

A New Era of Higher Inflation Risks

Investors face structurally higher inflation risks than pre-COVID.
Most portfolios remain poorly equipped to manage them.

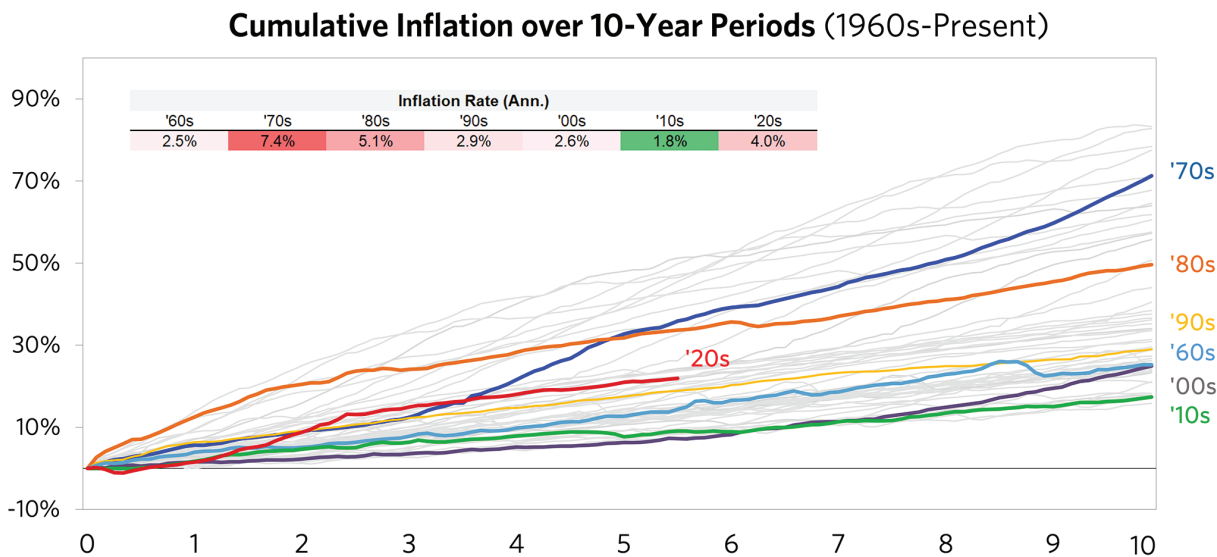
SEPTEMBER 22, 2025

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This year, we have written extensively about the three forces that define the new investment environment: 1) modern mercantilism, 2) unprecedented portfolio concentration, and 3) a once-in-a-lifetime technological transformation. In today's report, we explore how inflation fits into this story for investors from a secular perspective. **The headline is that the resting heart rate of inflation looks higher than it did pre-pandemic, with 2% more a floor than a ceiling. We expect a structurally wider cone of inflation outcomes, tilted asymmetrically to the upside and centered higher than the 2010s.** Going through things a bit more slowly:

- **In the 2010s, a uniquely favorable secular backdrop kept a lid on inflation (even when cyclical conditions were running hot).** China continued to grow global market share and export extremely low-cost goods to the rest of the world; shale came online; the post-GFC deleveraging and European sovereign debt crisis weighed on consumption; and inflationary pressures from the prior decade rolled off, like the end of the commodity supercycle of the 2000s. The result was an unusual convergence of downward secular forces, which was enough to largely override the effects of upward price pressures in other parts of the consumer basket, such as services and housing.
- **Today, many structural dynamics in the new investment environment look inflationary, especially in the US.** Across the world, governments are playing an increasingly activist role in the economy. In the US, the independence of the Fed is coming under increased pressure, even though that institutional independence is a bedrock of effective inflation management. President Trump's tariff and trade policies are rewiring the global trade architecture, tilting the world away from disinflationary globalization to inflationary deglobalization. The potential end of US capital exceptionalism could drive meaningful dollar devaluation and import inflation into the US as well. The way each of these secular dynamics ultimately flows through to inflation varies—some are downward pressures on aggregate supply, others are upward pressures on demand—but the directional pressure is clear.
- **AI is the obvious wild card and could prove massively disinflationary. However, assuming that AI will more than offset all the inflationary pressures from this environment is a highly speculative bet that looks undesirable for allocators to make.** It is also proving inflationary in the shorter term—already putting clear pressure on electricity prices and driving up demand for the resources and commodities needed to expand power generation and the transmission grid. Longer term, the most disruptive AI scenarios (a productivity miracle, post-scarcity abundance) could clearly drive unprecedented disinflation, but it's easy to imagine alternative worlds where you get the booming economic conditions and higher returns on capital with a more muted disinflationary result.
- **Investors are insufficiently prepared for the risks embedded in this new environment, even though the cost of hedging those risks is low.** Most portfolios remain highly concentrated in assets that materially underperform during inflation spikes (stocks and bonds), especially when those spikes require central banks to engineer a tightening of real conditions to bring inflation back under control. They are also heavily geographically concentrated in the US, the economy where we see relatively more structural inflation risks lining up. With inflation protection relatively cheap right now, the risk/reward of tapping into more inflation protection to ensure that investors meet their desired objectives looks strong to us.

In one sense, inflation in the new investment environment is not “new” at all—it’s a return back to baseline (i.e., pre-GFC), where inflation risks are front and center and overheating cyclical conditions can see inflation bounce above target.

