KGI

CIO Office

CIO Insights

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The Danger of Blue Skies: Tail Risks Ahead

Managing Low Probability but High Impact Events

16 January 2026

Constructive for the 2026 Market Outlook

L. E. A. D. Is Our Core Investment Strategy if Everything Goes as Expected

L Liquidity Shift

- U.S.: Larger Rate Cuts, Weaker Currency Adjustment
- Asia and Europe: Limited Rate Cuts, Capital Inflows Likely
- Japan: Rate Hike Expectations Persist, Yen Weak First Then Stronger
- **Positive on Europe and Asia**

A Adding Credit

- Fed Liquidity Support, U.S. Treasury Yields Face Downside Potential
- Event Risks Persist, Capture Quality Bond Opportunities
- Dollar Depreciation Risks Remain, Diversify into Non-U.S. Bonds
- **Focus on IG Corporate Bonds <10-year duration**

E Earnings Focused

- U.S. Equities to Start Weak, End Strong, Positioning Opportunities Ahead
- Europe’s Economic Recovery, Watch Sector Performance
- Corporate Reforms Bearing Fruit, Fiscal Stimulus Provide Extra Support
- **Positive on the U.S. leaders and Japanese small-mid cap companies**

D Diversified Asset

- **Gold**
- **Virtual Currencies**
- **Private Assets**

Source: KGI

Dovish Fed's Policy Breeds Runaway Inflation

Tail Risk 1

Q: Why is Federal Reserve's policy expected to be dovish?

1) Weakening job market;
2) New Fed Chairman is likely to be a Trump loyalist;
3) U.S.'s DOJ attempted prosecution of the Fed Chair

Q: Why would inflation come back?

1) Too much money chasing for too few goods
2) Companies pass through higher import duty costs to the consumers when the early imports in 2025 depleted

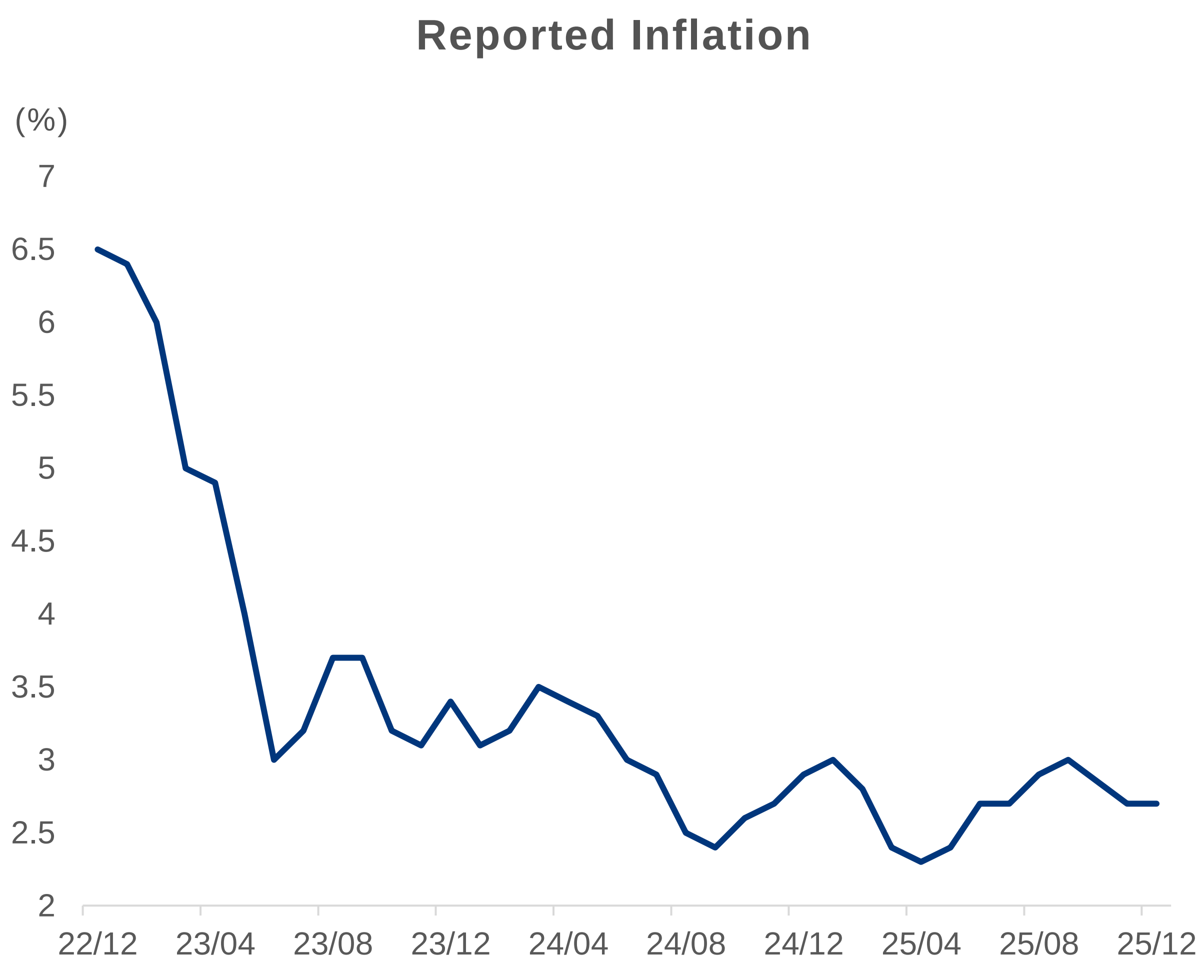
Outcome

Term premiums start to rise in the bond market on back of inflation expectation and fiscal concerns

