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GLOBAL STRATEGY

June 2, 2025

To Sell Or Not To Sell?

Some investors have expressed concern that the recent credit downgrade of U.S. Treasury bonds by Moody's signals looming fiscal trouble for the United States. A few clients have even asked whether the recent spike in bond yields could be a harbinger of America's own "Liz Truss moment". Our answer is: no.

In This Report

Credit Downgrade Is Irrelevant

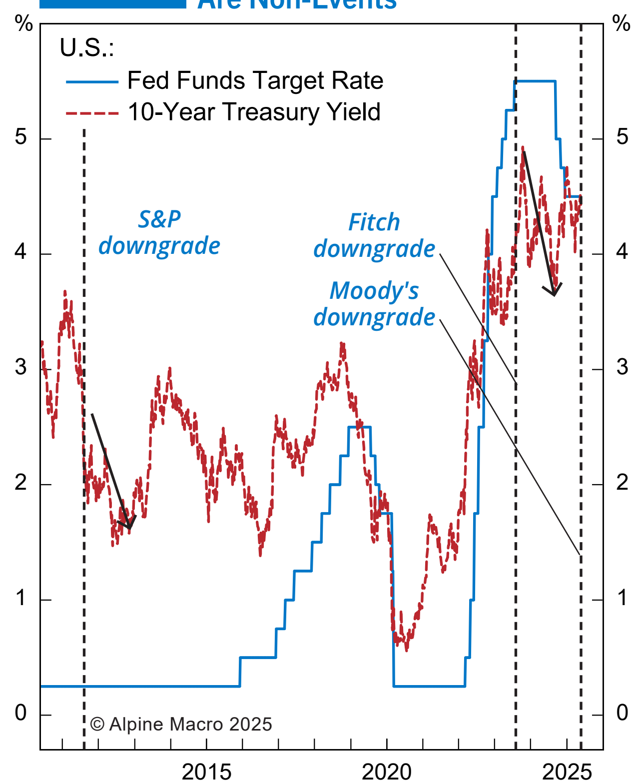
The main fiscal challenges facing the U.S. – such as its large debt load and persistent budget deficit – have long been known and are already priced into the bond market. As such, Moody's recent downgrade of the U.S. sovereign credit rating is largely irrelevant from a market perspective.

This is not the first time U.S. debt has been downgraded. In August 2011, Standard & Poor's cut its rating on U.S. sovereign debt. Ironically, that move was followed by a powerful bond rally, with 10-year Treasury yields plunging from 2.58% to 1.47% within a year (**Chart 1**).

The story was somewhat different with Fitch's downgrade in early August 2023, which coincided with the Federal Reserve's final rate hike of the tightening cycle. Bond yields briefly surged to nearly 5%, but a sharp rally ensued in the following months, driving 10-year yields down by over 100 basis points by the end of the year.

These episodes highlight a consistent pattern: credit downgrades of U.S. Treasury bonds have historically been non-events. Moody's action will likely be no exception, because financial markets

Chart 1 Credit Downgrades Are Non-Events



understand that the probability of the U.S. government defaulting on its obligations remains essentially zero.

No Chance Of A Sovereign Default

We have published numerous pieces explaining why, in a fiat money system, the risk of a sovereign debt default is effectively zero. Our core arguments can be summarized as follows:

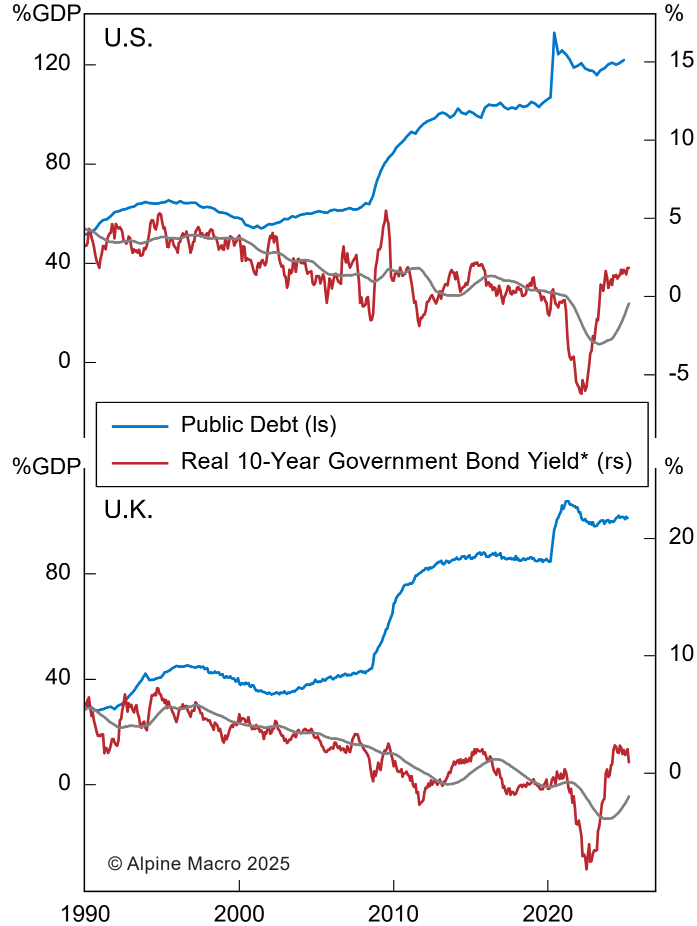
- In a fiat money system, the central bank can always act as the "buyer of last resort" for government debt denominated in domestic currency. This ensures there is always a buyer for such debt, eliminating default risk.

