Macro Talking Points

Fixed Income Insights

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In brief

- **Trade war escalation**
- **Keep an eye on the US yield curve**
- **At least the US Q4 GDP data was strong**

It is absolutely tariffic. The trade war is now in full swing, with the announcement of so-called reciprocal tariffs imminent. There is little visibility about the product scope and potential country exclusions, but preliminary indications point to the effective tariff rate reaching its highest level since the 1940s. The damage to global investor appetite has already been done, and consumer and business sentiment have also taken a shock, but we will have to wait a bit longer to see this reflected in macro data. Ultimately, the tariff impact on US growth may be substantial, possibly to the tune of roughly one percentage point, if not more. The adverse shock will manifest itself through different transmission channels, including a tax-like effect on consumer spending and a deterioration in financial conditions, among other effects. The key question is whether it will be bad enough to tip the US economy into recession. For now, the odds are against this outcome, but clearly the probability of recession is being revised upward. The list of key indicators to watch includes initial jobless claims, real consumer spending, corporate revenues and profit margins.

Looking ahead, an important question is whether the tariff shock will be permanent or temporary. In other words, is there a Trump put in the future? And could there be a Fed put as well? On the latter, it is reasonable to think that the US Federal Reserve could accelerate the pace of policy easing, but the potential cuts will likely be backloaded, and only if there is evidence that growth fundamentals have been badly damaged. As for the Trump put, there is a chance it could get triggered sooner. The bullish narrative around Trump 2.0 has been about short-term pain versus long-term gain, but it is really all about calibration. If the short-term pain becomes more severe than anticipated, and if it becomes evident that the growth-supporting policy agenda (tax cuts and deregulation) will fall short of offsetting the tariff pain, the Trump put could well be activated.

What does this all mean for fixed income? On the rates side, the backdrop for duration is probably turning more supportive. Until recently, the balance of risks to rates was skewed to the upside, but this is evolving quickly. We will also be watching credit spreads for the risk of further widening. As of now, US high-yield spreads have risen by some 85 basis points from their February lows, a meaningful move from a valuation standpoint.[1] Meanwhile, it is worth noting the US investment-grade spreads have so far displayed remarkable resilience. To be clear, HY spreads are still far from pricing in a US recession. Historically, the US HY spread widens at least 225 bps around recessions, as was the case during the mild 2001 recession. From an asset allocation standpoint, fixed income clearly remains an attractive de-risking asset class that may help investors manage the challenging market environment.

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Watch for yield curve signals. There have always been a lot of moving parts with the US yield curve, but given the uncertain times, it is worth paying attention to what the curve may be telling us. Until recently, the curve was in bear steepening mode. Not a great pattern as it typically tends to be associated with a negative shock to risk sentiment. Indeed, previously investors were focusing mainly on the potential inflationary impact of the looming trade war. However, we seem to have moved on. The curve may still be in steepening mode, but this time, it is of the bull steepening variety because market expectations are now pricing in more Fed cuts going forward. At this juncture, there are three and two-thirds Fed cuts priced in over the next year.[2] At this pace, we may soon be back to pricing policy easing in triple-digit basis point territory. The last time the rates market priced in at least four Fed cuts was back in early November 2024 before the Fed's hawkish December pivot. Going forward, investors will legitimately get nervous again if the yield curve stops steepening and goes back to bull flattening. If that happens, it will likely signal they are positioning for a significant deterioration in growth beyond what the soothing impact of potential rate cuts might produce. We are still some 35 bps away from inversion, so there is ample cushion for now, but let's keep a close eye on the yield curve.[3]

A look at the rear window. Investors take little comfort in backward-looking data, but these matter in the bigger macro picture The final revision of US Q4 GDP, which was published last week, looked pretty solid. The road ahead may look lot bumpier ahead, but it is worth stressing that the US economy is entering this zone of turbulence in a position of relative strength. The highlights of the GDP release included healthy profit margins — estimated at 18.2%, not far off their cyclical high — as well as robust consumer spending.[4] While the macro risks are now heavily skewed to the downside, it will all boil down to the magnitude and the duration of the looming growth shock. Between growth and inflation, it has become clear that the focus has now shifted to growth risks. With that in mind, nonfarm payroll this week will be a major datapoint to watch. A print below 100,000 may well spell trouble and further ignite fears of a major growth shock. ◢

Endnotes

[1] Source: Bloomberg. Bloomberg US HY spreads, data as of 27 March 2025.

[2] Source: Bloomberg. Based on the Overnight Index Swaps (OIS) curve. Data as of 28 March 2025.

[3] Source: Bloomberg, based on the difference between the generic 10-year UST yields and the generic 2-year UST yields. Data as of 28 March 2025.

[4] Source: Bloomberg, Bureau of Economic Analysis. Q4-2024 GDP.

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