

The September Outlook

Market Stance

CURRENT MARKET THEMES

The rally in risk assets which emerged in April has stalled more recently

Commentary

- A key feature of the global financial environment is a challenged economic and political outlook, which is not matched by particularly attractive equity and credit valuations
- A 'soft landing' environment has supported markets recently, but we expect a shift to a more 'stagflationary' environment in the coming months
- The economic case for significant interest rate cuts is more constrained in the US than markets are currently pricing

Upshot

- Saranac multi-asset portfolios have a higher than usual allocation to alternatives and short-to medium dated fixed income assets, and we would add to equity risk on more suitable entry points

ARTIFICIAL INTELLIGENCE, ECONOMIES AND MARKETS

The consequences of the latest AI technology have been an important driver of equity returns in the past year

Commentary

- It is too early to have clear view of the economic and market implications over time
- There is little evidence as yet of an acceleration in economy-wide productivity growth, but some of robust capital spending (e.g. on data centres)
- Potential winners from the theme are already more highly rated in equity markets, but this does not yet seem like a genuine 'bubble'

Upshot

- We continue to maintain exposure to the AI theme in equity portfolios

FISCAL CHALLENGES

Long-term bond yields have risen faster than shorter maturity yields in recent months as concerns over the sustainability of fiscal pressures in many countries continue to mount

Commentary

- This theme is likely to remain relevant over a multi-year period
- It reflects demographic pressures on spending, political constraints on tax increases, weak growth and a higher level of debt service costs
- At some stage, market pressures could force currently-unpalatable policy changes on governments

Upshot

- Value in government bond markets remains at short and intermediate maturities

GOLD

The gold price has reached new highs, and has risen by 35% this year alone

Commentary

- This rise largely reflects the highly stressed global political and economic environment: gold has remained a very effective hedge
- These stresses are likely to persist.
- Central bank buying remains firm, and there is still significant scope for higher private sector allocations

Upshot

- These are not our central cases, but identifying risk before the event facilitates adjustment in portfolios should circumstance change

 The Long Read

Debt sustainability in 2025: Elevated deficits meet fiscal expansion

SNAPSHOT

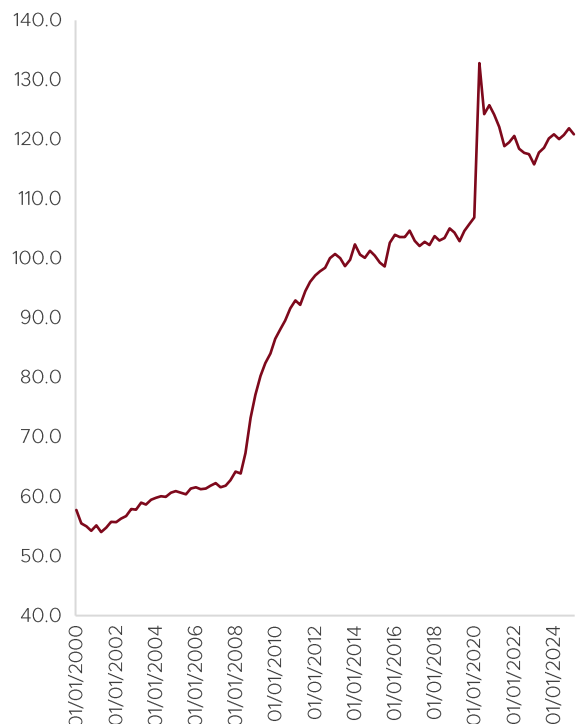
After more than a decade of unconventional monetary policy, fiscal expansion during the pandemic, and the inflationary aftershocks of the energy crisis, governments' ability to manage their rising debt burdens has become front of mind for many investors. Across the advanced world, governments have borrowed heavily to sustain growth and fund political agendas, while emerging markets have had to navigate a volatile dollar cycle and higher servicing costs.

This article explores the sustainability question through several lenses: the United States, whose fiscal trajectory is once again raising alarm among investors and rating agencies; the United Kingdom, where the Gilt market remains sensitive to credibility and structural demand shifts; Europe, where Germany and others are embarking on unprecedented defence and industrial spending; and emerging markets, which enjoy a return of investor appetite.

