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SPECIAL REPORT

February 20, 2025

Tariffs, Fiscal Policy And The Treasury Yield Curve (Part 2)

Part I of our 2-part *Special Report* focussed on how the Fed will react to higher tariffs. We also discussed the potential for fiscal policy to impart a steepening bias to the yield curve, either *via* some type of a risk premium or increasing Treasury supply. We concluded that the coupon curve will steepen in the medium term for reasons outside of fiscal policy, but that flattening is most likely this year as international trade tensions play out.

Part 2 discusses the key drivers of the term premium, as well as what part of the curve is most exposed to a blowout of the federal budget deficit (which is not our base case). Finally, we identify the most promising curve trades under 4 scenarios for the trade war, inflation and fiscal policy. As in *Part I*, we present the information in a Q&A format.

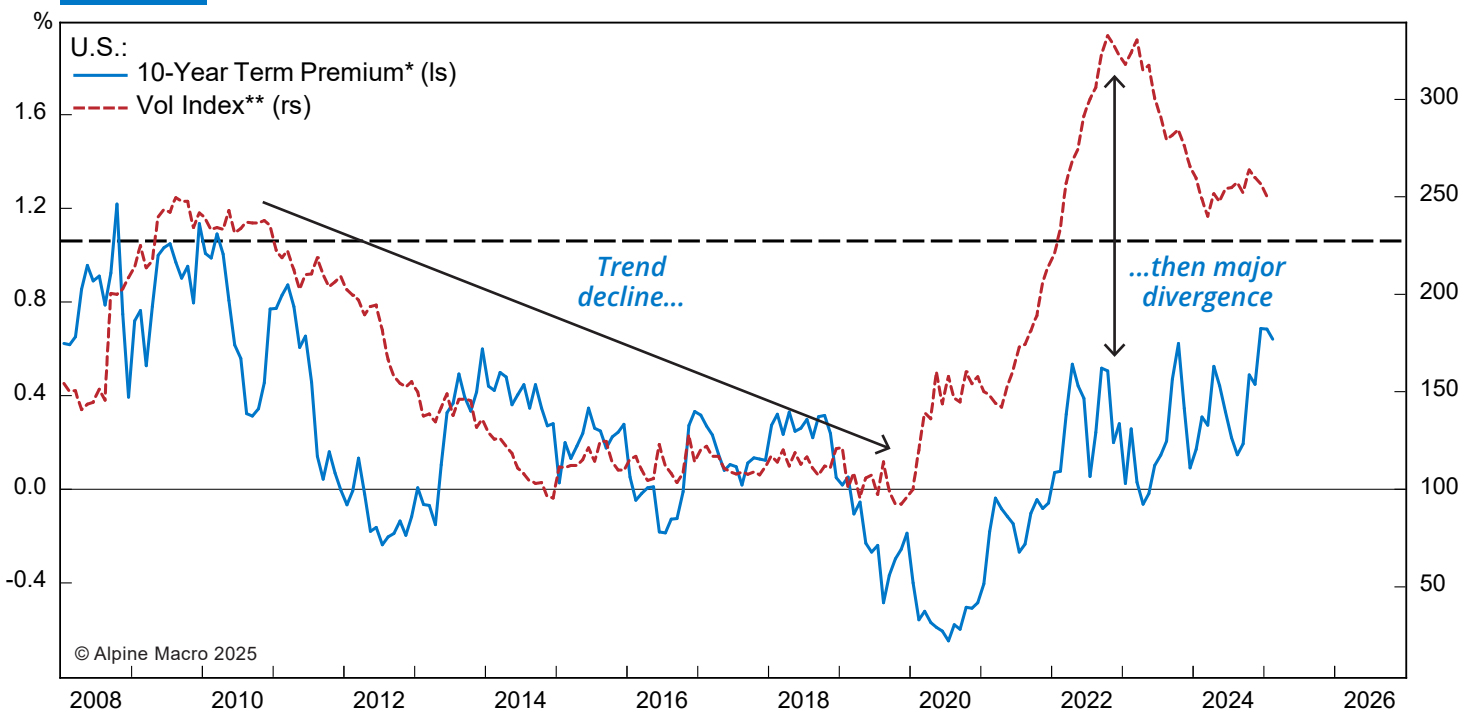
(1) Is the term premium returning permanently to a (normal) positive slope? Could it return to pre-GFC levels?

