Déjà vu all over again?

From the front page of this weekend's WSJ:

Trump to Impose New China Levy

President retaliates against rare- earth restrictions, threatens to cancel Xi meeting

By Gavin Bade, Lingling Wei and Brian Schwartz

President Trump said he would hit China with a 100% additional tariff and impose new export controls on critical software products after Beijing placed restrictions on the export of rare-earth minerals, hours after his threats of retaliation sent the S&P 500 to its worst day since April.

The new measures would take effect Nov. 1, Trump said in a Truth Social post. The export controls would affect "any and all critical software," he wrote. The measures could take effect even sooner, he said, "depending on any further actions or changes taken by China."

"It is impossible to believe that China would have taken such an action, but they have, and the rest is History," Trump wrote.

After months of trade talks with China, U.S. officials were cautiously optimistic the two sides had made progress. But China's announcement about the new controls Thursday elicited shock and anger within the White House.

Some members of the administration want to effectively restart trade talks from zero with Beijing, according to people familiar with the thinking, and U.S. Treasury Secretary Scott Bessent and U.S. Trade Representative Jamieson Greer, who have led the talks, are particularly incensed.

The renewed conflict shows that despite months of a tariff truce and repeated meetings between Chinese officials and Trump's team, relations between the world's two largest economies remain volatile and can erupt into crisis with little warning.

Still, a critical window for negotiation remains open in the escalating dispute. There is a month between Trump's Nov. 1 start date for tariffs and Dec. 1, the date Beijing set for new controls on rare-earth exports. The staggered deadlines provide a potential off-ramp for both sides to de-escalate tensions before the punitive measures are enacted.

Trump appeared to leave room for Beijing to step back from its new export controls, saying Friday evening that he had purposely set the imposition date for tariffs a few weeks in the future.

"That's why I made it November 1, we'll see what happens," Trump said.

Earlier Friday, Trump threatened to cancel an expected summit with Chinese leader Xi Jinping in South Korea later this month, blaming Beijing's new rare-earth measures.

Though Trump later suggested he would still be open to a meeting, the threat surprised some Beijing officials, who didn't anticipate the action would place the summit at risk. While Beijing remains confident, China analysts say, the unintended threat to the summit could give the Chinese leadership a reason to delay or walk back the measures.

U.S. stocks fell sharply on Trump's first threat Friday, with the tech-heavy Nasdaq losing more than 3.5%. The S&P 500 fell 2.7%, in its biggest one-day decline since April 10, while the Dow Jones Industrial Average lost nearly 900 points. Stocks had set record after record in recent weeks with investors betting that the worst of the trade war was over.

China's decision to strengthen its export controls was part of a calculated action to demonstrate Beijing's leverage over the U.S. economy and force Trump to the negotiating table with a weaker hand, The Wall Street Journal reported this past week. Beijing officials see Trump as eager to make a deal, but the Chinese have so far been unable to get the U.S. to agree to the full removal of tariffs and export controls.

The U.S. had agreed in August to place another 90-day pause on the 145% tariffs but the deadline for that agreement is mid-November, shortly after the U.S. Supreme Court will hear a case about the legality of many of Trump's levies. The U.S. and China have often celebrated trade talks, regularly noting progress between both sides, but a longterm deal has proved elusive.

Some administration officials have been quietly mulling countermeasures against China for months to deploy if relations between the two economies went sour, said a person familiar with the plans. Those include measures to protect U.S. infrastructure from Chinese incursion and further limit the ability of Chinese companies to invest in the U.S.

After Thursday's announcement, U.S. officials are also mulling the use of sanctions and additional export controls as a way to try to block China's access to U.S. markets.

The flare-up over export controls is a repeat of a dispute that Washington and Beijing supposedly resolved months ago. Earlier this year, Beijing tightened export controls on the minerals, causing alarm among U.S. industries from automotive to defense. Trump's team responded with export controls of their own on components upon which China relies on the U.S.

Vice Premier He Lifeng believed an informal "freeze" on new export controls had been agreed upon following recent talks in Madrid, according to people familiar with the discussions. But that understanding was shattered when the U.S. introduced new controls on foreign-owned companies.

Although the U.S. government provided Beijing with advance notice of the rule, and the Chinese initially seemed to acquiesce, a decision was made by Xi himself to hit back—and hit back harder, the people said.

The Chinese action could have far-reaching consequences for the U.S. economy. Earlier this year, U.S. automakers warned they would have to cease production in many factories if they didn't receive rare-earth magnets from China. They said stoppages could be as widespread as during the Covid-19 pandemic.

Though Beijing views its actions as a justified response, the retaliation may have backfired. "I don't think they anticipated that the summit would be in jeopardy," said Yun Sun, director of the China program at the Stimson Center, a Washington think tank.

China's stranglehold on rare earths vital to the technology in U.S. products prompted the threat of new tariffs from Trump.

From Global Investment Strategy on October 8th:

Fourth Quarter 2025 Strategy Outlook: Still On The Tightrope

I. Macroeconomic Outlook

Where We Went Wrong

Former Citigroup CEO Chuck Prince famously said in July 2007 that "as long as the music is playing, you've got to get up and dance."

He was not completely wrong. Being early on a call is nearly indistinguishable from being wrong on the call.

After being an optimist on the US economy for most of the time since 2009 – including in 2022 and 2023 when most investors were expecting a recession – I turned pessimistic in 2024, ultimately shifting my recommended stance on stocks to a modest underweight midway last year. At the time of that downgrade, I predicted that the US would enter a recession by the end of 2024 or early 2025.

That did not happen.

Where did I go wrong? Three things stand out:

• I underestimated the resilience of the US economy. This includes the strength of private-sector balance sheets, lingering pandemic savings, the lock-in effect from fixed-rate mortgages, and the general reluctance of firms to fire workers after having experienced severe labor shortages just a few years ago.

• I underestimated the stimulative nature of fiscal policy, supercharged most recently by the OBBBA and hints that President Trump will return tariff revenue to taxpayers.

• I underestimated the intensity of the AI boom. This boom has supported capital spending. It has also lifted stocks to unprecedented highs, generating a sizeable wealth effect in the process.

When will the music stop playing? No one can know for sure, but the odds that it will happen imminently have dipped over the past few months. Accordingly, we are revising down our 12-month US recession probability from 60% to 50%. We think the probability of a severe slowdown in the rest of the world has also fallen.

In Search of Goldilocks

Still, the global economy is nowhere close to being out of the woods. A 50% probability is well above the unconditional average of 12% since 1960 (calculated as the percentage of months that the US has been in an NBER-defined recession).

The remaining 50% also includes a scenario where the US economy overheats. Excessively strong growth would likely postpone a recession beyond the next 12 months but would arguably make the ensuing downturn even worse by forcing the Fed to raise rates again. We assign 20% odds to such a scenario, leaving a true soft-landing scenario with only a 30% chance.

A Weakening US Labor Market Suggests That Ice Is More Likely Than Fire

The higher odds that we assign to overcooling relative to overheating reflects our view that the headwinds to growth, at least for now, outnumber the tailwinds.

For one, the US labor market continues to cool. Average nonfarm payroll growth in the three months to August stood at 29K. Outside of health care, it was -30K (**Chart 1**).

The 3-month change in the index of aggregate hours worked in the private sector was down 0.2% in August. This series rarely turns negative outside of recessions (**Chart 2**). The government shutdown has delayed the release of the September jobs report, but the ADP reading pointed to a decline of 32K in private-sector employment during the month.

Some commentators have argued that weak employment growth is simply a function of slower labor force growth, owing to the tightening in immigration policy. There is some truth to that, but it overstates the case. If a shrinking labor supply were the main culprit, we would expect to see the smallest job gains in the sectors facing the biggest supply constraints. In fact, we see the opposite: The job openings rate is amongst the highest in the health care sector; yet, that is where employment growth has been the most resilient.

The fact that job openings are falling in most industries suggests that labor demand is declining faster than supply. The ongoing deterioration in perceptions of job availability in The Conference Board survey is consistent with this observation. So, too, is the fact that the ranks of discouraged workers are rising. The number of people who are not in the