- Government liabilities (debt) and central bank liabilities (money supply) are identical in quality, differing only in maturity. This equivalence makes public debt and the money supply fully inter-changeable – enabling the central bank to step in and purchase government bonds when needed.

- Sovereign default becomes a risk only when debt is issued in foreign currency or under a gold standard. In both cases, the central bank loses its ability to create the required currency (foreign or gold-backed) and thus cannot act as the buyer of last resort.

- High and rising deficits or debt levels do not automatically lead to higher interest rates or a "fiscal risk premium" in a fiat system. In fact, as shown in **Chart 2**, the causality may run in reverse, casting doubt on the concept of a "fiscal risk premium".

Chart 2 The Higher The Debt, The Lower The Rates



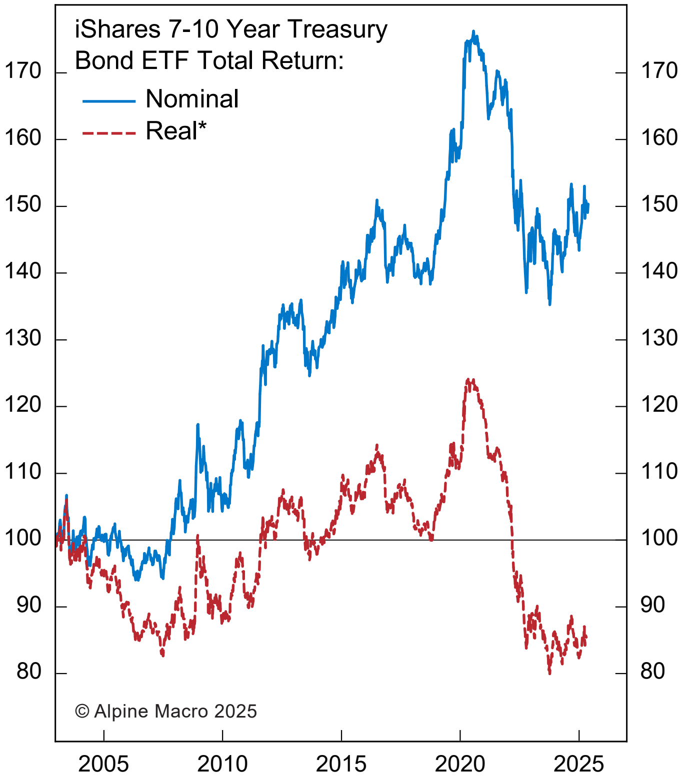
*Deflated by headline CPI inflation; grey lines denote 3-year moving averages

- "Fiscal excess" in a fiat regime should be defined not by rising deficits or debt alone, but by persistent public sector overspending relative to available resources – a condition that could trigger currency depreciation, inflation, or both.

Putting it another way, within a fiat money system, public debt may be eroded through inflation or currency depreciation, but it cannot be defaulted on through outright nonpayment.

Chart 3 illustrates the impact of inflation on bondholders: while long-term bonds have delivered

Chart 3 **Long Bond Returns: Nominal Versus Real**



*Deflated by headline CPI
Note: Both series are rebased to Jan 2003=100

a nominal total return of 50% since 2003, inflation-adjusted returns reveal a 15% loss in real purchasing power for investors. This highlights how inflation hurts creditors while helping borrowers.

Pro-Cyclical Fiscal Policy Is The Problem

To be clear, we are not suggesting that America's public finances are in good shape or free of challenges – far from it. However, the real fiscal issue facing the U.S. is not the widely acknowledged concerns such as large budget deficits or a growing debt load. Rather, it is that fiscal policy has become pro-cyclical since 2017.

Typically, economic policy is counter-cyclical: when the economy is strong, monetary and fiscal policies should be tightened to prevent overheating and inflation; when the economy weakens, these policies should reverse and become more accommodative to support growth.

By design, fiscal policy has a built-in counter-cyclical feature known as the "automatic stabilizer": during economic expansions, tax revenues rise and social spending (such as unemployment benefits) declines – both working to naturally restrain growth.

