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Sitting in the Slack Tide of US Fiscal Stimulus

Trump's policies on spending cuts, tariffs, and immigration could reshape the future of the US economy.

Insight from sub-adviser Wellington Management

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A slack tide is the brief period in tidal waters when the water is completely still—there's no movement either way in the tidal stream. It occurs just before the direction of the tidal stream reverses.

We tend to view fixed-income markets as a constantly evolving, probability-weighted, expected-value equation. Simply put, this means seeing a good result (outcome A) and a bad result (outcome B). I believe trying to predict the right future outcome and positioning your portfolio accordingly is futile. I find more value in identifying a crowded trade—where the probability of outcome A is perceived to be much higher than the probability of outcome B—and analyzing why outcome B may be more likely than market consensus and pricing imply.

Today, I believe the market is pricing the likelihood that the policies of President Donald Trump's administration will support US growth and lengthen the economic/credit cycles as outcome A. Outcome B, in which Trump's policies negatively shock growth and tighten financial conditions in the US, may be more probable than the market expects. Why? For the following reasons:

1. **Spending cuts** – The Trump administration's focus on cutting spending and waste, while potentially beneficial long term, could significantly hinder short-term growth. Since the beginning of COVID-19 in early 2020, federal outlays (expenditures) have represented an average of 25% of US GDP, up from an annual average of 19% for the prior six decades.[2] In my view, you simply can't cut off the flow of hundreds of billions of dollars of federal money and expect the US economic engine to keep humming the way it has been.
2. **Tariffs** – With so many moving parts, tariffs are complex to model, but my gut says they could be more of a headwind to growth than a meaningful catalyst for inflation. While it may be that Trump is using them as a negotiating tool, I see them as the only significant source of funds in his economic plan. In other words, the administration may need tariffs to fund tax-cut extensions and further stimulus. What this misses, of course, is how disruptive this posturing is for global trade, and how much it introduces uncertainty, to which the US is not immune. Growth outside the US is lackluster at best.
3. **Fourth-quarter growth** – The strength of the US economy in the fourth quarter of 2024 may have been due to rapid cash disbursement by the outgoing Biden administration and anticipatory spending by consumers and businesses ahead of tariffs. This could mean growth was pulled forward, potentially at the expense of future growth.
4. **Immigration** – Immigration hasn't only been a positive catalyst for labor-supply growth, but also a stimulant for aggregate demand. The effect of slowing immigration and large-scale deportations on inflation is a tougher call, but I believe it may be growth negative. With fewer people seeking

Key Points

- While the market is pricing in optimism, it may be underestimating the potential negative impacts of the Trump administration's policies.
- Despite previous false alarms, an inversion of the yield curve[1] could be a more reliable recession signal this time.
- A large federal deficit and fiscal excess could mean that any changes in government spending could have significant implications for the US economy.

housing, food, goods, and services, will prices adjust downward? The effects could be especially acute in the housing sector, as the US has been aiming to close a structural housing-supply deficit.

5. **Employment** – The Trump administration's buyout offers for federal employees, which aims to reduce head count, could hamper job creation. A striking 46% of US jobs added since January 2022 have come from the government and education/health services sectors.[3] Reduced hiring or job losses in these areas could significantly impact top-line job creation.
6. **Yield curve** – An inversion of the US yield curve[4] could serve as a true recession signal, unlike in 2022 and 2023, when it proved to be a false alarm. This time, we could see a scenario in which the curve inverts because the Federal Reserve remains hawkish on inflation while market participants buy long-duration[5] Treasuries, hoping for a more attractive hedge against a growth slowdown. The back end of the curve could also go lower because the market may start to price in better-than-feared deficits, as much recent yield-curve steepening may be a product of concerns around deficits. In my view, an inverted yield curve could be a troubling signal for credit markets, and we could see spreads[6] widening from their current, very tight levels.

Overall, I see the Trump administration's actions since taking office as a negative for growth. The stimulus measures the administration wants require Congressional approval, which isn't guaranteed. The federal deficit and fiscal stimulus pushed into the economy since the pandemic are unprecedented, with current spending relative to GDP historically seen only during crises, when growth was cratering.

I sense that the administration understands that the bond market may govern the amount of stimulus it can add. Further fiscal excess could come at a cost, through the level of bond yields. Contrary to the market's reactions during the past five years of rising fiscal deficits, we may have reached the upper limit of how much fiscal stimulus the government can provide.

If that's correct, then the only direction for stimulus to go from here is down. And if the government starts cutting spending, I believe the likelihood of a US recession goes way up and could lead to the reduction of US Treasury issuance.

With all that said, we may be at a slack-tide point for US fiscal stimulus, experiencing a fleeting calm before the tide turns and the flow reverses.

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Talk to your financial professional to better understand the impact of shifting policies on your portfolio.

[1] The yield curve is a line that plots interest rates of bonds having equal credit quality but differing maturity dates; its slope is used to forecast the state of the economy and interest-rate changes.

[2] As of 12/31/24. Source: US Treasury Department, 1954–2024.

[3] As of 12/31/24. Source: Bureau of Labor Statistics. 2022–2024.

[4] An inverted yield curve shows that long-term US Treasury debt interest rates are less than short-term interest rates. When the yield curve is inverted, yields decrease the farther out the maturity date is. An inverted curve has proven to be an indicator of a recession.

[5] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[6] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

Important Risks: Investing involves risk, including the possible loss of principal. • Fixed-income security risks include credit, liquidity, call, duration, and interest-rate risk. As interest rates rise, bond prices generally fall.