July 7th, 2025

FESC Asset Management

MACRO VIEW

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A Fed Blink and a Soaring Deficit: The End of Cheap Money

The initial half of 2025 has witnessed the emergence of a scenario we previously identified as a key concern in our last MacroView, which represents a potential escalation of market volatility risks beyond our baseline forecast. This scenario was termed "The Fed Blinks."

Our primary concern was the **Federal Reserve cutting interest rates prematurely**—or by more than 50 basis points—before clear evidence emerged that inflation was sustainably moving toward its 2% target. Our fears appear to have been justified. By late 2024, a significant disinflationary trend, alongside worries about economic slowdown and a desire for quicker monetary policy normalization, led the Federal Reserve to implement aggressive rate reductions.

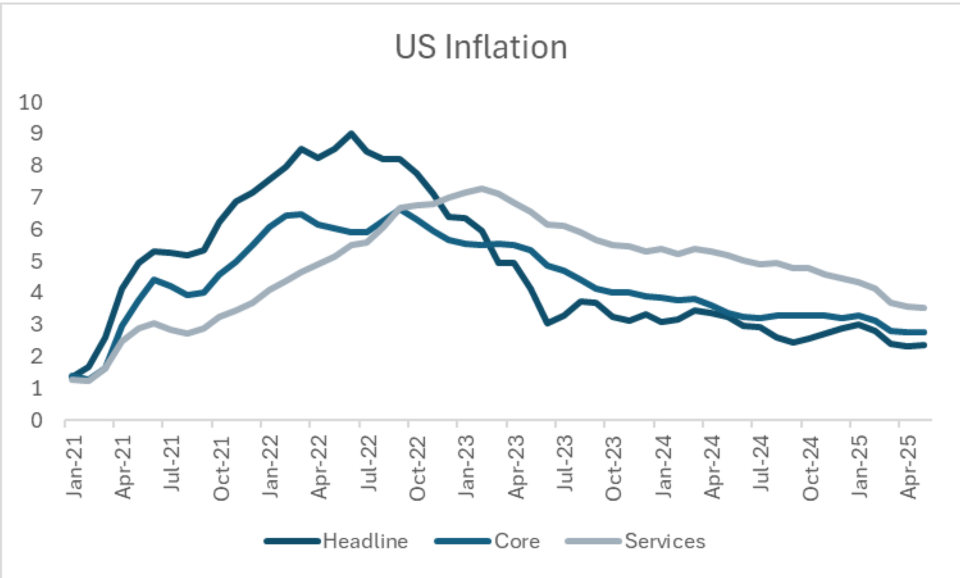
In our assessment, **this constituted a policy misstep —a "blink"— in the face of inflation that, while moderating, did not exhibit unequivocal signals of decelerating at a pace consistent with achieving the 2% objective**. According to the U.S. Bureau of Labor Statistics (BLS) Consumer Price Index (CPI) report for May 2025, core inflation remained at a stubborn 2.8% year-over-year, while services inflation stood at 3.7% year-over-year. These figures, while an improvement from 2023, remain above the levels needed for the Fed to comfortably reach its target without continued restrictive policy.

The Federal Reserve's premature action appears to have supported an inflationary trend, potentially cementing it for the long term. This is not to suggest that inflation is spiralling out of control, but rather that it is likely to settle into a new, higher average rate. The central bank's policy shift effectively removed a key counter-pressure to price growth, a move that could prove costly in the face of rising trade tariffs and a persistent fiscal deficit in the U.S. that could put sustained upward pressure on interest rates, independent of inflation trends. We believe this marks the definitive end of the "cheap money" era and the prelude to inflation’s "second act"—a prolonged period of higher interest rates.

Inflation and Tariffs

The risks to the inflation outlook have shifted significantly to the upside. While the latest inflation data from the BLS does not yet show a significant spike from new tariffs, we believe this is likely due to a temporary "front-loading" effect. Companies rushed to import goods in the first quarter of 2025 to beat the new tariffs, contributing to a record U.S. trade deficit of $450.2 billion in Q1 2025, according to the U.S. Bureau of Economic Analysis (BEA). This surge in imports means that retailers are currently selling inventory purchased at pre-tariff prices, likely compressing consumer prices for goods for the next three to six months.

However, if these tariffs remain in place, the risk of higher goods inflation is significant. **A potential rise in goods inflation could also spill over into the services sector**, as businesses pass on increased input costs to consumers. As shown in the chart below, while headline and core inflation have moderated, services inflation remains stubbornly high. The administration's assertive trade policy, which carries the potential to reignite inflationary pressures and induce supply chain disruptions, could establish a floor for the decline in services inflation. This is a salient point, given that the service sector accounts for approximately 70% of the U.S. economy.



