



TACO?" want to take a "BET" on that?

Report for the Week Ending 24 January, 2026

Dylan Smith

Monologue

"You'll find out." — President Trump, when asked whether he would use force to seize Greenland. Tuesday, Jan 20

"Our view is the middle powers must act together because if we're not at the table, we're on the menu [...] We shouldn't allow the rise of hard power to blind us to the fact that the power of legitimacy, integrity and rules will remain strong if we choose to wield them together." — Canadian Prime Minister Mark Carney. Tuesday, Jan 20

"We probably won't get anything unless I decide to use excessive strength and force where we would be, frankly, unstoppable. But I won't do that." — President Trump, Wednesday, Jan 21

"If Canada makes a deal with China, it will immediately be hit with a 100% tariff against all Canadian goods and products coming into the U.S.A." — President Trump, Saturday, Jan 24

To modify Harold Wilson's famous quip, **a week is a long time in geopolitics.** The quotes above sum up the saga that played out at the World Economic Forum in Davos, driving a volatile week in global markets. Although it ended in a relief rally after President Trump's perceived climbdown on Greenland, we're not convinced that tensions between NATO allies are settled for world leaders or for the investors trying to navigate their implications. Trump's mooted new tariffs on Canada prove that, while also showing how difficult it can be to trace the chains of cause and effect ricocheting through the global economic system.

A quick recap: Just before we published last week's note, we learned about President Trump's threat to raise tariffs on several European countries if Denmark refused to cede Greenland to America. We noted that this would dominate the week ahead. Trump ratcheted up tensions on Monday and Tuesday, reiterating his tariff threat and refusing to rule out the use of force. Europe and most of its fellow NATO members pushed back hard, both economically (proposing counter-tariffs and reminding the world about its large stock of US assets) and diplomatically (sending more troops to Greenland and reminding the US of the value of its European bases for projecting power into Asia). Stock markets plummeted, and the US dollar came under pressure. Solidarity among "middle powers" was captured in Canadian Prime Minister Mark Carney's viral speech on his country's place in the "new world order." Trump was forced to back down and ruled out an invasion of Greenland. Markets rallied, and the "TACO" (Trump Always Chickens Out) trade appeared to be validated. The saga appeared to be over until President Trump, clearly stung by the week's events, dramatically threatened to place a 100% tariff on Canadian imports in retaliation for its tariff-reduction agreement with China.

So, the net effect of Davos week has been an escalation of tensions between the U.S. and Canada, positioning the US-Mexico-Canada (USMCA) trade agreement review due mid-year as a key near-term market and economic risk event. In a nice piece of circularity, that's exactly where we left off on last week's Monologue, wondering what Canada's agreement with China would bring in the form of retaliation from the US. Now we know.

I want to use this space to push back on the consensus view on two key issues.

First, "TACO" should be eaten with a massive pinch of salt. President Trump may have ruled out boots on the ground for now, but tensions over Greenland will re-emerge before long. We're confident that Greenland-related tariffs (and/or other means of economic coercion) will be threatened again in the months ahead as the President pursues full US sovereignty over the island.

Europe's ideal strategy would be to kill the issue in NATO committees and working groups. Trump has no patience for such processes. And he's dead-set on grabbing Greenland. Read the quote below, from the same speech in Davos in which Trump apparently ruled out the use of force. Every time you see "Greenland," substitute "Crimea." Every time you see "Denmark," substitute "Ukraine."

"After the war, we gave Greenland back to Denmark. How stupid were we to do that? But we did it, but we gave it back. But how ungrateful are they now?" — President Trump, Wednesday, Jan 21

That could have been a statement by Vladimir Putin circa 2015 or 2022. That parallel is important. Western powers were repeatedly caught unprepared for Russia's invasions of Ukrainian territory because they saw little economic or strategic sense in it for Russia and believed Putin would back off. The same rationalist thinking is being applied to Trump. Analysts in this camp point out that he already has free rein to expand his bases and military presence in Greenland under existing agreements with Denmark, and that the US would lose more than it gains by blowing up NATO in pursuit of Greenlandic sovereignty.

This is true, but it might not be relevant. It's not how Trump is thinking. Like Putin, he's thinking about national prestige, the size of his flag's footprint on the global map, and his place in the grand sweep of history. Here are some more quotes from that Davos speech, which went under the radar amid the supposed military climb-down:

"And that's the reason I'm seeking immediate negotiations to, once again, discuss the acquisition of Greenland by the United States – just as we have acquired many other territories throughout our history.

And all we're asking for is to get Greenland, including right, title and ownership, because you need the ownership to defend it. You can't defend it on a lease. Legally, it's not defensible that way. Totally. And number two, psychologically, who the hell wants to defend a license agreement or a lease [...]" — President Trump, Wednesday, Jan 21

So eat all the TACOs you want, I prefer to take a BET (Believe Every Threat).

Greenland will be a headache for markets for as long as Trump is president, all the more so if Democrats regain control of the House and he decides to go legacy-hunting.

Second, we expect little change to the USMCA this year. 100% tariffs are simply not going to happen.

I'm going to immediately contradict myself by arguing that a rationalist argument actually does make sense on the issue of Canadian tariffs – albeit a narrow and sometimes bizarre subset of rationality called "political rationality."

A massive 100% tariff on Canada, or even a much smaller negotiated set of tariffs that would likely come with a renegotiated trade agreement, are **simply too politically harmful to Trump** to be worth pursuing ahead of the midterm elections. It would impart an immediate and large stagflationary shock to both economies. Midwestern states like Michigan, where a disproportionate number of tight electoral races are taking place, would be hit hardest.

American businesses are already lobbying hard to remove targeted tariffs on steel and vehicle parts and have presented a united front in support of preserving the key provisions of the USMCA accord.

The most likely outcome, therefore, is that all parties agree to punt the USMCA review and avoid full-scale renegotiations. And after the midterms, a Democrat-controlled Congress will likely reassert its powers over tariff policies, easing tensions with Canada.

Before signing off, I'd like to encourage you to read this week's Memo, which focuses on Japan – probably the more important issue for markets in the long-term than all this Trump-related drama.

Next week, we'll take on the even bigger issue of US dollar dominance and debasement. Stay tuned.

Dylan

Must-Reads

- **The West's Last Chance**: Carney's viral speech in Davos was, in part, intellectually grounded in Finnish President Alexander Stubb's theory of "values-based realism," as outlined in this article. A long but enlightening read, and highly recommended (Foreign Affairs will ask for your email, but the article is free).

- **America's own goal: Americans pay almost entirely for Trump's tariffs:**

Important new research from the Kiel Institute for the World Economy:
"Foreign exporters absorbed only about four percent of the tariff burden, 96 percent passed through to US buyers."