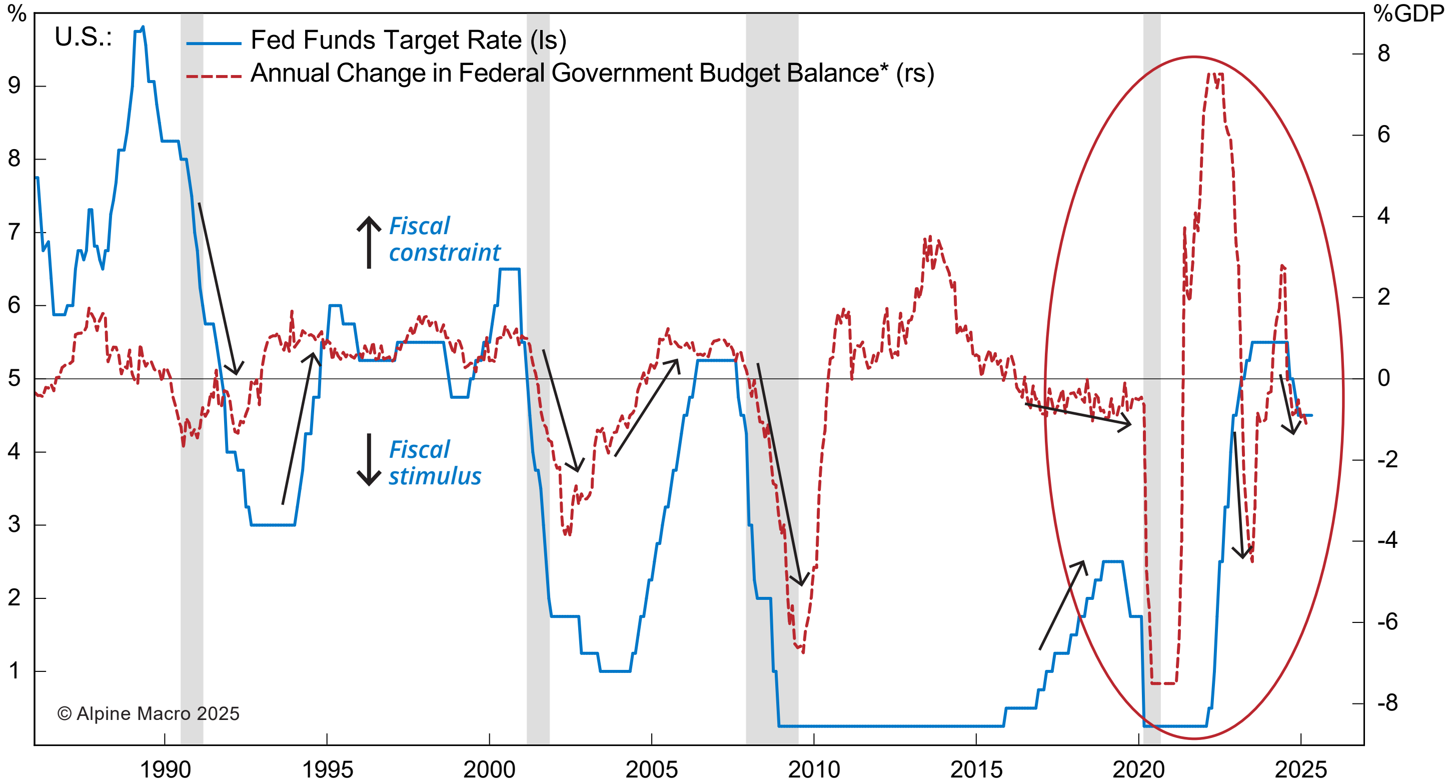
By the same token, in recessions, the process reverses itself, thus stimulating growth. **Chart 4** shows how U.S. monetary and fiscal policies have mostly leaned against the cyclical trend of the economy in history.

However, fiscal policy has undergone a major change since Trump 1.0; namely, it has become increasingly pro-cyclical. Trump's first tax cuts were introduced in January 2018 when the U.S. economy was strong, and the Fed had already begun raising rates. This was the first time fiscal policy worked against monetary policy.

Similarly, the Biden administration injected a sizable dose of stimulus *via* the CHIPS Act and the Infrastructure Investment and Jobs Act from 2023 to 2024, when the U.S. economy was going through a recovery boom after the pandemic crisis, with GDP growth accelerating to more than 3% and inflation way above the Fed's target.

From a cyclical perspective, pro-cyclical fiscal policy has created significant tensions in the bond market and has complicated the Federal Reserve's decision-making process. One could argue that the Fed would have cut rates more aggressively – and

Chart 4 A Regime Change In Fiscal Policy: From Counter-Cyclical To Pro-Cyclical



*Truncated at +/- 7.5
Note: Shading denotes U.S. recessions

inflation would have fallen further – had persistent fiscal stimulus not kept economic growth at or above the potential rate from 2023 through 2024.

Today, the Fed continues to face a challenging policy environment. Chair Powell understands that tariff hikes are "stagflationary" in the short term, while the "One Big Beautiful Bill Act" (OBBBA), if passed by the Senate, could prove expansionary. Under such conflicting forces, determining the appropriate monetary policy stance becomes especially difficult.

