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SPECIAL REPORT

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

Understandably, bond-focused clients have raised a lot of questions regarding the outlook for the Treasury yield curve. Most questions center around the term premium, tariff effects, the Fed's response and the impact of sustained federal budget deficits.

This report is **Part I** of a 2-part series that tackles these tough questions in a Q&A format.

(1) Will Tariffs Be Inflationary, How Will The Fed Respond, And What Impact Will This Have On The Yield Curve?

Mixed signals coming from the Trump Administration cloud the tariff issue, which remains highly fluid as we go to press. Canada and Mexico received a 30-day reprieve. Our geopolitical strategist, *Dan Alamariu*, argues that if the 25% tariff rate is eventually imposed, it will likely to be temporary as tariffs are being used as leverage to change border policy in these two countries, not necessarily trade policy. We expect a fairly quick negotiated solution because high tariffs are likely to trigger economic disruption, supply chain problems and market volatility. This could erode Trump's popularity and congressional support.

That said, uncertainty is elevated and there is a chance that negotiations are protracted. It took more than a year following the 2018 grab-bag of tariff activity for negotiations to begin to bear fruit.

If tariffs are maintained for longer than we expect, Alpine Macro's view is that they will result in a one-time jump in the price level rather than an ongoing inflationary surge. Tariffs are a tax on consumers, while the soaring dollar will help to limit any second-round effects of higher import prices.

That said, the FOMC will want to be sure that a one-time price increase does not turn into a self-reinforcing inflationary spiral as laborers try to recoup the loss in purchasing power. A key indicator the Fed will be watching in this regard is long-term inflation expectations. A breakout would be a warning sign that the tariffs are not simply a one-off shock to the price level.

Former Fed Chair Ben Bernanke was once asked about the appropriate central bank response to a negative supply shock, such as an oil price spike. His answer was that it depended on the economy's output gap. The central bank may decide to tighten into this shock if the economy is at full employment because it would be easier for oil prices to generate second-round effects as higher input costs are passed along. In contrast, the central bank might decide to ease if there is slack in the economy, since there is less risk of second-round effects.

The same logic applies to import tariffs.

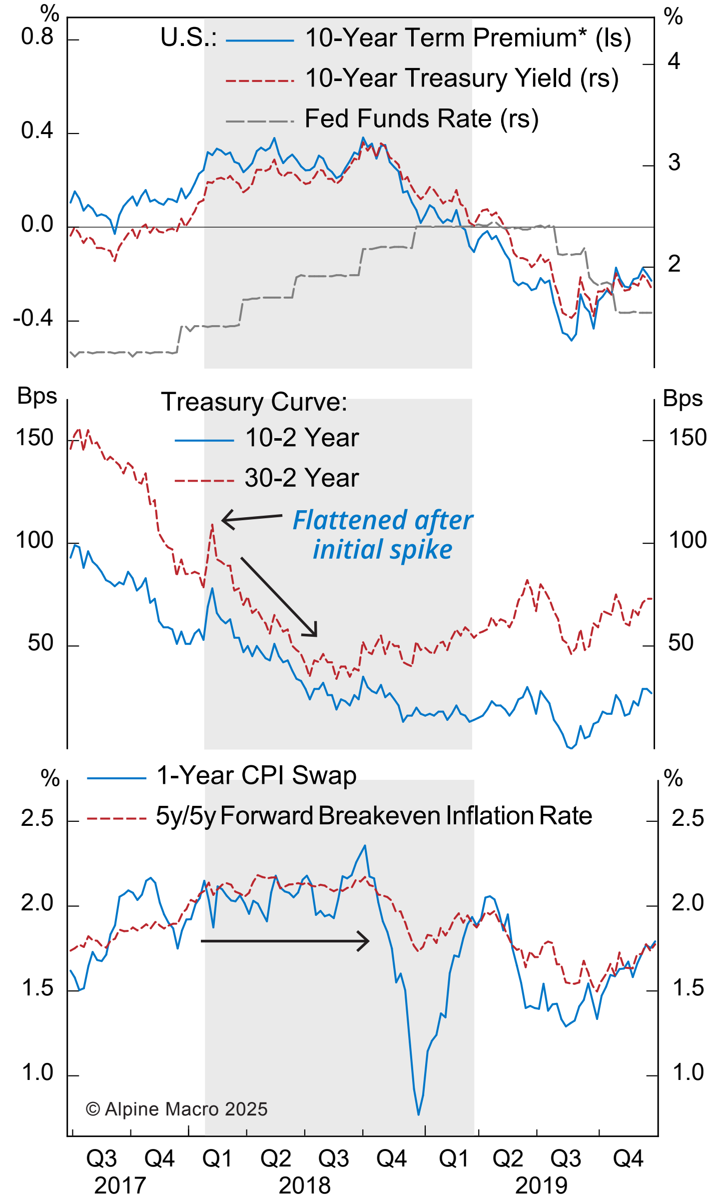
The 2018 trade war offers few lessons for today (**Chart 1**). The tariff increases were much smaller and narrower in scope than what is being threatened today. Long-term inflation expectations were stable and the coupon curve flattened, but the key difference was that the Fed was in the midst of a tightening phase at the time.

