D|A|DAVIDSON
The Strength of Advice®
CAIRNS WEALTH MANAGEMENT
A Member of D.A. Davidson & Co. member SIPC

Macro Memo
April 2025

Channeling His Inner Paul Volcker

We are living through the first intentionally induced economic upheaval in 45 years. When Paul Volcker was appointed as Federal Reserve Chairman in 1979 by President Jimmy Carter, the United States was facing its third significant wave of inflation that decade – each wave successively higher than the previous. To combat the persistent problem of inflation, Volcker dramatically raised interest rates. It was painful medicine: the U.S. endured a double-dip recession. But Volcker held firm to his plan.

Time has proven Volcker's action to be just the medicine the doctor ordered. While the country suffered short term pain, the tight monetary policy eventually defeated inflation and Volcker's leadership laid groundwork for a multi-decade bull market in financial assets.

Unsustainable practices, by definition, must come to an end. This can happen by either collapsing under their own weight or from a proactive effort. Think of forest fire management. A proactive response is a controlled burn. A reactive response occurs after a wildfire has already begun.

It's a strategic question as to how we should face our problems. Should we be proactive and address issues before they become catastrophes? Or should we take a more reactive approach and wait?

Our leaders often allow political calculus to override wisdom as they opt for the politically more palatable mode of management: kicking the can down the road!

Volcker, on the other hand, was a rare example of taking the more proactive approach. He figuratively conducted a controlled burn in a forest that had been irresponsibly managed for over a decade with undisciplined monetary and fiscal policies. In the moment he was very much maligned by the press for his effort[1] , but he did not relent. In retrospect, the same press recognized his efforts as heroic.[2]

Today, the country is once again in a difficult situation. President Trump and Treasury Secretary Scott Bessent now find themselves stepping into Paul Volcker's shoes. They face a difficult economy– this time a debt riddled economy struggling with fiscal dominance[3] . Following status quo policies will not get the country out of its mess because those policies indeed created the mess.

Today we have a grossly imbalanced economy: we over-consume, under-produce, have over-financialized, and are over-reliant on foreign supply chains. These issues are further exacerbated by unfavorable trade relationships.

Just as in the days of Paul Volcker, unpopular medicine is required to restore the economy to better health. The plan appears to include: the re-working of trade relationships, explicitly defining and formalizing strategic alliances, addressing government spending, prioritizing energy production, investing in the infrastructure to support innovation in world-leading technology, and repatriating critical industries.

We can expect those who benefited the most from the status quo policies to be the loudest opponents to any change. Look to Washington D.C. and Wall Street. We can count on them vocally opposing any policies that effectively take away their cookie jar.

Between Volcker and Trump, there were decades where irresponsible policy prevailed over the tough decisions required for sound economics. American leaders made it a habit of kicking the proverbial can down the road, favoring instead the most politically expedient route. But it's important to note that kicking the can does not make the can disappear!

Likewise, the period between 1980 and today was not without economic crises. In fact we experienced several. The difference being the responses were reactive rather than proactive. Responding after it was too late.

These crises included the 1987 Flash Crash, the 1998 bailout of Long Term Capital Management, the 2000 dot com bust, the 2008 Global Financial Crisis, and the 2020 Covid-19 pandemic. All these crises were quickly attended to with unconventional, accommodative monetary policy responses.

These accommodative responses come with consequences of their own. One of those consequences is the evolution of what has become a "carry regime." A carry regime arises when carry trades have pervaded an entire economy.

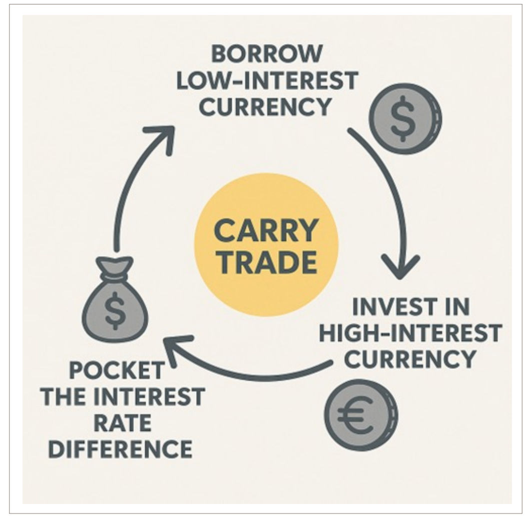
What's a carry trade?

A broad definition of a carry trade is an investment strategy that employs leverage and requires low levels of volatility for success. A carry trade makes the assumption that today will look like yesterday and tomorrow will be the same as today. To say the least, Trump and his administration intend to introduce significant change, certainly not a "low volatility" approach. To protect investment capital from this added risk, there will be a great unwinding of a number of highly levered carry trades, which will in the short-run surface as added instability to markets.