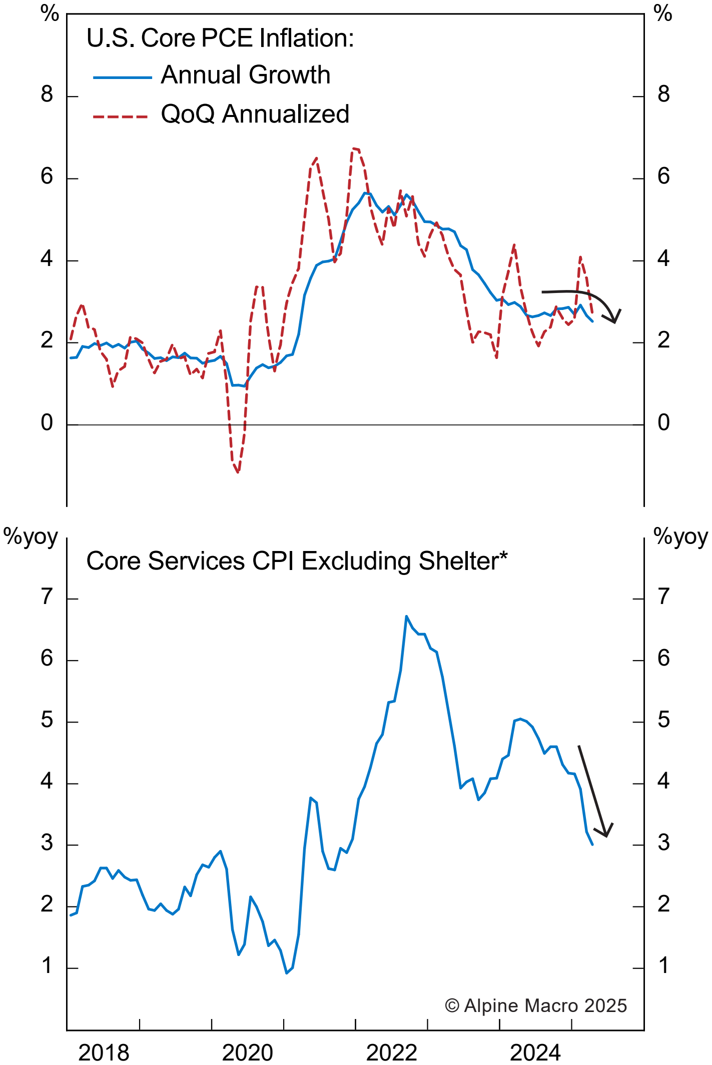
The bottom line is that neither fiscal nor trade policy under the Trump administration gives the Fed a compelling reason to cut rates quickly. As a result, any major bond rally is likely to be delayed.

Bull Versus Bear: In A Standstill

We went long duration on March 18, when 10-year Treasury yields stood at 4.29%. Last week, we reiterated that position. However, with yields proving stickier than we had anticipated, we are now reassessing our stance.

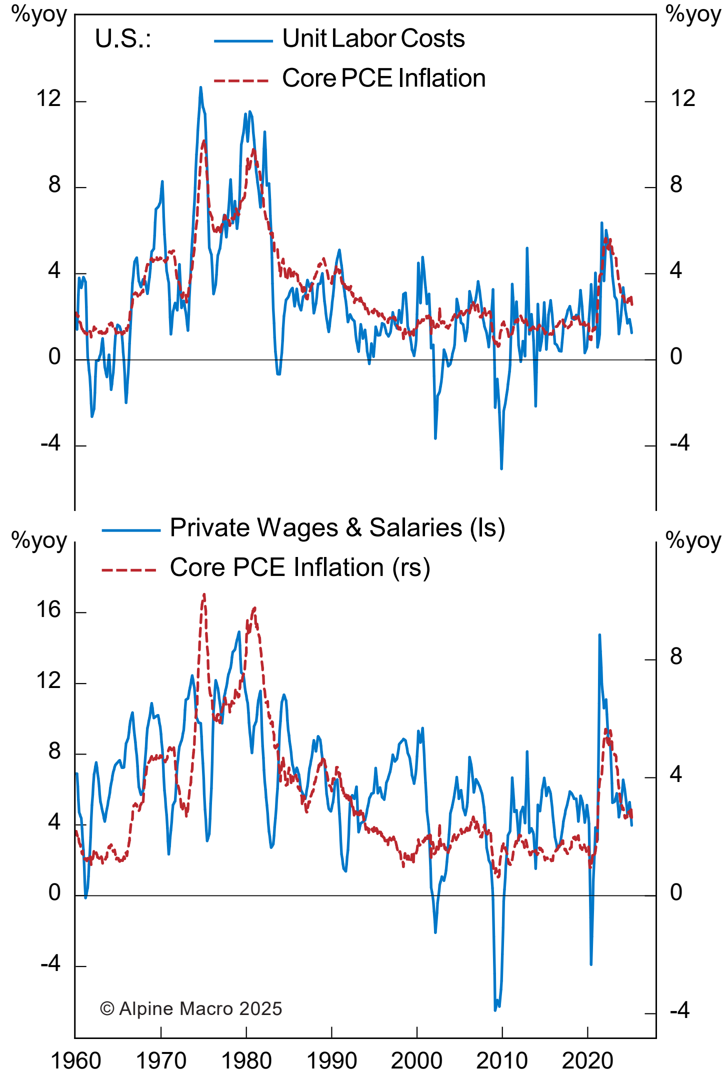
The toughest intellectual challenge for any investor is knowing when to cut losses and fold a position, versus when to stay the course and allow the thesis to play out. When it comes to the U.S. bond market, there is no clear answer – both bullish and bearish forces are at work. For now, these opposing pressures seem to be in a standoff, suggesting that yields may remain range-bound in the near term without a decisive move in either direction.

