Strategist's Corner
May 2025

Moody's Sends Investors a Reminder

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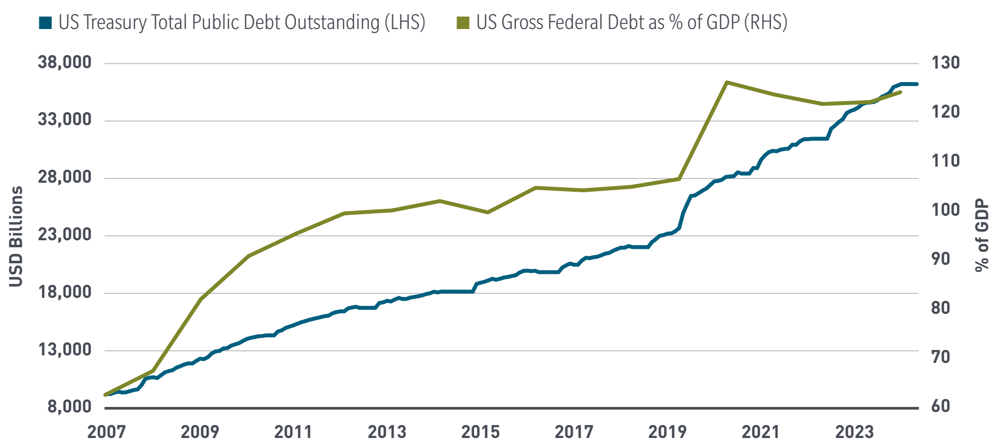
In brief

- It's not inflation that's pushing up yields, it's an uncertainty premium.
- The high existing US debt burden and elevated uncertainty could keep long-dated bond yields from falling even if the US Federal Reserve cuts rates.
- This may suggest a shift is coming toward a market driven more by fundamentals than by policymakers.

Since the global financial crisis (GFC) of 2008, policymakers in the United States have sought to reverse slowing money velocity and cushion the risk of financial losses with liquidity. As we wrote in last month's piece, liquidity can only be created in two ways: by growing income or growing debt. Incremental spending by US households and corporations fell after the GFC, so policymakers levered up.

While everyone is familiar with the statistics, we will reframe it quickly: The US' aggregate debt load has more than tripled from $10 trillion in 2007 to over $36 trillion today (green line in Exhibit 1). Even adjusted for changes in size of the economy, the US' debt-to-GDP ratio has nearly doubled from 65% to 125% (blue line).

Exhibit 1: No matter how you measure it, the US debt load has soared



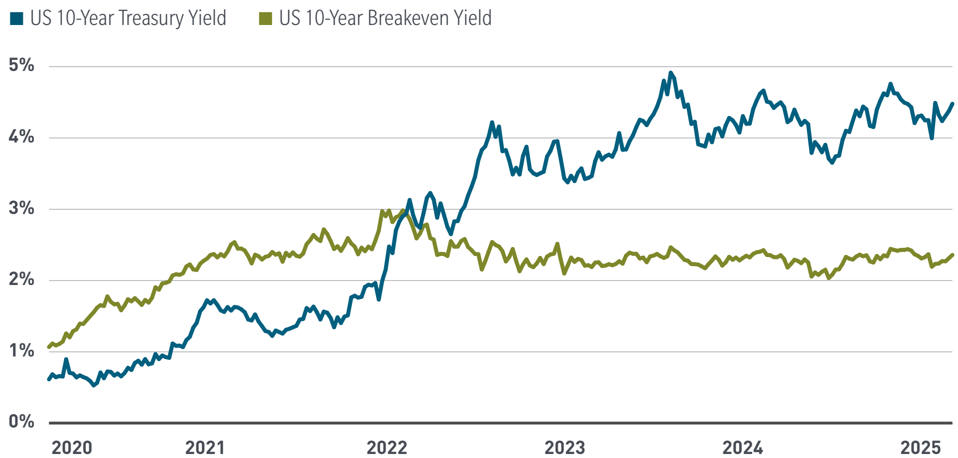
Source: Bloomberg. US Treasury Total Public Debt Outstanding - monthly data from 31 December 2007 to 30 April 2025. US Gross Federal Debt as % of GDP - Annual data from 31 December 2007 to 31 December 2024.

