

Client Commentary | May 30, 2025

Market Commentary

Investing Insights

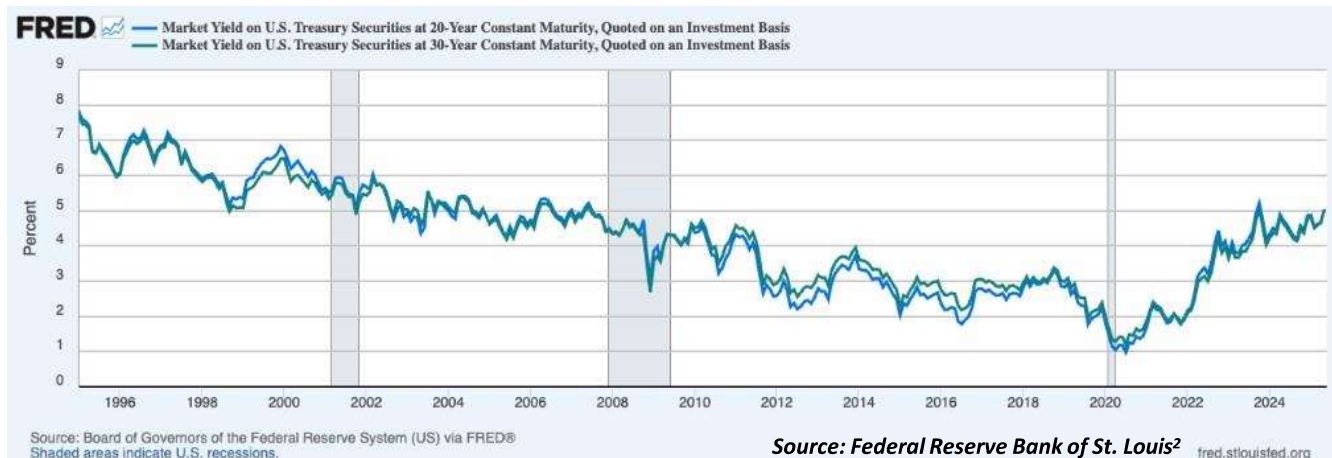
Bond Markets Signal Trouble Ahead. Should Investors be Worried?

Auctions for 20-year U.S. Treasuries are generally a routine, straightforward event that few investors pay much attention to.

That was not the case last week.

The auction for roughly \$16 billion in 20-year debt featured unusually soft demand, with investors bidding up yields past 5%, well above the approximately 4.6% average seen in recent auctions. The 20-year bond joined 30-year Treasury yields above 5%, and the 10-year also continued to inch higher, crossing 4.6%. Stocks sold off sharply on the news. 1

20-year and 30-Year U.S. Treasury Bond Yields Have Been Climbing Steadily



To be fair, these are not financial crisis-type moves in the bond markets, and there have been plenty of periods historically when yields are higher than they are now and the economy and stock market performed well. But it is correct to point out, in my view, that markets appear to be growing somewhat uncomfortable with the U.S.'s inflation and fiscal outlook.

In a past Mitch on the Markets column, I laid out three reasons why Treasury bond yields may move significantly higher:

1. Expectations for economic growth are going up, tied to expectations for pro-growth, pro-cyclical policies from the [current] administration.
2. Inflation expectations are going up, due to strong expected growth in an economy near full capacity *or because of other factors*, like trade policy (tariffs).
3. The bond market becomes increasingly concerned about fiscal health/sustainability, with growing deficits necessitating higher levels of bond issuance.

The concern is that yields are currently rising because of some combination of #2 and #3. The possibility of higher tariffs and higher government deficits (tied to the budget bill) aren't helping.

Let's start with the deficit issue. The starting point for the U.S. in 2025 is not great—the debt-to-GDP ratio is approaching a new all-time high, and the deficit relative to GDP is about 5% wider than it has historically been when the economy was at full employment. It is with this backdrop that “One, Big, Beautiful Bill” has passed the House of Representatives, which introduces tax cut extensions, new tax cuts, and spending provisions that are not fully paid for by cuts or new revenue. The implication is more annual budget deficits and additions to the national debt, which means more Treasury issuance. Yields are not likely to move lower in this scenario.

On the spending side, “One, Big, Beautiful Bill” introduces some spending cuts and measures like work requirements for Medicaid coverage, and the Department of Government Efficiency (DOGE) continues efforts to reduce government spending. But the scope of these spending cuts together is not likely to cover the cost of the tax cuts and annual government expenditures, which means shrinking the deficit is not likely. The Senate may demand more spending cuts in the bill, but the actual outcome remains to be seen. It's understandable that bond markets are a bit wobbly in the meantime.

On the inflation side of the ledger, it is really all about whether tariffs remain in force, and for how long. In Trump's first term, tariff threats were loud on the 'bark' but ultimately far more modest on the 'bite.' The tariffs that stuck were largely relegated to China, and corporations responded in many cases by rerouting trade through Vietnam and other intermediaries (including Mexico). U.S. markets and the economy did not feel much pain, and overall core inflation remained below 2% throughout this period.

We do not know where tariffs will end up for the wide variety of U.S. trading partners. But the baseline 10% universal tariff will arguably raise inflation at least moderately, perhaps to around 3% at the peak. Growth could also see an impact, given higher import costs and greater uncertainty. If Treasury yields go up in this case because of higher inflation and inflation expectations—without a corresponding acceleration in growth—that could trigger another correction in stocks, in my view.

