

CIO OUTLOOK

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At an Inflection Point

The global economy approaches year-end 2025 caught between two competing forces: the push of policy support and the drag of structural constraints that include inflation, a cooling economy, and fragmented global trade. The U.S. economy has been slowing, yet tariffs have started to boost inflation. The Federal Reserve (the "Fed"), mindful of growth risks, is cutting rates into this upturn of price levels. Europe is losing further economic momentum as its fiscal positions continue to deteriorate. China and the U.S. remain competing powers while continuing to demonstrate how deeply intertwined their economic fates remain.

Asset class volatility had been declining throughout the summer until tensions erupted in early October around the unresolved question of the long-term trade arrangement between the United States and China: specifically, whether a 100% tariff rate on Chinese electric vehicles and other strategic goods will harden into a lasting trade barrier, and how access to critical Chinese rare earth materials will be managed under this new regime. Markets had started to ignore this topic, as trade deals (or indications thereof) were struck with other major trade partners and ongoing negotiations between the U.S. Treasury Secretary and his Chinese counterpart seemed to kick the can down the road. Following the recent presidential meeting and Beijing's one-year suspension of its rare earths licensing regime, the tone has shifted toward cautious optimism. The pause gives both sides space to recalibrate, with the outcome likely to shape the global economic and market trajectory into 2026.

Key Takeaways

- As we approach year-end, the global economy is in a regime of policy accommodation constrained by structural headwinds, marked by stalled disinflation, fragmented trade, and uneven productivity gains.
- Central banks are easing into inflation, while expansive fiscal policy and ongoing U.S.–China negotiations leave markets teetering between cross-asset volatility and cautious stability.
- Elevated valuations and conflicting macro signals argue for tactical flexibility, tight risk control, and a preference for optionality over directional exposure.



Since the flare-up of volatility in mid-October, the market equilibrium has at least temporarily been disrupted. The narrative has shifted and more concerns over cracks in the economy have emerged, with stress in lower income cohorts, deteriorating credit quality, and signs of weak labor markets. The risk of punitive tariffs on Chinese imports and, of course, geopolitics are other wild cards. At the same time, the mix of easier policy, AI build out, onshoring, and capex incentives can still fuel a productivity-led expansion in 2026. Equity and corporate credit markets are pricing this scenario.

These competing narratives suggest that volatility is unlikely to recede materially, at least in the near-term. We see interesting opportunities to generate returns in the coming quarter in interest rates and equities, while net exposure to FX is more muted given the dampening effect of synchronized policy easing across major central banks. We are not anchored to any single narrative and will adjust positions dynamically over shorter horizons. A market that is dominated by two economic crosscurrents and priced to perfection is one where we need to be risk manager first.

The U.S. Macro Picture: Inflation Reawakens, Labor Cools, Growth on the Horizon?

After two years of steady disinflation, the U.S. economy is in a more ambiguous phase, driven by partially offsetting macroeconomic forces. Growth has been volatile, but on average over the past several quarters has slowed toward its long-term trend of roughly 1.75%, with underlying price pressures reemerging. Headline CPI has climbed back toward 3% in September, while core inflation measures remain sticky. Despite this, the Fed has opted to ease monetary policy, a decision it justified as “risk management” and one that marks a rare episode of rate cuts amid rising inflation.

The juxtaposition is striking. In most cycles, the Fed cuts because inflation is at risk of falling below target; in this one, it cuts because it fears what might happen if it doesn't. Policymakers are betting that inflation's recent pickup is temporary, not the start of a new trend. Markets, for now, follow the Fed's words.

Employment dynamics confirm that the economy has been cooling. Payroll growth has slowed dramatically, averaging just 40,000 per month over the past quarter, and participation has plateaued. The collapse in net immigration—from 2.8 million in 2024 to around 400,000 this year—has constrained labor supply, while demand is ebbing as companies freeze hiring in rate-sensitive sectors such as housing. Wage growth has moderated to 3%, barely ahead of inflation, and hours worked are trending lower.

The result is a labor market that is slowing without breaking—a necessary condition for disinflation, but also a headwind for consumption. The Fed's decision to ease amid this backdrop reflects its belief that weak growth and labor markets, not inflation, poses the greater medium-term risk.

