

CIO OUTLOOK

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From Policy Volatility and Market Resilience in 2025 to a Transition Year in 2026

2025 was a year defined less by a single macro outcome and more by the repricing of policy uncertainty itself. Trade policy volatility, fiscal dynamics, and political noise repeatedly pushed markets into stress-like correlation regimes, yet resilience ultimately prevailed, with the U.S. economy absorbing shocks better than feared. As we enter 2026, the backdrop is not a clean new cycle, but a transition phase in which policy volatility becomes embedded in prices, term premia remain elevated, and sequencing risk matters as much as direction.

2025 Review

Policy Volatility as the Dominant Macro Force

2025 wasn't as iconic as 1992, of course, when 'one' trade against the Bank of England made a fortune, but it had enough of the intoxicating cocktail of headlines, volatility, stress, and profits to be remembered by macro investors, probably in the same way as 2008 (GFC) or 2022 (inflation). An easy ride, it was of course not! We learned a lot of lessons, were often humbled, and yet were able to capture some of the opportunities that presented themselves.

The year will be remembered less for a single macro variable than for a structural shift in what drove macro outcomes. The dominant force was policy volatility—particularly trade policy. As the effective tariff rate rose sharply and unpredictably, investors repeatedly had to price a mix that is difficult to reconcile in

Key Takeaways

- Tariffs, fiscal expansion, and political uncertainty have structurally raised term premia, weakened traditional hedges, and increased cross-asset correlation during stress.
- The easing cycle is nearing completion, inflation risks are asymmetric, and fiscal credibility, rather than growth alone, will be a driver of rates and currencies.
- Across scenarios, the core theme is not a single directional bet but a structural bias toward curve steepening, underpriced inflation risk, selective non-U.S. opportunities, and tactical flexibility in a regime where the order of events matters as much as the outcome.

conventional frameworks: a simultaneous inflation-tilted and growth-negative impulse, layered on top of mounting fiscal deficits and an unusually active political backdrop. The result was a year in which market pricing frequently moved faster than the underlying data, correlations episodically behaved like a stress regime, and “visibility” became a scarce asset for both policymakers and investors.

Resilient growth, fragile confidence

The year began with an economy that still looked fundamentally resilient—especially in the U.S.—but increasingly sensitive to confidence and expectations. Early hard data held up well even as survey measures deteriorated, and markets oscillated between the “soft landing with patience” narrative and concerns that tariff uncertainty would tighten financial conditions through sentiment and risk premia rather than through immediate mechanical effects. That divergence would persist: 2025 repeatedly presented a split between pockets of real-economy durability and a growing sense that the rules of the game were shifting.

As the administration moved rapidly from signaling to implementation, trade policy transitioned from a headline risk to an active macro channel. Tariff announcements, pauses, retaliatory threats, and sector-specific measures arrived in quick succession, creating a stop-start environment for corporates. Even before the tariff escalation, inflation expectations began to lift and activity indicators became more fragile, putting the Federal Reserve into an early bind: a still-resilient economy, but a risk distribution that was turning stagflationary. The question was how tariffs would matter—through prices, through demand, through supply chains, or through confidence—and on what timeline.

Outside the U.S., shifting perceptions of U.S. reliability on trade and defense catalyzed policy responses with direct market consequences. Europe’s pivot toward greater strategic autonomy—particularly Germany’s embrace of larger defense and infrastructure commitments and loosening fiscal constraints—repriced European yields and supported the euro. This was more than a regional story; it marked a broader reintroduction of fiscal regime as a driver of global term premium, complicating the global “disinflation-to-synchronized easing” playbook that investors had been leaning on.

April’s shock and the limits of diversification

The year’s defining market event arrived with the April 2nd “Liberation Day” tariff announcements, which pushed the effective U.S. tariff rate dramatically higher and triggered a disorderly cross-asset repricing. The most important feature of that episode was the failure of traditional offsets as the U.S. dollar and Treasuries struggled to provide protection at the same time. Rates volatility surged, credit spreads widened, and the repricing challenged the assumption that duration is always the first and best hedge in a growth scare.

