



Q4 2025 OUTLOOK

PGIM Quantitative Solutions Multi-Asset Team

EXECUTIVE SUMMARY

Economic Outlook

- The initial volatility from the second Trump administration has eased, with bilateral trade agreements reducing economic policy uncertainty. However, legal challenges to tariffs and fiscal sustainability concerns persist.
- The Supreme Court will review the legality of 2025 tariffs, potentially invalidating over 70% and reducing the effective rate from 17.4% down to 6.8%. This could significantly alter trade dynamics.
- Recent jobs data disappointed, with flat non-farm payrolls since April and a major downward revision to employment growth. The Bureau of Labor Statistics overestimated job gains by nearly one million from March 2024-2025.
- Despite hiring stagnation, layoffs remain low and real wage growth is steady. Layoffs can be a lagging indicator of recessionary conditions. Our real private wage bill growth calculation, a more coincident measure of the economy, remains roughly consistent with the post-GFC/pre-COVID trend.
- Consumer balance sheets are in good shape and delinquency rates are stable. Ongoing investment in data centers as well as fiscal stimulus from the One Big Beautiful Bill Act (OBBBA) and deregulatory reforms from the Trump administration are also supporting economic growth.
- PGIM Quant's sentiment indicator shows reduced recession fears. The Federal Reserve's (Fed) Q3 Survey of Professional Forecasters projects 1.6% GDP growth over the next year—slower, but not recessionary.
- Core CPI rose 3.1% year over year in August. Inflation remains a public concern, with proprietary indicators showing elevated media attention despite a decline from 2022 peaks.
- The Fed lowered rates by 25bps in September to 4.00-4.25%, prioritizing labor market risks. Further cuts are expected through 2026, though political pressure for deeper easing is mounting.
- Leadership changes in France, the UK, and Japan have contributed to bond market volatility and policy uncertainty across major economies.
- A temporary US-China trade truce is in place, but elevated tariffs are dampening Chinese retail and industrial activity, posing risks to global growth.

Market Outlook

- Financial markets shifted back to risk-on mode in Q3, with volatility easing significantly. The VIX averaged 16, down from 24 in Q2, while the MOVE index fell to 83 from 104, reflecting a calmer environment for risk assets.
- US Treasury yields were supported by rising rate cut expectations, despite deficit concerns following the passage of OBBBA. Fed Chair Powell's dovish stance at Jackson Hole helped reinforce market confidence.
- Global bond markets faced pressure due to fiscal developments. Germany's stimulus-heavy budget, UK welfare reversals, and Japan's election outcomes contributed to rising yields and fiscal uncertainty across regions.
- Equities rallied strongly, with US small caps outperforming large caps. International stocks posted solid gains, and commodities—especially gold—attracted interest as inflation hedges, with gold reaching record highs above \$3,600/oz.
- Trade policy uncertainty eased after President Trump delayed tariff deadlines and secured deals with key partners. OBBBA's fiscal measures are expected to push the US deficit to 7% of GDP by 2026, supporting growth but raising long-term risks.
- Corporate earnings exceeded expectations, with S&P 500 companies posting 13% year-over-year growth in Q2. Positive revisions suggest continued strength, with an improvement in the broader market earnings, while Magnificent Seven growth has started to moderate from its earlier scorching pace.
- Bond yields may decline in the short term due to rate cut prospects, but long-term rates face upward pressure from inflation and supply concerns. Credit remains appealing amid moderate growth and attractive nominal yields.
- Commodities and real assets typically thrive during inflation. Commodities have stabilized, but geopolitical and inflationary risks have risen. Structural trends including rising defense spending and dollar diversification support sustained demand for commodities.
- While the macro environment remains pro-risk, persistent policy uncertainty and tail risks underscore the importance of diversified portfolios. Low stock-bond correlations are diversifying, and equity-commodity links may enhance inflation protection.

For Professional Investors Only.

All investments involve risk, including the possible loss of capital.

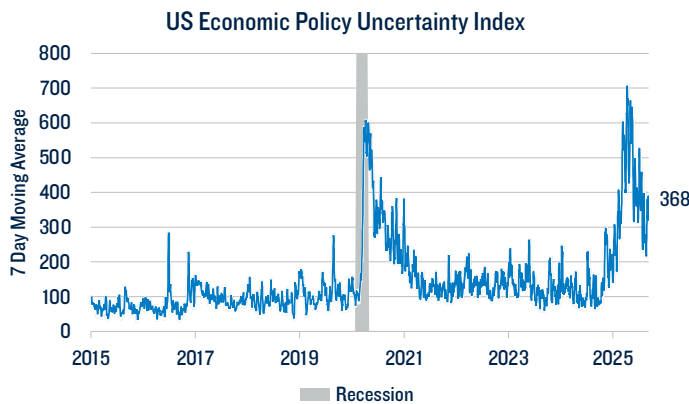
September 2025

Economic Outlook

Navigating Economic Crosswinds

While the year began with ever-shifting winds of change from the second Trump administration, these have settled into a more modest headwind as 2025 nears its close. The initial tariff tsunami has subsided with the administration pulling back on some of the more extreme measures with negotiated bilateral agreements. Uncertainty surrounding fiscal policy has also moderated with the passage of the One Big Beautiful Bill Act (OBBBA) and follow-up rescission package, although concerns about long-term US fiscal sustainability remain. Greater clarity on trade policy has contributed to a decrease in economic policy uncertainty so far in Q3 (Figure 1).

