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Better Sluggish than Sorry

Q4 Quarterly Scenario Update

Dylan Smith
October 2025

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36 Toronto Street
Suite 850, Toronto
M5C 2C5

Email: info@arcmacro.com
www.arcmacro.com



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Executive Summary

Overview

As of Q4 2025, the U.S. economy remains mired in a prolonged “Sluggish” macroeconomic regime characterized by below-trend growth, stable inflation, and easy financial conditions.

The signs that this regime may finally be coming to an end in the next 12 months are beginning to show. Activity is losing momentum, and inflation is back on an upward trend (with tariff impacts to hit in earnest around the turn of the year). Meanwhile, the Fed is indexed on employment and has gone into easing mode, spurring asset valuations to stretch even further from fundamentals.

Reflecting the notion that a change in the macroeconomic landscape is overdue, we now assign a 45% weight to Scenario 1, in which the economy remains in the current Sluggish regime for the next 12 months. This is still the modal scenario, but its probability has fallen below 50% and it’s now less likely than something else happening.

We see two main alternative paths that the economy can take, depending on how the financial sector evolves. In **Scenario 2 (35% weight)**, the AI bubble pops, triggering a sudden stop in investment and then spending. The economy is not overleveraged, so the crisis is shorter and shallower than in 2008. On a longer-term basis, the collapse resets valuations and clears macro imbalances, setting the stage for a durable recovery.

Scenario 3 (20% weight) is almost the reverse sequence of events. Here, there is no crash. Instead, the Fed continues to ease over the next six months, overstimulating the financial sector and getting behind the curve on inflation. This leads to a short period of overheating before inflation rises beyond even a dovish Fed’s tolerance, requiring a policy reversal that tips the economy into a Stagflation regime, made worse by a continually increasing public debt.

The options on the menu are “muddle on without treatment”, “take your medicine and recover quickly,” or “misdiagnose a chronic disease.”

We also provide analysis of the global secular themes that form the backdrop to our cyclical scenarios. These themes give additional rich context to the scenarios and will determine the degree to which markets and industries behave differently from similar past situations.

- **Global trade, industrial policy, and geopolitics:** Drives inflation and growth via tariff policy, influences investment patterns, and shapes global capital flows.
- **Public debt, interest rates, and inflation:** Soaring public debt burdens anchor long-run higher interest rate and inflation expectations, marking a break with the “lower-for-longer” post-2008 norm.
- **AI investment and its downstream effects:** Accelerates or attenuates growth, inflation, and labor market dynamics depending on the degree of adoption and the extent to which employees are replaced or augmented.

Scenario Summary

Scenario 1: Stuck in the Muddle

Weight: 45%.

Sustained “Sluggish” regime over the 3-year horizon. AI investment and fiscal stimulus offset tariff and immigration headwinds, creating an unstable equilibrium in which growth remains below potential while inflation drifts above target.

“K-shaped” economy with a difficult fundraising environment for private funds, slow middle-market deal flow, and elevated valuations requiring operational improvements and selective deployment. Software, financials, specialty retail, and utilities outperform.

Scenario 2: Sudden Stop

Weight: 35%

The AI bubble pops, triggering a short and shallow Crisis regime, followed by a Rebound. Due to persistent inflation, the Fed must remain restrictive, and the economy settles into a stable “Financially Constrained” regime.

Counter-cyclical investing opportunities emerge, shifting focus to undervalued assets with strong balance sheets and quality businesses that can capitalize on repricing.

Scenario 3: Slow Stagflation

Weight: 20%

Poorly timed Fed easing coinciding with tariff impacts, fiscal stimulus, and inflationary immigration curbs triggers an Overheating regime, which de-anchors prices and transitions into a Stagflation regime when rates finally rise.

For investors, this means a narrow exit window during the overheating for maturing funds. The Stagflation phase favors assets with pricing power and inflation protection—utilities, transport, healthcare, specialty retail, and private credit outperform.

Starting point

As of the end of Q3 2025, we've defined the U.S. economy as being in a "Sluggish" regime for 27 consecutive months.

Per our research,¹ Sluggish regimes are characterized by below-potential growth, broadly stable inflation (i.e., not spiking), and accommodative financial conditions.

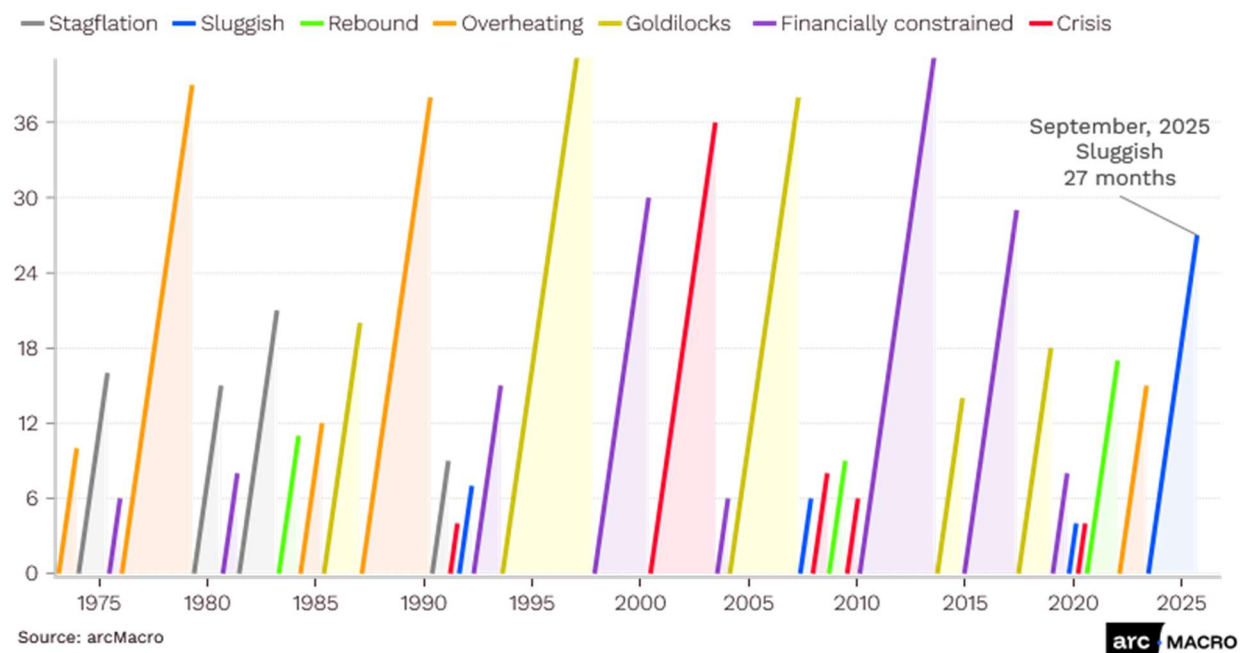
Such a long period under this combination is unusual; Sluggish regimes are typically shorter transitional periods (~6m-1yr) that signal a shift either into or out of a downturn.

In many ways, "Sluggish" does feel like an appropriate description of the state of the economy. On the one hand, there has been a fragile "soft landing," with inflation (until recently) getting close to target while a combination of AI-related investment and strong consumption spending growth has kept the economy growing. We are going forward, not backward.

On the other hand, it's been impossible to get things moving any faster. Firms and consumers not exposed to major growth themes and soaring stock markets have been in the doldrums and now face pressure from tariffs, preventing the U.S. from escaping to a higher-growth regime.

The U.S. economy remains in a "Sluggish" regime

United States, arcMacro Regime Summary



¹ For more details on the economic Regimes and the Factor analysis behind them, see the Appendix and read our comprehensive [White Paper](#).

