

How to stop worrying and start living with uncertainty

Report for the week ending December 05,
2025

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Monologue

In our memo this week, "The Age of Ambiguity," we document how and why uncertainty surrounding the US fiscal and monetary outlook is at levels not seen since measurements began in the early 1990s.

The economic outlook is genuinely difficult to assess at this juncture. Arguments for recovery, a popping AI bubble triggering a crisis, and everything in between, can be made to sound plausible.

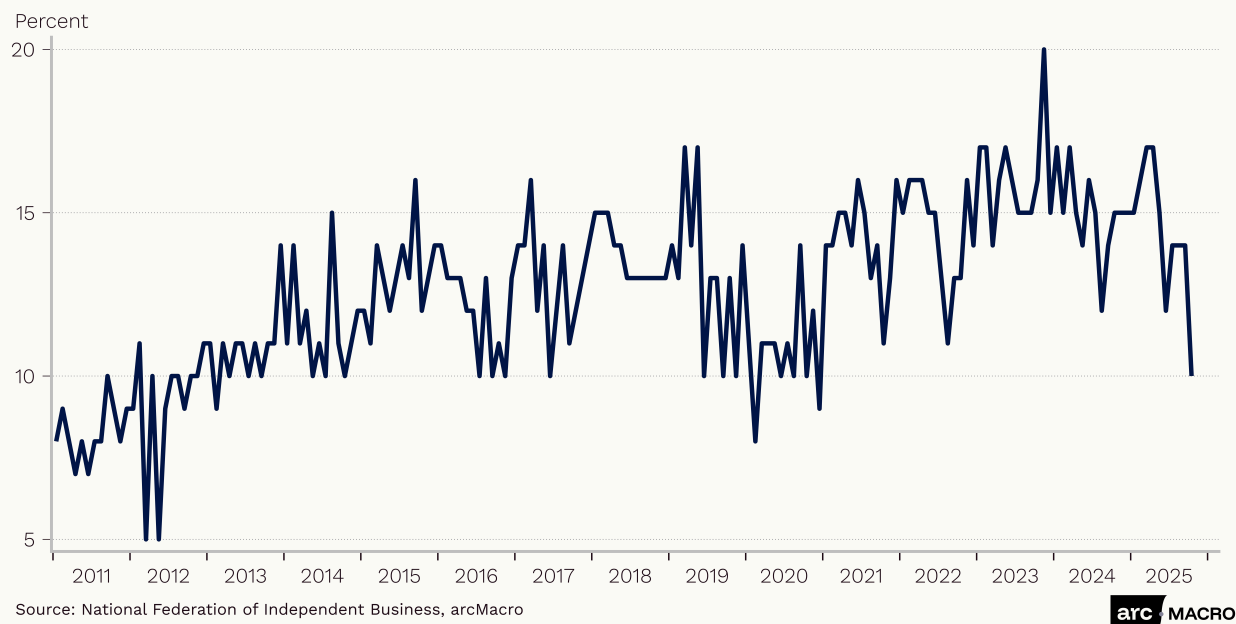
At times like these, distinguishing between *uncertainty* and *risk* can be helpful. Risk involves a "known distribution"—we have a sense of what's likely to happen, within a certain range of fuzziness. We can be confident of a trend around a mean. Uncertainty is when we don't know the distribution at all; probabilities can't be assigned because the range of outcomes is unknown. In plain terms:

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Academic research has consistently found that uncertainty has stronger negative effects on economic activity, particularly on investment. There is now plenty of evidence that the high level of uncertainty that has prevailed in 2025, primarily driven by trade policy uncertainty, has weighed on investment. Just look at the chart below, or at the reports from businesses in the latest Fed Beige Book.

Uncertainty has collapsed small business investment

United States, Share of small businesses making capital investments of \$100k or more



The fog of uncertainty may now be starting to lift. Uncertainty is shifting from abrupt and direct (trade and tariffs) to a longer-term background force (elevated monetary and fiscal policy). This type of ambiguity may not be economically ideal, but it gives financial markets something to do: price risk, intermediate capital flows, and (in my corner of the world) try to make sense of the trajectory. Stop worrying and learn to love it; it's not going away.

Why is uncertainty easing? In short, because the trade environment is collapsing from fundamental uncertainty to quantifiable risk. The administration has retreated from its bizarre "Liberation Day" global tariff formula and softened its stance toward Europe and ASEAN after making a formal deal with Europe and reaching a detente with China.

The last major domino to fall will be USMCA (CUSMA in Canada, T-MEC in Mexico—everyone puts their own interests first, it seems). A "review" of the accord that replaced NAFTA (and mostly kept it in place) is due by mid-year, and negotiations have already been soft-launched. But with Trump under pressure on domestic cost-of-living pressures, and a united US business lobby pushing hard to keep USMCA intact, he may not want to rock this particular boat just before midterms. And he has an easy face-saving out: he's the one who signed this deal in the first place. We

don't know how the agreement might be modified, but the scope for change appears to be shrinking.

The tariff outlook transitioning from pure, chaotic uncertainty to manageable risk could help unlock investment spending. Lower interest rates and fiscal stimulus arriving in the first half of next year will also contribute to domestic demand. The only downside relates to inflation – firms will also start to calibrate and pass through price adjustments as uncertainty clears, so we'll likely see inflation rise alongside growth.

This is not to say we're out of the woods in the long run. Trade uncertainty is being replaced by fuzzier ambiguity over the Fed's approach to inflation and interest rates, and what a US public debt rising to 120% of GDP could mean for economic and financial dynamics. In my view, the answer is "three things:" Above-target inflation, sustained high (and perhaps rising) risk premiums keeping the US yield curve relatively steep, and a continuation of the gradual global shift away from US assets and into a more diversified pool of safe(ish) assets.

