

Navigating interest rate uncertainty on the bond market during a second Trump term

US bond rates are a significant risk driver for institutional investors such as pension funds, insurance companies, and sovereign wealth funds who typically invest roughly 30% of their allocations into bonds and other fixed income classes. With Trump's election win, we must navigate the potential impacts of his policies on the bond market. Given the contradictory nature of his suggested policies, we see the potential for a new level of interest rate uncertainty driven by a mix of inflationary and growth pressures causing increased volatility in the bond market.

Following Trump's win, equity markets saw a brief improvement from the settled uncertainty of his upcoming presidency. However, this sentiment did not last as questions came up about what to expect from his proposed protectionist trade policies, deregulation, and tax cuts. The possibility of increased interest rate uncertainty during the second Trump term is due to the following:

- 1) US debt levels and sovereign bond rates: Trump policies, such as additional spending or tax cuts, can have a negative impact on US federal budget deficits. With US debt already at record levels, there is a tail risk of markets losing faith in the US Government to repay debt (à la France in recent months), which could lead to steep increases in (long-term) US rates.
- 2) Inflationary pressure: tariffs on imports would put additional upward pressure on short-term US inflation rates. This inflationary pressure could lead to increased federal spending to compensate consumers. Tariffs can also slow (general) economic growth around the world, which in itself could put negative pressure on US budget deficits.
- 3) A Federal Reserve balancing act: as the Fed might face contradictory economic developments, it will make it difficult for markets to predict whether the federal funds rate will go up or down. There might be increased pressure by President Trump on the Fed to lower rates to stimulate growth and lower government borrowing costs. Despite

the precedence in recent decades for the Fed's independence from political demands, such pressure could pose problems as it historically did between President Ronald Reagan and Chair Paul Volker.

There is also potential for a rise in down-side tail risks. As inflated asset values are further increased, financial fragility in the system can grow. This increased fragility makes the system more sensitive to any small disruption – for example, an economic slowdown due to trade wars – which could potentially trigger a renewed financial crisis. Recent history with the collapse of Silicon Valley Bank is an example of high(er) rates leading to and exposing such fragile conditions

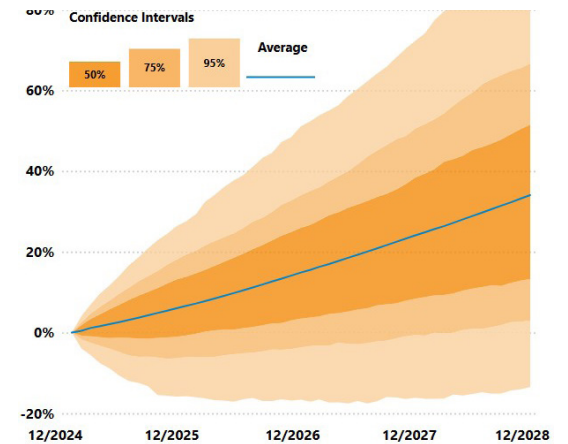
We cannot expect to know how bond rates will behave under Trump given this range of potential paths of interest rates. One possible narrative could see an inflation spike in the short-term, following significant tariffs, and would lead the Fed to raise rates. However, if the tariffs slow down economic growth, this scenario could cause the Fed to lower rates. Another potential narrative could also see Trump impose tariffs, but via an insourcing of production to improve economic growth, leading the Fed to increase rates. While there is value in thinking through such narratives, how can we know what the tail risks of an extreme scenario will be?

One way to navigate the higher interest rate uncertainty is through stochastic scenario analysis. While we don't know what the exact impact of a second Trump term will be on interest rates and subsequently bond returns, we can look at a set of possible scenarios to understand the tail risks (orange scenario-cloud graph below). By aggregating thousands of scenarios together, we can view a cloud of possible outcomes: including tail risk scenarios.

Scenario modeling allows us to understand the tail risks facing US interest rates in the next four years. The graph below represents a band of potential scenarios which capture what might happen. Interest rate risk is a key driver of total portfolio returns through their influence on bond performance and currency hedging costs. Additionally, interest rates indirectly impact the returns of other asset classes, such as equities, currencies and alternatives. In a well-diversified portfolio, interest rate risk is partially mitigated through diversification across asset classes, leveraging the correlations between them. Therefore, interest rate risk should not be analyzed in isolation, as correlations and diversification benefits with other asset classes must be considered.

The second chart illustrates the stochastic scenario-based projection of the cumulative total portfolio return over the next four years for a typical average US pension fund. The cloud of total portfolio returns incorporates multiple risk drivers (ex: interest rate risk, equity risk, and currency risk) and captures their diversification effects, showing the possible uncertainty around the average

Total portfolio return (Cumulative)



expected value (blue line). As such, scenario-analysis can help investors understand the potential impact of policy adjustments on their strategic risk profile.

Although no one can predict what path our economic markets will follow in the wake of Trump's policies – whether the path will be paved by US government debt or an unknown Fed rate – we will only learn with time which scenario is realized. But we expect that increased interest rate uncertainty will drive bond market volatility in the wake of a second Trump term.

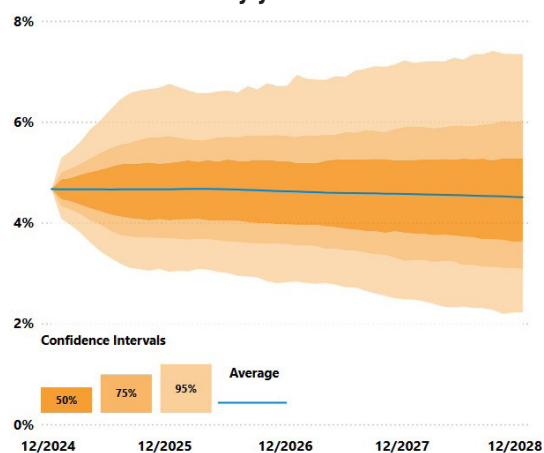
For institutional investors, it may be advisable to manage strategic (tail) risk by monitoring your forward-looking long and short-term risk budgets via scenario-based decision-making and stress testing. A thorough scenario analysis not only takes into account a comprehensive modeling of financial markets, but also other risks such as the impact on portfolio liquidity and the entire balance sheet (assets and liabilities).

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It provides solutions for Defined Benefit and Defined Contribution pension funds to help address issues including liquidity risk, complex liabilities, increasing investment performance analysis demands, and climate change related risks and opportunities.

10-Year US treasury yield



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