Yardeni Research

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Morning Briefing

On Global Bond Markets & Latin America

Check out the accompanying chart collection.

Executive Summary: When Trump's Big, Beautiful Bill passes, it will likely make deficits larger and increase the debt over the next 10 years. The US bond market hasn't been batting an eye. Was former US Vice President Dick Cheney right when he said in 2002 that federal budget deficits don't matter? They'll certainly matter if too much US government debt triggers a financial crises, which continues to be a no-show, William points out. … Latin American markets are coming into favor as global investors seek shelter from trade risks and Middle East uncertainties. Their several advantages include low valuations and rich natural resources, including rare earth minerals.

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

Global Bond Yields I: Do Deficits Matter? It's been 23 years since Dick Cheney's infamous *2002 dictum* that federal budget deficits don't matter. And as 2025 veers from one mini-crisis to another, it's hard not to think the former US vice president still has it right today.

After all, the Senate at this moment is taking up President Donald Trump's Big, Beautiful Bill, which is expected to *add $3.7 trillion* to the federal budget deficit over the next decade. That's in addition to the $16 trillion increase in the debt projected by the Congressional Budget Office under current law over the next 10 years. It takes the tax-cuts-pay-for-themselves argument further into uncharted territory, claiming a budget impact of just *$441 billion*. In reality, the Senate's version could add *$4.2 trillion* to Washington's deficit, according to the Committee for a Responsible Federal Budget (CRFB).

Yet from S&P Global, Fitch Ratings, and Moody's Investors Service, global debt investors are hearing crickets. Back in 2011, when S&P was the first to revoke Washington's AAA rating, the national debt was just *$14.7 trillion*, 62% lower than today's *$37 trillion* (*Fig. 1*).

Today, US debt is 83% higher than the *$6.2 trillion in 2002* when Cheney *dismissed deficits* out of hand. Yet nearly a quarter century on, *10-year yields* are just 4.28% and 30-year rates are 4.84% (*Fig. 2*). That's despite the near-doubling of annual US debt servicing costs over the last five years to *$1.1 trillion*, according to Federal Reserve Bank of St. Louis data. Washington now spends more on interest payments than defense (*Fig. 3*).

The US is hardly alone in suspending the usual laws of economic gravity. During Q1, global debt reached a new record high of over *$324 trillion*, according to the Institute of International Finance. That's a $7.5 trillion q/q increase.

Yet Eurozone benchmark German 10-year bund yields are *just 2.57%* (*Fig. 4*). Ten-year bonds issued by Japan, the developed nation with the biggest debt burden, carry a remarkably low *1.42% yield* despite the economic albatross of having one of the globe's ugliest demographic trajectories. Chinese 10-year debt *yields just 1.67%* even though Xi Jinping's government is the most opaque by far among top economies. A year ago, few might've expected to see Japanese and Chinese bond yields converging despite the two countries' vastly different challenges (*Fig. 5*).

The common thread is that global investors appear to be responding more to inflation trends, longer-term inflation expectations, and the direction of monetary policy than to the supply of government debt. Whether that's a mistake is a question for posterity. All global market investors can do is try to divine where new financial cracks might be forming.

Of course, strategists and policymakers would like the answer sooner than posterity will yield it. Recent decades offer for their scrutiny no shortage of sovereign debt crises in which the supply of debt did matter.

Global Bond Yields II: Tripwires Galore. Examples of sovereign debt crises triggered by too much supply of government debt include *Europe in 2010 and 2011*, Russia in 1998, East Asia in 1997, Mexico in 1994, Latin America in the 1980s. And, mostly recently, the UK in 2022.

Here are some possible tripwires for the next global debt reckoning:

(1) *Liz Truss redux.* No modern debt crackup rivals what transpired in the UK in September-October 2022. Then-Prime Minister Liz Truss tried to jam a large package of tax cuts through Parliament without offsetting spending cuts. The Bond Vigilantes rebelled, pushing yields more than *150 basis points higher* in just a few days (*Fig. 6*). A British tabloid

famously livestreamed a head of iceberg lettuce next to Truss's photo to see which would last longer. The lettuce won.

Trump inspired "Liz-Truss-moment" chatter in April and May when his tariffs ran afoul of debt traders. Count Stephen Jen of Eurizon SLJ Capital among those *worried* that Trump's "insane" unfunded tax cuts put the US at similar risk.

(2) *Trade war intensifies*. The mini-crash in the US Treasury bond market earlier this year came as bond investors worried that Trump's tariffs would accelerate inflation and reduce foreign demand for US assets. It took just *13 hours* of the market's screaming at him for Trump to relent. As Trump admitted: "The bond market is very tricky; I was watching it."