Reads of the Week

- **The Deep End**: If you can make it past the already retro-looking AI-generated cover image, you'll find an interesting analysis of rising risk appetite in the bulge bracket as active vintages struggle to realize value.
 - **It's time to sound the alarm on growing fiscal and financial risk**: Martin Wolf of the FT explores some of the market dynamics behind rising public debt burdens.
 - **The Games Wall Street Plays**: Alternative title: Teach your kids to gamble." An enjoyable weekend long-read.
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Market Monitor

Hassett the hatchet(?)

Has Kevin Hassett already taken his first action as Fed Chair? It certainly looks like he's steepened the Treasury yield curve. Five- and ten-year Treasury Note yields rose a hefty 12 basis points this week (the two-year note climbed a more modest nine basis points) following news that he's President Trump's leading candidate to take

over from outgoing Chair Jay Powell next year.

The link between long bond moves and the Hasset news is direct. The FT reported that Wall Street executives have warned the administration against the appointment on the basis that Hasset could lower interest rates too far and spark an inflation spike. Hence, a rise in the long-term risk premium.

Nothing is confirmed yet, however, and the open question now is whether the frosty reception from bond markets is enough to shift the President's thinking on Powell's successor.

Japan's rude awakening

Sovereign fixed income was the big story in global markets too, with Japanese yields rising to their highest level since 2007. The benchmark 10-year bond now yields just a hair below 2.0%, a sharp rise from 1.5% as recently as August. Markets are pricing in a definitive regime change in Japan as Prime Minister Sanae Takaichi gets her agenda moving. The New Japan is characterized by higher inflation, bigger fiscal spending, and thus higher interest rates.

Ultra-low rates have helped Japan carry a public debt burden above 200% of GDP for decades. A normalization of economic conditions—which would otherwise be positive—will put pressure on the public purse by raising interest costs if new borrowing remains as heavy as the PM's current plan implies.

The government is gambling that higher interest rates will spur a private-sector investment and growth resurgence to offset this dynamic by reallocating the large piles of unproductive household and corporate cash (around 50% of household assets are in cash, and corporates hold around 15% of GDP worth of cash deposits).

There are risks on the horizon for Japan, but risks bring reward. There is also a sense that Japan's sluggish economy is awakening from its 30-year sleep. We remain long-term bullish on Japan, especially for small-cap or private equity investors with exposure to rising domestic demand or a thematic focus on large corporate M&A.

Private credit looks for a clean bill of health from The Old Lady of Threadneedle Street

We'll be keeping a close eye on any attempt to accurately assess the level of systemic risk embedded in private credit. The Bank of England's upcoming stress tests (dates to be confirmed)—which most of the largest US private credit providers have now signed up for—will set the benchmark. These funds aren't regulated in the UK, so their voluntary participation is both commendable and a signal of confidence.

The Week in Markets

	Latest*	Change since last week (units)	Change since last week (%)	3-month change (units)	3-month change (%)	Year-to-date change (units)	Year-to-date change (%)
Equity							
S&P 500	6870	21.3	0.3	368	5.7	989	16.8
Information Technology			1.4		10.0		25.4
Financials			0.6		-0.7		10.8
Consumer Discretionary			0.8		2.0		5.4
Communication Services			0.8		10.2		34.9
Health Care			-2.7		11.6		11.1
Industrials			0.5		2.1		17.0
Consumer Staples			-1.4		-2.2		1.9
Energy			1.4		3.0		6.3
Utilities			-4.5		3.4		13.6
Real Estate			-1.5		-1.3		1.0
Materials			-1.5		-4.2		4.7
Nasdaq Composite	23578	212	0.9	1870	8.6	4267	22.1
Dow Jones Industrial Average	47955	239	0.5	2334	5.1	5411	12.7
Russell 2000	6267	52.3	0.8	353	6.0	724	13.1
Sovereign Fixed Income							
US: 2-year Treasury Note	3.56	0.09		-0.030		-0.69	
US: 5-year Treasury Note	3.72	0.13		0.070		-0.66	
US: 10-year Treasury Note	4.14	0.12		-0.030		-0.44	
FRA: 10-year OAT benchmark	3.53	0.12		0.030		0.35	
GER: 10-year Bund benchmark	2.78	0.09		0.070		0.39	
CHN: 10-year CGB benchmark	1.85	0.01		0.0420		0.173	
CAN: 10-year GoC benchmark	3.26	0.14		-0.13		0.030	
Corporate Bond Spreads							
US: A-rated	71.3	-5.1		-6.7		-2.8	
US: BBB-rated	106	-5.8		-2.6		4.4	
Leveraged Loan Spreads							
US: B-rated	403	-3.68		5.53		-7.01	
US: BB rated	261	-0.697		3.83		5.14	
US: CCC-rated	1511	15.7		163		240	
Foreign Exchange Rates							
DXY US Dollar Index	99		-0.5		0.7		-8.8
EUR/USD	1.17		0.8		0.1		12.2
USD/CAD	1.39		-0.8		1.1		-2.9
USD/CNY	7.07		-0.2		-1.1		-3.2
USD/JPY	155		-0.7		4.4		-0.9
GBP/USD	1.34		1.4		-0.3		6.5
USD/CHF	0.8		-0.8		-0.6		-10.8
Commodities							
WTI Crude	59.9	0.49	0.8	-3.08	-4.9	-11.6	-16.2
Gold	4243	51.9	1.2	697	19.6	1634	62.6
S&P GSCI Commodities			1.7		2.9		2.7
S&P GSCI Industrial Metals			2.3		12.6		18.0
S&P GSCI Agriculture			-1.2		0.1		-9.4

* Weekly closing value. Color indicates positive (green) or negative (red) change since prior week.

