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Markets in a fragmented world

Klaas Knot on fragmented markets, fragile calm, and the future of monetary sovereignty

UBS

Klaas Knot (Former Governor De Nederlandsche Bank) and Massimiliano Castelli (Head of Strategy & Advice, Global Sovereign Markets, UBS Asset Management)

Klaas Knot served as President of De Nederlandsche Bank for fourteen years and, simultaneously, as Chair of the Financial Stability Board. This makes him one of the most consequential figures in global financial governance, with a tenure that included the aftermath of the global financial crisis, the euro area's existential stress tests, a pandemic, an inflation surge and the accelerating fragmentation of the geopolitical order.

As a long-serving member of the ECB Governing Council, he was among the most persistent advocates for early monetary tightening when the consensus still favored patience, and one of the clearer voices on the risks accumulating at the edges of the regulated financial system.

In an exclusive interview, he had a wide-ranging conversation with Max Castelli, that is directly relevant for all types of investors. Topics covered include: the structural gap between geopolitical disorder and financial market calm; the durability of US growth driven more by AI-linked capital spending and asset-price wealth effects than by broad productivity; Europe's surface stability against its deeper structural stagnation; the conditions under which dollar reserve dominance could credibly erode; and the migration of systemic risk into private credit markets and retail-packaged products that have yet to be tested across a full credit cycle.

Klass Knot

Tuning out risk and narrative-driven markets

Knot noted that investors have adapted to instability, so much so that they may no longer distinguish disruption that can be absorbed from that which cannot. This leaves markets in what Castelli describes as a "fragile but persistent" equilibrium: geopolitical uncertainty remains high, and while markets stay resilient, sensitivity to truly systemic shocks is rising. The point is not that the system has become stable, but that it can appear durable right up until an extreme event forces a repricing.

Political pressure that might once have rattled currencies or pushed long term yields higher now often passes with little effect. Investors appear to have raised the threshold for what qualifies as meaningful risk.

The danger, however, lies in the accumulation of risks. The nature of risk is that it can compound over time and, just because risks are ignored or discounted, that doesn't mean they disappear. Put another way, a system trained to respond only to extremes may appear calm precisely when underlying fragilities are growing.

Nowhere is this tension more visible than in the United States. On paper, several forces should be weighing on growth. Higher tariffs, increasingly restrictive migration policies, and unresolved questions about fiscal sustainability would ordinarily dampen economic momentum.
Yet growth – and the equity market – remains resilient.

The underlying market logic is clear. Investment driven by artificial intelligence has taken on an outsized role in the economy, large enough to dominate many traditional headwinds. Capital spending linked to data centers, chips, energy infrastructure and automation is reshaping the outlook, at least in the near term.

What makes this phase unusual is that employment growth has slowed, yet consumption continues to expand. The link between work and spending has weakened, replaced instead by rising asset prices and the wealth effects they generate. And consumption is increasingly concentrated among the most affluent households.

This economic reality creates a self reinforcing loop in which markets validate expectations of future productivity and households respond by spending based on paper gains. As long as those expectations hold, the system remains stable. If they falter, adjustment may be abrupt. The issue is about the timing of productivity gains. Transformational technologies can be both real and over capitalized. The internet itself followed that path; productivity arrived, but not on the schedule markets first assumed.

Europe's structural challenges and de-dollarization?

By contrast, Europe's resilience looks like a consumer story. Households remain relatively well capitalized, debt burdens are manageable and unemployment across much of the euro area is at historic lows. And, after the shocks of recent years, inflation has settled close to target.

In the short term then, Europe appears quite balanced. Over the longer term, the picture looks less healthy. Deep-rooted structural impediments constrain Europe's capacity to adapt and compete, leading to chronically low potential growth. Europe's internal fragmentation is the most obvious roadblock. Despite decades of integration, restrictions on services, cross border labor mobility, procurement and financial flows act as hidden tariffs imposed by Europe on itself. Efforts to deepen banking and capital markets integration have advanced formally, but retreated in practice.

The consequences extend beyond growth rates. External influence depends on internal coherence and a currency, a financial system or a regulatory framework cannot project power internationally if it remains fragmented at home.

Periods of dollar volatility repeatedly trigger speculation about alternatives. Yet reserve status is sustained by depth, liquidity and scale. Investors seeking safety require instruments that can absorb vast volumes without friction.

The contrast between markets remains stark. US Treasuries trade in volumes that dwarf those of any single European sovereign bond. And fragmentation means that even collectively large markets struggle to function as substitutes. As a result, interest in diversification away from the dollar tends to be incremental. Capital shifts at the margins and, without common safe assets and fully integrated capital markets, Europe's financial system cannot offer a credible alternative, regardless of political intent.

Money, sovereignty and apparent calm

Uncertainty about political power inevitably reshapes attitudes toward money. Gold's renewed prominence reflects this search for assets unencumbered by institutional affiliation. Its appeal reflects a perceived protection against scenarios in which correlations collapse and conventional hedges fail.

Parallel debates are playing out in the digital sphere. As cash recedes and private payment systems expand, questions of monetary sovereignty become unavoidable. Public money serves as a settlement anchor precisely because it carries no counterparty risk. In moments of stress, this matters. Efforts to modernize payments are therefore an institutional response to a world in which trust in intermediaries cannot be taken for granted indefinitely.

Strip away the policy detail and market commentary, and a single insight from Knot stands out. Markets have become highly adaptive. In learning to live with geopolitical tension by discounting it unless it reaches extremes, investors have normalized structural fragmentation by treating it as slow moving and therefore irrelevant. They have embraced artificial intelligence as a growth engine while postponing hard questions about valuation and distribution. And they have assumed that systemic risk has been tamed, even as it shifts into less visible domains.

The calm is real. The danger lies in trusting it too much.

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