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The Pulse

Global Fixed Income Update

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Ahead
of the
Curve

“Modus vivendi” emerges at a critical time, while risk remains

The April 2 “Liberation Day” led to market turmoil after President Donald Trump’s announcement of draconian tariffs, threatening the post-WWII global economic order and sparking fears of potential collapse. U.S. Treasury yields rose, while the dollar fell, signaling foreign investor retreat, as noted by Minneapolis Fed President Neel Kashkari. Global investors, heavily weighted in U.S. equities, faced uncertainty about Treasury market functionality, causing capital markets to crater. Fortunately, the subsequent developments helped markets recover to pre-announcement levels:

Delayed and recalibrated tariffs—President Trump’s pivot toward delaying tariffs and leaving the opening for unilateral trade negotiations was the immediate succor that markets sorely needed in the wake of early April capital market distress.

Treasury market disruption was technical, not fundamental—While questions remain, hindsight indicates that much of the U.S. Treasury market’s early April dysfunction may have been more technical in nature, with extreme equity volatility temporarily paralyzing certain hedge funds that had grown important in the normal functioning of U.S. Treasury markets. To this end, Treasury Secretary Scott Bessent has argued in recent weeks that the current Supplementary Leverage Ratio (SLR) rule that requires banks to hold 25% of their balance sheets in liquid assets has also eroded their ability to act as intermediaries in the U.S. Treasury market. Against this backdrop, it is reasonable to assume that some type of SLR reform will be part of forthcoming federal budget legislation.

The U.S. economy and S&P 500 earnings have been resilient so far—Despite major market volatility and heightened headline risk, U.S. economic forecasts still largely point toward a slowing, but not recessionary, U.S. economy, while the latest S&P 500 earnings trends have been fundamentally sound.

Modus vivendi emerges between the U.S. and China in Geneva—With roots in the 19th century as a temporary or provisional arrangement between two parties that allows them to coexist even if underlying disagreements remain, modus vivendi appeared to be on display with recent high-stakes trade talks between the U.S. and China. Heading into their Switzerland meetings, there were signs for optimism. The early April U.S. call for 145% tariffs on China imports being reduced to a still severe 80% level was floated by President Trump as a foundation for the Geneva talks to begin. Subsequently, markets, for now, appear quite constructive on a temporary outcome where U.S. tariffs on imports from China are reduced from 145% to 30% while China tariffs on U.S. goods are also slashed from 125% to 10%. Ultimately, it now appears that when global trade negotiations end, U.S. tariffs are likely to be in a range of 10% to 20%. And while this sounds like an extraordinarily positive development relative to where markets first landed after Liberation Day, the fact remains that these tariffs still represent not only a major increase, but also a headwind for growth as well as a catalyst for higher inflation.

In the wake of the April volatility, several key highlights emerged from the Fixed Income Division at T. Rowe Price Associates.

Slower global growth and diverging economic outcomes as the U.S. potentially heads for a “technical” recession—In the wake of uncertain U.S. trade policy, real-time survey data now point toward a broad-based slowing of the U.S. economy. A key for the U.S. economy will be labor markets that now appear less resilient than they were at the start of the Fed’s hiking cycle in 2022, even though the domestic unemployment rate remains at 4.2%. Interestingly, it was in 2022 that the U.S. economy posted two consecutive quarters of negative gross domestic product growth (a “technical” recession) but avoided recession due to the overall resilience of U.S. labor markets and strong fiscal policy, among other considerations. Today, due to trade policy uncertainty, a similar setup for a technical recession exists. But in contrast to 2022, the economic “buffers” that saved the U.S. economy then are less supportive now. As a result, much is dependent on the federal budget legislation being drafted in Congress right now that is expected to extend and potentially add to the 2017 tax cuts (Tax Cuts and Jobs Act) delivered by the first Trump administration. Beyond avoiding a U.S. recession, the timing of this new legislation that is expected before the August recess is crucial as it will impact the U.S. economy on a delay and is likely to powerfully factor into U.S. midterm election outcomes in 2026.

Beyond the U.S., trade policy has distorted the economic trends of the world’s other major economies. Consider the export-dependent eurozone economy, where economic activity accelerated in front of anticipated tariffs. This demand “pull forward” now represents a headwind for prospective growth for the rest of the year. Against this backdrop, the European Central Bank is expected to be easing its monetary policy rate by 25-basis-point increments for the rest of the year toward a floor of 1.25%.

With its consumer economy still frozen due to its distressed residential property market, China’s export economy has also been beset by U.S. trade policy from a near-term perspective. Beyond these near-term headwinds for China, the country’s ability to adapt to changing economic and policy conditions, in conjunction with more policy response to come, highlight China as a potential driver for the global economy heading into 2026. Additional optimism for China also derives from a 30% tariff ceiling that now seemingly exists for global trade, while worries about a full-blown and near-term economic decoupling between the U.S. and China have abated.

U.S. trade policy introduces a near-term (and material) domestic inflationary impulse while being a deflationary influence for many other parts of the world—Even with trade talk progress between the U.S. and China, it’s likely the U.S. will place tariffs well above 10% on all imports, which is a material increase from the start of the year. Against this backdrop, U.S. trade policy could drive U.S. core inflation sharply and temporarily upward in the months to come. This temporary inflation shock appears to put the Fed in a tough spot as the central bank’s ability to appropriately calibrate policy to anticipated economic weakness becomes untenable without clarity on U.S. trade policy and its impact on inflation and the labor market. It is with this regard to this near-term “handcuffing” of the Fed that hopes for the U.S. economy now appear to disproportionately rest on fiscal policy. But while inflationary for the U.S., more restrictive U.S. trade policy arguably represents a deflationary influence for emerging markets. Uncertainty about tariffs, for example, can lead to a pullback in global demand, which can negatively impact commodity prices and other export markets on which emerging economies are more reliant.

Sector highlights and Fed watch—Spread sector valuations were at historically tight levels, but credit spreads notably widened after the Liberation Day announcement. However, spread levels have retraced since the initial blowout in early April as volatility subsided and the U.S. and China made progress in unilateral trade negotiations. Through this lens, many of our fixed income investment professionals have a generally neutral view across most global credit sectors in terms of valuations. A generally strong fundamental backdrop, a benign default environment, and continued attractive yield are also helping spur interest in credit.

Meanwhile, even though progress has been made between the U.S. and China from a trade policy perspective, Federal Reserve Governor Adriana Kugler believes that the Trump administration's tariff policies are still likely to boost inflation and weigh on economic growth. Our global economics team also agrees with Kugler and believes that even with a sharp pickup in tariff-driven inflation, the Fed will still cut its policy rate twice in 25-basis-point increments before year-end. This move would get the fed funds rate closer to where the central bank's new "neutral" policy rate may be in a less globalized world.

Strategy highlights that tie into global fixed income investing—Divergent economic and inflation outcomes are one byproduct of uncertain trade policies that are setting the tone for global capital markets year to date. As referenced above, U.S. trade policy that is likely to elevate domestic inflation for the rest of this year is just as likely to be deflationary for other parts of the world, including emerging markets, which would benefit respective fixed income markets. Meanwhile, new initiatives such as a material spike in German defense and infrastructure spending along with other developments may help accelerate additional evolution in international credit markets, highlighting the importance of active management in the global fixed income landscape as market dynamics change quickly.

Bottom line—Through a disciplined investment process, anchored by its Policy Week in conjunction with expanding quantitative capabilities and its ongoing global bottom-up research effort, T. Rowe Price fixed income is qualified to actively manage the array of global strategies that compose its investment platform through an investment environment that looks to be volatile in the months ahead.

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