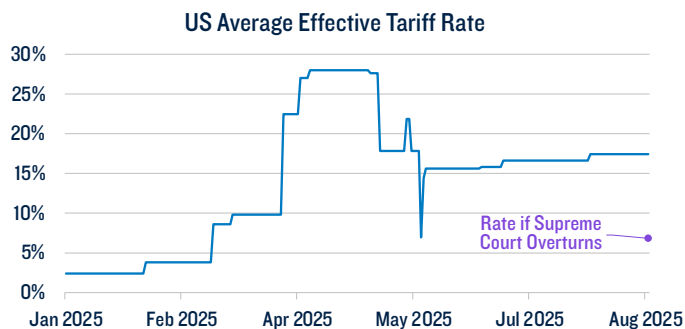
Figure 1: Economic Policy Uncertainty Historically Elevated, But Pulls Back from Q2 Heights



Source: Bloomberg, PGIM Quant. Data as of Sep 7, 2025.

Although the policy uncertainty index has receded, it remains historically elevated. While the administration has successfully negotiated bilateral agreements, progress has been bumpy, hitting some notable snags. In addition, many of the tariffs are on shaky legal ground. The US Supreme Court is scheduled to fast-track a review of these tariffs in early November. According to estimates from The Budget Lab at Yale, a ruling against the tariffs could invalidate over 70% of those imposed in 2025 to date, reducing the latest effective tariff rate from 17.4% down to 6.8% (Figure 2). In the meantime, we continue to debate the size of the potential impact of these policies on the economy.

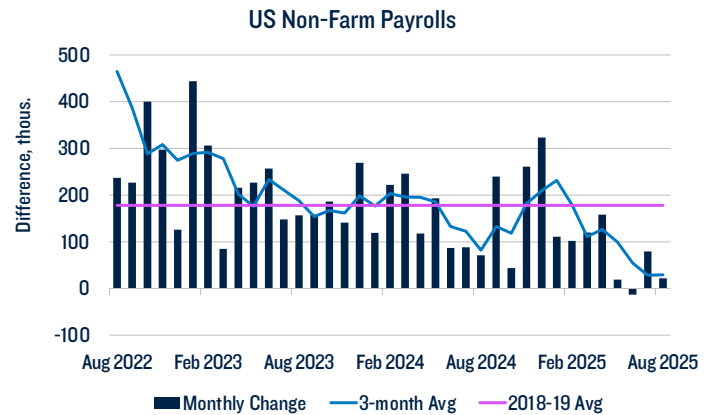
Figure 2: Tariff Rates at Highest Levels Since Late 1930s



Source: The Budget Lab at Yale. Policy as of September 4, 2025, accessed September 10, 2025.

While there was little evidence that elevated uncertainty introduced by tariffs was impacting the wider economy last quarter, cracks are now beginning to emerge. The July US labor report disappointed, with significant downward revisions to the May and June data. And the more recent report covering August wasn't any better. Non-farm payrolls are essentially flat since April (Figure 3). Moreover, the Bureau of Labor Statistics (BLS) announced in a preliminary benchmark revision in early September an overestimation of employment growth by nearly one million jobs from March 2024 to March 2025, suggesting a weaker labor market than previously understood.

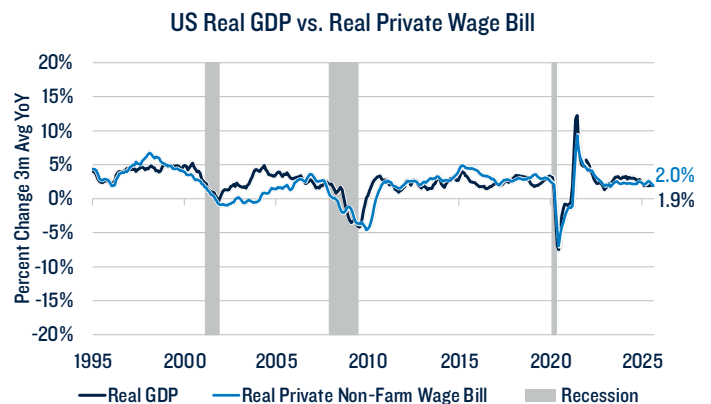
Figure 3: Firm Hiring Little Changed Since April



Source: Bloomberg, PGIM Quant. Data as of Aug 31, 2025.

Although firms are right-sizing their hiring, they are neither laying off workers nor cutting wages for existing employees. The layoff rate calculated as part of the BLS's Job Openings and Labor Turnover Survey (JOLTS) has hovered around 1% since early 2021. Admittedly, layoffs can be a lagging indicator of recessionary conditions. A more coincident measure of the economy is the real private wage bill growth calculated by PGIM Quant in Figure 4. It remains roughly consistent with the post-GFC/pre-COVID trend.

