Money Matters

Debt, Debasement and Divergence

February 2026

Second edition

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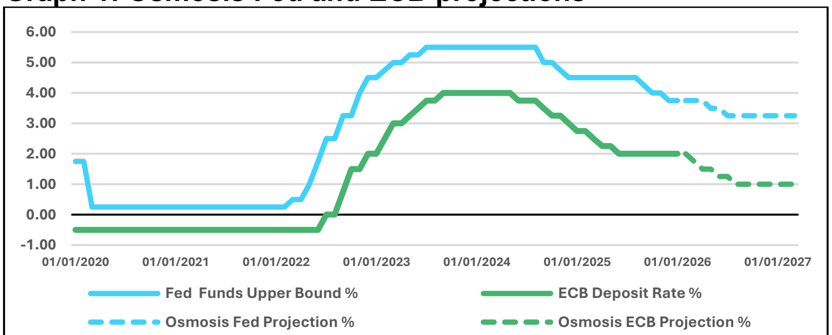
Macro: transatlantic divergence

The transatlantic economy is at a crossroads, with the US and Europe facing distinct challenges that will shape the policies of the Federal Reserve (Fed) and the European Central Bank (ECB) this year. In the US, robust growth numbers are masking underlying issues. The economy is increasingly driven by procyclical investments in the tech sector and consumption by higher-income households, while lower-income households struggle with affordability. This K-shape economy is becoming more pronounced, as seen in the stark divergence of consumer confidence numbers and hard realised economic data pointing towards different outcomes. At the same time, the labour market is in a state of stability, with neither significant hiring nor firing at the aggregate level, while at the sectoral level big differences are noticeable. The manufacturing and transportation sectors continue to shed jobs while health care and tech companies continue to generate new jobs.

This cycle is atypical due to the return of structural inflation pressures. The AI boom has increased energy demand, and global trade frictions are adding to inflationary pressures which we think are underpriced. We think the Fed is coming to terms with this - hence they paused their easing cycle in January until the data proves otherwise. Complicating matters are the politization of the Fed and the announcement of Kevin Warsh as the chairman replacing Jerome Powell in mid-May. The markets and pundits seem to have embraced Warsh as a hawk when it comes to inflation and the Fed's mandate (especially on the Fed's balance sheet) but we take a more nuanced view. Yes, Warsh would like to be more hawkish when it comes to setting interest rates and limiting how far the Fed can go deploying its balance sheet, but we feel that his hands are tied. The US is running large deficits, and its debt-to-GDP ratio keeps ballooning (now 121%). Without the help of the Fed compressing interest rates to keep debt affordable over the long term it's starting to look unsustainable. Still, we expect under Powell's leadership, that the Fed will continue to hold until May/June.

Graph 1: Osmosis Fed and ECB projections



Source: Bloomberg, Osmosis Investment Management NL, February 3, 2026

In Europe, the story is one of continued struggle but cyclically some recovery is expected due to increased defence spending (which

Quick Read

Growth in the US looks robust but is increasingly driven by pro-cyclical investments in tech and uneven consumer spending by high-income households.

Europe continues to struggle driven by a mix of high energy prices and bureaucracy but will likely see some uptick due to increased defence spending.

Europe might see some deregulation coming this year which may help boost growth.

Fed to be on hold until summer as growth remains robust and inflationary risks continue to pose upside risks.

ECB likely to lower rates further as growth remains below potential and inflation impacted to the downside by continued cheap imports from China.

ECB likely to respond to the strength of the EUR by lowering rates (hurdle to cut rates is lower).

Long-end government yields and precious metals continue to rise due to high debt levels and debasement concerns.

increasingly is being spent in Europe). Still, bureaucracy, a lack of industrial policy, and high energy prices are prolonging the de-industrialisation trend.

Fiscal spending by Germany will provide some relief, but growth is expected to remain just below potential for the Euro-zone. Weak growth in Germany and France is for the bigger part offset by strong growth in Spain, Portugal, and the Netherlands. There is a push within Europe to reduce bureaucracy and to become more self-reliant in terms of defence, technology and energy but we think that still needs to translate into more material plans - particularly for the latter two. That may mean more fiscal spending down the line, either via Europe or via the individual member states, but that still needs to materialise - which is perhaps more a story for the second half of 2026.