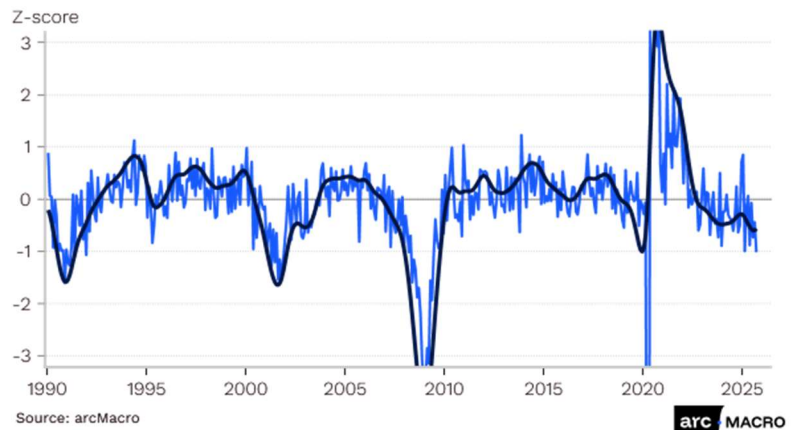
Economic activity: Slowing

Our Activity Factor is signaling economic growth at -0.5 to -1.0 standard deviations below the historical average. That level, if sustained, is on the edge of an official recession.

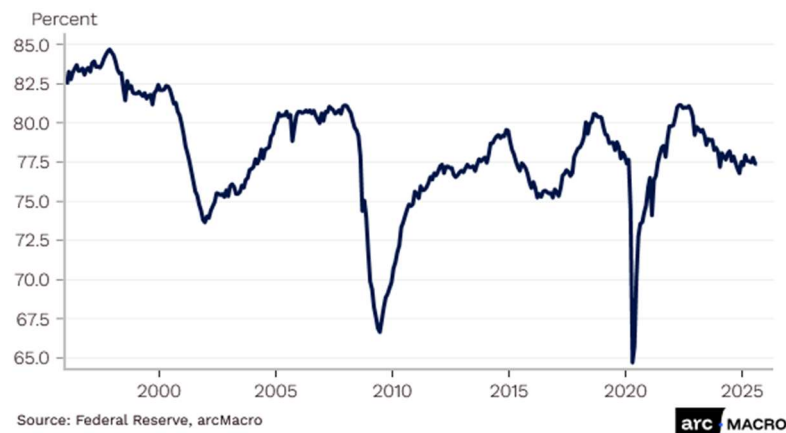
One advantage of the factor approach is that it gives us a more holistic, real-time, and less volatile picture than GDP.

This is particularly valuable at present, given the extent to which GDP is distorted by tariff-related volatility.

Economic Activity is trending down
United States, arcMacro Real Factor



Firms are building up spare capacity
United States, Capacity utilization

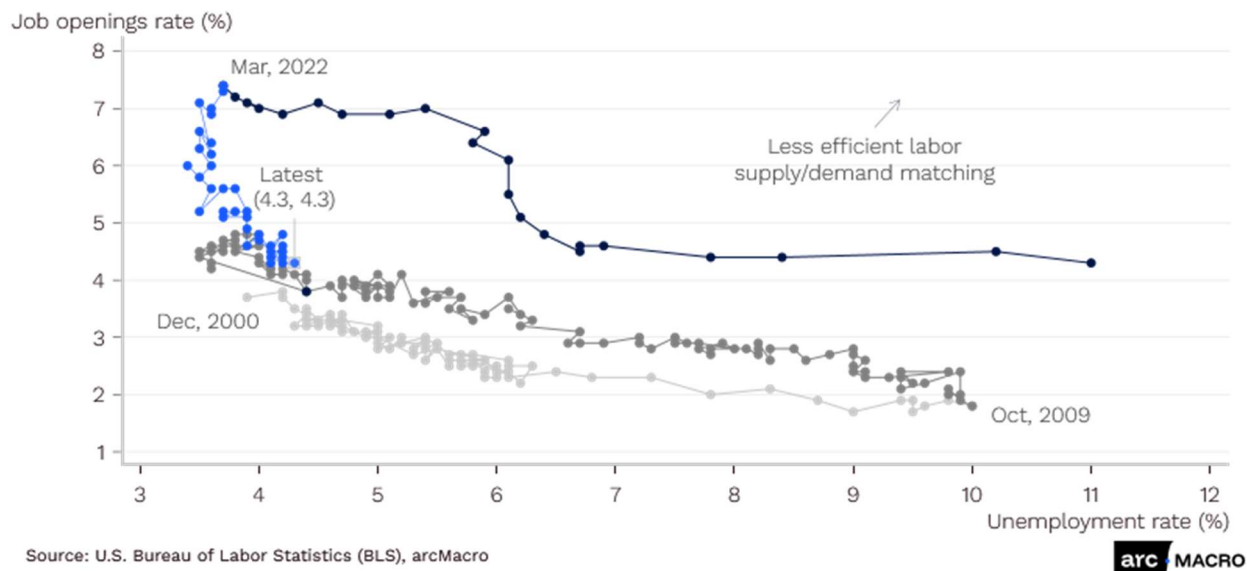


The two most important inputs into the Real Factor are measures of capacity utilization for capital and labor. These indicators comport well with the “Sluggish” regime theme. Firms have built up industrial capacity since 2022 and are unable to put it back to work, even with interest rates falling (see chart).

Meanwhile, the labor market is frozen. Unemployment is low by historical standards, but firms are hiring and firing at very low rates. The labor market has lost its dynamism.

The Beveridge Curve says the labor market is still tight by pre-COVID-19 standards United States, unemployment rate vs. job openings rate

• Post-COVID-19 Rebalancing: Mar 2022 - latest • COVID-19 Era: Mar 2020 - Mar 2022
 • Post-GFC: Oct 2009 - Mar 2020 • Pre-GFC (Dec 2000 - Oct 2009)



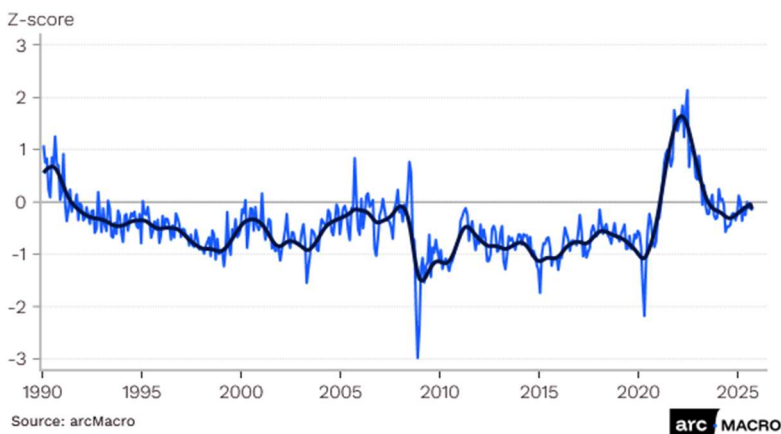
Prices: Drifting up

The disinflationary process that took CPI inflation from 9.1% in June 2022 to a low of 2.3% in the first quarter of 2025 has now clearly reversed. Our Price Factor has risen to levels that (aside from the post-COVID-19 spike) have not prevailed since the early 1990s.

There have been two drivers of that upward drift. First, slow-moving core services and shelter inflation stopped disinflating and are now moving sideways.