Chart 5A U.S.: Disinflation Should Resume Soon



*Source: Bloomberg Finance L.P.

Chart 5B The Fundamental Case For Disinflation

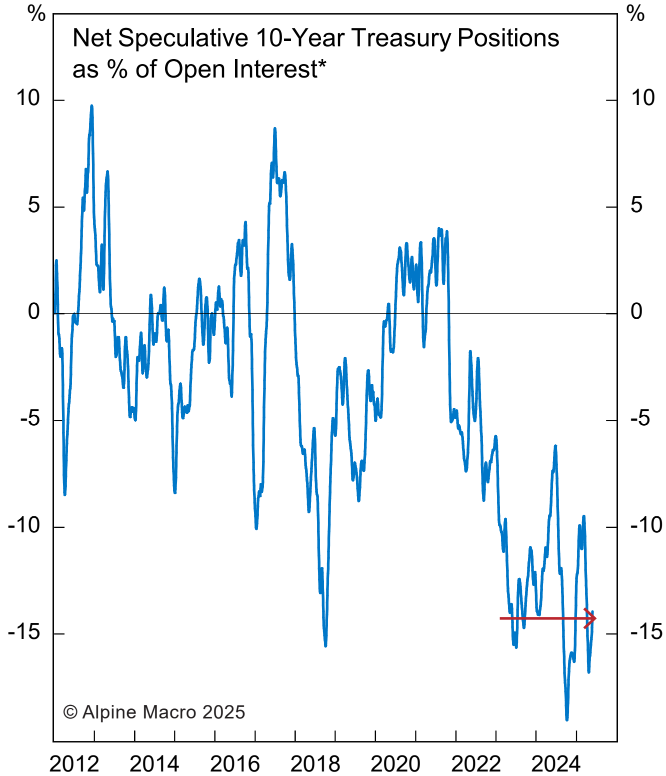


On the bullish side: there is growing evidence that inflation is poised to decline, despite Trump's tariff hikes. Core PCE inflation is easing on both a three-month and year-over-year basis. Wage growth is softening, the so-called supercore CPI is falling rapidly, and unit labor costs have dropped sharply (Charts 5A & 5B).

All these indicators point to a renewed disinflationary trend — something the Fed is likely to consider when determining its next policy move. Meanwhile, Chart 6 also shows that bond investors remain heavily short U.S. Treasurys. From a contrarian perspective, this positioning is bullish.

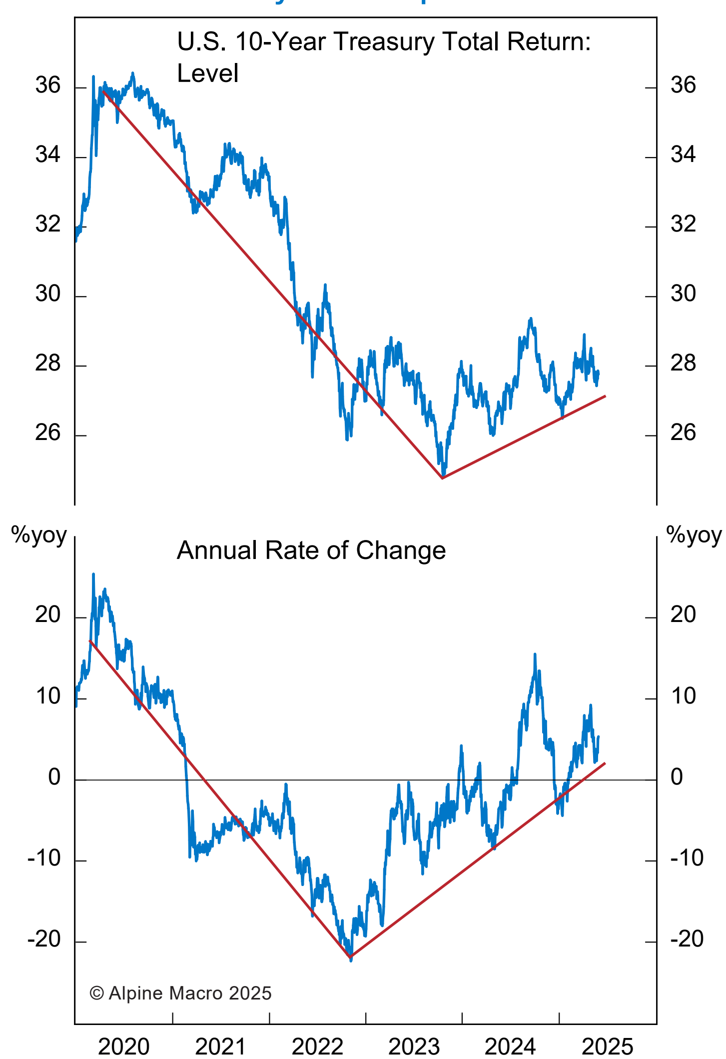
The technical configuration of the bond market appears more constructive than not. As shown in Chart 7, the bond bear market likely ended in October 2023, and the total return index for long-dated bonds has begun to trend higher.

