Yardeni Research

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Morning Briefing

Trump, Bessent & The Bond Vigilantes

Check out the accompanying chart collection.

Executive Summary: The bond market reacted favorably to Trump's pick for Treasury Secretary, Scott Bessent, suggesting receding concern about the federal budget deficit—as he has a plan to get the deficit under control. That should appease the Bond Vigilantes. We also like Bessent's "3-3-3" plan, which might boost US economic growth and improve the perilous fiscal outlook. That should set the stage for a continuation of our Roaring 2020s scenario for the rest of the decade. … Also: Eric discusses a potential normalization of the yield curve. We think it may be flatter than in past easing cycles, much as it was during the last half of the 1990s.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Fixed Income Strategy I: 'Trump Put' for Bond Vigilantes? The 10-year Treasury bond yield has finally found a reason to stop ascending. It rose 79bps since the Federal Open Market Committee's September 18 meeting (from 3.62% to 4.41% as of Friday's close). We chalked up the climb to a mixture of stronger economic growth, higher inflation expectations, and heightened fiscal supply concerns under Trump 2.0. Yesterday, the 10-year yield fell 14 bps to 4.30% (*Fig. 1*). What changed? Nothing fundamental. Rather, President Trump's selection of hedge fund manager Scott Bessent as US Treasury Secretary seems to have pleased the Bond Vigilantes.

Wall Street and the financial media widely view Bessent as a steady hand over what is an increasingly volatile bond market. His proposed "3-3-3" policy—i.e., 3% real GDP growth, federal deficits not exceeding 3% of nominal GDP, and 3 million additional barrels of oil or equivalents—is reminiscent of Prime Minister Shinzo Abe's "three-arrows" plan to revitalize the Japanese economy over a decade ago.

The drop in the 10-year's yield also means that at least 10bps of its climb could be attributed to government deficit worries, which one might describe as "term premium." That is the extra yield that compensates investors for taking duration risk, and typically helps create an upward sloping yield curve. As the term premium deflated, so did the spread between the 2-year and 10-year bond yields. The US Treasury yield curve fell flat yesterday after having turned positive in September.

We think Bessent's 3-3-3 plan might boost US economic growth and improve the perilous fiscal outlook. But Trump and Bessent are inheriting a much different fiscal and economic backdrop than Trump 1.0 did. Let's consider the differences and how they impact outlook for the bond market:

(1) *Trump 1.0 vs 2.0*. Inflation was subdued during Trump's first term. Headline and core CPI were just 1.6% and 2.1%, respectively, in October 2016. Today, they are 2.6% and 3.3%, while the so-called supercore CPI is north of 4.0% versus 2.3% back then (*Fig. 2*). The 10-year yield was 1.85%; today it is 4.31%. So the federal net interest expense was much more manageable then. Now it will continue to grow in excess of $1 trillion per year, even if yields fall back to their September 2024 lows (*Fig. 3*). The federal debt level has grown from 104% of GDP back in October 2016 to 121% of GDP, while the fiscal deficit has doubled from 3.1% of GDP to 6.0% (*Fig. 4*).

Fiscal expansion and higher inflation were important after years of flagging economic growth following the Great Financial Crisis (GFC). Today, the financial markets want continued brisk growth without high inflation or too much additional Treasury supply.

(2) *Bonds in a hot economy*. Today's bond market reflects a much hotter economy, perhaps one on the brink of overheating thanks to the 75bps of federal funds rate (FFR) cuts since September 18. Stronger-than-expected economic growth has been the main driver of both short-term and long-term bond yields, in our opinion.

The rise in the 10-year Treasury bond yield is highly correlated with the improvement in the Citigroup Economic Surprise Index (*Fig. 5*). Solid economic data led the FFR futures market to price-out earlier expectations for more rate cuts (*Fig. 6*). Inflation expectations also played a role in lifting yields. Breakeven inflation—or the difference between nominal and inflation-protected Treasury bond (a.k.a. TIPS) yields—has risen by dozens of bps as the Fed has slashed the FFR by 75bps since September (*Fig. 7*).

