LOOMIS | SAYLES

TEAM INSIGHTS
JULY 15, 2025

FULL DISCRETION TEAM

Extra Credit

Q2 Round Up: Tariff Backtrack, Fed "Wait and See" Mode, Fiscal Uncertainty

Market Volatility Rises in Q2 on Trade War, Fiscal Policy and Geopolitical Risks

The second quarter of 2025 saw a significant increase in financial market volatility, marked by an escalation in the global trade war, uncertainty in US fiscal policy and intensifying geopolitical risk in the Middle East. Risk assets sold off aggressively to start the quarter as President Donald Trump announced widespread reciprocal tariffs on April 2nd (aptly named "Liberation Day"), disrupting global trade and triggering uncertainty in growth and inflation expectations. As yields surged and liquidity thinned, the bond market flashed warning signs. A weak 3-year note auction set the tone, and with 10- and 30-year auctions looming, Trump took the off-ramp and paused tariffs for 90 days, which calmed investor concerns in the short-term. Investors shifted their focus towards uncertainty around US fiscal policy in mid-May as Moody's downgraded the US government's credit rating from Aaa to Aa1 and further highlighted long-term deficit concerns. This was quickly followed by the passing of the One Big Beautiful Bill Act by the House of Representatives, which has the potential to further exacerbate the fiscal gap. Lastly, in mid-June, geopolitical risk rose as Israel launched surprise attacks on key military and nuclear facilities in Iran. The US joined shortly thereafter to assist in striking Iranian nuclear sites, however, a ceasefire was announced shortly thereafter on June 24th. Despite the myriad of events, the 10-year US Treasury was stable quarter-over-quarter, moving from 4.21% to 4.24%, and, as expected, the Federal Reserve (Fed) remained on hold during their May and June meetings. Investment grade and high yield spreads initially widened but bounced back and ended the quarter near their pre-sell off levels.

Tariff Backtrack Supports Growth

Going forward, we believe the US economy will remain in the late cycle phase of the credit cycle, supported by the recent backtrack in tariff policy, a healthy mid-to-high income consumer and stable corporate fundamentals. Our base case calls for trend/below trend US growth and we do not anticipate a recession at this time. The risk of global trade seizing up and causing widespread recession appears to be diminished by tariff pause extensions, temporary truces and the potential for trade deals. In Europe, the shift toward more expansionary fiscal policy should raise long-term trend growth rates for those economies through large investments

	BASE CASE
CREDIT CYCLE	Late Cycle
MACRO	Stallflation/Tariff Backtrack
INFLATION	Unstable
POLICY RATES	Fed in "Wait-and-See" Mode
US RATES	Defensive on Long-End Yields
CORPORATE FUNDAMENTALS	Stable
FX	Mixed Signals
KEY RISKS	Deficit, Trade Uncertainty & Geopolitical Risks

in the economy. This could offset any negative impact with a potential change in the US trade relationship, the effects of which will be hard to predict. In China, the 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. A substantial trade deal could present an upside surprise.

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

US inflation has been sticky and continues to print above the Fed's target. The tariff backtrack in the second quarter has alleviated some of the concerns of inflationary pressures in the short-term, but we believe risks to unstable inflation remain. We believe prices may experience a temporary spike in the coming months as companies pass through tariff-related cost increases. In addition, the risk of a re-escalation in the global trade war remains as the 90-day pause on higher tariff rates ends on July 9th. 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, labor market health and ongoing job creation should keep consumer spending on firm footing, in our view. Absent a significant shock to the economy, we believe growth should remain positive, which puts the Fed in a difficult position – should they 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 likely continues to be data dependent, focusing on developments in the trade war, the budget and events of the Middle East.