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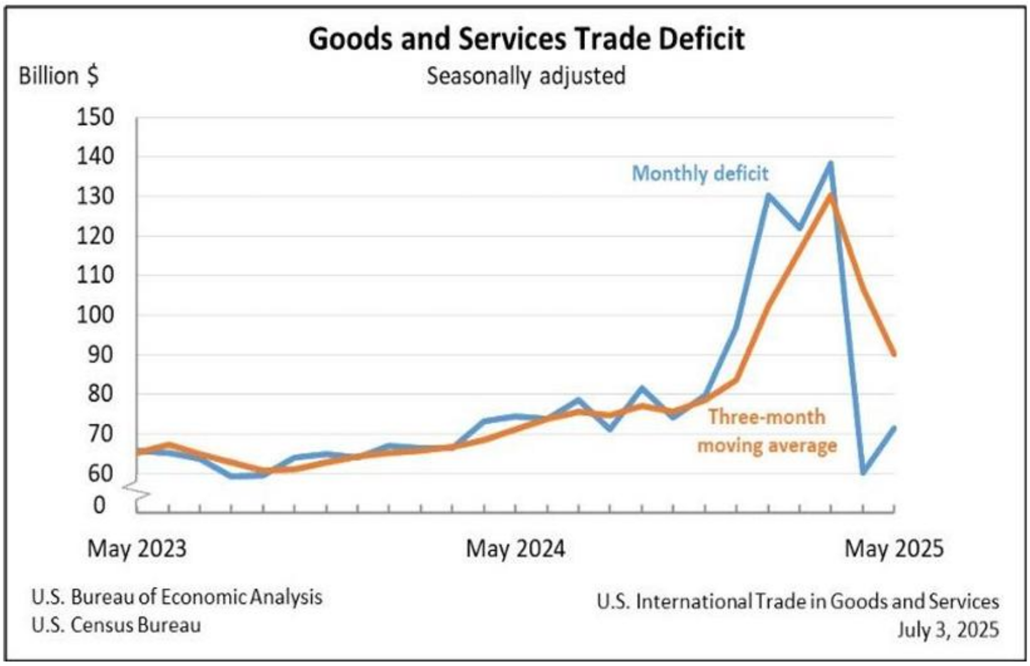


Notwithstanding these developments, we assess the current inflationary environment as more benign than anticipated in our prior edition, as the risk of uncontrolled inflation has receded. While we maintain the view that inflation is unlikely to remain near the 2% target over the long term and **will likely stabilize in the 3-3.5% range**, this level does not represent a "concerning" inflation regime in the traditional sense of a wage-price spiral. However, it does represent **a transition to a period of inflation rates exceeding the average of the preceding two decades**.

Given this outlook of higher average inflation, we continue to anticipate that short- and long-term interest rates will adjust higher. We continue to believe that the current Federal Funds rate target range of 4.25% - 4.5% represents an accommodative monetary policy stance that inherently incentivizes economic growth. Our rationale is based on the perspective that the real neutral rate is approximately 2%. In an environment where inflation stabilizes between 3-3.5% annually, we believe the nominal neutral interest rate (the rate neither stimulating nor restricting economic activity) should reside in the range of 5-5.5%. Therefore, we expect **the Federal Reserve to eventually resume its policy rate tightening cycle** to align with this range, particularly if the 2% inflation target remains elusive. Alternatively, the Federal Reserve may opt to abandon its 2% target altogether and revise its forward guidance to signal acceptance of inflation at or slightly above 3%. This latter scenario could trigger a more pronounced adjustment in market interest rates, especially the 10-year Treasury yield, as investors price in the new reality.

Rising Interest Rates and the Deficit problem

In fact, long-term U.S. debt yields have recommenced their ascent toward the 5% threshold, and we project that they could potentially trend toward 7% over the coming years. While the primary catalyst for this movement may no longer be runaway inflation or a de-anchoring of inflation expectations, the underlying weakness in long-term Treasury bonds and the associated yield increases could be driven by protectionism (higher tariffs), immigration policies[1], and more significantly by the persistent deterioration of U.S. fiscal deficit.