1. The United States: Deficits, Trump's Policies, and Rising Servicing Costs

The United States occupies a unique position in global markets. As the issuer of the world's most important reserve currency and the deepest sovereign bond market, it enjoys extraordinary latitude in financing deficits. Yet this privilege is not without limits, and recent trends highlight growing fiscal fragility.

Federal debt held by the public alone now stands at roughly \$29 trillion, while monthly budget shortfalls remain substantial; July 2025 alone produced a \$289 billion deficit, an increase of 19% on the previous year.

CHART 1**US Debt-to-GDP (%)**

Source: Bloomberg/Saranac

The Long Read

Overall debt has now surpassed \$37 trillion, and Moody's warns that the ratio of debt to GDP will climb to as much as 135% by 2035. Other longer-term models suggest the figure could reach an eye-watering 170% by 2055 if policies remain unchanged.

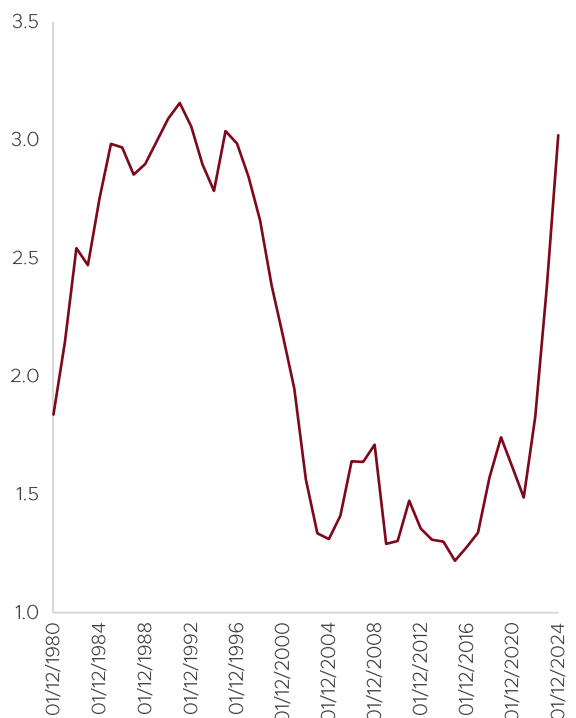
The trajectory is being shaped by the policy choices of President Trump in his second term. On the revenue side, the administration's decision to make the 2017 tax cuts permanent is a central driver. The Congressional Budget Office has estimated that extending these provisions adds trillions to projected deficits over the next decade. While tariffs on imports – especially those targeting China and Mexico – are expected to generate additional revenue, perhaps \$4 trillion over ten years, these gains are highly unlikely to offset the larger revenue loss from tax policy. Moreover, the potentially inflationary effects of tariffs raise costs for consumers and could complicate the Federal Reserve's monetary policy, in turn keeping interest costs for the Treasury higher for longer.

On the spending side, Trump has signalled continued prioritisation of defence and security, while showing little appetite for reforms to social security or medical insurance. With an ageing population, entitlement costs will therefore rise unchecked, accounting for the bulk of structural spending growth. The combination of tax reductions, tariff-related distortions, and higher outlays suggests deficits will remain entrenched above 6% of GDP through the late 2020s.

More alarming however is the cost of servicing this debt. Interest outlays totalled \$875 billion in 2023 and are projected to reach \$1.8 trillion by 2035 – more than 4% of GDP and larger than many discretionary categories. In scenarios where borrowing needs to rise further, for example an external macroeconomic shock, interest could easily exceed \$2 trillion annually, consuming resources that would otherwise go to public consumption and investment.

CHART 2

US Treasury Annual Interest Payments % GDP



Source: Bloomberg/Saranac

Although Fitch has maintained the U.S. rating at AA+, it did so while stressing that high deficits and the absence of a medium-term consolidation plan were key constraints. For now, investors still treat Treasuries as the ultimate safe asset, but confidence could erode if debt continues to climb at a pace unmatched in peacetime history.

