MULTI-ASSET

Rationalized

INSIGHTS

Trevor Slaven
Head of Multi-Asset Strategy & Allocation

Ben Gillingham, CFA
Director, Multi-Asset Strategy

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Executive Summary

- High conviction views are challenging when outcomes are subject to the whims of a few individuals and when technical factors can overwhelm the fundamentals
- We emphasize being nimble and seeking out positions that can perform in multiple scenarios; small positions can have large impacts in today's markets
- The treasury market will likely be choppy as tariffs stoke fears of inflation and continued budget deficits, counteracting the weaker growth backdrop
- In the U.S. rates market, we prefer curve steepening trades as Fed cuts may be seen as an inflationary "policy mistake" that hurts the back-end
- We prefer duration exposure in other developed markets like Australia and Europe where inflation will be less of a concern relative to the economic contraction
- Owning investment grade (IG) credit on-yield can offer protection across a spectrum of outcomes
- Carry-breakevens in high yield (HY) credit offer good long-term value; other post-GFC sell-offs found stability in the mid-9% range; Europe offers value on this basis as well
- Hedge portfolios with cash instead of currency bets; FX markets are too subject to countervailing forces today

A Volatile Week

There's an old saying that goes "don't try to rationalize with irrational folks, just keep your distance". Well, markets have been distancing themselves from the risks of last Wednesday's tariff announcements in extraordinary fashion. In the notes below, we humbly submit a few thoughts and observations in hopes of trying to make sense of how to best manage portfolios through this volatile period.

As you know, the Trump administration announced a slate of "reciprocal tariffs" last Wednesday that essentially covered every major economy in the world. In turn, China has retaliated with their own 34% tariff on all U.S. imports. Estimates of U.S. GDP growth have already been slashed by 200–300bp, recession probabilities have spiked, and many sell-side economists are calling for inflation to surge an additional 150–250bp this year.

In the three trading days since the announcement, the S&P is down 11.0%, a three-day decline commensurate with the worst moments of Q4 2008 (GFC), August 2011 (EU-crisis), and March 2020 (COVID). Treasury yields at the 10-year point touched as low as 3.86% before Fed Chair Powell's speech Friday morning, but at 4.18% are now actually higher than before the tariffs were unveiled. Counter to the consensus calls for higher inflation, inflation breakevens have declined 22bp on the back of oil and copper being down 14.9% and 16.4% respectively, also on-par with the worst moments of March 2020. In credit, IG total returns actually ended up on the week before falling 2% in Monday's session, while U.S. HY spreads are 119bp wider. **Figure 1** below highlights the severity of these three-day moves.

Figure 1: Three-day Cross-asset Market Moves

	U.S. IG (spread, bps)	U.S. HY (spread, bps)	U.S. 10 Year (yield, %)	U.S. Equities (price, return)
Last Level	116	461	4.18	5,062
Move Since April 2, 2025	+23	+119	+0.05	-11.0%
Z-score of Move	5.5	7.3	1.1	5.4

Sources: Bloomberg. As of April 7, 2025. Historical data uses rolling 3-day moves since April 2005.

How do we assess these moves against the policy rationale that is driving them?

The Trump administration came in to office with plans to address immigration, bring down inflation, lower federal budget deficits, and stimulate blue-collar job growth by revitalizing corporate investment domestically. Treasury Secretary Bessent's 3-3-3 plan (3% real GDP growth, 3% deficits, and 3mm bbl/d of additional oil production) reinforced these goals. Leaving partisanship aside, this is where the comment on "irrationality" comes in to play, which will factor heavily in how we assess the direction for markets going forward.

At face value, creating a recession via tariffs seems to run counter to the goals listed above. Last week's actions almost necessarily harm the employment and near-term corporate investment outlooks, both of which result in lower tax revenues and hence deeper deficits; lower energy prices won't galvanize new oil production; and as many economists are projecting, these tariffs will likely push many goods prices higher which creates a difficult conundrum for the Fed and the direction of interest rates (more on that in a bit). From our perspective, the apparent disconnect between this tariff policy and the administration's stated goals suggests we need to start thinking through potential policy evolution in the months ahead while protecting portfolios in the near-term.

So what are the likely outcomes from here?

WE SEE THREE POSSIBLE PATHS AHEAD:

1. These tariffs are a negotiating tool used to reach bi-lateral deals in the weeks/months ahead

2. The Trump administration believes so strongly in the power of tariffs (to raise revenue and to force manufacturing back in to the U.S.) that they keep them in place for years

3. The prospect of economic contraction that now feels inevitable becomes painful enough that the Trump administration scrambles to launch stimulative measures like additional tax cuts to counteract the tariff programs, undermining their budgetary goals.