CHART 1

Outside Of Health Care, US Employment Is Falling

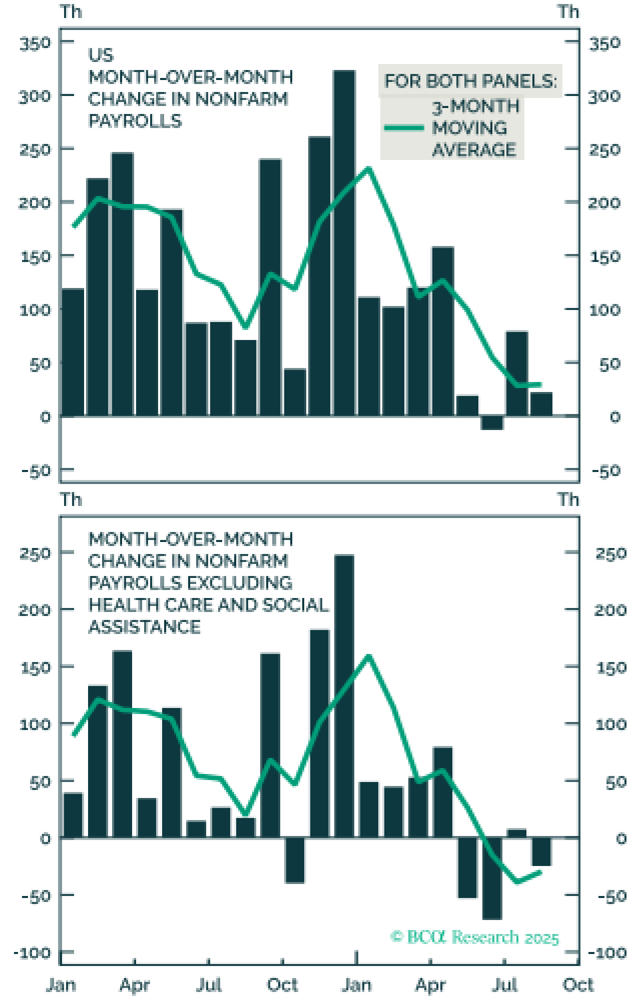


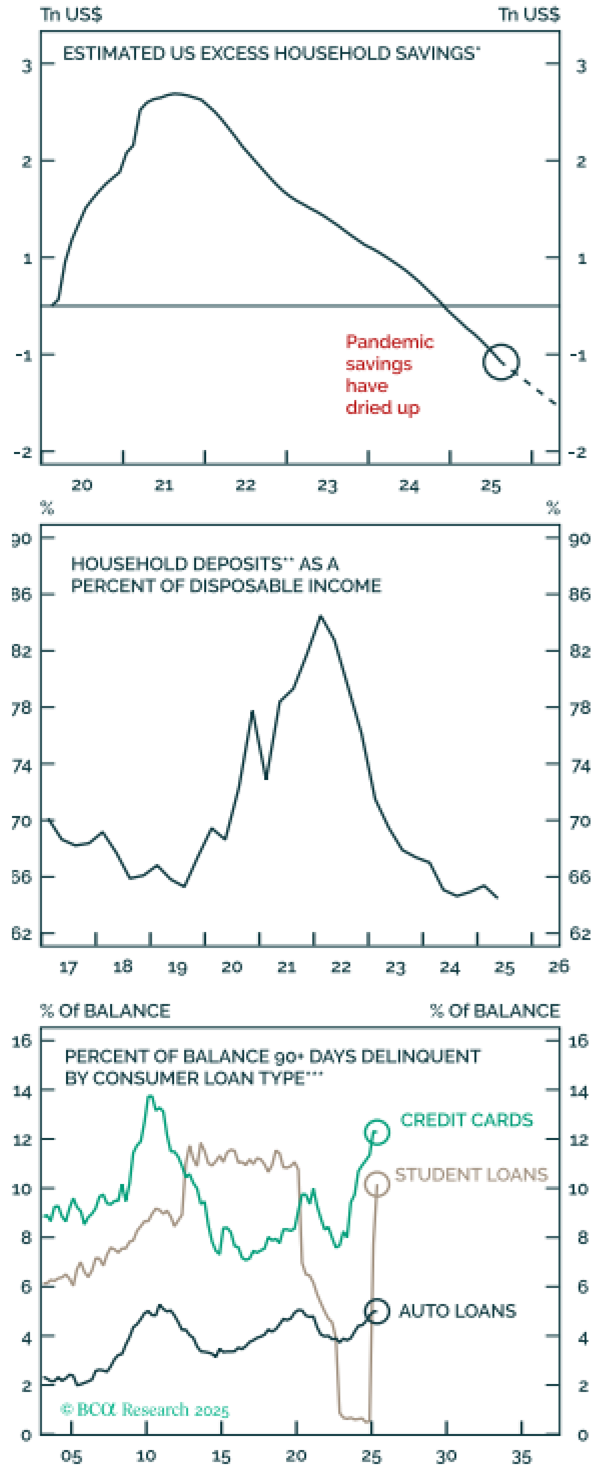
CHART 2

A Decline In Aggregate Hours Worked Often Spells Trouble

SOURCE: BUREAU OF LABOR STATISTICS (BLS).
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS. SERIES SHOWN AS 3-MONTH MOVING AVERAGE, TRUNCATED AT -2% AND 3%. CIRCLES IN THE CHART DENOTE THE TIMES WHEN THE SERIES FELL BELOW ZERO. DATA FROM JUNE 1964 TO MARCH 2006 USES AGGREGATE WEEKLY HOURS WORKED INDEX FOR PRODUCTION AND NON-SUPERVISORY EMPLOYEES.

labor force but still want a job has increased by 875K since January. Had those folks been included in the official unemployment tally, the unemployment rate would have increased by 0.76 percentage points since then. …

CHART 7
The Consumer Is Facing Headwinds



* SOURCE: "DATA REVISIONS AND PANDEMIC-ERA EXCESS SAVINGS", H. ABDELRAHMAN AND L. OLIVEIRA, FEDERAL RESERVE BANK OF SAN FRANCISCO, NOVEMBER 8, 2023.
** HOUSEHOLD AND NONPROFIT ORGANIZATIONS' CHECKABLE DEPOSITS, CURRENCY, AND TIME AND SAVINGS DEPOSITS.

We only have official job openings data until August. Real-time data from Indeed, however, suggest that openings dropped in September.

US Consumption: Resilient, But for How Long?

Real consumer spending reaccelerated to 2.5% in the second quarter. The Atlanta Fed's GDPNow sees real PCE expanding by 3.2% in the third quarter.

Although the evidence is still very tentative, spending looks to have cooled towards the end of Q3. Using big data, the Chicago Fed estimates that retail sales ex auto were flat in September. Real incomes are growing more slowly than spending.

Real disposable income was up 1.9% year-over-year in August. However, income growth has slowed sharply over the past few months. Real personal disposable income was down 0.4% in August compared to April (excluding transfers, it was down 0.1%).

Inflation is picking up and is likely to exceed 3% later this year. Given that nominal wage growth is around 3.5%, this means that real wages are barely growing. Sluggish real wage growth coupled with sluggish employment growth will translate into sluggish real income growth.

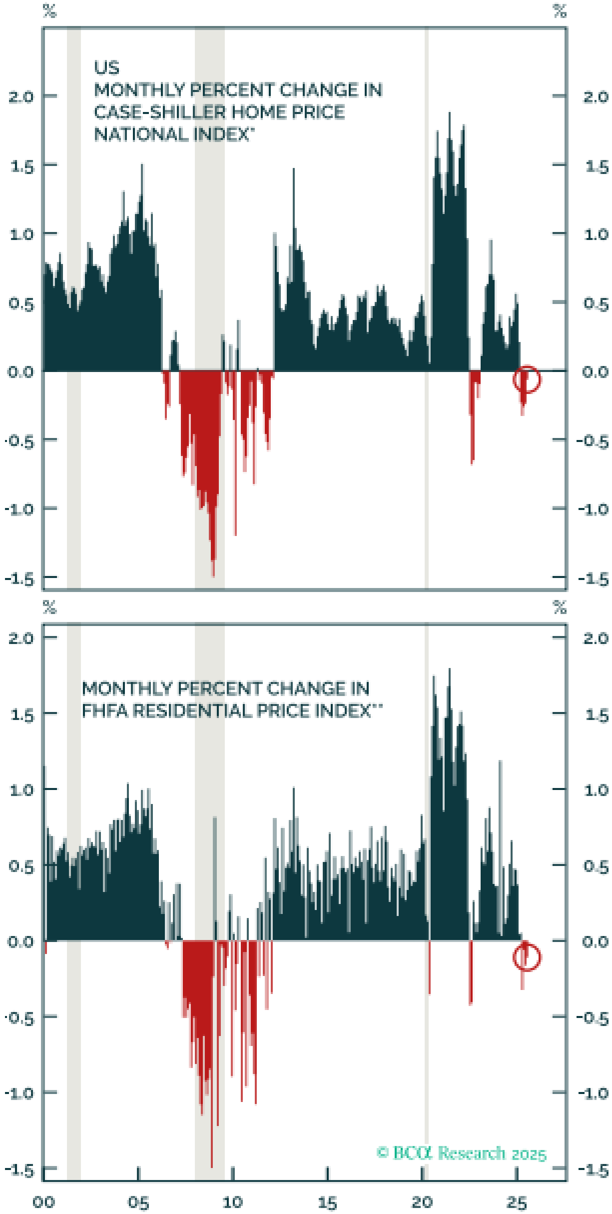
Unlike a few years ago, households no longer have a treasure trove of spare cash (**Chart 7**). As a share of disposable income, bank deposits are back to pre-pandemic levels. Credit card and auto loan delinquency rates are close to their GFC highs. Student loan defaults have soared as debt moratoria have lapsed.

What consumers do have is paper wealth, thanks to a record-high stock market and elevated home prices (Chart 8). These gains can be rather fickle, however. In the case of home prices, both the Case-Shiller index and the FHFA index have been falling since March/April (**Chart 9**). Despite a 70 bps drop in mortgage rates since the start of the year, the number of active sellers has increased relative to the number of active buyers (**Chart 10**). If equity prices start to fall too, the economy could experience something akin to the 2001 recession. That recession was more the result of a stock market collapse than the cause of one.

The AI Boom: Getting Long in the Tooth?

