Money Matters

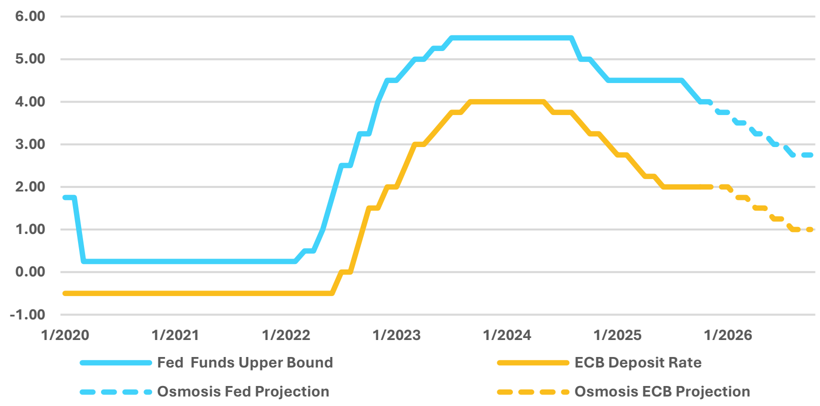
Prepare, don't wait for the proof!

Macro: Uneven yet easier

Across the Atlantic, the U.S. Federal Reserve appears poised for further rate cuts. The labour market is flashing early warning signs: in August, payroll growth slowed significantly to 22k, while unemployment hit a four-year high of 4.3%. Historically, such signals have prompted decisive action from the Fed, as seen in 2001 and 2007. That pattern may now be unfolding again, though in a more complex environment.

What makes this cycle more nuanced is the potential return of some structural inflation pressures, fuelled by the AI boom, which has increased energy demand, and by resurgent global trade frictions. U.S. import tariffs remain elevated, and tensions with China continue to simmer, particularly over advanced technologies and supply chain control. The resulting geopolitical rivalry adds a new dimension to inflation: supply disruptions and pricing power are increasingly influenced by strategic rather than purely economic factors. The Fed's challenge is to navigate weakening domestic employment while global dynamics keep price pressures stubborn. Markets might like these rate cuts for now but not if it turns out to be a mistake. In our view, if upcoming payrolls remain weak, near-zero growth could prompt the Fed to stick with a rate-cutting path well into 2026 (see Graph 1).

Graph 1: Osmosis Fed and ECB projections



Source: Bloomberg, Osmosis Investment Management NL, November 17, 2025

Meanwhile, Europe faces an even more entrenched set of problems. Structural stagnation continues to weigh on the Eurozone, with weak productivity, high regulatory burdens limiting competitiveness and political uncertainty as seen in France. Germany, the industrial core of the region, is especially vulnerable to high energy prices (including excessive carbon taxes) and waning global demand. Companies are relocating production to lower-cost regions, accelerating deindustrialization trends across the continent. Europe simply lacks a comprehensive industrial policy with sufficient protection against Chinese and US competition.

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Quick Read

The labour market in the US is flashing late cycle signals. Payroll growth has slowed significantly.

Fed is poised to cut rates further given weak labour market and slowing economy while inflation will slowly creep higher. Means policy error "in the making".

December rate cut seems likely but heavily data dependent.

Europe faces quite an entrenched set of problems. Structural stagnation given high regulatory burdens are limiting competitiveness.

Fiscal issue continues to simmer in France and broader Europe with lack of political will to implement fiscal restrain and much needed reforms to enhance growth and productivity.

ECB will be forced to come to the rescue as inflation and growth will slow further. The ECB will lower rates gradually in 2026 to 1% by summer.

Although inflation in the Eurozone has retreated toward the 2% target, growth remains sluggish, prompting the European Central Bank (ECB) to cut its deposit rate by 200 basis points from mid-2024 to mid-2025. Additional cuts may follow, but monetary easing alone cannot reverse Europe's broader competitiveness deficit. Without deeper structural reforms, an area where political appetite remains limited, Europe risks being locked in a cycle of low growth and recurring cost pressures.

Late Cycle Cracks: Credit, Banks and Autos

Beneath the market's optimism in 2025, signs of late-cycle strain are becoming visible. In private credit markets, structural fragility is rising. More loans are structured with payment-in-kind interest, and an increasing share of private credit funds are trading below Net Asset Value. These are not isolated signs but consistent with broader stress in the credit channel.