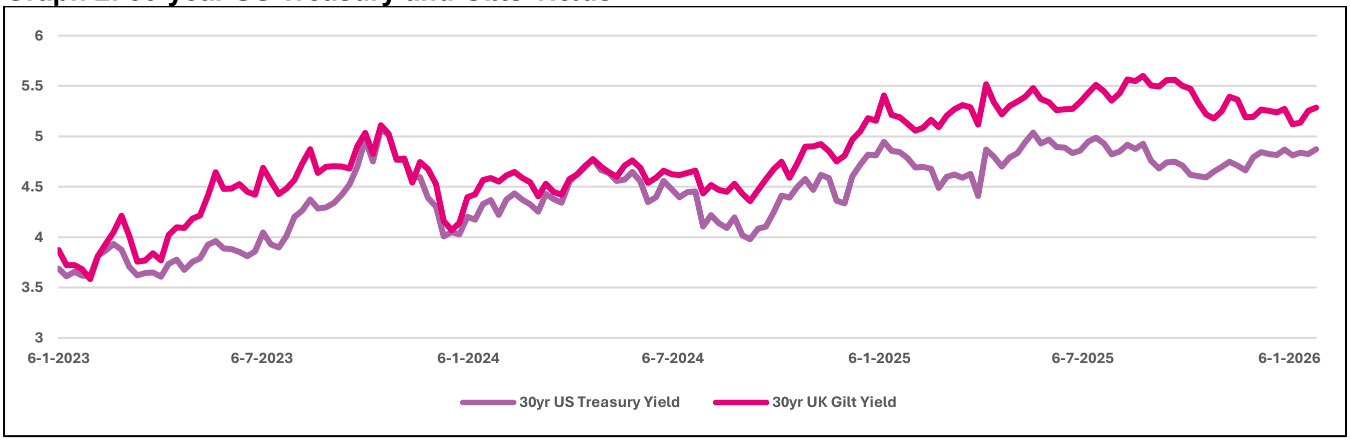
Inflation in Europe is being pushed down by China's export push and a strong euro, which is becoming a headache for European policymakers. As a result, the ECB is likely to gradually lower interest rates to stimulate growth but equally to combat the Euro which is growing too strong versus its trading partners. That means implicitly some financial warfare to come in the FX-markets.

Looking ahead, the Fed and ECB face distinct but equally complex challenges. The Fed must balance strong growth with inflation concerns and a stagnant labor market. The ECB, meanwhile, must address structural issues and weak growth in Europe. Both institutions will need to carefully calibrate their policies to manage these nuanced economic conditions.

First crisis, then debasement

We think government debt levels in developed markets and China are reaching unsustainable heights. The U.S. debt-to-GDP ratio is approaching 121%, while Japan's exceeds 260%. Europe is not far behind, with France and Italy facing debt levels above 110% of GDP while the UK is reaching 100%. China, too, is grappling with a rapid build-up of debt, as local governments and state-owned enterprises borrow heavily to prop up growth. The common denominator is that next to high debt-to-GDP ratios the budget deficits are also large (typically around 4 to 6%) with Italy perhaps being the positive outlier (-3.5%). The recent volatility in Japanese Government Bonds and U.S. Treasuries underscores the market's growing unease. Long-end rates, particularly the 30-year segment, are highly sensitive to fiscal sustainability concerns and indeed we observe growing volatility there. The steepening of yield curves reflects this anxiety, as investors demand higher term premia to hold long-duration debt (see Graph 2). This is even more precarious for the US and the UK given that both are also running large current account deficits next to their budget deficits making them even more vulnerable. That may partially explain the sensitivity of the Trump Administration to adverse market shocks by quickly de-escalating some of their policies. Perhaps it's good to remind ourselves that in this cycle the imbalances are on the sovereign balance sheet and not really on the corporate balance (with the exception of the private debt and equity markets!).

Graph 2: 30-year US Treasury and Gilts Yields



Source: Bloomberg, Osmosis Investment Management NL, February 3, 2026

The popular debasement trade, where central banks resort to aggressive monetary easing, yield curve control, and quantitative easing to stabilize markets, has not yet materialized. While money supply growth in the past year has picked up in some regions, it remains below inflation in many advanced economies, suggesting that we are not yet in an exuberant monetary environment (not even by a long shot). For true debasement to occur, we likely need a fiscal crisis first, a moment when markets force monetary policymakers to intervene decisively, as we saw with the UK LDI crisis and the many Eurozone crises post the Great Financial Crisis (GFC). Until then, gold and silver will continue to attract safe-haven flows as geopolitical risks remain high, undermining the Dollar’s reserve currency status. The real debasement trade will only begin once central banks are compelled to restart QE and suppress yields artificially - enabling fiscal dominance in full effect.

The path to debasement is fraught with risks. If fiscal dominance, where monetary policy becomes subordinate to fiscal needs, takes hold, central banks may have no choice but to monetize debt on a massive scale. This would likely lead to higher inflation, currency devaluations, and a further erosion of trust in fiat currencies down the line. For now, however, the market is in a holding pattern, waiting for the catalyst that will push policymakers into action.

Liquidity and Money Supply

Global liquidity conditions remain a critical driver of asset prices. After the historic surge in money supply during 2020–21, the subsequent contraction in 2022–23 weighed heavily on risk assets. This year, however, U.S. money supply growth has returned to a modest 3–4% year-over-year, supporting a recovery in asset prices. Yet, this growth is uneven and, in many cases, lags behind inflation, indicating that liquidity is not as abundant as some might think.