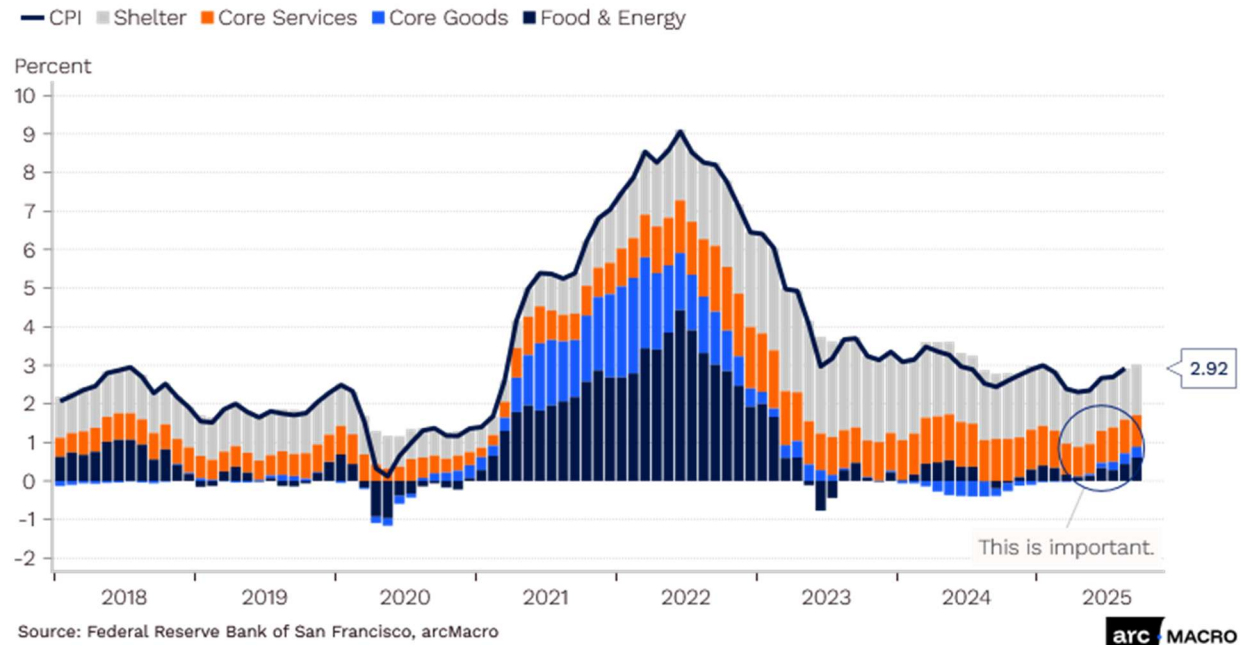
Second, goods and food prices – both exposed to tariffs and immigration restrictions – have gone from flat or falling to making positive contributions to inflation.

Inflation is creeping up United States, arcMacro Price Factor



Food and core goods are positive contributors again

United States, CPI contributions, YoY



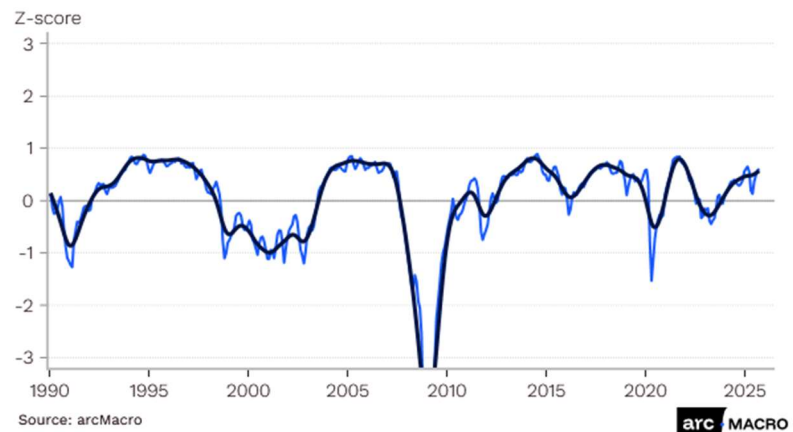
Financial conditions: Loose

The Fed may assess its current stance as “moderately restrictive,” but financial conditions writ large are easy.

Our Financial Factor, which tracks the credit cycle, has risen to more than half a standard deviation above the long-run average.

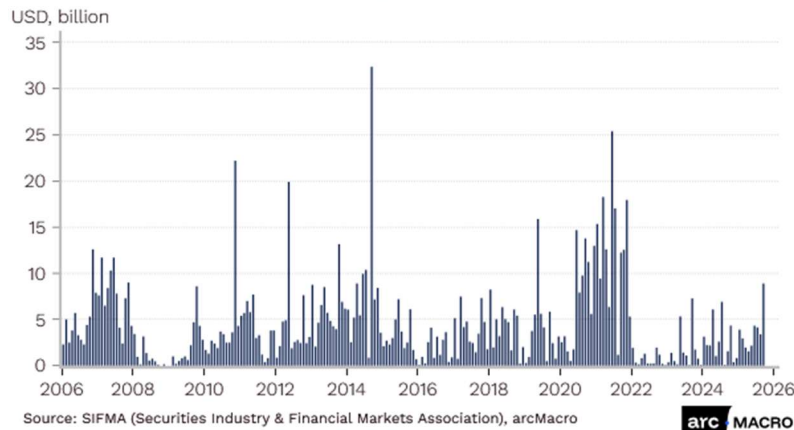
Financial conditions are accommodative

United States, arcMacro Financial Factor



Public market fundraising has picked up in 2025 H2

United States, IPO Underwriting Activity



All but the most distressed companies can borrow at tight spreads, signaling that investors are comfortable that credit risk is not rising.

Combined with lower risk-free rates, that's fuelling a surge in M&A activity and even catalyzing a rise in IPOs.

Another factor behind easy financial conditions is the depreciating U.S. Dollar. As of October 25th, the DXY U.S. dollar index is down -8.8% year-to-date. A weaker currency makes domestic investment more attractive to foreign buyers and has helped offset the negative impact of tariff policy on investment flows.

For consumers, banks are now loosening lending standards slightly after a period of tightening, despite a pickup in delinquencies in credit cards and auto loans.

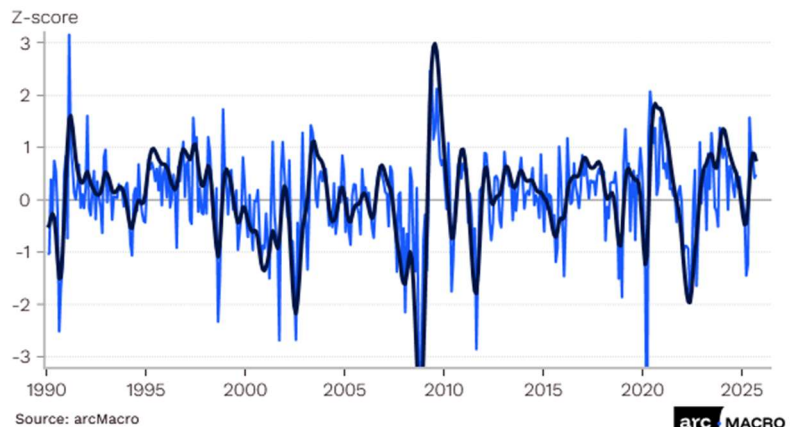
And of course, we can't ignore soaring equity markets. The S&P 500 is up 15.5% year-to-date, rebounding from both the April "Liberation Day" correction and a China tariff wobble in early October.

Sentiment: Positive but volatile

Our Sentiment Factor captures the fast-moving shifts in risk attitude that can trigger turning points in the financial and economic cycle. 2025 has been a volatile year for the indicator, but it currently stands in optimistic risk-on territory.

