April 15, 2025

Morning Briefing

More On Inflation & Bonds

Check out the accompanying chart collection.

Executive Summary: Tariffs are stagflationary, but consensus expectations may be overestimating the inflationary impact and underestimating the downside risks to growth. We evaluate the disinflationary forces that may counterbalance tariff-included price increases. … Also: The bond market's recent volatility may reflect a fundamental reevaluation by investors at home and abroad regarding the safety of US government debt. The continued decline of the dollar and appreciation of haven assets in Europe support this argument, while the impact of levered Treasury trades unwinding appears to be less significant.

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

Inflation: Consensus Too Worried? Tariffs are an odd tax. While most taxes tend to weigh on economic growth, tariffs are stagflationary in that they both weigh on growth and raise prices. Like most economists, we raised our inflation targets for the year after Liberation Day, April 2. We are now targeting 3.0%-4.0% core PCE inflation this year and 2.0%-3.0% over each of the next two years (*Fig. 1*). Over the near term, we expect consumer goods inflation to rise as tariff costs are passed on to consumers.

A large source of headline-rate disinflation over the past two years has been deflating goods prices, mostly due to China's overcapacity and export boom combined with sagging demand for goods after the pandemic buying binge. Over the medium term, Trump's Nitro Tariffs (TNT) might not upset these patterns. In other words, goods prices might continue to deflate.

We've started to think about what could happen from a contrarian perspective. There seems to be absolute certainty that inflation will be a major issue as the result of TNT. Is a contrarian call that inflation remains relatively subdued (with the PCED not straying too far north of 3.0% y/y) for the remainder of the year warranted? We're not ready to make that call, but let's discuss the case for such a sanguine inflation outlook:

Here are a few suppressants that could keep inflation contained:

(1) *US consumer demand.* The early innings of a recovery in goods demand will likely have a blowoff top in March or April reflecting consumers' front-running tariffs and businesses offloading inventory (*Fig. 2*). Meanwhile, our friends the Baby Boomers have been spendthrift for several years on the back of strong wealth effects. They now account for $82.5 trillion of the $160.4 trillion in total household wealth (*Fig. 3*). The current correction in stock prices and daily market volatility are likely to sideline some of the spending of retired Boomers with invested nest eggs. As for consumers still working, roughly half of consumer spending comes from high earners (households in the top 10% of income tranches), who also own a lot of stocks. Indeed, households (which include nonprofit organizations) have a record 43.5% of their financial assets tied up in the stock market (*Fig. 4*).

Big-ticket trips are likely one of the first discretionary spending items households will cut. Spending on airlines and hotels reached a record high $368.2 billion (saar) in February (*Fig. 5*). That may have been the peak. Meanwhile, CPI airline fares fell 5.3% m/m in March (*Fig. 6*). Perhaps the demand is already dropping off.

(2) *China supply*. China's trade surplus has grown to more than $1 trillion as it has attempted to export its way out of a property bubble bust, bad debts in local governments, and weak consumer demand (*Fig. 7*). That's put downward pressure on US import prices for the past few years. It likely will continue to notwithstanding the 145% tariff on Chinese imports.

Firstly, a number of products will not be subject to the 145% tariff on China. Secondly, China no doubt will continue to circumvent US tariff barriers by routing US-bound goods through trading partner nations. Indeed, there's strong incentive to do so: If anything, China needs to export even more goods than it currently does to avoid an economic slowdown.

For some imported products, there are no alternatives for US consumers, and at least a 10% tariff will need to be paid (depending on the product and country of origin). But for other imported goods, US consumers may find substitutes in domestically produced products or imports from countries with which the US has negotiated deals. Domestic products may also become more expensive due to higher input costs like American labor, but real wage gains for consumers in goods-producing sectors could theoretically help offset the higher prices.

(3) *Tax or price hike?* There will likely be conflicting signals as to whether tariffs create more

pain by weighing on economic growth or raising prices. In our view, the bigger risk is to growth. The volatility of TNT has cast so much uncertainty over both businesses and consumers that spending, hiring, and investment are likely to sharply slow over the next few months. That's before accounting for the negative growth effects of lower stock prices, real incomes/consumption falling due to higher cost of essentials and labor, and any export losses due to retaliation by other countries.

Bond Market I: Parsing the Moves. Despite the runup in yields, bonds appear not to be trading on inflation fears. Long-term inflation measures—including the difference between 10-year nominal and TIPS yields as well as swaps for the period five to ten years in the future—have sunk toward levels consistent with the Fed's 2.0% inflation target (*Fig. 8*)!