While markets eventually stabilized after policy de-escalated from peak tariff settings, April left behind two durable lessons that shaped the rest of 2025. First, policy shocks in the current environment propagate through multiple channels simultaneously—growth expectations, inflation risk premia, liquidity, and credibility—raising correlations and reducing the reliability of diversification. Second, the market’s tolerance for uncertainty is higher than expected, provided the trajectory of policy does not keep deteriorating. This set up the next phase of the year: a rally that did not require clarity, only a reduction in worst-case tail risks.

That dynamic played out forcefully as trade tensions partially eased and the most punitive tariff elements were paused (except for China). Risk assets rebounded, volatility subsided, and equities posted some of their strongest months in years. Yet the rebound did not eliminate structural concerns: with immediate tail risks less acute, attention shifted toward the medium-term consequences of tariff pass-through, the durability of consumption, and—critically—fiscal sustainability.

Dispersion and a late-cycle economy

Through the middle of the year, macro conditions evolved into a more complex two-track reality. On one track, the underlying economy showed signs of gradual cooling—particularly via softer labor momentum and weakening sentiment. On the other track, investment remained bifurcated: activity tied to artificial intelligence continued to expand robustly while non-AI segments looked increasingly constrained. This bifurcation mattered for markets because it sustained earnings resilience and risk appetite in concentrated areas even as broader demand signals grew less secure. It also contributed to dispersion and made leadership more fragile: the market could rally without the economy accelerating, so long as the capex cycle and select earnings pools remained intact.

Central banks, for their part, spent much of 2025 preserving optionality. The Fed's posture reflected the year's core tradeoff: officials repeatedly characterized tariff effects as closer to a price-level shock if expectations stayed anchored but acknowledged that rising short-term inflation expectations would constrain preemptive easing even as the labor backdrop softened. Abroad, the ECB acted more preemptively amid weaker growth dynamics but then signaled a firm pause after its last cut in June; the BoE remained constrained by elevated services inflation but eventually moved back towards easing at year-end; and Japan remained a key source of global duration risk, as fiscal constraints and uncertainty around BoJ normalization interacted with the yen - through imported inflation, hedging costs, and the possibility of reduced outward flows or repatriation by domestic investors.

By late summer, the evidence of tariff pass-through began to appear more clearly in goods-related inflation dynamics. At the same time, the labor market increasingly looked like a fragile equilibrium of low hiring and low firing—stable enough to avoid collapse, but soft enough to keep policymakers focused on downside risks. Political pressure on the Fed and mounting institutional noise further complicated the market's assessment of the reaction function, leadership risk, and the durability of policy independence.

The Fed's easing pivot arrived in September, framed explicitly as risk management: a move toward neutrality intended to reduce the probability that cooling labor dynamics would turn into something more adverse. Markets began to treat policy as more responsive to labor risks even in a tariff-tinged inflation environment. However, the year's political overlay remained acute.

The shutdown became a defining late-year complication. With key releases delayed or canceled, GDP tracking was compromised, and policymakers were forced to navigate with reduced visibility. Private indicators suggested an economy that was "unsteady but not collapsing". The Fed still delivered additional

easing while striking a more cautious tone about the path ahead, emphasizing that further cuts were not automatic in the absence of clean data and with rates approaching estimates of neutral.

As official data began to arrive again, they remained consistent with a cooling but not breaking economy. At the same time, longer-run concerns did not fade. Fiscal sustainability remained in focus across multiple regions, showing up in term premium behavior and currency dynamics. Japan provided a clear example, where stimulus ambitions pushed the yen weaker and pressured long-dated yields on fiscal concerns, reinforcing the broader 2025 theme: long rates were being influenced as much by fiscal credibility and supply as by near-term growth. Meanwhile, equity leadership showed signs of strain—particularly within mega-cap technology—as AI enthusiasm moderated especially over increased debt financing even while long-horizon AI infrastructure commitments continued.

