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Economic Imbalances

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Economic imbalances often require some type of adjustment to reflect economic realities and achieve a sustainable level of economic activity. There are currently three major imbalances in the US economy that can lead to a lower level of economic activity, higher interest rates, and/or a currency devaluation.

AI Capital Expenditures and Financing

In March 2026, the Bank of International Settlements (BIS) included a commentary in their quarterly review on financing of the AI (artificial intelligence) boom. The AI hyperscalers (Fab 5 = Alphabet, Amazon, Meta, Microsoft, and Oracle) have increased their capital expenditures dramatically. The hyperscalers are transforming from asset-light businesses that derive profit from unique software capabilities to AI businesses that require large capital expenditures and are beginning to look more like commodities that are difficult to differentiate. In the case of Amazon and Oracle, capital expenditures have exceeded cash from operations during the most recent twelve months reported by the companies. However, the financial statements don't tell the whole story.

Corporate bond markets have been the primary source of financing for the AI hyperscalers, but some alternative sources of the AI infrastructure buildout are not reflected on the financial statements of the AI hyperscalers. Special purpose vehicles (SPV) are being created to acquire or develop AI data centers. The SPV is usually financed with equity from a consortium of sponsors and debt raised through private placements. The hyperscalers typically hold a minority equity stake and are not required by accounting standards to consolidate the SPV operation on their financial statements. The hyperscalers also make commitments with the SPVs in the form of long-term operating leases or capacity offtake agreements to purchase or reserve power and computational capacity. Operating leases are required to be disclosed in the footnotes to the financial statements, but offtake agreements must meet certain criteria before disclosure is required.

Moody's is more skeptical than S&P about the surge in AI infrastructure spending being financed off the balance sheet. In a February 2026 report, Moody's estimated that the five hyperscalers mentioned above had roughly $969 billion of undiscounted lease commitments and more than two-thirds of the commitments were not yet reflected on balance sheets. Moody's argues that lease commitments, capacity purchase agreements, and residual value guarantees which are not reflected in the financial statements materially change the economic exposure of the hyperscalers.

In July 2026, Moody's commented further on the hyperscalers' financing. Moody's provided the following estimates for the Fab 5 and Coreweave:

- Direct debt had risen by $460 billion.
- Combined capital expenditures could reach $785 billion in 2026 and approach $1 trillion in 2027.
- Moody's encouraged investors to analyze all enterprise obligations, not merely reported debt to assess credit quality.

There are some productivity benefits from AI that are undeniable, but the surge in capital expenditures and related financing is something that economies rarely experience. If the hyperscalers do not have a surge in revenue that justifies the capital expenditures, there could be a quick end to the capital expenditure boom and potential defaults on contractual obligations.

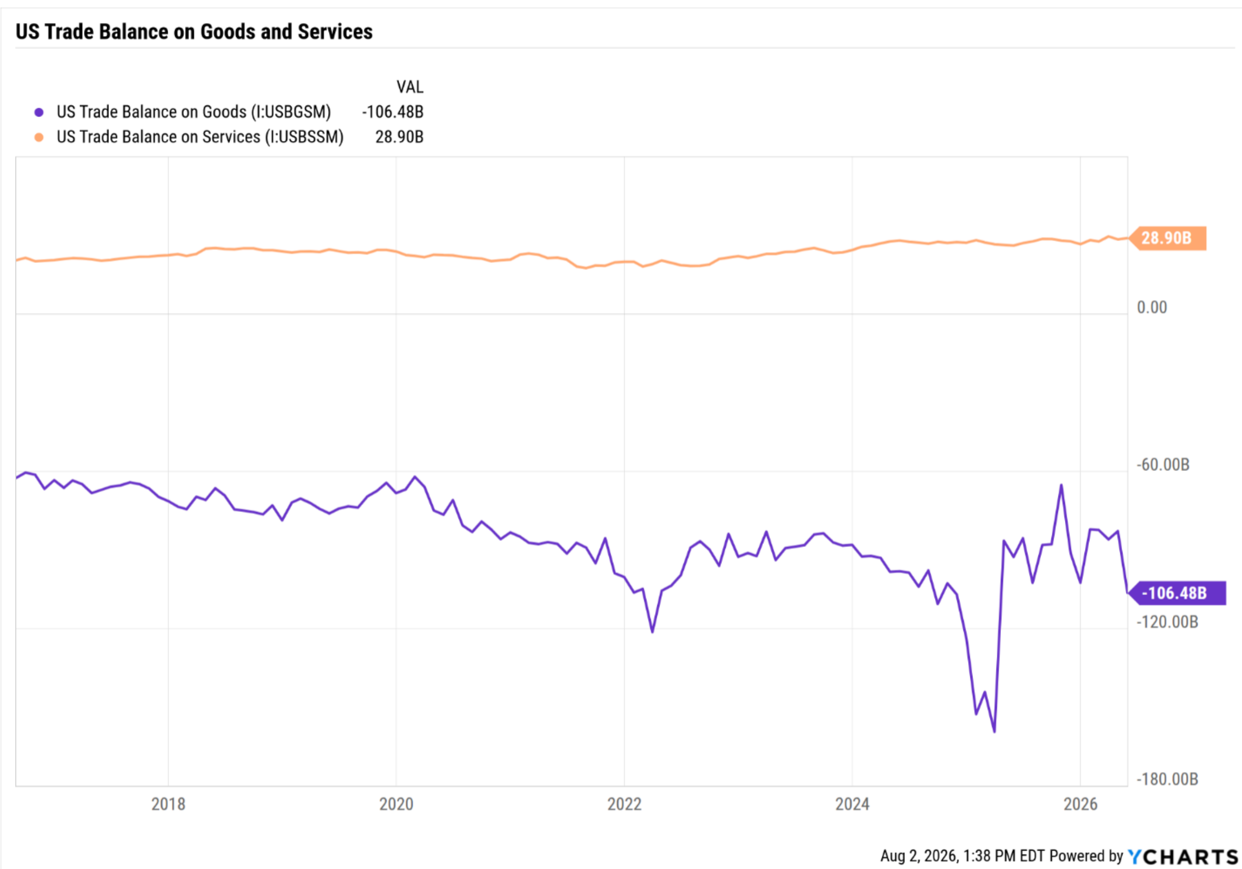
Fitch Ratings monitors the credit default rate of private credit. Its US Private Credit Default Rate (PCDR) rose to a new high of 6.0% in 2Q-2026, up from the prior record of 5.7% in 1Q-2026. Fitch recorded 32 private credit default events from 20 unique defaulters during 2Q. There have been 84 unique defaulters during the prior 12 months. Now that many private credit financings are AI-related, the credit quality within private credit funds will get more attention in the future.