- **Macroeconomic implications of immigration flows in 2025 and 2026:**

January 2026 update: Nobody knows exactly how much the Trump administration has altered the composition and size of the U.S. labor force, because the data are imperfect and come with a 2-year lag. The good folks at the Brookings Institution have given it the old college try, putting breakeven employment over the next two years a little above zero.

Macro Monitor

Bank of Japan holds steady amid market turmoil

The Bank of Japan held its policy rate steady at 0.75%. In deference to a highly volatile week in Japanese bond markets and the uncertainty created by the snap election in early February, Governor Kazuo Ueda avoided any concrete guidance on the future path of interest rates (we offer our thoughts in the market monitor section).

The Governor would have been relieved to see inflation falling from 2.9% year-over-year to 2.1% in a report released shortly before the decision, but the bank did upgrade its inflation projections owing to the weaker Yen.

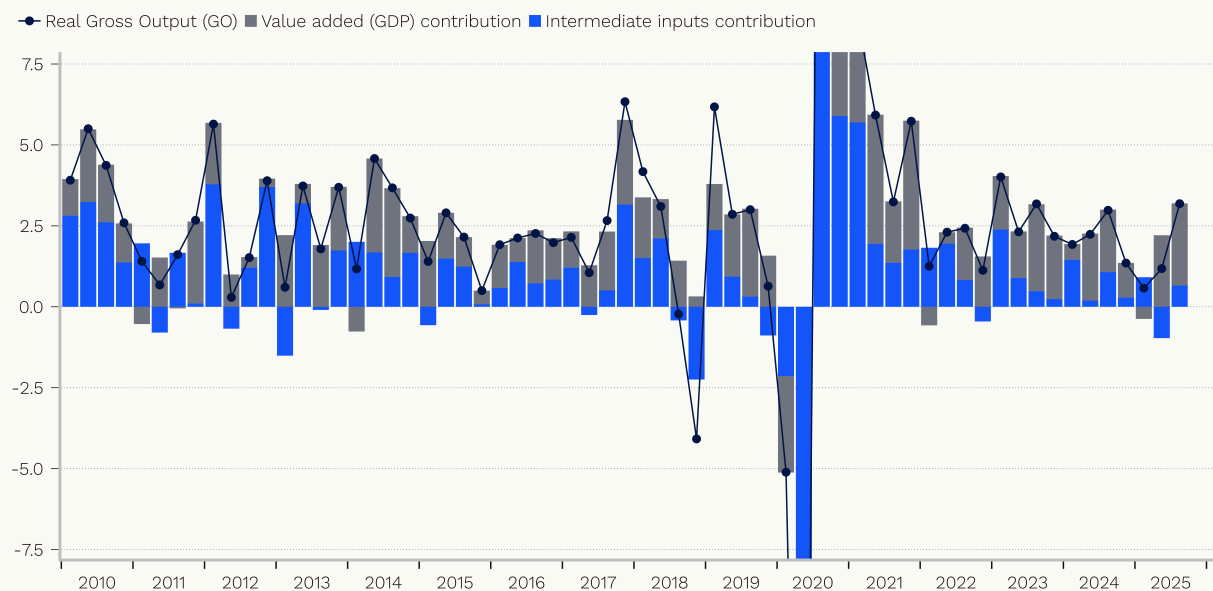
GOing OK

The third release of US national accounts data for the third quarter brought a tiny upward revision to annualized GDP growth (4.4%, up from 4.3%). More importantly, it provided details on industry-level "Gross Output" (GO), a holistic measure of economic activity that includes spending on inputs in addition to net value added (GDP) — the combined B2B and B2C components of the economy. It showed a strong recovery from the dip in late 2024 and early 2025.

The source of that recovery tells us that the cyclical growth upswing we're witnessing is concentrated on productivity improvements; spending on inputs is growing little, but value added is soaring. This is not about firms adjusting to tariffs. It's about the more productive services sector outgrowing the old economy.

Productivity growth is fueling an output recovery

United States, Contributions to Gross Output Growth, SA, QoQ ann.

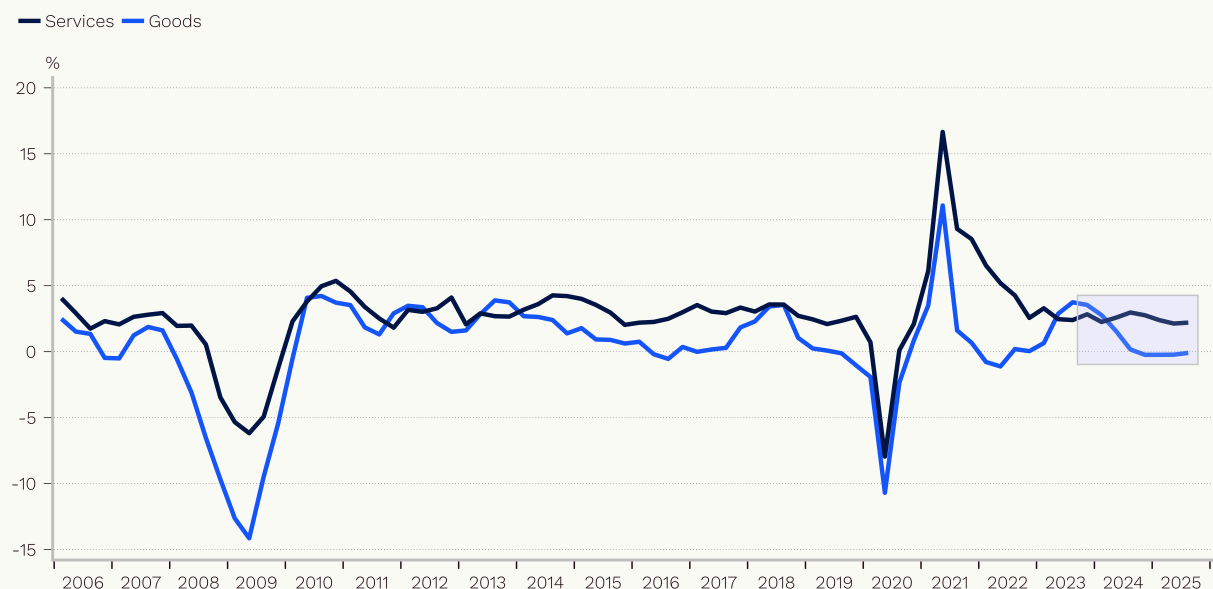


Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, arcMacro

arc MACRO

It's not tariff adjustment; output growth coming from the services sector (AI?)

