



## Market Commentary

### Big not Beautiful

#### The ugly truth

##### Key points:

- Negative newsflow surrounding the tariff agenda has been front and centre, with the administration keen to generate positive headlines to counterbalance this.
- The broader fiscal theme is a key focus in global bond markets. In Europe, yields have risen recently due to prospects of increased issuance linked to elevated spending plans.
- Also in Europe, Romanian asset prices recovered during the week, following Bucharest mayor Nicuşor Dan's victory over his right-wing populist rival in the presidential run-off.
- In Japan, proceeding with previously announced issuance plans despite the market's inability to absorb them has exacerbated volatility and further undermined bond market confidence.
- Next week, attention will be on whether US yields will rise further, with a break above 5% in 30-year Treasuries potentially leading to a steeper curve, broader risk aversion, and implications for long duration assets such as equities.

**23 May 2025 (London)** – Government bond yields continued to move higher in the past week, led by price action at the long end of curves, over worries relating to mounting government debt and perceived ambivalence from US policymakers with respect to these debt concerns. Although Trump's 'big, beautiful bill' still has a way to go before it is able to pass votes in Congress and the Senate, it appears that fiscal hawks have been pressured to get on board with draft proposals, for fear of being seen to go against Trump's wishes, and incurring the wrath of their party.

Planned cuts to Medicaid appear less aggressive than originally planned and an increase in SALT deductions for state and local taxes also appears to have been agreed. With the Trump administration already committed to cutting taxes and making little tangible headway in paring Federal expenditure, notwithstanding all the fuss and noise about DOGE, this infers risk to deficit projections. Placing expiration dates on tax cuts allows for a more benign assessment by the CBO. However, markets will tend to look through this, on the assumption that 'temporary' tax cuts have a tendency to become permanent over time.

Ironically, it may seem that the latest cut to the US credit rating by Moody's has actually galvanised support to get a Budget deal done. In the wake of negative newsflow surrounding the tariff agenda, it seems that the administration is determined to generate some positive headlines. In this respect, a fiscally accommodative Budget can be sold as pro-growth, and some will also claim that the boost to growth achieved will enable much of the tax cutting package to be self-financing.

However, this Laffer curve economics inspired thinking is being met with increased scepticism by bond market investors, who are concerned at an alarming rise in the debt trajectory and also the share of US expenditures and tax revenues, which are now being consumed in debt servicing costs.

On our own analysis, we think that the US deficit will remain around 7%, even assuming around USD300 billion in annual tariff revenue and an average growth rate at 2%. Should tariff revenues fall short, or more importantly, should economic growth disappoint, then there is a risk to the deficit skewed to the upside.

Additionally, the importance of borrowing costs as interest expenses mount means that fiscal outcomes will also be driven by movement in yields. Federal estimates assume that interest rates and yields will decline going forwards, helping to reduce the deficit.

However, if inflation stays elevated and the economy is performing relatively well, there will be little reason for the FOMC to lower rates. Meanwhile, if the Fed were to cut but longer-dated yields move in an opposing direction, as investors demand an increased term premium for owning longer-dated debt, then this would also mean that the deficit will remain stuck at an elevated level.

This may see the Treasury continue to shorten the maturity of the debt stock in an effort to mitigate a rise in borrowing costs. However, this in itself could actually increase vulnerability with respect to deficit financing in the future, given the need to keep rolling ever larger amounts of maturing debt.

All this said, there may be little to be gained by speculating on events too far into the future, and clearly the doomsayers and bond vigilantes have been sounding their warnings for many years without the sky falling in.

From this perspective, it may seem rational that the Trump administration ignores protests from the fixed income market for the time being. However, the risk is that long-dated yields may continue to rise, until they find support from a new buyer base attracted at the value on offer.

In this respect, US retail investors may be tempted by long bond yields closer to 6% or 7%, but this will infer them switching away from other assets they currently own and, from this perspective, the crowding out effect from rising government debt could pose a serious challenge to other competing financial assets on offer.

Over time, it may become politically desirable to reduce the deficit in order to bring long yields down and deliver support to mortgage rates. Yet we seem a long way from this inflection point in popular and political opinion. In this respect, policymakers seem content to keep calm and carry on, even though many in the administration will fundamentally understand that at this point in an economic cycle, the US budget should be in balance, not running such a glaring deficit. Essentially, Washington has thrown down the gauntlet to the bond market. Time will tell whether it attracts sufficient capital to stabilise yields, or whether the risks of a market tantrum could be on the rise.

The broader fiscal theme is a topic across bond markets globally. Over the past week, European yields have been rising on prospects for increased issuance, on the back of elevated spending plans. Signs of fiscal slippage coming from the UK's Labour party, in conjunction with higher inflation, have also pushed gilt yields up in the past week.