The bond market clearly thinks that the so-called neutral FFR that neither accelerates nor depresses inflation is closer to 5.00% than to 3.00%, so the current FFR may accelerate the economy and possibly inflation. That's why the 2-year Treasury yield has risen faster than the 10-year one. By cutting the FFR too much, too soon, the Fed is risking inflation not reaching the 2.0% target anytime soon.

So tax cuts and deregulation will have to spur enough growth to offset the drag from federal spending cuts under the newly created Department of Government Efficiency (DOGE) while also preventing inflation from flaring up as a result of higher tariffs. We think accelerating productivity growth will help Trump 2.0. Productivity growth was negligible in 2015. It has been on a new upward trend starting with Trump's first term that we expect to drive overall economic growth through the rest of the decade (*Fig. 8*). That should keep a lid on unit labor costs and therefore inflation as well.

(3) *Treasury supply*. During Trump 1.0 (before the pandemic), the fiscal deficit expanded by 1.5%. The 3-3-3 plan implies at least a 3% reduction in the fiscal deficit from current levels. That could be difficult to achieve considering that mandatory federal government spending represents 84% of overall outlays (*Fig. 9*). Of course, that doesn't mean there isn't a massive amount of government waste, fraud, and unnecessary spending across agencies. Elon Musk and Vivek Ramaswamy have their work cut out for them as co-heads of DOGE, but the government has been in desperate need of liposuction for decades.

More pressingly for Bessent, Treasury bills represent 22.1% of overall Treasury debt (*Fig. 10*). Treasury Secretary Janet Yellen's "solution" to placate the Bond Vigilantes has been to fund the deficit with T-bills, roughly tripling the total amount outstanding to $6.2 trillion since the pandemic (*Fig. 11*). Demand for bills to fund pandemic spending was obvious, with $2.2 trillion of those bills hitting the bill market since last May. Only $750 billion or so was needed to refill the Treasury General Account after having spent it down due to debt-limit related extraordinary measures. Bessent called out this faulty strategy in a recent *WSJ op-ed*:

"Mr. Trump must also address government borrowing. U.S. interest expense exceeds the defense budget. Treasury Secretary Janet Yellen has distorted Treasury markets by borrowing more than $1 trillion in more-expensive shorter-term debt compared with historical norms. Terming out that debt in favor of a more orthodox borrowing profile may increase longer-term interest rates and will need to be deftly handled. The only way to return to a prudent borrowing strategy without upsetting financial markets is restoring investors' faith in the economy and preserving the dollar's global role."

(4) *Treasury demand*. With no additional Fed purchases of Treasuries, there's been plenty of demand from other sources. Notably, the relentless money-market fund purchases of bills can no longer be funded from the Fed's overnight reverse repo facility (ONRRP). Roughly

$2.2 trillion of excess liquidity (a clear sign that the government overstimulated the economy during the pandemic) made its way to money-market funds and then to the Fed's ONRRP to earn risk-free daily interest. That cash pile is now down to $200 billion after most of the cash funded the surging Treasury bill purchases (*Fig. 12*).

Foreign investors, hedge funds (e.g., "households"), and asset managers have largely filled the gap left by the lack of Fed quantitative easing (*Fig. 13*). Banks also are big buyers of Treasuries to meet capital requirements enacted after the GFC, now holding roughly $4.4 trillion (*Fig. 14*).

Fixed Income Strategy II: When Will the Yield Curve Normalize? The spread between yields on 2-year relative to 10-year Treasury bonds, a.k.a. the yield curve, has re-inverted. What will it take to get a normal curve, and what would a normal curve mean for bond yields? Consider the following:

(1) *Inversion*. The yield curve tends to invert as the Fed hikes the FFR, which the bond market thinks will eventually cause a financial crisis and a recession, leading to a rate cutting cycle (*Fig. 15*). During the most recent round of tightening, the Fed nipped an emerging mini regional banking crisis in the bud, averting a widespread crisis and a recession.

