Caron's Corner Transcript – 5.12.2025

Fiscal Policy, Taxes and Bond Yields – The Impact on Markets

- The current administration's policy strategy is split into **three parts**:

    1. **Deregulation:** Deregulation can spur productive growth by allowing private sector efficiencies to push out the less efficient public sector.

    2. **Tariffs:** Tariffs represent a reset of global trade relations and polices, but acts a negative force on markets in the near and intermediate term.

    3. **Taxes/Fiscal policy:** Taxes and fiscal policy are expected to create fiscal stimulus, potentially a market positive, alongside deregulation, that will counter tariff headwinds.

- Two of the three are a positive, but one is a negative. As the lyric in that great song goes, "two out of three ain't bad."

- If it were only that simple…. while tax and fiscal policy may provide a tailwind, the question is **at what cost.** We look to the **bond market** for answers.

Jim Caron: Hello, this is Jim Caron, CIO of the Portfolio Solutions Group. Welcome to another edition of Caron's Corner, powered by The BEAT – Bonds, Equities, Alternatives and Transitional short-term cash investments. This is our asset allocation framework.

Today we're going to talk about fiscal policy, taxes and bond yields - and their collective impact on markets. This is certainly very topical and I have said since the start of the year to look at the current administration's policy strategy in 3 parts.

The first one is deregulation, which started on inauguration day with the power of the pen and executive orders, but also through appointments to key positions in regulatory bodies. Deregulation can spur higher productive growth by allowing private sector efficiencies to push out the less efficient public sector.

The second component is tariffs. We've come to know this element very well since early April. It's a reset of global trade relations and policies and acts as a negative force to markets in the near and intermediate term because it's a tax on profit margins that makes investors question future cash flows and multiples that they're willing to pay for them.

Now the third one is where we are today - taxes and fiscal policy. We're only at the start of this process and it's expected to create some fiscal stimulus. It's potentially a market positive, alongside deregulation, that will counter some, but probably not all, of the headwinds from tariffs. So 2 out of 3 parts of these policy strategies are positive, but one is negative, and as that lyric in that great song goes, "2 out of 3 ain't bad." If it were only that simple. While tax and fiscal policy may provide a tailwind, the question is at what cost, what to look for and the bond markets, generally speaking, have the answers. Let's get into it!

I call this the “land of rising bond yields.” Let's focus on 30-year bond yields, not just in the U.S. but across major bond markets namely Japan, Germany and the U.S. Let's start with Japan. 30-year Japanese bond yields have been sharply rising this year, moving from 2.3% to start the year to around 3.1-3.15%. This is roughly an 80-85 basis point rise in yields, but it needs to be put into context because of the low base that these yields started from. The culprits are inflation levels sustainably above target, a rising deficit and a debt to GDP ratio that's also very high. Additionally, the Bank of Japan started raising rates, which de-anchors the back end of the yield curve. With respect to Germany, 30-year German bond yields started the year around 2.6% and have risen over 50 basis points to 3.1-3.15%. Now inflation has remained sticky in Europe, but still low and seemingly contained. But the ECB is actually still cutting policy rates.

Moving on to the 30-year U.S. Treasury, and despite all of the recent rhetoric of a loss in confidence in the U.S. Treasury and the burgeoning U.S. deficit, 30-year U.S. Treasury yields have actually risen the least since the start of the year, from 4.78% to just above 5% today, a 20 to 30 basis point rise in yields, much less than what Germany and what Japan are experiencing. U.S. policy dynamics are quite different than Japan and Germany, but still, U.S. bond yields managed to rise by less. The point of all this is that rising long-term bond yields are not exclusively a U.S. issue. It's a global one and it's important to highlight because it adds context to the recent bond market movements.

To be sure, U.S. bond yields are higher in absolute terms than other markets, but when you take into account the currency effect and FX hedging, much of this effect is neutralized. In fact, non-U.S. markets look even more cheaply priced on their various valuation metrics. So why bring this up? Because unless there is a disruptive and sudden sharp move higher in U.S. bond yields, we don't think that that these current yield levels will destroy, inhibit or “pinch off” any economic growth or equity performance. Now clearly a rising yield is a headwind to equity performance, but it's really a question of how fast, sharp and sustainable it is. Of course lower bond yields would provide more stimulus, but it may not be a requirement for economic performance, or even a hurdle, at least not yet. Let's keep this in mind for context as U.S. fiscal policy and tax deficit conversations start to arise.