We would offer up a fourth alternative: that the U.S. economy is the most dynamic machine in human history, routinely reallocating 4–5 million workers every month, and capable of absorbing this tariff disturbance without much harm. But relying on this dynamism is particularly risky today given the labor market is already operating close to full potential with only modest growth in prime-age population and registered immigration flows to support expansion, and we are now lapping the most profligate non-war time fiscal spending in U.S. history, leaving little room or appetite for support. The near-term downside scenarios must unfortunately lead our analysis.

The worst case outcome for markets in the near-term (some variation of #2 from above) would involve a reflexive rise in unemployment as regular household spending slows, with consumers who have already worked through their post-COVID savings balking at the prospect of even higher prices on tariffed goods. While this reflexive contraction may not be imminent, more than 41 million Americans work in the Trade, Transportation, and Manufacturing sectors. Even a 5% decline in those sectors, akin to the 2000–2002 slowdown, would push the unemployment rate up 1.2% before considering any knock-on effects to other sectors or to aggregate wages. That leaves us expecting at least some period of economic pain, likely measured in months, especially as China and Europe seem to be fortifing their pushback against the Trump administration.

How do we marry these potential outcomes to opportunities in the market today?

One of the stand-out observations of the last week is that U.S. real yields are higher than they were going in to the announcement. While they have rallied from 2.25% coming in to the year, 10-year real rates are still in the upper-end of their 1.00–2.50% range going back to 2023, and for context, these yields reached -1.00% (or roughly 300bp lower than today) in the aftermath of the GFC and COVID. Point being, we see value in 10-year real yields above 2.00% as there is meaningful potential for these rates to rally in the worst growth outcomes.

Why real rates instead of nominal treasuries? There is a huge debate about the inflationary impact of these tariffs. Our bias is that the growth contraction, with lower commodity prices and a more hesitant consumer, will bring a disinflationary force that helps offset the tariff step-up in goods prices. But even in this "more stag, less flation" outlook over the course of the next 12–18 months, many economists are projecting a 150–250bp push higher in PCE this summer. The sequencing of this economic path is going to introduce a ton of noise around inflation which will likely reverberate in the nominal treasury market, especially as we weigh the prospect of foreigners selling their treasuries in a response to tariffs.

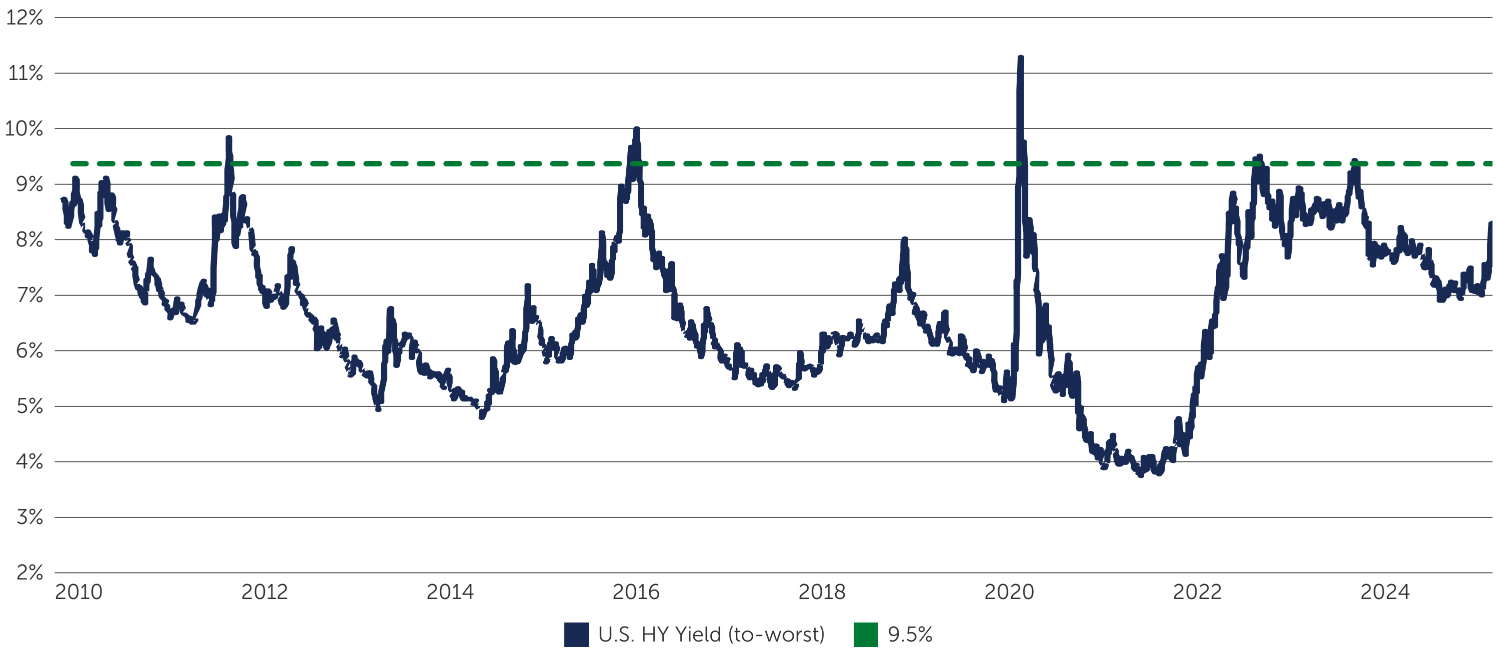
One final point on U.S. duration: we see the case for further curve steepening as now more likely over the quarters ahead. While the re-positioning chaos of the coming weeks will bring noise here as well, these tariff policies make it harder to see true progress on the deficit and debt issues, again combined with foreign buyers likely stepping back. And if the Fed does cut rates more aggressively, we would expect the bond vigilante theme to re-emerge at the back-end of the curve. The near-term pain for steepening positions would likely involve positive headlines on tariffs and hence a bounce in risk, so we think this curve posture fits nicely in portfolios today.

