NAB Economic Update 23 June 2025

Long-term signal vs. Short-term noise

NAB Economics

Key points

- In this note, we take the opportunity to focus on some longer-term thematics we believe to be important for investors, business owners and consumers. Headlines can be all absorbing, but they often take attention away from significant bigger picture changes.
- Specifically, we focus on the notion of regime change. This is not a novel concept but broadly refers to the idea that regimes occur in 30-40 year political and economic cycles. We believe we are currently in the early years of a new regime. This regime will look and feel very different to the prior regime that began in the late 1970s / early 1980s and lasted until circa 2015.
- The new regime will bring with it some significant long-term changes for the global economy and consequently, for financial markets too. Lower long-term US GDP growth, a more volatile macro-economic environment and structurally higher inflation are all likely to be characteristics of the new regime.
- For financial markets, we think this translates into some key longer-term themes, including a structurally higher and steeper yield curve (think pre-GFC trading ranges), a structurally weaker US dollar and a relatively lower return profile for US vs. non-US equity markets.
- For investors, the new regime will demand a different approach to portfolio construction. Some key correlations appear to be shifting, implying that unhedged exposures to US equities are no long a key source of diversification in portfolios. Our colleagues at NAB Private Wealth & JBWere note that relative to the prior regime, a new “regime friendly” portfolio might include more inflation protection, more exposure to commodities and energy (and AUD), less exposure to USD assets, more emerging market exposure; and fewer growth assets.

Thinking longer-term

It can be easy to become distracted by the constant shifts in US trade policy and unexpected geo-political escalations. While these dynamics are important for both anchoring near term forecasts and thinking more broadly about the distribution of risks to those forecasts, they also distract from thinking about some of the longer-term implications of shifts in policy for financial markets and economies. For investors, borrowers and others exposed to financial market volatility, understanding these longer-term trends is critical to gaining a better sense of potential shifts in valuation anchors across rates, FX and other financial variables.

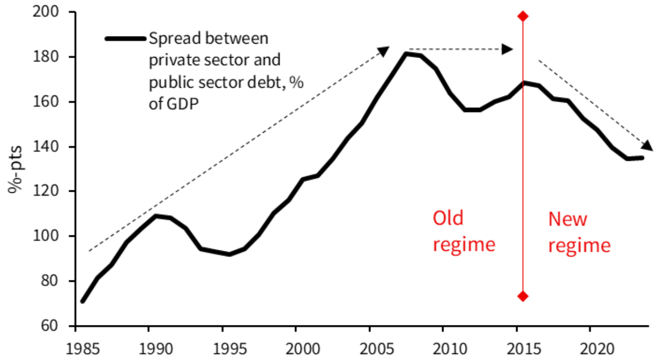
In this note, we take a longer term perspective, first considering the idea of regime change and its utility as a framework for understanding recent developments. We then highlight five longer-term outcomes we think are important and consider the implication of these for financial markets and portfolio construction.

Regime change

The concept of regime change is useful for thinking about longer-term shifts in trends. This framework demands acknowledgment that we have now entered a new, multi-decade economic and political cycle.

The prior regime was characterised by a commitment to free market policies, and free movement of capital, labour and goods across borders. It was the era of globalisation and the multi-national. In financial markets, it was reflected by a multi-decade secular decline in interest rates, mostly low and stable inflation, and consequently, a significant valuation boost to real assets (equities, property and infrastructure). It was also an era in which leverage on private sector balance sheets out-paced leverage on public sector balance sheets (see Chart).

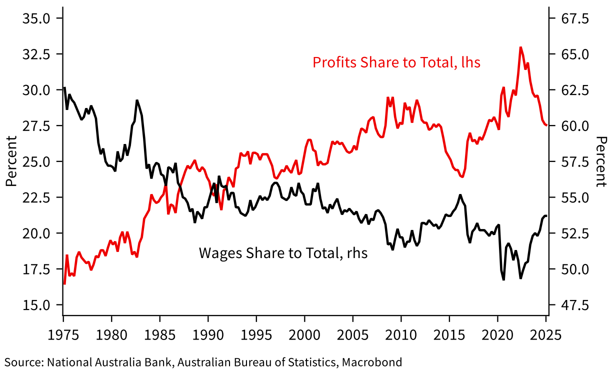
Private vs. Public sector leverage, Australia



Source: IMF and NAB.

