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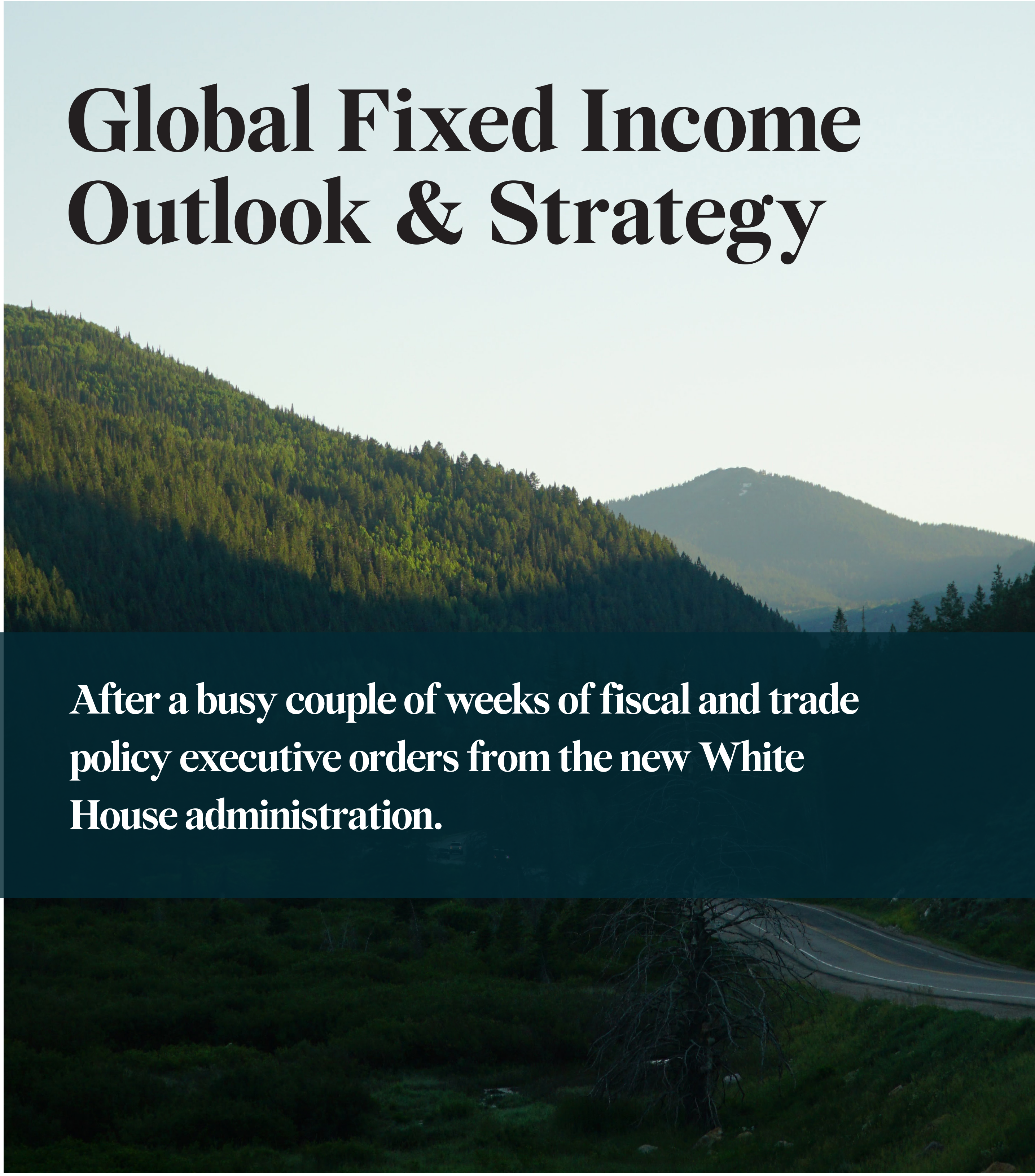
FEBRUARY 2025

Global Fixed Income Outlook & Strategy



After a busy couple of weeks of fiscal and trade policy executive orders from the new White House administration.

Market Recap & Outlook

We note that that the US 10-year Treasury yield and the trade-weighted dollar (DXY) are mostly trading with future Federal Reserve policy rate expectations. DXY and the ten-year note yield are closely tracking the December 2026 SOFR future. This contrasts with last October, when tariff and fiscal questions looked like becoming a separate factor for rates and the dollar's value.

Is this complacency? Headline exhaustion? Was January 13 Peak Tariff for DXY? We believe that instead the markets have accepted that the Federal Reserve will continue to be an independent policy-maker focused on its growth and inflation dual mandate, that any inflationary impact of tariffs will be gradual, and the Fed will react to their inflation effects. That is, tariff effects on inflation and/or growth will influence yields and the dollar via the Fed's reaction function. Tariff risks are captured in the December 2026 SOFR contract's movement, and are not a separate factor for now.

The US core personal consumption deflator has been range-bound at about 2.4% year-over-year (YoY) since last June. The core CPI has been stuck at just above 3.0% for the same period. We believe bullish factors probably include more declines in shelter inflation and smaller auto insurance charges, as insurers have mostly caught up with the accident losses from the pandemic. (Americans drove faster on emptier roads, had worse crashes, and all the sensors in cars now make repairs much more expensive). Bearish factors include recent PMI/ISM price readings and average hourly earnings, which are stuck at 4% YoY. Tariffs are bearish, but size, scope and timing remain unclear. The Chinese tariffs should have a measurable impact on the costs of imported apparel, toys, electronics, etc., but we do not know how much will reach the retail consumer. On net, we still expect a small decline in core inflation, but inflation stickiness may delay any Fed cuts until May or later.

Our GDP growth outlook for 2025 had recently improved, following a strong Q4 and an investor sentiment spike post-election. We still look for above-2% real growth, and for the current regime of US growth exceptionalism to persist for now. In our view, there is a risk that a more severe tariff environment could result in something like American Brexit and torpedo sentiment, but we do not see this in risk asset prices currently.

A bearish wild card for the US dollar is the overwhelming overweight of global investors in US growth equities. These have been boosted further by AI euphoria lately. Top line S&P 500 earnings growth has remained buoyant, but we see there is a risk that the massive capital expenditures in the AI arms race simply cut operating margins without increasing future revenues. This is unquantifiable, but a sudden sentiment shift against US equities is an equity flow risk for the dollar. This absolutely would be a separate factor from future Fed policy, but we cannot see any signs of it for now.

Our Strategy

Putting all of this in our fair value blender and spinning it, we see the 10-year Treasury as fair at 4.5%, and are USD duration neutral. We are also neutral USD, as US growth exceptionalism is offset by at least some prospect of future rate cuts.

The dollar aside, we have a mild preference for yen relative to Euro. We believe growth prospects look better for Japan, and policy rates are expected to rise. In Europe, stagnation is still our baseline forecast, and policy rates are expected to fall further.

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Important Disclosures

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