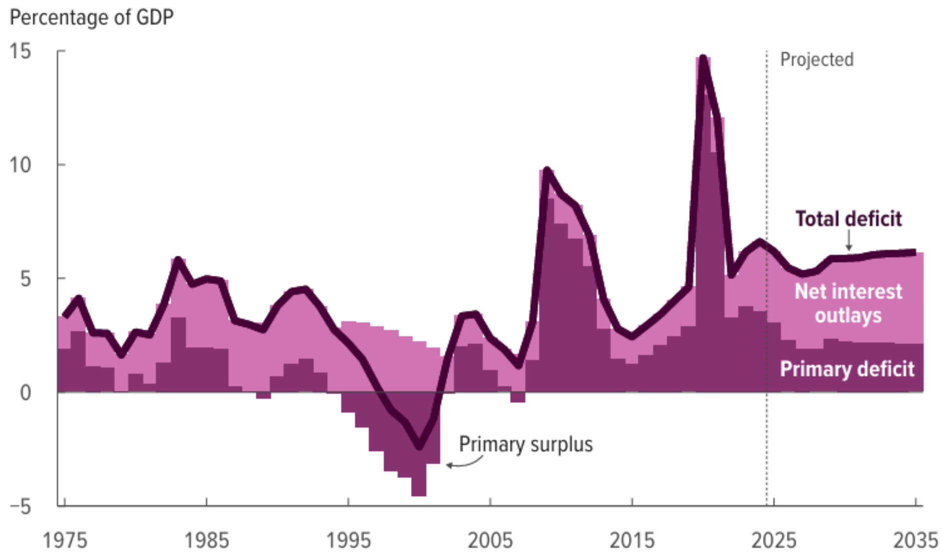
Regarding the **current account deficit, primarily driven by the trade deficit**, we assess that the administration's efforts to reduce it via tariffs are unlikely to yield significant results. The competitiveness of U.S. exports is limited, largely due to labor costs and the relatively high value of the U.S. dollar. The implementation of high import tariff rates has two possible outcomes: if tariffs are high and broad enough to deter imports, the impact will be a palpable increase in consumer prices and living costs. This outcome would be politically and socially challenging. Compounding this, persistent government borrowing and higher interest rates would further strengthen the U.S. dollar, limiting the propensity of consumers to purchase higher-priced domestic production. On the other hand, if tariffs are raised unevenly, producers and consumers will consistently find substitutes for cheap imports, creating a "whack-a-mole" dynamic where a reduction in the U.S. commercial deficit with one trading partner is offset by increases with others. We contend that the commercial deficit is a complex issue and that maintaining it, to some extent, sustains the life standards of U.S. citizens by providing access to affordable goods.

Similarly, the **fiscal deficit** presents a complex challenge. While the administration has initiated measures to curtail public expenditure through headcount reductions across various government agencies and efficiency enhancements, recent analyses[2] indicate these efforts are insufficient to achieve

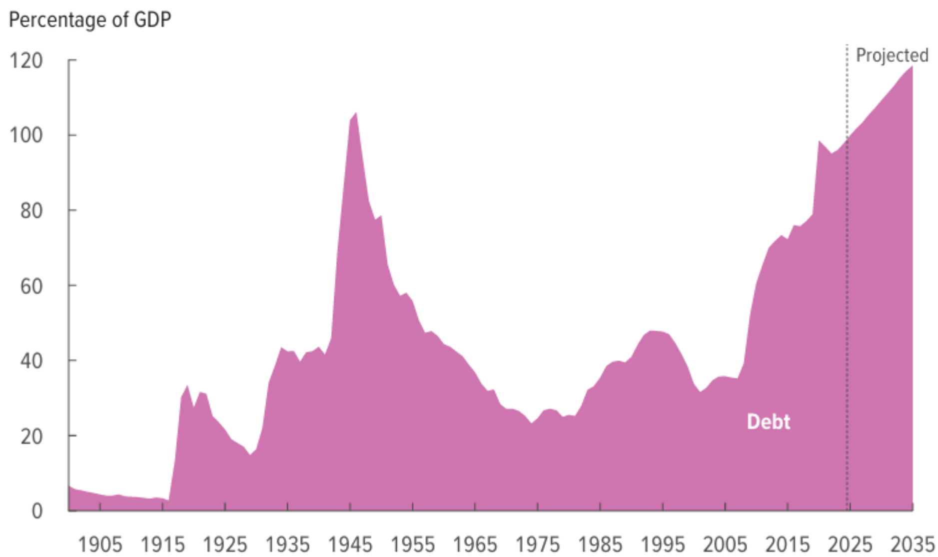
[1] We won't go deep into this argument throughout this MV edition. But the argument rests on the idea that deporting immigrants that are part of the labor force could structurally push up inflation through wage increases as labor shortages materialize. The Peterson Institute of International Economics has an interesting paper that estimates a 1.5% rise in inflation by 2028 if around 1.3M deportations take place during the actual administration. The number rises significantly to 9.1% by 2028 if the number of deportations rise to 8.3M. Just to dimension the problem, the administration is aiming for 15-20 million deportations; but perhaps it is more realistic a 2 to 5 million deportations.