Sentiment is surprisingly positive

United States, arcMacro Sentiment Factor

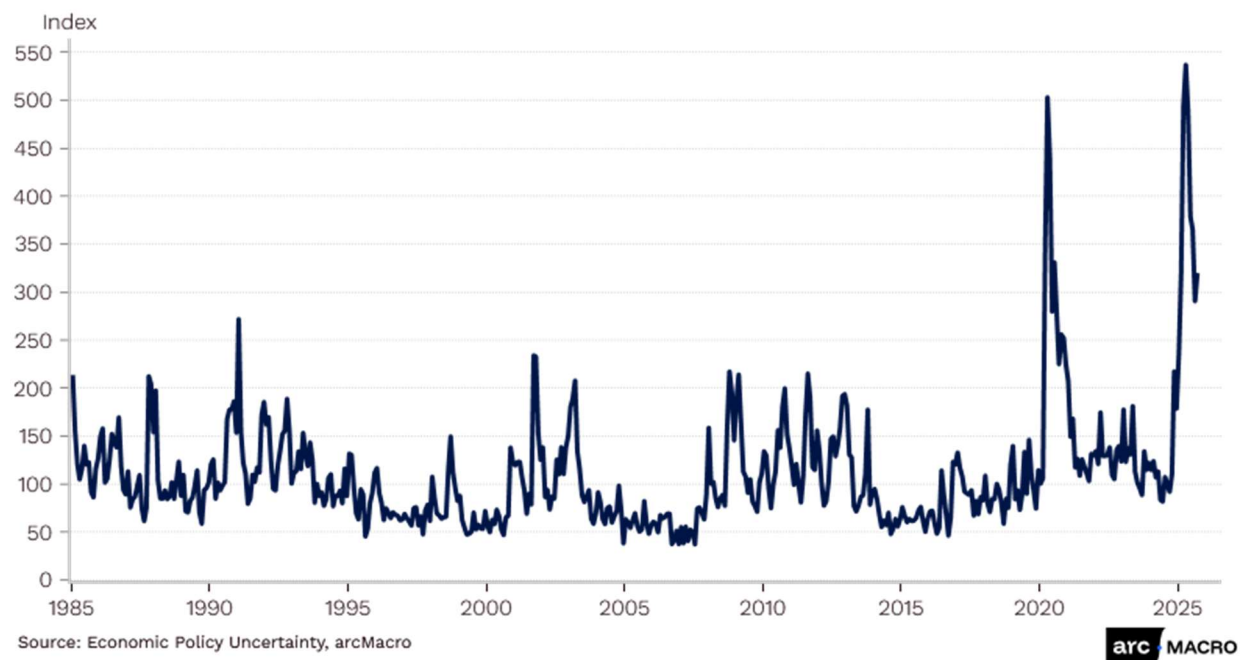


Part of the optimism undoubtedly stems from positive views of AI's transformative potential. Beneath that, we see a perception among investors that policymakers are acting as a backstop for markets. The Fed has adopted a fairly explicit easing bias, and the “TACO” trade is still alive.

If it weren't for still sky-high uncertainty levels, sentiment would be even higher.

Uncertainty Remains Exceptionally High

United States, Economic Policy Uncertainty Index



Secular Themes

Our scenario framework is designed to help navigate cyclical fluctuations over a 3+ year strategic horizon. The framework is situated within the broader secular context, which constrains the set of feasible scenarios and determines their likelihood.

These themes will play out over decades rather than years and are important economic drivers regardless of the cyclical dynamics at play. Their timing, extent, and interaction differ. To build our scenarios, we need to make assumptions on how they will play out.

Global trade, industrial policy, and geopolitics

This theme encapsulates the reorientation of the USA's role as a global superpower, particularly in the context of China's maturing economic and geopolitical status. Downstream of this are serious implications for the structure of global economic transactions and international trade.

In terms of cyclical dynamics for the U.S., this currently manifests in tariff policies and their pass-through into prices and activity—both directly and indirectly via the costs of switching to third-country or domestic suppliers and restructuring value chains. These are crucial assumptions behind our different scenarios.

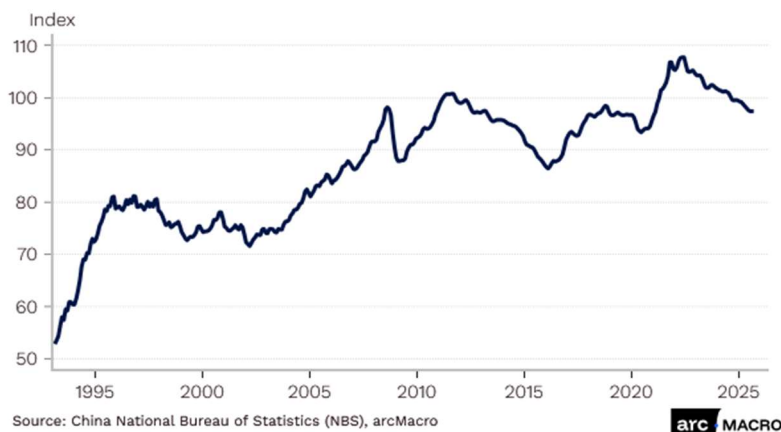
As time wears on and trade uncertainty resolves, attention will shift to what this means for cross-border capital flows and which high-growth regions of the globe are viable investment targets.

The U.S. hasn't taxed imports this heavily since WWII
United States, average tariff rate on all imports



Overcapacity is causing Chinese producer prices to deflate

China, Producer Price Index, 2011 = 100



There are sector-specific implications too, that may alter certain industries' sensitivity to cyclical dynamics. The defense industry (especially defense technology) has strong secular tailwinds insulating it from the cycle as NATO members raise military spending targets and seek to guarantee security without watertight U.S. guarantees.

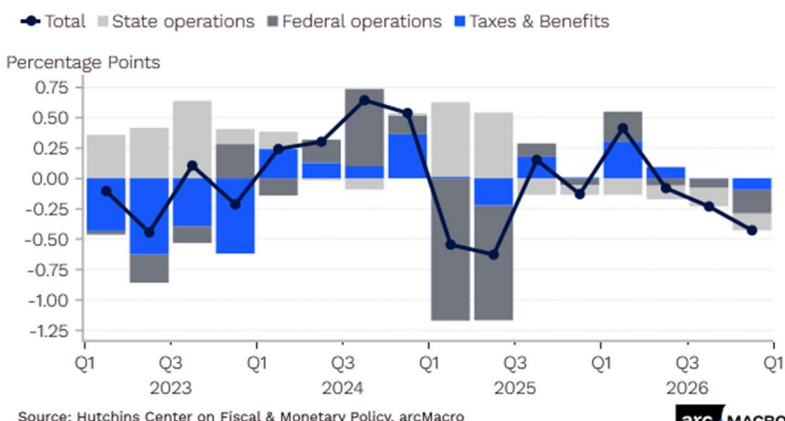
Another key element of this theme is China's industrial overcapacity, as evidenced by rapidly falling Chinese producer prices. U.S. and Western trade policy, in the form of import quotas, tariffs, and other "anti-dumping" measures, has offset the global deflationary impact that falling Chinese prices would usually have. This is a significant change from recent decades, when China's rise was a major force behind the period of low, stable global inflation we enjoyed before COVID-19 (alongside central banking reforms).

Public debt, interest rates, and inflation

A key feature of the post-COVID-19 era is the accumulation of massive public debt burdens and persistently high deficits. The [IMF's latest Fiscal Monitor](#) projects that, without policy adjustments, the U.S. government debt burden is headed for 144% of GDP by the end of the decade, which would make Americans more indebted than Southern Europeans.

Fiscal policy will boost growth in early 2026

United States, Fiscal policy, contribution to real GDP growth



In the near term, this will provide an economic boost. Tax reforms passed in the Trump administration's "One Big Beautiful Bill Act" will boost GDP growth in the first half of 2026, regardless of the cyclical scenario at play.

The longer-term risk of rising debt levels is that some countries (including the US) could fall into a debt spiral, in which new borrowing is required just to finance interest payments on prior debt.

Because tax revenues are linked to both inflation and economic growth, if structural reforms can't move the debt path, then higher nominal growth is required. And if the real growth rate can't be raised via productivity gains, inflation is the only way out.