U.S. regional banks, while stable for much of the year, are again showing signs of vulnerability. Narrowing net interest margins and credit losses from commercial real estate are weighing on balance sheets. At the same time, consumer credit stress is building, most notably in the automotive sector, where subprime loan delinquencies have climbed to multi-year highs. The stress may not be systemic yet, but it signals that monetary tightening has already begun to impact (some) fragile sectors.

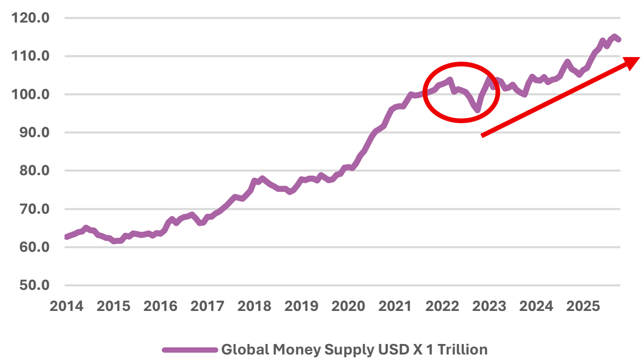
Central banks are aware of these limits but only to a certain degree. The 2022 UK pension fund crisis, where a sharp rise in gilt yields nearly triggered systemic margin calls, forced the Bank of England into emergency intervention. That event remains a cautionary tale: even if inflation is not fully under control, financial stability can become the overriding concern which they need to respond to (while they need to prevent it actually!). We believe we are again approaching that threshold. We see the Fed playing down concerns in credit markets for example while the numbers keep piling up.

Liquidity and Money Supply

Global financial conditions have remained unusually loose as measured by your standard financial conditions index while central bank rhetoric was more nuanced and inflationary focused, even in the face of recent tightening cycles. The broad rally across asset classes in 2025 owes much to liquidity in hindsight, with most central banks shifting course in 2024–2025. In fact, the number of global rate cuts during this period has exceeded that of the 2007–09 crisis.

However, we are now at a potential inflection point. Following a historic surge in global money supply during 2020–21 (as measured by M2 Money Supply), the first real contraction in decades occurred in 2022–23, driven by balance sheet reductions and restrictive monetary policy from the Fed, ECB, and Bank of England (see Graph 2). That retrenchment coincided with a major asset correction. This year, U.S. money supply has returned to modest growth (approximately 3–4% YoY), supporting a recovery in asset prices.

Graph 2: Global Money Supply



Source: Bloomberg, Osmosis Investment Management NL, November 17, 2025

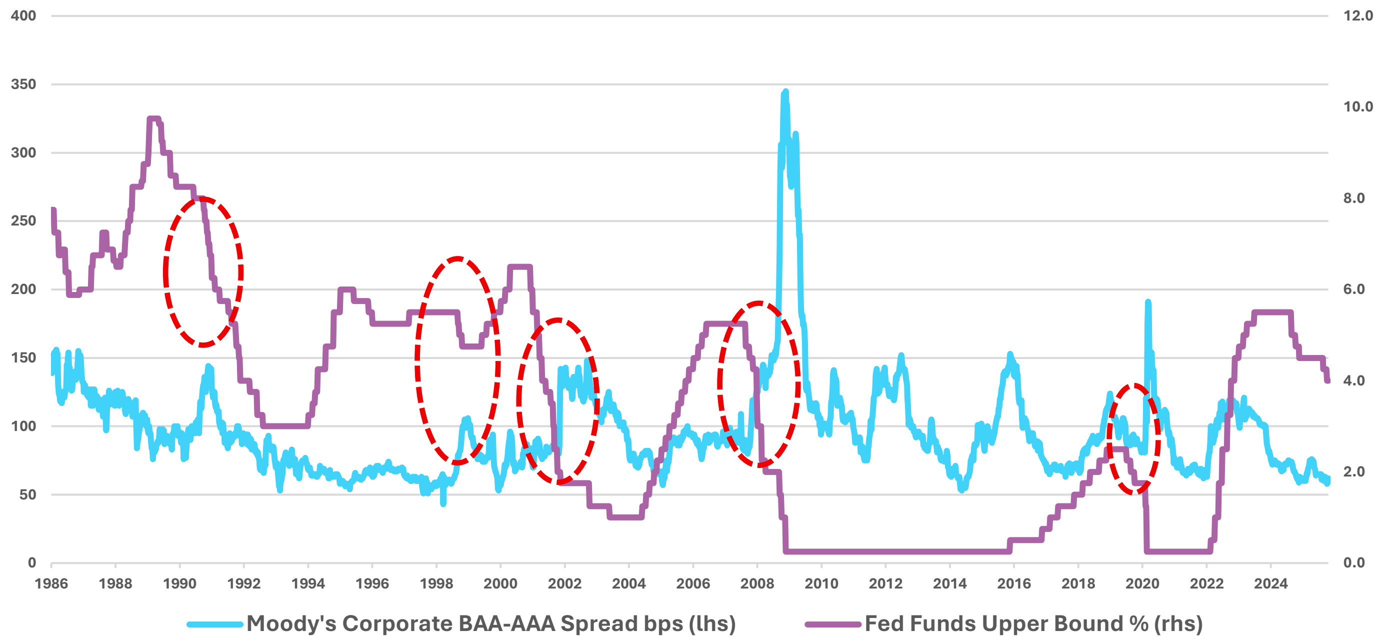
Liquidity cycles tend to dominate late-cycle dynamics. Late-cycle markets often pivot on liquidity inflection points. We suspect we are near one now. When liquidity expands, capital flows into equities, real estate, and risk assets. When it contracts, corrections follow, particularly in high-beta sectors. Investors were reminded of this in 2022 when a combination of Fed tightening and falling money supply crushed speculative segments like tech and crypto.