Source: S&P Global, Russell Investment Group, Nasdaq, U.S. Department of Treasury, Macrobond Financial AB, Central Bank of Germany (Deutsche Bundesbank), Bank of Canada, Intercontinental Exchange (ICE), International Monetary Fund (IMF), LBMA (London Bullion Market Association), Robert Shiller, Chicago Board Options Exchange (CBOE), U.S. Department of Labor, Pitchbook | LCD, arcMacro

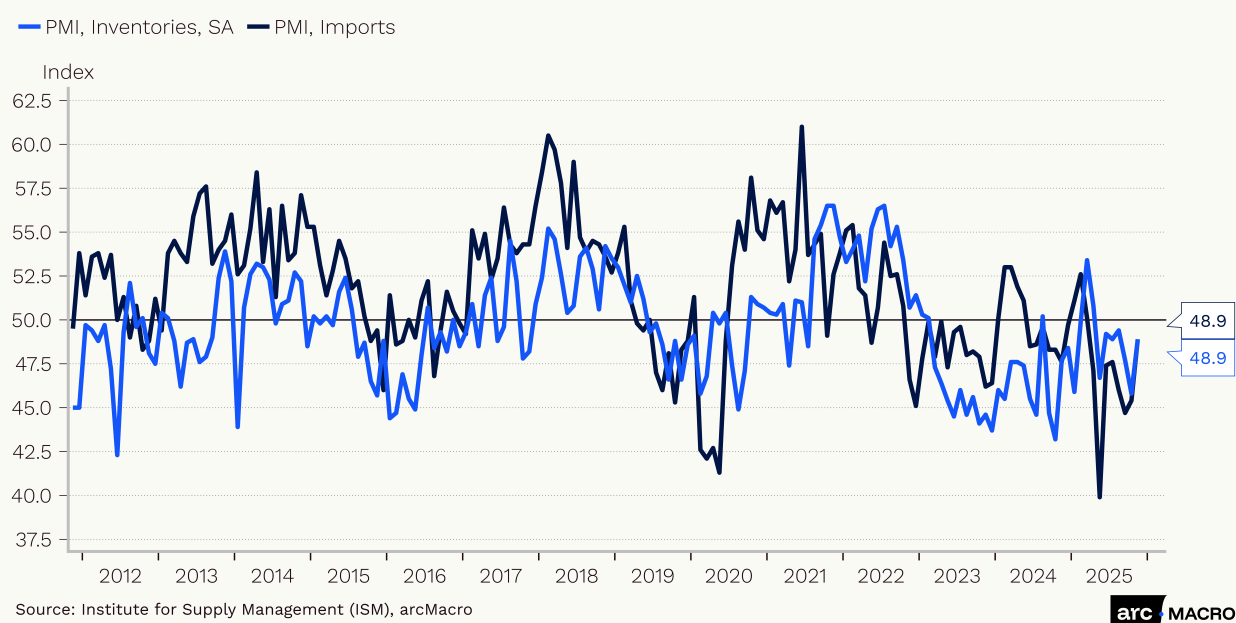


Macro Monitor

No major data releases landed this week, but the balance of tier-2 and tier-3 data was net neutral. The ISM Services Index improved to modest expansion levels, offsetting a slip below the 50-point expansion/contraction mark from manufacturing. The sub-indices revealed that manufacturers are still working through inventories and reducing imports, confirming our view that the bulk of tariff-related price adjustments will only arrive in the new year.

Inventories and imports both still shinking

United States, ISM Manufacturing PMI, Imports, Index, >50 = expansion



Small businesses reported lower hiring in the NFIB survey in November, but there was also a sharp rise in the number of firms intending to expand hiring over the next three months (19%, consistent with the share during major economic booms – see chart). This adds to evidence that we'll likely see a rise in aggregate demand in the first half of next year as new tax breaks kick in and firms make their long-delayed price and capital deployment adjustments.

Small businesses hiring plans are looking healthy in historical context

United States, NFIB small business hiring plans, Next three months, net, SA



Finally, the UMich Consumer Survey reported a rise in consumer sentiment—albeit off rock-bottom levels—up from 51.0 to 53.5.

Next week will be all about the Fed. Not so much the rate decision itself—we'd be surprised to see the committee shock markets by defying the 85% odds of a 25 basis point cut baked into forward prices, especially since they don't have much fresh data to pin such an action to—but for signals of further dissent and a read on the emerging balance between hawks and doves to be found in the final Summary of Economic Projections of the year.

See the appendix for arcMacro proprietary Factors and the Key Macroeconomic Indicators tracking chart.

What we'll be watching next week

- *FOMC Interest rate decision (US)*: The Fed will announce its decision and release its Summary of Economic Projections (including the "dot plot") on Wednesday.
- *BoC Interest rate decision (Canada)*: Wednesday's side-show. Consensus is for a hold after the BoC has delivered 100 basis points of easing this year, taking the target rate to 2.25% to help offset the negative trade shock from the US.

