FIXED INCOME INSIGHTS / 1Q 2025

Tariff Tantrum

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TOM CARNEY, CFA ®
Co-Head of Fixed Income & Portfolio Manager



NOLAN ANDERSON
Co-Head of Fixed Income & Portfolio Manager

Risk assets entered 2025 on a high note, propelled by the new administration's pro-growth policy agenda. From extending (and potentially expanding) the 2017 tax cuts to mass deregulation and the promise of a smaller, more efficient government, investors and business leaders sensed a return of "animal spirits" to the U.S. economy. Through mid-February, financial markets largely followed suit: the S&P 500 and Nasdaq indices hit all-time highs and credit spreads reached nearly 20-year lows.

However, as the narrative around policy expectations began to shift, markets began to sputter. Unlike with Trump 1.0, which kicked off with stimulative tax cuts, the Trump 2.0 policy mix (maybe due to an already strong economy and relatively high interest rates?) led with government cost-cutting (i.e., DOGE) and major shifts in geopolitics, particularly U.S. trade policy. By the end of the first quarter, markets began to price in weaker near-term growth as the pro-growth agenda faded from view. This led to lower stock prices, modestly wider credit spreads, and lower U.S. Treasury yields.

Along came Liberation Day.

While most investors expected some form of tariffs, few, if any, anticipated the breadth and scale of the April 2 announcements. Markets were surprised and reacted chaotically. As of penning this letter on April 11, the S&P 500 suffered a nearly 20% drawdown, the VIX breached 50 (the highest level since COVID), oil prices fell into the $50s, and high yield credit spreads blew out ~200 basis points (bps). However, the poor performance of U.S. Treasuries may be more concerning, despite classic risk-off conditions. After an initial flight-to-quality bid took 10-year Treasury yields down to approximately 3.86% on April 4, yields increased to approximately 4.48% as of April 11, with 10-year yields having their most significant three-day increase since 1982.

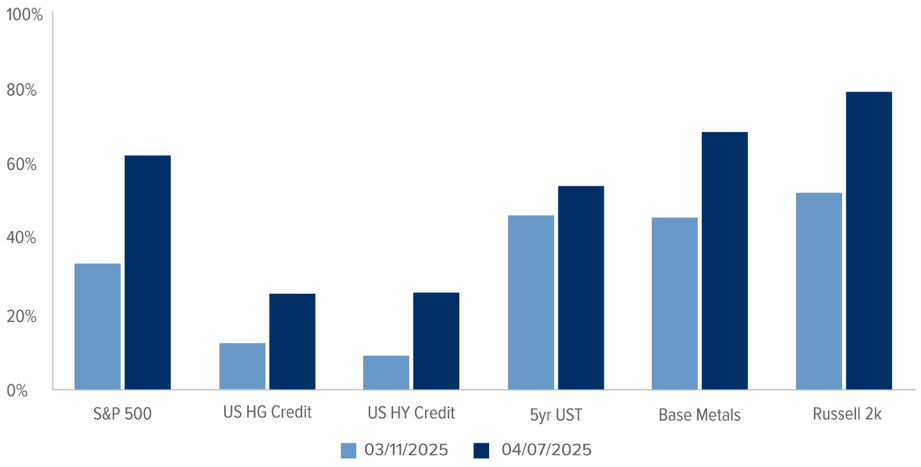
For fixed income investors, higher Treasury yields coupled with wider credit spreads served as a double whammy, inflicting negative returns despite significant equity declines. So, what happened? While no one knows for sure, Treasuries serve as collateral for a wide range of trading across the financial system. Technical pressure from forced selling, driven by the unwinding of hidden leverage across the financial system (as we saw during COVID), can overwhelm fundamentals in the short term.

In addition, foreign investors may have fled U.S. markets, putting upward pressure on U.S. Treasury yields. Foreign investors hold approximately $8.8 trillion in U.S. Treasuries, or about 30% of the Treasury market according to February U.S Treasury data. A material decline in demand or outright selling by foreign investors may continue to weigh on U.S. Treasuries.

So, where do we stand today?

The chart to the right illustrates J.P. Morgan's estimate of implied recession probabilities across various asset classes before and after Liberation Day. What stands out is the lack of re-pricing in credit relative to other asset classes. While wider credit spreads are broadly in line with 20-year medians, spreads in securitized products, namely ABS and CLOs, which typically lag those of corporate bonds, have yet to experience significant widening.

JPM: Implied Recession Probability by Asset Class



Source: Bloomberg Finance LP., J.P. Morgan Flows & Liquidity

Right or wrong, the tariff announcements have led to markets pricing in risks of lower growth and higher inflation. However, if fully enacted, tariff-related price increases may lead to further economic uncertainty and significant demand destruction in the U.S., leading to potential disinflation. Should that occur, we expect Treasuries will likely find solid footing while credit spreads widen out toward more recessionary levels.

While uncertainty is always present, the post-Liberation Day decision-making tree for asset allocators and businesses has become far more complex. With so many crosscurrents at play, investors should be careful to assign exact estimates to the impact tariffs, if implemented, may have on economic growth and inflation because of the knock-on effects the initial shift in conditions may bring.

There are legitimate issues facing the United States and designing/implementing a more competitive U.S. trading apparatus could go a long way toward helping our economic standing over the long term. However, globalization took decades to orchestrate, and should we move toward a more U.S. centric model, it would take time to recalibrate.

To that end, businesses will want to ensure new infrastructure housed in the U.S. is globally competitive on the cost curve without a tariff moat. In addition, one of the key challenges is that any negative consequences from tariffs may be felt here and now, while any benefits may occur over a multi-year period.

Outlook

Significant volatility and the uncertain outlook have expanded the menu of attractively priced investment opportunities. While overall spread levels are not target-rich, there are opportunities to deploy capital, particularly in corporate bonds.

In terms of the interest rates, the silver lining for fixed income investors is that yields on high-quality duration appear attractive from current levels. This may limit downside in prices should fears of near-term inflation risk abate due to tariff negotiations, or if fully enacted, the economic outlook shifts toward outright recession.

In the current environment, our goal is to remain patient and focus on being a risk manager and not a prognosticator. As we gain more clarity, we will react to changing market conditions and shift the portfolio to capture the best risk-adjusted returns we can find in the marketplace.

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