MONTHLY INVESTMENT *Brief*

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My name is Bond, Donald Bond

> *"Last days have shown that dislocations in the US bond market are perhaps the only lever to exert influence and pressure on the Trump administration."*

Equities down, credit down, dollar down…and yields up, an odd combination recently experienced by the US, and previously seen during the Liz Truss episode in the UK, and more frequently in emerging markets when there is a widespread loss of confidence. If this were to continue, a flight from US assets is a major big risk as the USD and Treasuries, are the world's safe havens, and the global financial system has been built on the assumption that they are safe. Hopefully, Prophet Trump has reassured financial markets by theorizing that "The bond market's going good. It had a little moment, but I solved that problem very quickly. I'm very good at this." All joking aside, which direction will the financial markets take? It would be very clever to give a definitive answer today. But beyond the noise, the key to the puzzle lies in one asset: US Treasuries.

Mister Bond is the new President

Forget Trump, JD Vance, Musk, the White House...The bond market is now in the driver's seat. And if bond yields keep rising, either the Trump administration will be forced to forget its trade war (wiping out the prospect of future tax cuts), or the FED will be forced to intervene. The US is living beyond its means. The proof is in the huge debt pile, which represents more than 110% of GDP, and a budget deficit that is expected to exceed 7% this year. In total, the US needs to roll over some $8 trillion in maturing Treasury notes and bonds, pay another $500 billion in interest on outstanding notes and bonds, and issue some $2 trillion in new US treasury debt this year. The main reason why the US has been able to generate growth whilst masking the decline in the standard of living over the past 50 years is because bonds have made it possible. With bond yields steadily declining since the early 1980s, the US has been able to issue ever larger amounts of debt and inject credit into the financial system.

Mister Trump is the first casualty of the trade war

Why bring up the US Debt narrative (again)? Because Mister Trump has decided to put an end to globalization, seeking to re-build the US industrial base (even if the recent announcements about semi-conductors cast doubt on this plan), and to balance the budget. And he has decided that the tool that will enable him to achieve these two objectives will be tariffs. The problem is that the bond market is not buying it. Over the last few weeks, the US 10-year yield has skyrocketed from 3.9% to 4.5%, pushing up borrowing costs. While it has not reached the alarm levels of around 5.5-6%, it is the speed of the rise that is causing concern.

Weren't the US 10-year yields above 5% just 15 years ago? Yes, but the situation is different now. The US has run up more than $20 trillion in debt since then. Knowing that they must renew $10 trillion over the next twelve months, the Trump administration desperately wants to do so through long-term debt rather than short-term debt. But if interest rates are prohibitive, the US administration will find itself with its back to the wall. A surge in yields would certainly lead to a recession, given the massive indebtedness of the US (interest payments are now the largest expenditure in the US budget). Such a situation would have many negative effects, ranging from a sharp drop in consumption due to a lack of savings and a dampened credit cycle, to a decline in households' confidence as both financial assets and property values fall, the two pillars of the US wealth effect.

Who hides behind Mister Bond?

The leading US bond salesman, as Treasury secretary Scott Bessent describes himself, has few options to bring yields down and tie the game for Mister Trump before time runs out. The first option would be to cut the US deficit to restore investor confidence in the "risk-free" status of US Treasuries. The probability of this happening is low, and the savings delivered by the DOGE are far from sufficient to offset the endless fiscal drift. **The second option** would be to sell physical assets (mostly untapped mineral resources) to pay down the debt, but this will not happen in the very short term. **The third option** would be to privatize Fannie Mae and Freddie Mac, putting downward pressure on US Treasury yields. The risk would be that this would put pressure on mortgage rates, which would weigh on households' sentiment. **The fourth option** would be to exclude Treasuries from the FED's supplementary leverage ratio (SLR) calculations, which requires the largest US banks to hold capital equal to at least 5% of their total assets, regardless of the risk weighting of those assets. This last option could be implemented quickly.