Bond markets understand this, which is why they've permanently shifted the term structure of interest rates. Gone are the days of on-target inflation expectations, sustained low interest rates, and negligible or negative premiums for holding long-dated bonds to term.

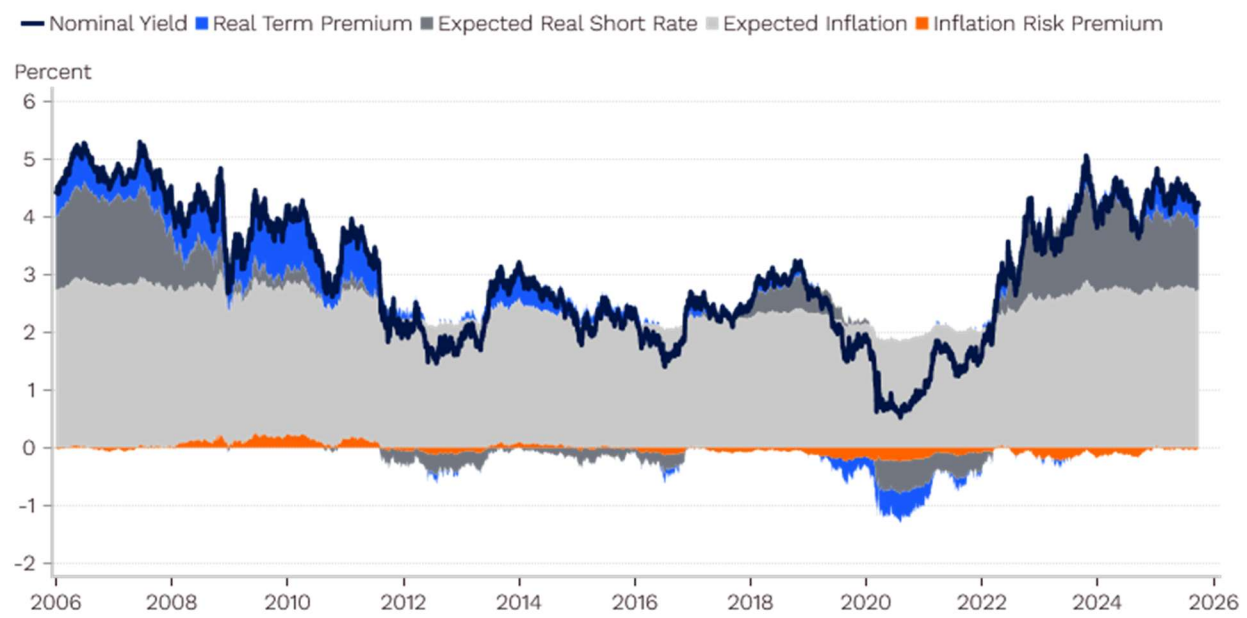
Instead, bond markets envisage a combination of higher inflation and higher interest rates, with a significant term premium signaling a high degree of risk and uncertainty around this outlook. This is closer to the "normal" that prevailed before the disruptions of the 2008 Global Financial Crisis (GFC).

We view this as a structural dynamic linked to slow-moving fiscal challenges, present in some form across all our scenarios. Thus, short of a crisis (and even in a crisis), we don't see a return to "low for long" interest rates.

What's more – though it's too early to incorporate this directly into our scenarios – we believe that the U.S. and other Western social democracies are headed for an inevitable and messy renegotiation of the social contract.

Normality resumes in the 10-year Treasury Note market

United States, DKW Term Structure Model



Source: Federal Reserve, D'Amico, Kim & Wei, arcMacro

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Non-discretionary budget items (healthcare and social welfare) have grown to such a large share of spending that room for maneuver on other economic priorities is constrained, and public investment is falling, contributing to productivity challenges. Add in higher military commitments outside the U.S., and the situation looks even worse.

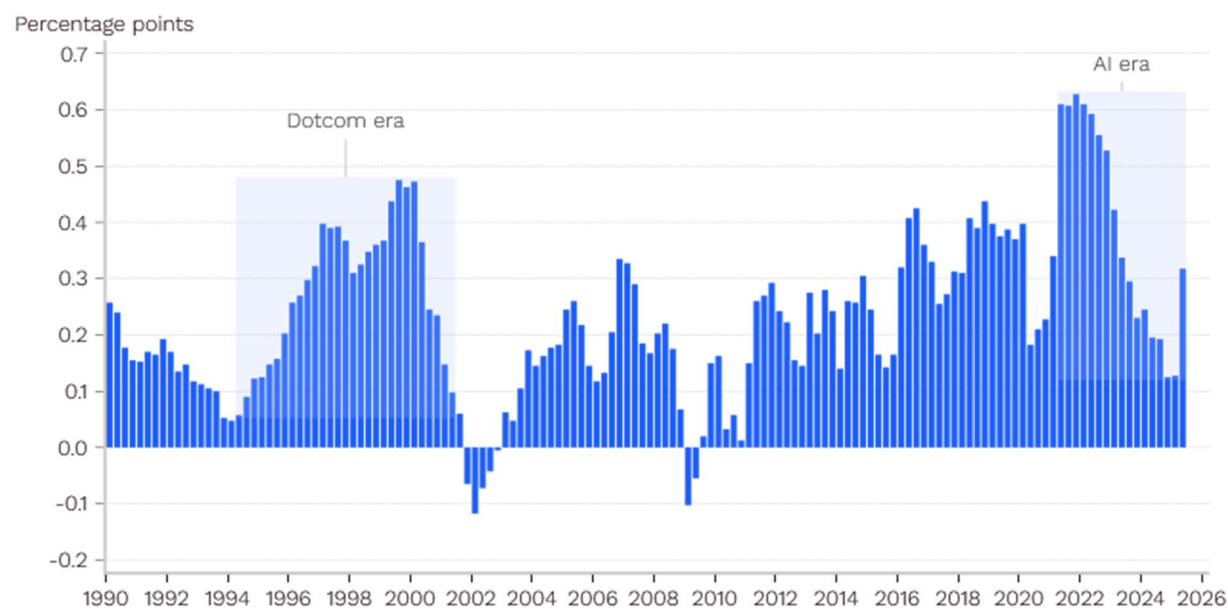
In some cases, this will mean a difficult process of spending review and a withdrawal of the State from specific sectors of the social economy. In others, it will mean tax code reform (higher U.S. tariffs – a tax on domestic consumers and import businesses – can be understood in this light). This is a slow-burn theme that will require crises to gain momentum, and we don't expect significant reforms on a 3-year timeline.

AI investment and downstream effects

The boom in AI-related investment is key cyclical dynamic that we discuss further in our scenario descriptions.

Looking beyond the cyclical horizon, there are two key questions relating to artificial intelligence that we will be monitoring. We do not believe that these questions will have a dominant impact on the economy over the next three years, but they are important secular considerations and will inform our outlook as new evidence comes to light.

The AI theme is directly powering GDP growth more powerfully than the internet
United States, Software and D&D, contribution to GDP growth, 4qma



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

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- **Will AI deliver a large and sustained economy-wide productivity boost?** This would be the “silver bullet” for public finances, since productivity-led growth can stabilize debt-to-GDP levels without inflation.
- **Will AI replace workers *en masse*?** Whatever its effect on productivity, if, as some fear, AI leads to large-scale unemployment, the consequences for economic activity and the fiscal outlook would be dire. For the record, we’re in the “augmentation” camp, expecting uneven but net positive effects on labor markets, with workers in some industries harmed and others helped.

As with the geopolitics theme, AI changes the cyclical sensitivity of specific industries. It’s undoubtedly changed tech stocks from something that responds to economic conditions to a core driver of the cycle itself.

It’s also turned utilities and parts of the energy complex from defensive, rate-dependent investments to equity-gear growth stocks (the downside being that potential overcapacity if AI data center needs are overestimated would set the industry up for years of sub-par returns).