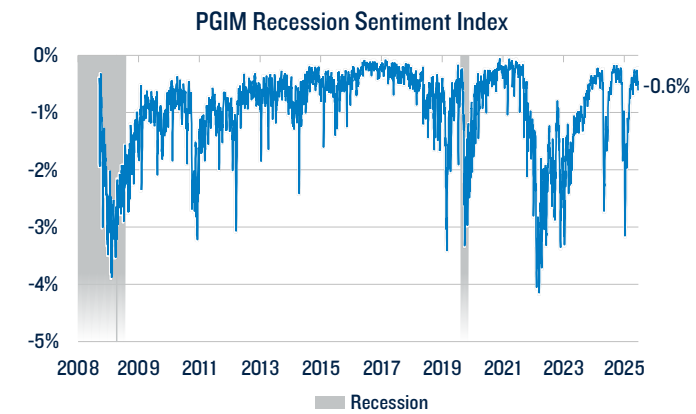
Figure 4: Aggregate (Real) Payrolls Continuing to Grow at Solid Pace



Source: Bloomberg, PGIM Quant. Data as of Aug 31, 2025.

The sustained strength in real wages has helped consumers weather the recent economic shocks, from tariffs to interest rate hikes and other pressures. Consumer balance sheets are in good shape and delinquency rates are stable. Ongoing investment in data centers that are fueling the AI boom as well as fiscal stimulus from the OBBBA and deregulatory reforms from the Trump administration are also supporting economic growth. Despite persistent economic policy uncertainty, PGIM Quant's proprietary recession sentiment indicator, which tracks negative sentiment in published articles about the US economy, has recovered to milder levels (Figure 5). And while economic forecasts can be less reliable in periods of potential recessions, the Q3 Survey of Professional Forecasters from the Federal Reserve Bank of Philadelphia projects a modest 1.6% pace of real GDP growth over the next year. This marks a slowdown compared to the recent trend, but not a recession.

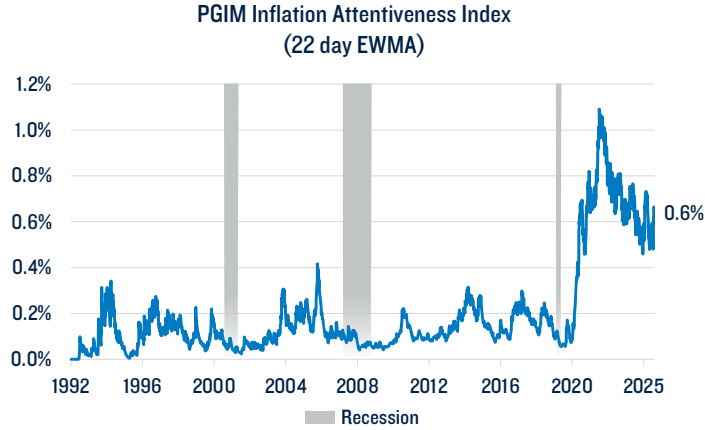
Figure 5: Recession Sentiment Recovers to Mild Level



Source: PGIM Quant. Data as of Sep 8, 2025.

Although recession sentiment has improved, investors and consumers remain concerned about the threat of higher inflation, particularly in the short term due to tariff risks. Core CPI remained elevated in August, rising 3.1% year-over-year, with moderating shelter costs offset by upward pressure on core goods inflation. In addition to the usual inflation data provided by government agencies, we measure inflation attentiveness through a proprietary indicator that captures the degree to which news articles are discussing inflation. Figure 6 shows that while this indicator has pulled back from its peak in 2022, it has yet to return to pre-COVID levels. Thus, we remain concerned about upside shocks to inflation.

Figure 6: Inflation Concerns Remain in Public Spotlight

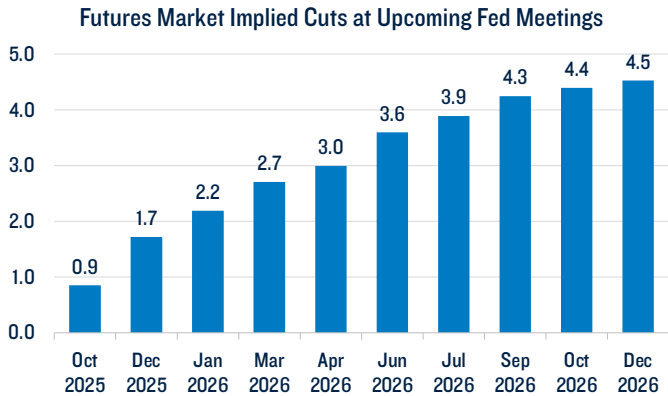


Source: PGIM Quant. Data as of Sep 8, 2025.

With increased downside risks to the labor market and elevated inflation, the US Federal Reserve (Fed) faced a difficult decision at its mid-September meeting. Ultimately, concerns over labor market risks won out, and the Fed cut its target policy rate range by 25bps to 4.00%-4.25%. Motivating the decision were projections suggesting a downward trajectory for inflation, despite its currently elevated level, particularly if unemployment climbs as expected. The decision to cut in September was largely in line with the default Taylor rules in the Atlanta Fed's utility.

Following its mid-September meeting, the Fed's Summary of Economic Projections (SEP) indicates two more rate cuts this year, followed by one in 2026 to reach a target range of 3.25%-3.50% (compared to 3.50%-3.75% in the June SEP). Market expectations (Figure 7) are more aggressive, anticipating four to five cuts through the end of 2026 (versus three from the Fed), consistent with policy rates closer to 3%.