[2] For reference on budget implications, we recommend you look into the Congressional Budget Office (CBO) website (https://www.cbo.gov/) and search for their recent "Cost Estimates" or "Analyses of Legislation". Particularly the following publications: "Information Concerning the Budgetary Effects of H.R. 1, as Passed by the Senate on July 1, 2025" and "H.R. 1, One Big Beautiful Bill Act (Dynamic Estimate)". Regarding tax cut

budgetary balance, especially as tax cuts are simultaneously extended. Indeed, the most recent budget proposal which has recently been approved by Congress and signed by the President, is projected to further exacerbate the public deficit as spending cuts are not offsetting the reduced revenue from administration-led fiscal stimuli. **The fiscal deficit is projected to grow to 7% of GDP** and debt as a percentage of GDP is projected to grow from 100% GDP to 130% in the coming 10 years. That is substantially above CBO latest projections:



Source: Congressional Budget Office (CBO) "The Budget and Economic Outlook: 2025 to 2035"



Source: Congressional Budget Office (CBO) "The Budget and Economic Outlook: 2025 to 2035"

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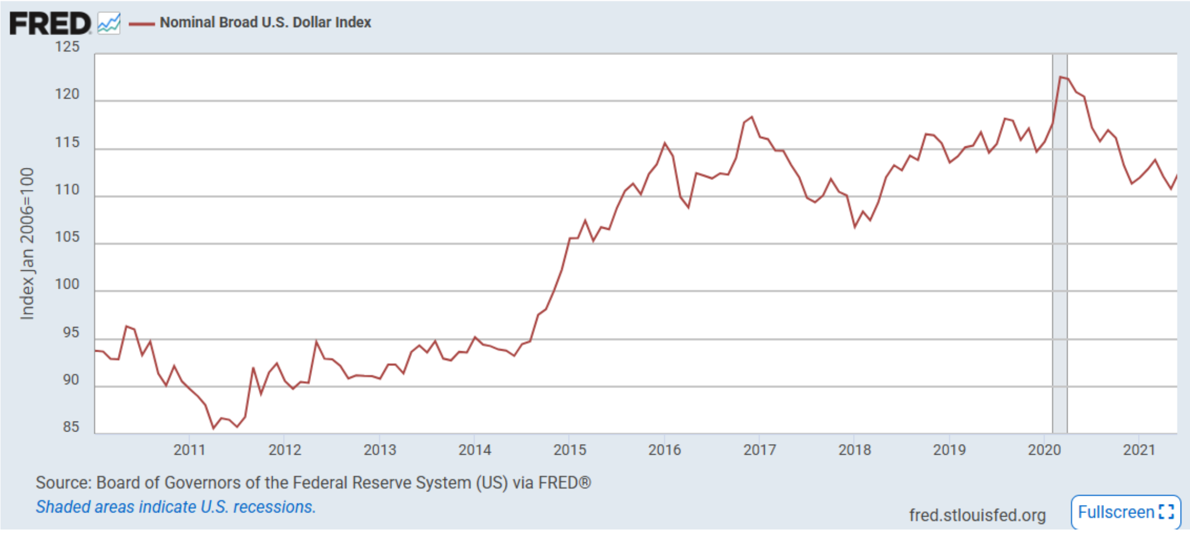
extensions visit Tax Policy Center official website (https://taxpolicycenter.org/) to find analyses related to the Tax Cuts and Jobs Act (TCJA) of 2017 and its potential extensions, which are highly relevant to current debates about expiring tax cuts.

We believe that the administration's optimal strategy to tackle the deficit problem lies not only in spending and tax adjustments, but also in focusing on the balance of payments (instead of the trade balance) by enhancing the global competitiveness of U.S. services. Efforts should be directed toward attracting foreign investment to bolster the dominant service-based economy, further globalizing its financial and insurance systems, consulting services, and technology-driven industries. Competing effectively in these sectors, rather than focusing on a 20th-century growth model based on manufacturing, is crucial. Attracting financial capital to support investment in these high-growth sectors could help compensate for a negative balance in trade and grow the U.S. economy, thereby helping to alleviate fiscal pressure. Absent a strategic pivot in this direction, a meaningful improvement in the problematic fiscal and trade deficit is unlikely.