United States, Real Gross Output (GO), SA, 4Q moving average QoQ annualized growth rate



Source: U.S. Bureau of Economic Analysis (BEA), Macrobond, arcMacro

arc MACRO

Stagflation rears its ugly head

The latest U.S. Purchasing Managers Index, one of the first data points covering 2026, showed a mild uptick in economic activity (manufacturing at 51.9 and services at 52.5, where 50 means activity did not change). Details below the surface had a distinctly stagflationary feel. "The near-stalled job market reflected concerns from companies over rising costs and softer sales growth in recent months." Price increases directly harming the labor market are a macroeconomist's nightmare, as policies to address one tend to make the other worse.

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

Must-Watch

What we'll be keeping an eye on in the week ahead:

- *The Supreme Court (US)*: The hearing over President Trump's efforts to remove Governor Cook from office continues this week. In the early going, the bench has expressed concerns over politicization and the extent of Presidential influence over the Fed's activities. The decision, when it comes, will move long-term interest rates meaningfully.
 - *FOMC meeting (US)*: A cut would be a massive surprise to markets, so we expect no changes. Chair Powell's comments on a range of issues in the press conference will be critical for the outlook.
 - *Producer Price Index (US)*: Only so that we can update [our tariff-related price pass-through tracking](#).
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Market Monitor

Public markets

Macro themes were in the driver's seat for global markets this week. A tumultuous World Economic Forum in Davos, spiked ahead of time by President Trump's aggression on Greenland, sent investors running for cover, before his climb-down on the use of force encouraged a relief recovery. Meanwhile, bond markets were

preoccupied with Japanese fiscal dynamics, and Gold's relentless rally pushed ahead.

Greenland and tariff tensions drove stocks and the U.S. dollar – what's the next catalyst?

The S&P 500 closed the week nearly where it started, but had to endure a -3.2% drop on Tuesday, when President Trump's tariff threats were met with European pushback, including implicit threats to weaponize its reported \$12.6 trillion holdings of U.S. assets. European bourses experienced similar round trips.

On a sectoral basis, US industries most sensitive to higher interest rates all lost ground as long-end interest rates rose and markets priced in less Fed easing.

Japan drove fixed income – the election campaign will keep the topic hot

The reason for higher long-end rates came from the other side of the world. Demand for Japanese Government Bonds (JGBs) collapsed as traders expressed concern over Prime Minister Takaichi's free-spending fiscal platform amid a ~220% debt-to-GDP ratio. The benchmark 10-year JGB yield rose by a heady 25 basis points from 2.175% to a peak of 2.375%, and the Yen fell dramatically before top officials talked it back off the ledge.

The depreciation dealt a body blow to the U.S. Treasury market as yields adjusted to preserve the Japan carry trade (borrow at low rates in Yen, park the money in U.S. Treasuries, collect the interest differential, rinse and repeat). Tuesday's closing yield of 4.31% was the highest since August.

Everything drove gold

What better sign of civilizational regression than the return of an inert lump of metal as the default store of wealth in a savage world? Geopolitical tensions and a weaker dollar were reflected in the gold price, which gained a whopping 7.3% this week, and is up 13.9% already this year.

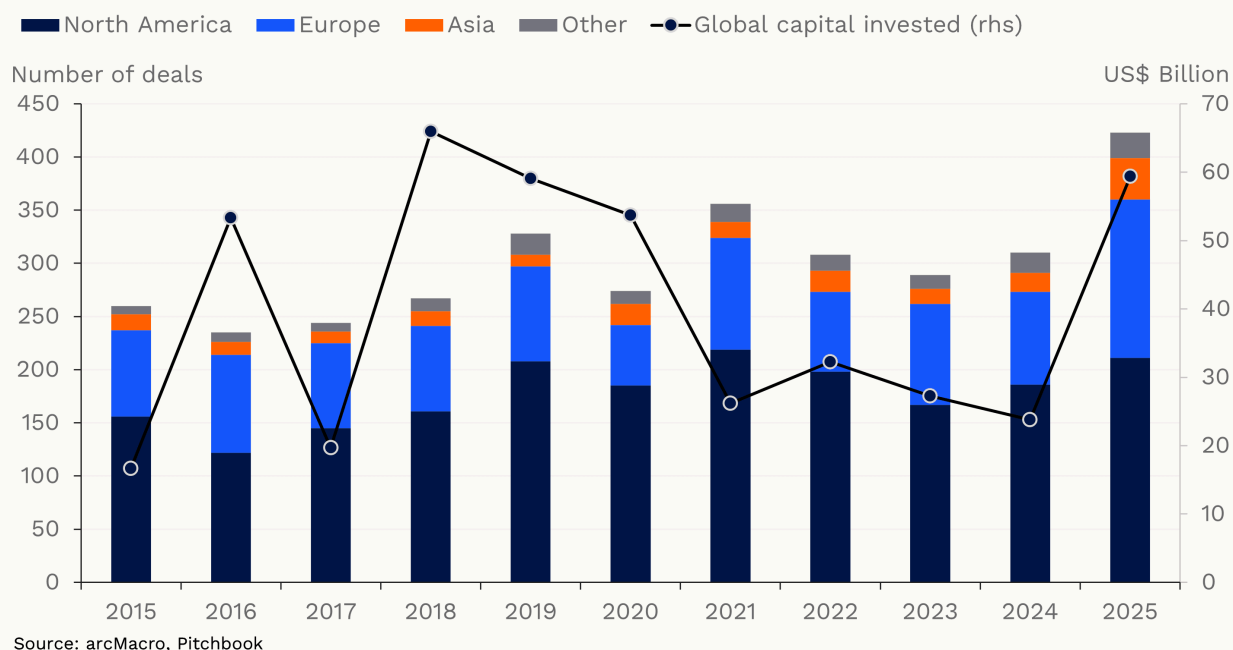
The question is now what can stop the rally? What's the fundamental value of a yield-free asset held primarily to hedge against economic collapse?

Private Markets

Alternative investors have not been missing out on the boom in security-related defense spending. Deal flow and capital invested in the aerospace and defense industry set new records in 2025, and that doesn't count adjacent industries supporting defense modernization and capability enhancement.