The bar is high for rate hikes in current circumstances. The economy does not have much slack, but the Fed believes that policy is on the tight side and long-term inflation expectations are not flashing red. Policymakers will not want to risk a hard economic landing.

Conversely, the FOMC has signaled a slower pace of rate cuts due in part to greater perceived upside inflation risk at a time when inflation has been sticky. This means that sustained import tariffs would limit the potential for rate cuts, at least until any negative economic fallout becomes evident in the data. "Wait-and-watch" is the best option for the Fed.

Bottom Line: We believe that a lingering trade war ***on its own*** would have a flattening effect on the curve. The Fed will not raise rates, but higher tariffs could limit rate cuts at least for the near term. They would undermine growth expectations further down the road and thus depress long-term yields. A trade war would also favor long-term bonds to the extent that it damages risk tolerance and sparks a flight-to-quality. Of course, investors and traders must also factor into the equation the possibility of fiscal stimulus.

Chart 1 2018/2019 Trade War



*Kim-Wright estimate
Note: Shaded area denotes intense phase of trade war

(2) Will Federal Fiscal Policy Impart A Steepening Bias To The Coupon Curve?

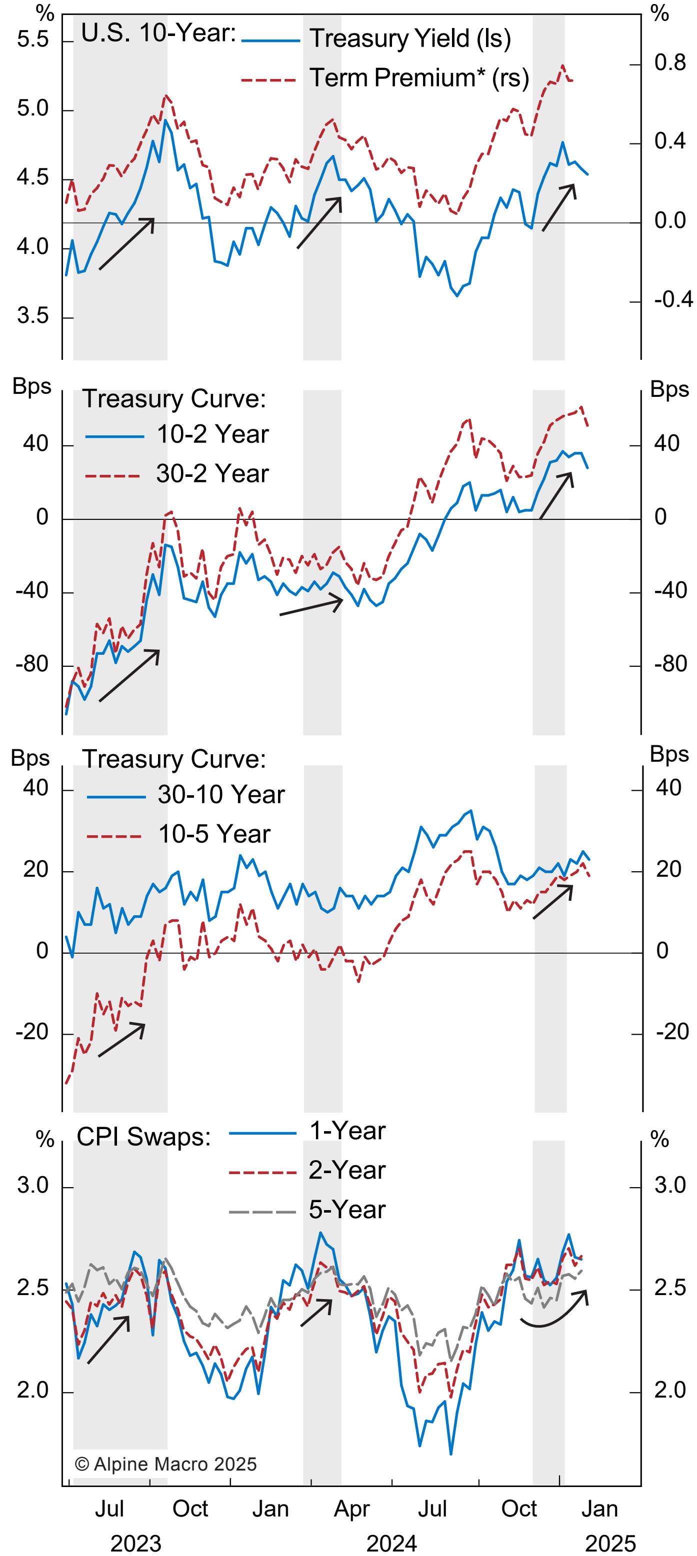
The DeepSeek shock and tariff announcements relieved selling pressure in the Treasury market as investors became more cautious in recent weeks. Nonetheless, the bear-steepening trend that occurred in December and early January raised questions regarding the impact of sustained large federal budget deficits on the Treasury market. Will bond "vigilantes" begin to demand a higher premium to own long-term Treasurys relative to short-term notes, especially if Trump manages to push through tax cuts without meaningful spending restraint?

