March 25, 2025

Morning Briefing

Meet Scott Bessent

Check out the accompanying chart collection.

Executive Summary: The actions of Treasury Secretary Scott Bessent will be key to how the financial markets react to Trump 2.0's economic agenda. Today, Eric shares insights into Bessent's beliefs and proposals, which may have overly concerned investors recently. Bessent would take a gradual approach to lowering the budget deficit and the dollar, mindful not to stir up market volatility. The dollar's global dominance is not at risk, nor is the Fed's independence. … Investors can also relax about the Fed's decision to slow its balance-sheet paring. It doesn't represent monetary easing or the end of QT. It's just a practical measure to lift pressure on reserve balances and should barely affect Treasury yields.

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

Fiscal Policy I: Trump's Treasury Man. Since President Trump took office two months ago, his economic team has been on the road making frequent media appearances. Between Treasury Secretary Scott Bessent, Commerce Secretary Howard Lutnick, and National Economic Council Director Kevin Hassett, there's at least one media hit a day. The trio seems to be marketing Trump 2.0 to both Wall Street and Main Street. The bulk of their time is spent assuring that tariffs are a long-term net positive and that reversing the Biden administration's "disastrous" policies may require some pain, but that both are part of a broader economic strategy to achieve more sustainable and America-first growth.

Hassett is the only one of the three with extensive policy experience, including serving as the chair of the Council of Economic Advisers (CEA) in Trump 1.0. So his views have been widely on display for some time. It remains to be seen how much sway Lutnick will hold in tariff negotiations that include US Trade Representative Jameison Greer, Bessent, Secretary of State Marco Rubio, and of course President Trump. So we have been focusing on trying to understand Bessent's views.

Bessent is a self-professed economic history buff, having taught it at his alma mater Yale for several years despite holding just a bachelor's degree. His motivation for leaving his hedge fund Key Square Group to join Trump 2.0 undoubtably is the opportunity to help spearhead what aims to be the largest realignment of global trade in decades.

What Bessent says and does as Treasury secretary will be key to the markets' reactions to Trump 2.0 for several reasons: (1) The Treasury Department's debt management strategy has gained outsized importance as the US deficit and debt ostensibly near tipping points. (2) Sanctions on Russian assets and their excommunication from the SWIFT international payments system may have hurt the dollar's global status and elevated alternatives, as can be seen by gold's surge since 2022 (*Fig. 1*). (3) Bessent may need to tap novel Treasury policies to achieve Trump 2.0's mandate of a weaker dollar and lower bond yields.

A few long-form interviews of Bessent—including earlier this month on *Face the Nation* and on the *All-In* podcast (hosted by Trump's AI and Crypto Czar David Sacks and a few other venture capitalists)—provide helpful insight into his views. They also help draw contrast to warnings by some in the financial media that the overarching economic plans are either doomed or lack cohesion.

Take a moment to consider some of the key takeaways regarding the next four year's economic policies, and our spin on what they may mean for the financial markets:

(1) *Unsustainable.* Bessent recently asserted that the American Dream is built on upward mobility and rising per-capita wealth/incomes, rather than the availability of "cheap goods." This drew fire from across the political spectrum, particularly with tariffs threatening to raise goods prices. But Bessent doubled down on his view, suggesting that unconstrained fiscal stimulus and overregulation led to record inflation for necessities and housing unaffordability (*Fig. 2* and *Fig. 3*). Therefore, in his eyes, it's no surprise that many Americans have been downbeat on the economy throughout the last few years, as real wages suffered despite strong reported economic growth. (In fact, the trend for real wages has been to the upside since 1995.)

(2) *Regulation*. Bessent believes that bank regulation has prevented the private sector from leveraging up (by preventing bank lending). Therefore, deregulation will help the private sector releverage and thus offset the negative growth impulse from government's deleveraging as the fiscal deficit is reined in relative to GDP (*Fig. 4*). With bank lending standards easing and the private credit market flush with cash, there's certainly a lot of pent-up supply of dollars to lend (*Fig. 5*).

A direct impact for bond yields is the Supplementary Leverage Ratio (SLR), which basically is a capital charge to banks for buying risky assets, but that includes Treasury bills and bank reserves. Despite the success of excluding Treasuries and reserves during 2020, the charge was reimposed in March 2021. By excluding bills and reserves permanently, which Fed officials have also supported, Bessent supposes that bill yields could fall by 30-70 bps. That would help save the government a lot of interest costs and also steepen the yield curve closer to historical norms (*Fig. 6* and *Fig. 7*).

(3) *Tax cuts*. Bessent believes that deregulation, reordered global trade, and lower government spending can pay for tax cuts and (at least in theory) boost economic growth enough to increase total government revenue.

