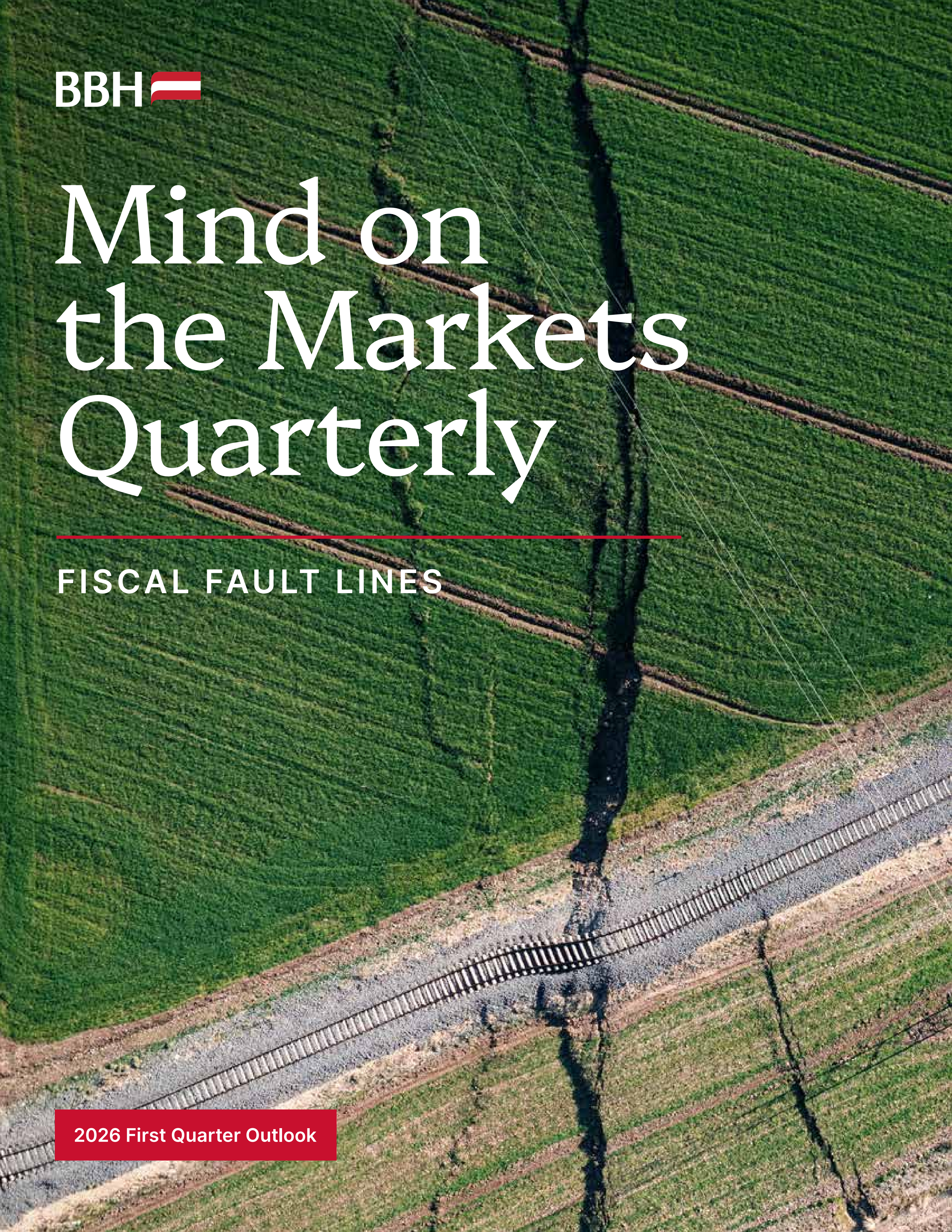


BBH

Mind on the Markets Quarterly

FISCAL FAULT LINES

2026 First Quarter Outlook

CONTENTS

Fiscal fault lines

By Elias Haddad[1]

Weak US fiscal credibility is a structural drag on the US dollar while providing a structural tailwind for precious metals.

[1] This article features contributions from Leo Ellenberg

In our view, 2026 will be a year of rising fiscal pressure where foreign exchange increasingly focuses on fiscal credibility alongside interest rate differentials. That should keep the US dollar trading on the defensive, with the Japanese yen poised to outperform. Precious metals are likely to extend gains.

2025: The year of precious metals

Silver, platinum, palladium, and gold emerged as standout performers in 2025 **(chart 1)** reflecting three underlying macro themes:

— Above target inflation. Major central banks have eased to support growth while headline inflation in many advanced economies remains at or slightly above targets. As a result, real yields (nominal yields minus inflation) moderated and reduced the opportunity cost of holding non-yielding assets like precious metals **(chart 2)**.

