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U.S. Bond Markets Search for an Equilibrium

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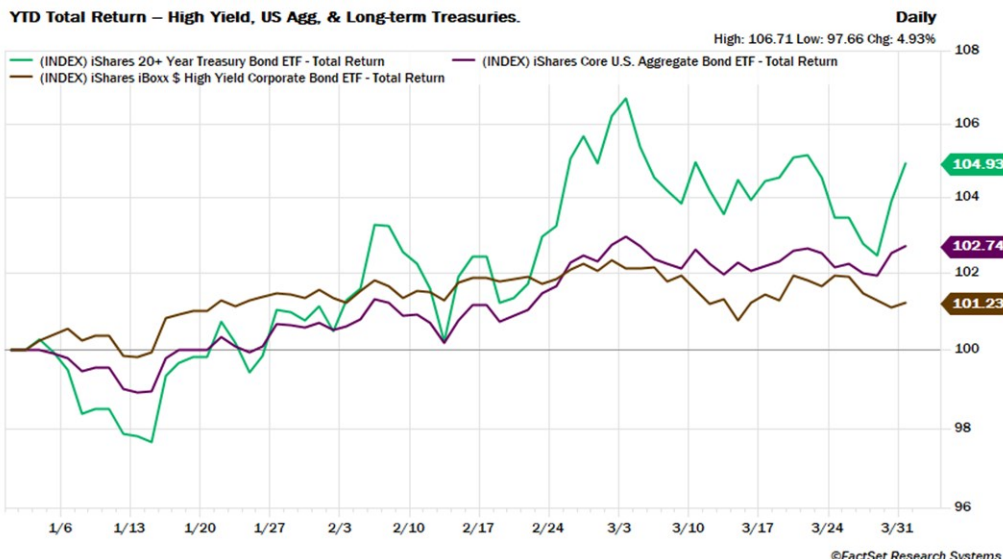
As Trump Administration policy takes shape, the bond market looks for its footing.

The first three months of the new administration have come and gone. While it has become evident that many components of the U.S. political economy are subject to change, that broader discussion is for another place. However, for the purposes of our clients' Fixed Income portfolios, some emerging components of this administration's policies are very relevant. One policy item that has featured more prominently than expected is the Administration's stated goal of reducing the 10-year Treasury yield. It's quite interesting for an administration to tailor policy to specifically target one point on the yield curve, but it's easy to understand the merits of such a strategy. Two of the main factors presently contributing to higher long-term yields in the U.S. are above-target inflation and persistent (and currently extreme) fiscal deficits. Many of the initial actions taken by the administration are purportedly aimed at reducing federal spending, reducing fiscal deficits, and lowering energy prices. If successful, this would likely succeed in lowering longer-term rates. So what? Well, as this line of thinking goes, lower yields would be useful on a few fronts: 1) reduce the cost of refinancing significant amounts of Treasury debt over the next several years, further reducing the fiscal deficit; 2) unlocking the housing market which is currently struggling under high mortgage rates and tight supply; and 3) lowering the overall cost of credit to encourage more domestic investment.

After an initial surge in long-term yields post-election, culminating with the 10-year Treasury yield reaching ~4.80% in January, we've since seen rates fall materially through March and ending the quarter approximately at the same level as before the November Presidential election. Overall, Fixed Income performance was solid due to falling medium- and long-term interest rates, with longer duration bonds performing the best.

Year-to-Date Performance



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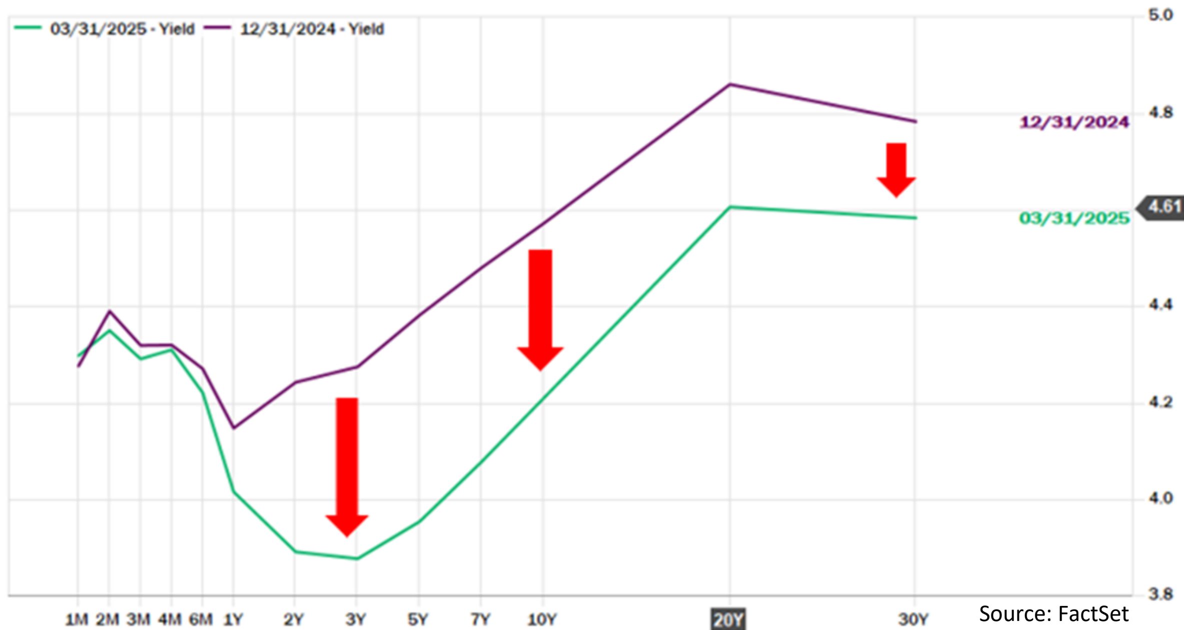
Medium and Long-Term Yields Fall in Q1



Source: FactSet

So, what is the Federal Reserve doing? Holding the line, for now.