Chart 6 **Bond Market Is Crowded With Short Positions**



*Shown as 3-month moving average; source: Commodity Futures Trading Commission (CFTC)

Chart 7 **Bull Versus Bear: A Cyclical Perspective**



Admittedly, the bond market recovery has been slow and uneven, with the longer the duration, the weaker the recovery. Nonetheless, the direction of bond prices is promising.

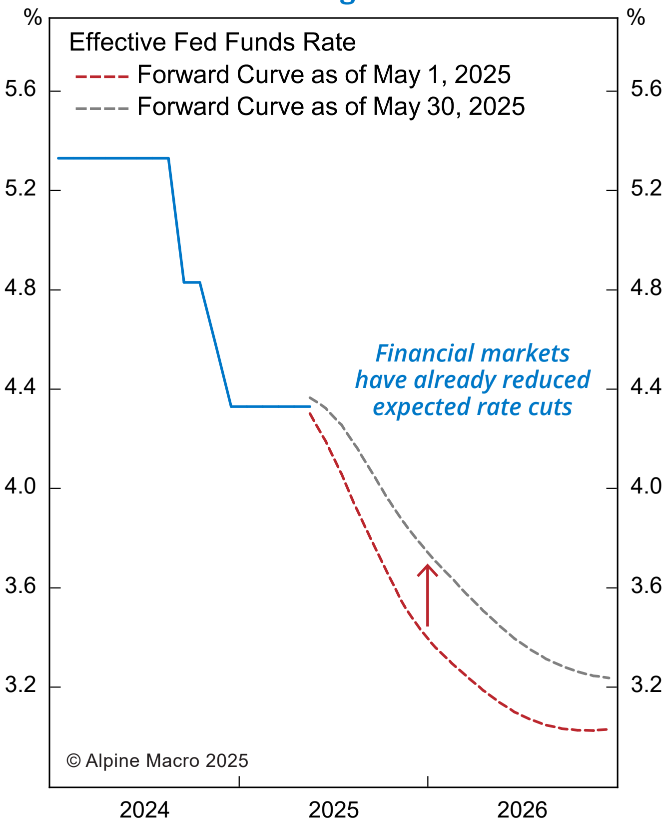
On the bearish side, there is also an extensive list of risks and headwinds that could keep yields elevated. Although the impact of tariff hikes may be temporary, the Fed could counteract them by keeping rates at the current level for longer than most anticipated (**Chart 8**).

Trump's OBBBA poses another risk. The Congressional Budget Office estimates that the bill would widen the budget deficit by $3.1 trillion over the next decade. While long-term fiscal projections are often imprecise, it looks certain that the passage of the bill in the Senate would amount to fresh short-term stimulus – another reason for the Fed to delay rate cuts.

Lastly, a weakening U.S. dollar is often – though not always – bearish for bonds. A declining dollar tends to lift equity prices, stimulate exports, and raise the price of imported goods – all of which can exert upward pressure on bond yields.

The bottom line is that the bond market appears caught between two opposing forces, making

Chart 8 Markets Are Pricing In Less Easing



it difficult for yields to move decisively in either direction. Given this stalemate, we are reverting to benchmark duration as of today.

What To Do With Equities?

While our bullish view on stocks has continued to play out, investors should also be prepared for a corrective phase. With the S&P 500 up nearly 20% in under two months, the market appears ripe for a setback. While it's difficult to pinpoint the exact catalyst for a potential pullback, we see three plausible triggers:

- The 90-day pause deadline (expiring on July 9) may spark renewed market anxiety if no substantial trade deal is reached before then.
- A rebound in bond yields could disrupt the current equity rally and weigh on valuations.
- A soft economic patch may result in earnings growth falling short of expectations.
- The court ruling that Trump's reciprocal tariffs are unconstitutional could enrage President Trump, making him more aggressive in his tariff threats.

Any of these developments could lead to a temporary setback for stocks, but none are likely to inflict lasting damage on the broader market.

The "Trump Put" remains in play, with many of his tariff threats increasingly viewed as negotiation tactics rather than firm policy. Over time, financial markets may become more desensitized to his rhetoric, especially as repeated threats lose credibility.