Jerome Powell could also play a leading role in saving yields as the FED has gained considerable credibility in its ability to tackle panic situations. If Mister Trump cannot force a "FED Put", Mister Powell can decide on his own to buy long-term US debt. FED holds 14% of US government bonds and nothing prevents it from holding 100%. The mechanism behind the mask is the famous quantitative easing. The US authorities could also decide to formally fix bond yields, as Japan did in 2016.

Our bet is that US institutions will prove sufficiently strong to preserve investor confidence

The worst-case scenario would be for trade uncertainty to plateau at high levels. This would lead to higher yields, further dampening growth prospects and slowing down the economy, further hurting the fiscal budget and leading to further USD weakness. Such a scenario would also import inflation, fueling a further sell-off in Treasuries . For this to happen, the dollar would have to lose its role as a reserve currency. This is the wish of Stephen Miran, the chairman of Trump's Council of Economic Advisers. But beyond a utopian ideal, a collapse of the dollar would create global imbalances from which few countries would benefit. Fortunately, there are safeguards in place to limit the risk of a worst-case scenario. Investors are still anticipating significant monetary easing (three 25 bps rate cuts in 2025). Furthermore, inflation expectations (10-year breakeven) are changing little at this stage, which reduces the likelihood of the Fed tightening of the FED's tone. Additionally, countries with a trade surplus with the US (almost all countries!) have no real alternative to reinvesting their surpluses in USD by choosing Treasuries as the underlying asset. That is why we are not buying the worst-case scenario.

How to position?

US Rates: In the past few days, short-term maturities (2-year) have been relatively well contained while longer maturities (10-year and 30-year) have been particularly hard hit. The "safe haven" status of the US debt has begun to be questioned. The Canada Pension Plan ($504 billion AUM) is among those rethinking its approach to the US. Meanwhile, one of Denmark's largest pension funds has suspended new investments in US private equity. It cites the fact that US Treasuries factor in a higher risk premium. But it also means that an attractive risk premium could attract foreign investors, and that the coming economic downturn will push US yields lower, not higher. That said, it makes sense to favor the front end of the curve to limit the risk of a further near-term sell-off in long-dated bonds.

European Rates: In the short term, growth fears might also dominate the direction of interest rates more than the inflationary impact of tariffs. Therefore, we are moving to a slightly long duration in core Europe, while being more cautious on semi-core and peripheral spreads. Given the long-term inflationary impact from stimulus programs and tariffs we favor the belly of the curve over the long end.

Credit: We stay cautious on credit risk for both Europe and the US. As spread levels are still relatively low in absolute terms, the compensation for the substantially increased uncertainty, market volatility, and recession risk is insufficient, especially for long duration high yield. By contrast, short duration investment grade and high yield should continue to benefit from still attractive yields.

Equities: If Treasuries are being sold due to continued instability, then the "risk-free" rate assumed for US equities will have to be increased and thereby incrementally increasing cost of capital to a negative level for equities. We are therefore maintaining our slight underweight position in US equities. However, as equity valuations have fallen massively, some company valuations appear cheap on a long-term basis. In this context and given fiscal stimulus programs in Germany as well as more targeted retaliation measures from Europe, we think Europe is a better relative play.

Conclusion: Do not "Make Investors Queasy Again" (MIQA)

Last days have shown that dislocations in the US bond market are perhaps the only lever to exert influence and pressure on the Trump administration. As Mister Trump told reporters a few hours before announcing the 90-day pause on higher reciprocal tariffs: "People were getting a little queasy" and "The bond market is very tricky". No one replied to him "It is the bond market, stupid" but the latest Trump 2.0 episode demonstrated the (market) limits of Mister Trump's policy. The good news is that we finally have two certainties. One is that Mister Trump's success is closely linked to the success of the bond market. The second is that the "Trump Put" exists. The bad news is that the policy flip-flop could last for several quarters, and the magic formula has yet to be found for Mister Trump to catch up and level the score at 1-1 vs. the bond market.

READ THE PRESENTATION

ODDO BHF Asset Management SAS (France)
A portfolio management firm certified by the French Financial Markets Authority (AMF) under n° GP 99011.
Established in the form of a simplified joint-stock company with authorised capital of €21,500,000.
Entered into the Paris Register of Trade and Companies under number 340 902 857.
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