LOOMIS | SAYLES

TEAM INSIGHTS
APRIL 11, 2025

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Q1 Round Up: Potential Escalation of a Global Trade War Increases the Probability of Stallflation

Initial Influx of Policy Actions Increases Growth and Inflation Uncertainty

Entering 2025, market sentiment was largely positive, supported by the new administration's potential pro-growth policies, such as tax cuts and deregulation. With the inauguration of Donald Trump on January 20th came immediate influx of multiple executive orders targeting immigration, energy, DEI initiatives and Biden-era policies. In addition, the Department of Government Efficiency (DOGE) was created to reduce federal spending and bureaucracy. Investors awakened to the idea that the new administration's policy actions could potentially cause disruption in the economy and financial markets in the back half of the quarter. The Federal Reserve (Fed) met on March 18-19th and held policy rates steady, however, the press statement did note that "uncertainty around the economic outlook has increased." During the quarter, the Treasury curve shifted lower, with the 10-year US Treasury decreasing from 4.57% to 4.21%. Investment grade and high yield spreads widened as uncertainty increased surrounding government policies, such as tariffs, and the market digested the long-term impacts to growth and inflation.

Growth Estimates Adjusted Lower

Our base case is that the US economy will remain in the late cycle phase, but we are decreasing our growth projections and moderately increasing the potential of a downturn. We do not anticipate a recession at this time, however, the implementation of tariffs and the potential for further escalation of a global trade war supports our view for a higher probability of stagflation going forward.

On a global basis, the policy of "America First" could potentially force European leaders to recommit to substantial borrowing for security infrastructure. By loosening the constraints of its budget deficit limit, Europe could see a surge in deficit spending, more government bond issuance and large investments in the economy. Trump's plan to "Make America Great Again" may have the unintended effect to "Make Europe Great Again." Like Europe, China has been overly dependent upon external trade and could face weak economic conditions. The Chinese government will likely continue to bolster domestic demand while it seeks to play defense in the face of tariff pressures, however, we believe uncertainty remains regarding the scale and effectiveness of such measures.

	BASE CASE
CREDIT CYCLE	Late Cycle
MACRO	Stallflation
INFLATION	Rising as a Result of Tariffs
POLICY RATES	Fed in "Wait-and-See" Mode
US RATES	Neutral
CORPORATE FUNDAMENTALS	Stable
FX	Mixed Signals
KEY RISKS	Trump Policy Uncertainty

Fed in a Tough Position – Focus on Growth or Inflation?

US inflation has been sticky and unpredictable. Absent a quick reversal of policy or negotiations that lower or eliminate tariffs, we believe there is upside risk to inflation in the short-term. On a long-term basis, we have been suggesting that inflation may remain unstable and potentially experience higher lows in future cycles due to structural factors, such as the fiscal deficit, trade protectionism, deglobalization, decarbonization and aging demographics. From a growth perspective, as a result of escalating tariffs, we would expect a negative domestic demand shock. Our view is that economic growth needs to be marked down, which has already started to manifest itself with lower consumer confidence. We believe the probability of a recession has increased; however, we likely would need to experience a period of higher inflation and declining (but positive) growth over the next couple of quarters ("stallflation") before we get to a recessionary environment. This has put the Fed in a tough position – focus on growth or inflation? In our view, the Fed may be comfortable with inflation hovering above their 2% target, explaining it away as transitory (again), in order to prevent the labor market from softening too much. The Fed seems to be in a "wait-and-see" mode and its "dovish pause" could abruptly change under a stagflation scenario in which the labor market weakens meaningfully but inflation hooks upward. The dual mandate of the Fed is back in focus, so a measured response is likely, and we expect a shallower cycle with a trough rate likely reached in 2026.

Fiscal Deficit is a Key Structural Risk

We believe the fiscal deficit is a key structural factor to monitor as it could be the Achilles heel of the Trump administration. Currently, the fiscal deficit is unsustainable and has the potential to stimulate inflation, which in turn could raise borrowing costs across the economy. A solution to the fiscal deficit problem would likely require bigger cuts than what DOGE has implemented, including in defense and entitlements as the "third rail" of the political domain, and that will likely be difficult for Trump or Congress to complete, in our view. Indeed, the House budget, passed on February 28th, calls for an extension of the tax cuts without offsetting enough spending cuts, but the net result could actually see the fiscal deficit grow by another $3T over the next ten years, in our view. Fiscal rectitude does not seem to be attainable, and this may reflect the reality that the mid-term elections are approaching quickly. Our structural view of higher interest rates remains intact, however, the increasing risk of a downturn has pushed rates lower in the short term. We believe Treasury supply will continue to be a topic of heavy discussion, which could increase interest rate volatility and put a floor under long-term Treasury yields. We believe long-term fair value for the 10-year US Treasury is approximately 4.50-4.75%, based on a 1.75-2.00% real rate and 2.75% breakeven rate; however, Trump's policies could push the fair value target slightly higher.