(3) *Central banks losing trust*. The glue holding many of the biggest bond markets together is central banks' substantial mission creep over the last few decades. The Bank of Japan (BOJ) is Exhibit A. By 2018, the BOJ had grown its *balance sheet* bigger than Japan's entire *$4.2 trillion economy*. The Fed's role has grown decade after decade, with US politicians all too happy to cede economic management to the central bank. The European Central Bank now routinely *oversteps its remit* by backstopping banks and stabilizing markets.

Yet as politicians meddle in central banks' operations—including Trump's threats to fire Fed Chair Jerome Powell and Tokyo politicians' lobbying against BOJ rate hikes—central bank credibility is on the ropes.

(4) *New Middle East oil crisis*. The fragile ceasefire among Iran, Israel, and the US could blow up at any moment for any number of reasons, sending global inflation soaring. An oil shock would resurrect one of Warren Buffett's most famous witticisms: It's only when the tide goes out that you realize who's been *swimming naked*. And the fact that the globe just added the equivalent of *two Indian economies'* worth of public debt during Q1 means there's a whole lot of skinny-dipping going on.

(5) *Rise of stagflation*. As inflation rates overtake economic growth rates in developed nations from the US to the UK to Japan at a moment of rapid debt accumulation, the sudden return of financial gravity is increasingly possible. That could have disastrous effects.

The takeaway is a caveat: Complacency isn't a luxury that policymakers can afford given the cacophony of overlapping risks confronting the global financial system.

Latin America I: The Trump Effect. One of the biggest surprises of the Trump 2.0 era is how it appears to be making Latin America great again.

As Trump's trade war hits economic friends and foes alike, the search is on for emerging-market shelters from the storm.

This comes as many developing markets that typically top high-growth/high-yield wish lists are becoming less appealing. China, of course, is the epicenter of Trump's tariffs, while *India's lofty valuations* put its markets in buyer-beware territory. Russia remains a pariah state, while geopolitical risks mar the argument for Pakistan.

While East Asian growth stars Indonesia, Malaysia, and Vietnam are still pulling in some capital, their proximity to China's slowdown and deflation is giving investors pause. So are the relatively high "reciprocal" levies that Trump has slapped on the Asia-Pacific region.

Latin America, against all odds, is having a real moment, with global investors seeking opportunities in regions less directly troubled by Trump's trade war or potential fallout from Middle East tensions.

Here are some reasons Latin America is back in vogue:

(1) *Less trade war exposure*. This is despite Mexico's physical proximity to the US. The nation's companies are, generally speaking, *not as exposed* to the US as many emerging-market peers. Like Mexico, Brazil's stock market has performed well this year.

The MSCI Latam index is *up 25%* ytd while the broader MSCI Emerging Markets Index is up 14% and the Asia sub-index just 12%.

For those uninterested in chasing Mexican and Brazilian shares higher, local debt markets are gaining increasing favor with global funds. This is despite fewer investment-grade ratings and less liquidity that investors can find in other emerging peers.

(2) *Attractive multiples*. As Leonard Linnet at Itau BBA *told Reuters*, Brazil is not only cheaper than China and India, but it's trading at a 23% discount from its own historical average P/E multiple. The Brazil MSCI index is trading at 8.1 times forward earnings versus 11.7 times for the China MSCI and 23.1 times for the India MSCI as of the June 27 close (*Fig. 7*).

Garrett Melson at Natixis Investment Managers argues that many Latin American countries have avoided the brunt of Trump's tariffs. "Latin America doesn't have quite as extreme trade surpluses with the US," Melson *told S&P Global*. "That might be an opportunity where you see a little picking up of the slack to the degree that you do have some reduced trade flows with China."

Netherlands-based Robeco, for example, is increasing its allocations in Chile, Brazil, and Mexico. The tech startup scenes in *Chile*, *Colombia*, and *Uruguay* are garnering more global attention as disruption creates new growth and wealth from the ground up.

(3) *Argentina getting groove back*. Even Argentina, considered a third-rail economy by many investors, is reappearing on investment radar screens. Over the last 12 months, the S&P Merval index is *up more than 26%*, more than double the y/y gains of *Brazil* and *Mexico*. Much of the financial chaos wrought by President Javier Milei's December 2023 *peso devaluation* and austerity drive seems to have passed.

Between January and March, Argentina's agriculture-driven economy grew a China-beating *5.8% y/y*, the second consecutive quarter of growth. Exports *increased 7.2%*, while imports surged 42.8%—a sign that China's consumer demand is increasing.

Latin America II: Lengthy To-Do List. Risks abound, of course. Argentina has a unique ability to break investment bulls' hearts.

In a *report* last month, the Organization for Economic Cooperation and Development (OECD) outlined a formidable to-do list for the nation, saying that its "monetary policy will need to remain tight to maintain inflation on a firmly downward path" and recommending that the government phase out subsidies, raise public-sector efficiency, and modernizing tax code. However, "higher international interest rates could make it more difficult to accumulate international reserves," the OECD noted, while higher US tariffs could hurt export growth overall but potentially benefit agricultural and livestock export prospects.