US Trade Imbalances

The US trade balance in goods hit a record deficit of $159 billion in March 2025 due to the introduction of higher US tariffs on imported goods. The trade balance in goods has since improved, but the trade deficit in goods increased to $106.5 billion in May. Since 2022, a trade deficit on goods of about $100 billion per month has been the new normal.

The US trade balance on services has been more predictable and has consistently had a surplus. As of May 2026, the trade balance on services was $28.9 billion for the month. The five major categories that generate the surplus on services are:

- Intellectual property (IP) and royalties – software and technology licenses, pharmaceutical IP, entertainment content and media rights.
- Financial services – investment banking, asset management, securities trading, insurance, and payment processing.
- Professional and business services – legal, accounting, engineering, scientific, and consulting services.
- Technology and digital services – cloud computing, data processing, software as a service, cybersecurity, and digital advertising.
- Travel and education – including tuition paid by foreign students.



An annualized trade deficit of $700-900 billion on both goods and services will be difficult to sustain as the world moves away from the US dollar as a reserve currency.

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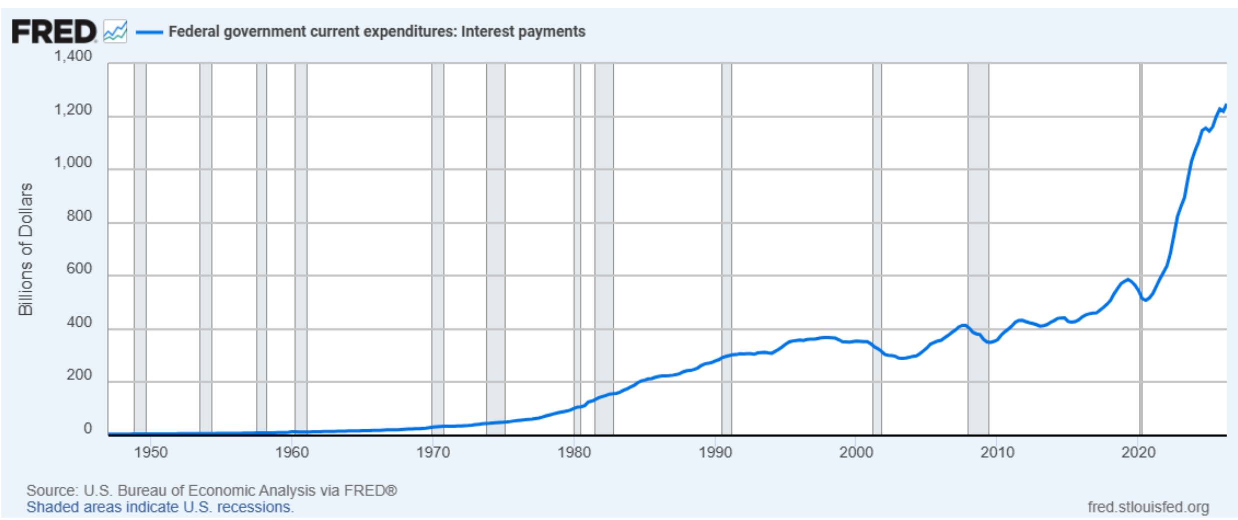
US Government Budget Deficit and Interest Expense

The latest Congressional Budget Office CBO published in February 2026 has a baseline projected budget deficit of $1.9 trillion for FY 2026 and $2.0 trillion for FY 2027. The federal government fiscal year ends on September 30. The projected deficit for FY 2027 does not reflect the additional $500 billion that the Trump Administration is asking for defense expenditures.

Since the Federal Reserve ended its quantitative easing program in 2022, much of the federal government debt that matured has been financed at higher interest rates. The graph below from the St. Louis Federal Reserve Bank shows the extent of the problem. As of the second calendar quarter for 2026, the annualized interest expense for the US government was at $1.25 trillion. This represents 22.3% of projected revenue of $5.6 trillion for FY 2026.



As the US Government continues to run large budget deficits accompanied by debt issuance, we are likely to see higher interest rates that reflect supply/demand, a higher probability of default, and a currency devaluation.

Given the current circumstances of the US economy, I continue to believe that an appropriate asset allocation consists of 1) a selective and defensive weighting of equities, 2) relatively short duration, high credit quality fixed income, and 3) an inclusion of precious metals bullion using the Sprott trusts.

If you have any questions or comments, please contact me.