GUGGENHEIM investments

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Notes on Treasury Market Activity

Update on our macro and market outlook following recent rate volatility.

Trading in the U.S. Treasury market, which has been volatile since the "Liberation Day" tariff announcement on April 2, was jolted again when Moody's cut the U.S. credit rating from Aaa to Aa1 on May 16. In April, the 10-year Treasury yield moved from an intraday low of 3.85 percent on April 4 to a high of 4.58 percent on April 11 and closed the month roughly unchanged at 4.16 percent. Since then, it reached a peak of 4.60 percent on May 21. At the same time, the S&P 500 traded in a 1,000 point range, at one point dropping almost 20 percent from its all-time high. The VIX volatility index spiked to 52.33—the highest since COVID—while the MOVE index jumped to 140. Stock prices and Treasury yields are now close to pre-Liberation Day levels, and volatility gauges are lower. Even though we are likely past peak headline risk, especially pertaining to tariffs, investors remain cautious, particularly about the looming fiscal challenges facing governments here and around the world. We expect continued volatility and uncertainty to drive markets and present investment opportunities.

Key Takeaways

- **Fiscal Policy Takes Center Stage:** The "Big Beautiful" budget bill passed by the U.S. House of Representatives—which could add trillions to the national debt—coupled with a Moody's ratings downgrade of U.S. Treasurys, has put bond investors on edge, sending yields on longer-dated bonds higher.
- **The Slowing Economy Could Cap Long-Term Rates:** While fiscal deficit concerns may continue pressuring long-term U.S. Treasury yields higher, the associated tightening in financial conditions could further slow growth and position the Federal Reserve (Fed) to begin easing sooner.
- **Take Advantage of Volatility and Tactically Add Duration:** We expect the 10-year Treasury yield to remain largely range-bound between 3.75–4.75 percent as the yield curve steepens, which creates a compelling opportunity in the 2–7 year range of the yield curve.

Moody's Downgrade Alone Should Not Materially Impact Yields...

- Moody's cut the U.S. credit rating from Aaa to Aa1 on May 16, the last major credit rating agency to make this move. **The rating change itself should not have material implications for yields,** as markets had already priced in the conditions driving the downgrade.
- **Moody's cited widening budget deficits, deteriorating debt affordability, and concerns about the commitment of elected officials** to alter the trajectory for rising U.S. debt. The timing of the downgrade was likely related to the budget bill in Congress.
- **No forced selling is expected.** The Bloomberg U.S. Aggregate Bond Index and other major indexes already classified U.S. Treasurys in the AA bucket after Fitch's 2023 downgrade, while money market and index funds aren't bound by rating requirements for Treasurys.

...But Fiscal Imbalances Are Unsustainable and Worrying Markets

- **The downgrade underscores deepening concerns about fiscal discipline.** As currently written, the budget bill could increase the cumulative deficit by over $3 trillion over 10 years—potentially exceeding $5 trillion if temporary provisions become permanent. After passing the House, the bill now heads to the Senate for likely modifications.
- Higher deficits could increase the Treasury supply at a time when the investor base is shifting toward more price-sensitive buyers, such as mutual funds, ETFs, and hedge funds and away from sovereigns. Absent a material shortening in the maturity structure of Treasury debt, this could put **upward pressure on longer-term Treasury yields and steepen the yield curve as investors demand higher term premiums**.
- **This process appears to be underway.** Last week, amid questions about the U.S. government's ability to shrink budget deficits and a lackluster 20-year Treasury bond auction, longer-dated Treasury yields surged, with the 30-year rising to a 20-year high of 5.15 percent, the 10-year climbing to 4.61 percent.

Long-Term Rates Are at the High End of Our Expected Range

- **We expect the economy to continue slowing this year** as the effects of tariffs are felt, lowering the expected path of monetary policy. Rising long-term interest rates could further slow growth, limiting how far and how long higher rates can be sustained.
- **While the long end of the curve is increasingly influenced by fiscal dynamics, expectations for Fed policy will continue to drive the front end.** After a rise in the price level this year from tariff effects, we expect inflation to moderate—particularly in core services and shelter. We anticipate that inflation expectations will remain well anchored through this process, **paving the way for Fed rate cuts as the labor market weakens**.

- **Monetary policymakers are treading cautiously** until there is greater clarity on tariff and fiscal policies and their effects on the inflation and growth outlook.
- We believe the effects of higher long-term rates and a slowing economy **will keep 10-year Treasury yields trading in a range of 3.75–4.75 percent**, although they could move briefly outside our expected range.

Investment Implications: Front End to Belly Offers Yield and Upside Potential

- **As the economy slows and the Fed approaches rate cuts later this year, short-to-intermediate maturities (2–7 years) offer strong value, combining yield, upside potential, and relative safety**—especially compared to the long end, which remains vulnerable to fiscal uncertainty. The convexity profile in this part of the curve provides an attractive risk/reward, as it captures much of the benefit of falling rates with less duration risk than the long end.
- With yields still elevated by historical standards, **investors are being paid to wait**—earning real income today with upside potential if rate cuts materialize.
- **Current rate volatility has created opportunity for tactical duration management** by adding to duration when yields approach the upper end of our target range, while paring exposure when rates dip.
- **Expect higher long-end interest rates to put pressure on equity valuations,** as the higher cost of capital will reduce the present value of future corporate earnings.
- **The view that recent volatility represents the beginning of a broad-based "Sell America" trade is premature.** Rising bond yields around the world suggest that concerns over fiscal discipline are global, not just focused on the U.S. But since Liberation Day, investors have been reflecting concerns over near-term outcomes related to unpredictable trade policy and the growth impact of tariffs.

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