CHART 9

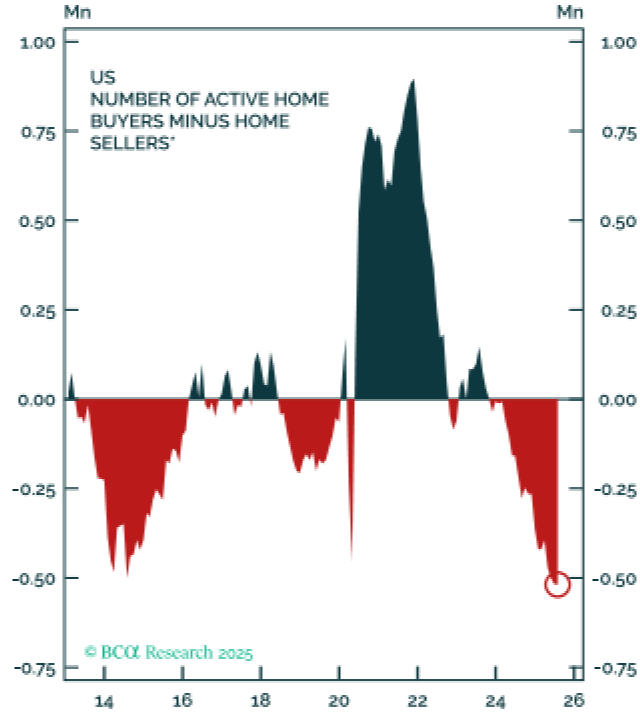
US Home Prices Have Fallen In Recent Months



* SOURCE: S&P GLOBAL.
** SOURCE: FEDERAL HOUSING FINANCE AGENCY.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.
SERIES ARE TRUNCATED AT -1.5%.

CHART 10

The Number Of Active Sellers Relative To Buyers Is Still Increasing



* DATA PROVIDED BY REDFIN, A NATIONAL REAL ESTATE BROKERAGE.

In 2001, falling equity prices led to a severe decline in equity wealth and a pullback in capex spending. Could the same thing happen to the AI boom?

The answer is yes. Investors may end up being mistaken about two key aspects of the AI trade. The first is how economically transformative AI will be; the second is how profitable it will be, even if it does end up having a big economic impact.

On the first question, the jury is still out. Today's Large Language Models (LLMs) could be a stepping stone to superintelligence, or they could just be one in a long series of innovations that incrementally raise productivity. For what it is worth, if you ask ChatGPT whether progress in LLM innovation is accelerating or decelerating, it seems to think the latter.

A recent study by McKinsey noted that while nearly 80% of companies are now using generative AI, the same fraction has derived no benefit to their bottom line from it. Another study by researchers at MIT found that 95% of companies had seen no gains from their AI investments. Adoption rates of AI appear to have dipped recently, although a rising number of firms still expect to increase AI usage over the next six months.

It is possible, and indeed even probable, that we are just seeing some teething pains in AI adoption, and that AI will ultimately have a significant beneficial effect on productivity growth. But that brings us to the second question: Will companies actually make a lot of money from it?

AI Productivity Does Not Equal AI Profits

If there is one mistake that investors routinely make it is that they underestimate the importance of market structure in determining corporate profits. The productivity gains from the rollout of the internet appeared in the US around 1995. However, it was not until 2005 – just as productivity growth was starting to come back down – that the profits from the internet began to materialize.

Arguably, those profits had less to do with innovation and more to do with market power. Companies such as Meta were able to harness so-called network externalities – people used Facebook because that was what everyone else was using. This created a natural monopoly for Meta.

In addition, tech companies such as Google and Microsoft were able to capitalize on scale economies. Once a powerful search engine or a valuable piece of software is created, expanding the userbase for these technologies is very cheap. In the language of economics, the fixed cost is high but the marginal cost is low. This means that average costs fall as the userbase expands, making it difficult for new entrants to compete.

The problem is that AI does not benefit as much from either network externalities or economies of scale. When you are interacting with an AI, you are interacting with the model and not with other users. This means that if OpenAI or any other AI company raise prices, you can simply move to a cheaper alternative. And there is plenty of competition to choose from, as all LLMs use the same underlying neural transformer technology and rely on basically the same training set: the corpus of the internet.

Moreover, adding users to an AI system is quite costly, as it requires constructing data centers, purchasing GPUs, and paying increasingly high electricity bills. This means that average costs do not fall dramatically with increased usage as they do for software and social media.

In that respect, today's AI systems look a bit like airlines. We could not have a global economy without airlines. Yet, because they offer a commoditized product and are capex and energy intensive, airlines rarely make money outside of situations when the demand for air travel is extraordinarily high.

Right now, the demand for "compute" is extraordinarily high. But just as airlines purchase more planes when demand is high, AI companies are investing billions in computing capacity. Today's huge profit margins in cloud computing are cyclical, not structural. They will come back down when the supply of computing power catches up to the demand.

Don't Drink the AI Kool-Aid

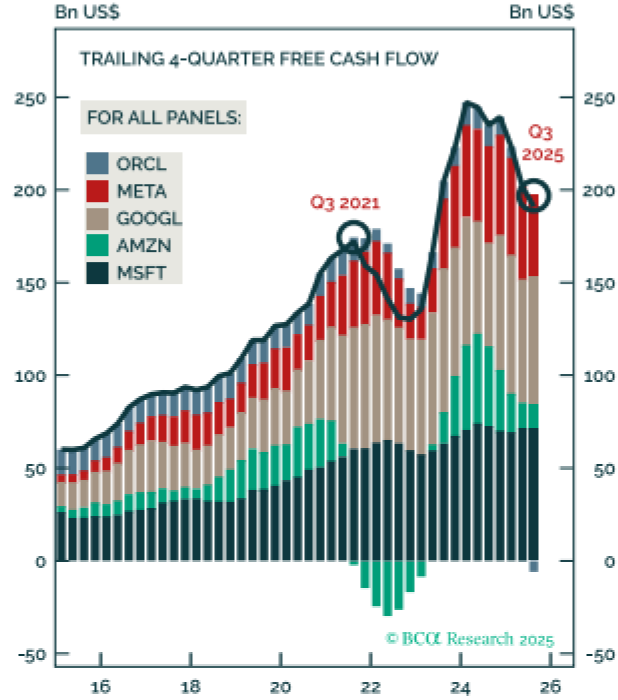
Second derivatives matter for markets. According to analyst estimates, hyperscaler capex growth is peaking. Granted, those estimates could be revised higher, but that would require AI companies to find new sources of revenue to justify their investments.

This will be difficult to achieve. A recent study by Bain & Co. concluded that the ongoing AI capex spending spree can only be justified from a profitability perspective if hyperscalers end up raking in $2 trillion in new annual revenue by 2030. As a recent story in the Wall Street Journal noted, that would exceed the combined sales of Amazon, Apple, Alphabet, Microsoft, Meta, and Nvidia in 2024. It would also be more than five times as large as today's entire global subscription software market.

Free cash flow generation amongst the hyperscalers is already declining because capex is rising faster than operating cash flows (**Chart 13**). The same happened to telecom companies towards the tail end of the dotcom bubble.

For now, we are still in the phase where the stock market is happy to reward any company that announces its intention to throw more money at AI. Not surprisingly, many companies are announcing their intention to throw more money at AI. But once that narrative changes, all those multibillion-dollar capex announcements will dry up in the blink of an eye. Actual capex will follow with a lag.

CHART 13
Free Cash Flow Amongst Hyperscalers Is Declining



SOURCE: BLOOMBERG FINANCE L.P.

The Odds of Overheating

What if the music does not stop anytime soon and the AI bubble continues to inflate, all while the Fed is cutting rates and fiscal policy is turning more stimulative as the provisions of the One Big Beautiful Bill Act come into effect?

At least initially, such an outcome might be welcomed by investors since the resulting tailwinds to economic activity would counteract the headwinds from slowing real income growth, a weakening housing market, the oversupply of office space, and a dearth of manufacturing construction outside of the AI sphere. However, the risk is that the pendulum swings too far, causing the economy to overheat again.

Beyond tracking the overall flow of the economic data, investors should keep an eye on inflation expectations. So far, they remain reasonably well contained. While the 1-year CPI swap implies that inflation will rise over the coming months, the 1-year, 1-year forward swap implies that it will fall back towards the Fed's target by 2027.

Consistent with the CPI swap market, 5-year, 5-year forward inflation breakevens are sitting at a reasonably tame 2.31%. The Cleveland Fed's monthly model of 30-year inflation expectations, which synthesizes data from Treasury yields as well as market- and-survey-based measures of inflation expectations, stood at 2.4% in September.

In addition to monitoring inflation expectations, investors should be on the watch for an acceleration in wage growth since this could set in motion a wage-price spiral. So far, such a spiral has not broken out: The Employment Cost Index, average hourly earnings, the Atlanta Fed's Wage Growth Tracker, and private-sector measures from the ADP and Indeed all show that wage growth is broadly stable.

Europe: Muddling Along

Euro area growth is expected to clock in at 0.1% (unannualized) in Q3, after registering 0.1% growth in Q2 and 0.6% in Q1.

Unlike US households, European households have plenty of excess savings. The personal savings rate stands at 15%. Relative to the pre-pandemic savings trend, households hold around €2.5 trillion in excess savings.

Bank balance sheets are in reasonably healthy shape. Lending growth has picked up, albeit from a tepid pace.

Less favorably, the euro area's trade surplus with the US has tumbled after soaring earlier this year. Although the region secured a trade "deal" with the US, it still faces a punishing tariff rate.

Increased competition from China is adding to the pressure. Chinese exports to the EU were up 11% year-over-year in July, even as the EU's exports to China fell by 8%. A stronger euro has not helped matters.