Private Capital is Supporting Global Re-armament

Global, M&A and Private Equity Deals in Aerospace and Defense



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	6916	-24.4	-0.4	216	3.2	70.1	1.0
Information Technology			-0.8		-0.6		-1.3
Financials			-2.5		1.1		-3.3
Consumer Discretionary			0.7		4.8		3.2
Communication Services			1.1		8.7		1.5
Health Care			1.1		7.8		1.6
Industrials			-1.6		7.5		5.8
Consumer Staples			0.9		3.9		6.6
Energy			3.1		12.5		10.1
Utilities			-2.0		-5.8		-0.3
Real Estate			-2.4		-2.6		2.0
Materials			2.6		12.7		10.0
Nasdaq Composite	23501	-14.1	-0.1	761	3.3	259	1.1
Dow Jones Industrial Average	49099	-261	-0.5	2508	5.4	1035	2.2
Russell 2000	6634	-21.3	-0.3	541	8.9	465	7.5
Sovereign Fixed Income							
US: 2-year Treasury Note	3.6	0.01		0.15		0.13	
US: 5-year Treasury Note	3.84	0.02		0.28		0.11	
US: 10-year Treasury Note	4.24	0.00		0.27		0.060	
FRA: 10-year OAT benchmark	3.48	-0.05		0.13		-0.080	
GER: 10-year Bund benchmark	2.9	0.07		0.35		0.050	
CHN: 10-year CGB benchmark	1.83	-0.01		-0.00250		-0.0175	
CAN: 10-year GoC benchmark	3.42	0.07		0.37		0	
Corporate Bond Spreads							
US: A-rated	62.1	-3.5		-13.1		-7.7	
US: BBB-rated	94.3	-3.2		-13.8		-10.2	
Leveraged Loan Spreads							
US: B-rated	391	3.7		-13		-0.84	
US: BB rated	257	1.22		-6.7		1.6	
US: CCC-rated	1686	42.8		319		122	
Foreign Exchange Rates							
DXY US Dollar Index	97.6		-1.8		-1.3		-0.7
EUR/USD	1.17		0.7		0.9		-0.4
USD/CAD	1.38		-0.7		-1.6		0.7
USD/CNY	6.96		-0.1		-2.2		-0.4
USD/JPY	158		-0.2		4.8		1.2
GBP/USD	1.34		0.0		0.3		-0.3
USD/CHF	0.793		-1.0		-0.2		0.0
Commodities							
WTI Crude	61.3	2.06	3.5	1.2	2.1	3.93	6.9
Gold	4946	335	7.3	876	21.5	578	13.2
S&P GSCI Commodities			3.8		7.0		6.5
S&P GSCI Industrial Metals			2.0		16.9		5.6
S&P GSCI Agriculture			0.0		-3.1		-0.9

* 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



Memo

Japan: Sticking to the Middle Path amid Competing Narratives

Bottom line: *It's easy to vacillate between "boomer" and "doomer" on Japan. There are risks and challenges, but a strong investment case for smart, patient capital remains intact.*

What it means for businesses and investors: *Avoid short-term financial engineering and stick to fundamentals. Identify investments that benefit from higher inflation and interest rates. Where possible, gain exposure via M&A, including private equity. Given the hot-money risks, patient capital has an advantage and can hedge FX risk, although potential long-term Yen appreciation may support returns.*

arcMacro has been bullish on Japan since its inception. We've been making a structural case for long-term growth and returns, and believe that demographic challenges, while real, are also manageable.

But with Japanese Government Bond (JGB) yields coming under heavy pressure after new Prime Minister Sanae Takaichi's snap election platform of reversing "excessive austerity", it's time to kick the tires on our bullish call.

To do so, we need to disentangle the many complex strands of the Japanese outlook operating over different timelines. We distinguish shorter-term financial dynamics (which are risky) from longer-term structural dynamics (which are positive).

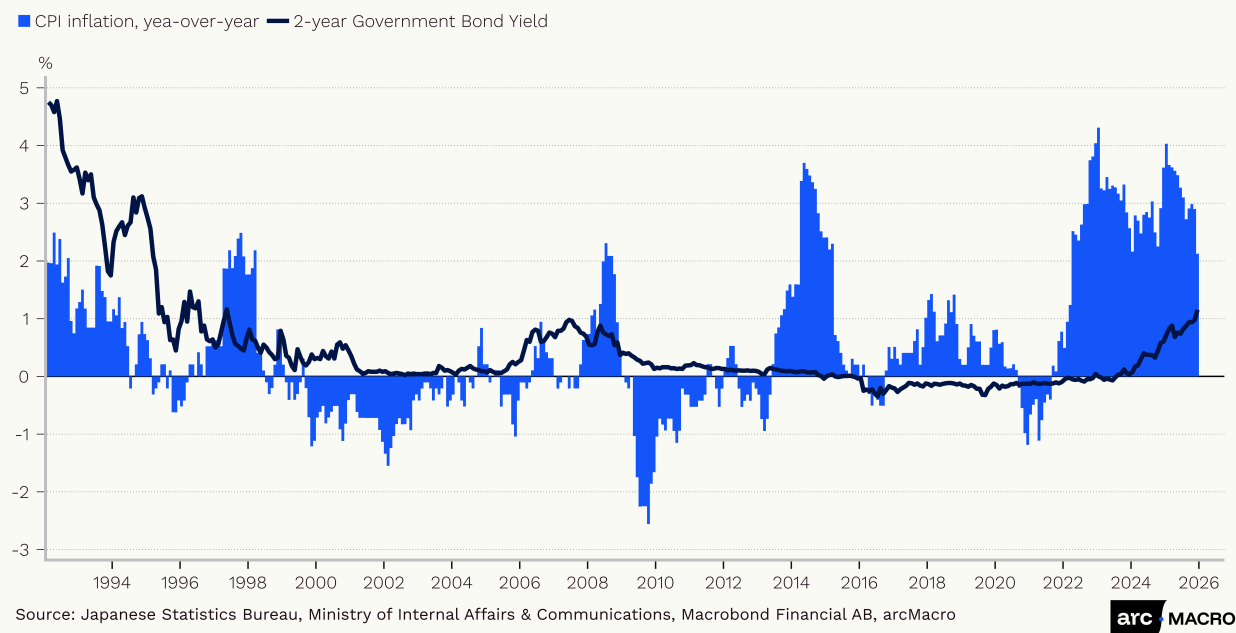
First, let's start by understanding what's changed.

When "normal" is deadly

The inflationary shock of the 2020 COVID-19 pandemic, combined with the fruits of reforms dating back to the start of the Shinzo Abe era, has jolted the Japanese economy out of three decades of "secular stagnation." Inflation has picked up to the 1-3% range and, crucially, stayed there. With economic growth holding up, the Bank of Japan has been able to exit its extreme negative interest rate and yield curve control policies, lifting interest rates into positive territory (though they remain low).

Inflation and interest rates are starting to resemble a "normal" economy

Japan



However, higher interest rates pose a problem. For a long time, ultra-low interest rates have been the only reason that Japan has been able to carry its famous 220% debt-to-GDP ratio. Most people know that number. What's less well known is that Japan's annual debt service costs are only 1.5% of GDP, below those of seemingly fiscally healthier economies such as the United States and the United Kingdom.

However, a sustained rise in borrowing costs could rapidly change that. [Modeling](#) by the folks at FT Alphaville just this week showed that if interest rates rise by the amount currently priced in the forward markets, Japan's debt service ratio would reach 10% of GDP. This is by far the highest rate sensitivity in the developed world.