Here are some related observations:

(1) *Twin deficit risks*. Argentina isn't alone. Even though Latin America is less directly vulnerable to trade war effects, *noted* Samy Muaddi of T. Rowe Price, any country running twin deficits in a period of tightening financial conditions "could suffer from collateral damage." For now, many economists think the Fed's next move is to cut rates unless tariffs fuel inflation; then it could be a rate hike.

Even so, as Ben Laidler at Bradesco BBI *told Bloomberg* in late April at the height of Trump's Tariff Turmoil, Latin America's outlook increasingly depends on local monetary policy decisions and elections than the trade war: "Whether you make or lose money in Latam this year is basically dependent on what happens in Latam," Laidler said. "The rest of the world is important, but it's much more about fiscal policy in Brazil, the reform agenda in Argentina and the elections that are coming in Chile."

(2) *Opportunities abound, too.* Along with big risks come big opportunities, said JP Morgan's *Nur Cristiani*. At a moment of "continued market volatility," she explains, "Latin America has remained relatively insulated from these tariffs." The region, Cristiani said, "could benefit from trade reshuffling." Brazil's agricultural sector "might gain from trade diversion, while Mexico could leverage infrastructure and North American integration for long-term gains."

In a *recent article* for *Americas Quarterly*, trade experts Antonio Ortiz-Mena and Diego Marroquín Bitar wrote that despite the turmoil, Latin America has a key advantage: natural resources. "Countries rich in rare earths, advanced semiconductor inputs, and food commodities may soon have newfound leverage," they argued.

Brazil controls the third largest reserves of rare-earth elements. While it can't rival China, Ortiz-Mena and Bitar said Latin America "could become a vital supplementary source to help diversify sourcing over the next decade. The lithium triangle of Argentina, Bolivia and Chile has already drawn increased interest from Asia and Europe, while Chile and Peru are major exporters of copper."

These and other unintended consequences of Trump's trade war are putting Latin America in the global spotlight.

Calendars

US: Tues: ISM M-PMI & Price Index 48.8/70.2; JOLTS Job Openings 7.54m; Construction Spending -0.1%; Powell. **Wed:** ADP Employment Chane 85k; Total Vehicle Sales 15.5mu; MBA Mortgage Applications. (Source: FX Street)

Global: Tues: Eurozone, Germany, France, Italy & Spain M-PMIs 49.4, 49.0, 47.8, 49.5 & 50.7; Eurozone Headline & Core CPI Flash Estimates 2.0% & 2.3%; Germany Unemployment Change 18k; Japan Consumer Confidence 33.6; Lagarde; Elderson; Schnabel; Bailey; Udea. **Wed:** Eurozone Unemployment Rate 6.2%; Lagarde; Lane;

Cipollone; De Guindos; Lane; Taylor. (Source: FX Street)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the June 27 week, forward earnings rose simultaneously for two of these indexes. LargeCap's forward earnings rose for a sixth straight week and in eight of the nine weeks since it bottomed during the April 25 week. MidCap's fell for the first time in the six weeks since it bottomed during the May 16 week. SmallCap's rose for a fifth straight week since it bottomed during the May 23 week. LargeCap's forward earnings rose 0.2% w/w to its fourth straight record high. MidCap's dropped less than 0.1% w/w to 2.4% below its record high, also during the April 4 week. SmallCap's rose 0.1% w/w to 14.0% below its June 2022 record. LargeCap's forward earnings is up 24.7% from its 54-week low during the week of February 1, 2023; MidCap's is just 6.5% above its 55-week low during the week of March 10, 2023; but SmallCap's has lagged considerably and is up just 0.8% from a 42-month low during the May 23 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%, 8.5%, 14.0%), MidCap (0.4, 2.1, 17.5), and SmallCap (-10.2, 1.8, 18.9).

S&P 500/400/600 Valuation (*link*): Valuations rose w/w for all three of these indexes during the June 27 week. LargeCap's forward P/E rose 0.7pt to a 19-week high of 21.9. It's now 0.4pt below its 43-month high of 22.3 during the December 6 week and 4.9pts 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 0.4pt w/w to a six-week high of 15.9. It's now 1.2pts below its 40-month high of 17.1 during the November 29 week and 3.7pts 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 0.5pt w/w to a 17-week high of 15.2. It's 2.3pts above its 17-month low of 12.9 during the April 4 week and 4.6pts above its 14-year low of 10.6 in September 2022, but remains 1.9pts below its 41-month high of 17.1 during the November 29 week. 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 27% discount to LargeCap's P/E, not much 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 31% discount to LargeCap's P/E and little changed from its nine-month-low 32% discount during the April 10 week. That compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 3ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E is now at a 4% discount to MidCap's, up from a 20-year low 10% discount in late 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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