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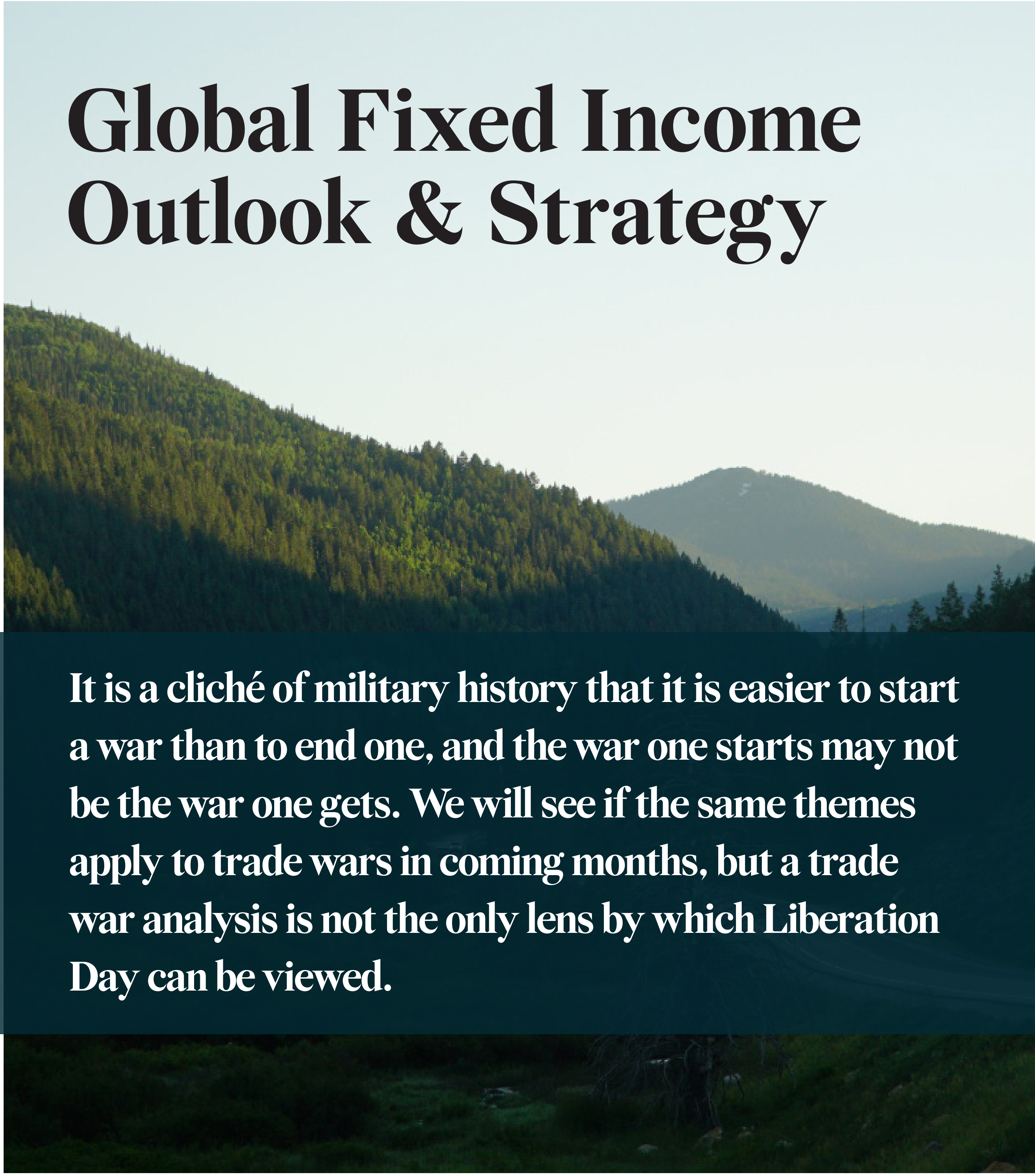

Global Fixed Income Outlook & Strategy

It is a cliché of military history that it is easier to start a war than to end one, and the war one starts may not be the war one gets. We will see if the same themes apply to trade wars in coming months, but a trade war analysis is not the only lens by which Liberation Day can be viewed.