Germany has felt the brunt of increased Chinese competition. By their own admission, German companies are less competitive now than at almost any other time in history.

Granted, the German government has ramped up fiscal stimulus. Once off-budget special funds are included, Germany's budget deficit should increase from 1.3% of GDP in 2023 to 2.8% of GDP in 2026.

Outside of Germany, however, the scope for fiscal stimulus is limited. France, Spain, Italy, Belgium, and Greece all have government debt-to-GDP ratios exceeding 100%.

Moreover, the long-term fiscal outlook across Europe is highly challenging. In Germany, there are 70% more people between the ages of 55 and 64 as there are between 15 and 24. Who is going to pay for their health care and pensions?

A skill-based immigration system would help, but that is the opposite of what Europe has. According to the OECD, labor market participation among immigrants is lower across most of the region than among the native-born. Educational achievement is also far lower, even among second-generation immigrants.

Structurally, I remain a Europe doomer.

China: Deflationary Pressures Amid Tech Progress

Tariff front-running boosted Chinese exports earlier in the year. Recent data, however, suggest that export growth has begun to slow. Outbound container shipping rates are at a two-year low. Highway truck volume traffic, which tends to correlate with exports, is contracting.

The housing market remains in dire straits. While home sales have stabilized to some extent, housing starts are in freefall. The latter are down 72% from their peak.

By some estimates, China may have as many as 90 million vacant apartments. In its 2024 forecast, which once again may turn out to be too optimistic, the UN projected that China will lose 700 million workers through to the end of the century. It is hard to imagine housing demand recovering in such an environment.

Despite a shrinking working-age population, the labor market remains weak. Youth unemployment has risen and recruitment surveys point to a slowing hiring trend.

Soft labor and housing markets are weighing on consumption. Durable goods spending slowed again in September as passenger car sales slumped and the growth in appliance sales fell into negative territory.

The government's response has been tepid. On the positive side, the authorities have increased fiscal spending. However, the combined credit/fiscal impulse is still only 2% of GDP – well short of what the economy requires. The government's "anti-involution" measures, designed to curb overproduction and price wars, may help in the long term, but will reduce output in the short run.

The one true bright spot has been tech. China's diligent and educated workforce is leading the way in robotics and making great strides in areas such as AI and biotech.

This is a key reason why tech-heavy offshore stocks have outperformed their onshore counterparts.

II. Financial Markets

A. Global Asset Allocation

Underweight Equities On A 12-Month Horizon (But Agnostic In the Near Term)

Watching the stock market rally can feel a lot like watching snow build up on the side of a mountain. You know that eventually there will be an avalanche, but there is no way to know which snowflake will trigger it.

So, what is one to do? Do you enjoy the view or do you move to safety? It depends on how nimble you are.

The blow-off phase is often the most profitable part of any equity bull market. Getting out early can be costly.

… I am agnostic about the near-term direction of stocks but see the risks as being tilted to the downside over a 12-month horizon. …

B. Equities

Valuations Don't Matter Until They Matter

There is an old adage that says stocks take the staircase up and the elevator down. While valuations rarely determine when a bull market ends, they can heavily influence how severe the ensuing bear market will be.

The S&P 500 currently trades at 22.7-times forward earnings. The forward P/E ratio today is similar to what it was in 2021. But the 10-year TIPS yield was near -1% back then. Today, it is 1.76%. Relative to bond yields, the earnings yield on stocks has never been so low outside of the dotcom bubble.

It is also worth noting that trailing S&P 500 profit margins were 7.7% in 2000. Today, they are 13.5%. Forward margins, which bake in faster expected earnings growth than sales growth, are even higher. On a price-tosales basis, the S&P 500 trades 61% above its dotcom peak. …

Large cap growth stocks have outperformed small cap growth stocks by a wide margin over the past seven years (**Chart 37**). As was the case following the collapse of the dotcom bubble, a fizzling of the AI trade will probably set in motion a major rotation away from growth stocks to value stocks and from large caps to small caps.

CHART 37

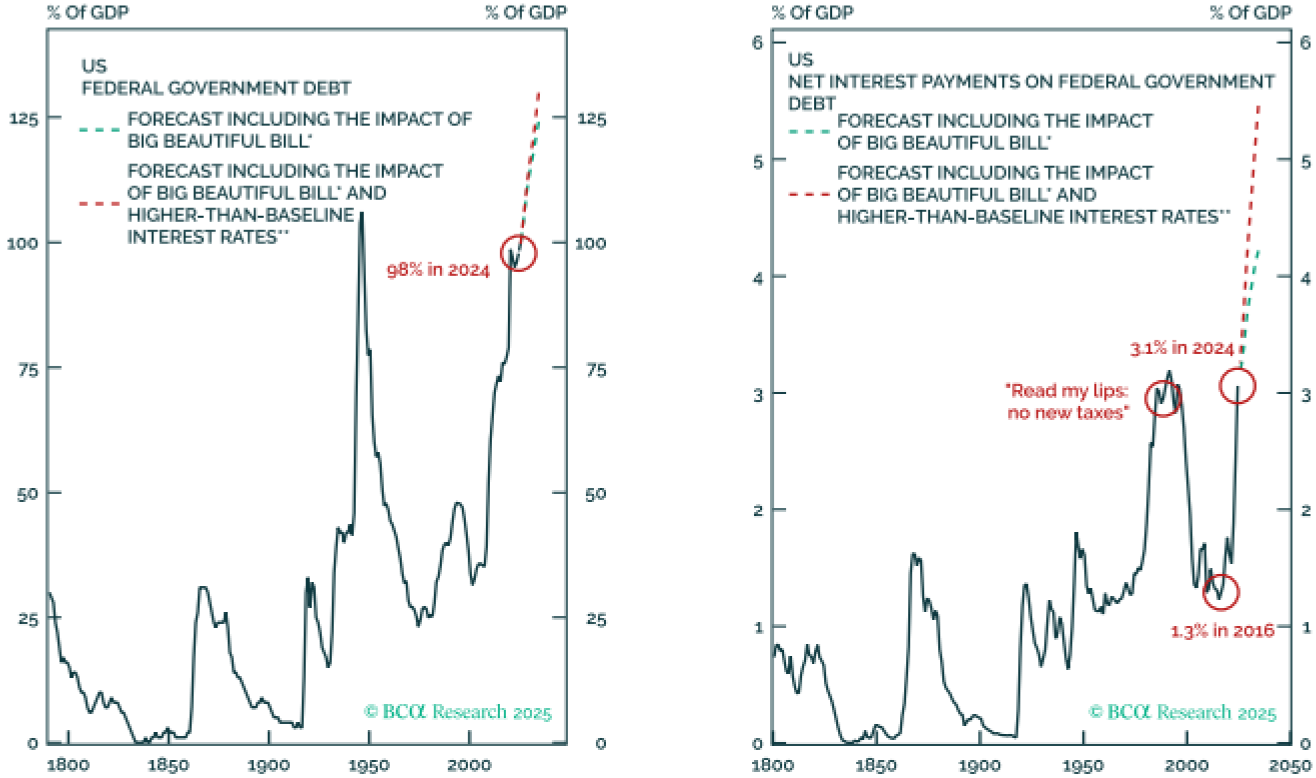
Look For Opportunities To Go Long Value And Small Caps

C. Fixed Income

Unsustainable Debt Dynamics Are A Risk

… The federal government surplus was 2.3% of GDP going into the 2001 recession while government debt was only 55% of GDP. Today, that surplus has turned into a deficit of about 6% of GDP and debt of 122% of GDP. Even in the absence of another round of fiscal stimulus, a recession could push the deficit towards 8% of GDP. This could cause US debt dynamics, which are already awful, to worsen further (**Chart 39**). It is difficult to know how bond investors would react to such an outcome. Admittedly, if yields were to rise, the Fed could step

CHART 39
Unsustainable Debt Dynamics In The US



* CALCULATIONS BASED ON ESTIMATES FROM "DEBT-SERVICE EFFECTS DERIVED FROM H.R.1, THE ONE BIG BEAUTIFUL ACT", CBO (JUNE 2025).
** ASSUMES THE AVERAGE INTEREST RATE ON FEDERAL DEBT IS RAISED ABOVE THE BASELINE BY A DIFFERENTIAL THAT STARTS AT 10 BASIS POINTS IN 2025 AND INCREASES BY 10 BASIS POINTS IN EACH SUBSEQUENT YEAR UNTIL IT REACHES 1% IN 2034.
SOURCE: US CONGRESSIONAL BUDGET OFFICE.

in and buy bonds. However, such a move would carry its own risks, especially if the Fed's actions were seen as politically motivated. In particular, inflation expectations could rise, sowing the seeds for a wageprice spiral. Considering how unpopular inflation is with the general public, the government might feel compelled to introduce price controls. Trump has already threatened companies that raise prices due to tariffs, so this would not be that far-fetched.

Structural Forces No Longer Bond-Friendly

Beyond the fiscal issues, at least two major disinflationary structural forces are morphing into inflationary ones.