Repricing policy risk premia

December added an important year-end corrective to the 2025 narrative by replacing conjecture with delayed hard data. The U.S. reported strong Q3 growth, underscoring that the economy absorbed the year's tariff shock more effectively than most forecasts implied, albeit with unemployment rising to a new cycle high of 4.6%.

This late-year data print sharpened what may be 2025's most durable macro lesson: many observers were correct that tariffs would be disruptive, but too confident about the timing and transmission. Widely advertised near-term scenarios—a rapid recession, a clean inflation shock, or an immediate reshoring boom—did not materialize cleanly. Instead, 2025 delivered a more uneven outcome: selective price impacts, shifting trade routes, and persistent uncertainty that complicated planning, alongside surprisingly resilient top-line activity supported in part by powerful investment themes such as AI.

Taken together, 2025 closes as a year defined by the repricing of policy risk premia. Tariffs and geopolitical shocks reintroduced stagflationary tails; fiscal dynamics reasserted themselves as a driver of term premium and currencies; and the information environment itself became unstable at key moments. Yet markets repeatedly demonstrated an ability to re-stabilize when perceived policy trajectories became marginally less adverse, and the U.S. economy ultimately proved more resilient than consensus expected. This is the handoff to 2026: moderating cyclical momentum, an easing bias constrained by inflation and politics, structurally elevated dispersion, and a market that must price not only macro outcomes, but the volatility of the policy process that produces them.

2026 Outlook: A Transition Year, Not a Clean New Cycle

If 2025 forced markets to price policy volatility as a macro regime, 2026 looks like the year that regime gets institutionalized into prices. Term premia should remain structurally higher, volatility risk premia more persistent, and cross-asset hedges less reliable until the policy path stabilizes. We don't expect the start of a clean new cycle, but a transition phase with three drivers:

- From rate cuts toward a plateau (and possibly back to hikes).
- From disinflation back to inflation uncertainty, driven by fiscal policy, energy-price volatility, and capex. Energy prices are not only driven by supply/ demand but also subject to geopolitical risk as the U.S. intervention in Venezuela underscores.
- From range bound curvature to structurally steeper curves.

An additional reason 2026 may feel transitional is that we may be entering the first macro phase of AI adoption: productivity improves before labor markets visibly re-accelerate. Many developed economies are already exhibiting an unusual mix of resilient output and cooling labor indicators. If AI-driven productivity gains deepen in 2026, they can support corporate margins and equity earnings even as hiring stays subdued—an outcome that is simultaneously equity-supportive and politically destabilizing.

A further source of uncertainty is the political calendar risk. Events like the decision by the U.S. Supreme Court on tariffs and the midterm elections in the U.S. could cause volatility. With the midterms, the incentive structure for a fiscal and trade policy is unlikely to become more predictable, especially if the administration pivots more forcefully towards addressing 'main street affordability' as topic. The key point is not the electoral outcome, but the widening of policy distribution during 2026, potentially reintroducing volatility and further elevating term premia.

The dominant questions become: where is neutral; how tolerant will the Fed be if inflation overshoots; and what is the term premium for financing large sovereign deficits in a politicized policy environment?

Some of our core market views going into the new year are:

- Steeper curves as term premia reprice higher globally.
- Limited long-term value in nominal fixed income in real terms, especially in the U.S.
- U.S. exceptionalism being questioned: relative opportunities may be better in Europe and Asia.
- Japan as a key global driver of yields and risk sentiment.
- Housing and mortgages as a key transmission channel for policy and politics.

A crucial question for the success of trading these views is how far and fast they will express themselves and in what order. This backdrop is especially fruitful for discretionary portfolio managers, who can anticipate developments and re-position exposure tactically. We will analyze this by looking at different scenarios.