This is an important question because a return to pre-GFC levels would imply a massive steepening of the curve.

The term premium trended lower following the GFC, falling into negative territory in 2019. The decline tracked our summary index of macro and bond volatility during this period (**Chart 1**; please see **Box 1** for details). Inflation was low and quite stable by historical standards. The Fed held rates at the zero bound for much of this period, and used forward guidance to signal to investors that they should expect rates would stay depressed for the foreseeable future. This crushed historical and implied bond volatility. The MOVE index fluctuated around a lower average level after the GFC than during the previous two decades. All of these factors helped to depress the term premium.

The situation changed drastically with the onset of the pandemic. Macro and bond volatility soared to a level not seen since the 1980s. However, the term premium largely bucked the trend. The most likely explanation for this divergence is that aggressive Fed bond purchases masked the impact of macro volatility on the curve (**Chart 2**).

Chart 1 Volatility And The Term Premium



*Kim-Wright estimate
Alpine Macro proprietary indicator; see **Box 1
Note: Horizontal dotted line denotes long-term average of term premium, 1997-2007

Box 1: Volatility Drivers Of The Term Premium

The term premium is the extra yield that investors demand to hold long-term bonds rather than rolling over short-term paper. Theory suggests that this premium is driven by policy uncertainty and the volatility of inflation, economic growth and bond returns. It is also affected by forecast uncertainty related to the economy and rates.

We combined the volatility-related series shown in **Appendix Chart A1** into a summary index of term premium drivers (**Chart 1**). In order to capture forecasting uncertainty, we used the dispersion of analysts' forecasts for inflation and rates (please see our recent report for details).[1]

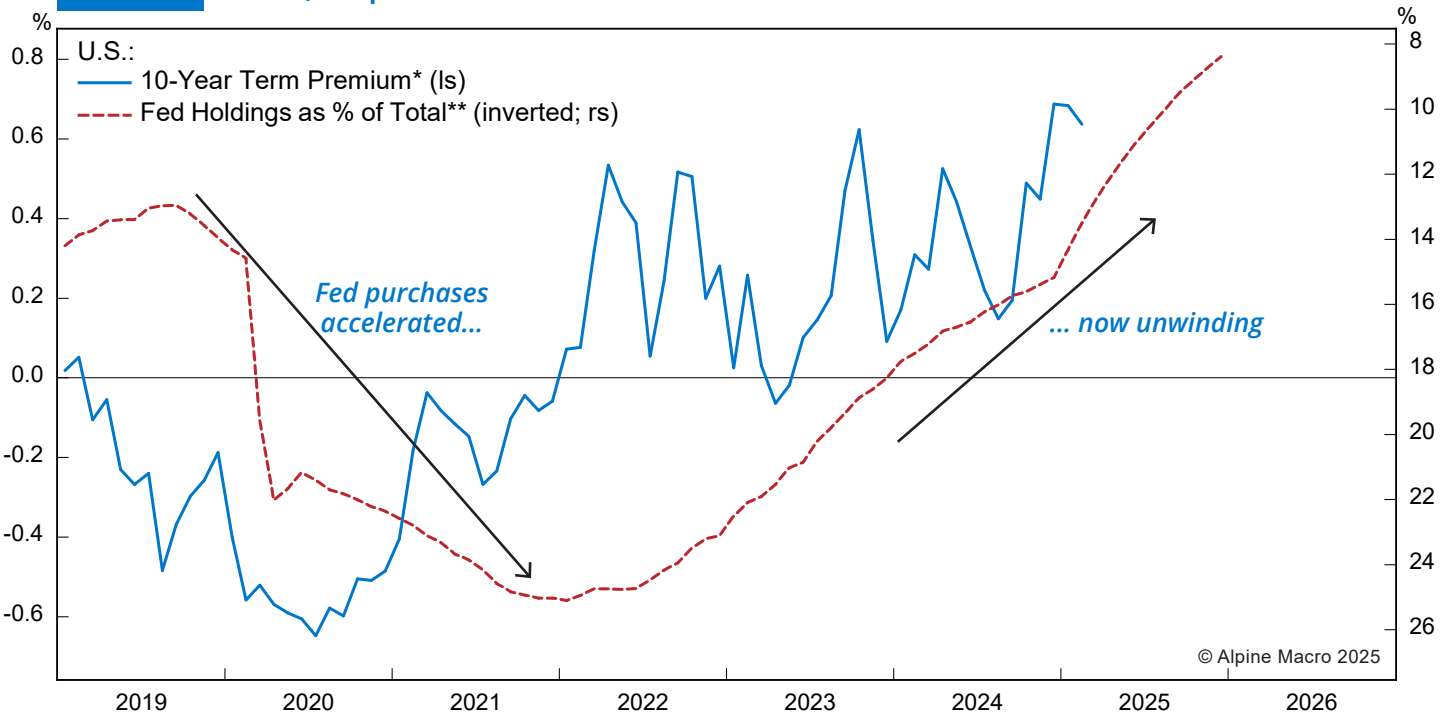
The volatility index reached a peak in early 2023. It then trended lower but stabilized at a high level in 2024. **Appendix 1** shows that CPI volatility picked up slightly last year, while the Economic Uncertainty Index spiked after the election.