Consequently, upward pressure on long-term interest rates is expected to persist. Financing the fiscal deficit will require increased debt issuance, exerting upward pressure on rates. Concurrently, the deteriorating public balance sheet will continue to strain government finances and raise concerns regarding the U.S. government's debt servicing capacity. Any capital outflows that stem from the lost confidence in US, could aggravate the situation by increasing borrowing costs at both the public and private levels. This movement will likely be gradual but discernible. We do not foresee an imminent debt crisis, nor do we believe such a catastrophic scenario is proximate. However, underlying vulnerabilities are beginning to appear. Moody's recently became the latest agency (following Fitch in 2023 and S&P in 2011) to downgrade the U.S.'s credit rating in May 2025, underscoring the prevailing concerns.

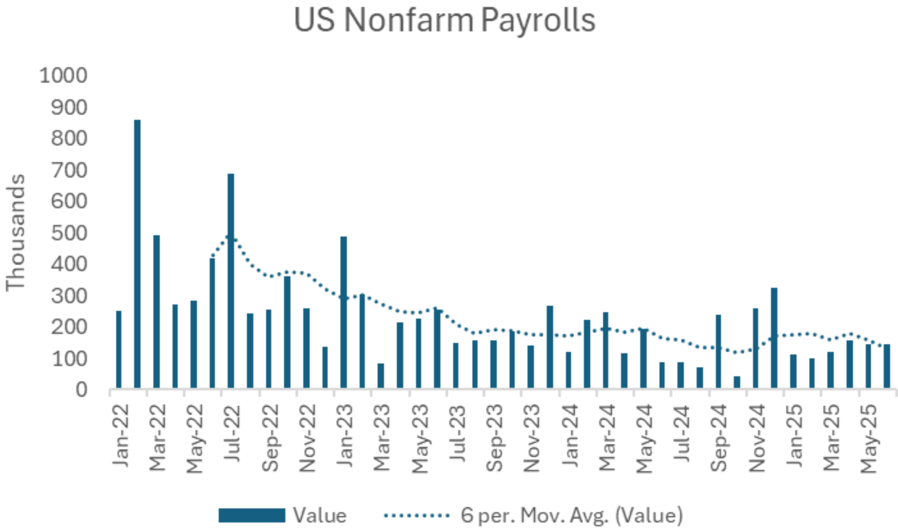
While the dollar might lose some value as global capital flows aim for diversification, we expect those flows to balance eventually, based on higher and more attractive interest rates in the U.S. Confidence in the U.S. might deteriorate, but it is unlikely to disappear overnight, at least not until there is a clear alternative. The U.S. is still the world’s largest economy with the most reliable currency, and in terms of growth, the economy remains resilient.



No worrisome weakness in the economy, no counter force to rising rates

In the short and mid-term, we do not anticipate a recession in the United States. We consider the deceleration observed in the first half of 2025 as a cyclical adjustment following the robust growth experienced in 2024. Employment figures remain robust. According to the BLS Employment Situation Summary for May 2025, nonfarm payroll employment increased by 139,000, which is similar to the average monthly gain of 149,000 over the prior 12 months, indicating a moderating but still healthy pace of job creation. The unemployment rate has risen to 4.2% but has remained within a narrow range around this level since July 2024, indicating no concerning upward trend. Furthermore, consumer spending, despite decelerating from growth rates near 4.8% annually at the end of 2024, continues to expand at a healthy pace. On the production front, leading indicators from the Institute for Supply Management (ISM) show that manufacturing has begun to exhibit contraction, while the services sector has stagnated, but we are still not on a clear path to recession. Only perception-based and sentiment indicators, such as consumer confidence, have begun to signal a sensible weakness. While noteworthy, this is insufficient to warrant a more pronounced economic slowdown at this juncture. We see uncertainty as the main catalyst of this recent deterioration in sentiment, and while it might slow growth in 2025, we expect the U.S. economy to find its way out sooner than later as the administration's policies causing this uncertainty face limitations structurally.

If growth acceleration crystalizes in the US towards the next year, the pressure on short- and long-term interest rates should be reinforced. Something we expect to play a crucial role in financial asset's repricing.