Other features of the old regime were the peace dividend (in a benign world, governments can redirect some portion of defence spending to other priorities), the dominance of liberal democracy in Western economies and US hegemony. It was also a world in which the gains to capital out-paced gains to labour as surplus was distributed across the inputs to production (Chart). We posit that it was this dynamic – inequity in the distribution of the gains of globalisation – which sowed the seeds of regime change.

Share of income, labour vs. capital (Australia)

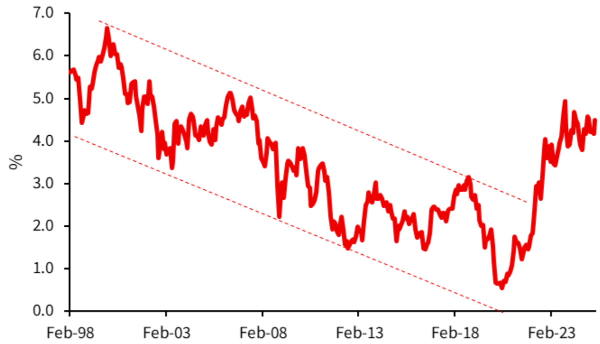


In the current regime, which likely began almost a decade ago with Brexit and the first Trump Presidency, the world looks and feels quite different. Many countries are now looking inward, placing national and economic security at the top of their agendas. In the new regime, "old" policies and tools are new (or reimagined) again – think industrial policy (Future Made in Australia, CHIPS Act etc.) and economic statecraft (tariffs, export controls and sanctions). Supply chain security for critical inputs is paramount.

Economically, the new regime will see a less efficient organisation of global production and trade. All else equal, this will come at a cost in the form of lower growth, and most likely, structurally higher inflation. While these forces will work in opposing directions in terms of their influence on long-run nominal yields, we believe there are on net other forces pushing equilibrium real rates higher. Indeed, the longer-term influences on the neutral rate of interest is a topic that deserves its own research note.

Against this backdrop, we should expect a higher term structure of interest rates relative to the post GFC trading range (as per the repricing in the Chart below) to sustain. This dynamic also aligns with our view of structurally steeper yield curves going forward.

UST 10Y yield



Source: Bloomberg and NAB.

Regime changes are not just reflected in economic shifts, but political shifts too. Indeed, the genesis of regime changes often takes place in politics first, and economics later (think Brexit and the election of Trump 1.0). This is why regimes, as we have described them, tend to be multi-decade events. They are not driven by politics, but rather, political outcomes are the manifestation of slow-moving trends that are the fundamental driver of regime change.

The big picture

The notion of regime change helps us to put in a bigger context some of the changes taking place in the US (and the world) at present across trade, industrial policy and international relations. It should also reinforce the idea that while the temptation might be to think about these changes as only lasting for as long as Trump's term as President, the broad direction of travel on many of these changes is unlikely to change once Trump's term ends.

So, thinking about the long-term implications of some of these changes is important. While the following list isn't by any means exhaustive, we think it nonetheless highlights some of the more important trends.

First, tariffs are likely to lower US economic growth (and corporate earnings) in the long run, all else equal. There are a few drivers of this conclusion: first, tariffs will raise the cost of investment, which will lower firms' demand for investment goods. This lowers the growth potential of the US economy. Second, tariffs also encourage rent seeking behaviour, which forces firms to divert resources away from profit maximization and towards lobbying government. Finally, there is evidence that the most productive and innovative firms in the US are those that are globally connected. Making such interconnection more difficult is likely to come at a cost to the US economy, all else equal.