Memo

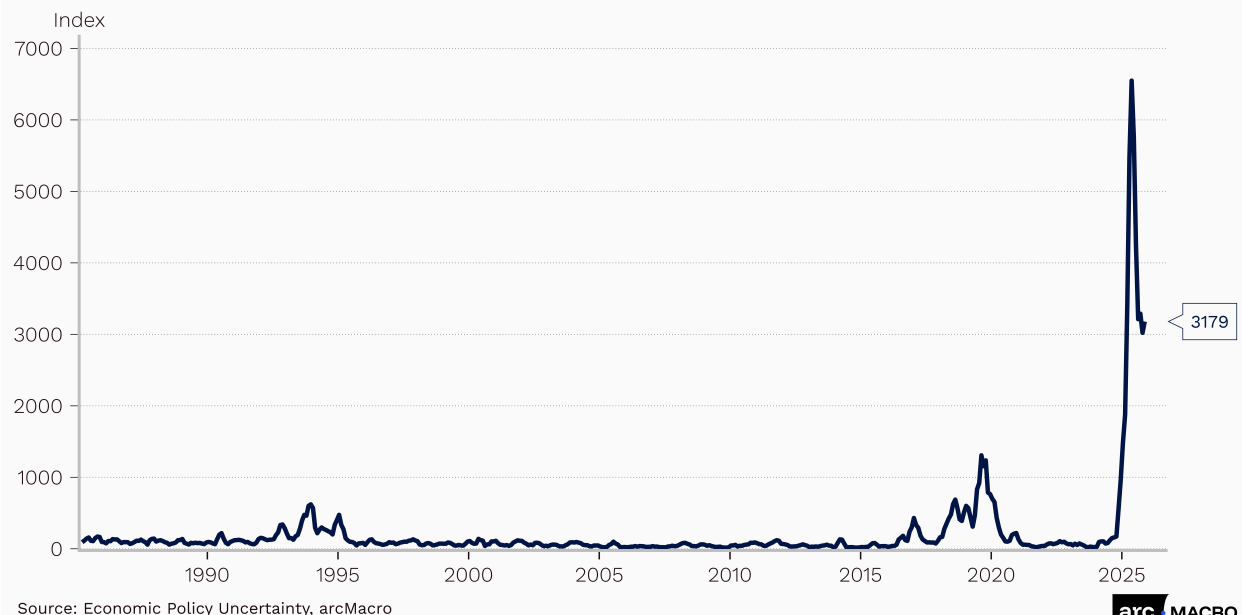
The Age of Ambiguity

Bottom line: Fiscal and monetary policy uncertainty is high, reflecting concerns about the ability and willingness of America's economic institutions to contain inflation. This will keep term premia high.

The incredible rise in trade-related uncertainty in the US makes this a strong candidate for "chart of the year" in 2025.

Trade policy uncertainty has eased but remains extreme

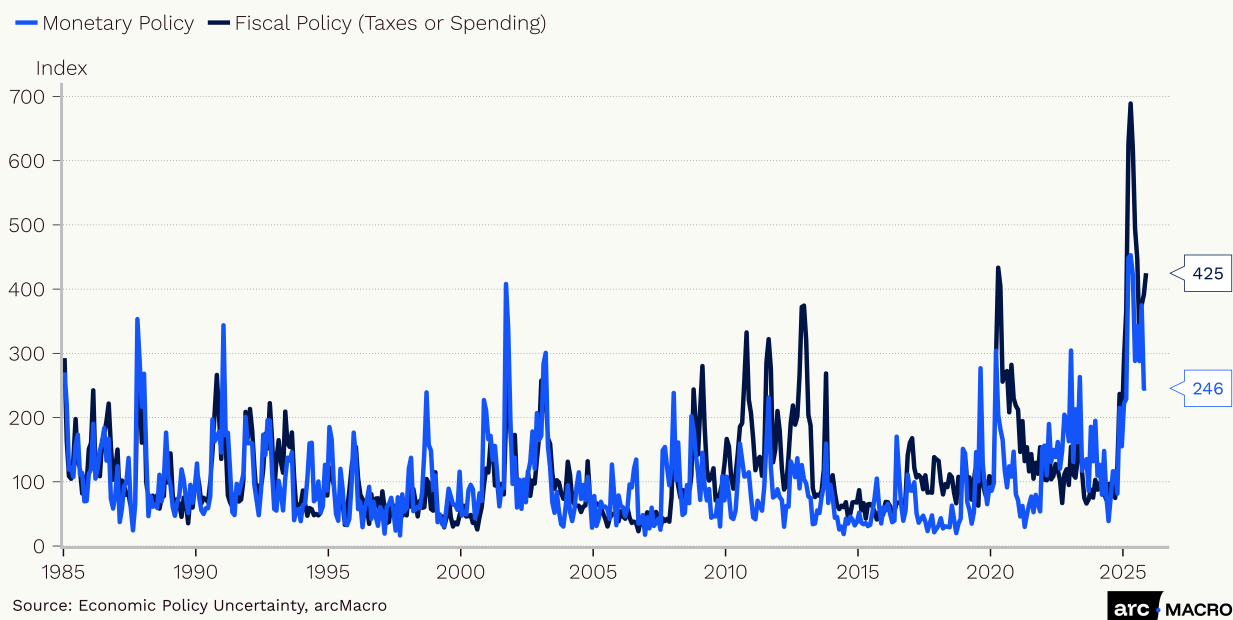
United States, Economic Policy Uncertainty Index, 3 month moving average



In all the fuss, we may have missed a less extreme but perhaps more persistent form of uncertainty emerging. Ambiguity associated with US government policy—taxes and spending, interest rates, and regulation—is also at unusually high levels.