Living with hot-money risks

A sudden fiscal unraveling of this nature is exactly what markets have been worrying about ever since Prime Minister Takaichi's electoral promise to lower taxes and raise spending. With appetite for Japanese debt shriveling, the cost of new long-term borrowing has doubled from 1.6% three months ago to 2.26% now (that's the yield on the benchmark 10-year JGB bond), and at the same time, weakened the Yen from already severely undervalued territory.

This puts the Bank of Japan into a bit of a bind. On the one hand, the chronically undervalued Yen (see chart below) and above-target inflation demand higher interest rates. On the other hand, higher interest rates risk undermining Japan's fiscal credibility and spooking investors.

The Yen is Significantly Undervalued

Japan, Real Effective Exchange Rate by source, Index, 100 = "Fair Value"



So the usual relationships between rates, yields, and the currency have become topsy-turvy and unpredictable. Japan's outsized role in global finance (formerly as a major risk-hedging venue, more recently the borrowing leg of a massive carry trade with U.S. treasuries) makes sudden large swings in asset prices an ever-present risk.

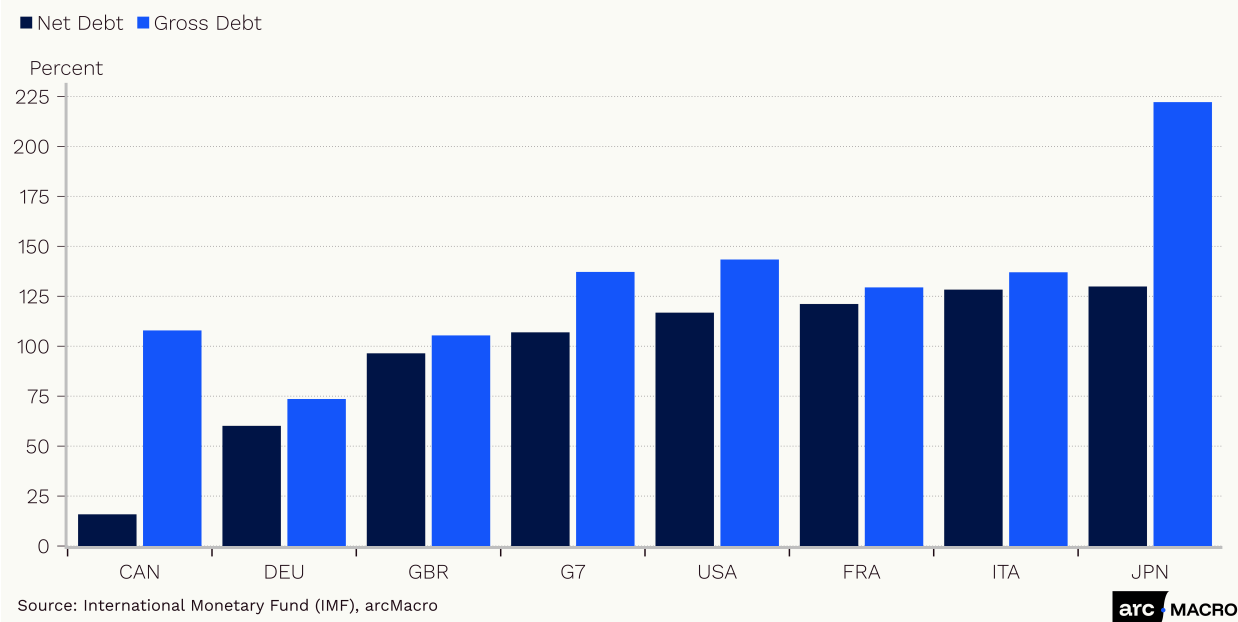
Some mitigating factors

There are three important factors that we think will help Japan permanently stave off a severe fiscal crisis.

First, Japan's history of market interventions has created a \$1.3 trillion public reserve of foreign assets. This could, in theory, be used to help manage down the debt, although it would need to be done carefully to avoid market spillovers. More practically, it serves as a buffer against speculative attacks by bond vigilantes.

Japan's public debt is not as scare on a net basis

G7, Projected general government debt, 2030, percent of GDP



Second, almost 90% of Japan's debt is owned domestically, and half of that by the Bank of Japan itself. If push comes to shove, local investors can be forced to take a haircut for the greater good. This is not a purely theoretical proposition; partial domestic debt defaults have been successfully used in emerging-market debt crises (e.g., Ghana).

Third, nominal GDP growth (higher growth and inflation) directly increases government tax receipts and mechanically lowers the debt-to-GDP ratio. To the extent that new fiscal spending creates fresh growth, it can pay for itself. Given the inflationary impact of the Prime Minister's agenda via the Yen, they may already be doing so, although we'd prefer deeper structural reforms to flashy spending increases.

What "normal" gets you

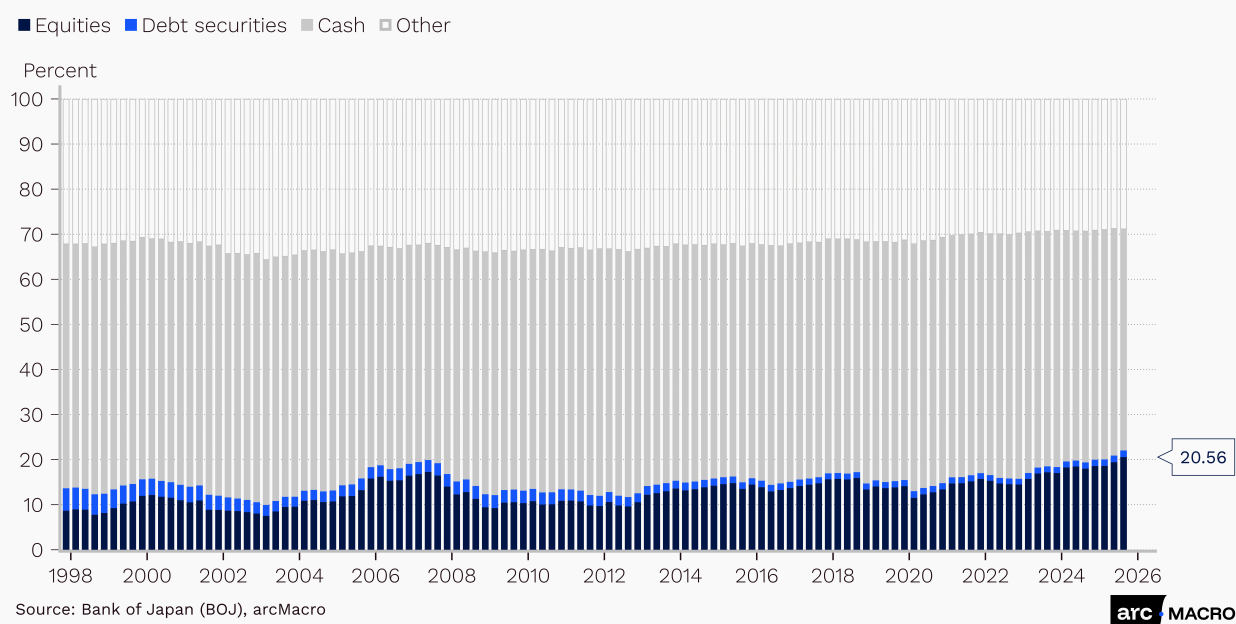
The great benefit to Japan of normal, positive-but-stable inflation and interest rates is that they will thaw the freeze in local savings and investment.