Figure 7: Market Pricing on Fed Cuts



Source: Bloomberg. Data as of Sep 18, 2025.

Even so, the anticipated faster pace of cuts may not be sufficient to quiet the aggressive cut drumbeat from the Trump administration. At the same time, the administration is seeking greater influence over the Fed's Board of Governors, potentially with the view of influencing selection of Regional Federal Reserve Bank Presidents whose terms expire in February 2026. Given the current Board composition, the Biden appointees, with Chair Powell's alignment, could block these efforts. However, if President Trump successfully removes Governor Lisa Cook—one of the Biden appointees whose dismissal has been temporarily blocked by a federal judge—and replaces her with someone more to his liking, it could grant him greater control over monetary policy. At present, the likelihood of this scenario is low given the nature of the accusations and the Supreme Court's May 2025 ruling in *Trump v. Wilcox*, but it is a risk we are monitoring.

Political turmoil has not been isolated to the US: The French Prime Minister lost a vote of confidence and was ousted due to a poorly received budget plan; the Deputy Prime Minister in the UK resigned over a tax scandal, prompting a cabinet reshuffle; and the Japanese Prime Minister resigned following defeat in the July upper house election. Not coincidentally, these resignations have contributed to the upward pressure on long-term bond yields that are addressed in the side bar.

Domestic and external policy turmoil has contributed to volatility in European economic data. Eurozone GDP saw solid growth in Q1, supported by robust business investment and exports in advance of implementation of US tariffs. However, a pullback in Q2 brought first-half GDP growth to approximately 1.4% annualized, consistent with the Eurozone's modest pre-COVID growth trajectory. Unlike the US, the Eurozone is closer to its inflation target, providing the European Central Bank with greater flexibility to resume cutting rates in the months ahead.

The Japanese economy has been relatively resilient compared to Europe. Second-quarter GDP growth was revised upward, marking an increase of more than 2% for four of the past five quarters. However, the economy faces mounting challenges as tariffs are expected to have a greater impact on the economy going forward, and rising inflation continues to squeeze households. This backdrop sets the stage for weaker consumption growth and potential rate hikes by the Bank of Japan (BoJ) in the near future. Additionally, the resignation of Prime Minister Shigeru Ishiba introduces the possibility of shifts in both fiscal and monetary policy.

Although China has largely been spared the domestic political challenges seen in Europe and Japan, it remains a primary focus of the Trump administration's tariff policy. The US and Chinese governments have agreed to a temporary trade truce, extended by 90 days in mid-August. While the tariff rate on Chinese goods is lower than the 145% the Trump administration initially threatened, the temporary 30% rate is still significantly above the status quo ante. And these tariff rates are taking a toll on the Chinese economy, with weaker-than-expected retail sales and industrial production reported for July.

Long-Term Bond Yields in the “Fiscal Five”

Government bond yield curves have steepened significantly this year, even amid the partial reversal leading up to the Fed rate cuts. As described in the Market Outlook, yield curves in the ‘Fiscal Five’—US, UK, France, Germany, and Japan—have steepened both out to the 10-year maturity and even more at the longer end. First, it’s important to note that fiscal positions across the Fiscal Five remain weak, especially given the current stages of their economic cycles. One way to look at this is to compare fiscal deficits now to those during previous late-stage expansions. By 2025, these economies have been recovering for many years, with unemployment rates ranging from 2.6% in Japan (always low), to 4.2% in the US (typically somewhere in the middle) and 7.7% in France (always on the high side), with an average Fiscal Five unemployment rate of 4.5%.

The last time the Fiscal Five sported an average unemployment rate of 4.5% was 2018, and before that in 2007. Today’s fiscal deficits range from 2.9% of GDP in Japan) to 6.5% in the US, averaging 4.4% across the group. In contrast, 2018 saw deficits ranging from a surplus of 1.9% (Germany) to a deficit of 5.3% (US), with an average of 2.1%. Similarly, in 2007, deficits ranged from a surplus of 0.2% to a deficit of 3.0%, averaging 2.3%. None of the Fiscal Five has a deficit today that is lower than those in either 2018 or 2007.

Figure 8: Fiscal Five - General Government Fiscal Balances vs. Unemployment Rate
(Percent of GDP at Cycle Ends, 2007 - 2025)

2025	US	UK	France	Germany	Japan	Average
Fiscal Balance	-6.5%	-4.4%	-5.5%	-3.0%	-2.9%	-4.4%
Unemployment Rate	4.2%	4.5%	7.7%	3.5%	2.6%	4.5%
2018	US	UK	France	Germany	Japan	Average
Fiscal Balance	-5.3%	-2.3%	-2.3%	1.9%	-2.5%	-2.1%
Unemployment Rate	3.9%	4.1%	9.0%	3.2%	2.4%	4.5%
2007	US	UK	France	Germany	Japan	Average
Fiscal Balance	-2.9%	-2.7%	-3.0%	0.2%	-2.9%	-2.3%
Unemployment Rate	4.6%	5.4%	8.0%	8.5%	3.8%	6.1%

Source: IMF WEO. Data as of Apr 2025.