(2) *Normalization*. In past tightening cycles, a crisis would lead the Fed to slash the FFR, causing the yield curve to normalize as the long-term outlooks for economic growth and inflation improved. The yield curve has reached a peak of +150bps to +300bps in the aftermath of past recessions (*Fig. 16*).

The futures market suggests that the FFR will settle around 3.7% over the next couple years. Assuming that is the long-run neutral rate, the 2-year yield would be around the same, leading to a 5.20%-6.70% 10-year yield.

We do not subscribe to this view. Our target for the 10-year yield is 4.25%-4.75%, based on expectations for around 2.25%-2.75% real GDP growth and 2.00%-2.25% inflation. That suggests either that the FFR will be lower than 3.7% or that economic growth will prove more resilient to elevated short-term interest rates. We are in the latter camp.

Productivity growth, combined with the overall shift away from capital intensive goods toward the high-tech and services sector, will likely continue to drive the overall economy even if the FFR settles around 4.00%. The yield curve may be flatter in this scenario than it has been during past easing cycles, perhaps settling around +50bps, closer to where it was during the latter half of the 1990s. This is especially true given that the Fed will likely cease quantitative tightening over the next year, which would remove a source of upward pressure on long-term yields.

Calendars

US: Tues: Consumer Confidence 112.0; New Home Sales 730,000 units; Richmond Fed Manufacturing Index; FOMC Minutes; API Crude Oil Inventories. **Wed:** Real GDP & Price Index 2.8%/1.8%; Atlanta GDPNow 2.6%; Personal Income & Consumption 0.3%/0.4%; Headline & Core PCED 0.2% & 0.3%; Headline & Core Durable Goods Orders -0.8%/0.4%; Initial Claims 220k; Chicago PMI 44.9; Pending Home Sales -1.7%; Wholesale Inventories -0.1%; MBA Mortgage Applications; FOMC Meeting Minutes; Crude Oil Inventories & Gasoline Production. **Thurs:** None. **Fri:** None. (FXStreet estimates)

Global: Tues: Japan Core CPI 1.8%y/y; McCaul; Pill. **Wed:** Germany Gfk Consumer Confidence -18.3; Lane. **Thurs:** Eurozone Core CPI 2.3%y/y; Eurozone Consumer Confidence -13.7; Japan Unemployment Rate 2.5%; Japan Industrial Production 3.8%; Japan Retail Sales 0.7%; Nagel; Mauderer; Lane; Bullock. **Fri:** Eurozone Headline & Core CPI 2.3%/2.8%y/y; Germany Retail Sales -0.6%; Germany Import Prices 0.2%; Germany Unemployment Change 20k; France GDP 0.4%q/q/1.3%y/y; France PPI 0.0%; Italy CPI -0.2%; Japan Household Confidence 36.4; Japan Housing Starts -2.0%; De Guindos. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): Forward earnings moved simultaneously higher for all three of these indexers for the first time since the September 13th week. LargeCap's forward earnings rose for an eighth week to a record high after falling for two straight weeks for the first time since December (when it fell for three straight weeks). LargeCap had snapped its 37-week streak of record-high forward earnings during the September 13 week, which was its lengthiest string of weekly record-high forward earnings in nearly 19 years (since the November 11 week of 2005, when it hit record highs for 42 straight weeks). MidCap's was higher for the first time in four weeks as it improved to 2.2% below its record high in early June 2022. SmallCap's rose for the first time in seven weeks and improved to

12.4% below its mid-June 2022 record. Through the week ending November 22, LargeCap's forward earnings has soared 20.3% from its 54-week low during the week of February 1, 2023; MidCap's is 6.4% above its 55-week low during the week of March 10, 2023; and SmallCap's is 1.4% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrends since mid-2022 have been relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Their forward earnings momentum has improved from three-year lows just over a year ago, but LargeCap's has improved faster than the SMidCap's. Here are the latest consensus earnings growth rates for 2024 and 2025: LargeCap (10.1%, 12.7%), MidCap (-0.8, 13.6), and SmallCap (-12.2, 17.8).