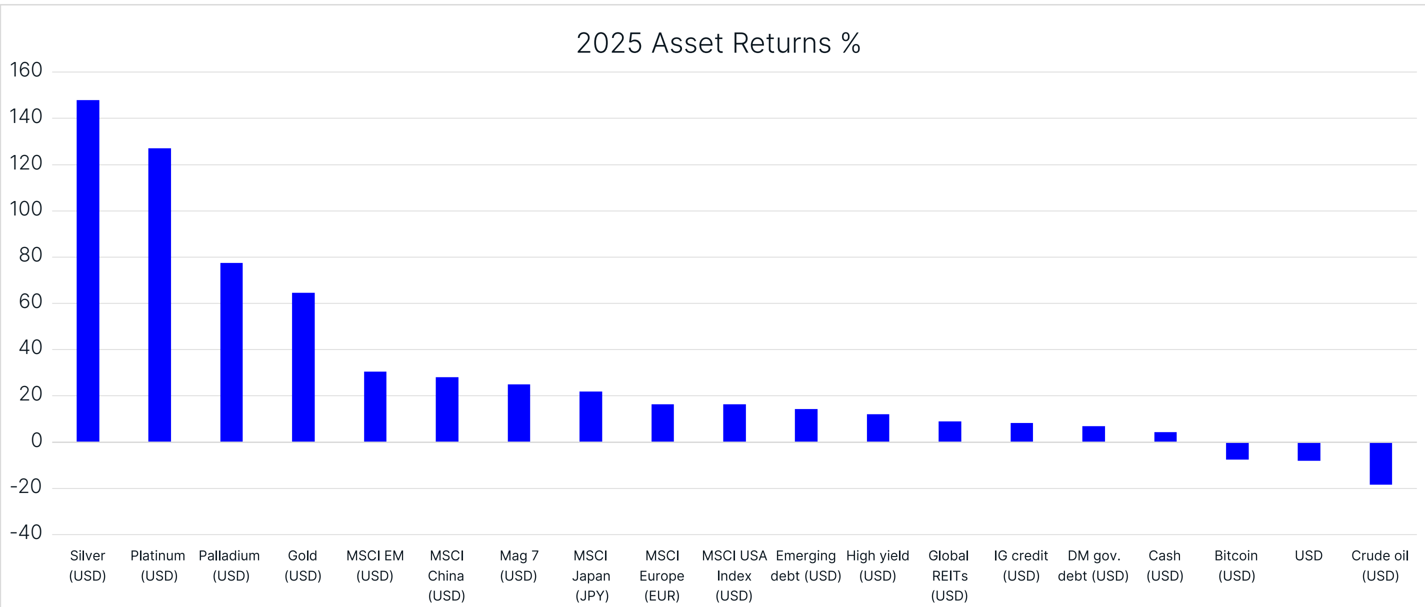


Chart 1 Source: Bloomberg

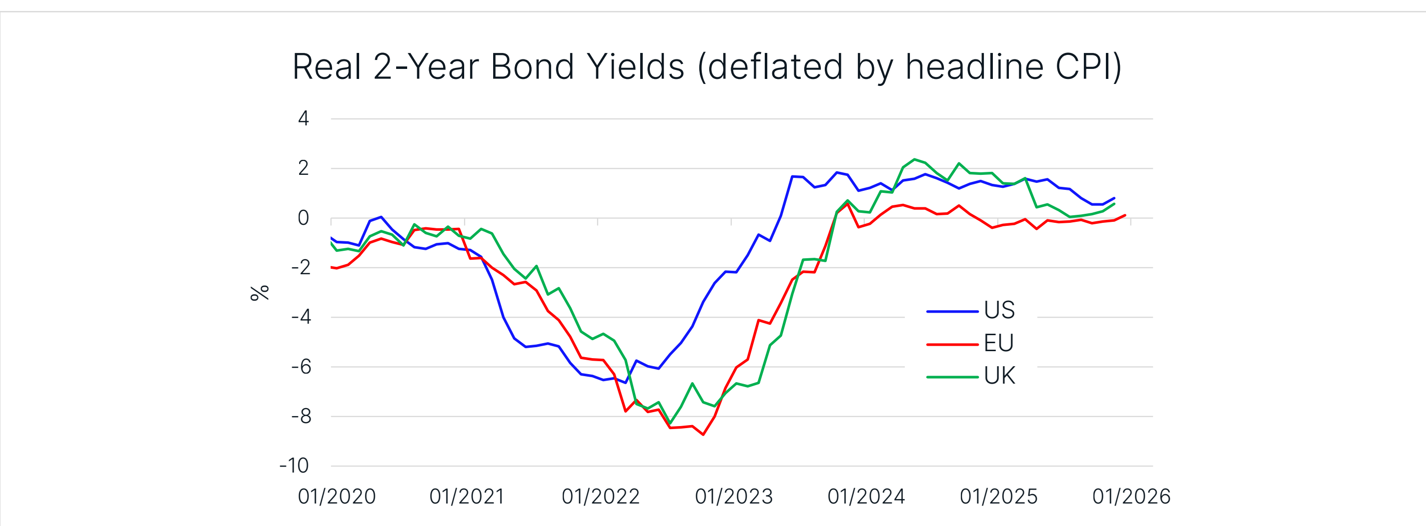


Chart 2 Source: Bloomberg

– Persistent geopolitical uncertainty. Central banks, led by China, have been ramping up gold purchases since financial sanctions were imposed on Russia in 2022 **(chart 3)**. This trend has gained momentum, with the world shifting from a unipolar to a multipolar world, making global politics more contested and crisis prone. Precious metals benefit in this new world order as they are free from direct links to the economic policy of any country, resistant to crises, and tend to retain their real value in the long term.