Meanwhile in Japan, the Ministry of Finance has appeared to mis-handle long-dated bond issuance, at a time when domestic buyers have been scared off by elevated volatility. In this respect, forging ahead with previously announced issuance plans, at a time when the market is not in a position to absorb this, has ended up compounding volatility and hurting bond market confidence further.

This tone-deaf approach to markets runs a risk in a country like Japan, as is the case in the US and elsewhere. Fundamentally speaking, if policymakers are inept and this causes yields to rise by too much, then this move up in yields can be self-fulfilling, in that higher borrowing costs add to concerns relating to fiscal debt sustainability, begetting even higher yields.

In this respect, the authorities in Tokyo would be better advised to raise short-term interest rates to demonstrate they are not at risk of being behind the curve on inflation, and they should also respond to bond market conditions by tailoring supply to underlying market demand. Perhaps it has been the case that Japanese yields have been dormant for so long that a lack of expertise and understanding with respect to market dynamics could be a problem for policymakers in Tokyo.

Elsewhere in markets, the past week saw a recovery in the price of Romanian assets, as Bucharest mayor, Nicușor Dan, vanquished his right-wing populist rival in the run-off vote for the Presidency. Fears of a confrontation with the EU have been greatly reduced and Romanian bonds, which had been trading at spread levels akin to a much weaker sovereign such as Turkey, have been able to materially recover, as the threat of multiple rating downgrades has also appeared to recede.

In credit markets, spreads have been broadly stable, helped by equity prices remaining firm. In the past few weeks, credit investors have been cheered as recession risks have appeared to recede. A pro-growth fiscal agenda, which further aids growth, is also something that may be credit positive.

Thus far, higher Treasury yields have not weighed much on risk assets, though there have been signs in the past few days that this could be changing.

In FX, the dollar has trended softer over the past week. Following the China tariff agreement last week, the greenback had rallied initially, as US growth estimates were upgraded and worries with respect to trade war escalation and supply chain disruption had been reduced. However, it may appear that the reprieve for the dollar has been somewhat temporary.

We have noted that many global investors have tended to be structurally over-allocated towards the dollar and US assets and now appear to be rethinking this. Asset allocation shifts may play out over months and quarters, rather than in a few weeks, given the requirement to discuss strategic shifts at multiple investment committees. Yet the decision to adjust hedging ratios is a decision that can be taken more quickly. In this respect, where investors have been running under-hedged versus a neutral hedge ratio, we see evidence of these gaps being closed as a first step.

In this respect, it seems likely that there will be selling into any dollar strength for the time being, and we think that the dollar is likely to continue to weaken. In this respect, we continue to favour the yen and also the Korean won.

### **Looking ahead**

In the coming week, our attention is focussed on whether US yields continue to move higher, breaking up through support levels that have managed to cap this move on several occasions in the past.

In this respect, the break above 5% in 30-year Treasuries could see a more rapid move towards 5.25%, with the curve set to steepen. If this does play out, then we think we could start to see this weigh on risk appetite more broadly, as investors in long duration assets, such as equities, reflect on an increased discount rate for future cashflows – not that such analysis seems to be much of a thought on the part of the US retail investor community for the time being!

Therein, there is a risk that if other markets ignore Treasury price action, then yields could keep moving upwards until they do so. Yet, predicting where this may come about, and even whether it comes about, is something subject to plenty of uncertainty.

In this context, maintaining a relatively low risk stance and looking for opportunities in markets and assets where prices have already dislocated, and appear out of line (such as the example of the Japan 10/30 curve) remains an attractive approach to us.

That said, we might think that a US curve steepening view is also looking attractive as a potential hedge to risk assets. In this respect, weaker economic data suggesting a growth scare, which weighs on risk assets, should steepen the curve, as short-dated yields rally more than the long end. Meanwhile, if a bond market tantrum is what brings about a broader market reversal, this will also be in the context of a steepening shift in the curve.

Moreover, it remains difficult to foresee the conditions that will bring about a renewed flattening of the yield curve in the coming months, absent an outcome where the Fed looks to raise rates, which remains very unlikely.

Steepening trades are consensual but it is tempting to think that – although such positions offer negative yield carry – the intrinsic asymmetry towards a steeper curve makes it worthwhile to adopt and maintain this stance, now that the front end of the US curve discounts only modest Fed easing in the months ahead.

Of course, it is possible that the Treasury market continues to trade in a range and support levels hold. Near-term fiscal fears may be overstated, and the end of the world may not be nigh. Yet, it seems tempting to think that the embedded attitude of the US administration towards debt and the bond market in general will only change once markets force a change upon them.

In this respect, the question is whether policymakers are being complacent with respect to the risks. They need to understand that 'Big' does not equate to 'Beautiful' in the eyes of the market.

**Notes to Editors**

Lydia Cambata: +44 7578 252 424

LCambata@BlueBay.com

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