Restoring Fiscal Sustainability

Only a few pathways exist to restore fiscal sustainability:

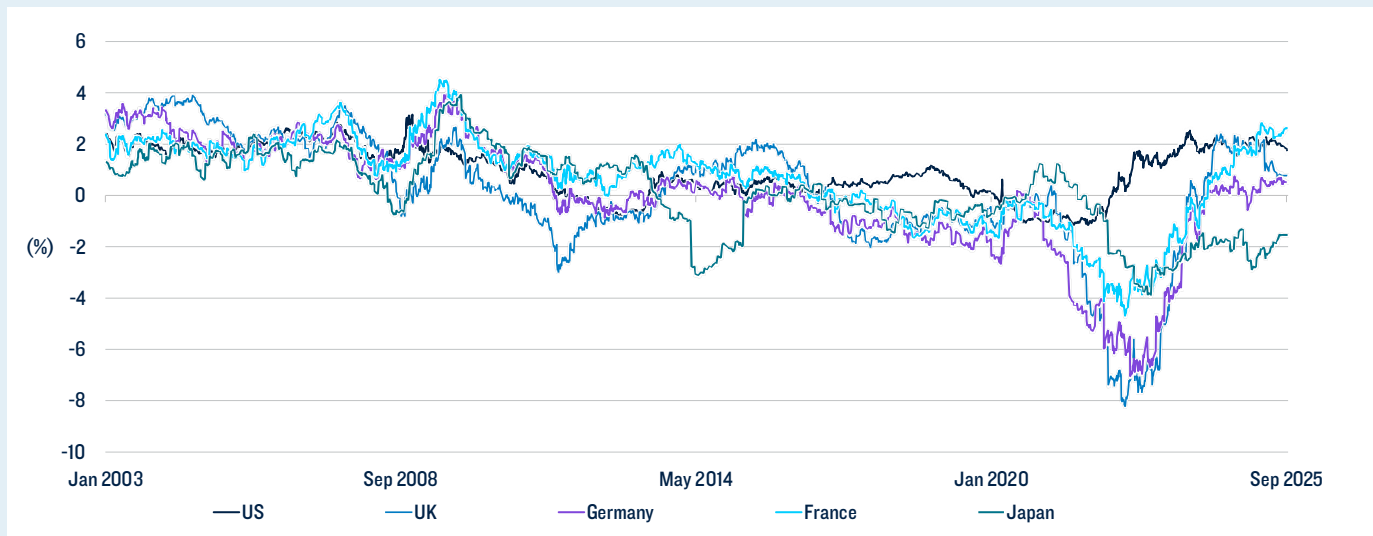
- Faster nominal GDP growth, driven by either population growth, increasing physical and intellectual capital, or productivity growth.
- Fiscal consolidation through higher taxes or lower public spending.
- Higher inflation.
- Debt restructuring—either through “hard” defaults or “soft” measures such as lengthening maturities, etc.

The most painless path to fiscal sustainability is higher nominal GDP growth, but with population growth declining sharply—not just in the Fiscal Five but globally—the burden falls on higher capital investment and productivity growth. While the US has experienced some capital deepening, its extent among the other Fiscal Five economies remains uncertain. And the formula for accelerating productivity growth lacks a clear roadmap. Furthermore, following the political upheaval that saw many governments ousted after the post-2021 inflation flareup, another round of inflationary policy seems unlikely, though not impossible, barring more dire alternatives. It takes a very strong government, or a dire crisis, to achieve significant fiscal consolidation. Currently, none of the Fiscal Five governments have strong mandates. France and Japan have both lost their prime ministers in September, while the ruling parties in the UK and Germany rely on “strategic voting,” which lacks broad support. Meanwhile, the US remains sharply divided politically. These are not favorable circumstances for fiscal consolidation, and, despite this year’s rise in long-term yields, there is no immediate crisis that would compel even a weak government to take dramatic action.

Nominal yields can rise either from “real” yields, inflation, or from various risk premia (that are not observable and are hard to measure). Interpreting real yield movements demands caution—especially over shorter periods when they tend to spike during times of turmoil, such as the GFC or the current situation in France. However, a sustained rise in real yields can reflect an improvement in the economy’s underlying productive capacity and a corresponding rise in investment demand, which drive yields higher.

Figure 9 illustrates the real yield levels of the Fiscal Five since the early 2000s. We can see that US real yields, recently between 1.75%-2.0%, have returned to their pre-GFC levels (while they had been rising since the mid-2010s, this trajectory was interrupted by the pandemic, a setback that has now been fully offset). Real German yields are at about 0.50% and real UK yields hover at about 0.75%. Real yields in Japan remain deeply negative. France is hard to read because inflation is largely determined by the European Central Bank and the current short-term turmoil that can drive real yields higher. But absent this short-term factor, the long-term trend for France seems to be downward. Ultimately, a rise in an economy’s productive capacity increases its debt servicing capacity, giving the US some advantages, although of course many other factors also come into play.

Figure 9: Real 10-Year Government Bond Yields of Fiscal Five



Source: Bloomberg. Data as of Sep 12, 2025.

