Macro Talking Points

Fixed Income Insights

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In brief

- **We are going on a bear (steepening) hunt**
- **The dollar grimace**
- **An unusual hypothetical recession**
- **Canadian client questions**

The wrong kind of curve steepening. There is the good kind of yield curve steepening and the bad kind. The good kind of yield curve steepening typically reflects an improvement, or presumed improvement, in macro conditions and growth expectations, usually due to central bank policy easing. But this is not it. Far from that, in fact. These days, we are observing bear steepening, when the long-end rates run the show. Not a great show, to be clear, as the risk to long-term yields remains skewed to the upside. This is the result of the combination of renewed inflation risks and weaker demand for US Treasuries, which tends to produce a negative signal for investor sentiment. Recently, there have been a number of unusual market characteristics illustrating that we may be experiencing some extraordinary times. One of them is the major divergence in the moves of front-end and long-end rates in the United States. The 2-year yields have declined by 8 basis points since the end of March, while the 10-year yields have risen by 22 bps during the same period.[1] This sort of correlation breakdown is not common. The last time that the correlation was this low between the 2-year and the 10-year yields was in 2022, under a substantially different monetary policy regime. At the time, it was the front-end rates that were running the show, reflecting the hawkish signals from the US Federal Reserve. Looking ahead, we will be watching rate volatility, long-end yield dynamics, and the shifts in the yield curve for signs that the dust may finally be settling.

The dollar does not smile anymore. The US dollar is down. Sharply so. More importantly, the dollar smile framework seems to have broken down. Back in the day, the higher pricing of recession risks — whether US centric or global — combined with a risk aversion shock would have caused the dollar to appreciate, as illustrated by the left corner of the dollar smile. However, that is not the case this time. We are facing a new market paradigm as the defensive characteristics of the US dollar are being undermined. In the process, the DXY index has fallen to about 98.40, a level we have not seen since early 2022.[2] The US dollar is much cheaper than it used to be a few months ago; however, that does not mean it is cheap by historical standards. Looking at the US Fed trade-weighted real broad dollar index, the current level still stands at a hefty 17% above its 30-year average, pointing to some significant overvaluation.[3] Overall, the market backdrop does not appear to be supportive of the dollar, at least based on the current information. This means that non-US assets are likely to be well positioned to outperform in the period ahead.

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A recession like any other. Historically, the Fed has been blamed for causing a number of recessions by hiking rates too much or too late (or both). After all, the late Rüdiger Dornbusch, a distinguished economist, is known to have said, "Economic expansions do not die of old age; they are murdered by the Fed." This time may be different, however. If the US were to enter a recession over the next twelve months, the Fed would have had nothing to do with that. In fact, to the earlier astonishment of many market participants, the Fed may be commended for having managed to engineer a soft landing, against all odds. So, if it isn't the Fed's fault this time around, where should the finger point? Well, if it is not monetary policy causing trouble, it is going to have to be fiscal policy. In other words, if a recession were to strike, it would be the result of a government-led fiscal contraction. This is highly unusual, and to be clear, we cannot recall a similar episode in recent history. There is still a significant lack of visibility about how large the tariff shock will be. While the initial tariff announcement pointed to major growth risks — given that it entailed a fiscal tightening of about 2% of GDP — since then, implementation delays and ongoing negotiations have led to downside revisions to the magnitude of the potential shock. In any case, the recession discussion remains purely hypothetical. First, policy uncertainty is still extremely elevated. In addition, the view from our fixed income investment team, as expressed in their recent strategy meeting, is that a recession is still unlikely to materialize in the period ahead, even though the recession probability has risen. This is mainly because the US economy entered this zone of turbulence in a position of strength and should likely prove to be resilient enough to avoid a growth crisis.

Client questions from Canada. I spent last week meeting with our institutional clients in Eastern Canada. Clearly, there was much to talk about, with the main focus around what is happening south of the border and the impact on the rest of the world. With that in mind, the key client questions related to the view on recession for the US, Canada and the global economy, as well as on alternative macro scenarios. The monetary policy outlook was also discussed heavily for the US and Canada. Beyond monetary policy, investors also inquired about our views on duration. Inflation was top of mind, as was the view on the US dollar, in the face of the recent market move. Global asset allocation came up as a topic of interest, especially in regard to the theme of challenges to US exceptionalism. Finally, under the same topic, Canadian investors wanted to hear about the merits of going global in fixed income. ◢

Endnotes

[1] Source: Bloomberg, generic UST 2-year and 10-year yields, data as of 21 April 2025.

[2] Source: Bloomberg. US dollar index = DXY index, data as of 21 April 2025.

[3] Source: Bloomberg, Fed. US Fed real trade-weighted broad dollar index. Monthly data. Data as of 31 March 2025.

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