Other dynamics around the world that reinforce rising rates

What's happening in Japan is highly relevant in this context. The resurgence of inflation in previous years and its re-acceleration earlier this year have led the Bank of Japan (BoJ) to backtrack on its Yield Curve Control policy. This policy involved the indiscriminate purchase of government bonds to stimulate the economy and maintain low long-term interest rates on sovereign debt instruments—a policy that had been in place for three decades.

In a previous edition of the MacroView, we discussed the key consequences of ending this program, and these appear to be materializing. **Japan's long-term bonds are experiencing significant price declines and yield increases as the central bank's demand withdraws**. To put this into perspective, the Bank of Japan already holds 52% of all government bonds issued, which amounts to roughly $4.1 trillion in Japanese bonds. Since the second half of 2024, the BoJ has intentionally reduced demand for sovereign debt, something that has resulted in an increased supply entering the market that isn't being absorbed, causing prices to fall and yields to rise. For instance, the 40-year bond reached a yield of 3.5% at the end of May, up from 1.3% two years ago.

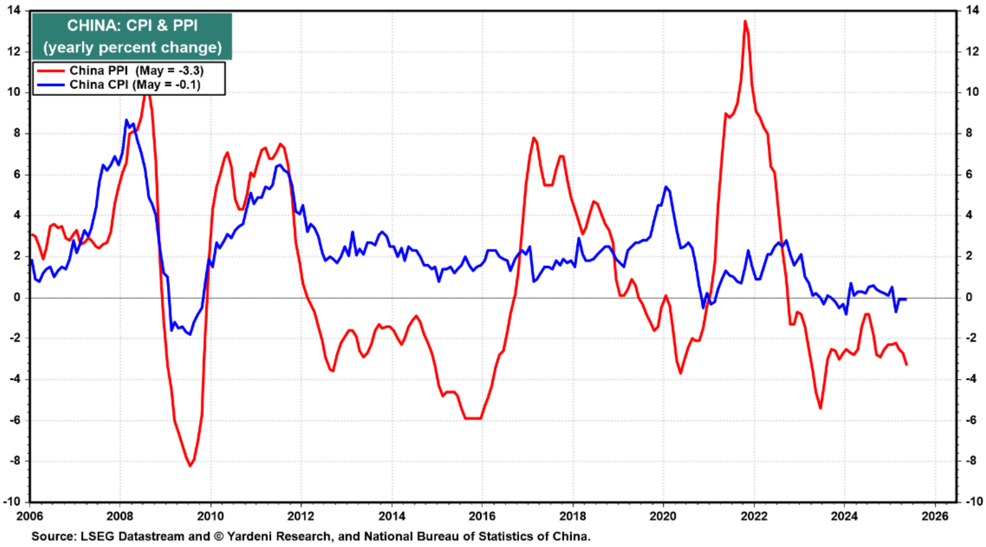
As the cost of debt rises in Japan, the repercussions for an excessively indebted government will be severe. Japan is one of the most indebted countries globally, and the fiscal pressure from rising interest rates will undoubtedly impact the Asian country's growth, especially as its economy is already in a recession.

Our primary concern, however, is what could happen outside Japan if the upward trend in Japanese sovereign bond yields continues. We believe this dynamic is fundamental for the global bond market and could reinforce a worldwide environment of increasing interest rates. In a world deeply immersed in debt, this is concerning. Higher interest rates could lead to defaults and debt crises at corporate, commercial, and sovereign levels. While we don't see an imminent risk of crisis, the global financial system's vulnerability is undoubtedly very high if interest rates were to surge.

The silent crisis in China

The economic outlook in China presents an even more challenging picture than in the United States or Japan. Not only does it carry a significant burden of public and private debt, but the persistent real estate crisis keeps the economy mired in a worrying deflationary environment. Contrary to our expectation of a robust recovery in 2025, the signs of improvement since the end of 2024 are still unclear. Consumer confidence remains at low levels, reflected in weak retail sales performance, a clear indication of a silent but palpable economic crisis.

