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Economic Update

Tariff Wars, Inflation, and Market Strategies

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Economic Update

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The US Government's 10-year (US10Y) bond yield is behaving oddly. Over the past 40 years, in virtually every instance when the US Federal Reserve (Fed) was cutting its key policy interest rate, long-term interest rates moved in lockstep lower with the reduction in short-term interest rates. It has now been nearly three months since the Fed first cut interest rates, and historically, the average decline in the US10Y yield would be 0.4%. Instead, the US10Y yield is 0.8% higher! This means while short-term borrowing costs are falling, long-term borrowing costs are rising, creating a headwind for anyone wanting to borrow long-term. There are three popular explanations for the anomaly.

The Classic Reason

In conventional economic theory, long-term interest rates are higher than short-term rates during periods of economic growth. This is because a strong economy usually leads to inflation, which means the central bank (in this case, the Fed) would be raising interest rates at some point in the future. Today's high long-term interest rate reflects the market's anticipation of higher interest rates in the future. Currently, the US economy exhibits solid growth at 2.5%. The services sector continues to expand, as seen in the Services PMI Index reading at 54.1, and even manufacturing is showing signs of recovery, with the Manufacturing PMI Index finally breaking just over 50, which is the key inflection point when the sector expands again. With the unemployment rate at 4.1% (still around multi-decade lows), real wage levels back to pre-COVID levels and households still spending, as seen in the good holiday retail sales figures, the US is undeniably in a period of economic growth. This fulfils the classic explanation for higher long-term interest rates.

The Concerning Reason

Alternatively, US bond investors are becoming worried that President Trump's policy platform will push already high levels of deficit spending into the stratosphere.

The US Congressional Budget Office (CBO, an independent, bipartisan group that reviews US government spending) continues to show that the debts of the US Government are on pace to exceed levels only ever achieved during World War II. With COVID behind us and the absence of a global conflict involving 70 nations, what crisis is the US government combatting? For context, US Government debt as a percentage of GDP peaked at 106% in 1946. The current spending path of the US Government is forecasted to reach and exceed that level by 2029 (four years from now). US bond investors are then said to demand higher interest payments, given the expected steady supply of new bonds needed to fund all this spending.

The Alarming Reason

If the US economy grows and government spending expands, this will surely bring on inflation. Even worse, inflation today at 2.8% is well above the Fed's target rate of 2%. If inflation gets out of control, the Fed will be forced to RAISE interest rates again, leading to headwinds for the economy and weaker capital market returns - perhaps even a crash, given how lofty US equity valuations are currently.

LIS believes all three reasons are interrelated, but the endpoint is not as alarming as the market currently expects.
We agree the US economy is in good health and was a key reason we added risk exposure back into our portfolios some months ago. We also agree that US debt levels will rise, and the government must curtail spending at some point. However, while inflation remains above target, services inflation is falling, and deficits as a percentage of GDP are forecast to decline, according to the CBO. While US debts are still rising, it is occurring at a decelerating rate - after averaging an annual increase of $2.2 trillion from 2020 to 2024; US debt growth should slow to $1.96 trillion and $1.9 trillion in 2025 and 2026, respectively. This means the stimulatory impact of deficit spending on the economy will ease in the coming years.

We believe that inflation will remain elevated, but not reach critical levels necessitating an increase from the Fed. This also means we are not expecting material interest rate cuts immediately either.

As long as the US economy and households remain healthy, slightly above-target inflation is manageable.

Then Along Came Tariffs

On 1 February 2025, President Trump announced various tariffs against Canada, Mexico and China. As we wrote in a previous note, the earlier rounds of tariffs under President Trump coincided with a 1.3% reduction in global GDP growth and a 7% decline in the broader stock market over 2018. Global GDP growth ended 2018 at 2.1% versus today's starting point, with global GDP growth around 1.3%. Global economic growth today is not as robust and the size of the proposed tariff package is significantly larger, so an extended period of tariffs could threaten recessionary-like conditions for many countries.

At the time of writing, Canada and Mexico have negotiated a one-month extension before the US will implement tariffs following concessions to boost border security. Markets have welcomed the deferral, but the parallels back to 2018 when tit-for-tat tariffs between China and the US and worsening market sentiment through the year, means investors must remain alert. The longevity of any tariffs is the real determinant on whether economic consequences will be manageable or severe.

It has become evident that President Trump will use the threat of tariffs aggressively. While President Trump may yet alter or even withdraw these latest tariffs, it is clear that we have less certainty about the future. Tariffs will have immediate and far-reaching negative economic impacts if left unaltered.

We recognise that current macroeconomic conditions are generally solid but lack the conviction that they will persist with the first shots of a trade war already exchanged.

Contact us on 03 9589 8888 or emailus@reliancewm.com.au to set up an appointment today.

Regarding DeepSeek and the recent sharp sell-off in artificial intelligence-related stocks, our portfolios have generally been underweight in the Magnificent Seven and US technology for quite some time. As a result, our portfolios continue to trade well on both an absolute and relative basis. Our philosophy of always seeking diversification and managing downside risk meant we had moved to other market areas where we could find better risk/return opportunities. For example, over the past year, we made dynamic asset allocation decisions to US small caps, global real estate and reduce our exposure to Australia, which has benefitted our investors. Similarly, using high-quality active managers has also added value to investors.

An active approach to portfolio management remains important during these volatile times.

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