– Artificial intelligence (AI) revolution. Precious metals are critical to the AI data center building boom **(chart 4)**. Every new server and power system requires large amounts of silver, gold, platinum, and palladium for high performance chips, wiring, and energy infrastructure.

In parallel, the US dollar edged lower against all major currencies in 2025 **(chart 5)** undermined by: US policy shocks in the first half of the year (tariffs, data reliability, fiscal worries, and threats to the Fed's independence) and later with the Fed catching up with global peers on interest rate cuts.

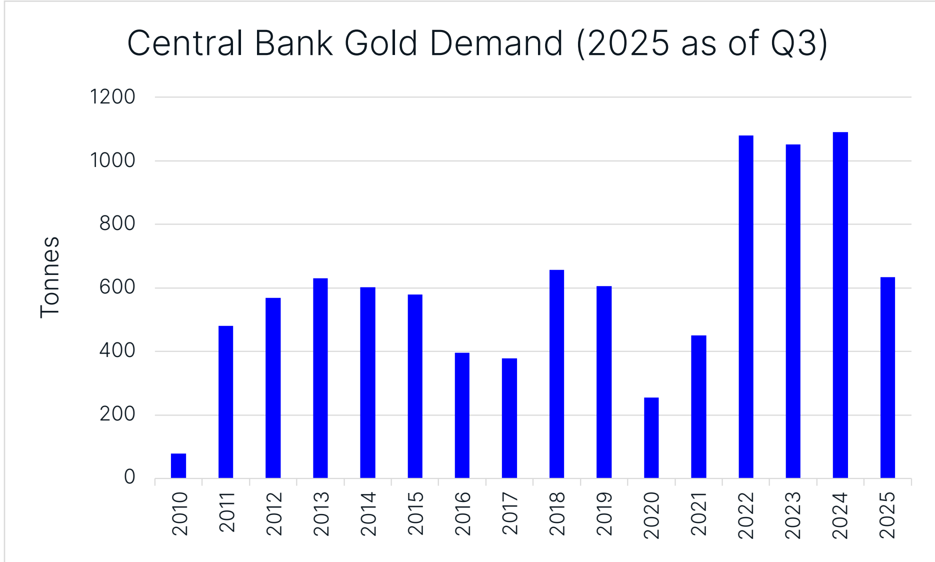


Chart 3 Source: World Gold Council

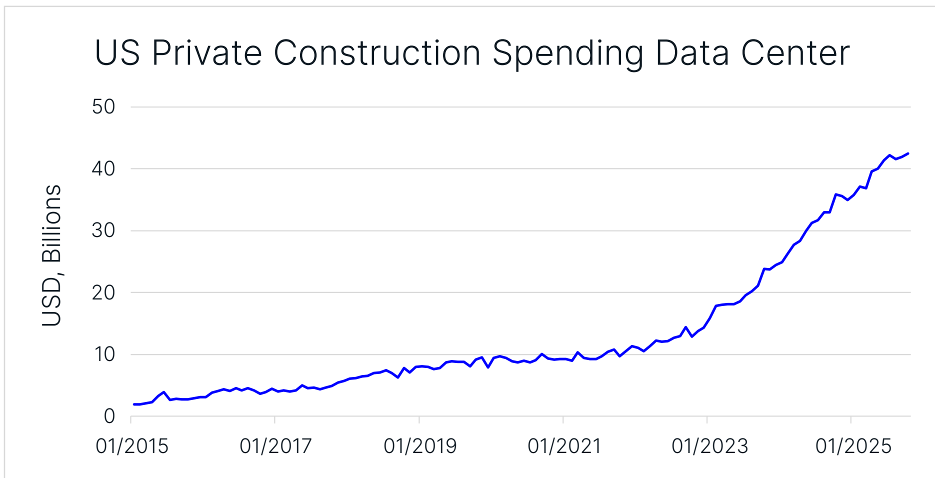


Chart 4 Source: US Census Bureau

G10

Versus USD	2025 Spot Return (%)
SEK	20.08
CHF	14.36
EUR	13.42
NOK	12.74
AUD	7.86
GBP	7.65
CAD	4.83
NZD	2.93
JPY	0.33

ASIA

Versus USD	2025 Spot Return (%)
MYR	10.06
THB	8.84
TWD	4.72
CNY	4.47
KRW	2.51
PHP	-1.25
IDR	-2.78
INR	-4.76

EMEA

Versus USD	2025 Spot Return (%)
HUF	21.43
CZK	18.16
PLN	14.98
ILS	14.40
ZAR	13.53
TRY	-17.65

LATAM

Versus USD	2025 Spot Return (%)
COP	16.72
MXN	15.62
BRL	12.35
PEN	11.75
CLP	10.65

Chart 5 Source: Bloomberg

Mounting public debt

According to the International Monetary Fund (IMF), public debt of the advanced G20 countries is seen rising to a new post-war record level of over 130% of GDP by 2030. The public debt outlook may be even worse due to looming expenditures on defense, costs arising from population ageing, the green transition, and political bias towards budget deficits. Additionally, investor concerns about large fiscal deficits will keep longer-term sovereign bond yields under upward pressure and add to fiscal strains as rising debt is compounded by higher interest expense **(chart 6)**.