S&P 500/400/600 Valuation (*link*): Valuations rose across the board for these three indexes during the November 22 week and were at multi-year highs for the SMidCaps. LargeCap's forward P/E rose 0.2pt w/w to 22.0, and is just 0.2pt below its 43-month high of 22.2 during the November 8 week. It's up 5.0pts from a seven-month low of 17.0 during the October 27, 2023 week and 6.9pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E jumped 0.7pt higher w/w to a 40-month high of 17.1. It's up 4.8pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E surged 0.6pt higher w/w to a 41-month high of 16.9 from a 40-month high of 16.7. It's up 5.8pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's 23% discount to LargeCap's P/E is the lowest since the March 16, 2023 week and up from a 25-year-high 29% discount during the July 5, 2024 week. It had been at a 19% discount during the March 2, 2023 week, which was near its best reading since October 14, 2021. SmallCap's 24% discount is the lowest since the March 9, 2023 week and is up from a 24-year-low 34% discount during the July 5, 2024 week. That compares to a 20% discount during the March 2, 2023 week; that one was near its lowest discount since August 2021. SmallCap's 1% discount to MidCap's is among the smallest since July 2021. Prior to that from 2003 to 2018, SmallCap's P/E had been mostly above Midcap's, and both were above LargeCap's.

US Economic Indicators

Regional M-PMIs (*link*): Four regional Fed Banks have reported on activity in the *manufacturing sector* for the month of November, and it's a mixed bag. The *New York* Fed was the first regional Fed bank to report on manufacturing activity during November, and the results blew past forecasts, soaring to its highest level in nearly three years! The *headline general business conditions* surged 43.1 points (to 31.2 from -11.9) to its highest reading since December 2021—after being in contractionary territory for ten of the prior 11 months. The *Philadelphia Fed* manufacturing index was a mirror image, with the current general activity index (-5.5 from 10.3) moving from expansion to contraction, posting its second negative reading since January. November's survey saw manufacturing activity in the *Kansas City Fed's* region moving to within a hair of expansionary territory, with its *composite index* rising from -8 in September to -4 in October, and -2 this month. Meanwhile, manufacturing activity in the Dallas Fed region also improved in November, with its production index (-0.9 from 14.6), a key measure of state manufacturing conditions, also moving closer to the breakeven point of zero.

Global Economic Indicators

Germany Ifo Business Climate Index (*link*): "The German economy is lacking strength," noted Ifo President Clemens Fuest. German *business confidence* fell more than expected in November, after posting its first increase in five months in October, sinking to 85.7 (vs 86.1 expected) in November from 86.5 in October; it was at 89.2 in May. The *current situation* was the biggest drag on the index, falling from a recent peak of 88.9 in April to 84.3 this month—the lowest reading since July 2020. The *expectations* component showed little change in November, ticking down from 87.3 to 87.2, after falling from 90.1 in May to a seven-month low of 86.4 in September. The *service* sector saw the *business climate* index drop significantly, with the *current situation* following suit. *Expectations* were also on the weak side. Meanwhile, the *manufacturing* business climate worsened in this month, led by the *expectations* component, while the *current situation* had a slight uptick, though was still described as "difficult." *Construction's business climate* worsened noticeably again in November, as companies were less satisfied with both their *current conditions* and *expectations*. Turning to *trade*, it improved again in November, as companies assessed their *current situation* as better, while *expectations* were less pessimistic. The report noted, however, that "sentiment among companies is still a long way off from being positive."

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