Graham's latest [economic research](#) highlights that potential and actual growth have both shifted downward, keeping the economy in approximate balance. In recent months, the decline in labor-force growth from immigration enforcement is being offset by a slow-building productivity revival driven by AI and capital



deepening. AI-related capex in the U.S., estimated to equal 1-2% of U.S. GDP, continues to expand even as broader investments stall.

Measured productivity has yet to surge (up only 1.5% y/y in Q2) but we may be early in the “J-curve” where output lags investment. If productivity gains spread beyond a few large tech and capital-intensive firms in 2026, productivity could accelerate toward 2%. That, combined with industrial-policy incentives, could renew U.S. growth momentum in 2026. But the path from here is uncertain and the data is diffuse enough to support either scenario: a 2026 growth breakout or a further slowdown in activity.

Insurance Meets Politics: The Fed’s Risk-Management Gamble

The Fed cut rates by another 25bps at its October meeting, but the tone proved far more hawkish than anticipated. Chair Powell emphasized that a further move in December is “far from assured,” signaling a deliberate effort to reclaim policy optionality after markets had priced in a near-certain follow-up cut. The optics are difficult: the Fed’s rationale for cutting remains that real rates remain high and policy effects take time to materialize. Chair Powell argues that easing now prevents a slowdown later. Yet, cutting into inflation risks un-anchoring expectations, particularly as fiscal deficits remain large.

For markets, this represents a new kind of policy asymmetry: central banks leaning dovish regardless of data. It keeps nominal yields capped but inflates risk premiums elsewhere, including potentially in the long end of the curve.

Beyond the policy stance is a deeper concern for the politicization of the Fed itself. The Supreme Court’s pending review of the attempted dismissal of Governor Cook have made institutional risk tradable. Even if no immediate change occurs, the perception of potential interference undermines confidence in the inflation anchor. The Bank for International Settlements (“BIS”) warned that institutional credibility erosion can shift inflation expectations faster than fundamentals. This risk defines the tail of the current macro distribution.

U.S. fiscal policy remains expansive. Revenues are improving, with government spending growth slowing to 3% nominal, down from 6%, but genuine restraint is still absent: spending continues to rise from an already elevated base, keeping fiscal policy supportive rather than restrictive. Treasury issuance is heavy, and fiscal dominance is a risk for long-term debt ratios. In the U.S., the implicit coordination between Treasury and the Fed will likely keep liquidity plentiful. While recently funding markets have shown signs of stress, the Fed has tools to counter that if necessary. The indication of an end of QT “coming into view” is a sign that the Fed will act early.

Besides widening term premia to price the lack of fiscal policy prudence, the upcoming U.S. Supreme Court review of the tariffs imposed under International Emergency Economic Powers Act (IEEPA) could cause volatility in interest rates, and potentially a leg up in equities. If deemed illegal, not only would the revenue source break away, but repayments of tariffs would add to the deficit. While some of the tariffs may be



rolled into a different legal framework, the decision could potentially reverse the signature economic initiative of this new U.S. administration and weaken its negotiation leverage, especially with China.

Europe: Stagnation Without Reform

While the dynamism of the U.S. economy allows for a debate about its path from here, the same is difficult to say about Europe whose slowdown has deepened with GDP growth near zero. France's fiscal position has become precarious, with deficits above 5% of GDP and no political will to cut spending. A crucial pension reform has been abandoned. The economic deterioration is structural. Germany, for its part, also shows little appetite for structural reform. Industrial output has stalled, and energy costs remain high. Populism is rising across the continent. Political leadership to break the growth deadlock remains as elusive as the electorate's willingness to support supply side reforms. Cyclical support may come from more spending by Germany, something that the market seems to have discounted and therefore may present opportunities.

The strengthening trend of the euro has stalled, and the currency has been range bound against the U.S. dollar – somewhat to our frustration, as it has been difficult to trade recently. Europe's weak economic backdrop leaves one with skepticism of how much further the euro can advance, even with the U.S. dollar still arguably overvalued. The best argument for an uptrend in the euro may be that less people expect it today compared to three months ago when bullish positions in the euro appeared crowded to us. For now, it's a market better watched than traded until the macro picture becomes clearer.

While the UK is also in what now appears to be an almost perpetual malaise, from the standpoint of a macro investor it is an interesting place. We see opportunities in the interest rate curve where the long end has value to us (i.e., it is pricing in too much pessimism), while the segment of the market most sensitive to central bank policy may not fully incorporate expected monetary support. That leaves us with a long duration profile in UK fixed income.

