

Trajectory

"You ask me to say what is particularly important to avoid. My answer is this: a mass crowd. It is something to which you cannot entrust yourself yet without risk."
Lucius Annaeus Seneca

Estimating America's economic trajectory is becoming ever more challenging with the constant trade reversals, delays, extensions, and exemptions by the Trump administration. Their communication has been disorienting to say the least. It is disruptive to global trade and unsettling to consumer and business confidence - but, paradoxically, it may serve the prudent investor.

This administration has injected a heightened level of volatility into financial markets. Nevertheless, history shows global trade is resilient to both hot and cold conflict, and quickly adapts. Thus the stock market has been taking things in its stride. Not even a regional war between Israel and Iran, and joined by America, can derail this market. Astounding!

Over time, the stock market also tends to absorb the media's narratives. The recent torrent of scary headlines involving debts, deficits, tariffs, the 'dollar's demise', and trade wars feeds investors' negative biases. However, investors who focus on what can go right and stick to their investment plan, can stay ahead of the game. Those who sell to 'avoid the loss' often pay a price in forgone financial wealth. And so cynicism prevails, dips are bought and markets continue to rally.

In this quarter alone, the media's narrative has shifted from apathy to con-

fused panic to complacency. To the casual observer, it feels like stability has returned. But that calm might be deceiving.

Behind the headlines, market liquidity is quietly deteriorating. Bid-ask spreads are widening in places that used to be tighter. Treasury auctions are growing more volatile. What might be causing this deterioration?

Perhaps it is years of irresponsible spending on unproductive debt that is to blame. The government can simultaneously borrow money and become less indebted - if the economy grows faster than the debt accumulates. The fiscal 2026 budget before the House is disappointing with respect to deficit reduction. While there are parts of the budget designed to stimulate economic growth, there is little in the bill that addresses the spending trajectory of the American government.

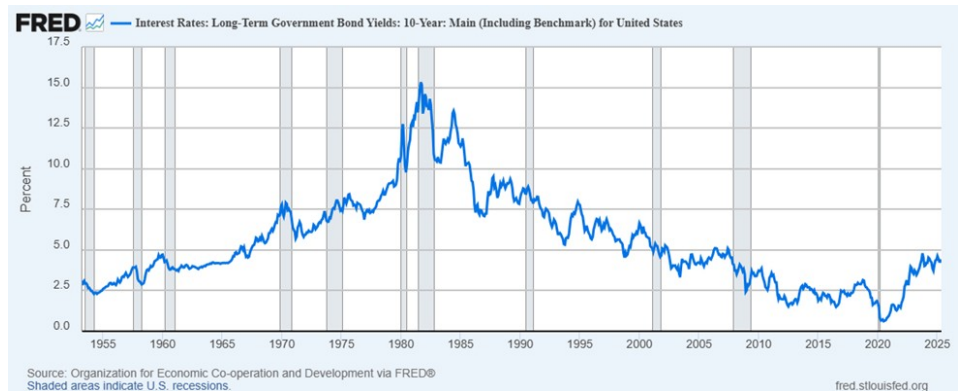
This year, the US will have to sell \$2 trillion worth of additional debt to fund its annual deficit. In addition, roughly \$9 trillion worth of existing federal debt will come due over the next twelve months. In theory the government has to repay that matur-

ing debt - but they don't have the funds to do so. Instead - quelle surprise! - they'll borrow new money to finance a total of \$11 trillion worth of debt over the next year.

America already has \$37 trillion of federal debt (123% of GDP). Today, the interest expense on the debt costs \$1 trillion per year, more than 20% of tax revenue. By 2035, the government projects that the debt will be at least \$61 trillion (129% debt to GDP). At that point, the Treasury Department could be spending well over 45% of tax revenue just to pay the interest on the debt.

This is an enormous amount of money, which means the US government needs every bond investor ready and willing to buy their debt. But there's a problem: investors, worried about deficits and the debt trajectory, are shying away from holding American government bonds. Long bond yields are rising to entice domestic and foreign buyers. (See chart) Could a bond buyers strike be afoot?

Rising yields hurt the value of existing bonds, while eroding the relative safety and utility of traditional fixed-



Trajectory (cont'd)

income allocations. If ten-year bond yields rise above 4.5%, then stocks should start feeling the pinch and react accordingly.