Looking ahead, most of the key drivers of the term premium appear to be imparting a steepening bias:

- elevated policy uncertainty, including a trade war and tax cuts, threaten to keep upward pressure on bond volatility;

1 Alpine Macro *U.S. Bond Strategy* "Higher Yields but Lower Bond Volatility?" (November 7, 2024).

Chart 2 Fed's QE Depressed Term Premium



*Kim-Wright estimate
**2025 figures are Alpine Macro projections

- the Fed's depressing effect on the term premium is unwinding. The central bank's share of the Treasury market is shrinking fast. Moreover, forward guidance has also been replaced with "data dependency".

We believe that the term premium will gradually move higher in waves, potentially shifting back into the 50-150 basis point range that existed in the decade before the GFC.

Nonetheless, transitions in the yield curve tend to take years. In the near term, the premium will remain quite volatile given that it is correlated with shifts in the market's discounted estimate of R-star, and thus affected by changes in market expectations for growth and inflation (see *Part I* for more details).

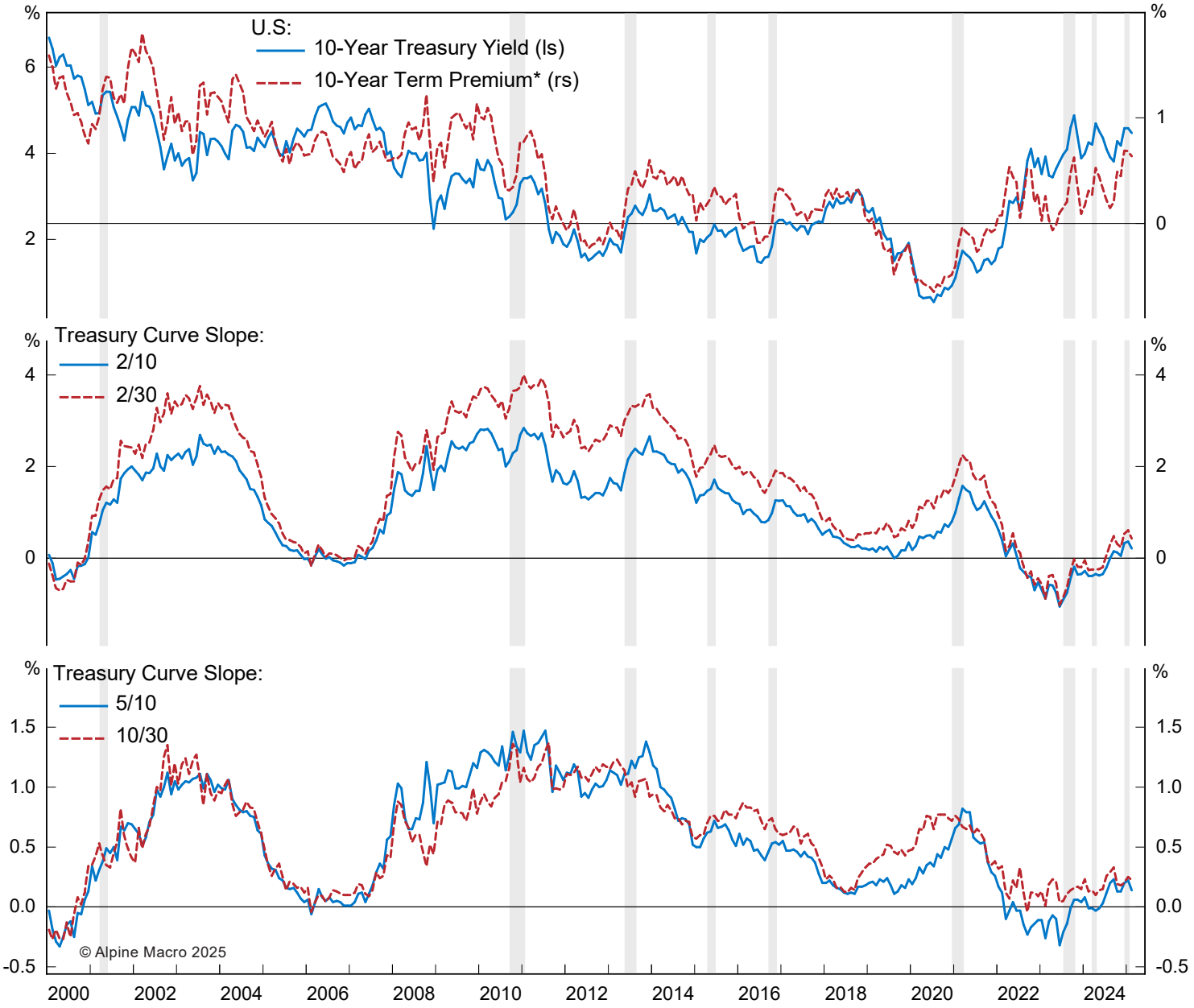
Bottom Line: The medium-term trend in the term premium is higher, but the transition will unfold in waves. In the near term, it will be policy and macro trends that drive shifts in the yield curve.