Looking globally, we see last week's developments as supportive for taking duration risk in markets like Australia, the U.K., Germany, and Canada versus the U.S. as the narrative in these countries should be more clear. These rates markets will not have the same tariff-induced inflationary impulse as the U.S.; they will likely benefit from the global commodity price deflation; and, they are very likely to see a growth slowdown as well. We see this as especially true for some of the Asia-centric economies like Australia given the growing retaliation between the U.S. and China.

Switching to credit, owning IG credit on yield feels like a comfortable spot in an uncertain world. Spreads are 30–40 wider at the index level since mid-February, out to the 110–120bp range in both the U.S. and Europe. If this tariff episode ends up looking like the worst moments of 2011 and 2015, both of which combined a mix of legimate political and underlying fundamental stress (especially in industrial and commodity producers in 2015), that would imply another 100–125bp of spread widening. We see that as an appropriately bearish worst case, and in that scenario, we believe the rate-risk hedge would hold, especially through real rates, with ample room for a duration rally to absorb that type of spread widening.

In high yield, we find it informative that in all of the major sell-offs post-GFC (2011, 2015, 2020, 2022), the pressure on all-in yields started to exhaust itself in the high-9% range (save for 5-6 days in March 2020; see **Figure 2** below). While there is still room for wider spreads in outcomes that mirror the 2011 and 2015 scenarios mentioned above, at 8.6% yields as of Monday's close, the carry breakevens, i.e. the return buffer that current yields provide against further widening, are already quite attractive. The value here is further bolstered by the underlying structure of the high yield market today with shorter durations, a higher quality ratings distribution, and less exposure to cyclical sectors like autos, retail, and chemicals. Given the historical observations of 9.5-10% index yields tend to be relatively brief and occur on very low trading volumes, making it very difficult to time and execute, we like building positions here while maintaining some dry powder to take advantage of any forced selling in the market.

Figure 2: Yield to Worst for U.S. High Yield



Source: Bloomberg. As of April 7, 2025.

