Over the past 10 years we have seen this accelerate with a raft of non-bank lenders posing as sound investment vehicles using high gearing to buy mortgages off the bank system.

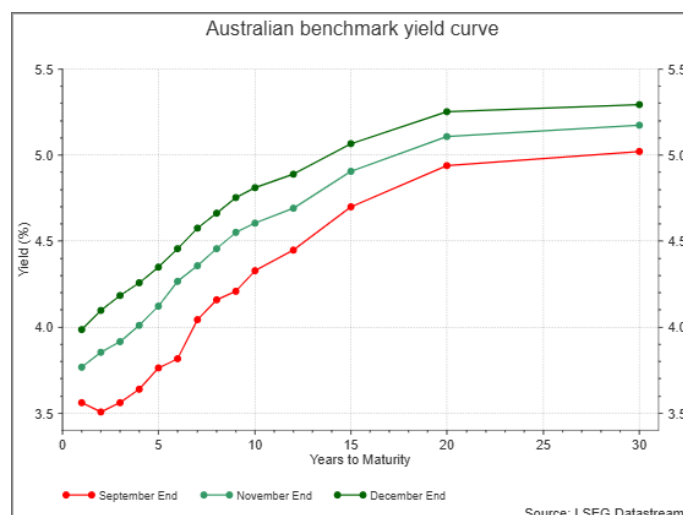
The distortion was inflated further by successive governments tax policies supporting home buying for occupancy or investment.

Australia has not suffered an economic contraction since 1992. When one arrives the household debt bubble will deepen and prolong the contraction.

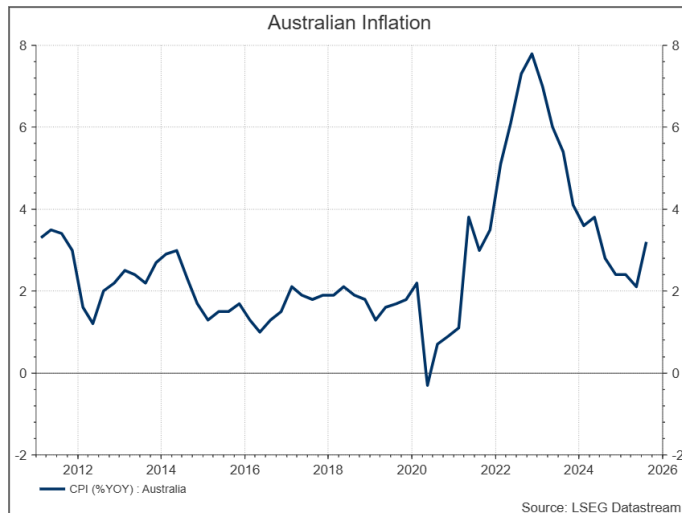
In summary, we see nominal GDP growth remaining positive but low (in the absence of an external shock) but GDP per capital growth declining. The combination of low labour productivity and high nominal wages will bring about higher inflation readings (possibly averaging 3.5% in 2026) over the forecast period.

Rates Outlook in Australia

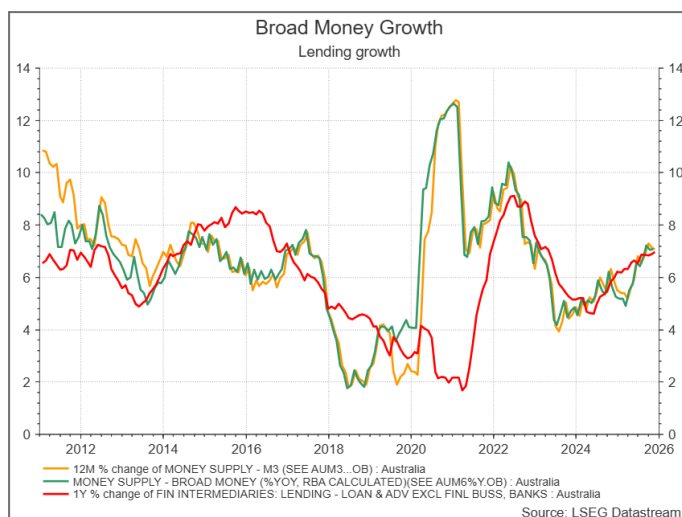
The Australian benchmark yield curve has shifted higher consistently over the past four months of the year.