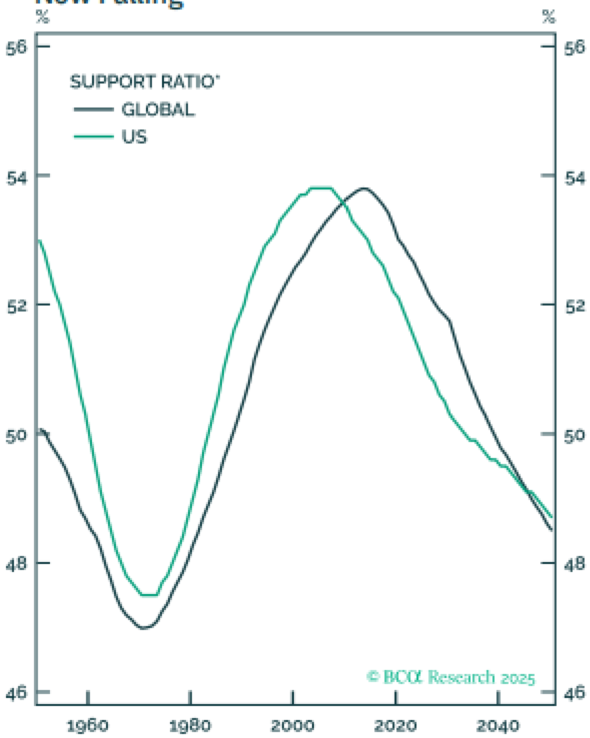
The first structural force revolves around demographics. The ratio of workers-to-consumers rose steadily in the US and around the world during the 1980s, 1990s, and 2000s, as more women entered the labor force and the number of dependent children per household declined. More recently, these so-called "support ratios" have begun to fall as baby boomers retire (**Chart 40**).

Consumption increases in old age once health care spending is included in the tally (**Chart 41**). As baby boomers transition from being savers to dissavers – and hence, transition from producing more than they consume to producing less than they consume – national savings will decline and inflation could rise.

The second potentially inflationary force is deglobalization. The shift to freer trade allowed the price of many imported goods to steadily fall over time. That trend began to stall out after the GFC and then went into reverse, first with the pandemic supply-chain disruptions and then with the Trump tariffs.

CHART 40

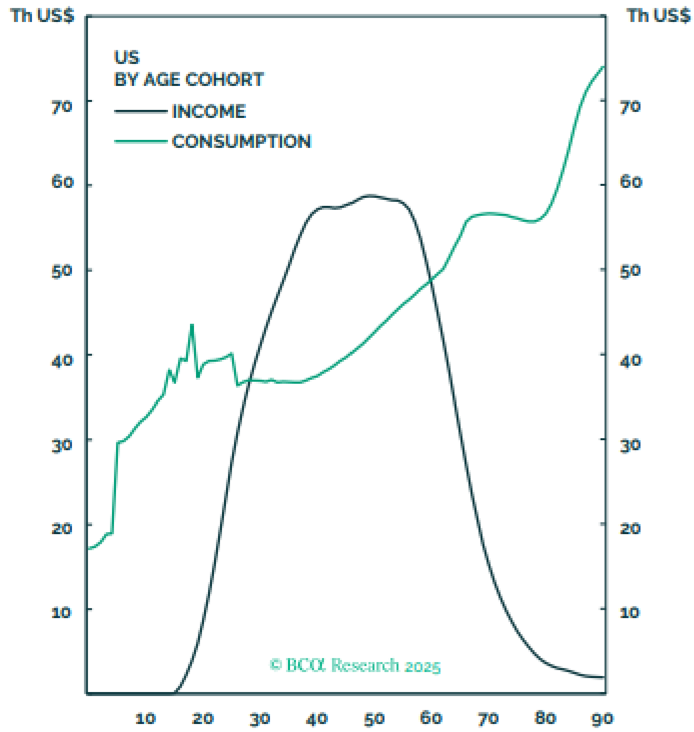
The Ratio Of Workers-To-Consumers Is Now Falling



* NUMBER OF WORKERS RELATIVE TO NUMBER OF CONSUMERS. NUMBER OF WORKERS INCORPORATES AGE-SPECIFIC VARIATION IN LABOR FORCE PARTICIPATION, UNEMPLOYMENT, HOURS WORKED, AND PRODUCTIVITY. NUMBER OF CONSUMERS INCORPORATES AGE-SPECIFIC VARIATION IN NEEDS OR WANTS BASED ON AGE-SPECIFIC CONSUMPTION DATA. THEY ARE ALSO REFERRED TO AS 'EFFECTIVE WORKERS' AND 'EFFECTIVE CONSUMERS'. GLOBAL MEASURE IS SHOWN AS A GDP-WEIGHTED AGGREGATE OF 46 COUNTRIES.
SOURCE: NATIONAL TRANSFER ACCOUNTS.

CHART 41

Consumption Increases In Old Age Once Health Care Spending Is Included



SOURCE: UNITED NATIONS, NATIONAL TRANSFER ACCOUNTS.

Services PCE inflation excluding energy and housing was 3.4% year-over-year in August. Without help from falling goods prices, the Fed will struggle to reach its 2% inflation target (**Chart 42**).

The bottom line is that weaker growth would probably push down inflation and bond yields temporarily. However, barring a sustained increase in productivity growth, both could spring up again once the economy recovers.

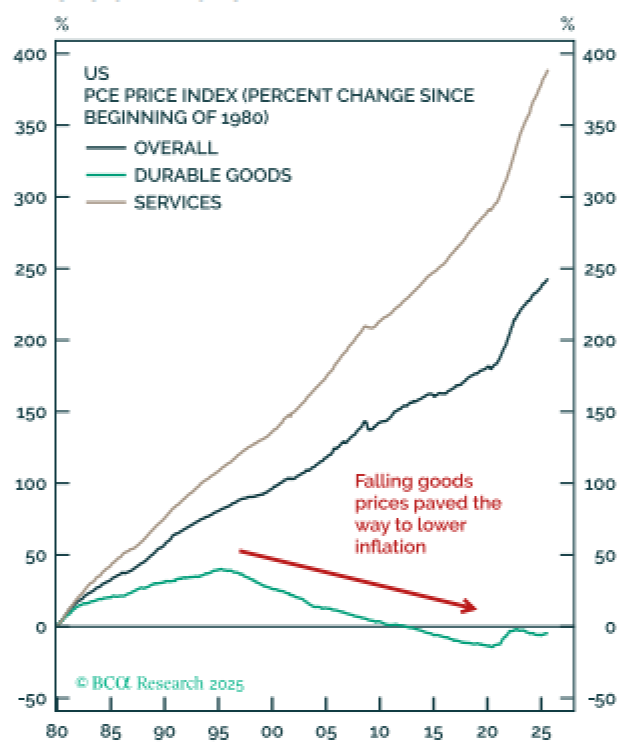
E. Commodities

Near-Term Unfavorable Supply/Demand Picture for Oil

The near-term outlook for oil prices remains challenging. As discussed earlier in this report, the risks to global growth are to the downside, which is negative for oil prices. While China's crude imports have risen, this appears to be driven by stockpiling rather than stronger end-use demand.

CHART 42

Falling Goods Prices Helped Push Down Overall Inflation

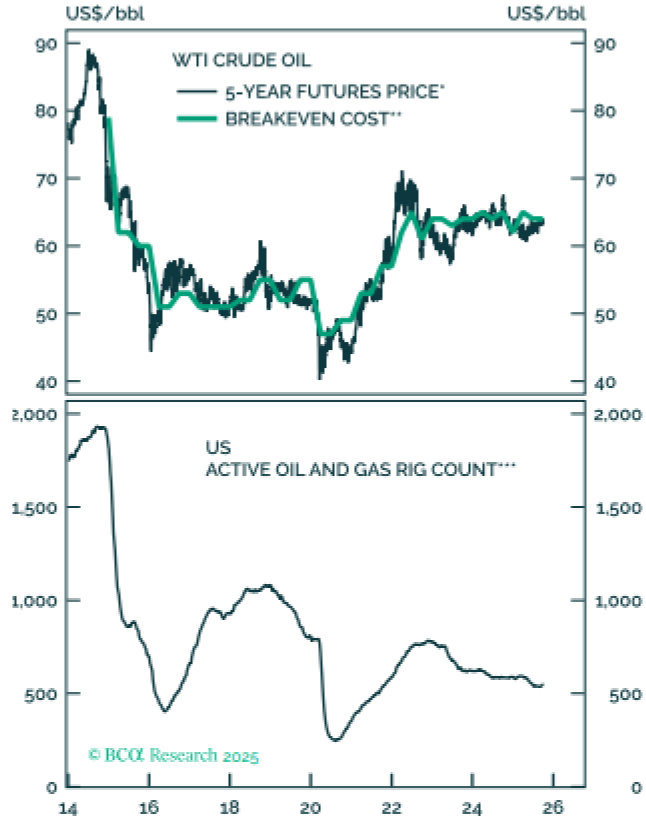


SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).

On the supply side, OPEC has lifted production quotas in order to regain market share. The fact that President Trump has been pushing for lower oil prices has probably also affected OPEC's calculus. According to the US Energy Information Administration (EIA), OPEC's spare capacity currently stands at 3.8% of production, roughly double what it was in mid-2022.

Despite an escalation of Russia-NATO tensions, Russian crude exports climbed to a 16-month high in September. While official Russian crude exports to India have declined after the US imposed an additional 25% duty on Indian imports, this has been counterbalanced by an increase in Russian exports to "unknown destinations." BCA's Chief Commodity Strategist, Roukaya Ibrahim, suspects that this may reflect disguised Russian shipments to India.