At the same time, fiscal shocks could be amplified because sovereign debt is increasingly held by hedge funds[2] **(chart 7)**. Unlike banks or 'real money' private investors (pension funds, insurance companies, and asset managers), hedge funds are leveraged and highly liquidity driven. They rely on short-term secured borrowing (repo financing) from bank dealers to finance their investments. In periods of stress, funding can dry up, making fiscal shocks translate into faster, larger, and more correlated market moves.

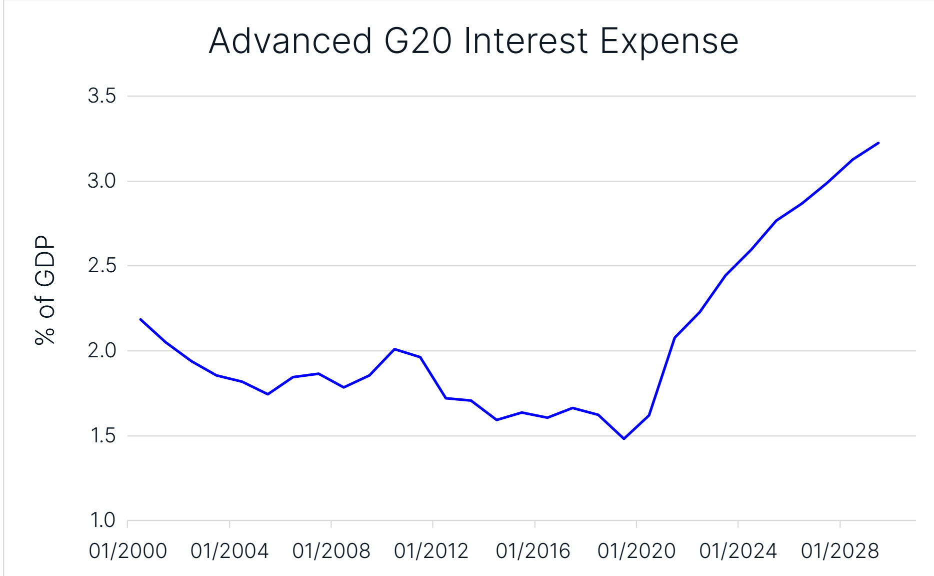
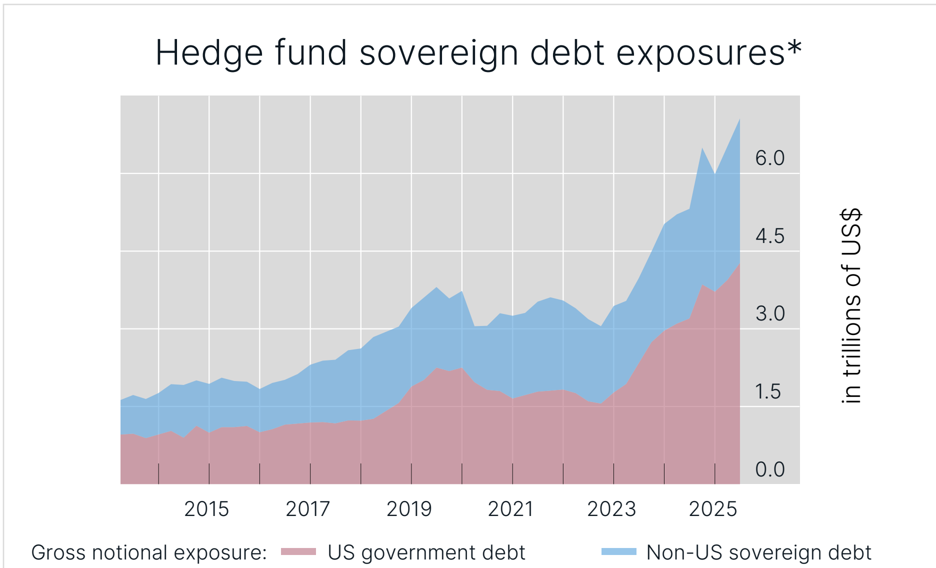


Chart 6 Source: IMF



*Gross notional exposure is the sum of the absolute value of long and short exposures, including via holdings of cash securities and through derivatives. US data include Treasuries and agency and government-sponsored entities bonds.

Chart 7 Source: Bloomberg

[2] www.bis.org/speeches/sp251127.pdf

Who's got street cred?

Countries whose primary budget deficit far exceeds their debt stabilizing primary budget balance lack fiscal credibility because this makes stopping debt growth more difficult. For reference, the primary balance is the government's overall budget balance excluding interest expense and reflects whether current fiscal policy is adding to or subtracting from debt. The debt stabilizing primary budget is the primary balance required to stabilize debt given economic growth and borrowing costs.

