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The bond market puts the brakes on Trump

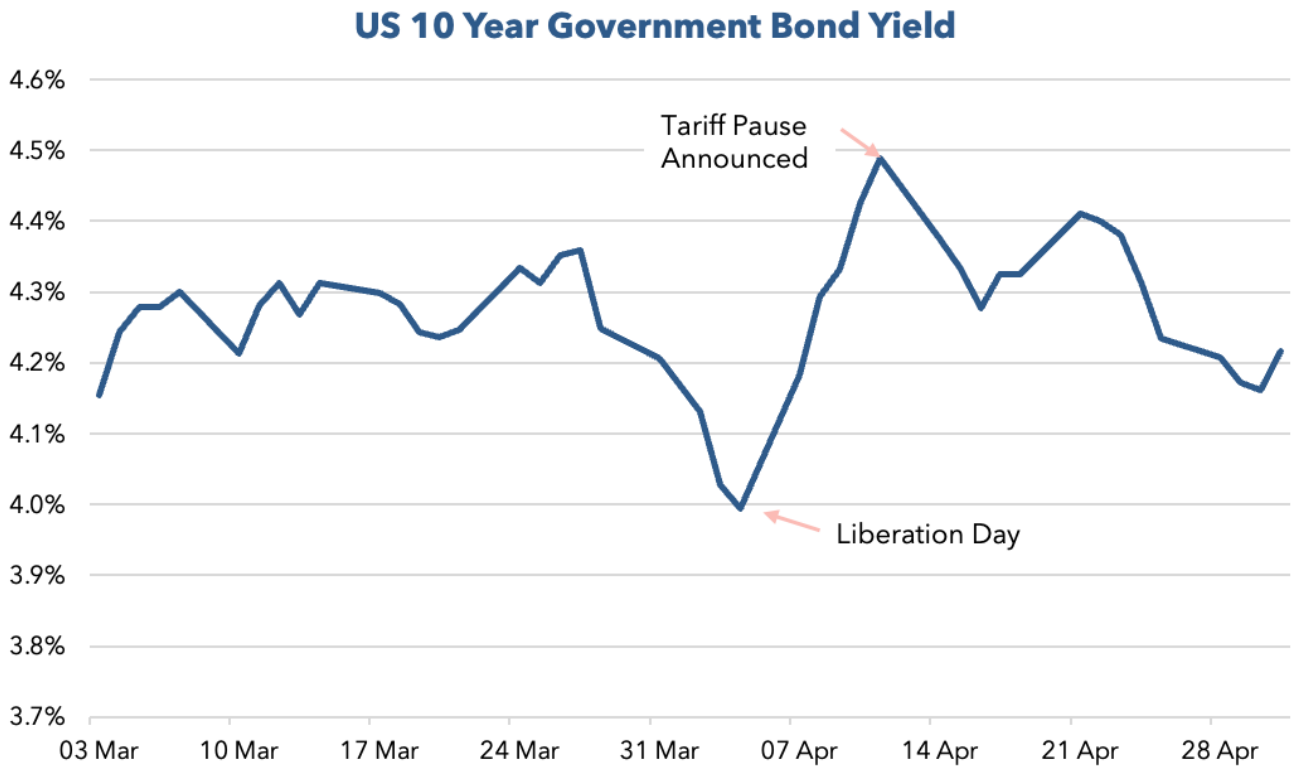
By Darryl Bruce

It has been just over 100 days since President Trump took office and slightly over a month since the so-called 'Liberation Day' in the US. The pace of change has been hectic with the US Administration's disorientating 'flood the zone' approach to policy releases. Policies are introduced, extended and/or then possibly retracted all within a news cycle.

Investment markets famously do not like uncertainty, and that has been the order of the day for some time now. Perhaps we should not be surprised. In many ways, President Trump has simply acted on his pre-election promises. Those of us, like me, who saw them as populist rhetoric aimed purely at capturing votes have been surprised. The equity market has been skittish, left to jump around in response to the latest headlines and sound bites. The investment grade bond market is normally a relatively safe haven in times of volatility, and so it has been this time around. As you would expect, given the risk off sentiment, high yield and unrated bonds have been more volatile. More on this below.

Trump may have surprised many, however, the market has also surprised Trump. Initially, there seemed to be no limit on his pronouncements. Economists were broadly unanimous in stating that his policies lacked a basic understanding of how economies work. Many pointed to the possibility of an unenviable cocktail of sharply slowing growth and high inflation. Trump remained dogmatic and resolute in the face of a barrage of criticism.

