CLOUGH CAPITAL
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U.S. Debt Trends: What They Signal for Liquidity, Rates, and the Dollar

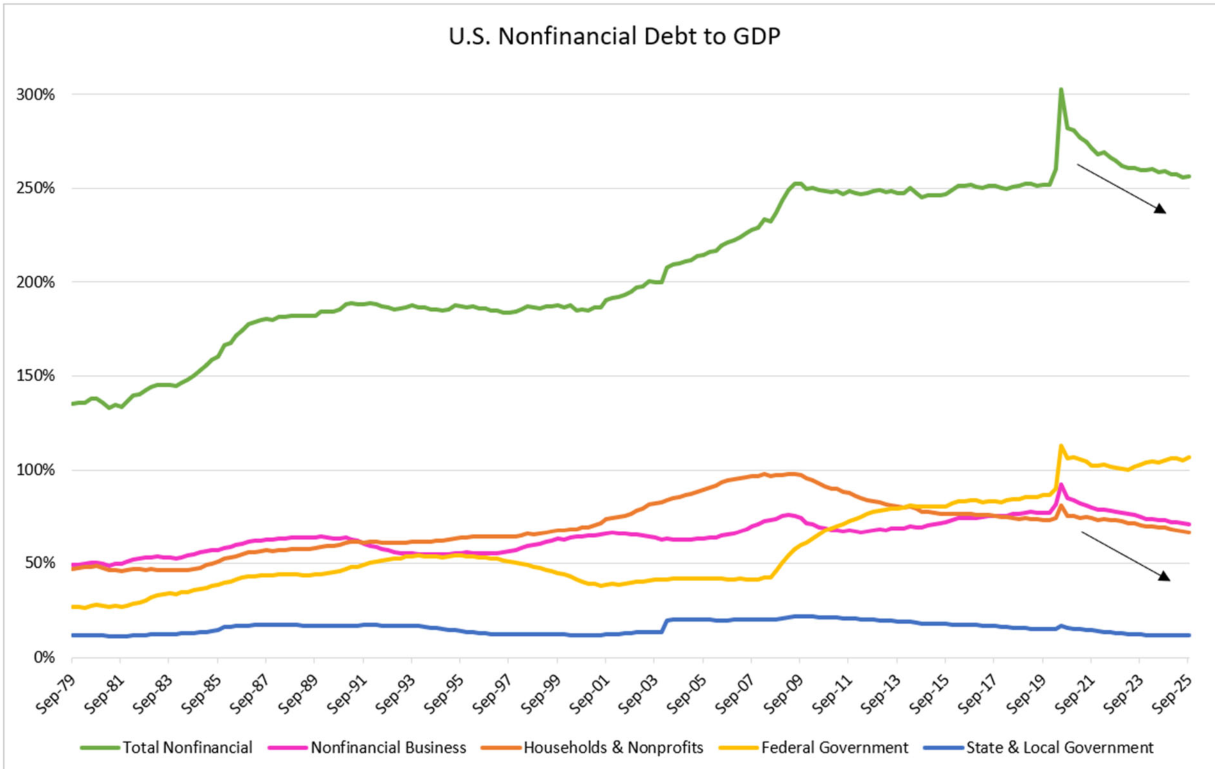
We see three signals from the financial markets that not only point to the health of U.S. risk assets but indicate talk of a U.S. debt crisis and a serious decline in the U.S. dollar's foreign exchange value are overstated. First, equities have performed well in the face of restrictive monetary policies. Since mid-2022, quantitative tightening has cut the size of the Federal Reserve (the "Fed's") balance sheet by over one third, yet the S&P 500 Index has risen over 80%.

Second, bond managers have raised hundreds of billions of dollars in recent years, expecting a flood of distressed bonds for sale, but credit spreads have remained narrow throughout the post-COVID recovery. The supply of distressed bonds has been limited, and few managers were able to invest those funds.

Third, in spite of government deficits and large U.S. Treasury borrowing needs, the dollar's foreign exchange value has held its own. In the mid-90s, it is currently near the middle of its trading range over the past 10 years and has been stable since April of 2025.

The reason for all of this, we think, is that for the past several years, the U.S. private sector has been throwing off excess cash, and liquidity available to the financial markets has been strong and it is growing. While much is made of the rise in government debt outstanding, private debt, which is a larger aggregate, is trending down as a percentage of gross domestic product ("GDP"). This has left both the economy and financial markets less dependent on what the Fed is doing. Liquidity is building up, even in the face of tight monetary conditions, and outside of recession, that is unique in the post-war period. We believe there are structural reasons for the decline in private debt. As demographics in the developed world age, spending declines and savings rise. At the macro level, the desire to save exceeds the ability to spend and invest. The result is that savers are asking the financial markets to absorb more capital than the economy can profitably invest. That began in Japan thirty years ago, migrated to Europe around the time of the Greek debt credit crisis, and could describe the U.S. economy in coming years, particularly if the U.S. constrains immigration.