In Japan's 1990-2020 "secular stagnation" period, a broad expectation that prices would either fall or remain constant gave households and firms little incentive to spend or to invest. If holding cash instead of spending it would make you wealthier, why not simply put it under the mattress?

The return of inflation forces households and businesses alike to seek higher yields to boost real returns, triggering an uptick in current consumption and creating a positive, growth-friendly feedback loop.

This is taking many forms. Households are slowly starting to diversify their portfolios, upping their allocations to local equities. Helped by reforms to local capital markets and foreign buy-in, this wave of demand has sent prices soaring. Critically, there is still a lot more domestic liquidity that can be reallocated from cash to stocks.

Households are learning to stop worrying and love the stock market Japan, Households assets, share of total household assets



In the business sector, corporate cash piles are being put to work, and the government and executives are looking for ways to shake out Japan's inefficient conglomerates to improve productivity. We expect this to create a surge of M&A activity, opening up an important role for strategic investors and private funds to help unlock value.

Not everyone buys in, however. The most common reason for not buying into this story is to argue that it is simply not enough to offset the shrinking effect that Japan's demographic decline will create.

Demographic adaptation

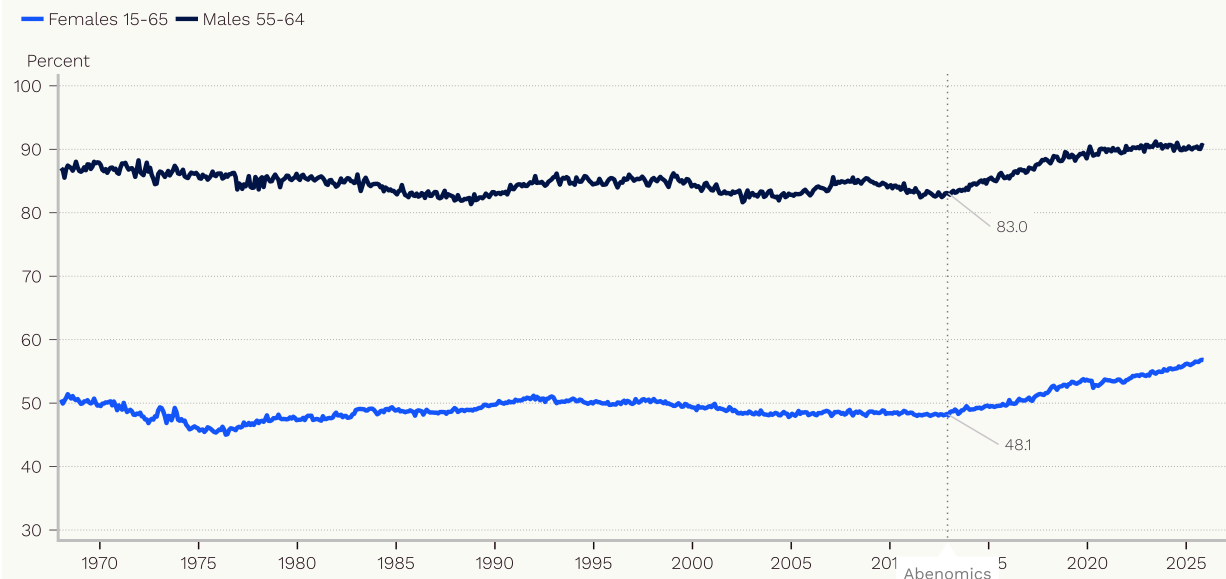
The biggest mistake investors can make is to assume that major problems don't elicit changes capable of solving them. Japan's demographic decline (negative population growth) is a case in point. Without adapting its domestic institutions to meet this challenge, Japan's economy would be shrinking in absolute terms.

That it is not tells us that Japan is adapting.

Women are joining the workforce and staying there for longer.

Japan is topping up its labor force via higher participation rates

Japan, Labor force participation rate, SA, percent

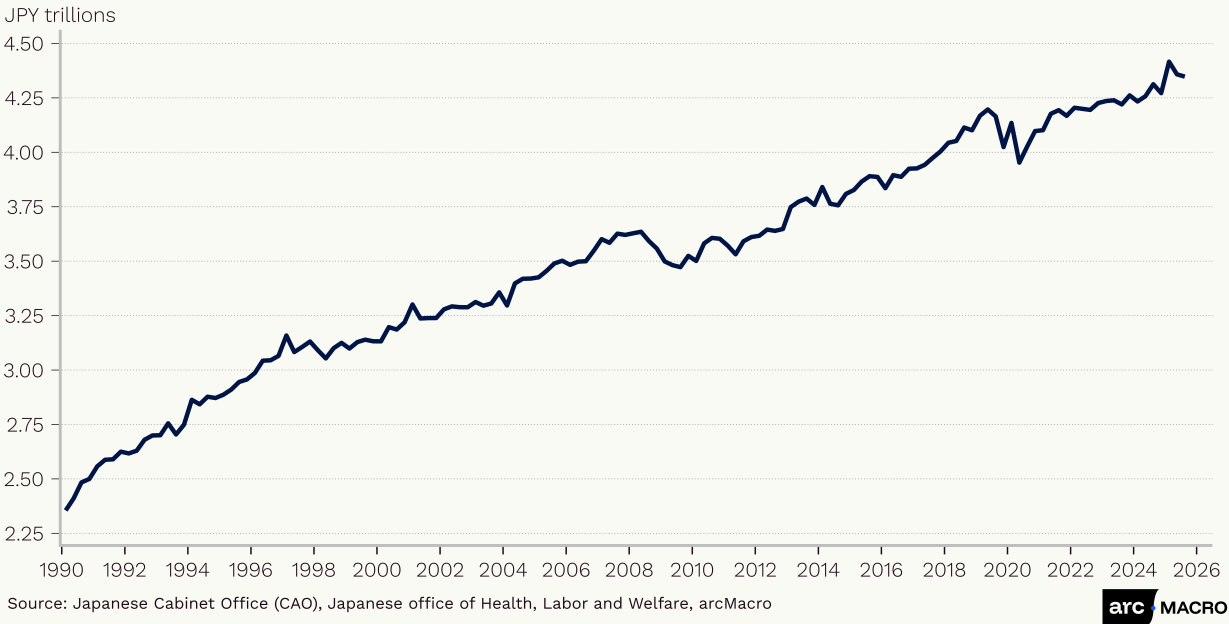


Source: Japanese Statistics Bureau, Ministry of Internal Affairs & Communications, Macrobond, arcMacro