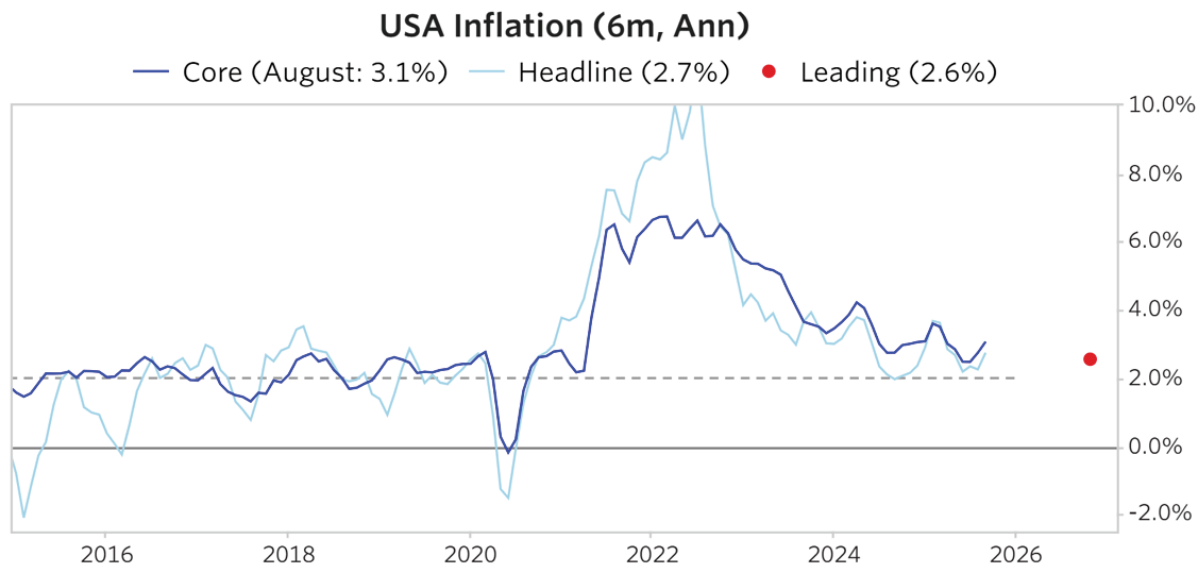


The benign inflation outcomes of the 2010s (and to a lesser extent, the 2000s) were the exception and not the norm

At the same time, much is new, and many of those new hallmarks are inflationary. The table below provides a concise summary of the most important secular pressures as we see them.

	DYNAMIC	DESCRIPTION
Upside pressures/risks	Greater state intervention in the economy	States playing an increasingly activist role in the economy (e.g., industrial policy & selection of national champions); unprecedented deficit spending & proactive fiscal policy.
	Deglobalization	Trump's tariff and trade policies & strategic vision to address the US's current account deficit; decoupling with China; onshoring and the rotation away from just-in-time supply chains.
	Threats to institutional independence	Increased attacks on the independence of the Fed (e.g., Trump calling for easier policy, for Governor Cook to be fired).
	Secular pressures on the dollar	Potential end of US capital exceptionalism, lower real rates & questions around central bank independence as downward pressures on dollar. Room for dollar devaluation to become an explicit policy goal of Trump administration ("Mar-a-Lago Accord").
	The energy transition	Cost pressures from development of green infrastructure.
Downside pressures/risks	Secular demographic trends	Deflationary impact of aging populations/demographic decline; on the flip side, tightening of labor markets in context of limited supply (per BoJ Governor Ueda's speech at Jackson Hole). Potential longer-term shifts toward more restrictive immigration policy in some economies.
	The AI transformation	Inflationary short-term pressures from electricity demand & AI capex; longer-term room for productivity miracle but extent and timing unclear.

Another way of highlighting some of the risks facing investors is to home in on the tensions embedded in the current US inflation picture. On the one hand, inflation is benign relative to pandemic-era highs and our systematic estimates expect it to continue falling somewhat. On the other hand, it is still clearly a thorn in the Fed's side, disinflation has basically stalled out for much of the last 12–18 months, and core has now been running above target (in six-month annualized core terms) for five whole years. The last half-mile is the hardest, and failing to get there can result in sustained inflation accrual that is painful for most portfolios.

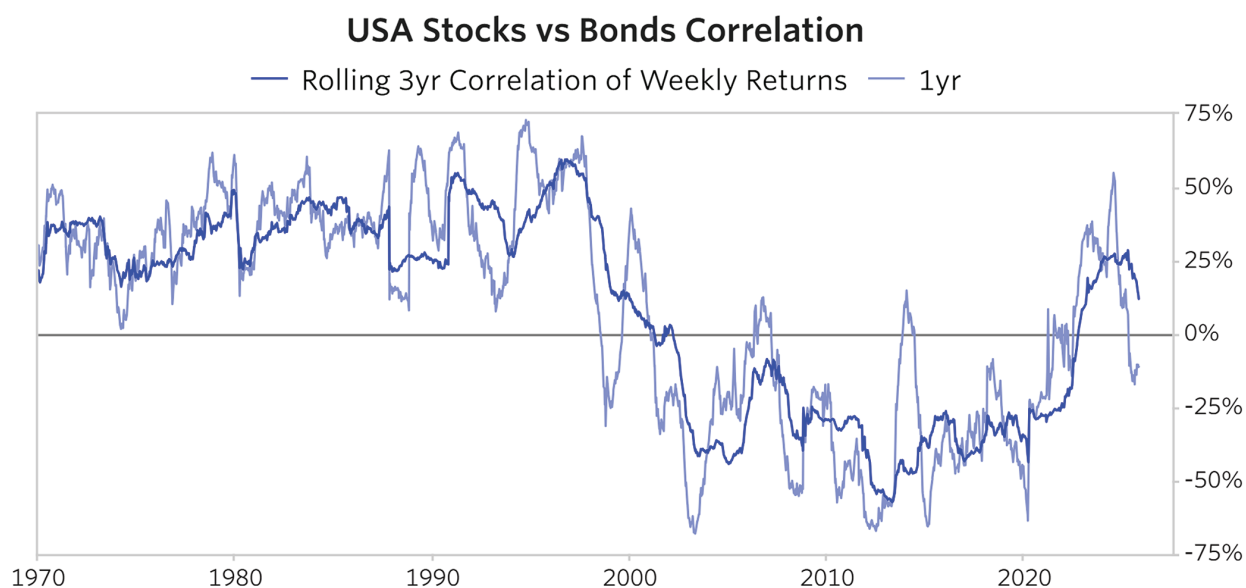


The remainder of this report is focused on further exploring the problem: structural inflation vulnerabilities amid a structurally more inflationary macro paradigm. In the past, we have written extensively about some of the ways that allocators can secure better inflation protection; in subsequent reports, we will provide our latest thinking on solutions to this problem, with an eye to unconstrained options available to allocators using a *Total Portfolio Approach*.

Most Portfolios Remain Highly Vulnerable to Unexpected Inflation, Especially in Real Terms

A core premise of our approach to portfolio engineering is that all assets have environmental biases to growth, inflation, and liquidity, and that these biases determine a given portfolio's aggregate ex ante exposures to different macro environments. Traditional portfolios are materially exposed to regimes where inflation comes in stronger than discounted—underperforming when that factor is rising in isolation, while experiencing material contraction when inflation also forces central banks to raise rates and tighten liquidity as a result.

