Marketing communication

Joy, despair and the road in between

Is Trump heading for an own goal?

Key points

- The Budget bill, which has been in the spotlight this week, is expected to result in a fiscal deficit of around 7% of GDP, despite USD250 billion in tariff revenues and solid economic growth.
- In Europe, the EU's potential openness to a US trade deal – with a 10% universal tariff –signals a softened stance in negotiations.
- Germany's position on fiscal policy is reducing the likelihood of further ECB rate cuts, while differing views on defence spending may lead to EU countries' broader infrastructure projects labelled as 'security'.
- In France, Bayrou survived a confidence vote with Le Pen's support, but risks of government collapse and fresh elections later this summer could widen French OAT spreads.

  The July 9th trade talks deadline and upcoming US inflation data are key events, with potential for a constructive market outlook if growth, inflation, earnings, and interest rates align favourably.

4 July 2025 (London): Markets have retained a broadly risk constructive tone during the past holiday-shortened week. In Washington, the principal focus has been on the passage of the 'big, beautiful bill'. This will come as a relief to the administration, considering the amount of time and energy directed at this centrepiece of legislation. It also helps to allay risks with respect to a government shutdown later this year.

As we have previously flagged, this Budget bill is likely to deliver a fiscal deficit around 7% of GDP, even allowing for USD250 billion of tariff revenue and relatively robust economic growth to support tax revenues. In the absence of plans to trim spending and raise taxes, so any deficit reduction will depend on the path of borrowing costs (as well as the outlook for the economic cycle).

A material reduction in the deficit (below 5%) thus appears dependent on a substantial reduction in yields. This helps explains part of the Trump administration's insistent calls for the Fed to lower rates. Yet, for now, borrowing costs remain on a rising trend, as old low coupon debt is replaced with new issuance at higher coupon levels.

With respect to the US economy, we see some mixed evidence that the pace of economic activity is slowing, notwithstanding a relatively solid monthly jobs report. Unemployment remains muted and we expect this to stay at subdued levels, partly thanks to the clampdown on immigration. However, we see the net impact of tariffs weighing on consumption, as well as raising prices, over the next several months.

This being the case, calls from the White House to deliver rate cuts seem likely to grow in volume over the course of the summer. For now, Powell has been resistant to this political interference and in his testimony to

Congress this week, the Fed Chair was happy to highlight that he would have been advocating further rate cuts if it were not for US trade policy and the threat to inflation that this represents.

Goading Trump further, Powell also raised concerns about US debt being on an unsustainable path and thus the chatter surrounding an early nomination with respect to Powell's successor seems likely to intensify in the weeks ahead.

With respect to trade, signs that the EU is willing to compromise with a US trade deal, which would embed a 10% universal tariff, suggests a softening in the existing stance. Since the start of this year, a 10% tariff (ex-China) seemed like a reasonable landing point to us, inasmuch that tariffs represent a quasi-consumption tax, which exempts domestic production.

Such an outcome would still require that the US lowers auto tariffs from the 25% rate that has been applied, and also steps back on sector-based tariffs with respect to steel and aluminium. However, it strikes us that there is a desire to be able to settle a deal on both sides and were this to be agreed, then we might expect a similar landing zone for Japan, Korea and other major trading partners.

An end to tariff uncertainty would certainly be welcomed by businesses, if this can be achieved. Current uncertainty with respect to policy makes it very difficult to implement a medium-term plan and is a factor that is weighing on business confidence and acting as a constraint with respect to investment.

That said, Trump remains a mercurial figure. He does not conform to pre-conceived norms nor a sense of following what may seem the most rational path. From this perspective, we enter the coming week with ongoing nervousness and uncertainty that Trump won't double down on tariffs or single out a specific country or sector for some 'special treatment'.

After all, the administration will observe that their threats and bullying of others are largely paying off. This was seen in the recent end to the 12-day war between Israel and Iran. It has been seen in NATO members agreeing to Tump demands. It has also been seen in Canada climbing down with respect to its digital services tax in the past week.

The US economy is doing fine all things considered; markets are at their highs and there has been a sense that 'Daddy gets what Daddy wants', even with respect to the 'big, beautiful bill'. In this case, we can't rule out that Trump won't seek to apply more pressure, should he feel unhappy with what he is seeing.

