

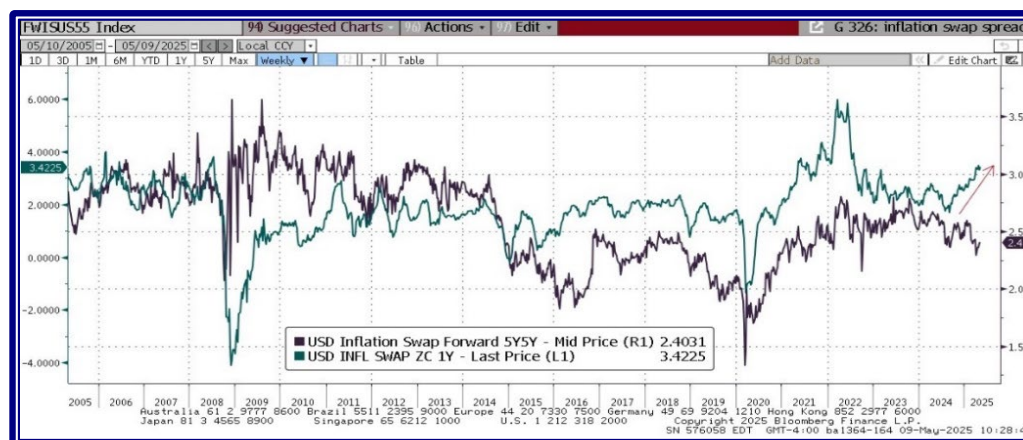
IN BRIEF: The U.S. Fixed Income Markets & Strategy

The Federal Reserve kept its key interest rate unchanged at this month's meeting. The economy is growing at a comfortable pace, the labor market is solid with ample participation, and inflation, while it has come down, is running just above its 2% target. Uncertainty and the risks of higher inflation from tariffs are rising, though. The Fed is waiting for clarity on the duration and magnitude of tariff policy and the impact on incoming economic data to pave the way to lower rates with conviction. At least some tariff relief is necessary to avoid a lasting impact on overall price levels. Chairman Powell stated in his remarks, "if the large increases in tariffs that have been announced are sustained, they're likely to generate a rise in inflation, a slowdown in economic growth, and an increase in unemployment,".

Additionally, the fallout from ongoing DOGE initiatives has yet to find its way through the system and into economic data. The ability of state and local governments to absorb the consequences from reductions in funding, services and workforce levels is yet to be known. We could see increases in layoffs and disruptions or even cutbacks in crucial services across a variety of industries.

The markets appear to be betting on at least some degree of tariff reversals. A quick comparison of inflation swaps spreads tells us the threat of inflation from tariffs is anticipated to be temporary. The 1-year swap rate (green line) climbed to over 3.40%, up from just 1.75% back in August, highlighting growing inflationary concerns for the short-term. However, the 5-year swap rate (purple line) is little changed since August, indicating that longer term inflationary expectations are more subdued.

1- & 5-Year Inflation Swap Rates



This swap rate¹ analysis tells us the Fed has an opportunity to support demand with fewer rate cuts. The risks to this case are that tariffs develop into a prolonged trade war and/or there is a DOGE fallout effect that overburdens state and local governments. In this case, the Fed has the additional challenge of balancing the need for lower interest rates as the economy slows within an environment of rising price levels. It's not likely in our view that tariffs will be rolled back in their entirety. With the plethora of ongoing negotiations, it is more likely that the pause in tariffs will be extended. The Fed's moderately restrictive policy lands them in a good position to act appropriately as conditions evolve.

¹ A swap rate spread is the interest rate expected to swap a floating rate note to a comparable duration fixed rate note. It is a measure of interest rate risk for a given period. A spread widening represents an increasing likelihood of higher inflation at the time the bond matures.

Another important caveat is that a framework of the Federal Budget is expected within the next week or so. Economists can then assess what tax cuts are included and what the timeframe will be. Whether the budget will be deficit-neutral or simply an effort to boost economic growth in an attempt to offset tariff pressures remains to be seen. The latter would most certainly fuel a rising deficit and higher inflation making it more difficult for the Fed to lower interest rates. Concerns over a rising deficit combined with stagflation pressures and uncertainty are limiting the upside to U.S. Treasuries, with the current 10-year yield somewhat range bound between 4.2% and 4.4% since the tariffs were announced.