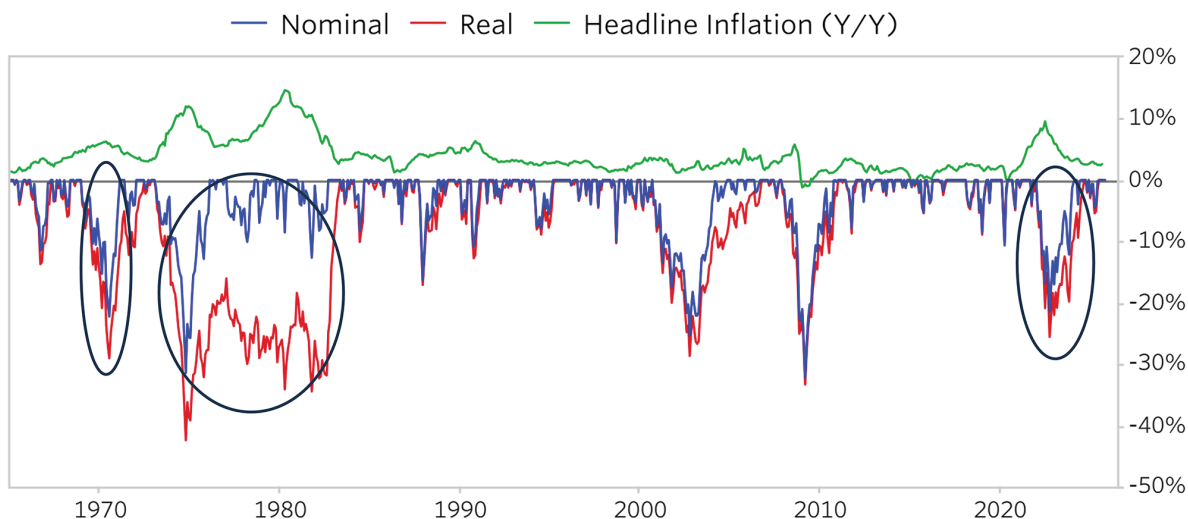
The recent pandemic shock viscerally brought this to the forefront for most investors—higher inflation volatility caused the negative correlation that stocks and bonds enjoyed in the 2000s and 2010s to flip, driving abysmal returns and outright drawdowns for 70/30s. Investors learned the painful lesson that the diversifying correlation they had grown used to had been a statistical artifact of the specific macro regime of the previous decade or so, and not a reflection of the immutable properties of the assets themselves. The chart below illustrates this; in the same way that the benign inflation of the late 2000s and 2010s was the exception, not the rule, so too was the negative correlation of stocks and bonds.



From a secular perspective, the diversifying negative correlation of stocks and bonds in the 2000s and 2010s was a departure from the decades prior

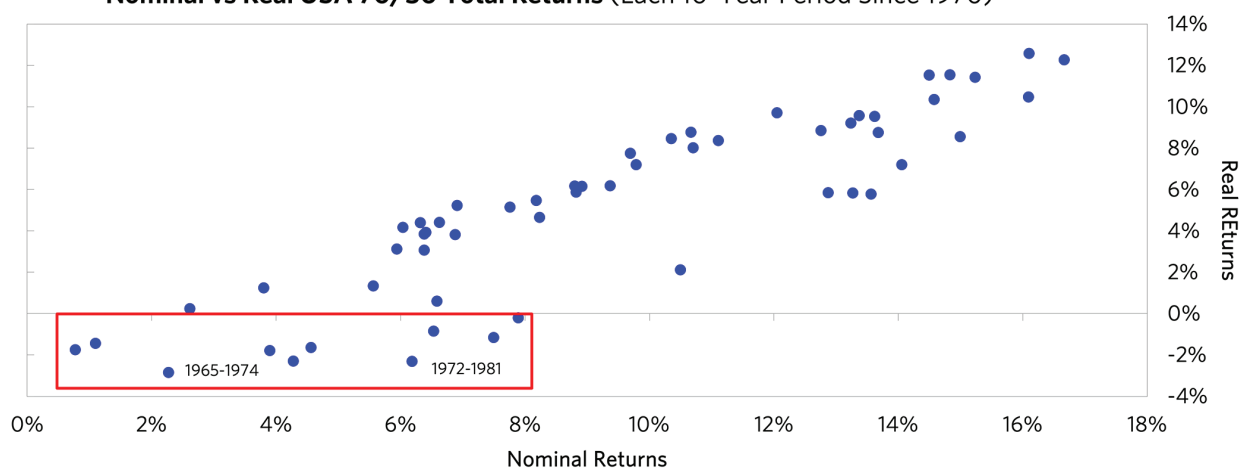
Consistent with this, roughly half of the worst drawdowns for traditional 70/30 portfolios since the 1960s have been during inflation spikes that triggered a tightening of liquidity conditions—the 1970s, the 1980s, and the COVID-era inflation spike. Importantly, during such periods, inflation also had the effect of mechanically eroding the real returns facing investors above and beyond the drawdowns they already faced in nominal terms. The late 1970s and early 1980s are an especially stark example—the traditional 70/30 took notably longer to get out of its drawdown in real terms than in nominal terms.

Inflation vs USA 70/30 Drawdown (Compounded Total Returns)



Another way that inflation impacts typical portfolios is that you sometimes see solid nominal performance that is actually extremely poor in real terms under the hood (i.e., accrued inflation has eroded real returns). The below scatter plot illustrates this, charting the annualized nominal returns versus real returns for US 70/30 portfolios for every trailing 10-year interval since 1970. As you can see, inflation accrual means that even moderate-returning decades can yield either middling or outright negative real returns under the hood.