As a percent of GDP, government revenues did fall from 19% in Q4-2015 to 17% by the end of 2019 and the deficit grew from 2.4% of GDP in 2015 to 4.6% in 2019 (*Fig. 8*).

Bessent wants to lower the federal budget deficit slowly, noting that some deficit hawks do not realize that swift cuts would weigh unduly on economic growth. The goal of a 3%-of-GDP fiscal deficit still has an uncertain time frame, so even moderate progress toward it is likely to be received favorably (*Fig. 9*).

Fiscal Policy II: Century Bonds. Much ado has been made in the financial media and on Wall Street about the administration's goal of deliberately weakening the dollar by issuing century bonds and pursuing a *Mar-a-Lago Accord*. This administration's focus is on lowering the 10-year Treasury bond yield as opposed to buoying the stock market, with Bessent likely spearheading this direction.

As part of the century bond proposal, Bessent would convert foreign investors' 5- and 10-year Treasuries into 100-year bonds, perhaps with a small withholding of interest payments (say, a percent or two of total coupon payments, not a full percentage point or two of yield). Nearly everything we've heard and read has been negative on this idea. Whether it will come to fruition remains to be seen. Most public responses have been quite critical. It's also not clear why foreigners would cooperate with this scheme.

We do not think outright currency depreciation measures will be taken until 2026 at the earliest. Tariffs, fiscal deficit reductions, and the stick approach forcing other countries to spend on their own defense obviously are indirect means of achieving a lower dollar. They are already under way but will take a lot of time to fully flesh out. We think investors would be better served focusing elsewhere.

Whether the Fed can remain independent in a Trump 2.0 administration is a more pressing issue for the markets. But we aren't too worried about this either: The idea of century bonds arguably underscores Trump 2.0's commitment to Fed independence. In our view, perceived threats to the status quo of dollar dominance and Fed independence are overdone.

Foreign central banks and therefore economies depend on the New York Fed's dollar swap lines to shore up the US dollar's value during financial crises and dollar shortfalls. For instance, from March through April 2020, foreign central bank swap line borrowing surged from zero to $450 billion. Indeed, *Reuters* reported over the weekend that some European officials were worried that the Fed would still provide this liquidity during Trump 2.0. The recent firing of two democratic Federal Trade Commission officials and an executive order creating additional presidential oversight over all "independent regulatory bodies" have raised these concerns.

But the proposed century bonds would rely on these swap lines, to ensure the accessibility and liquidity of dollar funding markets. Taking a note from the Fed's own playbook, Trump 2.0 imagines something similar to the Bank Term Funding Program (BTFP) for the rest of the world (ROW) (*Fig. 10*).

Domestic banks are forced to hold Treasuries by US government regulations. Therefore, they buy a lot of low-yielding debt as the debt stock grows rapidly during crises like those in 2008 and 2020, when the Fed had already slashed interest rates and the Treasury had to finance new stimulus programs. In 2023, the Fed backstopped its duration risk. So why not do the same for the ROW countries, which also hold US debt for economically mandatory reasons? The ROW remains the largest sectoral holder of US debt at about one-third (*Fig. 11*). Notably, that's down from nearly 60% during the Great Financial Crisis—but largely because the Fed has picked up much of the tab via quantitative easing (QE), not because of lack of demand. Foreigners hold most of their debt in longer duration notes and bonds, as they largely serve the purpose of reserve accumulation and perhaps some liability matching (*Fig. 12*).

From Steve Miran, Trump's current chair of the CEA: "Holding century bonds is less risky for reserve managers if they have access to swap lines granting them substantial short-term dollar liquidity. The desire to maintain access to such swap lines will be a powerful long-term incentive for remaining inside the U.S. security and economic umbrella."

Fiscal Policy III: Fed Independence & the Treasury Market. One of the primary reasons that Treasuries are used as reserves is their market depth and liquidity. President Trump's recent promotion of Fed Governor Michelle Bowman to vice chair of Supervision highlights that there will be no "shadow chair" and that the Fed will pursue thoughtful deregulation. On several occasions over the past two decades, regulators threatened Treasury market stability by tightening their grip over the banking system. As the debt stock grows, ensuring that the Treasury market is resilient is even more important.

There is no alternative to the Treasury market at the European Central Bank given its lack of jointly issued EU debt, and the Fed will remain the global financial system's fire chief. When you want to de-risk, you buy US Treasuries. In times of acute stress, dollars are even more pristine collateral. We'll likely all be talking about threats to the dollar's status for years to come. But we believe that incremental shifts in the balance of global trade and seeking to prevent the debt-to-GDP ratio from spiraling out of control are not going to upset its global dominance (*Fig. 13*).