We do not wish to trivialize the impact of structural budget deficits. There are long-term costs associated with sustained fiscal profligacy.[1] That said, low CDS spreads on U.S. debt, the strong U.S. dollar, continuing foreign capital inflows and stable long-term inflation expectations highlight that there are no serious worries about a default or attempts to inflate away the real value of government debt.

The recent bear-steepening phase resembled the other two such episodes that have occurred since mid-2023 (shaded periods in **Chart 2**). All three episodes were triggered by a spell of sticky inflation at a time of solid economic growth. The term premium increased in all three cases, and it has been trending gradually higher since the end of 2022. Some market commentators have argued this reflects a growing fiscal risk premium.

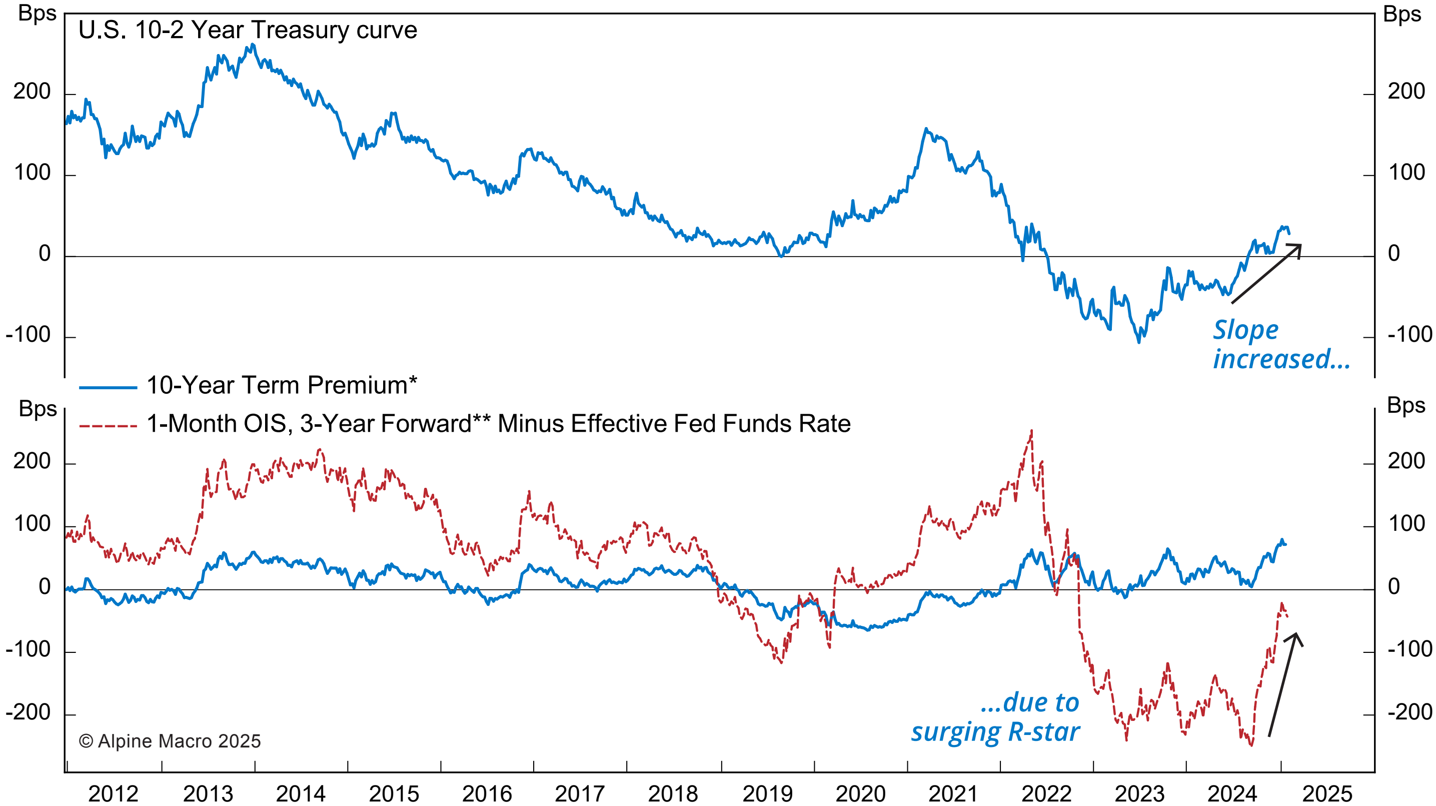
1 For more details on the costs, please see Alpine Macro *U.S. Bond Strategy* "Is Fiscal Policy Driving the Treasury Selloff?" (April 11, 2024).

Chart 2 Three Bear-Steepeners



*Kim-Wright estimate
Note: Shaded area denote periods of bear steepening

Chart 3 Investors Have Given Up On Return To A Low Interest Rate Environement



*Kim-Wright estimate
**Source: Bloomberg Finance L.P.

In our view, the steepening was mainly caused by an upward revision to the market's expectation for the terminal fed funds rate (R-star), rather than any risk premium related to the deficit. Chart 3 presents a longer history of the 2/10 Treasury curve slope along with its two key drivers. We use the 1-month OIS rate, 3 years forward (3y/1m), as a proxy for the market-discounted R-star.[2]

As the market trimmed the amount of rate cuts discounted in the curve following the November election, the spread between the market-discounted R-star and the current fed funds rate increased by a whopping 230 basis points. This shift contributed far more to the bear-steepening of the coupon curve than the steepening of the term premium.

Our interpretation is that bond investors have capitulated to the view that short-term interest rates are no longer destined to return to the depressed levels observed after the GFC (i.e. R-star is much higher now). The GOP election sweep reinforced this trend given the prospect that tax cuts and de-regulation will drive innovation, investment and growth.

Bottom Line: Fiscal unsustainability is a convenient scape goat every time yields back up, but bear-steepening phases have been driven by inflation scares and changes in the market estimate of R-star.

2 The OIS curve tends to flatten out around 3-years into the future.

(3) Won't Supply Be A Problem For Treasurys?

A lot of deficit-related angst in the financial press centers around supply. The fear is that the private sector will end up choking on a wave of issuance, which will drive prices down and yields up. The Fed's ongoing balance sheet adjustment adds to the Treasury supply pressure.