Going forward, liquidity will remain as critical as macroeconomic fundamentals. If central banks continue rate cuts and pause or reverse quantitative tightening, the cycle could extend, triggering a further melt-up in asset prices if growth does not surprise to the downside too much. But if inflation reaccelerates or growth surprises to the upside, even modest monetary tightening could derail markets. We need to place this into the context that 75% of capital market issuance is simply refinancing so if the music in credit and equity markets stops it can become rather ugly. Enter bear market!

Credit Spreads and the Fed Easing Cycle

One of the most misinterpreted dynamics in fixed income is how credit spreads react to the start of central bank easing. Intuition suggests that easier policy should narrow spreads, but history repeatedly shows otherwise. During past downturns, such as the dot-com bust (2001) and the Global Financial Crisis (2007–09), spreads continued to widen even after the Fed began cutting rates. For example, in 2001 the Fed started easing in January, but high-yield spreads peaked months later. In 2008, despite early rate cuts, spreads didn't tighten until the panic climaxed in late 2008. The lag between rate cuts and credit stabilization is structural: monetary policy reacts to, rather than anticipates, deteriorating macro and credit fundamentals. See Graph 3 for more context – notice the various mid-point of the Fed rate cut cycles as shown by the red dotted lines and how they overlap with the corporate IG spread peaks in the US. For reference we have used the BAA and AAA corporate spreads from Moody given their long history.

Graph 3: US Corporate Spreads versus Fed Rate Cuts



Source: Bloomberg, Osmosis Investment Management NL, November 17, 2025

Even in mid-cycle adjustments like 1995 or 2019, modest spread widening occurred after initial cuts as markets priced in growth risks. This suggests that going forward, we should not expect an immediate further compression in credit spreads. More likely, spreads will widen after the Fed begins cutting further driven by labour market and growth concerns, reaching a peak mid-recession before tightening resumes. The picture is more or less the same for equities. They start selling off when central banks are cutting rates while economic data is (seriously) deteriorating.

Conclusion

We consider the global economy to be late-cycle. Central banks are easing, but their actions reflect underlying weakness: Europe is grappling with long-term stagnation, and the U.S. labour market is clearly cooling. At the same time, liquidity remains a powerful force, but potentially a double-edged sword.

Markets have priced in a soft-landing scenario, yet rising delinquencies, credit vulnerabilities, and weak business investment suggest fragility beneath the surface. It is important to recognize that while monetary easing may continue, it is not a cure-all—especially in the face of persistent inflation pressures, geopolitical frictions, and unresolved structural inefficiencies. It all starts to come together at this point.

Looking ahead, we believe the prudent strategy is to stay defensively positioned, emphasise liquid quality assets (like covered bonds; trading up in quality), and closely monitor liquidity signals. Credit spreads are so tight that there is hardly any cushion left from a carry perspective (no breakeven!). Equally, historical analysis suggests that credit spreads and equities underperform the moment central banks are already advanced in their rate cutting cycle. The coming quarters may present opportunities, but they will likely be wrapped in volatility and late-cycle distortions. Timing the turn is notoriously difficult, markets can remain buoyant longer than fundamentals justify, but the cracks are forming. In this context, the best offense is simply a good defense. Prepare, don't wait for the proof!

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