Chart 8 shows the IMF's latest forecast for the 2026 primary budget alongside our rough estimate of the debt-stabilizing primary balance, and **chart 9** highlights the gap between the two. Switzerland is comfortably over-delivering on debt stabilization, and Canada is hovering near debt stabilizing territory, while the US and Japan have the largest shortfall, underscoring elevated long-term debt risks.

One way to capture this credit risk is to look at bond yield-swap spreads, computed as the difference between the sovereign yields and overnight swap rates of the same maturity. Widening bond yield-swap spreads reflect a premium that investors require to absorb large sovereign bond issuances.

The 10-year bond yield-swap spreads for the US, UK, and the Eurozone have narrowed since peaking in March/April 2025, consistent

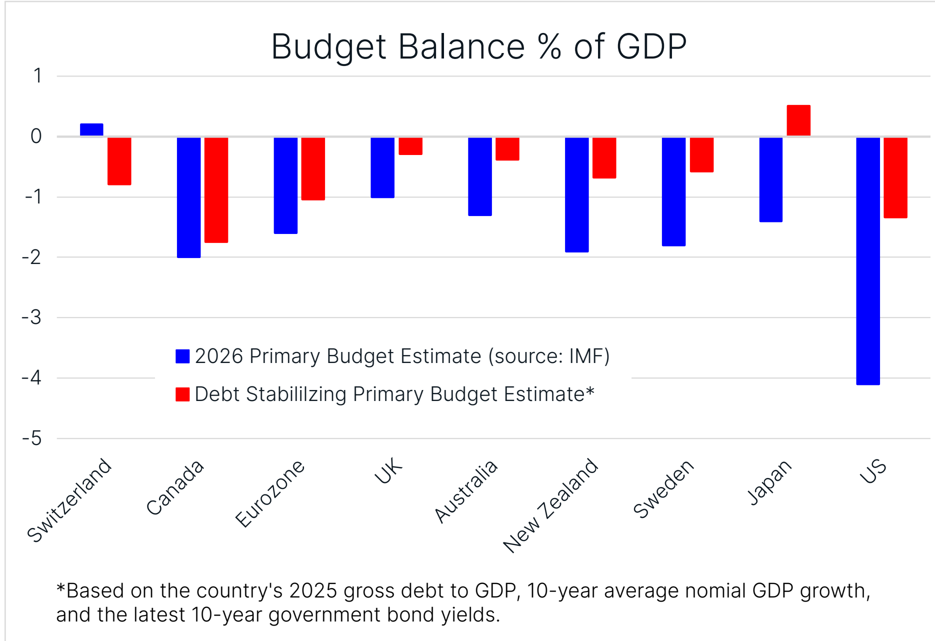


Chart 8 Source: IMF October 2025 Fiscal Monitor

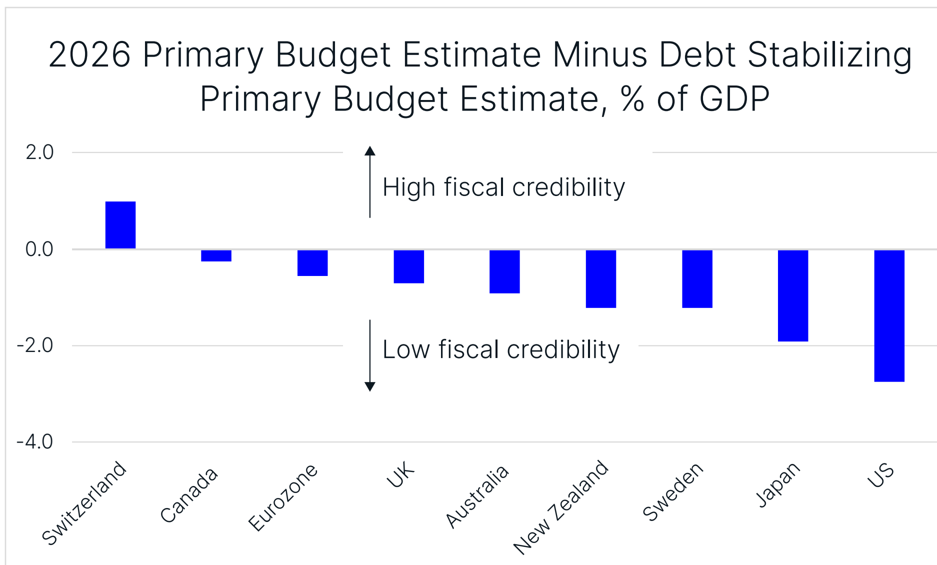


Chart 9 Source: Bloomberg

with waning credit stress.
In contrast, Japan's 10-year bond yield-swap spreads sit near recent highs as the Japanese government is on track to ramp up bond issuances to finance extra spending **(chart 10)**.