To see the degree of inflation shock that consumer surveys suggest Americans are worried about, an oil price shock would likely be necessary. But a barrel of crude is getting cheaper by the day on global economic growth fears (*Fig. 9*). As a reminder, the 10-year Treasury bond yield has fallen dozens of bps over the past few months. Given how sensitive it has been to the economic data—which supports the idea that the risk-free rate generally tracks with nominal GDP—it's hard to see much more upside for yields as TNT blows up the growth picture (*Fig. 10* and *Fig. 11*).

It's less the move in yields than the correlations with other assets that have been inciting broader worries about the US dollar and the sanctity of the Treasury market. On days when everything's going bust, so are bonds. Let's discuss:

(1) *Dollar down*. The DXY dollar index is down 3.33% over the past five days (*Fig. 12*). Meanwhile, the 10-year yield has climbed from 4.14% to 4.40% (and reached as high as 4.57% on Friday). The selloff from pristine safe-haven assets has sparked worries that investors see them as a bit less alluring now.

(2) *Bunds and euros up*. Over the same period, the 10-year German bund yield fell from 2.66% to 2.53%, widening the spread between US and German yields to nearly 200bps (*Fig. 13*). The euro has gained 3.8% ytd against the greenback (*Fig. 14*). These moves suggest a rotation out of US assets and into their European counterparts. Such rotations are tough to do on a broad scale given the lack of bund depth, but a relatively small move in yields has an outsized impact. Chinese state asset managers may have dumped a fraction of their US Treasuries for euros and bunds, weaponizing their balance sheets. If just a bit of selling pressure by foreign investors could cause so much angst in US financial markets, that would suggest the US's fiscal situation is very fragile.

(3) *Auctions in action*. Are investors broadly shunning US Treasuries? That's not apparent in the latest 10- and 30-year Treasury auctions, which saw strong demand (*Fig. 15*). Perhaps the issue is simply the velocity of the market moves themselves, as bond volatility can quickly stop out trades in what's normally a relatively calm market.

Bond Market II: The Technicals Driving Yields. The MOVE bond volatility index surged last week as Treasury yields jumped around (*Fig. 16*). There's been lots of chatter suggesting that the unwinding of various Treasury trades, including the cash-futures basis trade and the interest-rate-swap spread trade, has ginned up bond market volatility. The cash-futures basis trade was at the heart of the LTCM financial market crisis in 1998 and the Covid market upheaval in March 2020, so naturally it incurs a lot of interest. But this time around, it's the interest-rate-swap spread trade being blamed for the recent Treasury market dysfunction. Let's explain the trade briefly, decide whether it is indeed driving market volatility, and evaluate what it means for equity investors:

(1) *Swap spreads*. The deluge of Treasury issuance has put increasing strain on bank balance sheets. Post-2008 regulations also incur a cost to banks for warehousing those bonds. Thus, derivative contracts such as swaps have become much more attractive ways of gaining exposure to long-term bonds (i.e., duration). Swap spreads therefore can be thought of as the cost of gaining leverage from a bank by having a bank hold one's Treasury bond. Swap contracts are negotiated and therefore have counterparty risk and also have far less liquidity than cash bonds (they cannot be fire-sold for cash). The swap spread is negative by the amount that a bank or another investor earns by holding a Treasury bond.

A negative swap spread (the spread was recently around -80bps) yields that much less than would the Treasury bond of the same maturity. But it offers investors duration exposure while freeing up their balance sheets to invest in other assets. On the flip side, an investor taking advantage of the negative spread could purchase the cash bond and provide the fixed-interest payments paying 80bps. Levering up that bond in the repo market could produce attractive annual returns.

Of late, the swap spread started to narrow (climbing closer toward positive territory) as speculators thought that newly appointed Federal Reserve Vice Chair Michelle Bowman would exclude Treasuries from the Supplementary Leverage Ratio, freeing up banks to warehouse the bonds. But when Treasury yields started to rise due to selling pressure, the trade went the other way, and the swap spread hit new lows (or highs, in negative terms) of around -100bps. Also, the amount of trading activity in the repo market increased recently, suggesting that banks had a lot of Treasuries coming their way that they needed to finance. So rather than the swap spread blowing out and causing an unwind, the swap spread became more negative as investors started to sell Treasuries for discretionary reasons.

(2) *TIPS for investing.* Inflation-adjusted TIPS yields have surged to 2.2% (*Fig. 17*). TIPS aren't usually sold for liquidity purposes, i.e., to access cash as a levered trade unwinds. That further suggests that there are real fundamental concerns driving yields higher, rather than just investors exiting positions amid market volatility. Perhaps the likelihood of a new debt ceiling bill that blows out the deficit plus policy uncertainty are raising the term premium on bonds.