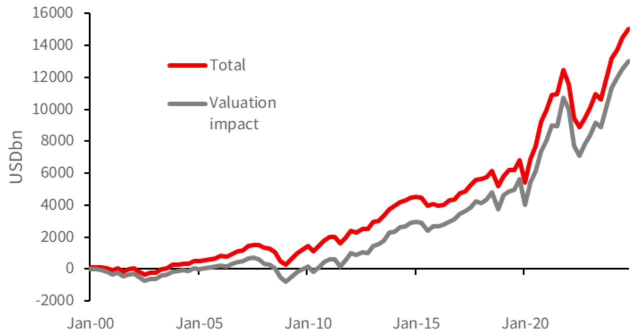
Second, inventories will be higher and inventory management more challenging, lifting macro-economic volatility. The desire to secure supply of key commodities, critical inputs into production and consumption goods will mean governments, businesses and households will run higher levels of inventories, all else equal. In a world of less efficient and possibly disrupted supply chains, the desire to hold inventories will be higher and means that "just in time" inventory management is no longer sufficient.

Running higher inventory levels imposes costs, because in most cases, it needs to be financed or comes at the cost of forgone consumption elsewhere. For businesses, this cost is either passed on to final consumers, or absorbed in margins. For governments, it presents as yet another demand on the public purse. And for households, the opportunity cost of higher inventory carrying costs is foregone consumption.

Regardless, "just in case" inventory management can pose challenges to business profitability and government budgets (too much / too little of the right /wrong good and the right / wrong time). And so it is quite possible that challenges around supply chain disruption and inventory management emerge as a source of macro-economic volatility in both nominal and real variables. While the pandemic experience was quite acute, it nonetheless provides an analogy for thinking about this kind of disruption.

Third, a desire to hold fewer US assets. One of the recent narratives in markets of late has been the "Sell America" theme. We think this is somewhat overstated, given that a relative valuation adjustment (in favour of non-US markets) would go a long way to resolving the extent of (assumed) portfolio overweights in US financial assets. Indeed, if we look at the flow of foreign investment dollars into US equities over the last quarter of a century, we find that most of the increase is in fact due to a revaluation factor, rather than new net buying (see Chart).

Foreign holdings of US equities



Source: Federal Reserve and NAB.

But to the extent that capital inflows have been required to fund the savings/investment imbalance in the US (twin deficits), it is quite possible that **a rethink of optimal allocations to USD assets by ex-US investors will require a relative cheapening of both the USD and US financial assets**. As our colleagues in FX Strategy noted, a shift in hedging behaviour by offshore investors may be enough to generate sustained depreciation in the USD (see here). A de-rating of US equity markets and a repricing of US sovereign bonds may take care of the rest.

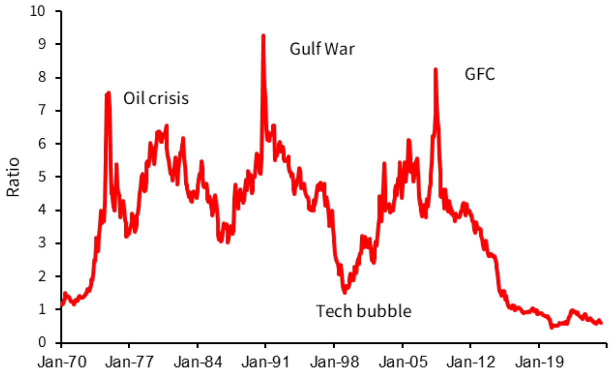
We should also note the impact of the shift in US security priorities on the demand for US dollar assets. In the prior regime, many countries were happy to run large reserve allocations to US assets (in the main, US sovereign debt). In the current regime, this may not be such an easily justifiable decision, because the US security umbrella is no longer providing as much shelter as it once was. Consequently, countries may deploy reserve assets elsewhere or into other financial assets (eg, gold).

Fourth, and perhaps importantly for Australia, we think that these changes will be supportive for commodity demand and by extension, commodity currencies. While the commodity demand story could be couched as a consequence of broader themes such re-industrialization, re-militarization and reconstruction, there is more to this story.