Bessent believes a sovereign wealth fund (SWF) could be crafted out of the government's current assets. For instance, the Social Security trust fund (around $2.8 trillion in assets) should be able to invest in equities and other non-Treasury assets to boost returns. The Treasury's claims on the government sponsored enterprises (GSEs), i.e., Fannie Mae and Freddie Mac, could be shifted to an SWF. Federally owned land could be used as an asset as well. Bessent doesn't view a revaluation of the government's gold holdings as a credible path to reducing the budget deficit, as some have suggested.

The jury is still out on what a SWF would look like; but if one is constructed, it would likely invest in domestic assets and encourage investment. On the margin, the idea can't hurt.

Monetary Policy: Is Quantitative Tightening Still on? At last week's March meeting, the Federal Open Market Committee decided to slow the Fed's paring of its balance sheet. Previously, the Fed had capped the amount of maturing Treasury securities that could be reinvested to $25 billion. This was lowered to $5 billion, while the $35 billion cap on agency debt and mortgage-backed securities (MBS) was maintained.

Fed Governor Christoper Waller was the lone dissenter on this action, preferring to maintain the pace of runoff. In a *statement*, he said that bank reserves remain abundant at over $3 trillion and funding market conditions remain stable, suggesting no need to tamper with QT (*Fig. 14*). An outside but notable voice, Larry Summers *said* that the decision to taper QT was alarming and suggested that the private sector was struggling to absorb the onslaught of debt issuance.

We respectfully disagree with both Waller and Summers. The decision to limit QT was a technical one on the basis of market plumbing and functionality, not one of monetary policy to reflect the real economy. It's unlikely to have any material impact over the intermediate term, either. Consider the following:

(1) *MBS*. The Fed would eventually like to hold no MBS, just Treasury securities. So there's $2.2 trillion of unwanted debt on its balance sheet (*Fig. 15*). Given that most mortgage holders have much lower rates than prevailing rates today, many having refinanced during the pandemic, there's little incentive to prepay. That's lengthened the duration of the Fed's MBS portfolio and kept the amount of MBS rolling off well below the cap, hence the decision to leave that cap unchanged.

(2) *Rate pressures*. While money market functioning broadly is in good shape and reserves are quite high, Waller is not necessarily right in saying there are no evident pressures. For instance, the spread between the Secured Overnight Financing Rate (SOFR) and the federal funds rate (FFR) has been more elevated recently than over the past few years (*Fig. 16*). This suggests financing in repo is getting tougher and tougher on stressful dates, such as quarter-end and year-end. So while everything is still fine, reserves have still been shrinking relative to GDP and thus their abundancy is diminishing as well. The Fed plans to end QT when reserves are "ample" (which means less than abundant but still much more than needed). The rise in SOFR relative to the FFR suggests ample is approaching.

(3) *Treasury yields*. In theory, QT raises Treasury yields by increasing the supply that the price-sensitive private sector has to hold. It's the reverse of QE, which involves the price-insensitive Fed bidding up bonds and thereby lowering yields. So we've been asked many times what impact tapering QT will have on bond yields. It won't be nothing but probably will be immaterial.

As the Treasury spends down its Treasury General Account (TGA) at the Fed to finance the deficit while the debt limit remains unresolved, reserves will get a boost. But eventually, the Treasury will rapidly rebuild the TGA, causing reserves to fall and potentially blowing through the "abundant" level the Fed hopes to eventually reach.

In short, the Fed, mindful of the volatility that could occur, decided to slow its pace of balance-sheet reduction for the time being and thus put less downward pressure on reserve balances. It's prudent central banking, not a measure to ease monetary policy.

Calendars

US: Tues: Consumer Confidence Index 94; New Home Sales 680,000 Units; Richmond Manufacturing Index 8; Williams; Kugler. **Wed:** Durable Goods Orders -1.0%; Nondefense Capital Goods Orders ex Air -0.2%; MBA Mortgage Applications Kashkari; Musalem. (FXStreet estimates)

Global: Tues: Ifo Business Climate Index 87. **Wed:** France Consumer Confidence 94; Spain GDP 0.8%q/q, 3.5%y/y; UK Headline & Core CPI -0.1%m/m, 3.0%y/y & 0.5%m/m, 3.6%y/y; Cipollone. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the March 21 week, forward earnings rose for two of these three indexes for a fifth straight week; that followed two straight weeks of all three falling simultaneously (the first time that had happened in 14 months). MidCap's forward earnings hit a record high for the first time in 33 months last week, and LargeCap's was at its fourth record high since the January 31 week. SmallCap's posted its eighth straight weekly decline and its longest since it fell for 12 weeks through December 2022 as it edged down to a 40-month low and is now 14.1% below its June 2022 record. LargeCap's forward earnings has soared 23.4% from its 54-week low during the week of February 1, 2023; MidCap's is 8.9% above its 55-week low during the week of March 10, 2023; and SmallCap's is now 0.6% below its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2026: LargeCap (11.3%, 9.5%, 14.2%), MidCap (-0.4, 10.4, 16.0), and SmallCap (-11.6, 8.1, 19.9).