Forget trade; fiscal and monetary policy uncertainty is at record levels

United States, Economic Policy Uncertainty Index subcomponents



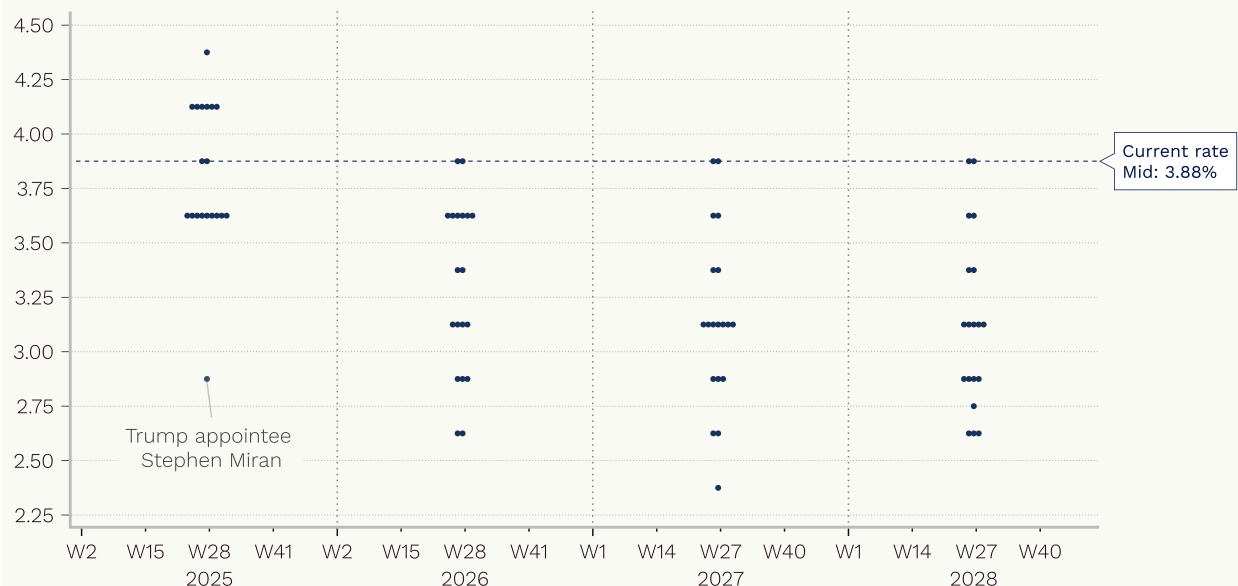
Monetary Uncertainty

Markets have locked in a cut at next week's Fed meeting, but the one-year outlook is anything but certain.

The range between the high and low 2026 interest rate projections among current FOMC members is remarkably wide, at a full 1.25 percentage points. Votes are thinly spread across that range. What's more, self-reported uncertainty over the members' growth, inflation, and unemployment projections that form the basis of their rate views has risen sharply in 2025, to levels usually associated with economic crisis.

A committee divided

FOMC "dot plot": Last Summary of Economic Projections

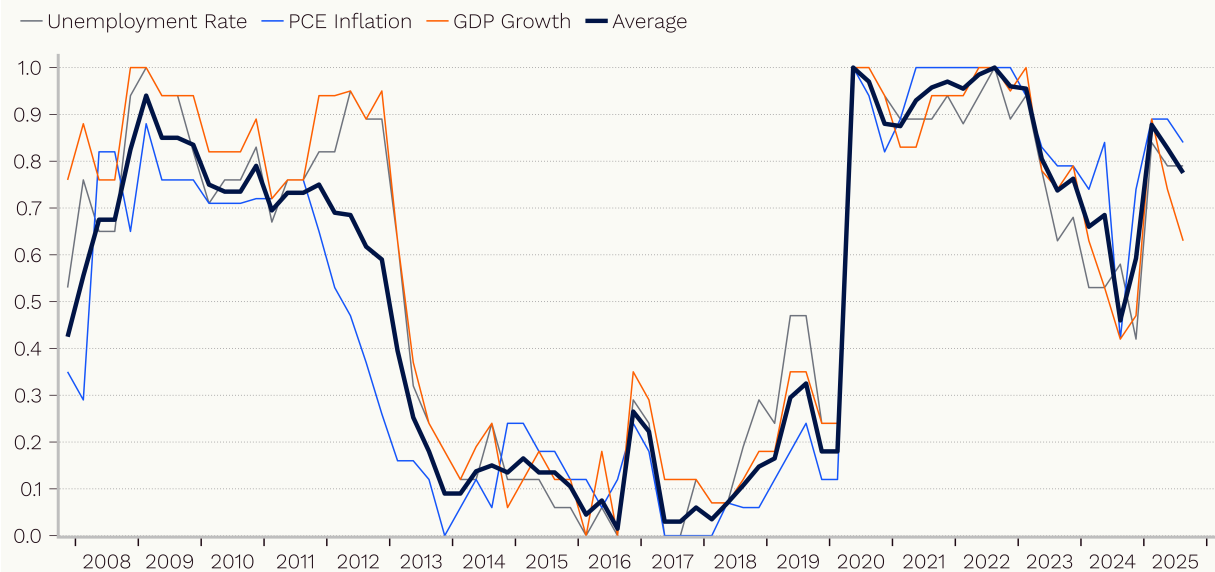


Source: Federal Reserve, arcMacro

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Fed rate setters have lost confidence in their projections in 2025

United States, Uncertainty around SEP participant forecasts, diffusion indices*



* A value of 100 indicates that all members report higher than average uncertainty about their projections
Source: Federal Reserve, arcMacro