(2) For those wishing to position for bear steepening, how best to implement the trade?

The Treasury market tends to trade directionally – it usually either bear-flattens or bull-steepens. Bear steepeners are infrequent and tend to be short-lived. However, as discussed in *Part I*, there have been three such episodes since mid-2023 (shaded portions of **Chart 3**).[2]

2 We focus only on the phases that lasted for at least three months in order to remove some noise, although we have included the three episodes since the middle of 2023 in the analysis even though they lasted less than three months.

Chart 3 Episodes Of Bear Steepening



*Kim-Wright Estimate
Note: Shaded area denotes bear steepening periods

Table 1 presents data on how different parts of the yield curve performed during these periods. **Box 2** provides some stylized facts.

The historical record underscores the difficulty of using butterfly trades to play expected changes in curve slope. Positioning for a steeper curve on a duration-neutral basis involves going long the bullet (e.g. 5-year) and short the duration-matched barbell (e.g. the 2- and 10-year bond). The problem is that the butterfly spread always moved against these trades (i.e. the 5-year yield rose versus the

Table 1 Curve Dynamics During Curve Steepening Episodes

Change In	Treasury Curve Slopes (bps)				Butterfly Spread (bps)*			Bullet/Barbell Excess Returns (bps)**		
	2/10	2/30	5/10	10/30	2/5/10	2/10/30	5/10/30	2/5/10	2/10/30	5/10/30
2001M03-2001M05	67	57	29	-20	14	41	20	-27	150	112
2010M09-2011M02	89	85	17	-6	25	37	10	-41	61	72
2013M05-2013M08	106	91	24	-16	36	60	17	-127	204	163
2015M04-2015M06	38	47	15	8	11	16	4	-7	-33	-19
2020M12-2021M03	90	87	36	-3	4	54	25	-82	73	114
2023M07-2023M10	94	109	40	15	16	50	23	-78	-7	48
2024M03-2024M04	5	5	0	0	3	3	0	12	2	-6
2024M12-2025M01	39	43	11	4	14	9	5	2	-2	-13
Average of All Phases	**66**	**66**	**22**	**-2**	**15**	**34**	**13**	**-43**	**56**	**59**

*Changes in Bullet yield minus Barbell yield
**Return of Bullet minus return of duration matched Barbell

Box 2: Stylized Facts: Yield Curve Dynamics During Bear-Steepening Phases

- 2/10, 2/30 and 5/10 slopes steepened in all eight episodes shown in Table 1.
- 10/30 only steepened in 3 out of 8 episodes.
- In all cases, the butterfly spread moved against steepening trades that favored the bullet over the barbell.
- For example, the 5-year yield rose versus duration-matched 2/10 barbell yield as the curve steepened, partially offsetting profits.
- Steepening trades using the 2/10/30 and 5/10/30 butterflies had the best batting average, outperforming 5 out of 8 times (i.e. positive values in Table 1 indicate that bulleted positions outperformed or barbells underperformed).
- Batting average for a 2/5/10 steepener is poor.
- For the most recent 3 bear steepening phases since 2023, the performance of steepening trades was spotty for all three butterfly spreads.