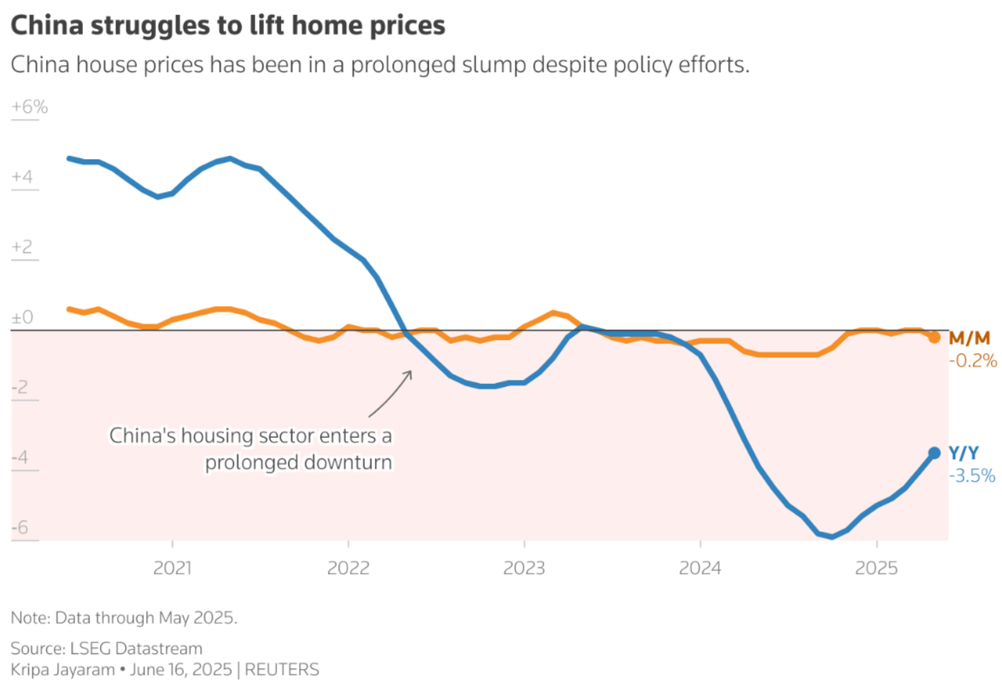
While the official GDP growth target of around 5% for 2025 might be achieved, the fundamental pillars of this expansion continue to be exports and infrastructure investment, while domestic demand suffers from a marked weakness. **This divergence has led to a deflationary environment, a troubling symptom for the world's second-largest economy**. The Consumer Price Index (CPI) has shown negative year-on-year rates, with a decrease of -0.2% in April 2025, prolonging a trend that raises concerns about the health of consumption and investment.



This growth model driven mainly by external factors and state investment appears unsustainable in the long term. The export sector faces increasing headwinds, exacerbated by US trade policy. Despite market diversification, such as the notable 15% year-on-year increase in exports to ASEAN in April 2025, exports to the United States, which experienced a 21% year-on-year contraction in the same period, remain a crucial component for the dynamism of this sector. The other engine, infrastructure investment, historically dependent on state financing, is beginning to show significant limitations.

China's central government debt is estimated at 60.5% of GDP, but when considering a broader metric that includes the debt of local governments and other related entities, this figure rises to a concerning 124% of GDP. The economic growth of recent decades was based on aggressive investment in construction, financed mainly by government borrowing, especially at the local level. However, the current real estate crisis has placed many local governments in a precarious financial situation, restricting their financing capacity and, therefore, their ability to continue driving growth through investment. While Beijing hare implemented debt swap programs to alleviate pressure on local governments, **the scope of these measures is limited and does not represent a definitive solution to the underlying problem.**

Even more alarming is the level of non-financial debt, which stands at a high 312% of GDP, while private debt is projected to be close to 194% of GDP. These levels of indebtedness severely limit China's ability to stimulate growth through credit expansion. Despite recent cuts in benchmark interest rates and the easing of requirements for obtaining mortgage loans, monetary stimuli are not significantly reactivating investment or consumption. Recent data on new credit growth supports this observation. After a rebound in March 2025, new yuan loans fell drastically in April to CNY 280 billion, the lowest level for that month in two decades, demonstrating the reluctance of both businesses and consumers to incur new debt. **The fall in property prices, persistent economic uncertainty, and the potential for high real interest rates (exacerbated by deflation) seem to have disincentivized credit demand from households and corporations**. While there is also a greater risk aversion on the part of lenders, especially after the turmoil in the real estate market.



With a limited fiscal and monetary capacity to aggressively stimulate the economy, the prospects for a significant rebound in domestic consumption and overall growth are uncertain. Aggressive fiscal stimulus would imply an even greater increase in debt levels, intensifying existing credit risks. On the other hand, monetary stimuli have proven insufficient given low consumer confidence and limited willingness to borrow. In this context, China seems headed for a slow process of adjustment, and the timing of a rebalancing remains unknown.