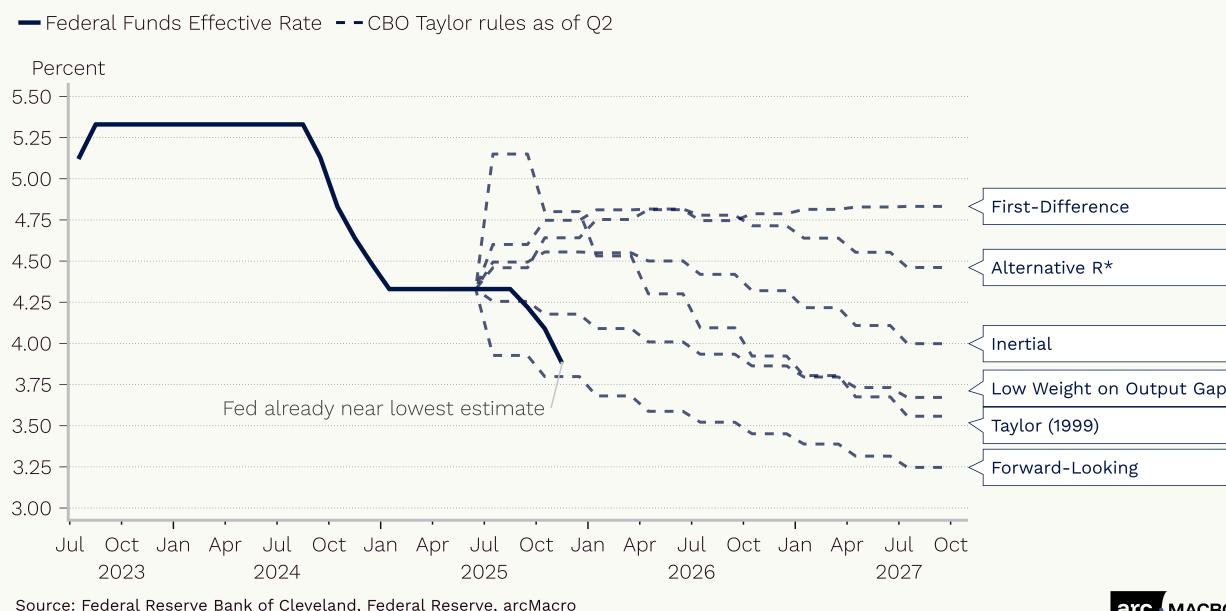
arc MACRO

We can see the level of monetary uncertainty reflected in so-called "Taylor rules," which are often used as a reference point for the appropriate level of interest rates. These rules connect the policy rate to the trend growth/employment and inflation relative to their long-run equilibrium. Academics have made many adjustments and

improvements to Taylor's initial 1992 rule, so we're now blessed with a dizzying array of models that—depending on the one you choose—advise anything between a further 50 basis points of easing to 100 basis points of tightening over the coming year (according to estimates run by the Congressional Budget Office).

It's worth pointing out that the Fed is tracking toward the extreme lower range of Taylor rule guidance.

Slightly different "Taylor Rules" generate drastically different Fed Fund Rate outlooks United States, CBO monetary policy rule estimates, Q2 2025



So far, this relates just to the challenges the current committee faces as it tries to read the economy. Who will lead the Fed when it makes its key decisions is still unknown, but the next Chair will likely break in some way with the Powell era. Kevin Hassett, the front-runner (at 72% odds on Kalshi), is a black box. In recent interviews, he has trumpeted various elements of the Trump administration's agenda but said very little about the economy, interest rates, or his philosophy on monetary policy.

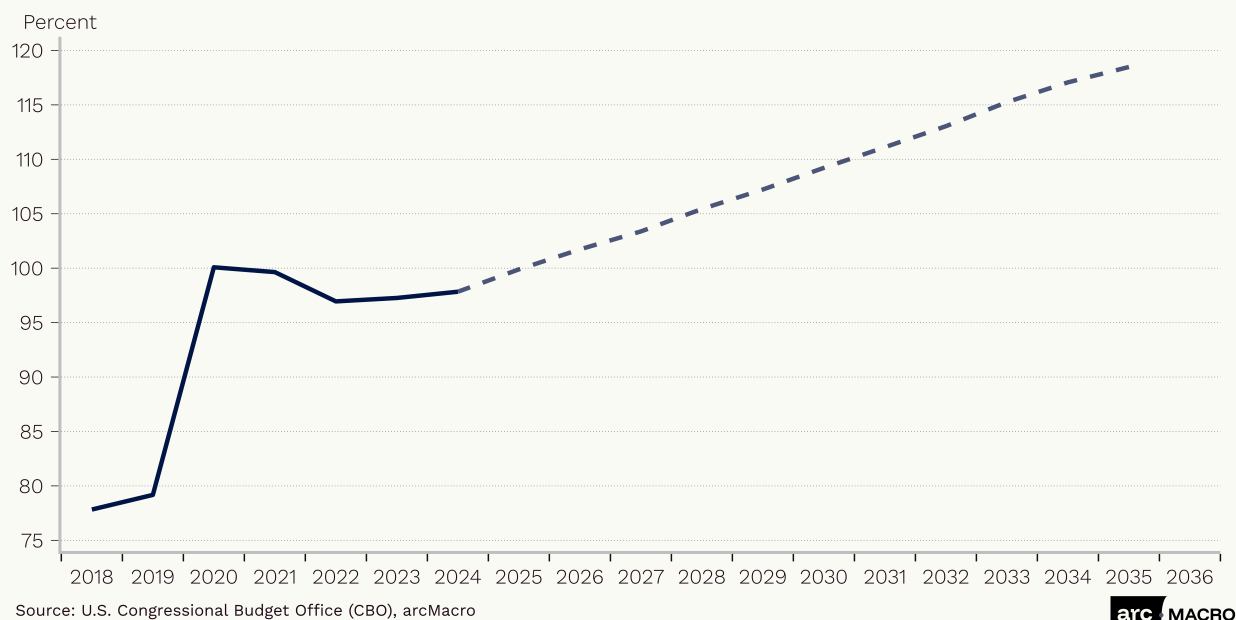
This adds another layer of uncertainty, further compounded by concerns that the committee's ability to resist political pressure to ease monetary policy is slowly being eroded.