In a world of more uncertainty – particularly as it pertains to supply chains, national interest, security alliances and energy supply – countries with a natural endowment of commodities (both soft and hard) are likely to be sought after. Shifting global alliances amid renewed national interest priorities are likely to mean less reliance on the US as a global hegemon (and hence less willingness to hold USD assets) and more appetite to look to other nations for mutually beneficial trading relationships.

A final point on commodities – they look relatively cheap as an asset class (see Chart).

Commodities relative to equities



Source: Bloomberg and NAB.

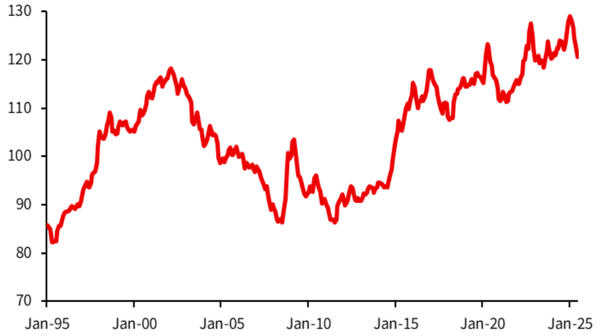
Financial Market Implications

For fixed income markets, we have already noted the prospect of a **structurally higher term structure of interest rates, and structurally steeper curves** too. We have written previously that this backdrop suggests scope for a structural shift down in the trading range for the AUS-US 10Y bond spread. While this move might in the near term be driven by a relatively less constrained RBA compared to the Fed, over the longer term we think it is likely to be driven by compression in the 10Y term premium spread between Australia and the US.

In credit markets, swap spreads are already very negative in the US. While the US fiscal outlook is in flux at present (with Trump's "One Big Beautiful Bill" yet to be legislated by Congress), markets are already in the process of rethinking the credit risk of the US government. Against this backdrop, **swap spreads are likely to stay negative, and it is possible that some high grade credit spreads trade negative too.**

In FX markets, and as noted above, we suspect the main dynamic of the regime change will be a weaker US dollar. This expectation is already embedded in our FX forecasts; we expect a ~12% depreciation in the USD dollar (basis DXY index) in the next 18 months. In trade weighted terms, the Chart below highlights the elevated valuation of the US dollar despite a 6.5% depreciation so far this year. Our near-term target for AUD is USD0.70 by year end, with further scope for appreciation likely in 2026.

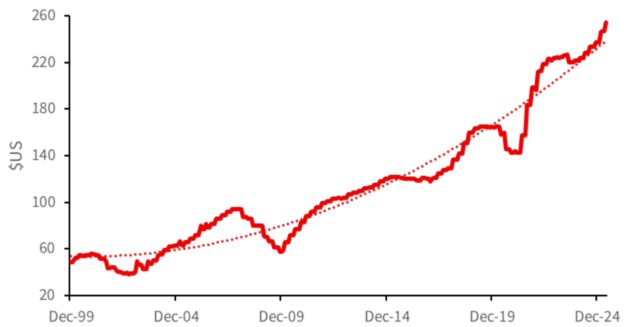
US nominal trade weighted dollar



Source: Bloomberg and NAB.

In equity markets, we think the main challenges are two-pronged; first, the trajectory of profit margins and earnings, and second, elevated valuations. In the prior regime, companies benefitted from cheaper labour (China's ascension to the WTO in 2001), free trade, lower company taxes and declining interest rates (Chart). It is not difficult to foresee a world where most of these are no longer a tailwind to earnings growth.

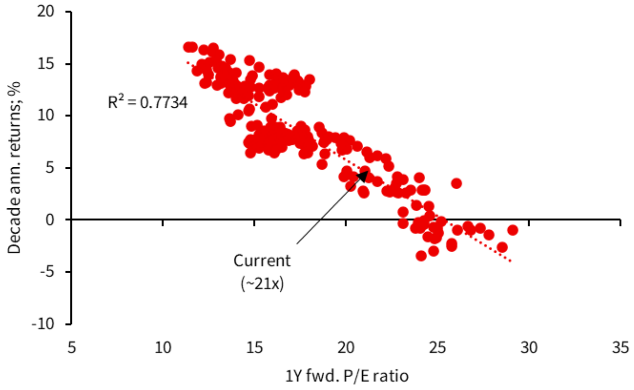
S&P500 Earnings per share



Source: Bloomberg and NAB.

