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Asset Allocation
Chart of the Month

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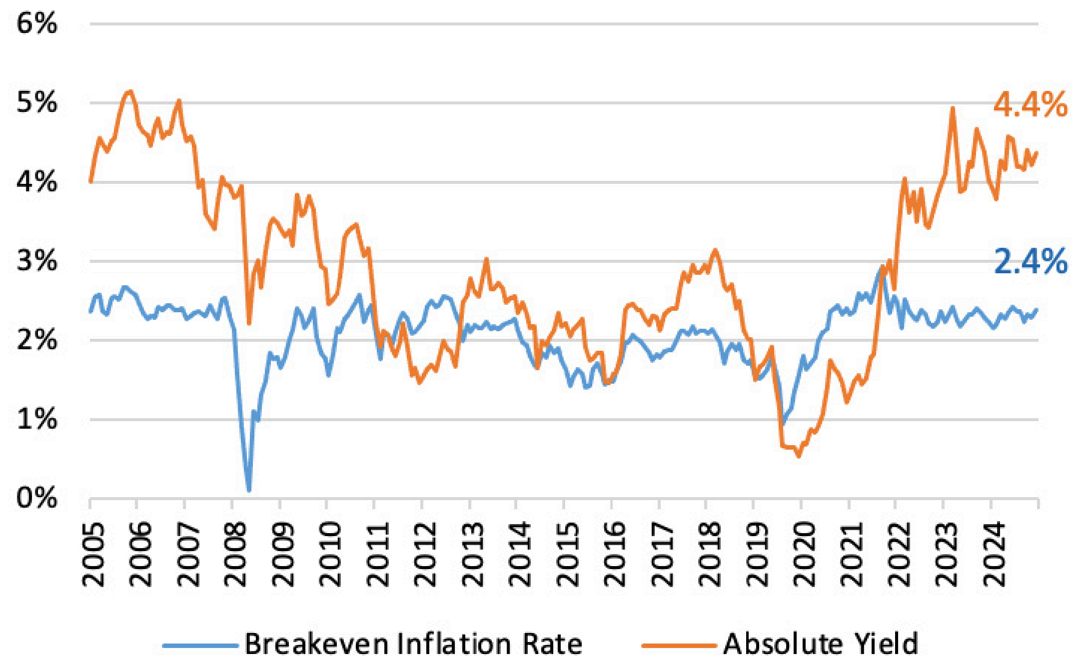
Looking Beyond the Noise

- The U.S. economy cooled in the first half of 2025 compared to last year. We expect growth to remain slow, but not stall, in the second half, weighed down by a weakening job market, a soft housing sector, and slowing consumption. Inflation is likely to remain closer to 3%, as we anticipate a greater portion of tariffs being passed through to consumers in the second half.
- While unsettled, it increasingly appears that U.S. import tariffs will stabilize around 15%. With the government now reliant on tariff revenue, this level may persist. Although it could cause a onetime bump in prices, we expect it will ultimately weigh on growth as businesses and consumers adjust.
- Against this backdrop, the Fed has been cautious, keeping rates steady amid uncertainty over trade policy. Officials remain wary of tariff-related inflation, choosing to hold off on rate cuts despite signs of labor market weakness.
- The Fed also faces sustained political pressure to lower rates. Treasury Secretary Bessent recently argued that "if you look at any model," the fed funds rate should be 150-175 basis points lower. However, models we track, such as the Taylor Rule, which links interest rates to inflation and growth, suggest the opposite: that the current rate could be too low, not too high.
- This political noise is problematic, as it could distort long-term interest rates. As Dan Carter, Senior Fixed Income Portfolio Manager at Fort Washington Investment Advisors, recently noted, "the current fed funds rate has only a limited impact on where investors value the 10-year yield."
- Long-term yields are also influenced by factors such as inflation expectations, fiscal policy, Treasury issuance, and investor demand. Politically driven policy shifts risk un-anchoring inflation expectations, pushing yields higher. At the same time, rising Treasury supply, needed to fund persistent deficits, could elevate the term premium if demand lags.
- For now, market-based inflation expectations remain stable. The 10-year breakeven inflation rate is holding between 2-3%. Given evolving conditions, we expect the Fed to modestly ease rates before year-end, but likely not to the extent urged by Secretary Bessent.
- Consequently, we anticipate a steeper yield curve, as short-term rates decline more than long-term yields. This outlook reflects our assumption that economic growth will slow to roughly 4% nominal and 2% real GDP.

Source: Carter, Dan, Monthly Market Pulse, Monthly Spotlight "The Fed Doesn't Control Long Rates" August 5, 2025, Fort Washington Investment Advisors.

U.S. 10-year Treasury Bond



Source: Bloomberg. 20 years of monthly data through Jul 2025. Breakeven inflation rate is a measure of expected inflection derived from the difference between the 10-year Treasury yield and the 10-year TIPS yield.

Word About Risk

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