2- and 10-year weighted average). This shift limited the profits of steepening butterfly trades and often turned them into a loss.

Bottom Line: Table 1 shows that steepening trades using the 2/10/30 and 5/10/30 butterflies had the best batting average, outperforming in 5 out of 8 bear-steepening episodes.

(3) If rioting bond vigilantes demand a higher premium due to runaway government debt, shouldn't the 10/30 part of the curve be most affected?

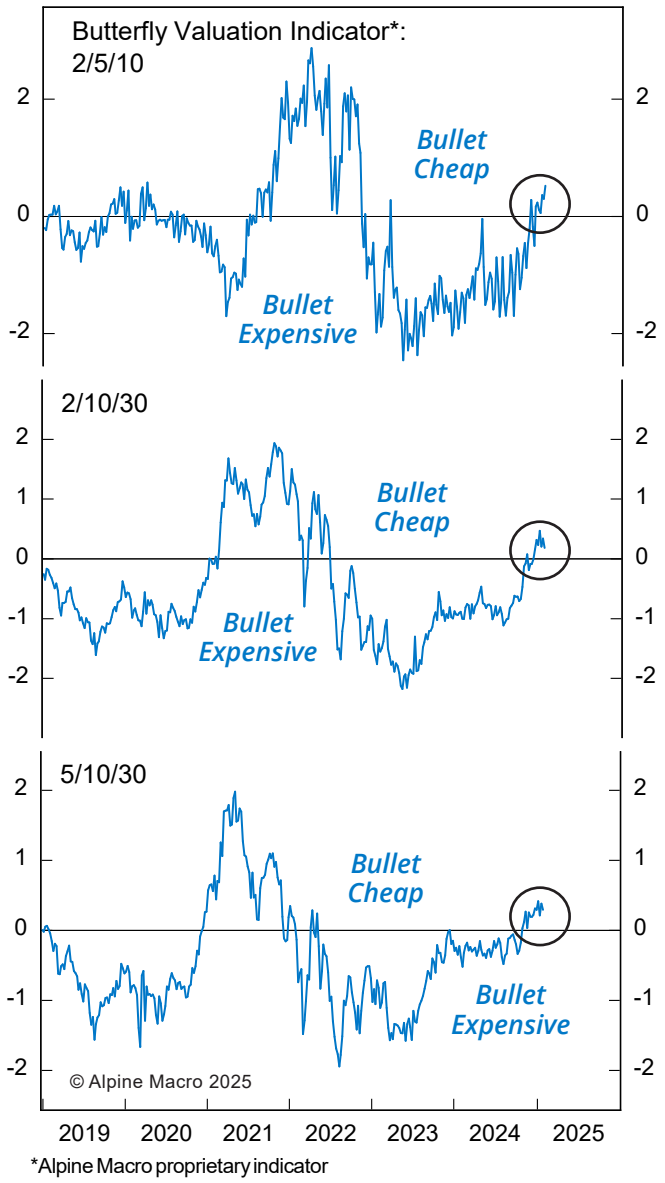
Theory suggests that the answer is, 'yes', but it is difficult to identify the effect using historical data.

The 10/30 curve steepened in only 3 of the 8 episodes shown in Table 1, but it may be the case that the bear-steepening was caused by factors outside of fiscal policy in most cases. It is difficult to tell.

In recent years, angst expressed in the financial press regarding unsustainable fiscal policy appears to be on the rise, especially when Treasurys sell off. Table 1 shows that the 10/30 slope steepened in two of the three bear phases since mid-2023. However, the only steepening trade that made money was in the case of the 5/10/30 butterfly in the fall of 2023 (48 basis points).