This is reflected in what is happening to the monetary aggregates. Money and credit levels are growing far too slowly for inflation to take hold. Federal Reserve Bank credit is down 4.4% year-over-year; commercial bank credit is only 5.4% higher; and M2 is 4.8% higher. Since these growth rates roughly equal the level of nominal interest rates, net new borrowing simply credits the interest costs of carrying the current debt stock, leaving little for use in the economy. These are recession level growth rates, and this shows up in a cash buildup. JPMorgan Chase & Co reported consumer cash holdings in checking, savings and money market accounts touched a record $22 trillion in the third quarter of last year, up from $14.8 trillion in 2019. Low U.S. dollar-based money growth implies that any decline in the dollar would come from U.S. foreign exchange market intervention. This is illustrated in the chart below.



Source: Federal Reserve as of September 30, 2025.

All of this tends to force the natural rate of interest lower.

The behavior of dollar liquidity should be compared to nominal GDP because it reflects funding of dollars relative to the demand for dollar assets or dollar payment settlement.

As a percentage of GDP, government debt has grown; COVID-related spending drove the federal debt to GDP ratio to the mid-120s%. But it is projected to level off for the rest of the decade. That would signal the end of growth in excess dollar supply from that source. On the other hand, relative to GDP, private debt, which includes households and businesses in the U.S., has been drawing down since 2021. Household debt, consisting of mortgages, private borrowings and credit card debt, compared to GDP has been declining since 2009. If these trends continue (the government debt to GDP ratio flattens out while private debt continues to move down), total dollar-related debt relative to GDP would fall over time. In other words, since dollar-based credit is growing more slowly than domestic demand for it, as measured by nominal GDP, it suggests deflationary pressures are building and insufficient dollars are being created to meet economic needs. Theoretically, that could create a dollar scarcity in the years ahead. Should the dollar fall for geopolitical reasons, it would likely attract larger investment flows into the U.S. That would strengthen the economy and likely result in higher stock prices.

We expect short-term interest rates to fall in 2026 and early 2027, and that would be positive for both stocks and bonds. Slower U.S. population growth will likely lessen final demand and lead to a protracted period of both disinflation and weaker labor conditions. Both would be triggers for more easing from the Fed. Deregulation and productivity growth will support business profits, allowing businesses to simultaneously invest and reduce debt liabilities. Finally, in addition to reducing interest rates, the Fed is moving from the policy of quantitative tightening, whereby it sells securities into the marketplace and reduces the size of its balance sheet, to quantitative easing, where the Fed buys securities and grows its balance sheet. That will further increase liquidity flowing into the financial markets.

The rise in private savings allows the economy to grow faster without creating inflation. It also suggests the multi-decade trend to lower interest rates will resume. If our thinking is correct, short-term rates will be forced downward because the financial sector will face a structural decline in demand for credit and have little incentive to pay up for deposits, the largest component of its liabilities. Deposits held by the banking system have already fallen from $20 trillion in

2022 to roughly $18 trillion today. That reflects the challenge the financial sector has faced in lending and investing the flood of savings it has gathered. Any rise in interest rates simply aggravates defaults and in a fractionalized banking system, defaults automatically stop credit.

The ability of the private equity industry, which today manages over $11 trillion in assets, to raise capital not only reflects the flood of savings in the economy, but its growth ironically adds to underlying deflationary pressures. When a bank lends, or purchases an investment, it creates money and adds to the dollar-based credit stock. If private equity makes the investment, it must raise outside capital to do so, and another asset must be sold somewhere to provide that capital. New money is not created. But now, even private equity is facing difficulties in both finding new investments for the enormous funds the industry has raised and also monetizing the investments it already holds. Today, private lending exists largely to lend to companies owned by private equity entities. A National Bureau of Economic Research study indicated 75% of middle market borrowers of direct lenders were private equity owned firms. Only when leveraged lending by the banking system is involved is new dollar-based credit created.

All of this points to lower short-term rates. The financial sector creates most money market assets (deposits, asset-backed commercial paper). If demand for credit to operate the economy is slowing, the demand for and price of financial sector liabilities will decline. The so-called money rate will decline.

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