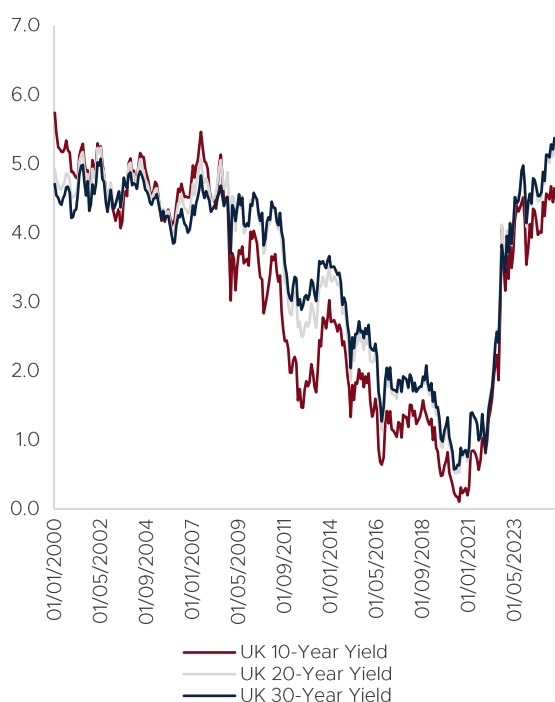
2. The United Kingdom: Rising Gilt Yields and Structural Pressures

Across the Atlantic, the United Kingdom faces its own fiscal challenges. Public sector net debt has climbed to almost 96% of GDP, the highest since the 1960s, and the Gilt market has been volatile. Ten-year Gilt yields have traded between 4.5-5%, with thirty-year yields rising above 5.6% - levels unseen in almost three decades.

The Long Read

CHART 3

UK Gilt Yields



Source: Bloomberg/Saranac

A deeper structural issue lies in the demand side of the Gilt market. Pension funds, which once absorbed nearly 30% of Gilt issuance, are gradually reducing their exposure as schemes mature. The Office for Budget Responsibility projects this share will fall to just 11% by 2075, a trend that could add £22 billion annually to debt-servicing costs. At the same time, the Bank of England is unwinding its quantitative-easing portfolio, removing another major source of demand. The U.K. will therefore depend more heavily on foreign investors, who may require higher yields to hold sterling debt.

Chancellor Rachel Reeves faces the unenviable task of closing a £20–£40 billion fiscal hole ahead of the autumn budget. Options include tax increases, spending cuts, or more borrowing – none of which are politically palatable.

Rising Gilt yields already threaten to crowd out government spending priorities, and any missteps risk repeating the destabilising events of 2022, when investor confidence briefly collapsed and forced a reversal of fiscal plans. Some commentators have even drawn parallels with the 1976 IMF bailout, warning that Britain's reliance on foreign capital, coupled with persistent twin deficits, could make it vulnerable to a confidence crisis. Such comparisons may well be misguided however, as the UK government maintains the option of increasing taxes in order to make up the revenue shortfall, however politically unpopular that may be.

While sterling bonds have underperformed other major bond markets this year, yields have not risen nearly as sharply as during the 2022 mini-budget crisis, suggesting that investors are prepared to give her the benefit of the doubt – at least for now. One must also remember that rising government bond yields have been a global phenomenon, rather than specific to the UK bond market. However with debt levels near record highs, structural demand waning, and political constraints tightening, the sustainability of Britain's fiscal path remains somewhat uncertain.

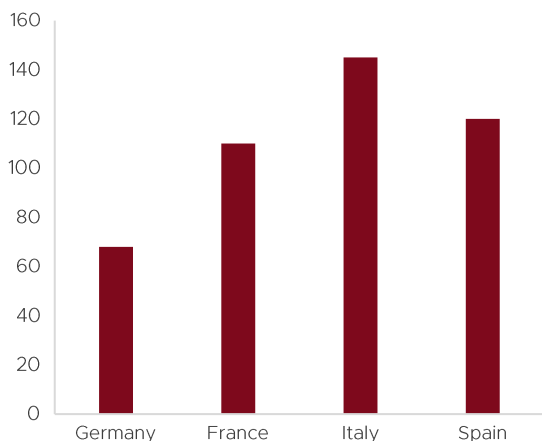
3. Europe's Fiscal Expansion: Germany and Beyond

The European story of debt sustainability has taken a new turn. For decades, Germany was the anchor of fiscal conservatism within the euro area, adhering to balanced budget rules and resisting debt mutualisation. Russia's invasion of Ukraine and the need to rearm, however, have triggered a historic shift. Germany has committed to spend more than 2% of GDP on defence, with tens of billions directed toward new equipment, personnel, and infrastructure. This comes on top of significant outlays for the energy transition and industrial policies, designed to reduce dependence on Russian fossil fuels and compete in green technologies.