CHART 64
US Shale Is The Main Anchor For Oil Prices



* SOURCE: CHICAGO MERCANTILE EXCHANGE (CME).
** SOURCE: FEDERAL RESERVE BANK OF KANSAS CITY. FIRMS WERE ASKED WHAT OIL AND NATURAL GAS PRICES WERE NEEDED ON AVERAGE FOR DRILLING TO BE PROFITABLE ACROSS THE FIELDS IN WHICH THEY ARE ACTIVE.
*** SOURCE: BAKER HUGHES.

US Shale is Now The Marginal Setter of Oil Prices

Over the past decade or so, the marginal price setter in the oil market has transitioned from OPEC to US shale. That has made oil prices less volatile because shale production tends to be more elastic with respect to price.

The current breakeven price of US shale producers is about $64/bbl (**Chart 64**). Now that oil prices have fallen close to breakeven, drilling activity has declined. According to data from Baker Hughes, North American rig count has dropped from 784 in late 2022 to 549.

While a deceleration in global growth would push oil prices down even further, prices would probably drift back up once growth revives.

Gold: The Trend is Your Friend (For Now)

The price of gold is up 53% since the start of the year and 91% since the end of 2023. In real terms, gold prices are now above their 1980 peak.

There is no doubt that the price of gold is stretched and that the risk of a correction has risen. Nevertheless, we still contend that gold remains in the middle innings of a structural bull market.

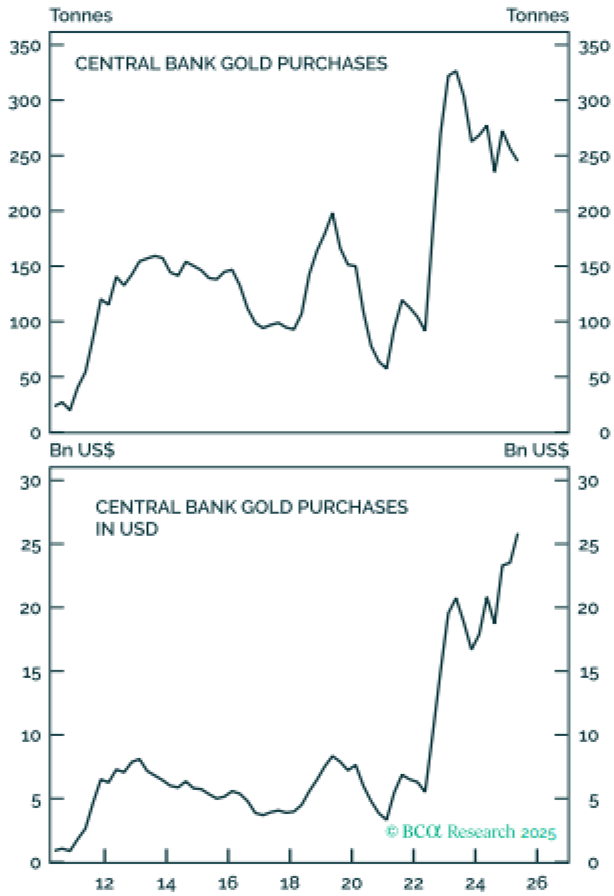
Concerns about government solvency in the major economies will not go away anytime soon. Nor will lingering worries about the US dollar's role as a reserve currency.

The share of gold in China's foreignexchange reserves has increased from 1% in 2008 to around 8%. That fraction is likely to keep rising. As a whole, central banks continue to buy gold at twice the prepandemic pace (**Chart 66**).

Ultimately, gold prices will stop rising when investors decide that they hold enough of the yellow metal. That may not occur anytime soon. The volume of gold held by the major US-based ETFs, such as the GLD, has been rising this year but is still below where it was in 2022 (**Chart 67**). As a share of global wealth, the value of all

CHART 66

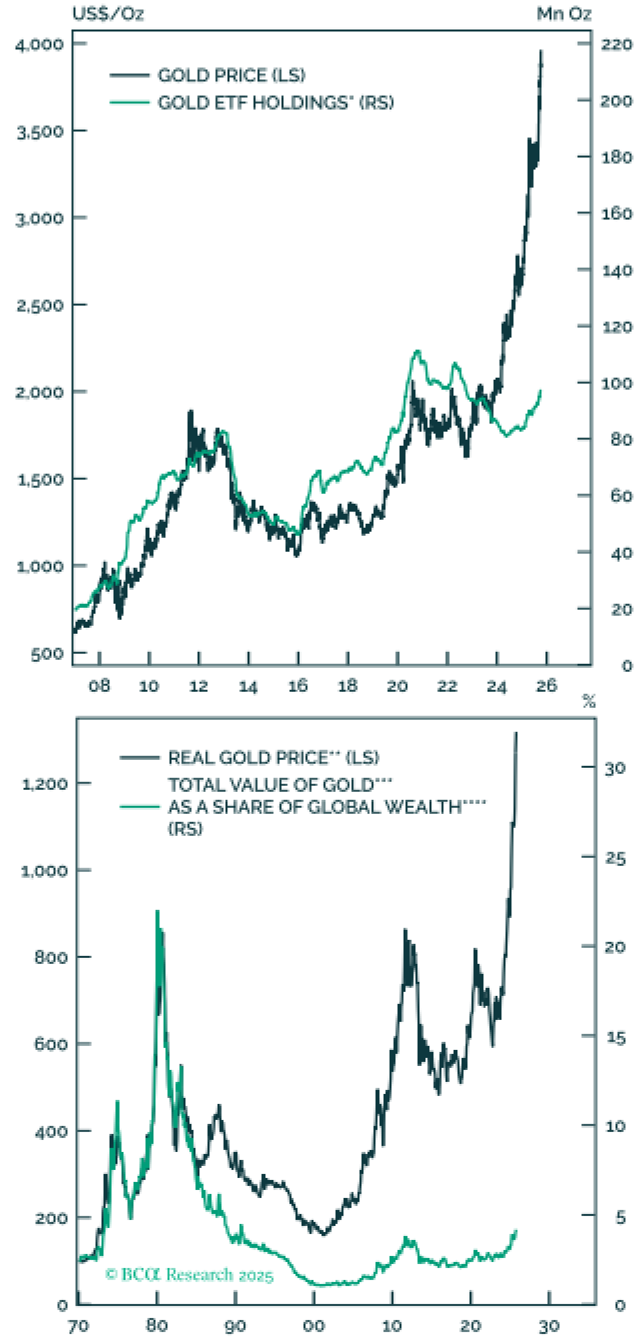
Central Banks Still Bullish On Gold



SOURCE: METAL FOCUS AND WORLD GOLD COUNCIL.
NOTE: SERIES ARE SHOWN AS 4-QUARTER MOVING AVERAGES. PURCHASES IN VALUE TERMS ARE CALCULATED BY MULTIPLYING THE PURCHASES IN VOLUME TERMS BY THE AVERAGE LBMA GOLD PRICE FOR EACH QUARTER.

CHART 67

While Real Gold Prices Are At Record Highs, Gold Allocations Are Still Modest



* SOURCE: BLOOMBERG FINANCE L.P.
** DEFLATED BY HEADLINE CPI, IN AUGUST 2025 US DOLLARS. SERIES REBASED TO JAN 1970 = 100.
*** GOLD PRICE MULTIPLIED BY TOTAL STOCK OF GOLD SUPPLY. SOURCE: METALS FOCUS, WORLD GOLD COUNCIL, US GEOLOGICAL SURVEY, AND BCA CALCULATIONS.
**** SOURCE: CREDIT SUISSE, MSCI INC. (SEE COPYRIGHT DECLARATION), OECD, AND BCA CALCULATIONS.

above-ground gold still stands at a fairly modest 4%. For reference, gold's share of global wealth briefly exceeded 20% in the early 1980s. By that measure, gold prices still have upside.

HCM's view on gold, as detailed on our website, hasn't changed. From Friday's Markets A.M.:

Why Gold Will Lose Its Luster

By Spencer Jakab

Investors' latest shiny object is an actual shiny object.

The price of gold has beaten U.S. stocks, bitcoin and even shares of AI wonder-stock Nvidia this year. There's no saying how far that epic run will go, but there are almost certainly better places to park your savings in the long run. History and common sense tell us so.

Yes, gold is the original money and has been very handy in a crisis. Yes, unlike that dollar in your pocket, it isn't anyone else's liability. And its price has zigged when other investments have zagged—also a good thing.

Just don't dream of getting rich on gold, especially after its latest epic run above $4,000 an ounce. Years ago, Warren Buffett pointed out the absurdity:

"(Gold) gets dug out of the ground…then we melt it down, dig another hole, bury it again and pay people to stand around guarding it. It has no utility. Anyone watching from Mars would be scratching their head."

Buffett is old enough to have lived through three stretches when the metal absolutely smoked stocks: the early 1930s, during the inflationary 1970s and in the first decade of this century. Underlying economic conditions were totally different in each period.

But your timing had to be almost perfect because the times in between were long and painful. From 1928 through the end of last year, a dollar invested in gold grew to less than $13,000; a dollar in the S&P 500 with dividends reinvested would have grown to nearly $1 million and small-capitalization stocks to almost $5 million. Even corporate bonds would have done four times as well as gold.

The latest gold fad has been dubbed "the debasement trade." As WSJ economics columnist Greg Ip explained this week, there's a growing fear of central banks losing inflation discipline, eroding currencies' value.