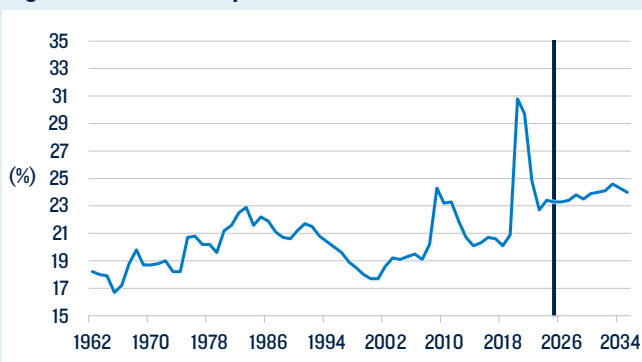
Where yield increases originate—i.e., from real factors or from inflation—also influences other asset prices. In particular, if yields rise primarily due to “real” factors, the effect on equities tends to be less disruptive, as higher productive capacity should translate into higher corporate earnings. There are also implications for currency markets. Namely, firm US real yields can underpin the dollar and hold it at levels that exceed market expectations. To be sure, the USD had a rough first half of 2025 (down by 10.7% for the DXY Index). But it has since rebounded, albeit modestly, even as US short-term interest rates have fallen more sharply than those of its peers. Despite the shock of broad and rapidly changing tariffs as a centerpiece of US economic policy, investors appear willing to “look through” these issues and focus on what’s real.

Fiscal Dynamics in Focus

1. Are today's deficits largely "hangovers" from the pandemic?

Not exactly, but spending seemed to reach a permanently higher level after the pandemic. Figure 10 shows US federal expenditures as a percentage of GDP since 1962. These historically averaged around 20%, fluctuating within a fairly narrow range of 17%-23%, even during major recessions like the 2008-2009 GFC. Pandemic-related spending ballooned deficits, and while pandemic-related stimulus programs have ended, federal spending as a share of the economy remains at historic highs. And it is expected to keep growing, despite reductions to baseline spending in programs such as Medicaid under the OBBBA.

Figure 10: US Federal Expenditures as Percent of GDP 1962 - 2035E



Note: Vertical line denotes estimates (2025 and after).

Source: Congressional Budget Office. Data as of Jan 2025.

2. Did Moody's US sovereign credit rating downgrade matter?

Not too much. Few investors still "have to sell" on downgrades (and the US sovereign rating is still high investment grade). Many investors changed their mandates after the S&P's 2011 downgrade to exclude the US and other G7 countries from automatic "sell on downgrade" requirements. And since Moody's May downgrade, US 10-year yields have fallen by 40bps, whereas yields in Germany, France, and Japan rose. UK yields have fallen a modest 2bps. At current ratings, there is little evidence to suggest a material impact.

3. What's in store for Japan's fiscal policy?

Japan's next government, to be decided in October, will likely loosen fiscal policy. Already, all major parties have called for fiscal stimulus of some sort, with most discussion centering around the consumption tax. The ruling Liberal Democratic Party favors modest tax "rebates" as a sort of "compensation" for recent inflation. Other parties advocate for temporary or permanent, partial or across-the-board consumption tax cuts. These measures primarily aim to address cost-of-living issues with very questionable impacts on inflation or long-term economic growth prospects. And let's not forget, the consumption tax is key to Japan's long-term fiscal sustainability.

4. Will governments turn to inflation to ease (real) debt burdens? Who is closest to that?

No government or central bank will admit to using inflation to ease real debt burdens, a strategy that remains distinctly out of favor. However, occasional remarks that "tax revenues are rising nicely" due to inflation, hint at the idea. And there are persistent expectations in some corners of the market that eventually, some government(s) may have little choice but to reflate. Many academics feel that any government that runs an excessively loose fiscal policy will inevitably have to inflate. Among G7 nations, Japan often emerges as the most likely candidate, given its exceptionally high debt-to-GDP ratio and stagnant nominal growth. But the government prefers an orderly "soft restructuring" among domestic groups over disorderly inflation, and the government retains credibility among the public. Governments with weak credibility and therefore little ability to impose costs are the ones most likely to opt for inflation.

5. What are some good references for further reading?

IMF Fiscal Monitor (<https://www.imf.org/en/Publications/FM>). For relatively current data, forecasts, and analysis across the globe.

Austerity: When It Works and When It Doesn't, Alberto Alesina, Carlo Favero, Francesco Giavazzi. Detailed treatment of fiscal consolidation plans and differential impact of tax increases vs. spending cuts, and within spending cuts, investment vs. consumption. Focus on Europe.

This Time Is Different: Eight Centuries of Financial Folly, Carmen M. Reinhart, Kenneth S. Rogoff. Broad-brush treatment of public debt crises and their aftermath throughout history. Editor's note: Subject to the inevitable criticisms any such broad survey would face, a patient collection of data on precursors to and effects of financial crises with an emphasis on fiscal crises.

Market Outlook

Higher Ground Ahead?

Financial markets were in risk-on mode during Q3, recovering from the turbulence of Q2 triggered by the announcement of reciprocal US tariffs. Market volatility, as measured by both the VIX and the MOVE indexes, eased, reflecting the more benign environment for asset classes. After averaging at around 24 and peaking at 52 in early April, the VIX moderated to around 16, falling even lower than its Q1 average of 19. Meanwhile, the MOVE index eased to around 83 in Q3, down from 104 in Q2.