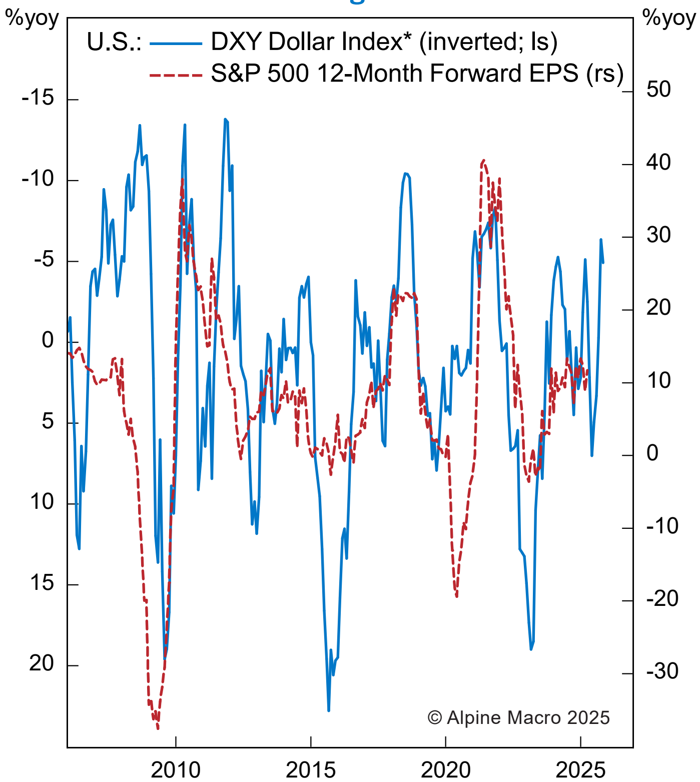
Meanwhile, with falling core inflation, any spike in bond yields will likely be transient. While a softer economy could pressure earnings expectations, slowing growth tends to push bond yields lower, providing support for equities.

Three Bullish Factors

Heading into the second half of the year, three major factors could support a move to new highs in equities:

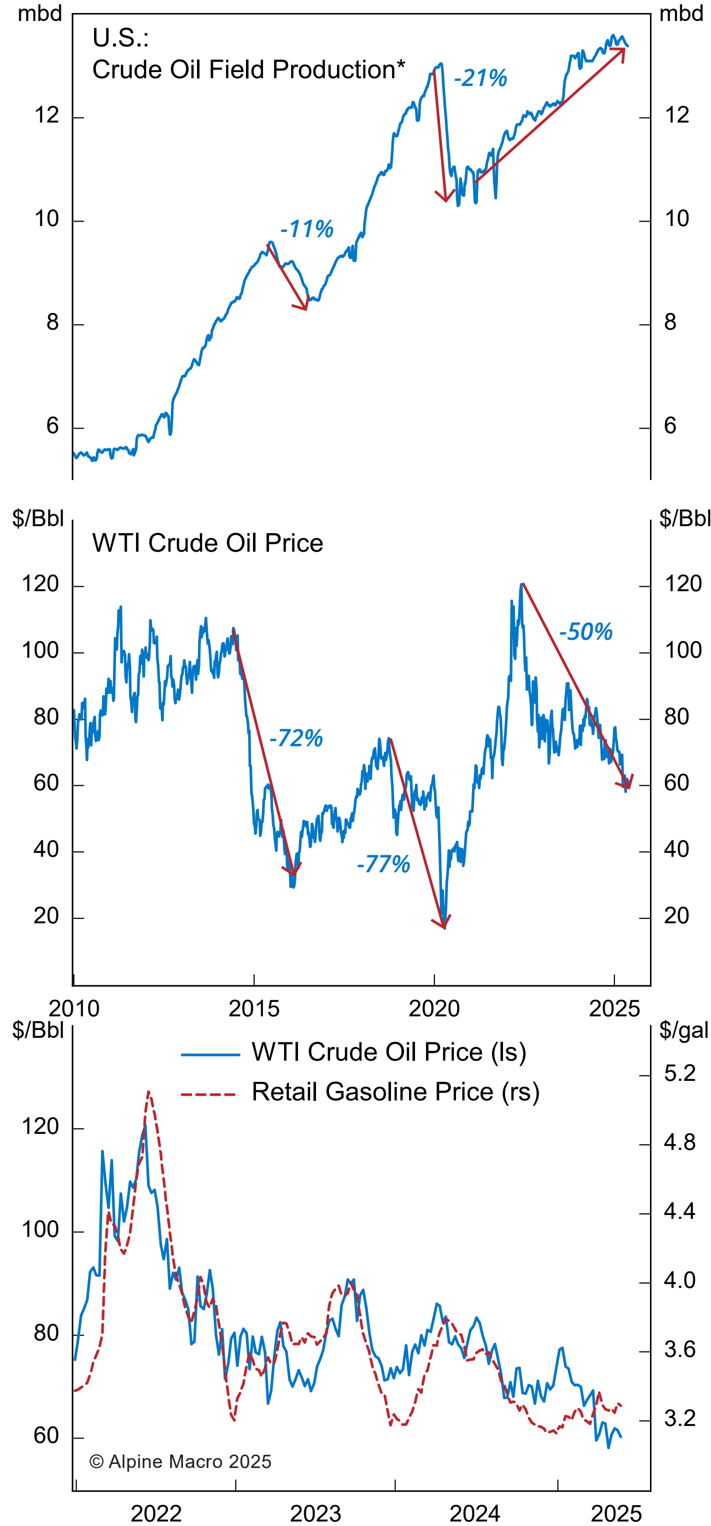
- A weaker U.S. dollar may boost earnings. **Chart 9** shows that earnings per share (EPS) tend to rise 2 to 3 quarters after the dollar begins to weaken. This implies that a dollar-induced rebound in corporate earnings could begin to materialize in the back half of the year.