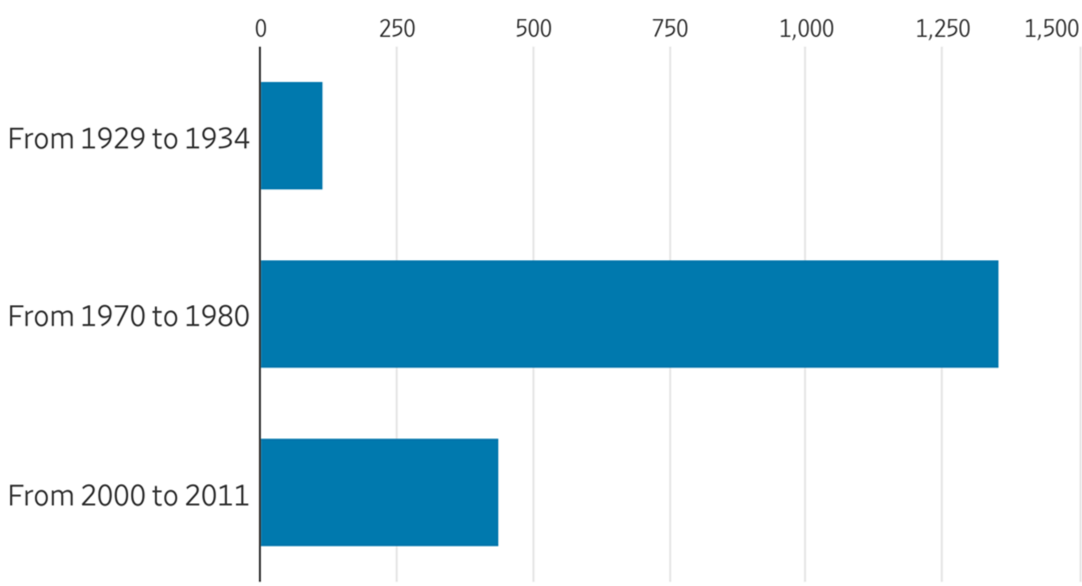
Not every investor thinks so: Investing columnist James Mackintosh points out that inflation expectations baked into bond prices are subdued.

It's true that economic and market conditions have rarely been as good for hard assets like gold to shine, at least compared with other investments. Stocks have almost never been so expensive and sovereign-debt levels look unsustainable in many countries.

But there's probably a better way to shield your wealth: stodgy stocks that are resilient to inflation. A company that owns oil reserves, land or factories whose debt would be debased by inflation could hold its value. Unlike gold, it also can pay you dividends while you wait for doomsday. Companies with intangible assets like patents or brands might do fine, too.

If hyperinflation strikes and gold prices leap to $400,000 then it's a fair bet that the Dow will be worth at least 4 million once the dust settles.

Gold's outperformance of S&P 500 in percentage points



Note: S&P 500 and its predecessors
Source: Aswath Damodaran

Gold's Role Reconsidered: What Drives Its Value And Returns?

October 10, 2025 • Larry Swedroe

Gold gleams in investment portfolios worldwide, revered as a timeless safe haven and inflation hedge. But does this precious metal live up to its lustrous reputation? New research from Claude Erb and Campbell Harvey challenges conventional wisdom about gold, revealing a more complex—and less reassuring—reality for investors.

The Gold Narrative Vs. The Data

In their September 2025 paper "Understanding Gold" Erb and Harvey conducted a rigorous examination of gold's actual performance against its storied reputation. What they found should give investors pause: while gold offers genuine diversification benefits, it falls short of the guarantees many assume it provides.

The researchers investigated three critical questions:

Can gold truly hedge against inflation and currency fluctuations? Despite widespread belief in gold's protective powers, the data tells a more nuanced story, challenging existing perceptions.

How has financialization changed gold? The transformation from physical commodity to financial asset—through ETFs, futures, and other vehicles—has fundamentally altered gold's price dynamics and market behavior.

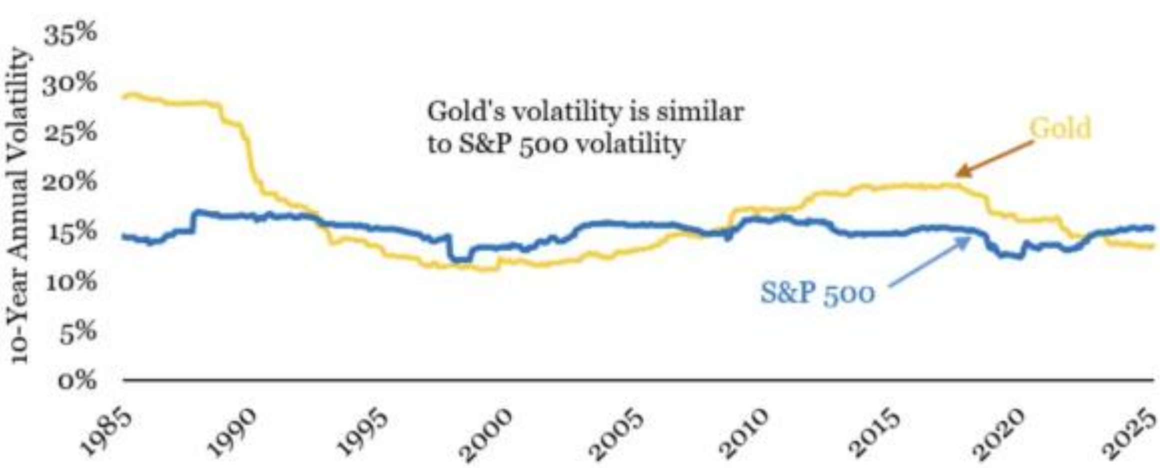
What role does dedollarization play? As countries reduce their reliance on the U.S. dollar, how has this geopolitical shift influenced gold's recent price surge?

What The Evidence Really Shows

The Volatility Surprise

Here's a fact that undermines gold's "safe haven" image: gold exhibits roughly the same volatility as the S&P 500, and is seven to eight times more volatile than the inflation it supposedly hedges against. This isn't the profile of a stable store of value—it's the signature of a speculative asset.

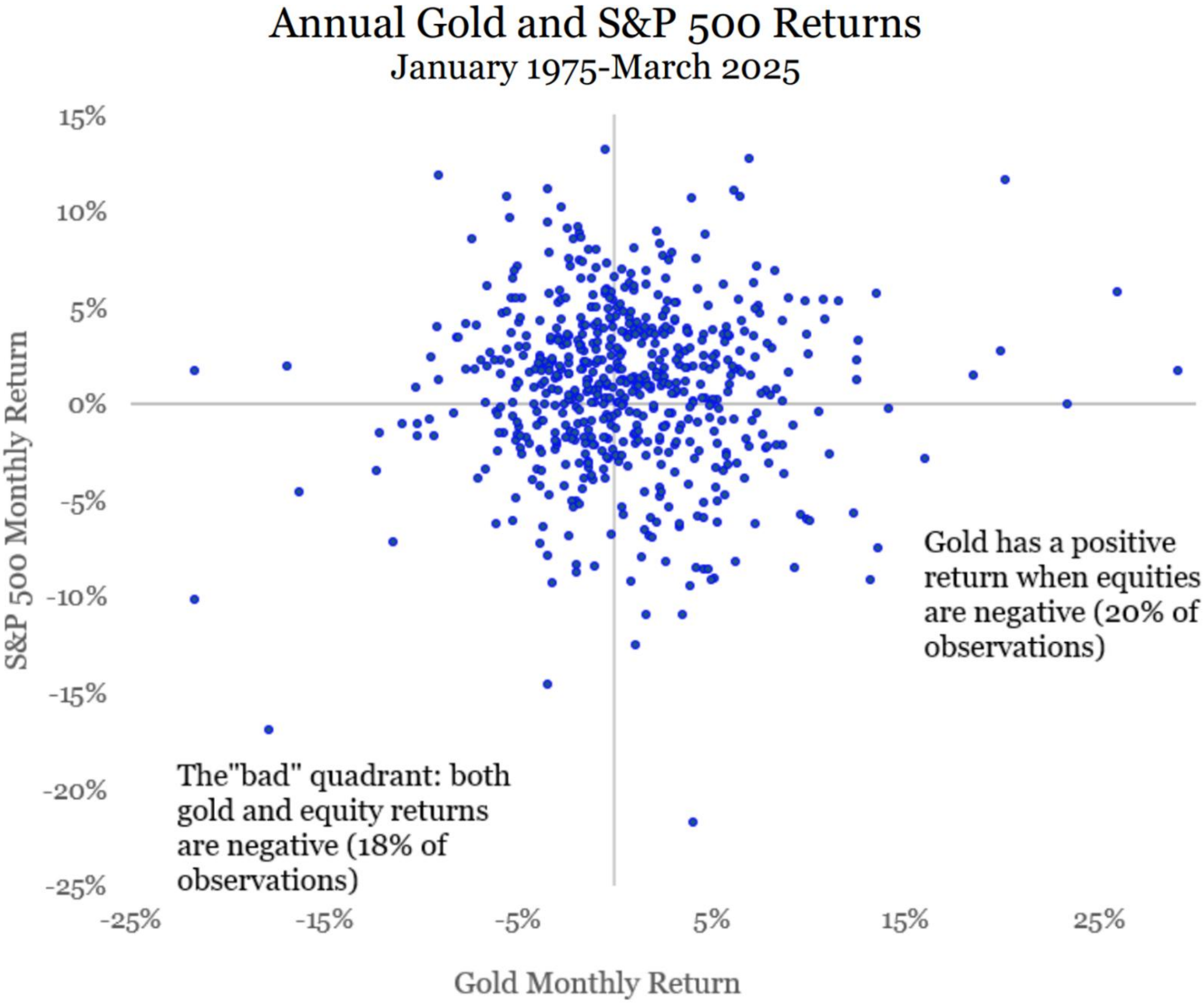
Exhibit 1
10-Year Volatility of Gold and the S&P 500
1985–2025



Notes: The S&P 500 is represented by a continuous full-sized S&P 500 futures contract (SP1 Comdty) switching to the more liquid S&P 500 E-mini futures (ES1 Index) as of September 1997; and Gold by Generic 1st Gold Futures (GC1 Comdty).
Sources: Research Affiliates and Bloomberg.

