Flash Fixed Income

May 2025

Are markets complacent on tariff risks?

- **The US needs trade deals to avoid a recession, but even if they emerge the effective tariff rate is expected to be meaningfully higher than during Trump's first term and versus expectations at the start of the year.**
- **Both a lower tariff and higher tariff outcome can drag on growth and raise inflation, but in our view the inflation-focused Fed is only able to act aggressively if unemployment starts to move significantly higher.**
- **While we believe a zero-growth environment should be OK for credit given the strength of corporate balance sheets entering 2025, and although we could see sector-specific issues we would not expect a mild recession to drive a large default cycle in the US.**

Markets have rebounded strongly from the lows of early April, emboldened by the Trump administration's pull-back from the near worst-case tariff rates announced on April 2 and its insistence that a number of trade deals can be struck during the President's 90-day pause.

Equity markets in the US are still down slightly year-to-date but are now sitting higher than the level seen pre-April 2, while credit spreads have reversed most of their widening but remain (at least in the US) wide of their pre-April 2 levels.

The initial market turmoil was triggered by the risk the April 2 tariffs posed to the global economy. The question for investors now is how much of the macro risk remains after the softening of the US stance, and how well that risk is being reflected in risk asset valuations.

Trade deals may not be enough

Let's start with trade policy. Put simply, we think the trade deals being promised by the US will have to happen if the administration does not want to push the US economy into recession. This does not just apply to China, where a 145% tariff effectively reduces trade to zero (no more trade deficit), but to a host of other countries given the prohibitive level of enhanced tariffs due to kick in at the end of the 90-day pause. We would argue that the bargaining power of the US is constrained by the fact that it is apparently trying to do deals with around 75 trading partners at once, though its focus will rightly in our view be on the 18 or so most important partners in the coming weeks. Trade deals are complex, and even in ordinary circumstances can take years (look at the UK after Brexit), so what we might see is a number of "agreements in principle" style announcements while the finer details are agreed in the background. Whatever deals do finally emerge, we expect the effective tariff rate to be a meaningfully increase, relative both to President Trump's first term and to consensus expectations at the beginning of this year.

Tariffs affect the economy in a number of ways. Most importantly, higher input prices reduce the purchasing power of consumers and ultimately real incomes, thereby driving lower consumption. Heightened uncertainty also reduces business investment as corporates wait to make longer term capital allocation decisions, while falling corporate profit margins from higher costs might drive layoffs as companies try to protect profitability. Finally, asset price volatility can lead to a tightening in financial conditions and suppress economic activity. The theory dictates that, very roughly, a 1% increase in the effective tariff rate increases core Personal Consumption Expenditures (PCE) inflation by 10 basis points (bp) and reduces annual GDP growth by a similar amount; the initial April 2 announcement saw some economists downgrade their US growth forecasts for 2025 to negative and their core PCE forecasts to 4%+ on a year-on-year basis.

We think a recession is less likely to happen now that President Trump has publicly acknowledged what the economic fallout of the April 2 announcement were forecast to be. The fact remains

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	1.09	1.17	3.1	4.4
GBP IG	1.68	1.89	5.4	5.7
US IG	1.48	0.83	5.3	6.4
EUR HY	1.30	2.39	5.8	2.9
GBP HY	2.49	1.96	8.7	2.9
US HY	1.51	3.33	7.8	3.2
EM HY	1.38	2.07	8.4	3.8
Euro Senior Banks	1.43	0.91	3.0	3.6
CoCo	2.08	2.89	6.6	3.4

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however that even assuming deals happen the effective tariff increase is likely to be in the region of 10-15%, and the impact of this on the real economy in the US and outside its borders could still be significant.

The Fed is shackled by inflation threat

What does this mean for monetary policy? The Federal Reserve (Fed) is certainly in a tricky position, and in our eyes the path for US rates from here is binary. Assuming the administration doesn't get rid of tariffs altogether, then the two scenarios are either lower tariffs (trade deals keep the effective rate down to something like 10%) or higher tariffs where rates remain at or close to "Liberation Day" levels. In both cases we expect to see slower growth and higher inflation, but in our view the Fed is only going to be able to act aggressively in a higher tariff scenario where the unemployment rate starts to move significantly higher.