Fiscal Uncertainty

Fiscal uncertainty is harder than monetary uncertainty to measure, but any watcher of bond markets knows it's high. The CBO projects that America's net Federal debt will rise from 98% of GDP currently to nearly 120% by 2035.

Can the US carry a 120% of GDP public debt burden?

United States, Debt held by the public, CBO projection, percentage of GDP



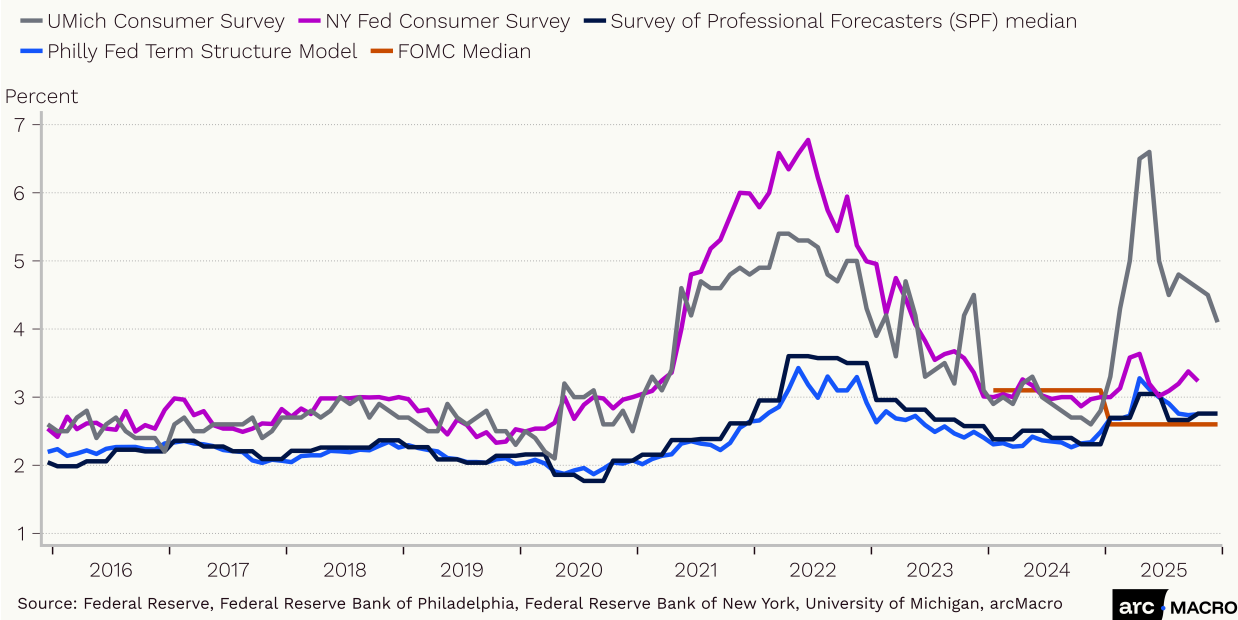
With the recent government shutdown demonstrating just how fraught any budget policy can get—and with neither party committed to reining in growing deficits—there is no real reason to push back on the CBO's projections. The uncertainty here relates more broadly to whether the US can carry such a heavy debt burden, and what its economic implications will be.

Implications

Elevated fiscal and monetary policy uncertainty does not bode well for the inflation outlook. Unlike the labor market (which is clearly weakening from "very tight" at a gradual pace), there is substantial disagreement on the inflation outlook. The charts below show that this is the case on a one-year horizon, and potential monetary policy mistakes and a loss of fiscal control are raising longer-term inflation risk.

Inflation expectations are high and dispersed

United States, Expected inflation over the coming year



The combination of fiscal and monetary uncertainty and upside inflation risk means that the term premium will remain high and the yield curve steep. This will work against Fed easing by keeping the cost of longer-term capital outlays high.

Alongside high risk premia, we anticipate that the "debasement trade" will remain with us, as reflected by the gradual loss of appetite for dollar-denominated assets. Not that this is not "de-dollarization" but rather a general trend toward greater diversification toward other safe havens and periodic confidence crises.

The Treasuries risk premium is stubbornly high

United States, 10 year Treasuries, risk premium



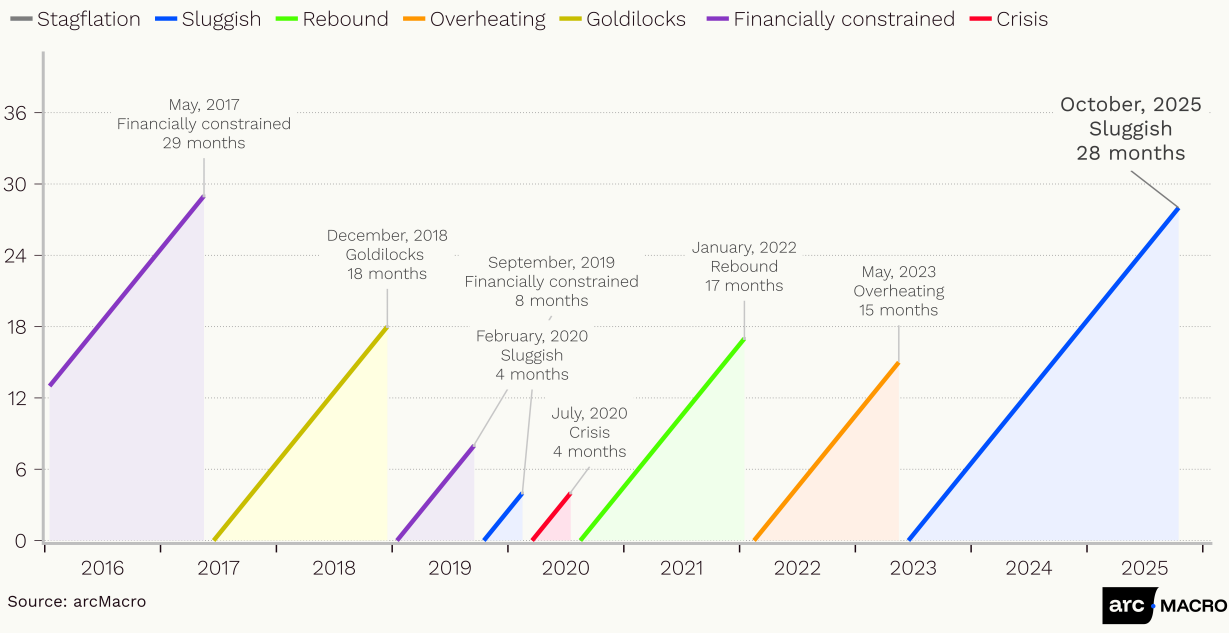
Appendix: Proprietary Factor and Regime Model and Key Macro Indicators