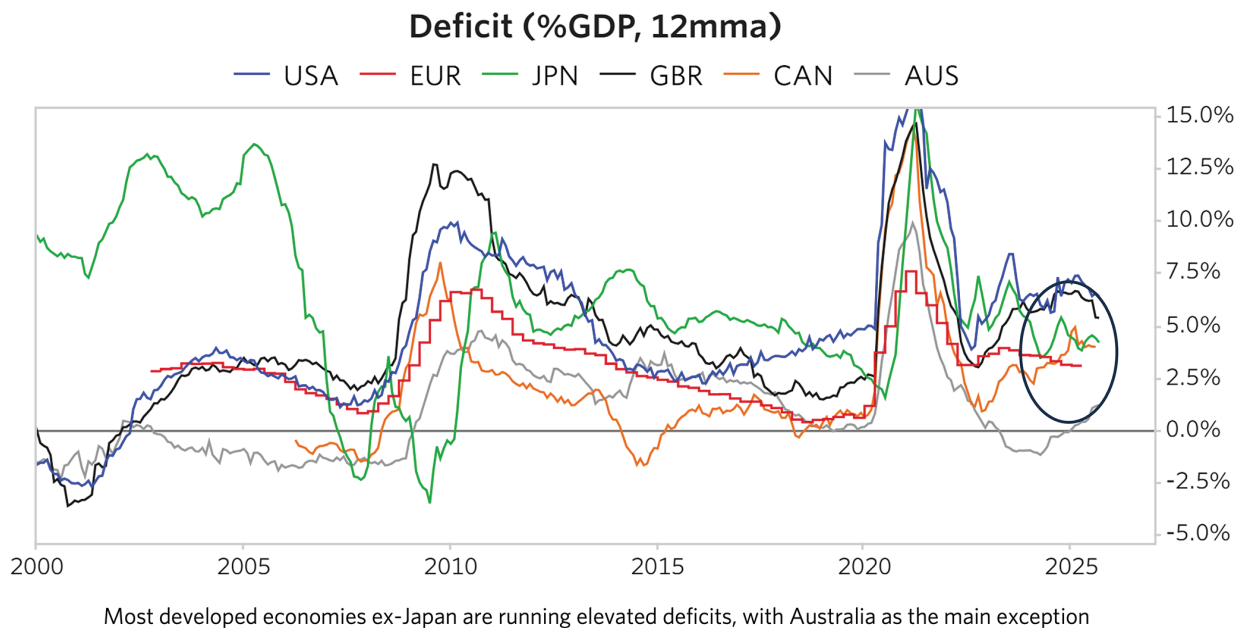
Nominal vs Real USA 70/30 Total Returns (Each 10-Year Period Since 1970)



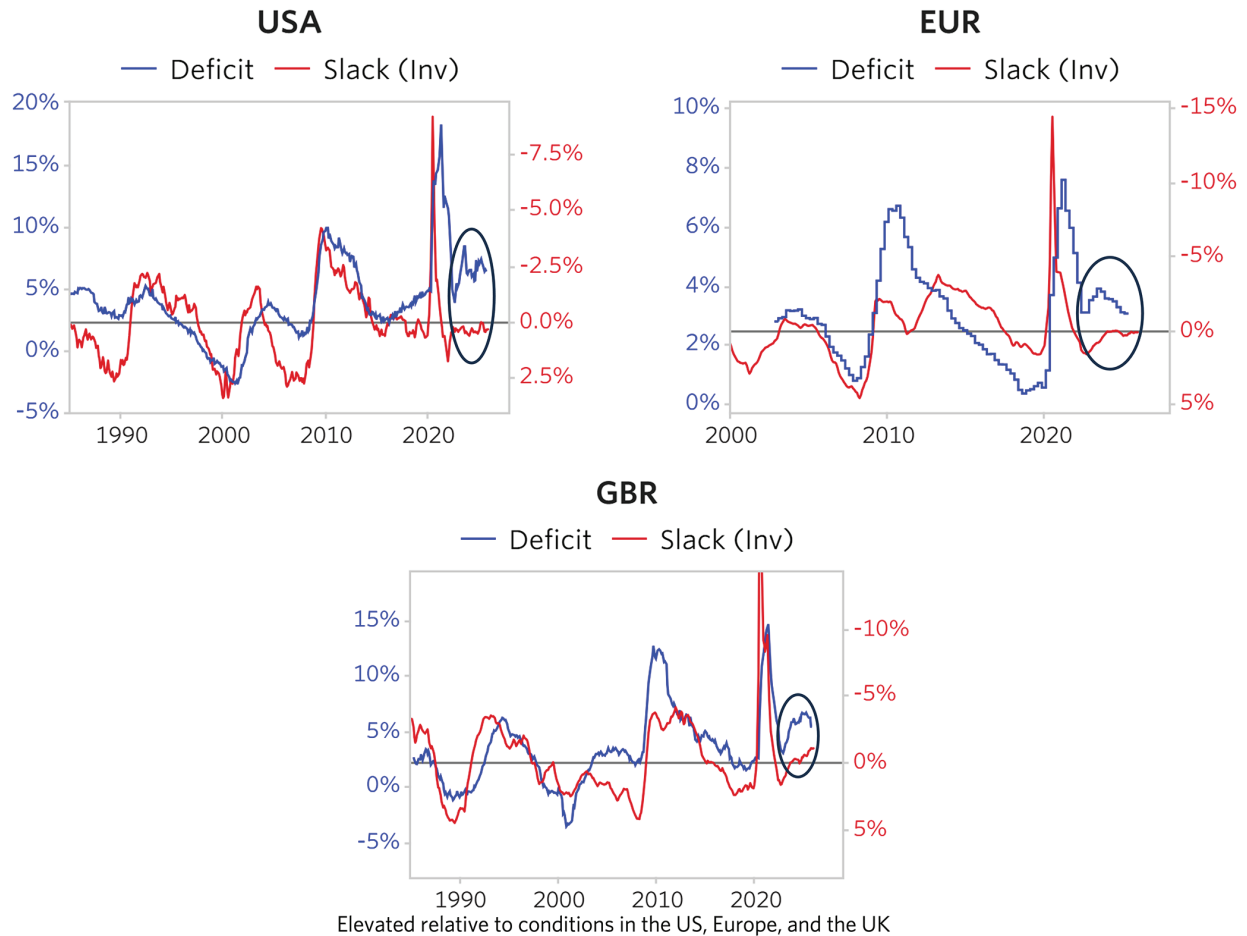
Many Hallmarks of the New Investment Environment Create Clear Upside Risks to Inflation

The state is playing an increasingly activist role in the economy, potentially pushing spending beyond productive limits

We are seeing unprecedented deficits relative to conditions across many developed economies. The US is running a ~7% GDP budget deficit despite the fact we are in a mid-cycle expansion. It's easy to see how that could easily shoot up several percentage points should conditions weaken, revenues fall, and automatic stabilizers kick in (though to be clear, that is not our base case over the next 12 months). This isn't just a US phenomenon—we're seeing similar dynamics in Europe and the UK as well (though not Canada, where the deficit is consistent with pronounced weakness, or Australia, which is benefiting from its status as a major commodity exporter).



Deficit (%GDP, 12mma) vs Economic Conditions



Elevated relative to conditions in the US, Europe, and the UK

This fiscal posture can be inflationary in three main ways: 1) it is a source of additional demand being funneled into economies that don't need conditions propped up; 2) it risks being spent in particularly inflationary areas/ways; and 3) the borrowing itself can crowd out important private sector activity in a way that is inflationary longer term.