The multi-year high in the 10-year bond yield-swap spreads between Japan and the US highlights investors' heightened concern over Japan's fiscal outlook relative to the US **(chart 11)**. That explains why USD/JPY remains overvalued relative to the level implied by US-Japan interest rate differentials **(chart 12)**.

We believe worries over Japan's fiscal profligacy are overdone. Japan's nominal GDP growth is running at around four per cent and leading indicators point to an encouraging growth outlook, while 10-year government bond yields are closer to two per cent. With growth comfortably exceeding borrowing costs, Japan can sustain primary budget deficits without putting its debt ratio on an upward trajectory. In this environment, fiscal sustainability is far less fragile than markets currently imply, and the yen's undershoot looks stretched.

That leaves the US with the weakest fiscal credibility among the major economies, and more vulnerable to renewed fiscal strain. Combined with the prospect of additional Fed funds rate cuts while most other major central banks have stopped easing, the American relative fiscal and monetary backdrop argue for a weaker US dollar over 2026.

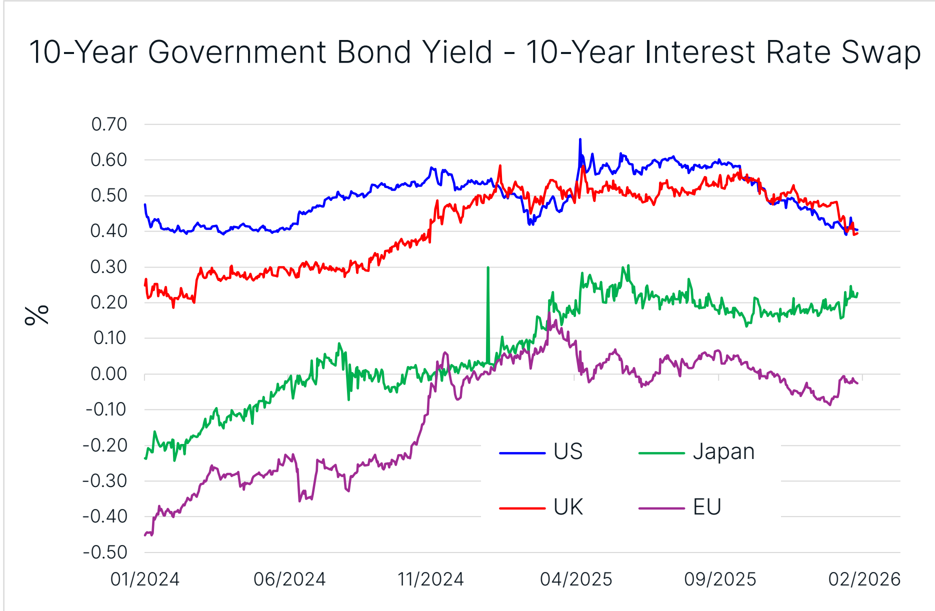


Chart 10 Source: Bloomberg

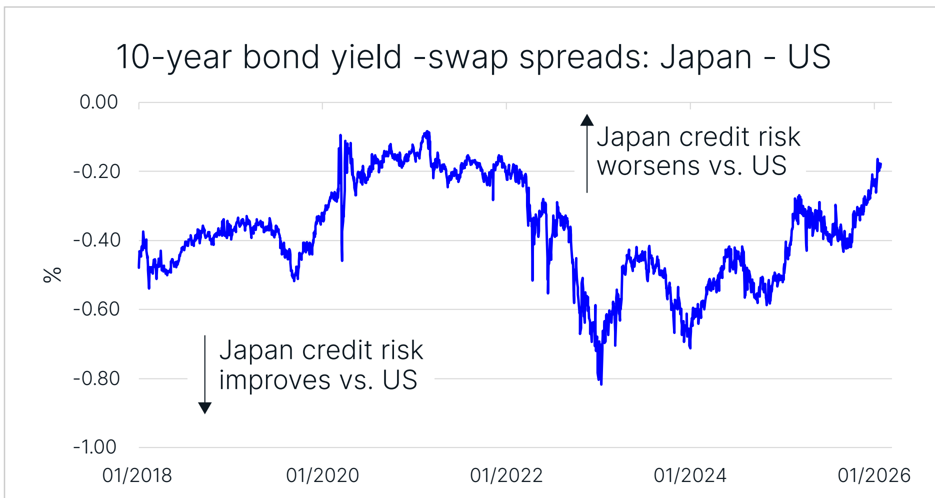


Chart 11 Source: Bloomberg

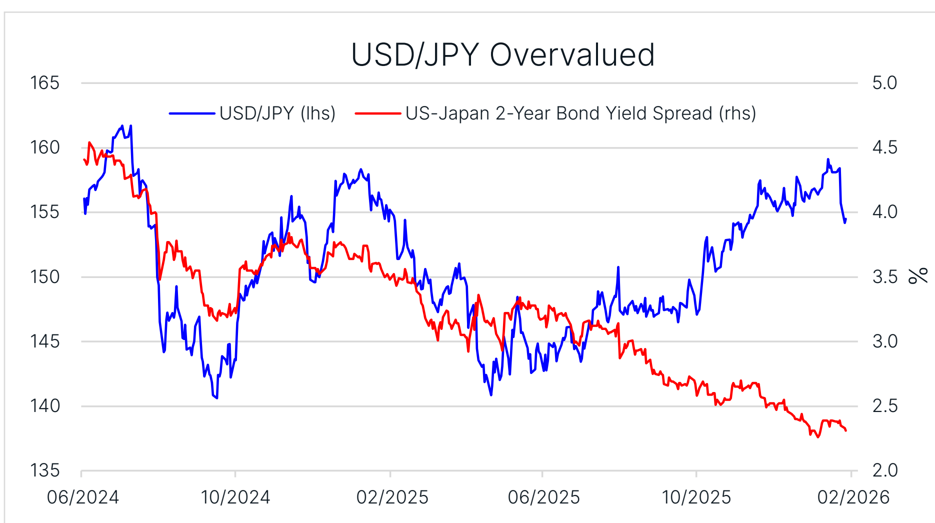


Chart 12 Source: Bloomberg

EMERGING MARKETS IN THE NEWS:

Bridging new frontiers

Insights from Julian Bolton

From war torn nation to thriving economy, Vietnam is reinventing itself and attracting renewed attention from global investors.

Vietnam has come a long way since the end of its war in 1975, when the nation was left as one of the poorest in the world.