In China, money supply growth has been more robust, but it is increasingly directed toward supporting struggling sectors rather than fostering broad-based economic activity. The People’s Bank of China (PBOC) has maintained an accommodative stance, but the transmission of liquidity into the real economy remains weak. The result is a credit-driven growth model that is becoming less efficient over time.

The liquidity landscape is at an inflection point. Central banks are shifting from tightening to easing, but the pace and magnitude of this shift will be constrained by inflation and fiscal concerns. If liquidity conditions tighten unexpectedly, due to a fiscal crisis, geopolitical shock, or inflation resurgence, asset markets could face another correction. Conversely, if central banks err on the side of excessive easing, we could see a renewed surge in money supply, fueling another leg higher in risk assets. For now, the balance is precarious, and the risks are skewed toward volatility yet underpriced in our view. Credit and equity markets seem way too sanguine while valuations are at multi-decade records.

The ever growing dispersion – a headache for the Fed

There's an old saying that a rising tide lifts all boats, but today's market environment feels more like some vessels are catching big waves while others are stuck in shallow waters. The dispersion between large and small caps, between high-quality and distressed credits, tells a story of diverging economic realities that investors can't afford to ignore.

Let's start with equities. The performance gap between the S&P 500 and Russell 2000 has become a chasm. While mega-cap tech stocks continue their AI-fueled ascent, small caps are struggling with tighter credit conditions and weaker consumer demand. More than 40% of Russell 2000 companies remain unprofitable, compared to just 10-15% of S&P 500 firms with the differential slowly rising over time. This isn't just about size, it's about structural advantages. Large caps benefit from global diversification, pricing power, and access to capital markets that small businesses simply don't have.

The sentiment data paints a similar picture. NFIB's Small Business Optimism Index shows main street is worried about labour shortages, interest rates and input costs, while large-cap CEOs remain focused on strategic growth and M&A opportunities. This divergence in confidence reflects the K-shaped recovery we're experiencing, some businesses are thriving in the new economic reality while others are fighting for survival. The small-cap companies are far more important from a labour market perspective than the large cap companies. Still, it underscores the difficulty the Fed faces in setting monetary policy simultaneously to meet its inflation and employment objectives. You can argue that with inflation above target, very easy financial conditions for large cap companies and exuberant financial markets, monetary policy may simply be too loose while remaining extremely tight for small cap companies and median and lower income households as discussed above.

Credit markets tell the same story but with different characters. The spread between BB-rated and CCC-rated corporate bonds has widened significantly. CCC credits currently trade at spreads of +635 basis points, while BB credits are near +170 bps. This isn't arbitrary pricing, it reflects real differences in fundamental credit quality and default risks. CCC-rated companies face higher leverage, weaker cash flows, and more immediate refinancing risks in this higher-rate environment.

Monetary policy is exacerbating these divisions. For large corporations, the Fed's rate cuts represent cheaper borrowing costs and easier access to capital. For small businesses reliant on bank lending, the story is different. Banks have tightened lending standards significantly, making credit harder to come by for Main Street. This creates what we might call "size-dependent monetary policy", which is accommodative for the market giants but restrictive for smaller enterprises.

Where does this leave us in the economic cycle? The late-cycle dynamics are playing out differently across market segments. Large caps and high-quality credits may continue to benefit from their structural advantages and access to cheap capital. But the stress in small caps and distressed credits suggests the economic weakness is real and concentrated in certain sectors including the private credit and debt markets. It’s not easy to make policy now at the Fed!

Conclusion

The global economy in 2026 is defined by **divergence** and uncertainty. The transatlantic divide is stark: the US maintains robust, albeit uneven, growth, fueled by technology and high-income spending, while Europe struggles with structural weaknesses, de-industrialization, and sluggish expansion. Both the Fed and the ECB are walking a tightrope, juggling growth, inflation, and labour market stability, all while contending with distinct regional challenges and political pressures.

Meanwhile, soaring government **debt** in developed markets and China is sounding alarms over fiscal sustainability and the risk of currency devaluation. As markets anticipate bold central bank action, gold and silver remain in demand as safe-haven assets, bolstered by geopolitical tensions and waning confidence in fiat currencies leading to the **debasement** investment thesis.

In this environment, caution is key. A defensive investment stance, prioritizing liquid, high-quality assets like covered bonds and closely tracking liquidity indicators, is prudent. With credit spreads at historic lows, there’s little margin for error from a carry perspective, and history shows that both credit and equities tend to underperform once central banks are deep into rate-cutting cycles. While opportunities may emerge in the coming quarters, they will likely be accompanied by volatility and late-cycle distortions. Timing market shifts is notoriously difficult, and momentum can outlast fundamentals, but the warning signs are clear. In uncertain times, the best strategy is a strong defense.

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