In addition to the Treasury's emphasis on reducing long-term yields, the other key interest rate story in the first quarter was the exercise of patience from the Federal Reserve (the "Fed"). After cutting rates by 1.00% over the last four months of 2024, the Fed decided to keep monetary policy largely unchanged in the first quarter. The Federal Funds rate was unchanged although the Fed modestly adjusted its balance sheet policy by reducing the monthly runoff of Treasury bonds it holds. On net, the Fed is in "wait and see" mode. In the words of Fed Chair Jerome Powell during the March FOMC meeting press conference, "**We do not need to be in a hurry to adjust our policy stance,** and we are well positioned to wait for greater clarity." Later in that same conference, on the subject of inflation, Jerome Powell even trotted out the notorious "transitory" term, stating, "It can be the case that it's appropriate sometimes to look through inflation if it's going to go away quickly without action by us – **if it's transitory** – and that can be the case in the case of tariff inflation."

Despite the inaction in the quarter, the FOMC Committee did notably revise its outlook. While the Fed is usually a data dependent institution, it's quite clear that prospective tariff policies underpinned the Committee's new outlook. The GDP growth forecast decreased for 2025 while the inflation forecast increased. Some of the key factors leading to this new outlook include: less progress on inflation in recent months, greater uncertainty among businesses and consumers, and a cooling labor market. At the same time,

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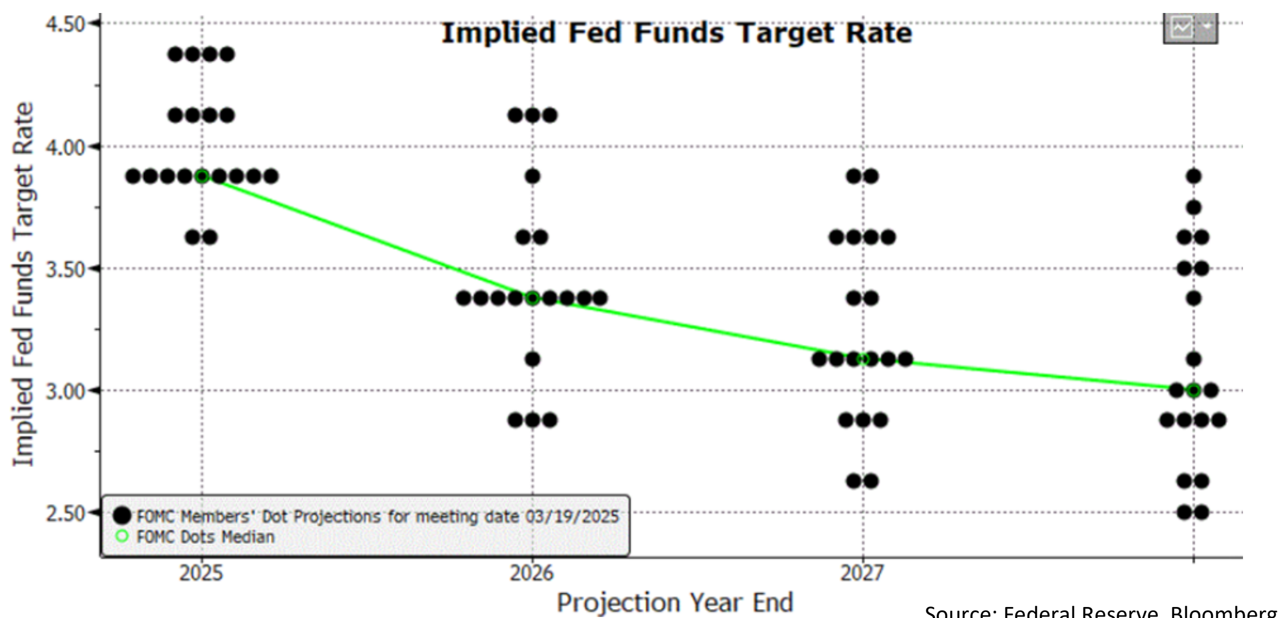
the median expectation for the Federal Funds rate was unchanged in 2025 and 2026. This is a good indication that while tariff policy will likely have a material impact on the economy, it is too difficult to say exactly how it will change the economy and what the Fed should do in response. For example, a higher inflation environment suggests a tighter policy posture would be prudent (i.e. fewer rate cuts), but slowing growth and a weaker labor market are typically responded to with rate cuts to keep the economy moving. At this point, it's too early to know just what shape the economy will take in the coming months.

March Dot Plot



Source: Federal Reserve, Bloomberg

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