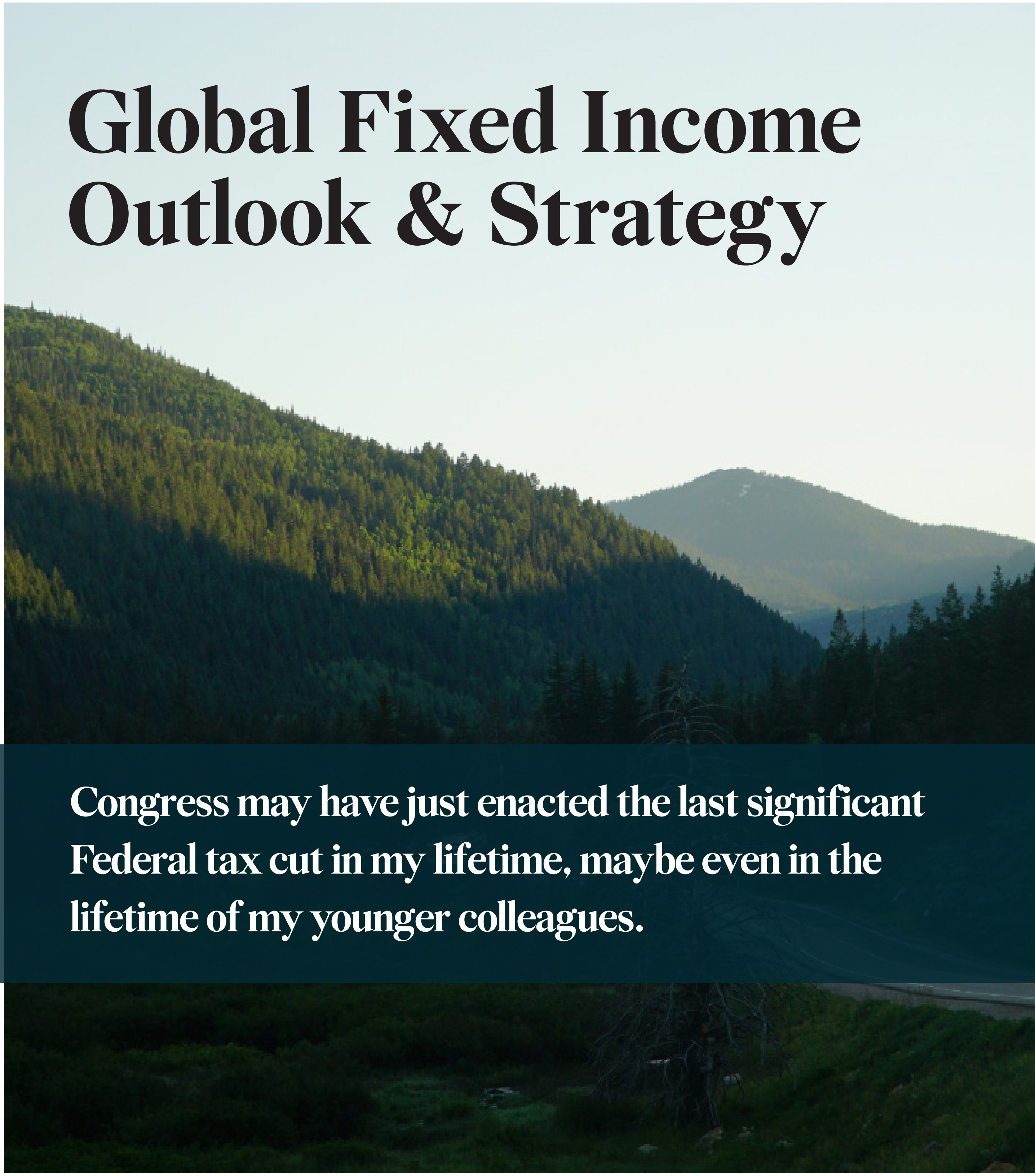
JULY 2025

Global Fixed Income Outlook & Strategy



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Market Recap & Outlook

Congress may have just enacted the last significant Federal tax cut in my lifetime, maybe even in the lifetime of my younger colleagues. The main effect of the new budget is to extend current tax rates, preventing the scheduled increases in rates that were due to take effect in 2026. Minor cuts were added, including higher deductions for state and local taxes, partnership benefits, exemption for tipped wages, and benefits for older pensioners. There were also hikes for university endowment income and overseas remittances. The biggest revenue raisers are the new tariff schedules, which are still a work in progress, and outside the Congressional budget process. On net, the fiscal package is slightly stimulative, while the tariffs are slightly contractionary. The Federal deficit as a percentage of GDP may be in the approximate 7% range in 2026, up from 6.7% in the 12 months through May of this year.