A look back

In 1986, the government introduced a series of economic and political reforms called Doi Moi – shifting to a market economy and setting the foundation for the trajectory of significant economic growth that has helped the country approach full emerging market (EM) status.

Last October, index and benchmark provider FTSE Russell announced Vietnam will be reclassified from Frontier to Secondary EM status with an effective date of September 2026, subject to an interim review in March 2026, after being on FTSE's reclassification watchlist since 2018. This will place the market alongside India, Indonesia, and Philippines, among others and open new foreign investor flows into the market.

FTSE Russell highlighted the establishment of the non-prefunding model as a core driver for the move to EM status, providing sufficient progress in enabling access to global brokers. The next focus is to gain EM status on MSCI's index hierarchy, which has a larger capital pool and stricter requirements, with Vietnam aiming to meet the upgrade criteria in 2030.

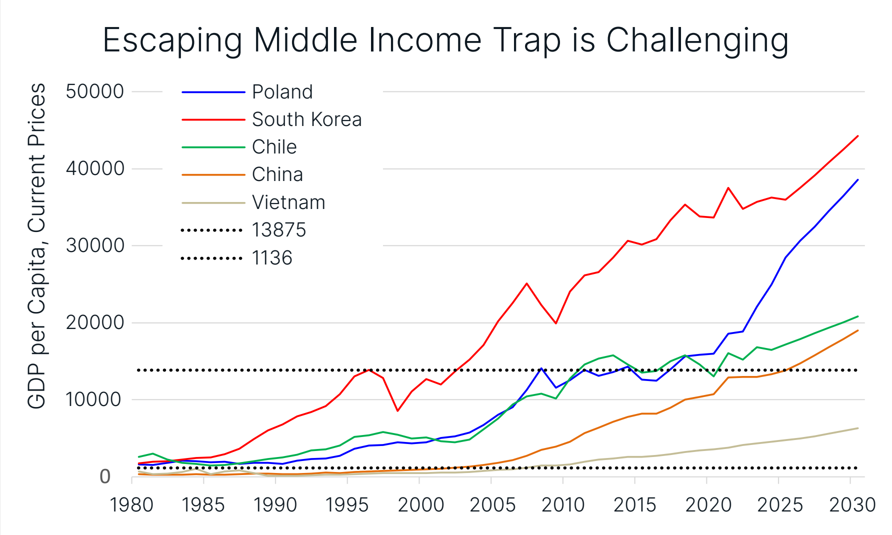
Vietnam: towards 2045

Elias Haddad

Vietnam aims to be a high-income country, defined as having a GDP per capita of between $15,000 - $18,000, by 2045.

Achieving this will require Vietnam to grow at an average annual rate of roughly six percent over the next two decades. That is realistic given that Vietnam's real GDP has averaged 6.5% in the last two decades and surged by 8.5% over 2025. The far greater challenge lies in escaping the so called 'middle income trap,' where countries fail to transition to high-income status.

