PM Perspectives

# Pay attention to Newton's law: Position for the world's reaction to Trump's America First agenda

Author

**Myles Bradshaw**
Head of Global Aggregate,
Global Fixed Income,
Currency & Commodities

"May you be born in interesting times" is a proverbial curse that perhaps best describes today's market environment. After dealing with uncertainty caused by Covid, inflation, a US regional banking crisis and a war in Europe, investors now need to adapt to uncertainty in US trade, fiscal, immigration and foreign policy; all at once. The market is rightly currently focused on the very fast moving impact of US tariff policy, its impact on economic fundamentals from the disruption of supply chains, and the impact on market technicals as leveraged investors respond to higher market volatility by degrossing their book. Much has been written about what President Trump may or may not do, much less on how the rest of world may react. Therein lies the investment opportunity: capitalise on a gap in global bond valuations, with European—particularly German—bonds looking expensive compared to other markets, and yield curves, particularly in the US, looking too flat.

## Every action creates an equal and opposite reaction

Newton's Law cannot be directly translated from physics to economics. But the reaction to a shift in US foreign policy is already becoming clear, as seen by Germany's constitutional amendment to its debt brake, which has removed barriers to defence spending in excess of 1% of GDP and created a €500 billion infrastructure fund. Europe's security independence will probably require more effort than that announced by Germany alone, while fiscal policy will also likely be called on to support industries hit by US trade protectionism.

In contrast to European fiscal activism, US fiscal policy appears less stimulative than previously thought. It's likely that potential tariff revenue may still be used to support further tax cuts, but initial US congressional budget resolutions only roll-over the 2017 Trump tax cuts alongside fiscal savings elsewhere. From a macro perspective, these initial resolutions would be a negative fiscal thrust, contrasting with previous fears of unfunded US tax cuts. The shift in relative fiscal policy has implications for monetary policy: a tighter US fiscal stance should trigger a relatively looser monetary policy, while more European fiscal activism eases the burden placed on the European Central Bank.

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## Markets are under-pricing the shift in relative US-Europe macro policy

The fundamental outlook matters most when it is not reflected in market pricing. Despite March's German fiscal announcement, markets are still pricing a fiscally prudent eurozone.

The five-year yield, starting five years' forward, is a stable forward bond valuation metric that, unlike spot 10-year bond valuations, is less distorted by where central banks have pegged short-term interest rates today. (**Exhibit 1**) shows how US and German five year, five-year forward yields have increased since 2021 due to the economic and policy shocks from Covid, which improved private sector balance sheets at the expense of government balance sheets and raised inflation expectations. As a result, markets reduced the probability of outright deflation, negative rates and quantitative easing, leading to a recovery in medium-term inflation expectations. US and European inflation expectations (**Exhibit 2**) are both back to the range seen before the global financial crisis (GFC).

**Exhibit 1: US Treasuries and German Bund valuations**

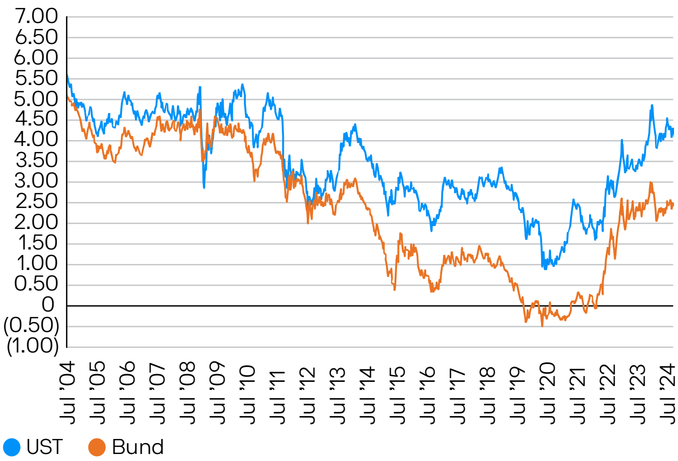
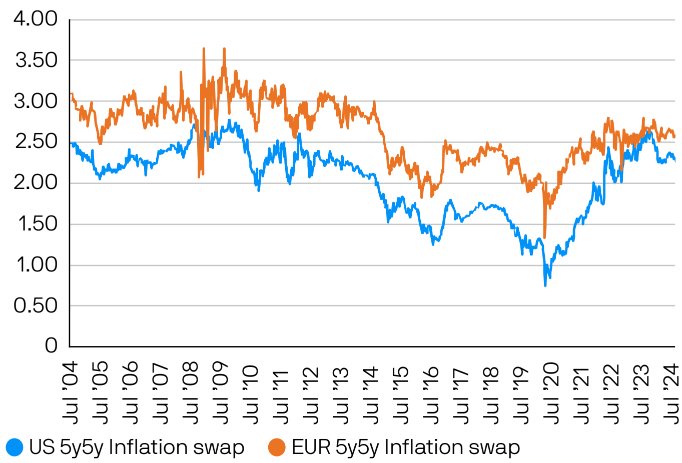