(3) *Any diversification benefit?* The popular iShares 20+ Year Treasury Bond ETF (ticker: TLT) is down 48% over the past five years (*Fig. 18*). Long-duration bonds are not providing any hedge to falling stock prices as fiscal and inflation fears drive yields higher. At these rates, shorter-duration bonds are a better hedge—unless, of course, the Fed slashes the federal funds rate (FFR) quickly, as it often does during recessions (*Fig. 19*).

(4) *Powell to the rescue?* Could the Fed backstop the Treasury market? Of course, and the existence of various facilities is likely quelling volatility anyway. However, using quantitative easing when inflation remains elevated could dent US credibility and widen term premia, ultimately driving the yield curve much steeper. Gobbling up all the long-duration Treasury issuance might work to cap yields but would likely reduce investors' appetite for other US debt and assets substantially, creating another problem.

If PCED inflation remains below 3.0% y/y, we believe the Fed might cut the FFR to 3.5% this year. Any real financial crises would probably see those cuts accompanied by balance-sheet policy that lowers the 10-year Treasury bond yield below our 4.25%-4.75% forecast range as well. These are unlikely scenarios, but growing in probability as TNT indelicately blows up various segments of the global economy and financial markets.

Calendars

US: Tues: Empire State Manufacturing Index -14.8; Import Prices 0.1%. **Wed:** Headline & Core Retail Sales 1.4% & 0.4%; Industrial Production -0.2%; Capacity Utilization 78.0%; Business Inventories 0.3%; NAHB Housing Market Index 38; Powell; Schmid; Hammack. (FXStreet estimates)

Global: Tues: Eurozone Industrial Production -0.4%; Eurozone ZEW Economic Sentiment 14.2; Germany Wholesale Price Index 0.2%; France CPI 0.2%m/m, 0.9%y/y; ECB Bank Lending Survey; UK Claimant Count Change 30.3k; UK Average Hourly Earnings Including Bonus 5.7%. **Wed:** Eurozone Final Headline & Core CPI 2.2% & 2.4%; UK Headline & Core CPI 2.7% & 3.4%y/y; BoC Press Conference. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the April 11 week, forward earnings fell for all of these three indexes simultaneously for the first time in eight weeks, and were down from record highs for LargeCap and MidCap. LargeCap's forward earnings fell 0.2% w/w, and MidCap's dropped 0.6%. SmallCap's fell 0.2% w/w to 12.6% below its June 2022 record. LargeCap's forward earnings has soared 23.3% from its 54-week low during the week of February 1, 2023; MidCap's is 8.5% above its 55-week low during the week of March 10, 2023; and SmallCap's is only 1.1% above 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 (9.7%, 10.2%, 14.3%), MidCap (0.4, 8.2, 16.1), and SmallCap (-10.2, 7.1, 19.7).

S&P 500/400/600 Valuation (*link*): Valuations recovered last week from their worst week in five years when they dropped to their lowest levels since November 2023. On a percentage basis, LargeCap's forward P/E rose the most w/w since the November 11, 2022 week, gaining 1.1pts w/w to 19.3. It's now 3.0pts below its 43-month high of 22.3 during the December 6 week and 2.3pts above the seven-month low of 17.0 during the October 27, 2023 week. That compares to a 30-month low of 15.1 at the end of September 2022 and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.5pt w/w to 13.7. It's now 3.4pts below its 40-month high of 17.1 during the November 29 week and just 1.5pts above the 12-month low of 12.2 in October 2023. That compares to a record high of 22.9 in June 2020 when forward earnings was depressed, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose just 0.1pt w/w to 13.0 from a 17-month low of 12.9. It's now 4.1pts below its 41-month high of 17.1 during the November 29 week and just 2.4pts above its 14-year low of 10.6 in September 2022. That compares to a record high of 26.7 in early June 2020 when forward earnings was depressed, and a record low of 10.2 in November 2009 during the Great Financial Crisis. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E is at a nine-month low

28.8% discount to LargeCap's P/E, just a hair above its 25-year-low 29.3% discount during the July 5, 2024 week. That compares to a 19.0% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E is now at a nine-month low 32.1% discount to LargeCap's P/E, which compares to a 22.6% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's 1.6ppts above its 24-year-low 33.7% discount during the July 5, 2024 week. SmallCap's P/E weakened to a nine-month-low 4.6% discount to MidCap's, but that 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.

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