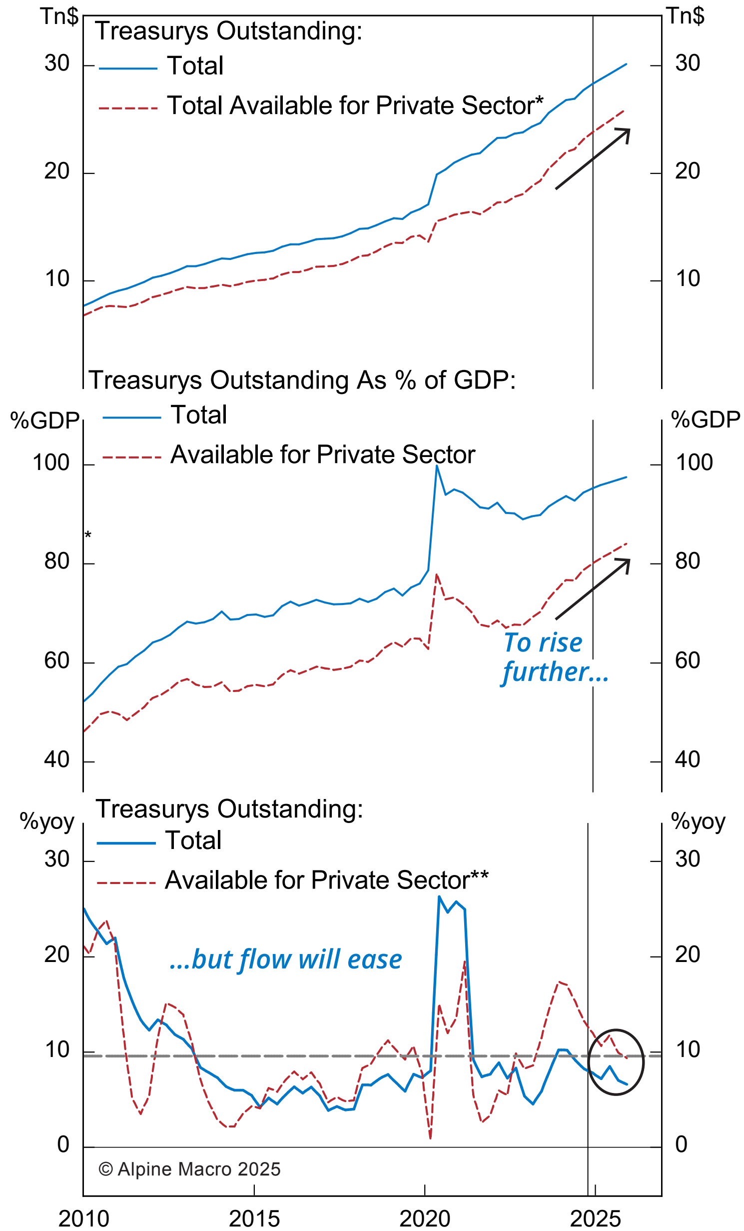
Private sector Treasury absorption has indeed increased relative to GDP, but at least it has peaked on a flow basis.

Chart 4 presents the stock and flow of Treasury securities that the private sector is absorbing, after removing the effects of Fed and foreign official transactions (including bills, notes and bonds). The stock of privately-held Treasurys reached 80% of GDP in the fourth quarter of last year, which is very high by historical standards. We estimate that this ratio will continue to rise through 2025.

That said, the ***flow*** is probably more important than the ***stock*** in terms of the pure "supply effect". The 4* bottom panel of **Chart 5** shows that the annual growth rate of private absorption peaked at 17% at the end of 2023. We estimate that growth will decelerate to about 10% by the end of this year, equal to its long-term growth rate.

We may be underestimating this year's net issuance, given uncertainty regarding the new administration's fiscal plans. Nonetheless, we do not expect a major budget blowout under Trump 2.0 (see below). This means that the ***flow*** of Treasurys that the private sector will be forced to take down this year should not be record-breaking.