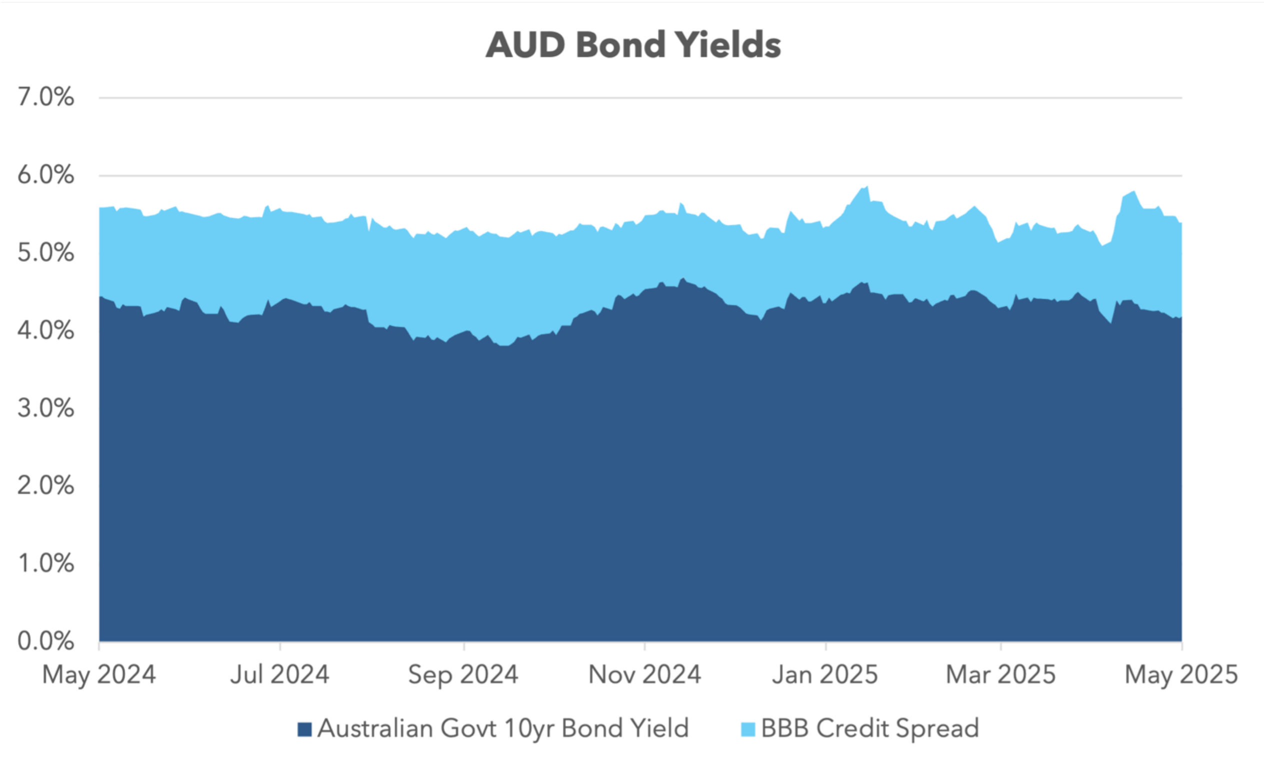
That was until the bond market stepped in and started sharply increasing the yields on US Treasuries – see chart below. Treasuries have historically been viewed as the ultimate safe haven investment. After an extended hibernation it was a re-emergence of the 'bond vigilantes'* as the market started to price in a premium for political risk in the US.



When you have a lot of debt it is crucial to remain on good terms with the providers of that capital. Despite being seen as the ultimate safe haven, no one has more debt than the US Government - about US$36trn and it is increasing rapidly. The combination of on-going budget deficits and a weighty refinancing requirement as existing debt matures, means that the US needs constant unfettered access to the bond market. The bond market pushing yields higher was a clear sign that it was demanding a more orthodox approach from the world's largest borrower. Trump finally caved and announced a 90-day pause on the introduction of tariffs.

Investment markets broadly have responded positively to these developments and while Treasury yields have pulled back, they are still higher over the month. For a while, there was no reining in President Trump and he was able to act with absolute impunity. Now it is clear that he needs to bring buyers in the Treasury market along with him which should result in less erratic policy making. However, there is still a lot left to play out during this 90-day pause on the introduction of tariffs.

Turning our attention to the impact on the AUD bond market. The chart below reflects the yields on the Australian 10-year Government bond (dark blue) and the average BBB rated corporate bond (light blue). Government yields also increased in Australia at the beginning of April however it was an 18 basis point increase compared to a 50 basis point increase in the US. Also, unlike the US that domestic yield is now below where it was trading on Liberation Day.



Credit spreads have widened, as you might expect, and outright BBB yields are offering slightly better value although the move has not been dramatic. Meaning that capital values are little changed over the past month or so.

The high yield market has been more patchy. Anecdotally we have being matching up supply and demand in high yield bonds however it is not a great time to come to the market with large volumes of supply. There are pockets of opportunity for savvy buyers in high yield who are comfortable looking through the short term noise.

Ultimately, as buyers of corporate debt we need to ask ourselves the question – *will the issuer survive and be able to refinance at maturity?* There is no question that the level of uncertainty has increased in recent months but in the vast majority cases we remain confident of the outlook for most issuers.

It has been an action packed (slightly over) 100 days since Trump took office. April offered a crescendo of sorts following the swathe of Liberation Day announcements. We are in an eerie calm at present during Trump's tariff hiatus however no doubt nerves will start jangling once again as this period comes to a close. As outlined above, we can take some comfort from the US's reliance on continued access to the bond market. This should have the ability to act as a brake on some of Trump's more extreme plans.

In the meantime risk averse investors have found a relatively stable home for capital in the investment grade bond market. The high yield market is also offering some compelling opportunties however in the short term they are likely to be more buffetted around by day to day newsflow.

**'bond vigilantes' is a term that was coined in the 1980s and it refers to the idea that bond holders punish profligate borrowers by demanding higher yields to compensate for higher risk*

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