Let's now talk about portfolio positioning and what are we doing about all of this. Well we're maintaining an overweight to European equities but may shift from construction areas to broader and mid-cap sectors of the market. Germany remains a key overweight along with broader Europe. We've closed our slight underweight to U.S. equities and used this recent movement in markets to do that, playing it more neutral these days. We believe a lot of progress has been made on tariff negotiations, but a lot is probably in the price already, so U.S. equities do look a little bit pricey to us. Nevertheless, it doesn't warrant a significant underweight.

In bonds, we hold a slight underweight in duration and favor yield curve steepeners, which is what's been going on. From a credit perspective, we like owning European high yield and hedging back to U.S. dollars for because U.S. dollar-based investors get the additional FX carry. The European high yield market is a higher quality market, with stronger supply technicals, and offers roughly the same yield as

U.S. high yield after taking into account the carry from FX hedging. So European high yield does look like an interesting relative value play in a global portfolio for dollar-based investors.

We are also increasing our exposure to bank loans, shorter-term floating rate and higher yielding credit. Recession risks have receded and we prefer to reduce interest rate sensitivity in portfolios. That's how we're managing this recent rise in yields.

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Diversification does not eliminate the risk of loss. There is no assurance that the Strategy will achieve its investment objective. Portfolios are subject to market risk, which is the possibility that the market values of securities owned by the portfolio will decline and that the value of portfolio shares may therefore be less than what you paid for them. Market values can change daily due to economic and other events (e.g. natural disasters, health crises, terrorism, conflicts and social unrest) that affect markets, countries, companies or governments. It is difficult to predict the timing, duration, and potential adverse effects (e.g. portfolio liquidity) of events. Accordingly, you can lose money investing in this portfolio. Please be aware that this strategy may be subject to certain additional risks. The success or failure of such decisions will affect performance**. Active Management:** in pursuing the Portfolio's investment objective, the Adviser has considerable leeway in deciding which investments to buy, hold or sell on a day-to-day basis, and which trading strategies to use. There is the risk that the Adviser's **asset allocation methodology and assumptions** regarding the Underlying Portfolios may be incorrect in light of actual market conditions and the Portfolio may not achieve its investment objective. Share prices also tend to be volatile and there is a significant possibility of loss. The portfolio's investments in **commodity-linked notes** involve substantial risks, including risk of loss of a significant portion of their principal value. In addition to commodity risk, they may be subject to additional special risks, such as risk of loss of interest and principal, lack of secondary market and risk of greater volatility, that do not affect traditional equity and debt securities. **Currency fluctuations** could erase investment gains or add to investment losses. **Fixed-income securities** are subject to the ability of an issuer to make timely principal and interest payments (credit risk), changes in interest rates (interest-rate risk), the creditworthiness of the issuer and general market liquidity (market risk). In a rising interest-rate environment, bond prices may fall and may result in periods of volatility and increased portfolio redemptions. In a declining interest-rate environment, the portfolio may generate less income. **Longer-term securities** may be more sensitive to interest rate changes. **Equity and foreign securities** are generally more volatile than fixed income securities and are subject to currency, political, economic and market risks. Equity values fluctuate in response to activities specific to a company. Stocks of **small-capitalization companies** carry special risks, such as limited product lines, markets and financial resources, and greater market volatility than securities of larger, more established companies. The risks of investing in **emerging market** countries are greater than risks associated with investments in foreign developed markets. **Exchange traded funds (ETFs)** shares have many of the same risks as direct investments in common stocks or bonds and their market value will fluctuate as the value of the underlying index does. By investing in exchange traded funds ETFs and other **Investment Funds**, the portfolio absorbs both its own expenses and those of the ETFs and Investment Funds it invests in. Supply and demand for ETFs and Investment Funds may not be correlated to that of the underlying securities. **Derivative instruments** can be illiquid, may disproportionately increase losses and may have a potentially large negative impact on the portfolio's performance. A **currency forward** is a hedging tool that does not involve any upfront payment. The use of **leverage** may increase volatility in the Portfolio.

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