US Treasury yields benefited from growing expectations of rate cuts throughout the quarter. Earlier in the quarter, yields faced upward pressure from concerns about deficits following passage of the OBBBA and President Trump's heightened criticism of Fed Chair Powell. Later, rising expectations for rate cuts combined with inflation data showing minimal signs of tariff pass-through and a more dovish tone from the Fed Chair drove yields lower. Outside the US, bonds faced headwinds. In Europe, fiscal developments weighed on sentiment, as Germany unveiled a draft budget with more front-loaded stimulus, while the UK government's about face on welfare spending sent gilt yields spiking by more than 15bps in early July. Similarly, concerns over additional fiscal stimulus rose in Japan following the July 20 upper house election that resulted in the ruling LDP-Komeito coalition narrowly losing its majority. French Government bonds also trailed, with the Franco-German 10-year spread widening by 13bps to end August at 79bps.

Stocks surged from their April lows, gaining over 5% quarter-to-date (as of September 10) and setting fresh all-time highs in late summer (Figure 11), with US small-cap stocks besting large caps on rate-cut optimism. International equities also delivered solid gains, with EAFE and Emerging Market stocks advancing approximately 7% and 4%, respectively. Commodities saw ongoing interest as an inflation hedge, with gold hitting record highs above \$3,600/oz. The US administration's fiscal policy efforts to encourage economic growth and specifically, investment spending, have been key drivers of asset class performance.

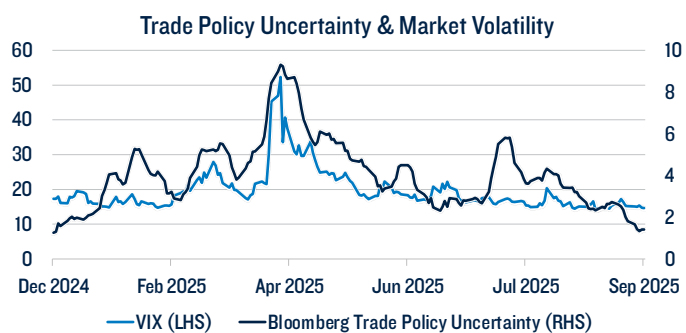
Figure 11: Risky Assets Take Center Stage in Q3 2025



Source: Bloomberg. Data as of Sep 12, 2025.

Tariffs continued to take center stage for markets during the quarter, with President Trump extending the initial 90-day deadline from July 9 until August 1. However, a flurry of agreements with key trade partners helped ease trade policy uncertainty. Overall, the current backdrop remains supportive of risk assets. With the signing of the OBBBA, tax cuts and other measures are projected to push the US federal deficit to 7% of GDP by 2026 and keep it elevated in the coming years. While global growth expectations have been revised lower since the start of the year, improved clarity on tariffs and reduced trade uncertainty (Figure 12) are likely to put a floor on deterioration in growth expectations.

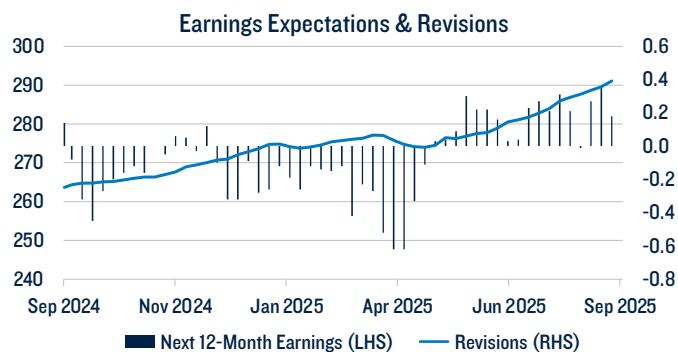
Figure 12: Market Volatility Eases with Trade Policy Uncertainty



Source: Bloomberg. Data as of Sep 12, 2025.

Corporate earnings have continued to surprise on the upside, defying fears of tariff-related impacts. Second-quarter earnings growth for the S&P 500 surged to around 13% year over year, more than double the earlier tariff-adjusted forecasts, bolstered by solid 6% revenue growth. Earnings revisions (Figure 13) have since turned positive, with expectations for around 10% growth over the next four quarters. US earnings exceptionalism persists relative to other developed markets, where growth is expected to range between 6-8%. Within the US, large-cap tech has retained its dominance, with the Magnificent Seven (Mag 7) delivering 22% earnings growth compared to 9% for the rest of the S&P 500. However, this earnings spread has significantly narrowed in recent quarters as growth among the Mag 7 moderates while broader earnings growth improvement lifts the rest of the index. Meanwhile, earnings in Emerging Markets have been revised lower over the past year, particularly in Asia, reflecting a more challenging outlook.

Figure 13: Positive Earnings Revisions & Higher Earnings Expectations

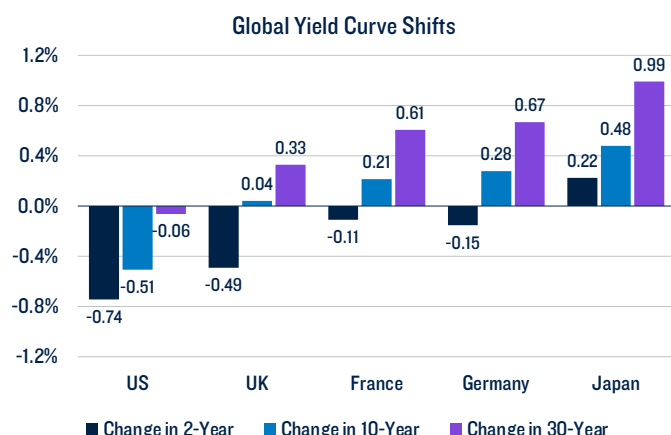


Source: Citi, Bloomberg. Data as of Sep 12, 2025.