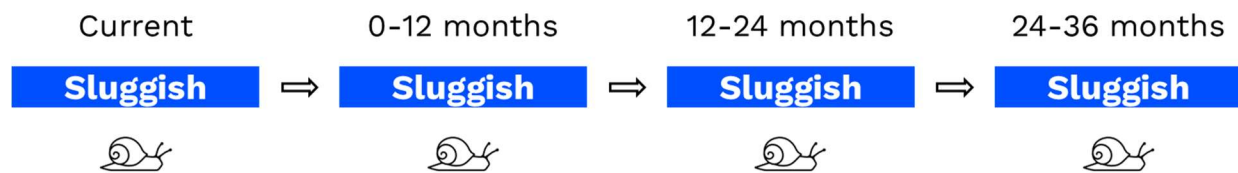
Seven AI-linked stocks constitute a third of the S&P 500

United States, Market cap, share of "Magnificent 7" in S&P 500



Scenario 1: Stuck in the Muddle

Overview



Narrative

Not too hot, not too cold, but not quite right either. Goldilocks doesn't have the diction to describe our modal scenario.

A constellation of shocks holds the economy in an unstable and unsatisfying equilibrium. Growth is below potential. Inflation is stubbornly above target and drifting up. Financial conditions are relatively easy, but valuations are so elevated that capital allocation is challenging.

Investment in AI and related industries, durable consumer spending, broadly stimulative fiscal policy, and patchwork deregulation provide the economy with growth impetus. Rates fall only slightly from current levels.

These forces offset the adverse effects of higher tariffs on imports and restrictive immigration policy, which nonetheless prevent inflation from falling to the target and prevent meaningful monetary stimulus.

Probability assessment

Weighting	Value	Comment
Model weight	52%	
Subjective adjustment	-7 pp	Forces will eventually slip out of balance. While this is the modal scenario, it's not more likely than something else happening, in our view.
Blended weight	45%	

Key macro indicator forecasts

Key Indicator	Unit	Current	0-12 Months	12-24 Months	24-36 Months
Gross Domestic Product	Average growth (%)	2.0	2.0	2.0	2.0
Consumer Price Index	Average growth (%)	2.7	3.2	3.1	2.8
Fed Funds Rate (FFR)	End-of-period	4.125	4.0	4.0	4.0

Macroeconomic features

Assumptions: what you need to believe

- **Forces are in balance:** The relative magnitude of the tailwinds (AI, fiscal and deregulation, consumer) and headwinds (tariff and immigration policy) are roughly equal.
- **If AI is a bubble, it's a long way from popping:** After all, the Dotcom bubble burst half a decade after it was identified.

Consequences: what you need to prepare for

- **Activity:** Growth remains positive, but below potential. The economy is “K-shaped” for both consumers (spending driven by upper-income segments) and businesses (wide dispersion between mega, large, and small businesses, and between fast-growing and stagnant middle-market companies).
- **Prices:** Inflation is persistently above target, but the Fed reverses course before prices can become unanchored. Demand is not strong enough to re-accelerate prices.
- **Financial conditions:** Relatively easy, but historically high valuations make capital allocation challenging.

Market Strategy

Public benchmarks

Equities

The market remains sensitive to news cycles and occasionally corrects, but the bull run extends. Roughly normal annual returns by historical standards.

Fixed income and FX

The yield curve is relatively flat but not inverted, as the Fed pauses its easing policy at or above 3.75% -4%. Inflation and fiscal concerns keep the term premium positive.

The Trump administration successfully talks the dollar down, and investors continue to bet on long-term devaluation (but not full-blown loss of reserve status).

Commodities

Surpluses in key commodity markets (notably oil) and tepid demand keep the overall commodity complex subdued, but volatility in geopolitically sensitive markets is a constant risk.

Private markets

Scenario summary

Element	Description
Fundraising	Challenged, with fluctuations
Deal flow	Slow, especially in the middle market
Valuations	Elevated
Returns	Mixed

Strategic considerations for illiquid investing

A protracted Sluggish regime demands disciplined capital preservation and selective deployment. LPs' denominator effects keep funding flowing, but a strong track record is essential.

Operational improvements and margin expansion remain the name of the game. Hold periods will continue to stretch out, making continuation and secondary vehicles a highly active market.

The timelines involved in this scenario mean that funds will eventually be forced to accept lower multiple realizations, as there is little upside and significant downside risk.

Corporate performance

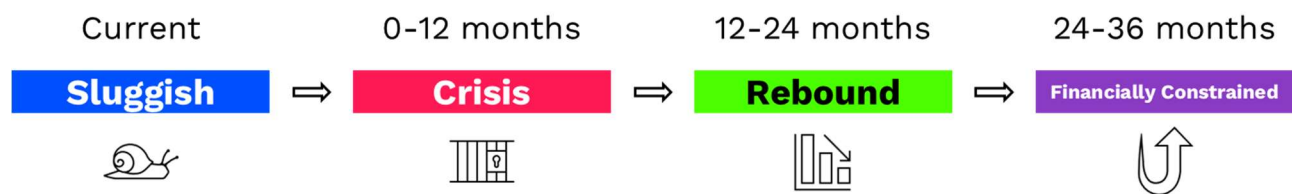
If the macro environment is not set to change significantly, it makes sense to double down on what already works, but on a shorter investment horizon. Utilities and defense, which are exposed to secular themes and have defensive characteristics, are particularly appealing.

Outperforming industries

Industry	Detail
Software, internet telecoms	Strongest performers in the current bull market.
Funds and trusts, investments, and insurance, leasing	The financial sector consistently outperforms in Sluggish regimes. The Fintech niche is especially attractive.
Specialist retail	Exposed to consumer tailwind.
Utilities	Supported by AI tailwinds.
Industries	Careful screening for tariff impact required.

Scenario 2: Sudden Stop

Overview



Narrative

This scenario captures the mounting risk of a loss of confidence in the AI buildout theme—the most potent force driving equity valuations and broader investment growth. This triggers a stock market bust, which ricochets into the real economy, temporarily freezing investment and then spending.

Importantly, this is not a deep or sustained crisis because firms and households are not overleveraged. Instead, there is a “clearing out” effect. Unsustainable AI-linked business models fail, but overall, a valuation reset combined with accommodative monetary policy gets capital moving, and the economy enters a “Rebound” regime.

Throughout this process, the specter of inflation remains. Ever-larger fiscal deficits mean that inflation expectations cannot fall, while tariffs and immigration curbs maintain upward pressure on prices. This limits how far the Fed can cut and precludes quantitative easing, meaning that after the rebound, the economy settles not into a “Goldilocks” regime, but a mildly financially constrained state that prevents a quick resumption of the asset price inflation cycle.

Probability assessment

Weighting	Value	Comment
Model weight	43%	
Subjective adjustment	-8 pp	Re-assigning some probability to Scenario 3 to capture risks of sustained downturn.
Blended weight	35%	Major risk

Key macro indicator forecasts

Key Indicator	Unit	Current	0-12 Months	12-24 Months	24-36 Months
Gross Domestic Product	Average growth (%)	3.8	-0.8	4.5	2.8
Consumer Price Index	Average growth (%)	2.7	2.5	4.0	3.3
Fed Funds Rate (FFR)	End-of-period	4.125	1.5	2.75	4.25

Macroeconomic features

Assumptions: what you need to believe

- **AI has “bubbly” characteristics:** Most AI-linked assets are overvalued, and overcapacity is building.
- **There is a trigger event:** A missed earnings report or other negative news can trigger a sudden loss of confidence that breaks the bull market and stymies investment.
- **Lower valuations will reallocate capital:** Capital is being sucked into AI-connected businesses at the cost of allocations to other sectors and themes; resetting valuations will allow capital to move to different industries, including funding more rapid adaptation to tariff costs.
- **Inflation has secular drivers:** If not, the Fed can take more active easing measures, prolonging the Rebound phase and ending in a “Goldilocks” regime.