Policy and Macro: A Fed That Steepens Curves

Policy setup: Cuts are nearly done; the next debate is hikes

Our baseline is that the Federal Reserve is nearing the end of its cutting cycle. One or two additional 25 bps cuts in early 2026 are plausible, followed by a pause. Policy then shifts from "how much more easing?" to "when do we hike again?", especially if nominal GDP remains solid. With the midterm calendar approaching, fiscal negotiations and institutional noise are also likely to complicate the policy reaction function, reinforcing the case for higher term premia and a steeper curve.

A key amplifier here is institutional: a new Fed Chair perceived as more growth-focused can create persistent uncertainty about how the inflation target is interpreted in practice. Even without an explicit change in mandate, that uncertainty could express itself as higher term premium, steeper curves, and a market that is less willing to price long-run inflation risk as neatly mean-reverting.

Scenario 1: Soft landing / controlled easing (base case)

In the base case, the labor market softens but does not break. The Fed delivers a couple of additional cuts into early 2026 and then holds. Headline inflation prints close enough to target, but the balance of risks remains asymmetric: markets keep a mild hiking cycle priced further out, while the back end stays preoccupied with deficit finance and debasement risk. The curve steepens not because growth is booming, but because the market demands more compensation for long-duration exposure.

Signposts:

- Unemployment drifts higher but remains consistent with a slowdown rather than a recession.
- Core services inflation stabilizes while tariff-related goods inflation is episodic rather than persistent.
- As 2026 progresses toward the midterms, watch for episodic spikes in policy-process volatility as catalysts for term-premium jumps and cross-asset correlation shifts.
- Auctions clear without repeated tails; term premium rises gradually rather than disorderly.

Scenario 2: Reflation

The key variant of this reflation regime is “high nominal GDP”: productivity gains keep real activity respectable, while expansionary fiscal policy and a more growth-tolerant Fed leadership keep demand—and inflation—running above long-run equilibrium. In that world, the Fed’s “pause” becomes conditional, markets pull forward hikes, the 5–10y sector cheapens globally and the curve bear-steepens as real yields and term premium rise together. This is a regime where trades that benefit from higher anticipated inflation are structurally attractive because inflation uncertainty is being underpriced relative to the overheating macro backdrop.

Signposts:

- Capex and nominal activity stay firm (e.g., resilient PMIs/new orders) and wage/income growth remains sticky. Productivity surprises higher (nonfarm productivity up, unit labor costs contained) even as hiring remains subdued.
- Breakevens and inflation swaps drift higher as medium-term inflation risk is repriced.
- Five-to-ten-year real yields cheapen and curves bear-steepen as markets pull forward the next hiking cycle.

Scenario 3: Growth scare / labor rollover

In the growth-scare scenario, the labor market deteriorates more sharply, forcing the Fed into additional cuts beyond what is currently priced. The front end rallies, but the long end fails to rally in parallel because of debt, deficits, and term premium. The market delivers a bull steppener rather than a “classic” parallel

rally—an important distinction for portfolio construction of asset owners, because it changes what duration actually hedges.

Signposts:

- Initial jobless claims trend higher and hiring slows broadly; unemployment rises faster than expected.
- Front-end rallies on repriced cuts, while 10–30-year yields are comparatively sticky on supply/term-premium concerns (bull steepener).
- Credit spreads widen and equity breadth deteriorates, consistent with tightening financial conditions.

Global Central Banks: Cuts Nearly Done, Japan as the Marginal Driver

A similar “late-cycle easing exhaustion” theme shows up abroad. The ECB appears at the end of easing and has adopted a truly neutral bias, and the BoE will likely soon be there as well (perhaps one to two additional cuts at most). After that, markets may begin to price the next hiking cycle, especially if European growth and inflation surprise to the upside and fiscal expansion plans are executed.