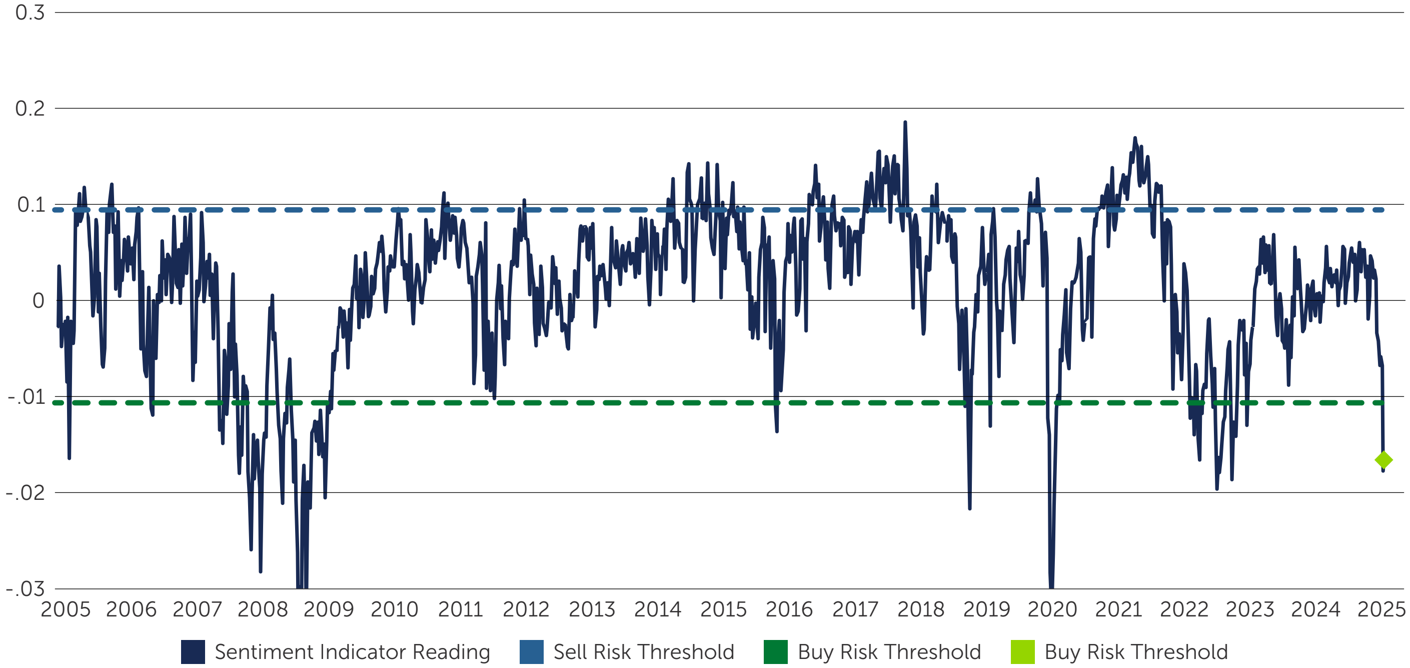
Looking at currencies for a moment, there has been an incredibly strong correlation between broad USD moves and U.S. real rates since 2020, with Fed expectations becoming the dominant force in driving FX direction. Given the stated view on the asymmetric attractiveness of real yields, you would think that leads us to a bearish view on USD. That would seem even more appropriate when you layer on the risk for the rest of the world to "band together" with their own trading agreements exclusive of the U.S. However, the FX story has some question marks in our mind.

While the U.S. does have a Net International Investment Position of -$26 trillion dollars, much of the world is still "short dollars" whether through their trading needs or debt-management requirements. To the extent that U.S. imports slow dramatically, that removes a major source of supply of USD for the rest of the world that works against the weak dollar view.

We are also reminded of the Larry Summers' quote that details how EUR, JPY, and CNY aren't exactly handsome alternatives to the dollar long-term. While gold has performed beautifully, and should do well in a lower real rate environment, near-term it may become a source of cash for investors who need it and want to re-deploy in distressed markets. In short, we see the FX market as too noisy for reliable hedging today, and would prefer to hold cash until we gain more clarity.

On risk more broadly, sentiment has swung aggressively. While the speed and violence of these moves suggests there is likely more to come, we are reminded that the biggest rallies occur inside of bear markets as highlighted by the stunning 11.4% intra-day reversal in Nasdaq futures on a Monday morning "fake news" headline. Our Analytics team highlighted this weekend that their proprietary Sentiment Indicator has swung in to the "Buy Risk" zone, which looking forward 3-months has a 75% hit rate going all the way back to 2005 **(Figure 3)**.

Figure 3: Barings Risk Sentiment Indicator



Source: Bloomberg, Barings. As of April 7, 2025.

Finally, this sentiment indicator reminds us of one point of context on equities: given their long-duration cash flow profiles, the earnings of any one year really don't contribute more than 5–6% of the fair value of future cash flows, depending on the growth profile. More impactful is the long-term growth rate, where every 1% decline in future growth can take 11–14% off the equity value. With the S&P 500 down -18% from its February highs, the market is pricing in a multi-year 1.25–1.75% reduction in earnings growth trajectories. While we can certainly see that lower growth this year, we think projecting that meaningfully lower growth profile in perpetuity is starting to look like an overshoot.

Conclusion

It's hard to call anything a "Conclusion" right now; it is much more of a "to-be-continued". We will continue to look for investment opportunities that can work across the various potential outcomes we have noted or that have a substantial margin of safety for even the worst scenarios.

But if we can editorialize briefly, it is probably fair to state that the U.S. has become overly-reliant on stimulus this century, and too allergic to organic recessions and the "creative destruction" process. Now, last week's events hardly feel "creative" right now, but even if the near-term economic pain plays out in a way that isn't elegant or commendable, it will hopefully lay the ground work for a durable growth trajectory looking to the years ahead, especially given the starting point of having worked off the excesses of 2021. Our biggest fear here is a reflexive rise in unemployment and decline in consumer spending more broadly. We will be watching those employment dynamics very closely in hopes that the economy doesn't get "rationalized" before these tariff policies do.

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