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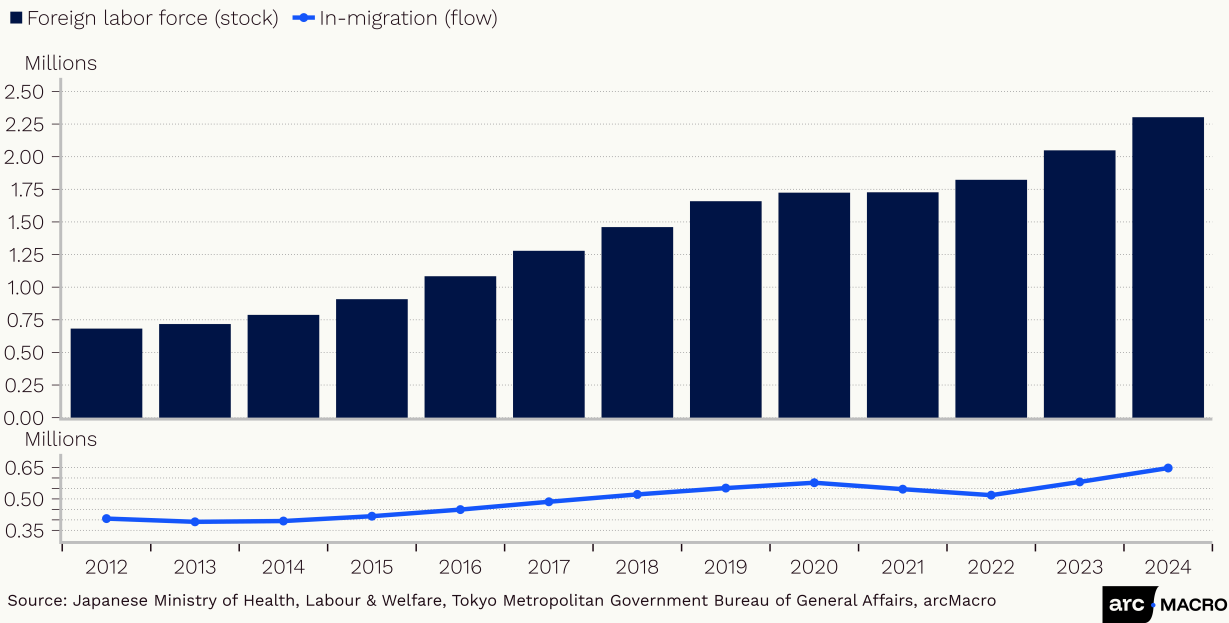
The hourly productivity of Japan's labor force is growing steadily, and on a per-worker basis, Japan's productivity is unrivaled.

Continual productivity improvements are supporting growth
Japan, Real GDP per hour worked, SA, JPY trillion



Japan is slowly opening up to foreign workers to plug labor shortages.

The foreign-born labor force has tripled since the start of "Abenomics"
Japan



One negative development in this regard is a rise in anti-immigrant sentiment among the electorate, which Prime Minister Takaichi has historically tapped into. This puts progress toward using a more open border to mitigate demographic decline at risk, at least in the near term. Electoral rhetoric is one thing; hard policy shifts will need to be monitored closely.

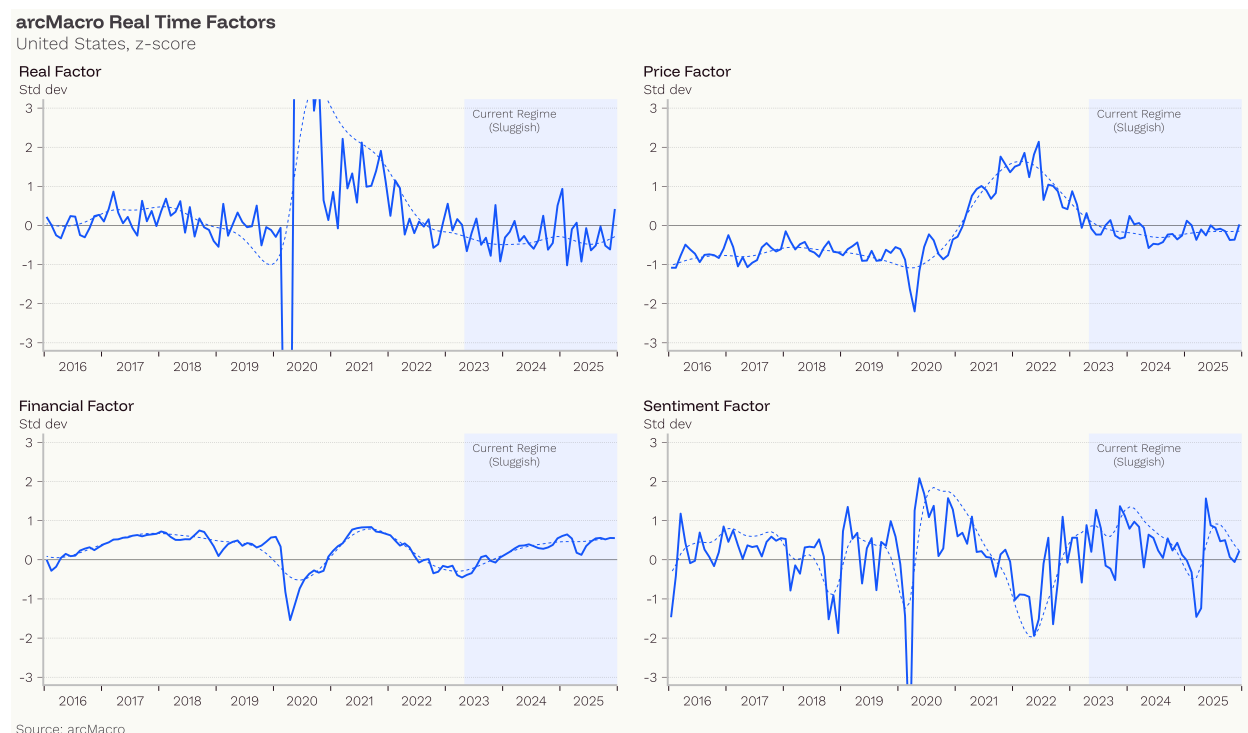
Still bullish

On all of these measures, there is room for further reforms to unlock greater investment and tackle long-term challenges. The big post-election test for the Takaichi government will be to make sure that progress is maintained on some, if not all, of them.