Fiscal Deficit is a Key Structural Risk

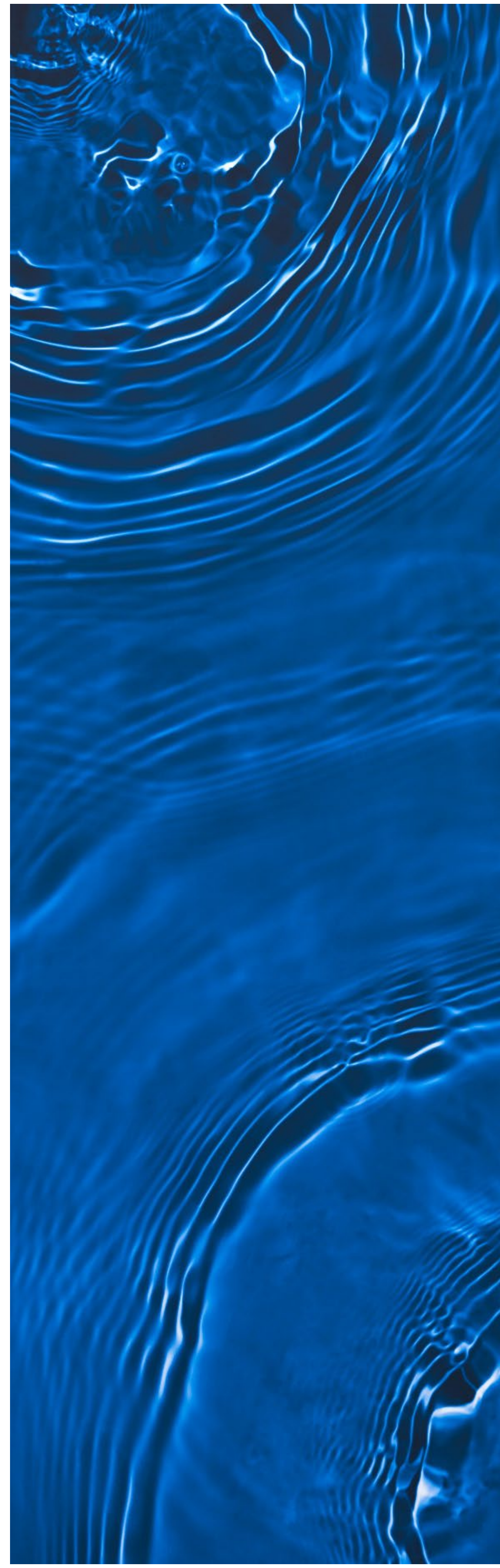
We believe a key risk is the structural economic and demographic factors that are weighing on the US fiscal deficit. Large nondiscretionary spending, mostly related to entitlements and defense, have led to a deficit that is structural rather than counter-cyclical. Debt servicing costs have also risen significantly, as interest rates have increased and the overall debt burden has expanded. Currently, the fiscal deficit is unsustainable and has the potential to stimulate inflation, which in turn could raise borrowing costs across the economy. The One Big Beautiful Bill Act extends most of Trump's tax provisions, raises the debt ceiling and potentially increases the annual deficit over the next decade. Unless there is significantly higher growth (which we believe is unlikely), expenditures are reduced or another large source of revenue materializes (tariffs), we do not see a stabilization or contraction in the deficit occurring in the near term. US budget negotiations are ongoing, however, 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. 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 the long end of the curve, at this point, is not adequately pricing in potential risks. 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.

Despite Uncertainty, Credit Health Remains Stable

Our investment process lends itself to constantly reassessing value through our risk premium framework. Our Credit Health Index (CHIN) within investment grade and high yield corporate credit suggest defaults/losses will be in line with historical averages for this part of the cycle. Geopolitical and fiscal uncertainties have provided pockets of spread widening, however, risk premiums remain below the lower end of our 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.

Maintain Flexibility in an Uncertain Environment

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. The fiscal gap remains a long-term threat to yield stability, and investors will need to be compensated for a potential rise in yields at the long end. Fortunately, bondholders can manage through this uncertainty. In this environment, we believe that reinvestment rate risk is on the side of the fixed income investor, but the challenge is getting to progressively higher step-ups of yield while maintaining or growing principal. Given our expectation for a relatively benign loss environment, 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, for which we would consider redeploying reserves faster. In today's environment, we believe bond investors should maintain flexibility with regards to interest rate and credit risk, considering the risk/reward of the intermediate part of the curve against the long-term risks associated with long-end curve exposures while being selective in potential opportunities in investment grade credit, high yield credit, bank loans and securitized credit, in our opinion.



Important Disclosure:

Meet the Team

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About the Team

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

27	Investment Professionals
23+	Years of Industry Experience (Portfolio Management Team)
$80.3	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 6/30/2025
Average years of expertise reflected at portfolio management level

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