Crisis Performance: A Mixed Record

Gold's reputation during market turmoil is partly justified, but the evidence is more nuanced than popular belief suggests as the following chart demonstrates.



Notes: The S&P 500 is represented by a continuous full-sized S&P 500 futures contract (SP1 Comdty) switching to the more liquid S&P 500 E-mini futures (ES1 Index) as of September 1997; and Gold by Generic 1st Gold Futures (GC1 Comdty).
Sources: Research Affiliates and Bloomberg.

However, since 1975, during 11 major stock market drawdowns, gold rose in eight instances and declined in the other three (though less than did the S&P 500). This provides genuine diversification value, but it's not the foolproof protection many investors expect.

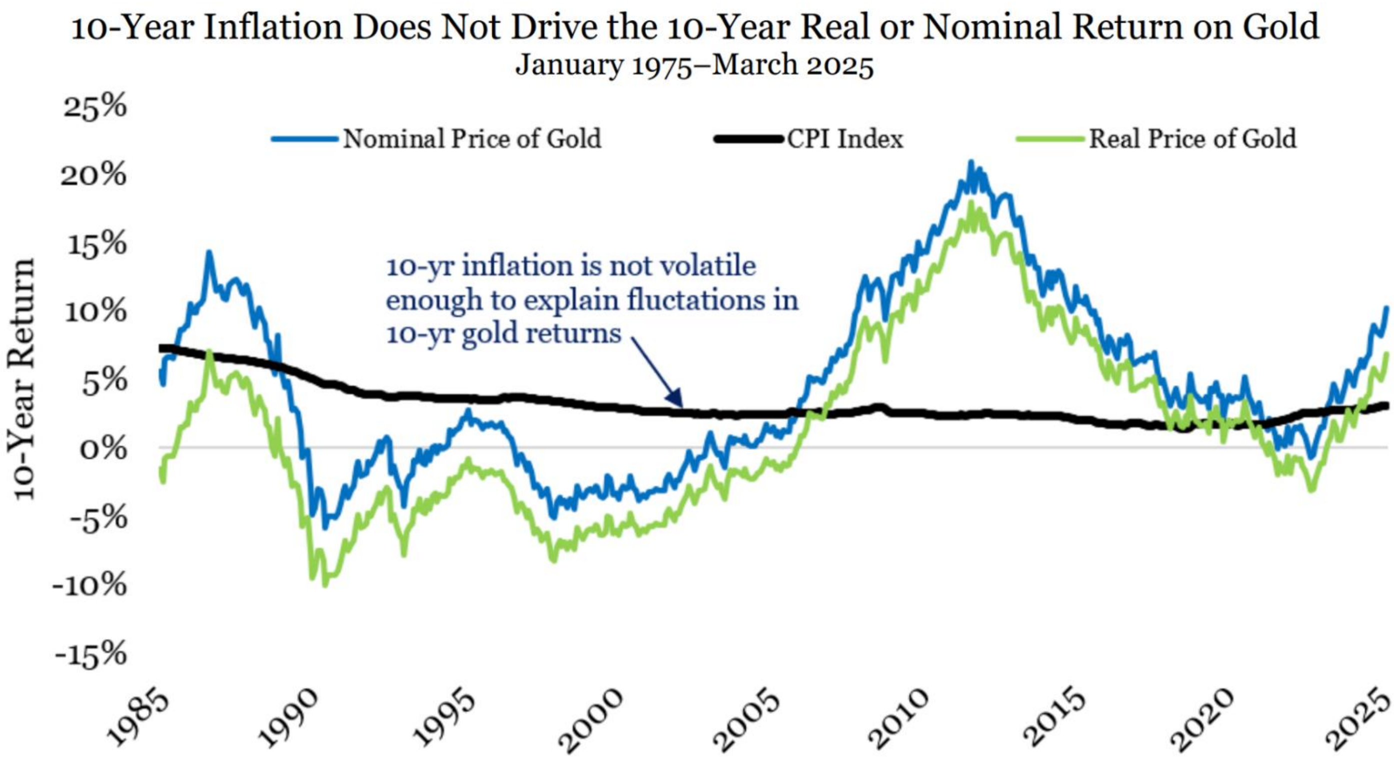
Drivers Of Returns

The most powerful insight from Erb and Harvey's research centers on real yields—inflation-adjusted interest rates. When real yields fall, gold tends to thrive; when they rise, gold suffers. This relationship is more predictive than inflation itself, revealing that gold behaves more like a zero-yielding financial asset than a commodity or monetary hedge. In addition, the real price of gold rises and falls based on short-term supply and demand imbalances, making gold's behavior more similar to other commodities than to a monetary asset or store of value in the traditional sense.

The Inflation Hedge Myth

Perhaps most surprising: gold does not reliably hedge against inflation in practical investment timeframes. When examining one-year periods, researchers found no meaningful correlation between gold price changes and inflation surprises. When inflation surges unexpectedly, investors cannot count on gold to rise in tandem.

While gold may maintain purchasing power over centuries—a cold comfort for investors with timeframes measured in years or decades—it functions more like other commodities in the short to medium term, rising and falling based on supply and demand imbalances rather than systematically tracking inflation or currency values.



Notes: The real price of gold is the nominal price divided by the CPI's level.
Sources: Research Affiliates and Bloomberg. Gold (GC1) and CPI (CPI Index).

The Financialization Effect

The introduction of gold ETFs fundamentally changed the market, making gold more accessible to investors, increasing demand. It has also intensified the role of sentiment and financial flows in driving prices, overwhelming traditional fundamental factors. Thus, gold doesn't systematically track inflation or currency values.

The Valuation Warning

The real (inflation-adjusted) price of gold today stands at exceptionally high levels by historical standards. Erb and Harvey point to a troubling pattern: when gold prices have been above average in real terms, subsequent returns have consistently disappointed. This suggests investors purchasing gold at current elevated levels may face lower or even negative real returns in the coming years. On the other hand, perhaps we will experience a large spike in inflation.

Role In Portfolio
Given its modest return, most of gold's value is derived from its ability to diversify a broader portfolio and provide optionality in periods of uncertainty.

Erb and Harvey also noted that there are some potential tailwinds for gold including further dedollarization (with central banks decreasing their allocation to US dollars and increasing the allocation to gold) and also the potential for regulatory changes which could lead to gold being considered a Tier 1 asset—it is not currently a Tier 1 High Quality Liquid Asset under Basel III, a framework that sets international standards and minimums for bank capital requirements, stress tests, etc. However, Erb and Harvey cautioned against assuming these tailwinds will overcome the valuation headwind created by today's elevated prices.

Key Takeaways For Investors
The research demands a fundamental reframing of how we think about gold:

Abandon the conservative hedge mindset. Gold is a speculative asset driven by shifting supply and demand dynamics, market sentiment, and financial flows—not a reliable hedge against inflation or currency fluctuations.

Recognize its real value. Gold's primary benefit lies in diversification and potential protection during specific market regimes, particularly when real yields are declining. This is valuable, but limited.

Set realistic expectations. Don't expect high real returns or consistent protection across all economic environments. And remember that sentiment, historical narratives, and behavioral biases often lead to over- or underestimation of gold's usefulness.

Size allocations appropriately. Any gold position should be based on clear understanding of its actual risk and return drivers, not on historical narratives or behavioral biases.

The Four Most Dangerous Words
As Erb and Harvey noted: "Based on past performance, expected returns should be very low or negative over the next 10 years. But that may be pessimistic if demand for gold has, in fact, undergone a structural shift that has caused significant price appreciation."

The fundamental question: will this time be different? Those four words—"this time is different"—are considered by many to be the most dangerous in investing.

The Bottom Line
The key lesson from Erb and Harvey's research is clear: investment decisions should be based on empirical evidence rather than conventional wisdom or compelling narratives. Investors should be skeptical of rationalizations that current circumstances—financialization, de-dollarization, geopolitical tensions—make gold fundamentally different from its historical patterns. While these factors help explain current price levels, they don't necessarily justify sustained high valuations or guarantee future performance. When it comes to gold, the data tells a story that's considerably less lustrous than the metal itself.

Gold can play a useful role in diversified portfolios, but investors must approach it with eyes wide open—understanding its true drivers, accepting its limitations, and sizing positions based on realistic expectations rather than golden myths.

Larry Swedroe is the author or co-author of 18 books on investing, including his latest Enrich Your Future. *He is also a consultant to RIAs as an educator on investment strategies.*