Increased Volatility is Creating Potential Opportunities

Our investment process lends itself to constantly reassessing value through our risk premium framework. Our Credit Health Index (CHIN) and risk premium framework within investment grade and high yield corporate credit suggest defaults/losses will be in line with historical averages for this part of the cycle. Based on recent market volatility, risk premiums have widened and entered the lower end of a value range. We believe that credit health remains stable as corporate fundamentals, technicals and earnings growth continue to be positive even as the economy has potentially started to downshift. It is difficult to see any real signs of credit deterioration, and in our opinion, corporate balance sheets can weather potential volatility in the macroeconomic backdrop.

We believe that long-term value has returned to fixed income markets with a combination of discount-to-par (positive convexity) and favorable yields. As investors sit on record levels of cash, we expect strong demand will likely support bond markets. We have largely kept risk unchanged given the lack of clarity around tariffs, however, elevated dispersion within various credit markets has created potential opportunities in investment grade credit, high yield credit, bank loans and securitized credit, in our opinion. Our view is that risk premiums have become more attractive and, as a result, we believe investors should also consider moderately leaning into credit risk for any potential extra carry pick-up. We are mindful of the risks going forward, such as a growing US deficit, trade protectionism (tariffs) and geopolitical risk. Each of these risks could further elevate market volatility and create additional buying opportunities in credit, interest rates and currencies.

Meet the Team

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CHERYL STOBER
Investment Director

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Associate Investment Director

About the Team

The Full Discretion team brings decades of expertise and collaboration to create tailored solutions for their clients.

28 Investment Professionals

23+ Years of Industry Experience (Portfolio Management Team)

$79.1 Team Assets Under Management (Billion USD)

Team Philosophy

We have a legacy of independent thinking and leaning into the market when others may be pulling away. We take a deep-value, equity-like approach to credit selection across global fixed income markets. Our disciplined process helps gives us confidence in seeking to identify macro trends, formulate a clear view on market sectors, and invest throughout the credit cycle.

For more than 40 years, we have been applying our distinctive style of bond picking to deliver portfolios designed to provide excess yield potential and have low correlations to traditional benchmark-focused fixed income strategies.

Source: Loomis Sayles, as of 3/31/2025
Average years of expertise reflected at portfolio management level

Important Disclosure:

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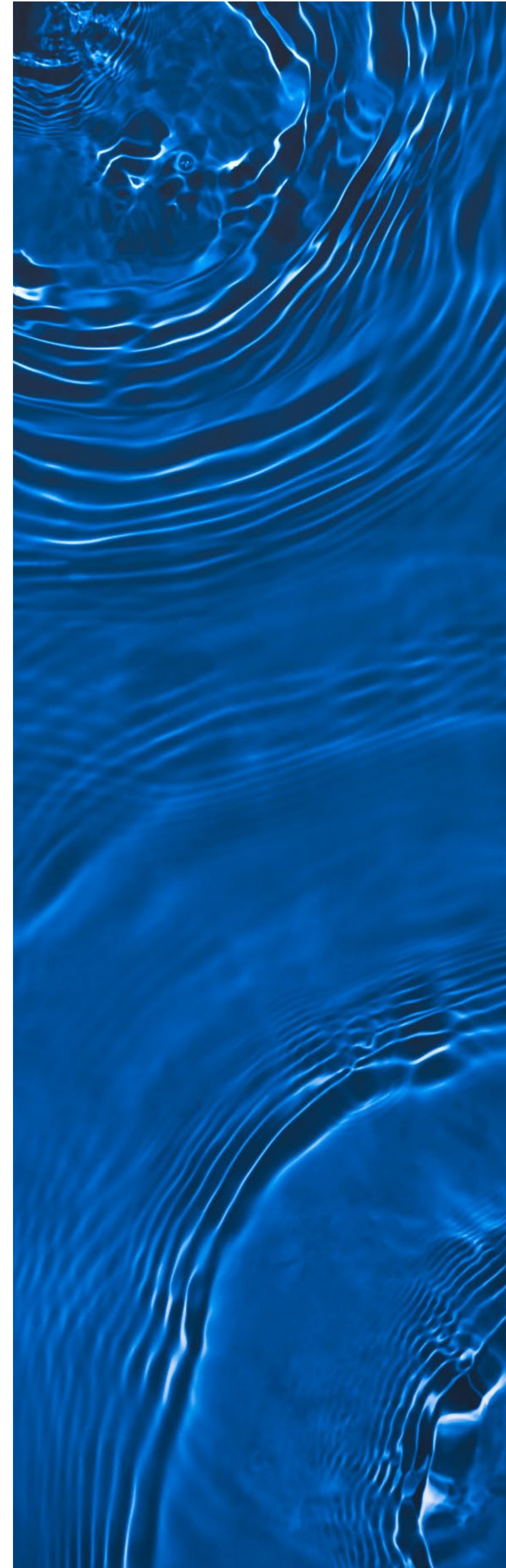
Market conditions are extremely fluid and change frequently.
Any investment that has the possibility for profits also has the possibility of losses, including loss of principal. There is no guarantee that any investment objective will be realized, or that the strategy will be able to generate any positive or excess returns.

Past performance is no guarantee of future results.



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