On the second point: in general, the public sector is less price-sensitive than the private sector, especially when its spending is targeted at areas of specific strategic or political interest. The inflationary impulse is clearest when the policy impulse basically boils down to extra nominal spending not attached to more capacity build-out (e.g., social service provisions). Sometimes the pressures are more cross-cutting, as is the case when policy is specifically geared toward building productive capacity. The concerted defense push is a good example here: NATO member states are mobilizing a huge pool of spending in support of a specific strategic object, and one upshot of this is that many will meaningfully build out their defense and manufacturing capabilities. Even if this is disinflationary longer term, the efforts are likely to push up against price constraints in the interim.

Quotes from Key Policy Makers	Announced Policies
EC Pres Ursula von der Leyen: “The need to invest in our security is therefore becoming ever more urgent. And we know that this investment will not come from anywhere else.” Canadian PM Mark Carney: “We will ensure that every dollar is invested wisely, including by prioritizing made-in-Canada manufacturing and supply chains. We should no longer send three-quarters of our defense capital spending to America.” British PM Keir Starmer: “The realities of our dangerous new era mean that the defense and national security of our country must always come first.” Swedish PM Ulf Kristersson: “Sweden and Europe are facing an entirely new security environment. That’s why today we unveiled Sweden’s largest military rearmament plan since the days of the Cold War.”	• Germany: Debt brake reform • EU: Readiness 2030 • Canada: Increase defense spending to 2% of GDP by March 2026 • UK: Increase defense spending to 2.5% of GDP by 2027 • Sweden: Increase defense spending to 3.5% of GDP by 2032 • Norway: Increase defense spending to 3.3% of GDP in 2025 • NATO members: Increase defense spending to 5% of GDP by 2035

Elevated deficit spending relative to conditions also risks crowding out business capital investment, which could be inflationary longer term. It’s the total amount of borrowing in the economy that matters, and when the public sector is borrowing this aggressively, that ratchets up rates and crowds out the private sector. The UK is a useful case study here. It has experienced the worst productivity growth in the developed world over the last few years owing to a combination of 1) the long-term drag from Brexit-induced capex underinvestment, 2) large and growing government spending on social services (e.g., healthcare, entitlement spending), and 3) inflexible labor markets. The capex hangover is only one piece of the story, and it was largely driven by Brexit and not elevated rates, but the UK case nevertheless highlights the risks associated with secular pressures that decrease the private sector’s marginal propensity to drive business fixed investment.

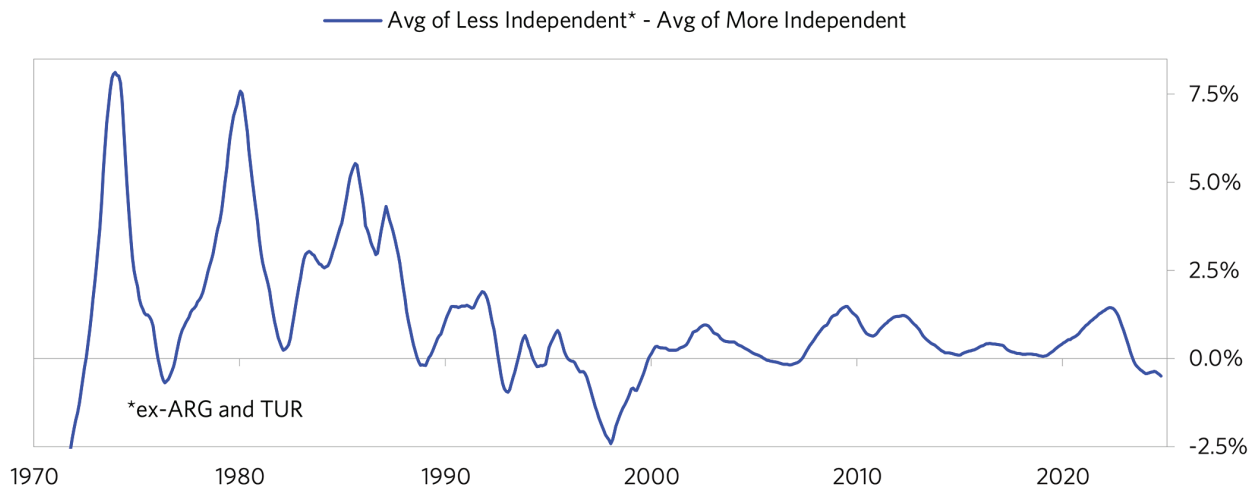
Central bank independence—a foundation of modern inflation management—is increasingly under threat in the US

Over the past few months, Trump has ramped up criticism of the Fed for keeping rates restrictive relative to his preferred policy posture. He has also taken actions to assume greater executive authority and influence over the body, raising questions about its trajectory. Below, we lay out some of Trump's key quotes and actions, most recently firing Governor Cook over alleged mortgage fraud, a firing that Cook is contesting in the courts.

Trump Administration's Comments & Actions with Regards to the Fed	
Criticisms of the Fed's Monetary Policy	"You are, as usual, 'Too Late.' You have cost the USA a fortune and continue to do so. You should lower the interest rate by a lot! Hundreds of billions of dollars being lost! No inflation." —President Trump, 6/30 "Could somebody please inform Jerome 'Too Late' Powell that he is hurting the Housing Industry, very badly? People can't get a Mortgage because of him. There is no Inflation, and every sign is pointing to a major Rate Cut." —Trump, 8/19 "I'd love if he wants to resign, that would be up to him. They say it would disrupt the market if I did." —Trump, 7/16
Changes to the Fed Board	Said Fed Governor Kugler resigned over disagreements with Powell's monetary policy stance. Trump fires Governor Cook over alleged mortgage fraud and potential DoJ investigation. Stephen Miran, chair of the administration's Council of Economic Advisors, appointed to the Fed as a voting governor.

Central bank independence is a hallmark of modern inflation management. There is a range of outcomes around what happens under less independent central banks, with the main risk being that politicians are more likely to push central banks to ease. But, on balance, that intervention generally increases the odds of an undesirable inflation outcome. At the start, there is often a valid case for easier policy, as we see today (albeit with a small margin for error). Over time, however, political influence generally expresses itself as a downward pressure on rates relative to conditions. This can also weigh on the currency (either because of the lower rates, or because of capital outflows as investors shift to price in higher political risk premiums). Consistent with this, economies with less independent central banks have typically seen higher realized inflation over the long run.