Bottom Line for Investors

There's still time. Tariffs, growing budget deficits, and sluggish economic growth are not foregone conclusions, and sharply rising bond yields aren't either. We could see a breakthrough in trade deals, changes could be made to One, Big, Beautiful Bill to make it more budget neutral, and inflation could remain in check as the economy remains fundamentally strong. U.S. Treasury bond yields could remain in a trading range under these circumstances, and the Fed may even find cause to lower the fed funds rate and steepen the yield curve in the process.

In 2023, acute worries over too much debt and deficit spending faded as inflation came down and the economy grew, fueling the bull market in stocks and pulling in foreign investment. The door is open for this possibility in 2025, too.

¹ Wall Street Journal. May 22, 2025. <https://www.wsj.com/finance/investing/the-bond-market-is-waking-up-to-the-fiscal-mess-in-washington-fcebd153>

² Fred Economic Data. May 21, 2025. <https://fred.stlouisfed.org/series/DGS20#>

THE STEADY INVESTOR:

Key Weekly Events

- **Trade court limits emergency tariff authority**
- **Fed survey shows steady household financial health**
- **Fed signals caution amid tariff risks**

Federal Trade Court Delivers Setback to U.S. Tariff Policy

A federal trade court issued a landmark decision on Wednesday limiting the executive branch's ability to impose broad-based tariffs under the "International Emergency Economic Powers Act (IEEPA)." The IEEPA is a law typically used to target foreign assets in times of national emergency, which the court ruled does not apply to trade deficits. The court stated that trade deficits and economic imbalances do not meet the threshold of "unusual and extraordinary threats" as defined in the statute, concluding that the use of IEEPA in this context overstepped constitutional boundaries by effectively granting unchecked tariff-setting powers to President Trump. While the immediate market reaction was positive—equity futures rallied on the news—the broader impact of the ruling could be significant. If upheld, it may force future administrations to rely on either Congress or more narrowly defined trade laws, such as Section 301 of the Trade Act, to justify tariff measures. It also introduces greater legal scrutiny to the use of emergency powers in economic policy, potentially curbing

the scope of unilateral trade actions in the years ahead.

For investors, the outcome reinforces the value of monitoring not just economic indicators but also the legal and institutional frameworks that underpin trade and fiscal policy. In cases like this one, the worst outcome of punitive tariffs on all trading partners may not be realized for legal reasons.¹

Fed Survey Shows How Most American Households are Doing Financially

Despite persistent concerns about inflation and economic direction, most Americans reported financial stability at the end of 2024, according to the Federal Reserve's latest Survey of Household Economics and Decision-making (SHED). Roughly 73% of U.S. adults said they were "doing okay or living comfortably" financially, which was unchanged from 2023 but still below pre-pandemic highs. While overall economic sentiment remains muted, we're starting to see signs of incremental improvement. The share of adults describing the economy as "good" or "excellent" rose to 29%, up from 22% the previous year, although well below the 50% who felt that way in 2019. Meanwhile, the percentage of people who felt worse off than the year before declined to 29%, continuing a two-year downtrend from a peak of 35% in 2022. Most Americans are still feeling the pinch of inflation, particularly when it comes to food, groceries, and housing. Just 63% said they could cover a \$400 emergency expense with cash or its equivalent—a figure consistent with prior years but still highlighting the vulnerability of many households. Rent inflation remains a key pain point, with median rents up roughly 10% annually since 2022.

Taken together, the report paints a picture of a consumer base that is financially intact but psychologically cautious. From an investment standpoint, this disconnect between relatively healthy fundamentals and muted public sentiment suggests a meaningful opportunity: if reality continues to surprise expectations to the upside, there may be more resilience in both the economy and markets than widely assumed.²

Fed Minutes Show Cautious Stance in Light of Tariff Risks

Minutes from the Federal Reserve's May meeting revealed a cautious tone among policymakers, driven by concerns that recent shifts in trade and fiscal policy—particularly tariffs—could reaccelerate inflation. While economic growth was described as “solid” and the labor market “broadly in balance,” officials acknowledged a growing risk that inflation could persist even as employment and output soften.

This potential mismatch—higher prices alongside slowing demand—would force the Fed into a difficult balancing act. Policymakers noted that such tradeoffs could complicate progress toward their dual mandate of stable prices and full employment. As a result, the Fed reiterated its intention to wait for greater clarity before lowering rates further. For investors, it's clear the Fed remains in wait-and-see mode, and any future rate decisions will hinge not only on economic fundamentals but also on the evolving policy landscape. Markets expecting near-term cuts may need to recalibrate, as the central bank appears willing to stay patient in the face of uncertainty.³

¹ Wall Street Journal. May 29, 2025. https://www.wsj.com/politics/policy/trade-court-strikes-down-trumps-liberation-day-tariffs-9bafa448?mod=djemMoneyBeat_us

² Financial Advisor. May 28, 2025. <https://www.fa-mag.com/news/about-73--of-americans-do-at-least-ok-financially-in-fed-survey-82671.html>

³ CNBC. May 28, 2025. <https://www.cnbc.com/2025/05/28/fed-warns-it-could-face-difficult-tradeoffs-if-tariffs-reaggravate-inflation-.html>

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