In fixed income markets, global government bond yields, particularly on the long end, have remained under pressure (Figure 14), driven by policy uncertainty surrounding tariffs and fiscal spending concerns. In the US, government bonds faced cross currents as tariff-related worries pushed long-term yields higher, while signs of a labor market slowdown led short rates lower on back of rate-cut expectations. Over the course of Q3, the US 30-10-year spread has widened to approximately 65bps, up from 55bps at the end of Q2 and just around 20bps at the beginning of the year. While long-term inflation expectations remain contained, policy uncertainty has contributed to a rising term premium as investors demand greater compensation for holding long-maturity US debt to offset heightened risks.

Outside the US, government yields are also under pressure. Even in Japan, where the BoJ is expected to continue its rate hike path, yield curves are steepening as longer-term Japanese Government Bonds (JGB) face declining demand amid prospects of rising interest payments and widening deficits. Overall, we expect that while rate cut prospects may push yields lower across the curve, longer-term yields are likely to stay anchored by inflation and supply concerns. Credit remains modestly attractive, supported by a steady economic outlook and attractive nominal yields.

Figure 14: Yield Curves Steepening Across Markets

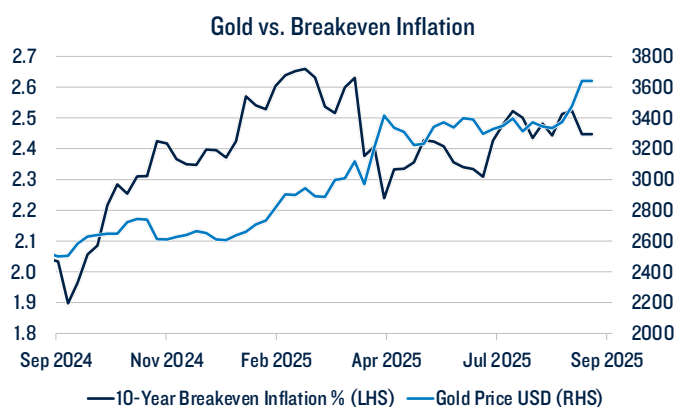


Source: Bloomberg. Data as of Sep 12, 2025.

Commodities and real assets typically perform well during periods of elevated inflation.¹ In recent months, commodities have stabilized as prospects of a severe economic hit from tariffs moderated, while potential geopolitical risks and escalating inflation expectations have risen. Gold (Figure 15) continues to shine, driven by ongoing central bank purchases, inflation worries, and sustained safe-haven demand.

Amid trade war concerns, commodity supply is increasingly concentrated in geopolitically sensitive regions such as the Middle East, Russia, China, and the US, raising the risk of supply disruptions. Despite OPEC+ efforts to normalize supply, declining spare capacity heightens the risk of oil shocks. Structural trends such as rising defense spending and moves toward dollar diversification support sustained demand for commodities.

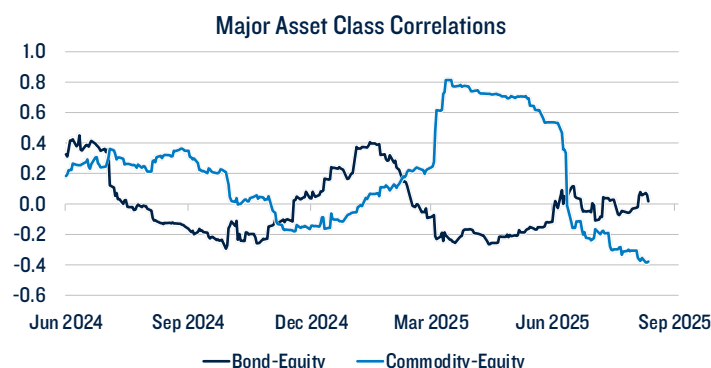
Figure 15: Gold Trends Higher With Inflation Expectations



Source: Bloomberg. Data as of Sep 12, 2025.

Putting it all together, despite recent signs of a slowing US labor market, we remain in a risk-on macro environment, even as persistent policy uncertainty heightens the potential for tail risks. While trade-related concerns have subsided, legal risks around tariffs and questions about Fed independence underscore the necessity of broadly diversified portfolios. After turning positive earlier in the year on the back of broader concerns about dollar assets, stock-bond correlations² (Figure 16) have returned to low levels over Q3 and remain diversifying. Meanwhile, equity-commodity correlations offer valuable portfolio diversification, particularly as rising inflation risks could pose challenges for both equities and fixed income assets.

Figure 16: Bonds & Commodities Diversify Portfolios



Source: Bloomberg. Data as of Sep 12, 2025.

¹<https://www.pgim.com/us/en/institutional/insights/asset-class/multi-asset/quantitative-solutions/commodities-set-to-gain-amid-elevated-inflation-regime>

²<https://www.pgim.com/us/en/institutional/insights/asset-class/multi-asset/quantitative-solutions/cross-asset-correlations-constructing-portfolios-amid-market-turbulence>

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