Inflation vs Target in Economies with Less vs More CB Independence

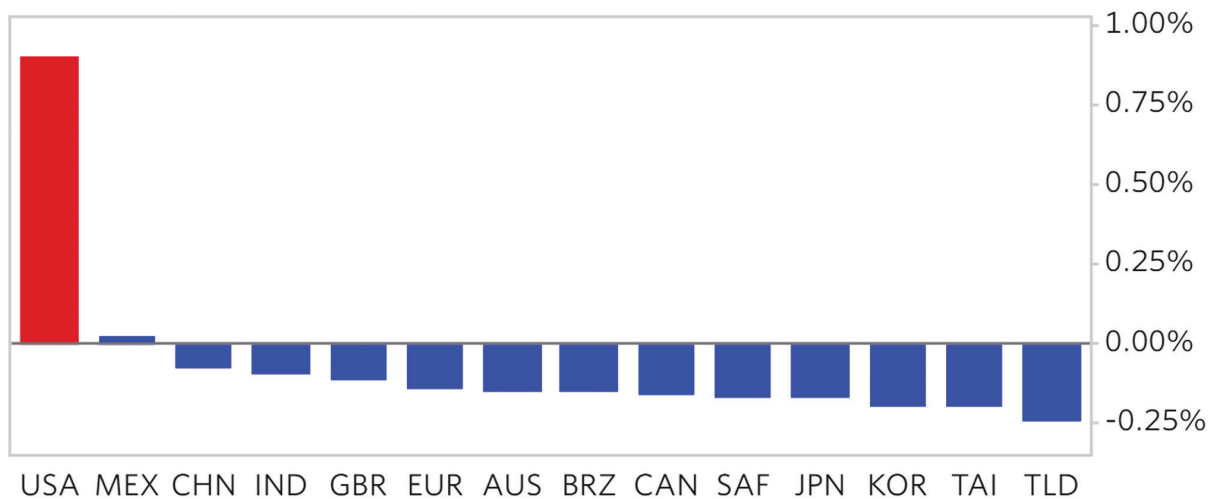


Exactly how things shake out is unclear, and it's far from our base case that Trump fully takes over the keys of the FOMC, but this is a structurally new inflationary risk facing the US that investors need to keep front and center.

An unprecedented attempt at rewiring the global trade architecture is unfolding in real time

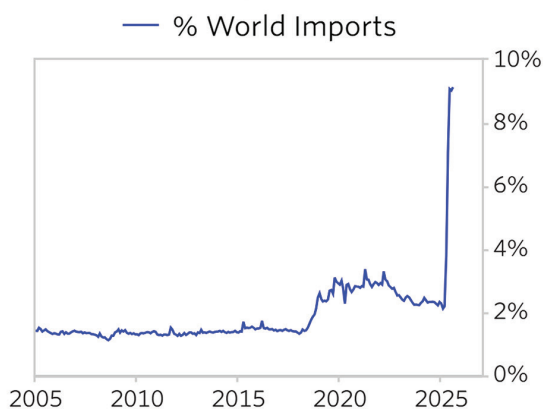
Thus far, modern mercantilism has been a disinflationary pressure basically everywhere outside the US. By triggering a sharp dollar sell-off, it has materially decreased the cost of dollar-denominated commodities in local currency terms outside the US, and by engineering profound hurdles to US/China trade (at times an effective trade embargo, at other times just meaningfully elevated tariffs), it has increased the odds that we will see Chinese goods dumping in non-US markets. Even in the US, we're mostly reading Trump's tariff regime as driving more of a one-off price increase rather than creating sustained inflation pressures.

Est Inflation Impacts (Incl Excess Global Supply, Next 12m)

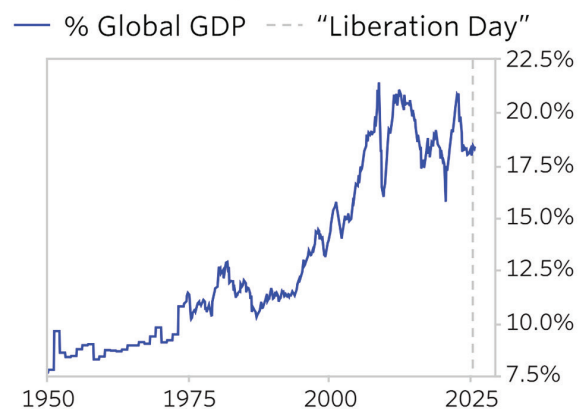


But what matters is not the effects of what's unfolding right now—it's the long-term strategic vision that Trump's 2025 tariff and trade policies are in pursuit of. Trump is trying to engineer a seismic reversal of more than half a century of globalization—a rotation away from lowest marginal-cost production, the global division of labor, and just-in-time supply chains to a world that prioritizes domestic industrial bases and balanced current accounts. It's not clear how far this rewiring will go, but the cost of things like a US manufacturing renaissance is the higher prices necessary to sustain them and a potential misallocation of capital to get there.