While the recent US debt downgrade by Moody's reflected a "known known," we think it's a good reminder for investors to consider a risk factor that has been building for several years but has been largely ignored by markets. You probably thought I'd cite inflation, but no. It's something else.

First, why isn't it inflation?

The chart below shows 10-year US Treasury and 10-year TIPS break-even yields. While the moves from the pre-COVID low through 2022 reflected the inflation shock brought on by pandemic stimulus, yields have taken a different pathway since. While nominal bond yields have risen, break-evens have not.

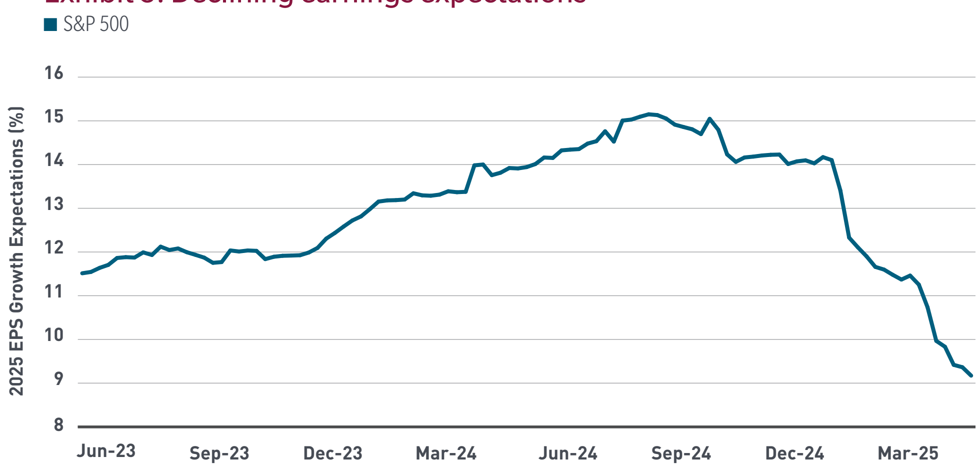
Exhibit 2: While nominal yields have risen, break-evens haven't



Source: Bloomberg. Weekly data from 1 May 2020 to 16 May 2025.

If this were an inflation story, companies would be raising prices and earnings forecasts would probably be rising. Instead, companies are not raising prices, and expectations are declining, as shown below, because of higher and stickier input costs compared with years before the pandemic.

Exhibit 3: Declining earnings expectations



Source: FactSet. Weekly data from 2 June 2023 to 16 May 2025.

This suggests that the rise in nominal yields and the Moody's downgrade are about something else: an uncertainty premium.

What's the risk then?

Financial assets are legal claims on cash flows. One investor's asset is someone else's liability. In that context, Treasury yields exist to compensate lenders for the uncertainty about the future. When uncertainty rises, liquidity falls and yields rise. Rising Treasury yields equate to higher US liabilities.

While the situation remains fluid, we believe it's reasonable to assume we'll face higher tariff rates than we have at any point in our lifetimes. If so, tariffs are a tax and extract real money (liquidity) from the economy, and investors are demanding to be paid for this, which is different from the 2010s.

Why the Fed may not be much help next time

Our industry dedicates enormous mindshare to the US Federal Reserve. I sort of understand why. For years investors have believed, based on the post-GFC experience, that central banks control the price of time. But for most of that period, US debt loads were growing, and capital was racing into the US.

Falling federal funds rates have historically been accompanied by declining corporate earnings and weaker economic growth. While in the past, a weak growth backdrop has applied downward pressure on yields, I think the combination of an already existing high debt burden along with elevated uncertainty may keep longer-dated bond yields from falling even if the Fed cuts rates. In other words, future rate cuts may buoy earnings and financial asset prices less than they did in the past.

Conclusion

While the high US debt burden shows no signs of easing, US liquidity does. Unlike past years, today's Treasury bond investor has shown significantly greater sensitivity to new uncertainties and is asking for a higher premium.

While the trade war may or may not evolve into a full-fledged capital and liquidity war, a long ignored chronic risk, the US budget deficit may now become an acute risk.

While we're not expecting anything resembling a debt crisis in the US, borrowing costs for consumers and corporations may remain elevated in the face of a lower federal funds rate later this year. We think this could lead to broad dispersion in operating and financial performance between businesses that can navigate the new world and those that can't.

That could upend years of outperformance by passively managed strategies and mark the beginning of a new regime where fundamentals drive market performance, not policymakers.

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