Our valuation indicators show that the 10-year bond was quite expensive versus the wings heading into each of these three steepening phases, meaning that the belly of the curve had plenty of room to underperform as fed rate cuts were priced out (Chart 4). Today, butterfly spreads are all close to fair value.

Chart 4 Belly Of Curve Near Fair Value



*Alpine Macro proprietary indicator

Bottom Line: Theory suggests that changes in fiscal risk premia should affect the long end of the curve the most. History shows that steepening trades do not always work well. However, improved butterfly valuation means that the odds have improved that a long-end steepening trade will work as a short-term trade if massive unfunded tax cuts make it through Congress this year (not our base case, see below).

Table 2 Yield Curve Simulations

			Level in 6 Months			
	Current	6 Months Forward	(1) Tariffs/ No Fiscal	(2) Tariffs/ Fiscal Blowout	(3) No Tariffs/ No Fiscal	(4) No Tariffs/ Fiscal Blowout
2-year	4.26	4.12	4.0	5.2	3.9	4.6
10-year	4.47	4.4	3.9	5.3	4.4	5.0
2/10 slope	21	28	-4	12	44	42
Butterfly Trades*						
2/5/10			-35	2	2	8
2/10/30			-129	54	1	23
5/10/30			-68	37	0	11

Note: All data are in basis points, except 2- and 10-year yields (%)
*Positive values indicate that bullet (belly) outperforms the barbell (wings)

(4) How should investors play the yield curve under different trade war/fiscal stimulus scenarios?

Our base-case view is that tariffs will eventually be negotiated down to low levels (please see *Part I* for more details). We also believe that there will be no "fiscal blowout". In other words, Congress will block unfunded tax cuts that exceed $200 billion per year. There is a good chance that tax cuts may even be fully offset by expenditure restraint and cost cutting.

Nonetheless, there are clear risks to both of these views and clients have asked how best to play alternative scenarios. We simulated the impact on the yield curve of four scenarios shown in **Table 2**:

(1) **Trade war/higher inflation, no fiscal blowout (Bull Flattener):** Tit-for-tat tariffs prove to be stagflationary. A trade war and initially higher consumer prices cause the FOMC to go on hold for the remainder of 2025. By next year the negative impact of tariff activity undermines economic growth, leading to a resumption of monetary easing. The market's discounted terminal rate (R-star) declines by 50 basis points and the 10-year term premium drops by 20 basis points in the 6-month investment horizon. The coupon curve flattens and barbelled positions outperform bullets, especially for the 2/10/30 trade.

(2) **Trade war/higher inflation, fiscal blowout (parallel shift or slight flattener):** A lingering trade war proves to be inflationary, but Congress

attempts to offset the negative economic shock with fiscal stimulus. Short- and long-term inflation expectations begin to move higher, forcing the Fed to pivot and rate hikes. The Fed funds rate increases by 75 basis points over the next year, while the terminal rate and the 10-year term premium both jump by 50 basis points (reflecting rising inflation expectations, market volatility and policy uncertainty). Steepening trades outperform in this scenario (i.e. favoring the belly of the curve versus the wings). It is best to use the 2/10/30 or 5/10/30 for this trade, according to our Yield Curve Simulator.

(3) **No trade war/inflation declines, no fiscal blowout (Bull Steepener):** Easing inflation allows the Fed to trim the fed funds rate a little more than what is currently discounted. However, an elevated equilibrium interest rate and robust productivity-driven growth limit the downside for the fed funds rate. The 2/30 curve steepens by more than forward rates, but there is not much juice in curve trades in this scenario.

(4) **No trade war/inflation declines, with fiscal blowout (Bear Steepener):** Fed policymakers are pleased that inflation is grinding toward the target. However, the risk that substantial fiscal stimulus stokes an already solid economy keeps the central bank on hold. Further rate cuts are priced out of the curve. The market-discounted R-star jumps by 50 basis points and the term premium rises by 20 basis points, reflecting policy uncertainty, market volatility and concerns regarding Treasury supply. Overweighting the 10-year versus the 2/30 barbell is the best place to be in this scenario.

Scenario (3) reflects our base-case view, for which curve trades look uninteresting.

However, we believe that the risks to our base-case view are more on the trade war side than on the fiscal side. Tariffs may ultimately not rise much, but protracted negotiations could linger through the year before the situation is resolved. Investors may begin to worry that the price level shock is at risk of morphing into lasting inflation. A risk-off phase could undermine economic growth and spark a flight into government bonds, especially at the long end.