Market Recap & Outlook

The US tariff hikes are largely being analyzed in trade policy terms, which in isolation would imply a stronger US dollar. While there are differing opinions across Loomis Research and the portfolio teams, another way to organize thinking about currency consequences is to consider the tariff hikes as a fiscal policy tightening, and then employ portfolio theory. This analysis points to the conclusions we wrote about last month: weaker equities, lower yields, lower oil prices, and a weaker USD.

The US government needs money. Total net Treasury debt is 100% of GDP, or $30T. Revenues are in the 17% of GDP range, spending is about 24%. The deficit is 7% of GDP. So what to do? Spending cuts are the first resort, but the Polymarket bettors have grown more pessimistic since the beginning of the year, and now place only a 25% probability that Doge, etc. can cut as much as $250bn from spending. Some sell-side bank guesses are materially lower, at $60-100bn, or about 0.25%-0.35% of GDP. This is not enough, in our view. We believe the alternative is to go after transfer payments… Medicare, Medicaid, and Social Security …in a serious way, but this is politically fraught, and we think meaningful cuts here will take some time. So where to get money? Taxes! But how?

There is approximately zero appetite for a bipartisan tax and spending package along the lines of the Bowles-Simpson proposal of 2010 (which failed) in a deeply divided, tax-averse Congress. But there is one kind of tax that can be enacted by Presidential decree: tariffs. The initial average tariff proposed on Liberation Day was about 22-23%. This was estimated as a 1.5%-2.0% of GDP fiscal tightening. This would raise serious cash, but probably slow the economy into recession via supply shocks, lost purchasing power, and negative wealth effects. We doubt that this will ultimately be the effective rate, but a baseline of 10% on everything with much higher rates for China is where we might see the policy settle. So perhaps we are looking at an ultimate effective rate of 12-15%. Stay tuned. This is not equivalent to a Value-added tax (VAT) but it rhymes. We believe consumers ultimately pay most of it, like a VAT (incidence attribution is complicated).

Current policy settings and portfolio positioning look like the opposite of what we saw in the first Reagan administration, in 1980-82. Then we had a massive fiscal ease (tax cuts, defense) and an even more massive monetary tightening (Volcker!). US equities and bond markets were massively under-owned by the rest of the world (RoW) after the 1970s inflation decade. The USD rose for four years.

Today the situation is the reverse. U S equities are heavily held by the RoW, (about 30% of total) as are Treasuries (25%), and equities were priced for optimism. Fiscal policy looks like imposing the highest tax hike since 1968, and Fed funds futures imply 100bp of cuts this year. So if the first mix sent the USD up, maybe the opposite mix will send it down.

Lastly, US equities and the dollar may be re-rated lower by overseas investors, who could demand a higher risk premium to invest. Team America is changing its brand. As Leo Lewis wrote in the London Financial Times, writing from Tokyo (two of the largest overseas pools of capital) globalization, rules based international order, and Pax Americana are out. Mercantilism, isolationism, and protectionism are in. Larry Fink of BlackRock noted that the US has become an engine of volatility rather than an absorber of volatility. Higher risk premia seem reasonable.

Our Strategy

We remain bullish Treasuries, bearish equities and credit, (but are starting to buy in specifically wider industries), bearish oil, and bearish USD. The US economy may narrowly evade recession if enough tariffs are rolled back, but near-zero GDP growth looks plausible. Headline inflation will have to absorb 100bp of supply shock effects. The Fed may cut four times, starting in June, as hard data soften. We believe less liquid assets are likely to become even less liquid.

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Important Disclosures

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