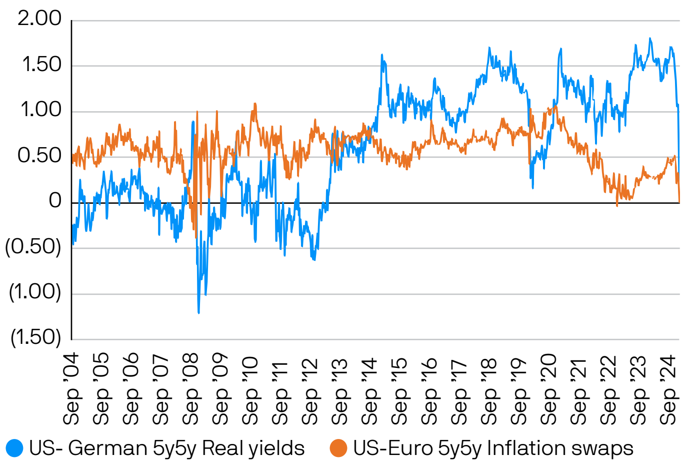

**Exhibit 2: US and eurozone inflation expectations**




Source: J.P. Morgan Asset Management, Bloomberg.

A closer look at these forward expectations reveals that, while US medium-term bond valuations have returned to levels seen before 2007, eurozone bond valuations have not. The reason is due to differences in real yield valuations, not inflation expectations, as shown in (**Exhibit 3**), which breaks down US and German five-year, five-year forward nominal yields to reflect differences in inflation expectations (orange) and real yields (blue). We can see that markets clearly reacted to Germany's fiscal announcement in March, but real yield relative valuations are still in the range established after 2014 when eurozone deflation risks were paramount. In contrast, differences in inflation expectations, which also capture relative deflation risks, are running at half the average 2015-2021 rate. In other words, markets are pricing similar US and eurozone inflation risks, but investors are paying a real yield premium to own German vs. US government debt. A return to pre-GFC relative valuations could see the five-year, five-year forward real yield premium, which currently stands at 100 basis points (bps), return to zero.

**Exhibit 3: US vs. German real yield and inflation expectations spreads**




Source: J.P. Morgan Asset Management, Bloomberg.

## US tariffs could be the macro catalyst for tighter US-European spread convergence

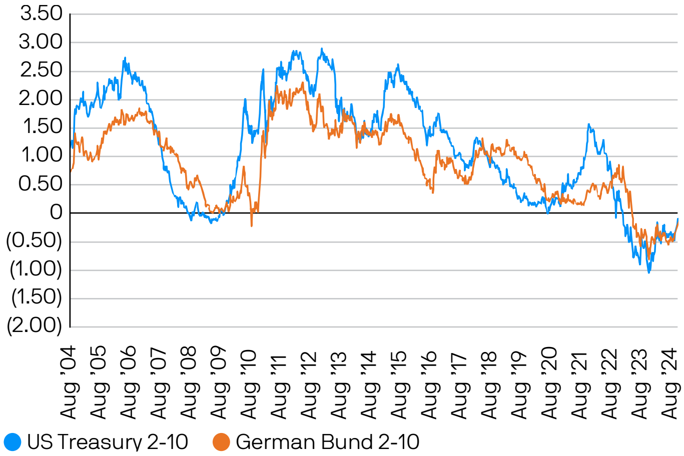
Medium-term valuations are objective anchors for investment decisions. A mis-valuation offers investors the potential for excess returns, but realising this excess return usually requires a fundamental or technical catalyst. The catalyst for further convergence of the US-German spread is likely to come from a convergence of nominal growth expectations.

A trade war is likely to be a stagflationary shock for the global economy. The extent to which growth or inflation risks dominate market pricing depends on the policy response: the size of tariff retaliation, fiscal support, and speed and size of central bank cuts. US prices are expected to increase due to tariffs. But unlike the Covid supply shock, today's looser labour market, the absence of excess savings held by US consumers and a tighter US fiscal outlook, mean that downside growth risks are likely to dominate market pricing.

Despite a 10% fall in the US stock market in the two days after President Trump's tariff announcement, US interest rates, at the time of writing, are expected to be cut to around the Federal Reserve's estimated 3% neutral rate. By contrast, the European Central Bank is expected to cut eurozone rates to below their 2% estimated neutral rate. Assuming the zero bound on interest rates holds, there is substantially more room for US short-term interest rates to fall than in Europe should the economic backdrop worsen.

This analysis also suggests that yield curve steepening strategies are more attractive in the US, with the two-to-10 year curve steepening 150bps-200bps in an easing cycle (**Exhibit 4**). With the two-to-10 year German curve at about 80bps today compared to +40bps in the US, the valuation message is clear: US Treasuries offer a better return profile than Bunds if a recession unfolds.

**Exhibit 4: US and German two-to-10 year yield curve**




Source: J.P. Morgan Asset Management, Bloomberg.

## The shift in the relative fiscal outlook is not fully reflected in valuations

Relative valuations and shifts in the outlook for fiscal policy support an underweight in German bonds against the US. Potential excess returns are substantial if the US-German real yield valuation returns to pre-GFC levels, which would better align relative real yields with market expectations of relative inflation risks today. At the same time, with the five-year, five-year forward US-German real yield spread in line with the 2015-2021 average, which was a period dominated by euro deflation risks, the downside risk from this trade appears low. As a result, we see greater value in holding US duration over Europe in our Global Aggregate portfolios.

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