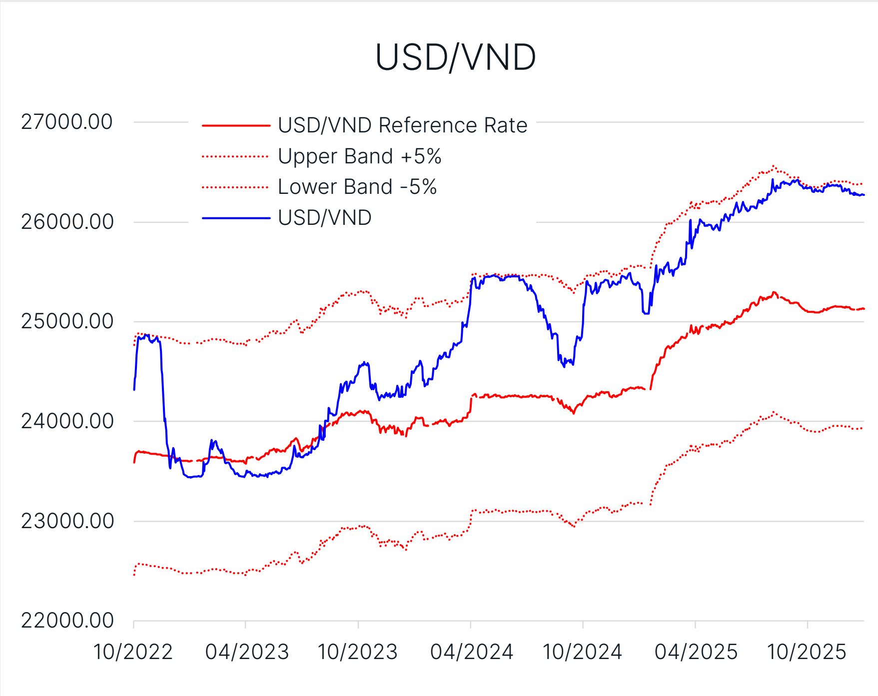
Currently, 108 countries are classified as 'middle-income' with GDP per capita ranging from $1,136 to $13,845. The IMF estimates Vietnam's GDP per capita at $4,745 in 2025. Over the last 34 years, only 34 economies have succeeded in breaking out of the middle-income trap, notably South Korea, Chile, and Poland. All three nations boosted productivity by accelerating investment, introducing new ideas from abroad to their economies, and ultimately becoming innovators themselves.



Note: Dotted black lines denote middle income range. Data from 2025 are IMF forecasts.
Source: IMF

Vietnam's government has already embarked on an ambitious reform agenda to improve productivity, upgrade key infrastructure, and boost domestic demand. That will be a gradual process. In the meantime, exports and foreign direct investment will remain key pillars of Vietnam's growth strategy. That means the Vietnamese Dong (VND) faces structural downside pressure.

Indeed, USD/VND has been trading at the upper end of its trading band (implying a weak VND) for over a year.



Source: Bloomberg

As a background, the State Bank of Vietnam (SBV) manages the VND through a crawl-like* exchange rate arrangement. Since October 2022, the USD/VND trading band has been set at +/-5% from the daily reference rate. The daily reference rate is based on:

– the previous day's weighted average USD/VND exchange rate;

– a weighted average of movements in VND exchange rates vis-à-vis seven other important trading partners' currencies;

– domestic macroeconomic factors.

From frontier to secondary emerging market status

Prior to the FTSE announcement, both the FTSE and MSCI indices classified Vietnam as a Frontier market, preventing many investors from investing in it – particularly passive funds. The reclassifications may deliver significant benefits to Vietnam's equity market, increasing investor inflows and liquidity, enabling further growth. The World Bank has estimated that these upgrades could bring foreign net inflows of $25 billion by 2030,[1] the majority of which could come after the MSCI upgrade. Beyond market implications, achieving EM status elevates Vietnam on the global stage, strengthening the country's voice in the region and among peers.

In November 2024, to enhance their chance to be elevated, Vietnam eliminated the requirement to fully pre-fund equity trades, removing a long-standing operational obstacle foreign investor had faced when investing into the Vietnam market. Previously, investors had to execute an FX transaction to purchase Vietnamese Dong (VND) before placing a securities trade. This process can tie up liquidity and leaves residual VND balances that required later repatriation, creating unwanted cash management complexity.

* A crawl-like arrangement is when the exchange rate remains within a "narrow margin of 2% relative to a statistically identified trend for six months or more (with the exception of a specified number of outliers), and the exchange rate arrangement cannot be considered as floating". Source: IMF/Reuters. IMF reclassifies India's FX regime as 'crawl-like' from 'stabilized'. 26 November 2025.

All figures sourced from elibrary-areaer.imf.org/Documents/Exchange Rate Classification Methodology/ExchangeRateClassificationSystemDefinitions_2008.pdf

[1] Source: Reuters, Vietnam set to launch new stocks trading system in bid for market upgrade

This reform marked a significant step towards improving market accessibility and addressing a persistent barrier that was cited by FTSE and MSCI and that deterred many global investors from entering Vietnam's stock market.

To advance its long-term objectives and in addition to the newly established non-prefunding (NPF) model, Vietnam has initiated measures to increase foreign ownership limits, establish a central clearing counterparty by 2027, and introduce securities lending programs. The market has also advanced technologically with the launch of the new Korea Exchange (KRX) trading system in mid-2025.

Next steps and challenges ahead

While the new NPF model marks meaningful progress for the market, it still comes with challenges. It requires an arrangement between investors and their brokers to establish trading limits. When the investor places their order, the broker checks the trading limits and confirms whether the trade is eligible for NPF or not. Due to this process, we've seen a slower adoption of the new model than initially anticipated. With investors wary of the new requirements, most clients have continued to prefund their equity trades.

At BBH, we are closely monitoring changes in Vietnam and collaborating with local providers to navigate evolving market dynamics.

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