Japan: A Test of Monetary Resolve

Japan's new leadership has reintroduced political uncertainty into what had been a predictable normalization path. Prime Minister Sanae Takaichi's commitment to expansive fiscal policy and reluctance to endorse further monetary tightening have unsettled markets. With headline inflation still around 3%—well above the BoJ's historical comfort zone—the risk of policy drift has grown.

The Bank of Japan's gradual exit from yield-curve control is now complicated by pressure from a government that views higher rates as a threat to its fiscal agenda. Domestic investors, long tolerant of near-zero yields, are starting to demand compensation for inflation risk, while foreign holders of JGBs see limited value with the yen still depreciating.

The yen's renewed weakness reflects this disconnect of fiscal expansion paired with a central bank now potentially reluctant to follow through on normalization. For now, a weaker yen provides a short-term boost to exporters and equity markets, but it also re-imports inflation through energy and food prices. The



credibility of Japan's long-term inflation framework could again come into question. This backdrop will leave the market in flux and allow for thematic (duration) and tactical (currency) opportunities.

China: Slowing Momentum, Strategic Necessity

China's economy remains the global swing factor. Growth momentum has weakened as the property sector continues to contract, private investment lags, and external demand softens. Yet despite these cyclical pressures, China's strategic leverage in global supply chains has rarely been greater.

The introduction of Notice No. 61, extending export licensing to all products containing Chinese-origin rare earths, underscores Beijing's willingness to use its dominance in critical inputs. While the measure was framed as administrative modernization, its timing, which coincides with U.S. tariff hikes and new technology-export restrictions, was unmistakably political. In practice, this move gives China veto power over segments of the global technology ecosystem. However, Beijing's latest decision to suspend the rare earths licensing regime for one year tempers the immediate risk. Although framed as a gesture of flexibility, the Chinese Ministry of Commerce noted that exports will continue "at current levels," which were already down roughly 30% in September versus August, suggesting that supply may remain constrained in practice. For the U.S. and its partners, the pause likely provides space to advance the newly announced G7 critical minerals alliance, aimed at diversifying supply chains and reducing strategic dependence on China.

For the U.S. and its allies, the challenge is dual: to reduce dependency on Chinese inputs while avoiding an inflationary supply shock. For China, the risk is overreach; excessive restriction will accelerate investment in alternative supply chains and erode its market share over time. This delicate balance explains why both sides have, for now, kept back-channel negotiations active, now reinforced by the more amicable tone of the recent presidential meeting.

Fundamentally, the U.S. and China need each other. The U.S. cannot rapidly replace China's scale in manufacturing, and China cannot replace U.S. demand or access to dollar funding. Both economies are therefore converging toward what might be termed "competitive coexistence," a world of selective decoupling but sustained interdependence. The transition to that equilibrium will be rocky, punctuated by tactical escalations and fragile truces, each capable of moving markets sharply.

From a portfolio perspective, this relationship defines the range of global outcomes for 2026: if trade tensions continue to stabilize, China's fiscal stimulus could lift Asia's growth cycle. Should tensions re-ignite, further supply-chain fragmentation could dampen global trade volumes and re-ignite cost-push inflation in advanced economies.

We continue to monitor Beijing's policy stance closely. Fiscal measures announced at the October Plenum suggest the Chinese government remains committed to supporting domestic demand through infrastructure and local government financing, though without a return to the broad credit excesses of the past. The renminbi will likely remain range-bound against the U.S. dollar, reflecting both capital controls



and the authorities' desire to prevent disorderly depreciation. A rapid deterioration in the relationship between China and the West could, however, trigger exactly that.

Conclusion: Between Fragility and Renewal

2025 ends with sharp contrasts. Inflation is rising even as policy eases. The labor market is cooling yet U.S. growth remains robust. Europe drifts without reform. China and the U.S. need each other, even as they continue to test the boundaries between strategic competition and pragmatic cooperation. The Fed remains the market's anchor, but its politicization introduces a tail risk that cannot be ignored.

This combination of higher inflation, lower growth, and elevated policy uncertainty defines the late-cycle environment. It is not necessarily recessionary, but it is unstable. The path ahead will be rocky, alternating between optimism about AI-led investment and concern over trade, demographics, and institutional strain. In this regime, risk management is strategy: optionality over conviction, liquidity over leverage, and patience over prediction.



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