Japan matters disproportionately because it is not just a central bank story; it is a global flow story. Even gradual BoJ normalization has the potential to change the behavior of Japanese institutional investors. Higher domestic yields and a rising probability of repatriation can lift global yields and steepen curves, turning Japan into a key marginal driver of both global duration and risk sentiment.

Rates and Curves: Steepening Is the Core Theme

The highest-conviction macro expression is curve steepening as a multi-year trade. The drivers are structural and mutually reinforcing:

- Rising term premium as markets reprice long-run inflation uncertainty and fiscal risk.
- Heavy sovereign issuance and persistent structural deficits.
- Potential shortening of weighted average maturity (WAM) by sovereigns, which raises exposure to the refinancing channel and reinforces term premium.

The favored expression could be 2s10s steepeners—a way to isolate ‘policy plateau + term premium repricing’ without requiring a strong view that the long end collapses in a downturn.

There is also selective and tactical value in long-dated points (e.g., 30 years) where term premium may already be substantial (notably parts of Japan and the UK), even while U.S. nominal duration looks less compelling in real terms.

A key tail risk remains a deflationary accident or policy error that produces a front-/belly-led rally. But the critical feature of this tail is that debt and deficit concerns may limit the long-end rally—again reinforcing

the idea that duration as hedge is more conditional in this regime. That logic supports hedging rate shorts with selective front-end longs where appropriate and a tactical management of the positioning.

Inflation: The Market Is Too Complacent

Medium-term inflation pricing in many markets still assumes a clean return to target with limited volatility around that path. Our view is that this is complacent. The drivers of upside inflation uncertainty are less about a classic demand shock and more about the interaction of:

- energy and geopolitics,
- lagged shelter dynamics,
- fiscal support,
- and capex intensity (AI, infrastructure, energy transition, reshoring).

This asymmetry supports being structurally positioned to benefit from higher inflation risk—via breakevens and inflation swaps—and maintaining caution on long nominal duration, particularly in the U.S., where fiscal dynamics and political noise are more likely to express through term premium.

FX: A Weaker Dollar Bias, a Stronger Yen Optionality, Managed China

The FX regime implied by these macro priors is one where the USD gradually weakens rather than collapses—particularly if U.S. policy is seen as closer to the end of cuts while other central banks shift from dovish to neutral or mildly hawkish, and if term premium normalization undermines the “U.S. duration as default safe asset” narrative.

Europe presents a plausible positive surprise pathway if growth and fiscal dynamics are better than feared, making EUR upside credible in constructive scenarios. JPY has meaningful optionality: continued BoJ normalization and repatriation flows can generate appreciation while also exporting higher yields to the rest of the world. China is treated as a managed regime: a controlled path that balances competitiveness with stability rather than a clean float.

Asia valuation asymmetry is increasingly hard to ignore. China ran a record goods trade surplus above \$1 trillion in 2025, and external-balance frameworks argue the renminbi is meaningfully undervalued. We do of course not expect a free float; rather, we expect continued management with a bias toward gradual appreciation if external pressure rises or policymakers prioritize rebalancing. Japan’s yen also screens cheap on a real-effective basis versus its own history, reinforcing the asymmetry around BoJ normalization and potential repatriation flows. Near term, the Venezuela regime-change shock adds volatility to LATAM FX (e.g., MXN) and to energy-linked currencies such as CAD as markets reassess the distribution of medium-term oil prices.

Equities: Early-Year Upside, Then Regional Rotation Risk

Equities sit at the intersection of two forces: the near-term support from earnings and capex, and the medium-term valuation and rate-structure constraints that come with a world pricing higher term premium. If AI-driven productivity gains accelerate, earnings can compound even as hiring remains subdued—supportive for equities despite a late-cycle labor profile.