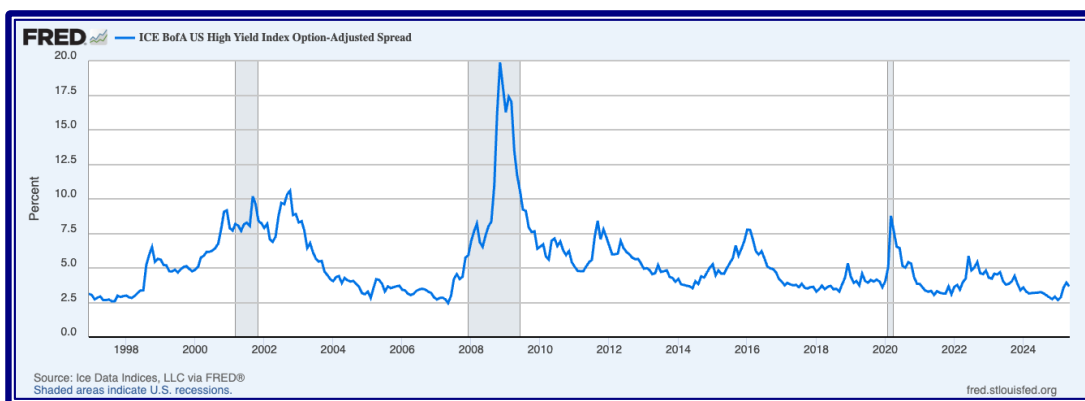
2–10-year Treasury spreads returned to positive territory in August of 2024, as the markets began to anticipate greater pro-growth policies leading up to the election. Throughout the duration of the latest inverted curve, the economy showed resilience and avoided a recession. However, uncertainty is weighing on Treasury spreads as they modestly retreated in April and the spread remains well below its long-term average.

10-Year Minus the 2-Year U.S. Treasury Spread



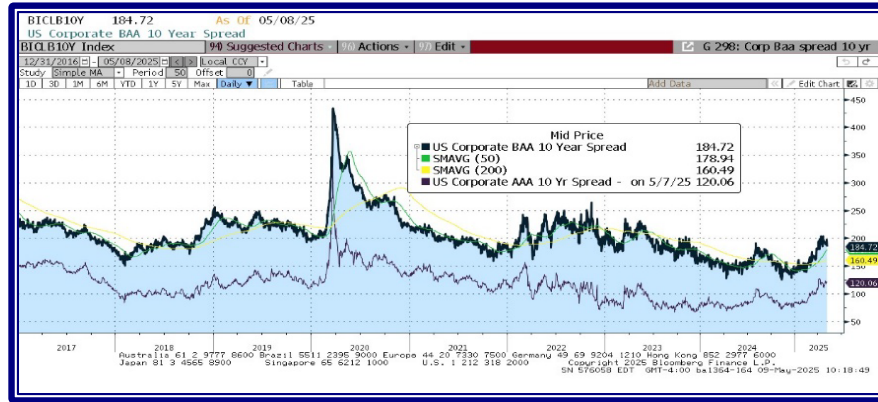
High yield spreads, although elevated off January lows, remain relatively low. The loftier the spread, the higher likelihood and greater intensity of a recession. Current spreads indicate that although recession probabilities are rising, one might be milder in nature.

High Yield Spread



Year-to-date through the first week of May, corporate bonds lead fixed income markets climbing 3.25%, followed closely by U.S. Treasury and Agency indexes which traded up 2.64% and 2.31% respectively. High yield bonds were up 1.51% as compared to only 0.48% for AAA municipals. So far this year, bonds performed their job protecting principal and providing income, as the S&P 500 index fell over 3% through mid-May. The relative out-performance of the bond market took place during the first 3 months of the year, as market volatility after April 2nd “Liberation Day” has kept markets range-bound awaiting policy certainty. Treasury yields trended lower overall this year after peaking at 4.79% in mid-January. Credit spreads widened, particularly in high-yield, as policy-related growth concerns weighed on risk assets.

AAA & BAA 10-Year Corporate Bond Spreads Trending Higher



IN CONCLUSION:

In the near term, the short end of the Treasury curve could find support at current levels as economic data weakens. Additionally, 10-year yields are relatively higher over the past 15 years and suggest a potential buying opportunity. However, although we expect more deal announcements, the overall effective tariff rate could remain relatively high between 10-20%. Trump has consistently favored tariffs to raise tax revenues and Steve Marin, the chair of the Council of Economic Advisers, has himself referenced 20% as an optimal tariff rate. A 20% effective tariff could result in a higher core PCE inflation rate, currently running at 2.6%, and pushing short rates toward 4.0%. This would result in a marked slowdown to GDP forecasts which were running at 3.0% pre-tariff, according to MRB research. Analysis by the International Monetary Fund determined that a universal 10% rise in U.S. tariffs, accompanied by euro area and China retaliations, has the potential to reduce U.S. GDP by 1%, and global GDP by roughly 0.5%, through 2026. Once the impact begins to flow through into economic data, the yield curve is likely to steepen. But keep in mind, Trump's 90-day tariff pause demonstrates the administration's sensitivity towards adverse policy reactions and therefore yields may be capped at 4.5-5%. We are comfortable at this point to take opportunities in high quality issues, limiting duration between 2-5 years or the belly of the curve.

10-Year U.S. Treasury Yield



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