In assessing the macro backdrop, we continue to express no clear directional view on US yields. In contrast, we feel much more confident on the shape of the Treasury curve needing to steepen. Prospects for the next Fed Chair being elected as a dove to deliver rate cuts may benefit the front end of the curve but will be a worry with respect to longer-dated maturities, given the potential threat to price stability and a weakening of the Fed's inflation mandate.

The front end of the curve may also be supported by softer economic activity numbers over the summer, whereas the long end can be troubled by concerns with respect to fiscal irresponsibility and the rising trajectory of the US debt. Officials in the administration have noted that they want to skew issuance towards shorter-dated debt at a time when they think yields are 'too high' and this may be technically supportive for longer-dated bonds.

Yet the truth is that the US curve remains flat from a historic standpoint. Furthermore, measures such as changes to the supplementary leverage ratio (SLR) will only encourage banks to buy more Treasuries if the yield curve is steeper in the first place, so they can earn carry as they roll down the curve.

In the Eurozone, bund yields have ticked higher in the past week, with prospects for firmer growth and increased debt supply weighing on yields as investors continue to digest plans linked to increased fiscal spending related to defence and security.

In Germany, there appears some intent to get moving on spending and we would infer that the direction of travel in fiscal policy means that further ECB rate cuts are unlikely, unless inflation surprises to the downside.

Across the EU, different member states seem to have differing levels of enthusiasm for spending lots of money directly on defence and in light of this, it has even been floated that defence funds be used to pay for a bridge between Sicily and the Italian mainland.

A liberal approach with respect to defence and security spending may see a number of other infrastructure projects also labelled in the context of security. This could easily meet with ire from the US administration down the line, but it also highlights how recent commitments can end up being more broad-based drivers of growth than may initially meet the eye.

In European politics, Bayrou survived a new vote of confidence in France, but only thanks to the support of Marine Le Pen's National Rally. In the short term, another confidence vote is unlikely, and for now, Le Pen is biding her time. However, we can see renewed risks that she pulls the rug on the French Prime Minister later in the summer and triggers fresh Parliamentary elections. From this point of view, French OAT spreads are supported in the short term, but a spread below 60bps represents an attractive level to get short France, on a spread basis.

At this level, we think the spread will be asymmetric, given that further spread compression becomes unlikely, whereas a move out to new wides could be possible, were National Rally to collapse the existing government and prevail in a new election, as polls may suggest.

In the UK, the Starmer government is also in trouble, but in this case from within the ranks of the Prime Minister's own Labour Party. Rachel Reeves' failed attempt at welfare reform has ended up in tears, literally speaking. Despite the Prime Minister giving the chancellor the vote of confidence, it's still possible that she won't even make it to an autumn reshuffle and this is set to raise questions with respect to the government's commitment to the OBR fiscal framework.

Meanwhile, the leadership of Starmer himself is also being questioned, with the Labour leader cutting a very isolated figure within his own ranks. Ongoing fiscal slippage in the UK means that pressure will come on the government to raise taxes, leaving it stuck between a rock and a hard place.

The government is trying to rely on strong growth and lower borrowing costs but appears unable to deliver on either account. Up to this point, markets have been inclined to give Labour the benefit of the doubt. However, the hangover from the Truss tantrum remains in investors' minds. In this context, the UK has to continue to demonstrate its commitment to fiscal restraint but this may well be called into question in the weeks ahead.

There have been few material macro performance drivers over the past week. In FX, the dollar has continued to trend somewhat weaker, though even here price action has been relatively muted over the past several days. Credit spreads have continued to edge tighter, as equity markets climb a wall of worry and as recession fears continue to melt away. Yet valuations are already compressed and so this serves to constrain prices action. Elsewhere, Romanian spreads rallied on government plans to rein in state spending.

Looking ahead

In the week ahead of us, next Wednesday's July 9th deadline on trade talks has been a date that investors have had in the back of their minds for the past three months. We continue to run relatively little directional risk going into this potential risk event and will look to reassess prospects for the summer, which will stretch ahead of us, once this and the following week's US inflation release are behind us.

There is a pathway that points to a constructive environment for bonds and stocks in the second half of the year should growth surprise to the upside, inflation remain muted, earnings be robust, and interest rates fall. However, this is just one plausible scenario and there are a number of other pathways, several of which point towards much less constructive outcomes. In this context, we remain nervous with respect to investor complacency.

In light of this, Manchester City's humiliation at the hands of Saudi minnows Al-Hilal this week serves as a timely reminder that anything can be possible. Indeed, at this rate it is even half believable that Chelsea end up as eventual victors at the Club World Cup!

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