USA Average Tariff Rate

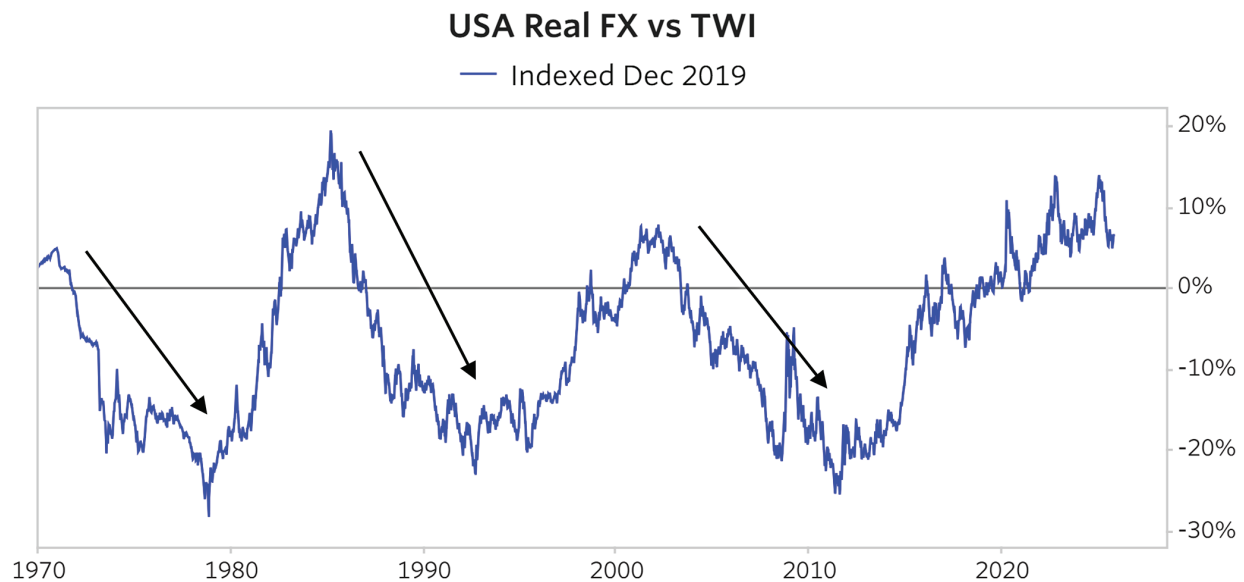


World Export Volumes



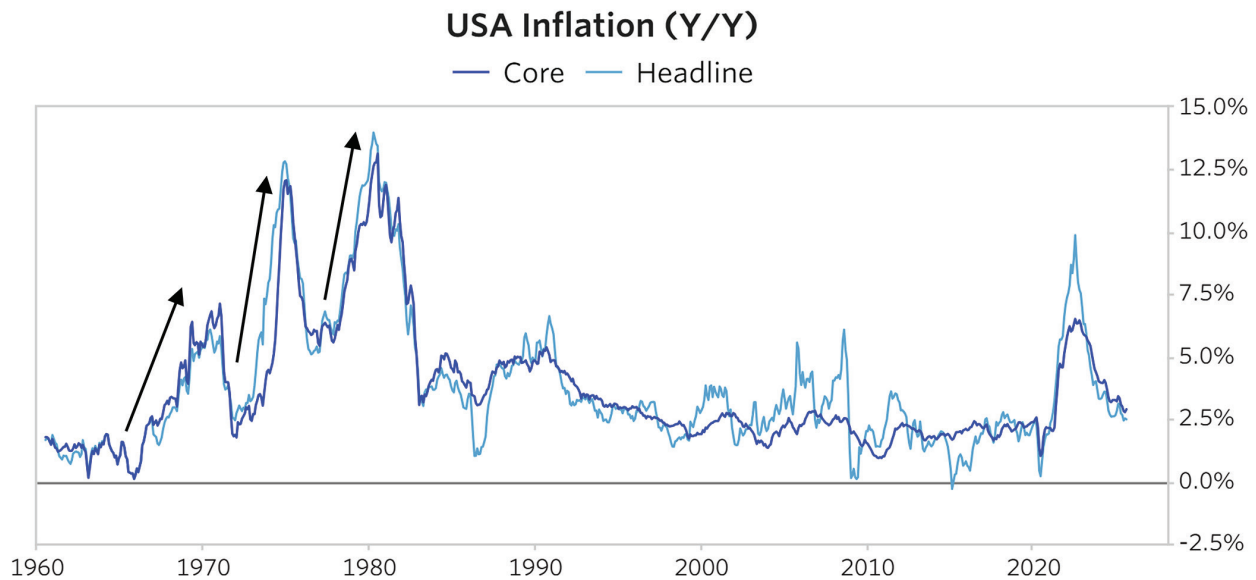
A confluence of secular pressures could weigh on the dollar and import inflation into the US

The potential end of US capital exceptionalism, threats to Fed independence, and lower real rates are all directionally dollar-bearish pressures that are unfolding at a time when the dollar is still relatively expensive in real terms (even accounting for the recent sell-off). As you can see in the chart below, scanning back over the last few decades highlights just how far dollar devaluation can run when it picks up steam. Dollar devaluation cycles have generally been associated with commodity bull runs (true in the 1970s and 2000s, more mixed in the 1980s). Commodities being dollar-denominated means that these cycles are a cheapening of commodities in local currency terms, pushing up demand, but also a hit to the revenues of commodity producers in dollar terms, encouraging them to pull back production and/or delay capex. As we scan ahead, dollar devaluation is likely to exert itself more through commodities than imported goods inflation, as most US trade is invoiced in dollars, but we'd still expect a marginal upward pressure through the goods channel as well.



The recent inflation wave has likely increased the risks associated with future price shocks

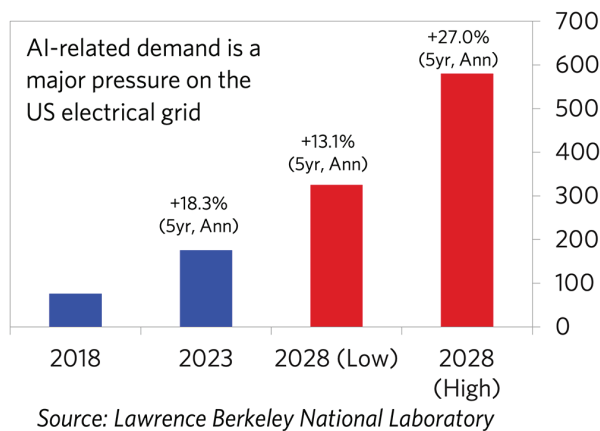
The 1970s and 1980s are the canonical proof point that once you've let the cat out of the bag, it can be hard to get it back in. After one painful experience, businesses can become more willing and able to pass on factory-gate inflation, and consumers can become more attuned to the impact that inflation has on their real wages. Put differently, one inflation wave can lay the foundations for the second by attuning players in the economy to inflation and rewiring how they respond to price pressures—even ones quite divorced from the initial price shock. That amplifies the risks associated with subsequent shocks and all else equal increases the odds they manifest in wage-price spirals.



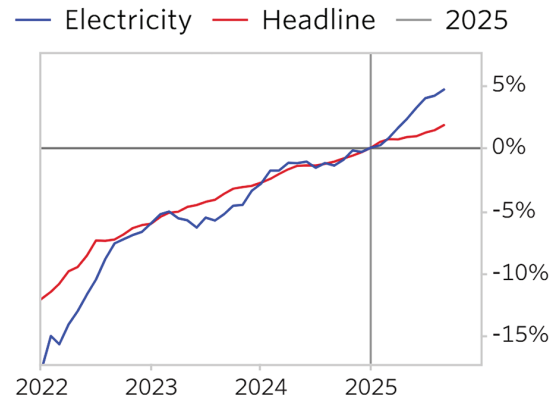
The AI Transformation Is the Main Force Pushing the Other Way, but the Extent and Timing Are Unclear

The AI transition is already coming up against supply constraints and creating inflationary pressures. This transformational technology has a physical footprint—AI compute requires a huge amount of electricity and the underlying infrastructure (data centers, transmission grids) to support that energy demand. We're already seeing the impacts as a result: electricity inflation is outstripping the broader price pressures in the economy; colossal data center capex (much of which is still ahead of us) is flooding nominal spending into the US, helping prop up the expansion; and this capex is pushing up against constrained supply for key input materials.

