With yields likely to fall in the year ahead and cash returns diminishing, investors should deploy cash to lock in currently elevated yields on quality bonds. (UBS)

Bessent appointment seen as an anchor of stability and responsibility

25 November 2024, 2:25 pm CET, written by UBS Editorial Team US Editorial Team

US Treasuries advanced on Monday during Asia trading hours as markets responded to President-elect Donald Trump's pick of Scott Bessent for Treasury secretary.

Bessent, who is well known and well regarded on Wall Street, heads the hedge fund Key Square Capital. If approved by the Senate, he would be in charge of implementing and advocating for a broad swathe of Trump's economic agenda. Viewed as a "fiscal hawk," Bessent has voiced a more moderate tone on tariffs in recent public comments, suggesting using them as a tool for negotiations.

The initial market reaction suggests that the choice of Bessent in this crucial role is seen by financial market participants as an anchor of stability and responsibility in the Trump cabinet.

In fact, we think markets could start to see that the risks of higher inflation and interest rates are implicit constraints on the Trump policy agenda, with the eventual policy outcomes potentially less inflationary than some investors previously feared. While we do not rule out further volatility, we expect US Treasury yields to fall in the year ahead following the 65-basis-point rise over the past two months.

Trump's policies are likely to be a pared-down version of the original proposals. It was made clear over the past few years that high inflation is bad for both stock and bond returns. More significant for politicians is that the past month

demonstrated the high political cost of inflation. This would suggest it's not in the incoming Trump's administration's best interest to proceed with a policy agenda that risks higher inflation, especially amid large federal budget deficits and rising net interest payments on the national debt. We think the use of selective tariffs, on a range of goods or sectors from specific countries or regions, is the mostly likely outcome, reducing the pass through to consumers, while the most expansionary US fiscal plans are likely to be shelved.

Trump follows the financial markets as a barometer of his administration's performance. Since last fall, US equities started to come under pressure whenever the 10-year yield climbed above 4.6%, and the S&P 500 fell 10% when the yield flirted with 5% in October 2023. Higher rates because of better-than-expected growth shouldn't be a fundamental problem for equities and the economy, but rates rising because of higher inflation, or just the risk of inflation reaccelerating, is a problem. Higher rates are also a major headwind for the housing market—any time the average 30-year mortgage rate has surpassed 7%, housing market activity has slowed sharply.

The Federal Reserve should continue to cut interest rates. Although tariffs could temporarily increase inflation, we expect the Fed to look through one-off increase in some prices related to tariffs and continue its path of rate cuts toward achieving a neutral policy stance. The US central bank has made clear it does not want to see more labor market cooling, and recent comments by Fed officials indicated that there is room for additional rate reductions. We forecast 125 basis points of further Fed rate cuts by the end of 2025.

So with yields likely to fall in the year ahead and cash returns diminishing, investors should deploy cash to lock in currently elevated yields on quality bonds. We also believe the US dollar is now overvalued, and recommend investors to use periods of strength to reduce US dollar exposure through strategies such as hedging dollar assets, switching USD cash and fixed income exposure to other currencies, and through options.

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Original report: **US yields should fall amid policy constraints and Fed cuts, 25 November 2024.**

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