 The Long Read

CHART 4

Debt-to-GDP (%)



Source: Bloomberg/Saranac

Markets have responded cautiously. European bond spreads over German Bunds remain very well contained for now, reflecting ECB support and a perception of shared fiscal responsibility within the euro area. Yet the overall level of yields has increased markedly. Long-term Bund yields hover above 3%, compared with near-zero levels just a few years ago. Investors are increasingly pricing a higher term premium into European sovereign debt, reflecting both larger issuance needs and uncertainty about the long-term trajectory of the European project.

4. Emerging Markets: Between Debt Stress and Investor Appetite

If advanced economies wrestle with fiscal credibility, emerging markets face an altogether different but equally precarious challenge. Debt burdens, particularly in hard currency, have grown significantly in the wake of the pandemic, and servicing costs surged when global interest rates rose. In 2024, emerging economies spent a record \$400 billion servicing external sovereign debt, diverting funds from essential development spending.

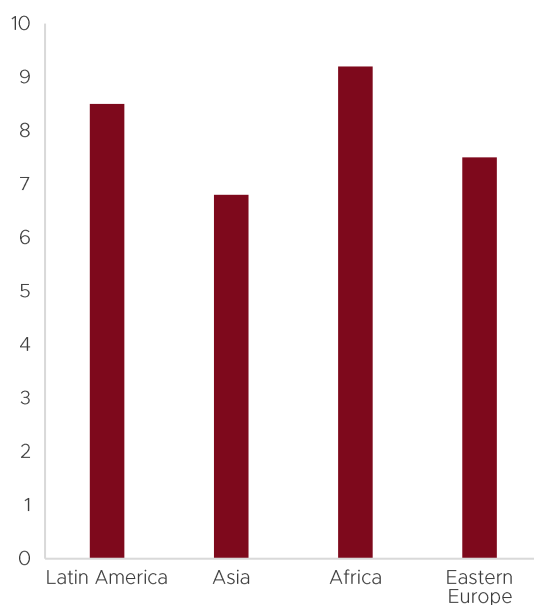
Between 2020 and 2023, no fewer than 15 sovereign defaults occurred, underscoring the fragility of the system.

Yet paradoxically, emerging market debt has attracted fresh investor attention in this year. Concerns about fiscal dominance in the U.S. and doubts about the long-term trajectory of the dollar have spurred capital rotation toward higher-yielding emerging-market assets. Issuance has surged, with emerging market bond issuance up 20% year on year in the first half of 2025, driven in large part by corporates.

A weaker dollar has also alleviated pressure on local-currency bonds, with many emerging market currencies appreciating against the greenback. Credit quality has improved modestly, with fewer issuers rated at distressed levels, and spreads have tightened. Sovereign bonds in emerging markets currently yield an average of 7.8%, offering a significant premium over developed-market alternatives.

CHART 5

EM Bond Yields (%)



Source: Bloomberg/Saranac

The Long Read

Nevertheless, substantial risks remain. Political instability, commodity price volatility, and the ever-present threat of sudden capital outflows remain. Trade wars and geopolitical tensions could quickly undermine this delicate equilibrium. While some forecast double-digit returns in EM debt and currencies in 2025, these projections depend on benign global conditions and continued investor appetite for risk. The IMF has warned of a “perfect storm” facing emerging markets if growth slows, commodity prices weaken, or global financial conditions tighten once again.