What we're seeing now is a market in transition. The classic model - where the Fed would lower interest rates to encourage soft landings and the Treasury market would absorb an endless supply of new bonds - is breaking down. Yields are rising in spite of Fed policy, Treasury auctions are repeatedly falling flat, and the US dollar has traded down about 11% year-to-date against a basket of other fiat currencies. Prudent investors can no longer afford to treat American bonds as the undisputed 'risk-free' asset.

Economist Torsten Slok has some germane points. "Economic data have mirrored the volatility in the markets and trade policy. Soft indicators (e.g., confidence surveys) have fluctuated in tandem with news of on-again, off-again tariffs, while hard data (i.e., employment and inflation) have shown more resilience. This discrepancy has added to uncertainty and continues to fog the economic outlook. Although tariff levels are currently lower than initially feared, ... potential shipping disruptions and higher costs will act as a drag on output and margins. Corporate earnings, already being revised downward, can come under further pressure. This is not a political view; it's just a view expressing that policy uncertainty is elevated and is likely to remain so."¹

While bond investors remain on edge, stock investors seem overly complacent. Examining credit spreads (tight), the VIX index (low), equity flows (high), and other risk indicators, one might conclude that stock investors are indeed correct in their judgement.

However, returns from stratospherically priced stocks, while sufficient for now, are hardly enough to justify their current valuations. This market is made up of "price-insensitive buyers" - the most dangerous type of stock market

participant. The crowd's money flows in, big stocks get bigger, and the index rises. That rise draws in more money, which buys more shares, pushing prices even higher.

The S&P 500 trades at a P/E multiple just shy of 30x and the Nasdaq trades at multiple of 40x. There is no measure by which this market is inexpensive or even close to that. These exceptionally high valuations imply low prospective returns and rightly caution against making outsized investments. During a pull back, the biggest and most liquid stocks will be sold first, the smaller and more thinly traded later. And yet, most stock market investors seem blissfully indifferent.

Lurking beneath that complacency, liquidity is drying up. A big part of the liquidity drain comes from the Federal Reserve's quantitative tightening programme. The Fed has slowly reduced its balance sheet, now down to \$6.6 trillion, about 25% below its 2022 peak. That's a significant reduction in reserves. Reserves are used to support everything from credit expansion to market stability. Central bank liquidity, is only one factor. Another is private market liquidity, and that depends on "functioning intermediation". Once both factors come under pressure, the entire system becomes vulnerable, even if prices appear relatively stable. Equity flows play a role here; flows into passive investments, such as stock ETFs, have remained strong despite tighter credit conditions and falling market depth. That demand can temporarily increase prices, making everything look healthier than it really is.²

When liquidity becomes problematic, markets can stop functioning altogether. The "... risk is that these [passive] flows suddenly reverse. When everyone sells at once, there may be no buyers for the underlying assets. This can lead to what traders call "air pockets," which are moments where price gaps suddenly lower, and liquidity vanishes. It's not just a theoretical risk. This has played out previously in high-yield

credit and even in Treasuries during previous stress events. It's a structural vulnerability that's easy to overlook until it's too late."³

While there's a host of reasons why this market might roll over, it's the inelastic buyer and inelastic seller situation that makes it so dangerous. When the selling starts, there may not be buyers.

If our estimation for the markets is correct, investors may wish to have a sizeable allocation in cash. Prudence would suggest searching beyond American stocks to where valuations are more reasonable. Should the US dollar continue to weaken, investors will want a significant allotment to precious metals; the debt situation is a big part of why gold keeps going up - foreign governments and central banks are dumping their US Treasuries and buying gold instead. As reshoring critical supply chains and expanding domestic industrial capacity advances, inflation is probably going to be higher and sticky; solace may be found in some commodities and in selective technology companies. An allocation to keep in check: long-term US Treasury bonds.

The Trump administration's trade policies are leaving everyone guessing. There will always be headlines or analysts warning investors to step aside. Some of those concerns will be valid. However, reacting emotionally rather than logically often results in poor investor outcomes. Therefore, have a plan and try to stick to it.

This is not a call to panic, but a call to think and to prepare.

Sources:

1. Torsten Slok, "Mid-Year Outlook", [Apolo](#), June 2025
2. ValueWalk, "The Great Illiquidity Crisis Nobody's Talking About", [ZeroHedge](#), 26 June 2025
3. Ibid
4. Chart previous page, Federal Reserve Economic Data, [St. Louis Fed](#), June 2025