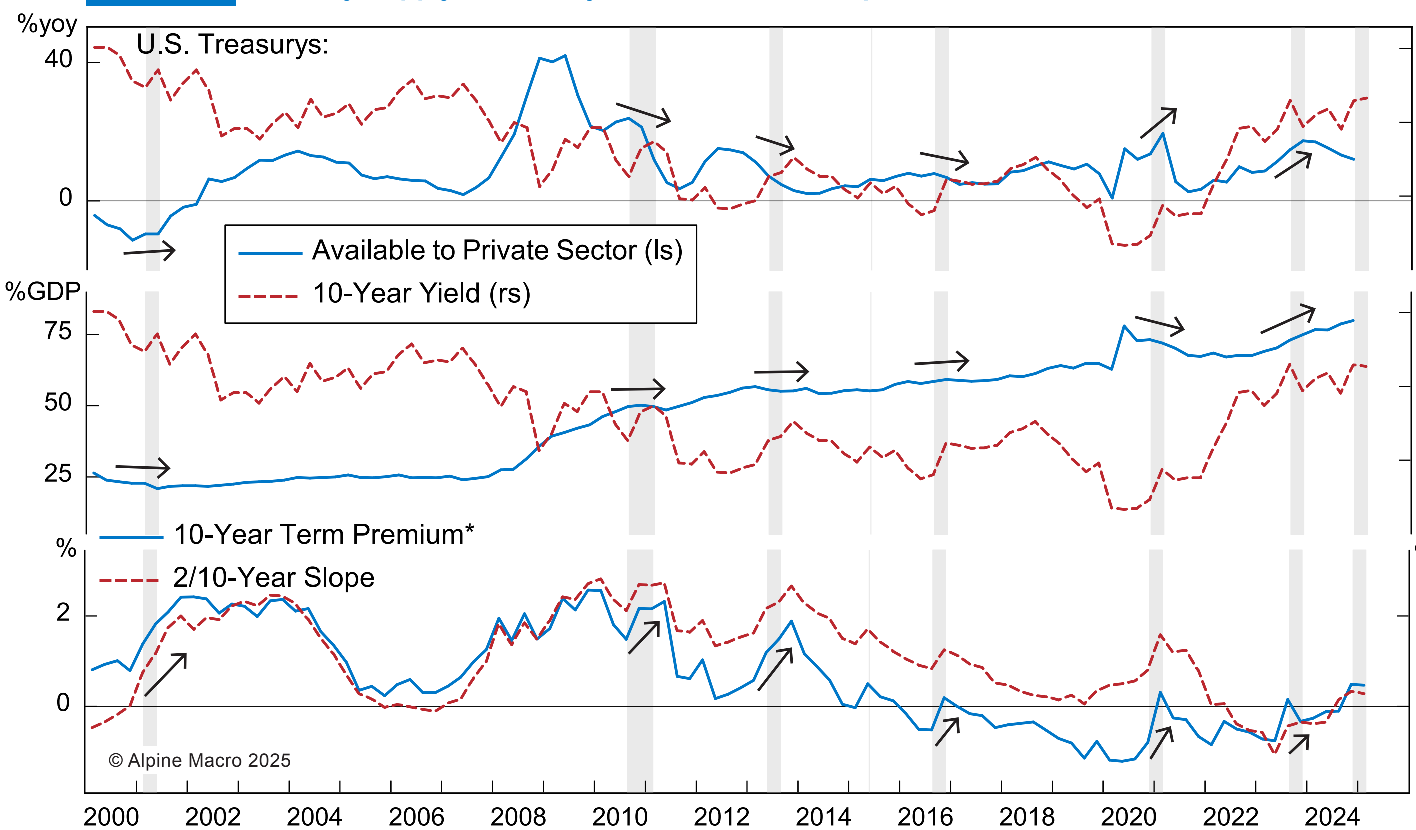
Chart 4 Treasury Supply: Stocks Vs. Flows



*Excludes amount held by the Fed and foreign central banks
**Horizontal dotted line denotes long-term average growth
Note: Vertical line denotes start of forecast period, for foreign official holdings of Treasurys forecast starts from 2024Q2 onwards.

In any event, Treasury yields and the slope of the curve historically have not been well correlated with the flow or stock of private sector absorption (**Chart 5**, bottom panel).

Chart 5 Treasury Supply: Not A Key Driver Of Bear-Steepeners



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

Bottom Line: No doubt, a surge in issuance and sustained structural budget deficits can reinforce any negative sentiment that may develop in the Treasury market for other reasons (e.g. sticky inflation). However, fiscal risk premia have not been the main driver of meaningful bear-steepening phases historically, including the three examples since mid-2023.