Consequences: what you need to prepare for

Phase 1: Crisis

- **Activity:** The stock market rout transmits first into a collapse in business investment, then a reduction in consumer spending (via a softer labor market and extinguished wealth effect).
- **Prices:** Price growth softens as a demand slowdown overpowers other inflationary forces. However, inflation remains above target, limiting the Fed’s ability to ease rates.
- **Financial conditions:** Sharp tightening in financial conditions as credit spreads spike and collateral value falls with the broader market. Bank lending standards tighten, and deal flow slows.

Phase 2: Rebound

- **Activity:** 6-12 months after the initial rout, a strong recovery sets in as sentiment recovers and unused capacity gets put back to work.
- **Prices:** As demand recovers, underlying price pressures assert themselves and inflation moves well above target.
- **Financial conditions:** Financial conditions gradually ease up, with the “shadow” banking system providing the initial impetus.

Phase 3: Financially constrained

- **Activity:** After the rebound has played out, growth settles down close to or just below the long-run average.
- **Prices:** During this period, prices are gradually squeezed back down to target.
- **Financial conditions:** Tight-to-neutral financial conditions are required to prevent excess liquidity from translating into price growth.

Market Strategy

Public benchmarks

Equities

The path of the stock market defines the scenario. First, a collapse deep and sudden enough to trigger a broader downturn, then a rapid but partial rebound to relative valuations more in keeping with historical averages.

Fixed income and FX

Risk premia rise sharply as the Fed cuts rates, steepening the yield curve and pushing up spreads across the fixed-income complex.

Dollar performance and the degree of U.S. Treasury outperformance are indeterminate, as markets test the U.S. safe-haven status. However, we don't see a sufficient supply of safe assets to provide an alternative, so the dollar likely appreciates and the belly of the yield curve compresses.

Commodities

The Gold bull market finds a new gear as its safe-haven status shines and lower rates decrease the relative cost of carry.

Energy and industrial commodity prices weaken as demand declines, and lag the recovery in other, more forward-looking asset classes.

Private markets

Scenario summary

	Crisis Phase	Rebound Phase	Financially Constrained
Fundraising	Severely constrained	Strong	Challenging
Deal flow	Weak	Accelerating	Average
Valuations	Falling sharply	Normalizing	Normal
Returns	Negative	Strong	Weak to average

Strategic considerations for illiquid investing

Shift to defensive positioning by reducing new investments, closing on fundraising, and preserving dry powder. Prepare to support existing portfolio companies through the downturn.

Aggressively deploy capital when the best opportunities emerge, 6-9 months into the crisis, when forced sellers capitulate. Maintain the deployment pace into the recovery phase while valuations remain attractive, but before competition returns.

The subsequent financially constrained period demands strategic exits of mature assets while valuations remain reasonable from the rebound. Maintain higher cash reserves throughout to capitalize on distressed opportunities and support portfolio companies as needed.

Corporate performance

In this scenario, investment decisions are heavily driven by macro factors and essentially industry-agnostic.

Once the Crisis hits, investors don't need to be too discerning about what industry a target sits in; underpriced assets can be found across the board, and patient capital can afford to wait out the lows.

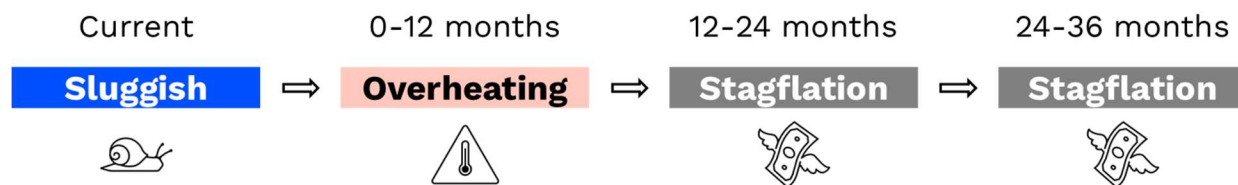
That said, we can identify a few industries that typically outperform in Rebounds and subsequent stable periods. The most defensive assets that hold value during the Crisis (utilities, telecoms) will have the weakest long-term prospects.

Outperforming industries

Industry	Detail
Air transportation	Pent-up travel demand; low fuel costs.
Accommodation	Pent-up travel demand.
Durable goods retailing	Benefit from lower interest rates and recovering incomes.
Manufacturing	Tends to outperform during Financially Constrained regimes.
Clothing manufacturing and retailing	Outperforms in a rebound and demand returns.

Scenario 3: Slow Stagflation

Overview



Narrative

A constellation of inflationary factors combines in the near term to accelerate prices. This includes both direct tariffs and tariff-related cost increases (e.g., supply chain adjustment, domestic producer margins), easier monetary policy (Fed over-indexes on employment growth), deregulation (especially in the financial sector), fiscal stimulus (Q1/Q2 of 2025), and constrained immigration.

In the shorter term, the stimulative factors (easy financial and fiscal conditions) outweigh the growth-negative factors (tariffs and immigration restrictions). Activity accelerates alongside inflation, creating an impression of economic health but pushing the economy into an “overheating” regime.

During this period, financial conditions are easy, characterized by tight credit spreads, rising IPO and M&A activity, and elevated valuations.

However, the Fed is already behind the curve, and high inflation becomes entrenched. This triggers a reversal in the path of interest rates, which, combined with the lagged impact of tariffs and immigration restrictions, stalls economic growth, even as inflation remains high. It takes several years to return inflation to target, during which financial conditions tighten, and valuations reset.

Probability assessment

Weighting	Value	Comment
Model weight	5%	
Subjective adjustment	+15 pp	The model downweights the probability of a mild “stagflationary” period of low growth and high inflation because of the severity of prior stagflation episodes.
Blended weight	20%	Significant tail risk; not a “black swan.”

Key macro indicator forecasts

Key Indicator	Unit	Current	0-12 Months	12-24 Months	24-36 Months
Gross Domestic Product	Average growth (%)	3.8	3.2	1.5	0.0
Consumer Price Index	Average growth (%)	2.7	3.5	6.0	4.0
Fed Funds Rate (FFR)	End-of-period	4.125	3.0	3.5	5.25

Macroeconomic features

Assumptions: what you need to believe

- **Interest rates:** The Federal Reserve continues to ease interest rates, downplaying inflation risk and indexing on employment creation. Rates drop as low as 3.0-3.5% over the next 12 months.
- **Tariffs:** The average U.S. tariff rate stays at current levels or rises somewhat without triggering a severe market correction (Scenario 2).
- **Fiscal stimulus:** The Trump administration retains or extends proposed tax cuts and does not make economically meaningful cuts to program spending.
- **Labor market restrictiveness:** Strict immigration policy sharply curtails the inflow of economically active migrants (both legal and undocumented), causing some areas of the labor market to tighten despite tepid labor demand.
- **Risk appetite:** Investors retain an appetite for risk over the next 6-12 months, and can shrug off negative news, driven by a self-reinforcing loop of rising M&A activity, low rates, and solid activity.

Consequences: what you need to prepare for

Phase 1: Short Overheating Regime

- **Activity:** Key growth drivers, including consumption and AI-related investment, remain in place. Investment spending outside of AI picks up a little as lower interest rates pass through and M&A activity accelerates. Sectors such as manufacturing and real estate remain cyclically slow but do not deteriorate further.
- **Prices:** Prices accelerate gradually, but not fast enough to trigger alarm bells. Import prices and durable goods rise instead of falling, and inflation in “sticky” categories rises.
- **Financial conditions:** Credit availability goes from easy to easier. M&A activity picks up, supporting private valuations. Public markets retain elevated valuations relative to earnings.