Bottom Line: We lean toward flattening trades for this year: favor the 2/30 versus the 10-year.

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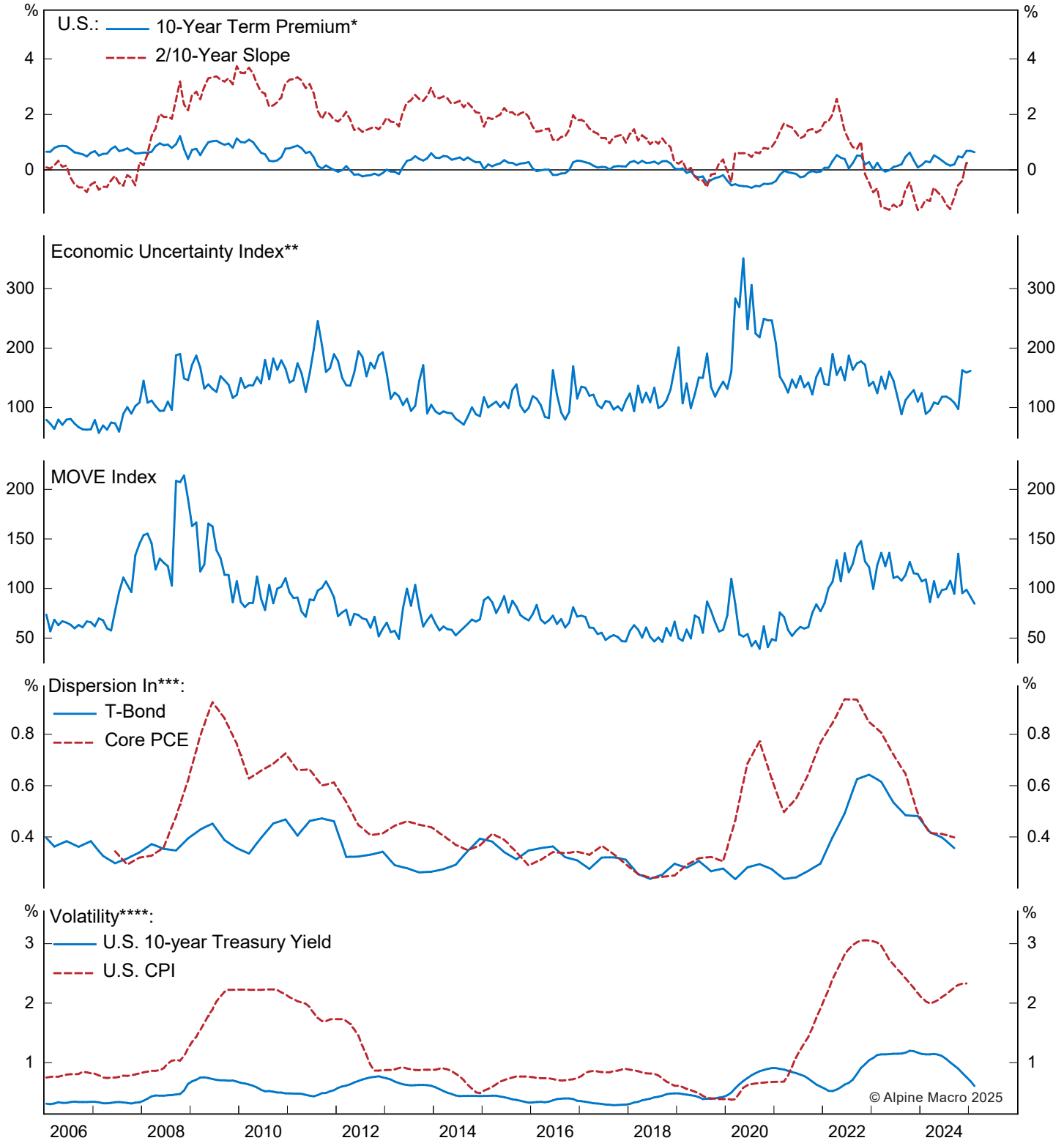
Chart A1 Components Of Volatility Index



*Kim-Wright Estimate
**Source: Economic Policy Uncertainty
***Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia
****3-year moving standard deviation