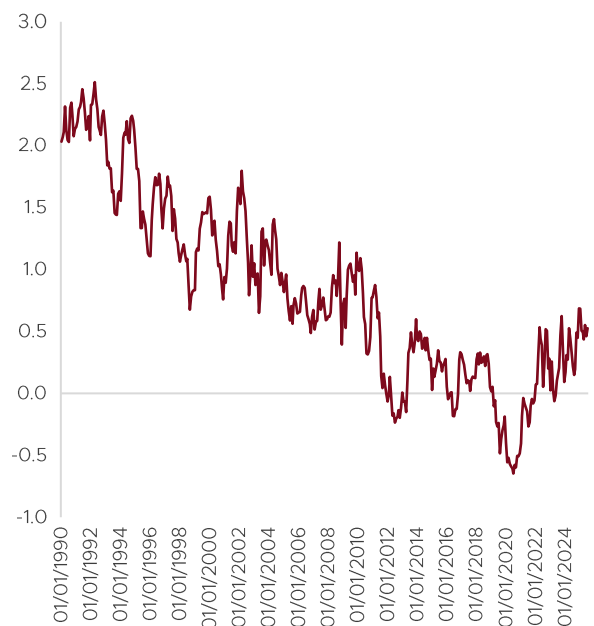
5. Market Reaction: Yield Curves and Investor Sentiment

Inevitably global bond markets have been forced to adjust to a new era of fiscal loosening and rising debt ratios. One of the clearest signals is the steepening of yield curves across regions. In the United States, the deeply inverted curve of 2023 and 2024 is beginning to normalise as long-term yields climb in response to heavy issuance and persistent deficits. Investors are now demanding a higher term premium – the extra yield required to hold long-dated bonds relative to rolling over short-term debt. For much of the post-2008 era, the U.S. term premium was near zero or even negative, reflecting abundant central bank demand and subdued inflation. Today, with the Treasury flooding markets with new supply, the term premium has risen back into positive territory, adding materially to long-bond yields. This shift means that even if policy rates fall, borrowing costs for governments may remain elevated.

In the United Kingdom, a similar pattern is visible. The Gilt curve has steepened, particularly at the long end, as supply expands and pension demand wanes. Term premiums on long-dated Gilts have widened sharply, reflecting investors’ reluctance to tie up capital in sterling debt without a clearer path to fiscal consolidation. Europe is experiencing its own version of this dynamic.

CHART 6

US Term Premium Estimate



Source: Bloomberg/Saranac

Bond yields, once anchored by ECB purchases and the perception of fiscal rectitude, have seen their term premium rise as markets digest Germany’s defence expansion and broader EU investment programs. Emerging markets, meanwhile, present a mixed picture. In local debt markets, term premiums are easing as central banks cut rates and currencies stabilise, but for hard-currency sovereign bonds, spreads over U.S. Treasuries remain sensitive to global shifts in risk appetite. The overarching theme, however, is consistent: higher fiscal burdens translate into higher term premiums.

Conclusion

The question of debt sustainability has no simple answers. For the United States, the challenge lies in reconciling tax cuts, tariff policies, and rising entitlement costs with an already unsustainable trajectory.

 The Long Read

Without credible reform, debt and interest outlays will continue to spiral, eroding fiscal flexibility and global confidence. The United Kingdom faces a narrower but acute set of risks. Debt remains high, Gilt yields elevated, and structural demand from pension funds in decline. While the government has temporarily reassured markets, the fiscal challenges remain daunting. In contrast, Europe's fiscal expansion marks a new era. Germany's embrace of defence spending and industrial policy represents a historic break from fiscal restraint. While necessary for security and competitiveness, this shift raises debt ratios and pushes yields higher. Emerging markets, meanwhile, straddle risk and opportunity. Investors are enticed by high yields, but vulnerabilities remain acute. A global shock could quickly reverse recent optimism.

What unites all these cases is the fragility of fiscal positions in an era of higher rates. After years of near-free borrowing, markets are once again disciplining governments through steeper curves and rising risk premiums. Sustainability now requires credible frameworks, political will, and the recognition that debt cannot expand indefinitely.

Within Saranac multi asset portfolios we have taken a cautious approach to longer-dated bonds for some time. Over the past two years or so, the relatively high carry available on even short-dated, high quality corporate bonds made investment into riskier, longer-dated debt far less appealing, particularly in light of flatter yield curves at the time. With intermediate and longer-dated bond yields rising meaningfully over the past year or so, we have recently started to reallocate some capital into bonds with maturities of between 5-7 years; after all investors are finally receiving adequate compensation for the increased risk via higher term premia. Importantly, we continue to avoid investing in bonds with long maturities, partly because of the risk of fiscal accidents, and partly because of the uncertainty with regard to Trump's proposed policies, some of which may well push term premia higher still.

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