Phase 2: Stagflation

- **Activity:** Growth stalls out. Depending on secular tailwinds, it may remain positive but well below potential. More likely is a mild recession.
- **Prices:** The Fed loses control of inflation, and price growth spikes to well above 5%. Even after the peak, inflation remains above 4% on a sustained basis.
- **Financial conditions:** A sharp tightening occurs as the reality of a sustained Fed hiking cycle sets in. The yield curve inverts. Credit spreads rise across the rates complex. Valuations adjust downwards to balance out supply and demand.

Market Strategy

Public benchmarks

Equities

The bull market continues during the Overheating regime. However, the subsequent tightening cycle hits equities hard via the discount factor, and stocks go through a correction period before moving sideways. The result is significant downward revaluations relative to earnings

Fixed income and FX

US\$ depreciation, initially because of lower US interest rates, later because of sustained high inflation accelerating dollar devaluation dynamics.

Long-end yield spike: Combined effect of rate increases and rising inflation term premium spike long-end rates.

Commodities

Gold faces opposing pressures: higher rates make zero-yielding assets unappealing. But inflation fears stoke gold demand, and in the current global context of concern over dollar devaluation, this effect will dominate.

Industrial and energy commodities are a major wildcard. From the current starting point, this scenario is benign to deflationary, as demand will decline when growth slows. But any localized shock, especially to oil prices, will turbocharge the inflationary side of the equation. Think of commodities as an exogenous accelerator.

Private markets

Scenario summary

	Overheating	Stagflation
Fundraising	Improves from the current environment as cash flow improves and enables allocation turnover	Generally challenging, with large funds and a strong track record through the COVID crisis, prioritized.
Deal flow	Strong across the board.	Subdued, with leverage expensive and focus on operational quality. Extension vehicles (continuation, secondaries, etc.) return to prominence.
Valuations	High, roughly in line with current levels.	Normalizing, but with higher dispersion across assets.
Returns	Strong (depending on vintage)	Generally pressured, but with high divergence across industries and verticals, depending on price and financial conditions exposure.

Strategic considerations for illiquid investing

The “Overheating” phase presents a narrow exit window. Maturing funds should aggressively take advantage of the heightened optimism around M&A, even if that means shortening holding periods.

Now is a good time to initiate fundraising.

During this phase, discipline should be exercised for funds in the deployment phase, with careful attention paid to targets' exposure to inflation and higher interest rates.

In the subsequent “Stagflation” phase, top-quartile funds will consist of assets with strong pricing power, sticky customer bases, and proven competitive advantage. Diversification via real assets may offer further inflation protection.

Structurally, private credit is set for a strong comeback as floating rate structures and tight covenants again prove their worth during a challenging credit market.

Corporate performance

The key to success in this scenario is to look for inflation resilience alongside limited sensitivity to rising interest rates and tightening financial conditions.

As always, we can profile at the industry level, but individual assets within industries may differ significantly depending on their business structure, customer base, and marketing strategy.

Historically, commodities have outperformed significantly in stagflations. However, those were commodity-driven stagflation episodes. This case is a different type of high-price/low-growth episode.

Outperforming industries

Industry	Detail
Utilities	Stable, inflation-indexed revenue.
Telecoms	Utility-like.
Transport and warehousing	Very strong cost pass-through.
Specialty retailing	Sticky customer base and high margins (but be selective).
Leasing	Often inflation-indexed, sees higher demand when financing costs rise.
Healthcare services	Sticky demand, strong margin buffer.
Healthcare manufacturing	Sticky demand, strong margin buffer.
Education services	Usually similar to healthcare but may be exposed to immigration restrictions and funding challenges.
Insurance	The utility of the financial sector.

Beyond the Horizon

A challenge in this quarter's Report was the lack of official data for the end of Q3 owing to the ongoing U.S. government shutdown. While there is enough private data to estimate the factors, it's possible that the simultaneous release of a large amount of official data will shift them meaningfully, particularly the Real Factor.

Any changes to the scenario outlook before the next update will be communicated in the weekly `arc_Tangents` note.

What we didn't include

With seven scenarios and a 3-year horizon, we have 21 possible scenario paths. Not all of these are feasible (the model assigns most probabilities close to zero).

Nonetheless, it's worth noting some scenarios that missed the cut and might emerge in the near future.

- Based on recent data trends, the model assigned a relatively high probability of a transition from "Sluggish" to "Financial Constrained" regime in the next 12 months. However, the model is not aware of the Fed's current easing bias, so this outcome is less likely than the temporary Overheating regime we envisage in scenario 3.
- The outer regime of Scenario 2 is that the economy settles in a period of "Financially Constrained" growth (due to an inflation overhang). This was a toss-up with Goldilocks and would depend on productivity growth and the extent of the inflation in the Rebound phase.

Turning to 2026

Our next Quarterly Report will encapsulate our 2026 Outlook. You can expect a focused section on the key factors we'll be watching in 2026, including how we expect secular themes to evolve. We will also factor in early probabilities around the U.S. midterms and what they may imply for our Scenarios.

APPENDIX: arcMacro Regime Summary

arcMacro Regime Summary

Regime	Occurrences	Historical share	Average duration	Average GDP growth		Average inflation	Average annual S&P 500 return	
	Count	Percent	Months	Percent	Std. dev	Percent	Percent	Std. dev
Goldilocks	5	27	32	3.2	0.4	2.5	14.5	10.8
Financially Constrained	8	21	16	3.4	0.4	2.9	14.7	15.8
Overheating	5	19	23	3.9	0.8	5.7	3.0	18.0
Crisis	5	10	11	0.0	0.6	2.0	8.5	17.8
Stagflation	4	10	15	-1.3	0.9	8.8	8.7	21.5
Rebound	3	7	13	5.5	1.5	4.0	10.6	23.2
Sluggish	4	7	11	1.8	0.4	3.0	18.5	14.9

Source: arcMacro

Goldilocks: This is the regime that policymakers are aiming for. The real economy is robust without being inflationary or creating financial imbalances. There is a general sense of equilibrium. Since 1970, the economy has spent more time in this Regime (27%) than any other, but we have not experienced a Goldilocks period since 2018.

Financially Constrained: In this regime, financial conditions are tight and are gradually cooling the economy. At times, this regime has reflected a “hangover” from a prior crisis, where growth has rebounded but credit remains tight. It can also result from a traditional central bank tightening cycle. In both cases, growth is coming down from an unsustainably high level (Rebound or Overheating Regimes), which explains why average GDP growth is relatively high. These regimes are common and highly variable in length.

Overheating: Easy credit conditions fuel unsustainable growth, pushing aggregate demand beyond supply and fueling inflation. The post-COVID-19 boom was a classic example. Creates the weakest return environment of all the Regimes as asset values become stretched.

Crisis: Total collapse in growth and credit, accompanied by stable or falling inflation. Very weak aggregate demand, with low-capacity utilization on the supply side. Extreme flight to safety behavior. Usually short-lived, but can stretch several years (e.g., dotcom recession) or double dip (GFC).

Stagflation: Simultaneous inflation spike and real economy collapse, usually accompanied by a credit crunch as monetary policy responds to inflation. Low (nominal) returns, but with very volatile markets. We have not experienced a Stagflation Regime since the First Gulf War, but we may be approaching one.

Rebound: Any period of super-strong real activity, which can only be achieved when idle economic capacity is rapidly reactivated. Always follows Crisis or Stagflation Regimes. Strong (but volatile) return environment, usually sparked off by a sudden surge in the Sentiment Factor (“animal spirits”).

Sluggish: Usually a transition Regime when entering or exiting a crisis. Real activity is below average, but not because of a lack of credit availability. Inflation is stable. The U.S. economy has been mired in a Sluggish Regime, without entering a recession or a recovery, since 2023. This is an unprecedented state of affairs over the past half-decade of economic history.