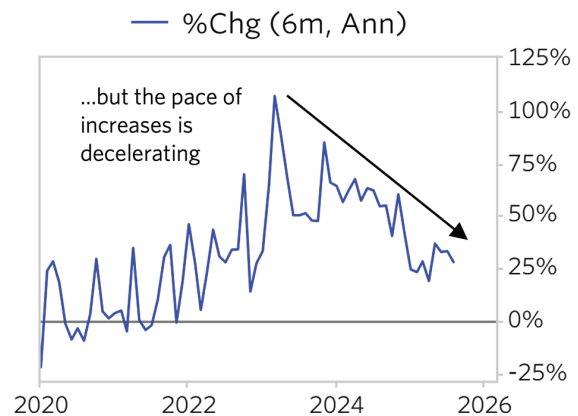
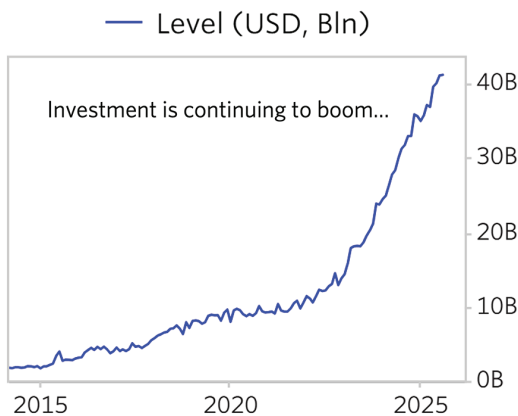
USA Data Center Electricity Consumption



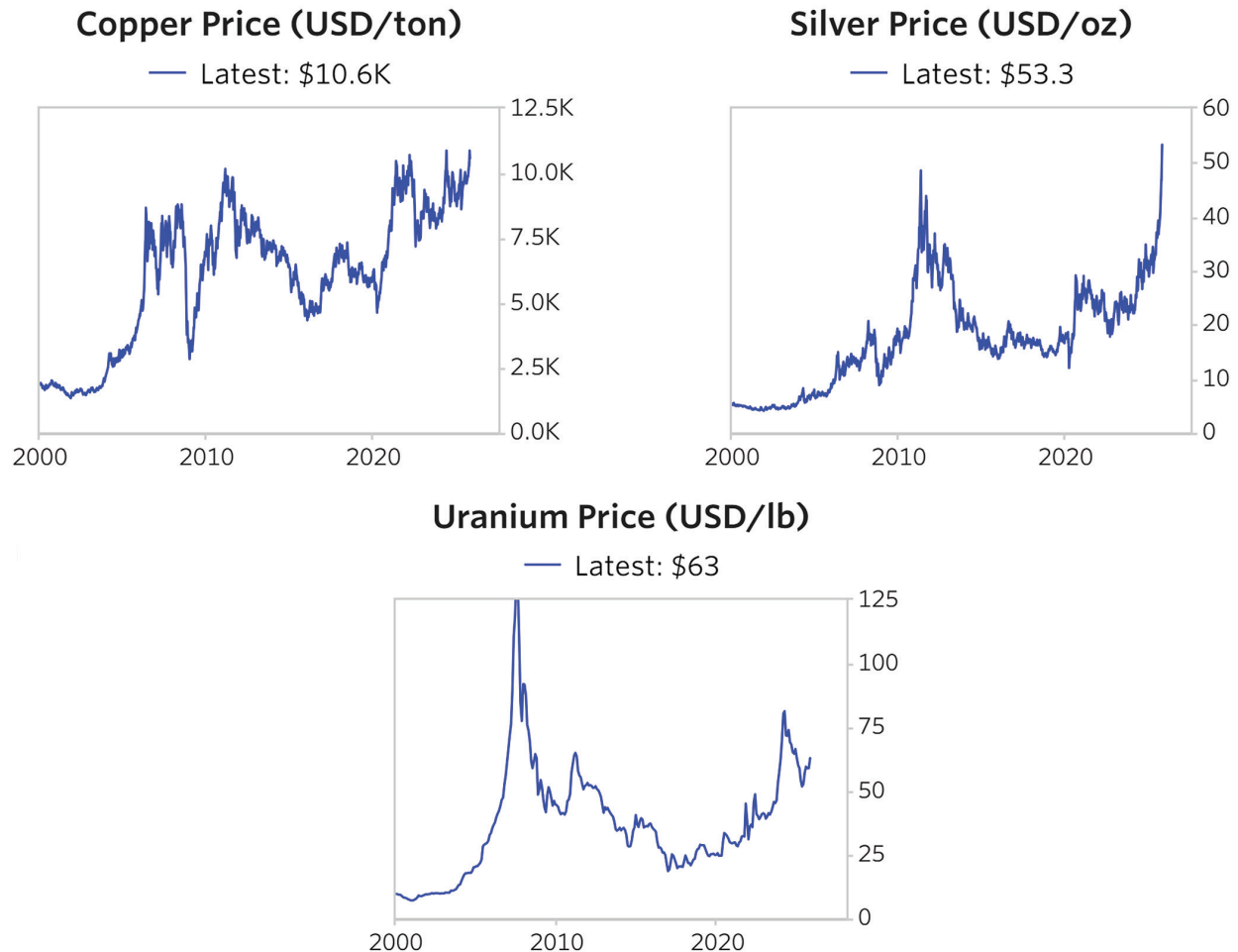
Electricity CPI (Lvls, Idx EoY 2024)



USA Data Center Construction Through July 2025



This wave of AI capex build-out is also putting an upward pressure on key input commodities like copper, silver, and uranium at a time when the supply/demand picture in these markets already looks tight under the digitization push and the energy transition. If AI adds additional incremental demand, these commodities look set to experience significant structural supply deficits and upward price pressure.



The wild card is how much productivity this AI transformation unlocks, how that productivity flows through to conditions, and over what time frame this occurs.

The linkages are relatively clear: productivity improvements will decrease the cost of labor on a productivity-adjusted basis; the automation of work will cool the labor market (to the extent that it erodes aggregate demand for labor and does not simply improve how productive that labor can be); AI will spur cost-saving technological innovations, driving down costs (to the extent that businesses do not simply absorb those savings in their margins); and AI will also spur quality-enhancing innovations, driving down goods inflation on a quality-adjusted basis.

The question is the magnitude. Trying to quantify these dynamics is ultimately highly imprecise, because there is a huge cone of outcomes around where AI settles and the ultimate impact on the structural economic landscape. The question then is what investors ought to do given that cone of outcomes. As stated above, **the bet that the disinflationary impact of AI will be more than enough to offset the long list of secular inflation risks is ultimately a speculative one, and one where the risk/reward for allocators does not look attractive.**

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