While we have some sympathy for the notion that there has been a structural uplift in the valuation multiple applied to US equity markets, we have more sympathy for the view that long run returns are largely determined by current valuations. A valuation multiple at current levels is historically consistent with an annualized return over the next decade of ~4% (see Chart). Indeed, our colleagues in the CIO Office of NAB Private Wealth and JBWere revised down their expected returns for international (that is, largely US) equities last year from ~6% to ~5%.

Valuation vs. returns*



Source: Bloomberg and NAB. * For S&P500, data from Jan-96 to May-15. Chart plots current valuation against realised subsequent 10Y annualised return.

Portfolio construction

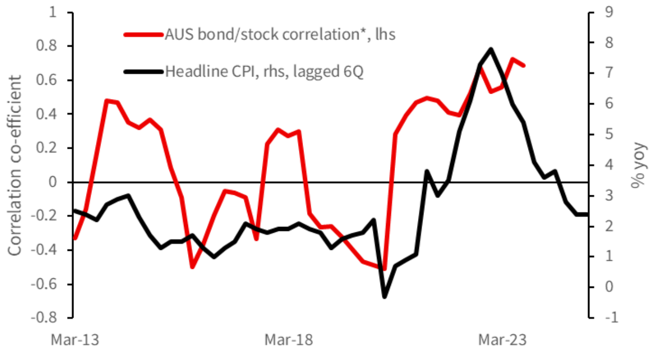
The potential for repeated shocks to supply chains – either as a consequence of higher frequency extreme weather events or disruptions to global production – means that investors will likely need to become accustomed to more regular inflationary episodes, short-lived or otherwise.

This has implications for portfolio construction, because supply-side inflation often forces a shift towards a more positive (or less negative) correlation between stock and bond returns. For multi-asset portfolios fundamentally premised on a negative correlation between bond and stock returns, this may prove problematic.

We should acknowledge that the low and stable inflation environment of the prior regime (particularly post-GFC) allowed central banks to focus on the labour market aspect of their dual mandates. When demand shocks threatened growth, central banks moved aggressively to protect the downside for fear of inflation falling further below target. Unsurprisingly, stock/bond correlations were quite negative through this period. Most would now happily argue we are no longer in this regime for both central banks and the correlation of asset returns.

While the chart below only reflects the past decade of history, there does nonetheless seem to be some (lagged) relationship between movements in bond/stock correlation and inflation in Australia (see Chart). It will be interesting to observe whether this persists in the new regime; historically, the chart suggests that the bond/stock correlation should become less positive now that disinflation has taken its course. But the nature of current shocks – geopolitical events, threats to central bank independence and meaningful shifts to trade policy and supply chain security – suggests that asset class correlations will continue to be pushed away from those which persisted in the old regime.

Trends in CPI and bond/stock correlation



Source: Bloomberg and NAB. * 8 quarter rolling correlation of quarterly equity market and sovereign bond returns.

Our colleagues in the Chief Investment Office at NAB Private Wealth and JBWere have also argued that portfolios should look quite different in the new regime from those that have realised robust returns in the prior regime, particularly portfolios that were heavily weighted to USD exposure in the past decade and a half. Relative to the prior regime, a new "regime friendly" portfolio might include:

- More inflation protection;
- More exposure to commodities and energy (and AUD);
- Less exposure to USD assets
- More emerging market exposure; and
- Less growth assets.

Conclusion

It is clear that there are some significant long-term shifts taking place in economies, politics and financial markets. It is easy to lose sight of these at a time when there is a lot of short-term noise. However, as we have observed, these developments have important implications for financial markets and relative asset price performance. Framing the analysis using the idea of regime change is helpful for providing a context for thinking about such changes. And for anyone with exposures to financial markets, whether they be an investor, borrower, hedger or otherwise, understanding the long-term signal is always more consequential for performance than listening to the short-term noise.

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