There is a risk that their focus remains too narrow and too short-term, but Japan has momentum. Until we see more data to the contrary, we remain structurally long-term bullish on Japan.

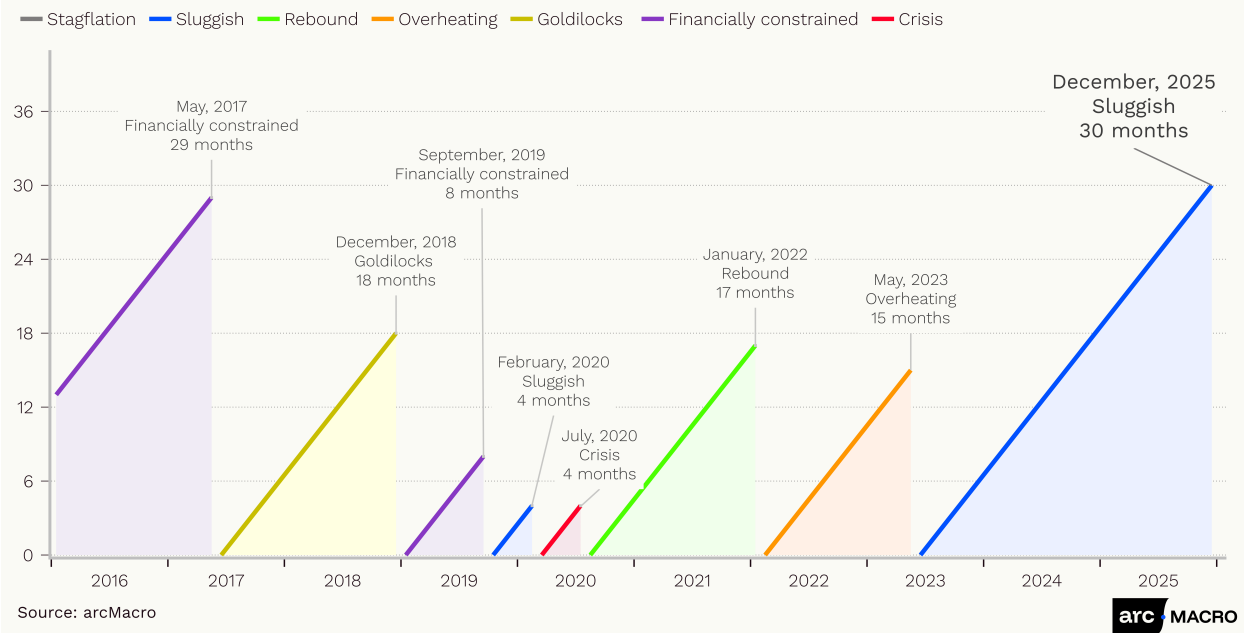
Appendix

Proprietary Factor and Regime Model and Key Macro Indicators



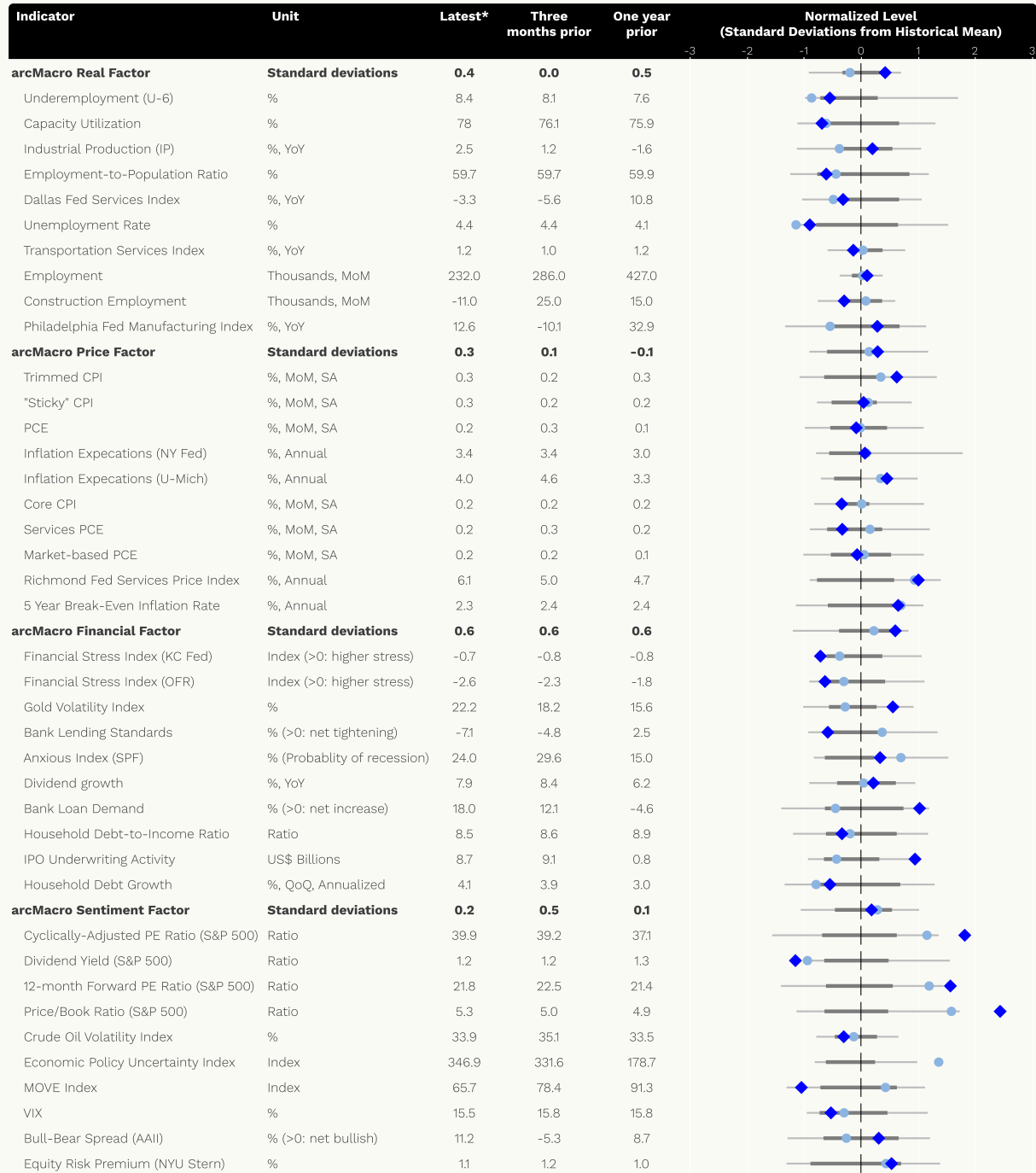
arcMacro Regime Summary

United States, Cumulative Months in Regime



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.