For those who are less interested in the mechanics of the carry trade, feel free to skip to the conclusion of this memo.

Details of a Carry Trade

The classic example of a carry trade occurs in currencies. It starts with borrowing money in a low-interest-rate currency - recently that has been the Japanese yen – and investing in a higher-interest-rate economy, such as Australia. The difference between the cost of borrowing and the yield on the investment is known as the "carry return". If the yen stays relatively stable to the Australian dollar in value, the trade works.



Again, carry trades succeed when volatility remains low.

The return of a carry trade, although positive, may not be high. Hedge funds that engage in carry trades amplify their returns using leverage. The return per trade may be low, but if you make a lot of them, the total return on invested capital can be quite high. Because the investment returns on individual trades are low, and the use of leverage is risky, carry trades have been referred to as, "picking up pennies in front of a steamroller." All is fine and dandy, unless a mishap occurs.

On a larger scale, this definition would fit private equity companies. Their business models typically require borrowing large amounts of capital to acquire portfolio companies. They hope to enhance the value of those companies through their management expertise and then sell them for a profit. For their model to succeed they need interest rates to remain stable. If the cost of capital goes up (volatility) it could force them to sell portfolio companies at adverse prices. The same holds true for publicly held corporations that borrow money to buy back their own shares. This is a form of financial engineering that can increase earnings per share on paper without increasing revenues through increased product sales. Again, if interest rates go up in a meaningful way (volatility) the strategy unravels.

On yet a larger scale, the US government has come to fit the definition of a carry trade. However, the massive scale to which the notion of carry now applies requires conceding that it is no longer a trade and rather a regime, transcending all sectors of the economy. At the Federal government level, carry trading takes the form of massive deficit borrowing matched with government hiring. The return on this trade takes the form of a juiced-up quarterly GDP performance number. Since government employment largely represents administrative and regulatory functions which, like carry trades in general, offer little lasting increase in productive wealth to the economy, the process of borrowing and hiring must be maintained to keep GDP performance at that level. This is both an unhealthy and unsustainable approach to managing the economy, prompting Treasury Secretary Scott Bessent to recently describe the US economy, "…like a body builder on steroids, appearing strong while destroying his internal organs"[4].

Conclusion

While today's economic environment is very different from the early 1980s, it still faces meaningful risks. Imbalanced trade relationships have been neglected to the point where a financial forest fire is a very real possibility. The persistence of the carry regime has led to a macroeconomic landscape with multiple flashpoints, including an over-financialization of the economy, overly frothy market prices, and an overreliance upon supply chains originating outside our own shores. President Trump and Treasury Secretary Bessent appear to be taking a page from the Reagan/Volker playbook by proactively creating a financial controlled burn rather than waiting for a larger crisis to materialize. Obviously, there is risk involved in this approach. Precisely how will this controlled burn occur? What if it gets out of control? How do investors navigate these risks?

Clearly tariffs are the match igniting this process. President Trump's repeated references toward "deals" suggest he is interested in something more than tariff revenue though. He appears to have begun execution of his strategy to reshape the global financial system, which he has said many times includes rebuilding America's manufacturing base, weakening the US dollar to encourage exports, restructuring Treasury debt, and having allies contribute to the expense of militarily defending them.

As mentioned earlier, the concept of carry only works absent volatility, absent meaningful change. But the Trump administration is a change agent like financial markets have not seen in over 40 years. Which for the financial markets means the carry regime will likely be unwinding and volatility will remain elevated. In our 2025 Outlook: Buckle Up we used a rollercoaster as an analogy. Well, the ride has left the platform, and provided you positioned your investment portfolio for potential volatility you should allow it to run its course. The surest way to injure yourself on a rollercoaster is attempting to get off midway through the ride.

As always, If you would like to discuss any of these ideas in more detail I would welcome the conversation.

[1] Just one example: https://www.nytimes.com/1982/10/18/opinion/volcker-s-monetarist-policy-painful-costly.html

[2] https://www.nytimes.com/2019/12/10/business/dealbook/paul-volcker-death-legacy.html

[3] Fiscal dominance occurs when, in order to pay our bills, the Federal Reserve gives up the fight against inflation

[4] https://www.cf.org/news/watch-treasury-secretary-bessent-explains-trumps-tariff-plan/

DAN CAIRNS,
CFP®, CIMA®, CPWA®, RICP®
Senior Vice President, Financial Advisor
(916) 581-7549
dcairns@dadco.com | cairnswealthmanagement.com

2901 Douglas Blvd., Suite 255 | Roseville, California 95661
CA Ins. Lic #0A12472 | D.A. Davidson and Co. member SIPC