Tactically, the year may start with a “hawkish cut” wobble as markets digest the end of the easing phase and the re-emergence of hike risk further out. Strategically, the bias is to buy that volatility into 2026, anchored in earnings growth and growth impulses from both the U.S. and Germany, plus ongoing productivity/capex themes (AI, infrastructure, reshoring).

The key equity uncertainty is not whether equities can rise, but where leadership migrates:

- a scenario where the U.S. still leads on earnings quality,
- a rotation where Asia (including China tech) outperforms as USD weakens and relative valuations matter more,
- and a European upside surprise where steepening supports financials through improved net interest margins (NIMs), even as idiosyncratic political risk remains a constraint.

Housing, Mortgages, and MBS: Transmission Channel and Opportunity Set

Housing and mortgages are likely to be a key transmission channel in 2026 because political desire for lower mortgage rates collides with limited tools. The structural constraint is affordability: supply response is slow (zoning/permitting/build timelines), while populist interventions can create near-term mispricing that increases longer-term instability.

The tactical microstructure matters. Builders’ reluctance to cut prices and the prevalence of temporary rate buydowns can create future LTV and credit complications when subsidies roll off. Meanwhile, AI-driven refinancing and faster borrower response functions may increase negative convexity relative to standard models. Banks, scarred by SVB-type episodes, may remain reluctant marginal buyers of mortgages, leaving policy and technicals as meaningful drivers.

Within that complexity, our constructive view is on agency MBS relative value: room for spread tightening versus Treasuries without requiring a large directional rates move, and a preference for mortgages versus Treasuries relative to swaps—even in a challenging rates environment. We also like MBS as a different expression of the steepener trade.

Commodities: Capex and Debasement Hedges

Commodities fit naturally into the 2026 narrative. Copper and silver are leveraged to capex-heavy regimes (electrification, infrastructure, transition) and to reflationary nominal growth. Gold remains supported by debt/debasement concerns and the possibility that policy ultimately leans on stealth financial repression if the political economy favors lower real funding costs over overt austerity.

Venezuela adds an important supply-side optionality to this real-asset framework. Venezuela holds the world's largest proven crude oil reserves (about 303bn barrels, ~17% of global reserves), but translating reserves into supply would require large-scale rehabilitation of degraded infrastructure and multi-year investment—particularly given the extra-heavy crude mix. If governance and capital mobilization allow, incremental Venezuelan output could meaningfully widen the medium-term downside distribution for oil prices, pressure higher-cost producers, and dilute OPEC's ability to sustain a tight price band; in the near term, uncertainty can still support risk premia.

Portfolio Implications: One Regime, Multiple Paths

The common thread across scenarios is not a single directional bet; it is a structural bias:

- toward steeper curves,
- toward inflation risk being underpriced,
- toward selective non-U.S. opportunity as U.S. exceptionalism is questioned,
- and toward intellectual flexibility and tactical positioning which is a strength of our discretionary portfolio managers, because sequencing risk is high and the path matters as much as the destination.

In this environment, we also value explicit geopolitical convexity. Episodes like Venezuela are a reminder that the 'policy process' can change abruptly, raising correlation risk, changing inflation uncertainty, and supporting portfolio hedges. In practical terms, this argues for caution in U.S. long nominal duration, preference for being paid inflation risk, a modest USD weakening bias with JPY optionality, selective equity exposure with an eye toward regional rotation, constructive agency MBS relative value, and a real-asset allocation that benefits from capex intensity and fiscal/debasement dynamics. These trades could be paired with explicit hedges that recognize that in this regime, "growth scares" are more likely to steepen curves than flatten them.

A year from now, we expect some of our views to have been wrong, as markets always find new ways to surprise. Our edge is staying flexible, managing risk tightly, and adjusting quickly as the data and policy process evolve. We enter 2026 with high conviction in steepening and inflation-risk asymmetries, but with the discipline to pivot as the sequence of outcomes becomes clearer.

We thank you for your partnership and trust during this tumultuous year and are excited for the opportunities that 2026 may bring.

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