Final Thoughts

Against this landscape, shaped by the aforementioned dynamics, the crucial question for investors is what market participants will favour in the coming months: **an attractive interest rate environment in the U.S. driven by elevated rates, potentially leading to a resurgence of the dollar and the continued prevalence of U.S. exceptionalism; or the growing allure of other markets, as we increasingly navigate a multipolar world less reliant on U.S. financial, economic, and political leadership.** If the U.S. deficit problem aggravates further, will there be viable alternatives? While a definitive answer remains elusive, portfolio diversification is undoubtedly a prudent strategy. In the short term, we anticipate capital flows gravitating towards economies characterized by robust domestic markets, limited reliance on exports, strong and liquid currencies, openness to capital flows, and deep financial markets. Institutional strength will also play a pivotal role in positioning countries as credible alternatives. However, any movement out of the U.S. is likely to occur in waves. Should policies like those advocated by the Trump administration persist in the U.S., capital could continue to migrate; conversely, if such policies face limitations or are reversed, compelling reasons for capital to return to the U.S. will emerge. Successfully navigating these shifting tides will be paramount for investment success in this evolving global landscape.

Alternate Scenarios

1. **A Deep US Recession –** This is our main alternate scenario. Should economic data and sentiment significantly deteriorate, this scenario warrants serious consideration. A contraction in US growth would fundamentally alter the landscape, particularly for short-term interest rates. A weaker US economy would likely compel the Federal Reserve to implement deeper rate cuts. While this might initially appear positive for risk assets, its outcome is far from certain. In such a downturn, fiscal deficit concerns could escalate, accelerating a pronounced portfolio diversification away from US assets. This would manifest as a correction in US equity prices, while US long-term interest rates could paradoxically rise. This presents a highly challenging environment where investment portfolios would face limited alternatives (perhaps only precious metals) and necessitate rapid repositioning to mitigate losses.

Investment opportunities

Alternatives to the USD and US T-Bills — For portfolio diversification, we recommend reducing U.S. Dollar exposure in favour of other liquid currencies like the Euro and the Yen. For investors seeking attractive yields on short-term debt, currencies such as the Australian, Canadian, and New Zealand Dollars offer compelling options.

Precious Metals — Despite the strong rally in Gold over the past year and a half, we still advise maintaining a position, whether through futures, ETFs, or Gold Miners. As a classic safe haven asset, gold remains a crucial alternative to the U.S. Dollar. For those willing to accept higher risk, Silver and Platinum are in earlier stages of their appreciation cycles and, in our view, present excellent opportunities.

Semiconductors and chip components — Recent market fluctuations present opportune windows in this sector. We advise maintaining or building positions in semiconductor and chip component firms, whether through individual stocks or sector ETFs. As the foundational building blocks of modern technology, semiconductors remain crucial for virtually all electronic devices. For those willing to accept higher risk, firms focused on AI, 5G, IoT, and EV technologies are in earlier stages of their appreciation cycles and, in our view, present excellent opportunities due to their continuous innovation and increasing global demand. Quantum computing-related stocks also present opportunities, though any investment decision here would be more speculative than the aforementioned choices.

China and India Equity — We maintain a strongly positive outlook on the Chinese equity market. Although the economic crisis has not yet been fully overcome, the market appears to have bottomed out, and we are confident a significant rebound is the most likely outcome after years of declines. We have a particular preference for the technology sector. In India, equity prices have retraced after a strong rally in 2024, creating favorable entry points for a continued bullish trend. At the macro level, we are highly supportive of India's outlook, noting its robust domestic market, falling interest rates, and strong signs of industrialization. We find the financial, construction, and healthcare sectors particularly attractive.

Emerging Equity Markets — We are actively scouting for opportunities in solid Emerging Markets or those recovering from periods of high stress. This includes the equity markets of Argentina and Brazil, which show strong signs of recovery from past volatile episodes. For investors seeking markets with solid macroeconomic fundamentals, a deeper look into Indonesia, Taiwan, Vietnam, or Poland could be highly rewarding.

Agricultural commodities — A very important space to watch once growth reactivates in China and other emerging markets.

Short US sovereign long-term debt — Our conviction trade remains unchanged: we expect yields on long-term US government bonds (those with maturities of 10 years or more) to continue their ascent. We therefore recommend favouring short-term fixed-income investments and building positions that benefit from rising long-term yields.

For any questions or any further information in the outlook, please feel free to Contact us at: info@fesc-am.com . We will be glad to be in contact with you and discuss.

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