The market has begun to brace for interest rate increases by the RBA in the year ahead. At the short end of the Australian curve the 1-year bond yield has surged 50bps since the September CPI reading shocked the market. This reflects the reality that the disinflation following the transitory impact of the pandemic lockdowns on global supply chains has been superseded by 'cost-push' inflation.

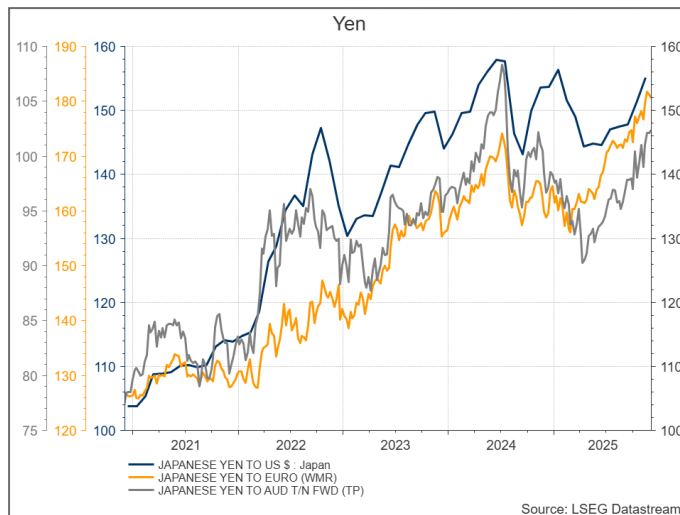


In an Australian context inflation will be fuelled by strong money supply growth and strong lending growth that implies the RBA monetary settings are stimulatory.



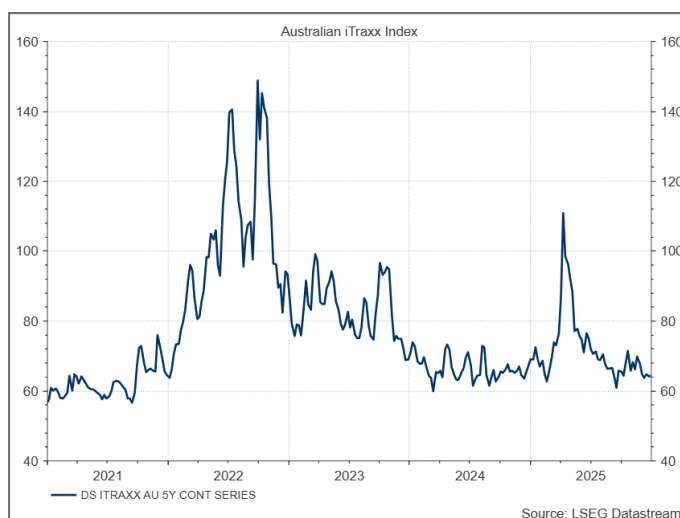
Since September, selling pressure has appeared in the 5 to 10-year part of the benchmark curve and yields have surged. The most plausible explanation of this was the unwinding of the Yen Carry Trade.

The pressure has come from the Yen weakness against the Euro and not the US dollar, as was the case in June 2024. The Yen Carry Trade is done through most developed economy markets. The Bank of International Settlements estimates its size at US\$22 trillion.



Credit Margins

Floating rate credit margins for Australian banks and corporates remain near the very tight levels, implying a benign economic outlook. The Australian 5-year iTraxx index (a broad measure of corporate credit margins) was remarkably steady throughout December.



Major bank credit margins moved only slightly wider in December and may remain in a tight range until new issuance arrives after financial reports are released in March. There is a risk that offshore banks may be attracted to issuing new debt in Australia by

the tight margins and the lack of new supply from Australian banks in the next two months (Kanga issues) and this pushes credit margins wider.

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