(4) What Would Trigger A Treasury Bond Crisis?

We are not expecting the federal deficit situation to deteriorate nearly as much as many fear.

Our geopolitical expert, *Dan Alamariu*, has made the case that political feasibility will restrain tax and spending changes that lift the budget deficit.[3] Dan estimates that federal debt will be boosted by $0-2 trillion over the next decade, relative to the CBO baseline. This estimate is far below the $5-10 trillion that some forecasters are predicting.

That said, we do not wish to sound complacent. An extra $2 trillion on top of an already alarming baseline debt outlook is far from comforting. Entitlements are unsustainable in the long term given growing demographic pressures and surging interest cost.

This raises the question of what would it take to spark a "buyer's strike" in the U.S. Treasury market?

We have emphasized in previous research that there are no clear thresholds that have triggered

3 Alpine Macro *Geopolitical Strategy* "U.S. Politics & Policy Monitor" (December 19, 2024).

vary*

fiscal crises in other countries. Tipping points very by country, reflecting the depth and structure of the financial system, the soundness of the economy, the dependence on foreign capital, and the asset preferences of domestic investors.

Moreover, comparisons with other countries that have hit the debt wall in the past are not that helpful because the U.S. is a special case. It has a huge economy and has political and military clout. The dollar is the world's reserve currency and America is able to borrow in its own currency. This suggests that the U.S. will be able to "get away" with its borrowing habit for longer than other countries that have hit the debt wall.

A robust productivity tailwind also helps. It raises expected returns to U.S. assets, attracting foreign investment. Faster GDP growth also pads government tax revenues. This reduces the risk that persistent U.S. "twin deficits" will spark a flight from Treasurys.

Despite these advantages that the U.S. Treasury market enjoys, we can speculate that the risk of a crisis would escalate if one or more of the items discussed in **Box 1** emerge. None of them have a particularly high probability of occurring over the next year. However, the ones we would worry about most are additional unfunded tax cuts followed by a recession. This would be an explosive combination for the deficit.

Bottom Line: A fiscal crisis is likely down the road if future governments fail to deal with entitlements, but is not a major risk for 2025. Inflation and growth dynamics, rather than any change in the fiscal risk premium, will continue to dominate shifts in the Treasury curve this year.

Part II will discuss key drivers of the term premium. It will also outline yield curve strategy under four macro/policy scenarios involving tariffs and fiscal policy. Our bias is that the coupon curve will eventually steepen, but flattening is most likely in the near term as trade tensions play out.

Mark McClellan
Chief U.S. Bond Strategist

Box 1: Potential Triggers For A Debt Crisis

- **Recession:** Given that the starting point for the federal budget deficit of in excess of 6%, then a garden-variety recession could push the deficit to an alarming 8%. Congress would find it difficult to raise taxes or cut spending in the midst of an economic contraction. Indeed, there would be political pressure to lift unemployment benefits.

- **Unfunded tax cuts:** As noted above, we estimate that the increase in U.S. federal debt relative to baseline in Trump's second term will be in the $0-2 trillion range. An increase in the deficit of $200 billion per year is not a good thing, but is probably insufficient to trigger a crisis. Conversely, our sense is that the bond market would react negatively if Trump manages to boost the debt level by a projected $5-10 trillion ($500b to $1 trillion per year). It is impossible to determine where the tipping point lies between $200b and $500b per year.