Chart 9 **The Weaker The Dollar, The Stronger The EPS Growth**



*Advanced by 6 months

Chart 10 **Oil Output, WTI And Gasoline Prices**



*Shown as 4-week moving average; source: EIA

- Lower oil prices will ease energy costs. This is the first time oil production has continued to grow despite a substantial decline in WTI prices – now down 50% from previous highs (**Chart 10**). Gasoline prices have dropped 11% year-over-year and nearly 40% from their 2022 peak. Lower gas prices will provide relief to households and help sustain consumer spending.

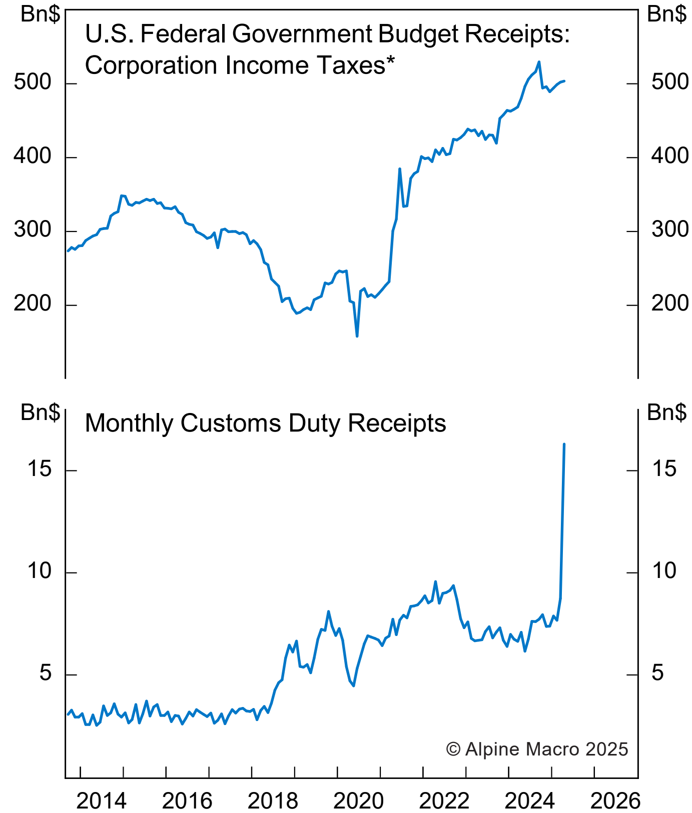
- A potential pivot by the President toward deregulation and domestic tax cuts. After financial markets took a heavy hit from reciprocal tariffs, the administration appears ready to shift gears, as signaled by the proposed "beautiful bill". Notably, federal duty receipts have surged

(**Chart 11**). At an average tariff rate of 10%, tariff revenues could reach $360 billion a year, compared with total corporate income tax receipts of $500 billion. President Trump can easily use duty revenues to fund any corporate tax cut while maintaining revenue-neutral.

Bottom line: Stick with our roadmap and maintain a 65/35 allocation between equities and bonds to ensure a balanced portfolio.

Chen Zhao
Chief Global Strategist

Chart 11 Duty Receipts Are Soaring



*Shown as 12-month moving sum
Source: U.S. Department of Treasury

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Investment Recommendations						
Tactical Investment Positions (3 - 6 months)						
Recommendations	**Open Date**	**Open Levels**	**Stop**	**Closing Date**	**Closing Levels**	**P&L Since Inception**
Long Gold ($GLD)	12/09/2024	245.36	-	-	-	42.6%[1]
Long S&P 500 Energy ($XLE)/ Short WTI Crude Oil ($USO)	01/13/2025	90.3/82.2	-	-	-	8.7%
Long EUR/USD	03/21/2025	1.08	1.10	-	-	4.7%
Long S&P 500 Index ($SPY)	04/07/2025	504.38	-	-	-	16.9%
Short USD/JPY	05/12/2025	148	-	-	-	2.8%
Short USD/MXN	05/12/2025	19.61	-	-	-	1.2%

Note: P&L is calculated using daily closing prices.
[1] Return is calculated based on a continuous Long GLD position, first initiated on 04/01/2024, stopped out on 11/11/2024, and reinstated on 12/09/2024.

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