S&P 500/400/600 Valuation (*link*): Valuations mostly edged higher for these three indexes during the March 21 week. LargeCap's forward P/E rose 0.1pt w/w to 20.3 from a 28-week low of 20.2, and is now 2.0pts below its 43-month high of 22.3 during the December 6 week. It's up 3.3pts from a seven-month low of 17.0 during the October 27, 2023 week and 5.2pts 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 was steady w/w at a 15-month low of 14.7, and is now 2.3pts below its 40-month high of 17.1 during the November 29 week. It's up 2.4pts 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 was up 0.1pt w/w to 14.6 from a 27-week low of 14.5, and is 2.5pts below its 41-month high of 17.1 during the November 29 week. It's up 4.0pts 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 P/E is at a 27% discount to LargeCap's P/E, up from a seven-month low 28% a week earlier and above its 25-year-low 29% discount during the July 5, 2024 week. That compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E is at a 28% discount to LargeCap's P/E, up from a 17-week low 29% in later February, which compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 6ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E is a whisker of a discount below MidCap's and remains 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.

Global Economic Indicators

US PMI Flash Estimates (*link*): Business activity in the US gained momentum in March; however, business expectations for the year ahead sank to their second lowest reading since October 2022, as companies grew increasingly cautious about the economic outlook—citing worries over customer demand and the impact of aspects of the new administration's policies. March's *C-PMI* (to 53.5 from 51.6) climbed to a three-month high from February's 10-month low; however, the rate of expansion was well below December's 32-month high. March's improvement was led by the service sector, with the *NM-PMI* (54.3 to 51.0) showing an acceleration in growth during the month. Meanwhile, manufacturing activity deteriorated in March, with the both the *M-PMI* (49.8 from 52.7) and *M-PMI Output* (48.8 from 54.5) measures contracting and falling to three-month lows. *Turning to prices, input cost* pressures increased at the sharpest rate in 23 months, across both goods and services. They surged mainly in the *manufacturing* sector—where the rate of inflation reached a 31-month high—while the *service sector's* rate was at an 18-month high. Higher costs led to a steeper increase in *manufacturing selling* prices, which posted its highest rate in 25 months in March, while there was a modest acceleration in *service's selling price* inflation.

Eurozone PMI Flash Estimates (*link*): "Eurozone output continues to rise as manufacturing returns to growth," according to the report. The *Eurozone's C-PMI* climbed to a seven-month high of 50.4 in March, according to the flash estimate, with the *M-PMI* (48.7 from 47.6) climbing to a 26-month high, nearing the breakeven point of 50.0, while the *M-PMI Output* (50.7 from 48.9) measure climbed to a 34-month high, moving into expansion territory for the first time in two years. Meanwhile, the *NM-PMI* (50.4 from 50.6) continued to hold just above 50.0. Turning to the *Eurozone's two largest economies*, *Germany* was buoyed by an upturn in manufacturing production. Germany's *C-PMI* (to 50.9 from 50.4) climbed to a 10-month high, with the *M-PMI Output* (52.1 from 48.9) measure swinging from contraction to expansion—reaching a 36-month high. Germany's *M-PMI* (48.3 from 46.5) jumped to a 31-month high, nearing the breakeven point of 50.0, while the *NM-PMI* (50.2 from 51.1) showed a slowing in activity during the month. Meanwhile, *France's* economic downturn continued as the first quarter came to an end, with *business confidence* dropping to its lowest level since April 2020. France's *C-PMI* (to 48.0 from 45.1) remained in negative territory, though declined at a slower pace. Both France's M-PMI (48.9 from 45.8) and *M-PMI Output* (48.8 from 44.5) measures showed an improvement—with the former climbing to a 26-month high and the latter at a 34-month high, as both indexes moved closer to expansion territory. Meanwhile, the report noted "a solid increase output was recorded in the rest of the Eurozone, extending the current sequence of growth to 15 months."

Japan PMI Flash Estimates (*link*): Japan's business activity declined for the first time in five months. The *C-PMI* (to 48.5 from 52.0) flash estimate fell into contraction territory in March, on widespread weakness. March's M-PMI Output (46.5 from 48.4) measure sank deeper below the breakeven point of 50.0, with manufacturing output declining at the fastest pace in a year. Meanwhile, March's NM-PMI (49.5 from 53.7) dipped back below zero this month, falling from February's six-month high, only the fourth time that business activity has fallen in the past three years. *As for pricing*, cost pressure picked up, with average *input costs* rising at the fastest pace in 25 months, leading to a further solid rise in *prices charged*.

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