Why do we believe that this might be the last tax cut? Because the US fiscal position is in large structural deficit and the debt stock is larger. The flow deficit of about 7% of GDP combines interest expense of over 3% with a primary deficit of approximately 4% of GDP. Debt held by the public is about 100% of GDP or $30 trillion, although the public includes the Federal Reserve, which holds approximately $4.2 trillion. So marketable debt ex-Fed is "merely" 86% of GDP. Why worry?

Worry seems reasonable, as each year with these deficits adds approximately 2% of GDP to the debt stock, and the interest bill will compound, in our view. Medicare and Social Security spending are rising due to demographics. We believe defense needs are more likely to rise than decline, given Chinese and Russian military ambitions. We believe within a couple of years, the US debt stock will reach an all-time high, exceeding the 106% level reached at the end of WWII. So what? Countries have run higher debt stocks and survived. Japan has a higher stock, and the United Kingdom ran debt up to 200% of GDP during the Napoleon Wars (Guillaume Vandenbroucke, 2021). The reason for worry is that the US government is running an experiment on the willingness of investors to hold US government securities at current yields in the face of a trend erosion in US solvency, in our view.

Empirical studies of the effects of debt levels on US interest rates are extensive but unsatisfactory, in our view. A recent survey and data review (Gust, Christopher, and Arsenios Skaperdas, 2024) puts the effect at about 3 basis points on US interest rates per one percentage point of increase in Debt/GDP ratio. Other observers have seen little effect until this year. In our view, we may have moved into a new regime for which debt stocks should be considered due to rising debt levels.

We saw a sharp break in the relationship between Fed monetary policy expectations and Treasury behavior this spring, when tariff growth concerns lowered Fed policy futures yields, but ten-year Treasury yields rose rather than declined. We see a newly emerged risk premium of approximately 30-50bp in yields for long Treasuries at this time. At 3bp per point of GDP, did the market just discount the next five years of deficits, or will risk premia keep trending up? Investors will need to decide.

Governments can reduce debt burdens in several ways. The traditional way is to tighten fiscal policy and run a primary surplus. The British Empire ran a primary surplus for 80 years in the 19th century to cut its debt stock (Piketty, T., 2017). They did it on the gold standard, with zero inflation and bond yields of 3-4% while GDP growth ran at 2%. So R (the real interest rate) exceeded G (the real growth rate) and the British government still paid the debt down. Victorian Finance Ministers were hardcore.

In our view, we are now soft core. There is no plan to shrink the primary deficit directly by fiscal tightening. The plan is to have G exceed R. Perhaps deregulation and AI productivity gains will accelerate GDP growth to approximately 3%. The current US administration appears to be hoping and planning for this. The US government is also aiming for lower R. Treasury that will limit duration supply by increasing T-bill issuance while Supplementary Leverage Ratio (SLR) bank capital relaxation is hoped to increase demand. In our view, both strategies appear to be very optimistic while inflation expectations are thought to be somewhat stable, with the five year forward expectation holding at 2.6%.

Our Strategy

In such a world, Treasury pressures on the Fed to cut rates seem unlikely to dissipate, and we remain USD bears.

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Sources:

Guillaume Vandenbroucke, "How Much Debt Is Too Much? What History Shows," St. Louis Fed On the Economy, Oct. 12, 2021.

Gust, Christopher, and Arsenios Skaperdas (2024). "Government Debt, Limited Foresight, and Longer-term Interest Rates ," Finance and Economics Discussion Series 2024-027. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2024.027.

Piketty, T. (2017). Capital in the twenty-first century (A. Goldhammer, Trans.). Belknap Press.

Important Disclosures

Key Risks: Credit Risk, Issuer Risk, Interest Rate Risk, Liquidity Risk, Non-US Securities Risk, Currency Risk, Derivatives Risk, Leverage Risk, Counterparty Risk, Prepayment Risk and Extension Risk. Investing involves risk including possible loss of principal.

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