Source: KGI

Inflation Expectation on the Rise Amid Falling Reported Inflation

Inventory From Cheaper Imports in 2025 Is Depleting



Source: Bloomberg, Federal Reserve Bank of New York, KGI

Fiscal Concerns Cast Doubts on G7 Holding Power in Treasuries

Tail Risk 2

- China has been reducing its holding in the U.S. treasuries by U.S.$365bn over the last five years despite the U.S.$1.8 trn trade surplus with the U.S. over the same period.
- Japan is keeping its holding in the U.S. treasuries stable at U.S.$1.2 trn while its cumulative trade surplus with the U.S. reached U.S.$360bn over the last five years.
- Belgium and Cayman represented a combined U.S.$434bn increase in holdings in U.S. treasuries. Belgium is the headquarter of Euroclear which provides custody services and a lot of global hedge funds are domiciled at Cayman. Sovereign demand is not translated into rate-sensitive investment demand.
- United Kingdom's U.S.$435bn increase in the U.S. treasuries seems odd when its cumulative trade deficit with the U.S. totaled U.S.$119bn.

Outcome

If the current U.K. government is replaced by a new leadership that focus on big increase in public spending, there could be a weakening of its holding power in the U.S. treasuries. Any sudden surge in funding cost will also drive a quite unwinding on the treasuries holding from the hedge funds.

Source: KGI

Change in “G7+China” Holding in the U.S. Treasuries

U.K.’s Holding in U.S. Treasuries Increased Despite Growing Trade Deficit With the U.S.

Country	Holdings (billions of USD, as of Oct 2020)	Holdings (billions of USD, as of Oct 2025)	Change U.S.$ mn	Comments
Japan	1,273	1,200	-73	Trade surplus increased over the last 5 years
China	1,054	689	-365	Trade surplus increased over the last 5 years
United Kingdom	443	878	435	Trade deficit with the U.S.
Canada	131	419	288	Trade surplus increased over the last 5 years
France	137	390	253	Trade surplus increased over the last 5 years
Germany	74	115	41	Trade surplus increased over the last 5 years
Italy	44	66	22	Trade surplus increased over the last 5 years
Belgium	239	468	229	Euroclear is headquartered in Belgium which provides the securities depository and custody services
Cayman Island	221	426	205	A lot of global hedge funds domiciled at Cayman

Source: KGI

U.S. Supreme Court Voting Down the Tariffs Under the IEEPA

Tail Risk 3

- According to online prediction platform, the odds of this happening is 75%.
- Trump may find some other ways to implement tariffs. During the process of resetting and basing the tariffs on different methodology, this could induce even higher uncertainty to the global supply chain.
- The Court could force the Treasury department to refund the tariffs to importers which may take up to one year to do so. During the process, tariffs represented a major source revenue to the U.S. government will become increasingly apparent. The worsening fiscals of the U.S. government may in turn put pressure on the U.S. treasuries.

Outcome **Increase in the volatility of the long-end of the yield curve.**

Source: KGI

Tariff Revenue Could Be as Much as U.S.$3bn Per Year

Without Tariff Revenue, the U.S. Government Need to "Eat" the Fiscal Deficit

Our estimates of the tariff revenue could be simplistic but the estimates by different non-partisan bodies does highlight that tariff represents a major revenue although bulk of it is from the U.S. importers.

Projections of tariff revenue from different bodies

	2026–2035 Tariff Revenue Forecast (U.S.$ trn)
Tax Foundation Estimates	2.3
Congressional Budget Office	3.3
The Budget Lab at Yale	2.7
Penn Wharton Budget Model	5.2
Average	3.4

Source: KGI

U.S. Breaks up With the NATO

Tail Risk 4

- After the U.S. captured the president of Venezuela, Nicolas Maduro, the U.S. administration has repeatedly mentioned the potential use of military force to seize Greenland which is an autonomous territory of the Kingdom of Denmark.
- The NATO is surprisingly silent in response to this threat from the U.S.. It could very well merely a bluff from the U.S.. However, in the very unlikely event that a conflict happened, this could lead to a rapid disassociation between the U.S. and the other NATO members.

The implications can include:

1. NATO's members' purchase of the U.S. treasuries may come to a halt
2. Significant rise in the geopolitical risk premium which could cause a rapid decline in risky assets
3. The U.S. dollar will weaken further
4. The exports by the U.S. defense contractors to the NATO members will be negatively impacted
5. The list of negative consequences is long and we believe any right mind would not be stepping into such territory. However, this remains a key tail risk that we have to manage.

Source: KGI

Where Could Trump Strike Next?

Further Aggression From the U.S. Will Drive a De-Rating of Global Risky Assets

Source: KGI

Investment Strategies

With a Tilt to Manage The Tail Risk

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D Diversified Asset

- **Gold**
- **Limited Virtual Currencies as risk premium increases**
- **Private Assets focusing on Asia**

Source: KGI

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