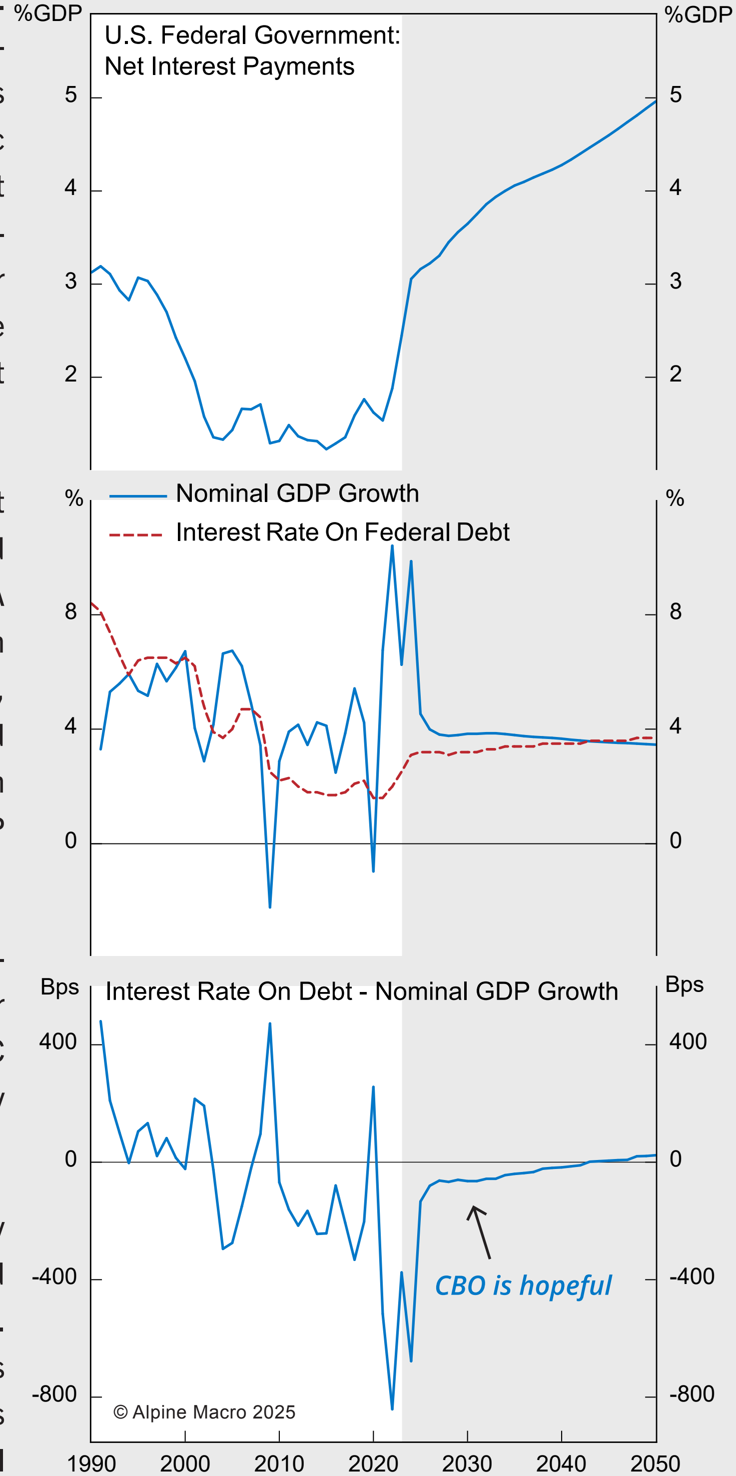
- **Productivity Surge Proves Temporary:** A critical element in Alpine's macro view is that the U.S. has entered a lasting period of strong productivity growth, much like the 1990s. However, if this proves to be wrong, then a return to a lethargic productivity backdrop would trim government revenue growth and make U.S. assets less attractive to foreign investors. Moreover, weaker productivity growth would undermine the hope that the U.S. can grow out of its public debt problem.

- **Borrowing Rates Exceed GDP Growth:** Interest rates on government debt typically exceeded nominal GDP growth before 2000 (**Chart B1**). A return to that state would dramatically worsen the debt arithmetic and risk an explosive, self-reinforcing, spiral in interest payments and public debt. The CBO assumes in its long-term projection that rates stay below nominal GDP growth until after 2040.

- **Fiscal Dominance:** Any move by the Administration to remove Chair Powel prematurely or otherwise seek to gain influence over the FOMC would trigger a violent reaction in the Treasury market. This scenario has a low probability.

- **Trust Funds Run Dry:** The Social Security Old-Age and Survivors Insurance Trust Fund is projected to deplete its reserves by 2033. Medicare's Hospital Insurance Trust Fund is projected to be depleted by 2036. These dates are a ways off, but any signs that these funds will run dry earlier than currently expected could set off alarm bells.

Chart B1 Will Interest Rates Remain Below Normal GDP Growth?



Note: Shaded area denotes forecast period; source: CBO

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