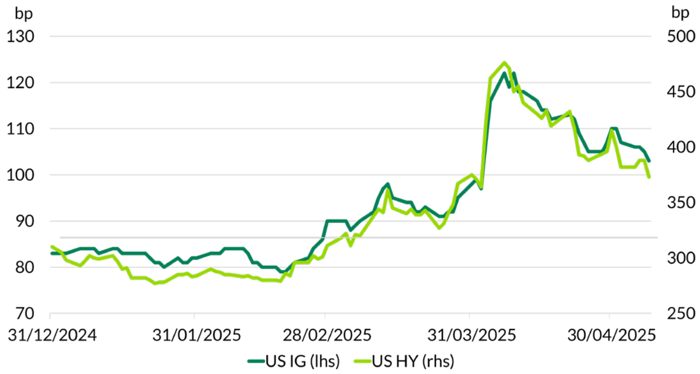
Fed board member Christopher Waller laid out this scenario analysis in a speech in April, saying he would support a "limited monetary policy response" in the low tariff scenario. At his post-meeting press conference on May 7, chair Jerome Powell was clear on the wait-and-see approach in the coming months; the Fed will underweight soft data in the near term while it waits to see if it follows through in the hard data.

In our view this means the Fed is very unlikely to move at the June 17-18 meeting, as we doubt the labour market data in particular would have weakened significantly enough (the June 6 non-farm payrolls data is surveyed in early May). However, the Fed may need to play catch-up on rate cuts in H2 2025 if the soft data does seep into the hard data and unemployment starts to rise.

Credit over equities (and rates)

From a markets perspective a few things stick out to us. First, not that we are biased, but equities (particularly in the US) look overvalued relative to credit and government bonds. We believe a 0% growth environment should be OK for credit given the quality of corporate balance sheets coming into 2025. We could see some sector-specific issues (retailers with large foreign cost bases, for example) that investors could diversify away from or not play in at all, but all things considered we would not expect a mild recession, if it happens, to drive a large default cycle in the US. The S&P 500 index meanwhile is still pricing in double-digit earnings growth on a 21x forward multiple, so to us the risk-reward looks far better in credit, especially given relatively high all-in yields. At the index level, credit spreads are still wide of their April 2 levels in both US investment grade (IG) and high yield (HY) bonds (see Exhibit 1).

Exhibit 1: US IG and HY spreads remain wide of April 2 levels



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Second, we still prefer credit to government bonds. With the Fed's hands largely tied and tariff policy driving inflation higher, the most likely driver of lower yields from here would only be a significant move higher in the unemployment rate. Given the volatility across rates curves in different geographies this year, we think credit, and in particular higher quality credit, offers better risk-adjusted return potential for selective credit pickers.

Third, and this is a point we continue to stress, we believe the impact on fundamentals for European credit will be minimal. Yes, there is a cyclical aspect if global growth slows, but given the relative size of growth downgrades in Europe versus the US, in addition to the lack of inflation impulse (if anything tariffs could be disinflationary for Europe if it receives excess Asian supply), we expect the direct tariff impact to be small.

Our view remains that credit is well positioned to manage through the macro risk in the coming months, but we do expect the hard data to weaken, particularly in the US. To us that has meant being selective from a bottom-up perspective, both by geography and by sector, and building "dry powder" for taking advantage of further tariff-driven volatility. Ultimately, given high all-in yields and strong corporate balance sheets, we think the longer term story for credit remains well supported.

Rates dashboard

			Change (bp)		
		Current (%)	1w	1m	YTD
US Treasury	2yr	3.87	5	-3	-37
	10yr	4.38	7	5	-15
	30yr	4.84	5	11	9
UK Gilt	2yr	3.93	7	-7	-53
	10yr	4.55	4	-23	-6
	30yr	5.32	1	-26	15
German Bund	2yr	1.77	1	5	-31
	10yr	2.54	0	-6	17
	30yr	2.99	2	2	39

			Change (bp)		
	Market projection	Current (%)	1w	1m	YTD
Base rate 4.50%	end-2025	3.67	11	5	-27
	end-2026	3.27	6	-14	-68
Base rate 4.50%	end-2025	3.58	8	-3	-54
	end-2026	3.44	6	-15	-54
Base rate 2.50%	end-2025	1.69	0	-2	-21
	end-2026	1.84	0	-3	-22

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