arcMacro Real Time Factors

United States, z-score

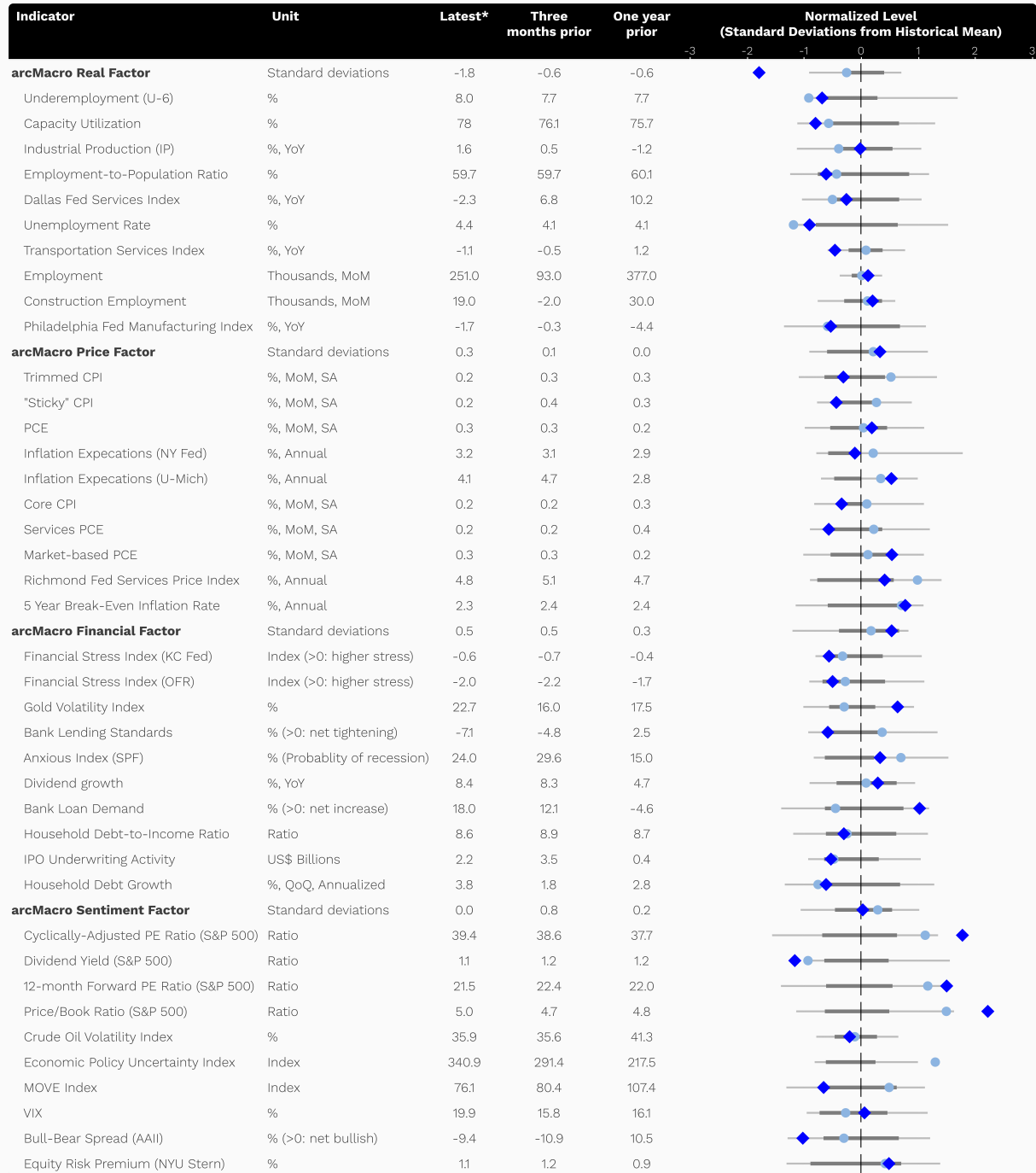


arcMacro Regime Summary
United States



arcMacro Factor Input Monitor

Top 10 inputs by factor loading



■ 10th-90th Percentile ■ 25th to 75th Percentile ● Mean of past 5 years ◆ Latest Value

Source: arcMacro, BLS, Fed, Dallas Fed, DOT, Philadelphia Fed, Cleveland Fed, Atlanta Fed, BEA, New York Fed, University of Michigan, Richmond Fed, Macrobond, Kansas City Fed, The Office of Financial Research (OFR), CBOE, S&P Global, SIFMA, Robert Shiller, Economic Policy Uncertainty, ICE BofAML, LJKmfa, AAIL
*Most recent published data point. Time period and frequency do not necessarily align.