Frankly my dear, Bond Markets don't give a damn!

The big developments this week have been in bond markets, with the US debt downgrade from Moody's causing a brief stir on Monday. Ultimately, the announcement is a belated catch up to the other rating agencies which have already downgraded US debt; Fitch in 2023, Standard and Poor's as far back as 2011.

This event is therefore unlikely to be the straw that breaks the camel's back as US fiscal sustainability, US hegemony, and the role of the dollar as global reserve currency are already well in the crosshairs of economic debate.

With an acute aversion to criticism, the White House has alleged politicisation in response, but it may simply be the case that Moody's felt it would be imprudent not to make this change, given everything that has gone on thus far into this administration. It was likely the contingent requirements for the US maintaining a stable outlook which were considered close to overstepping the mark:

"The constitutional separation of powers among the three branches of government"

"Effective monetary policy led by an independent Federal Reserve"

Maybe the first of these is stepping into the boundaries of critiquing democratic process instead of focusing on fiscal metrics, but the comment with regard to the Federal Reserve is apt. With Jerome Powell's term concluding in May 2026, there is growing recognition that if his replacement lacks balanced judgement, then the US will continue to lose credibility.

Credibility is crucial when maintaining such high fiscal deficits. The "One, Big, Beautiful Bill" made its way through the House this week with a vote of 215-214. You can say what you like about President Trump (at your own risk) but that margin of victory highlights once again that he is a master of getting things done.

The bill, in its current form, is expected to add $3.3 trillion to the federal deficit and take the US debt to GDP ratio to 125%, but it will need a majority of 60% to pass through the Senate so we expect there will be some more back-and-forth before its final iteration.

Bond yields have been rising as these concerns grow and spiked midweek following a $16bn 20-year treasury auction which achieved a yield of over 5%, the highest since 2020. This led to a sharp but controlled sell-off in equity markets which fell on Thursday as a prudent response to higher borrowing costs, and a sign of things to come should investors lose faith in the administration.

As the week draws to a close bond markets have settled, and the combination of higher yields and the dislocation of a cheaper US dollar offers an opportunity for investors who haven't [lost faith].

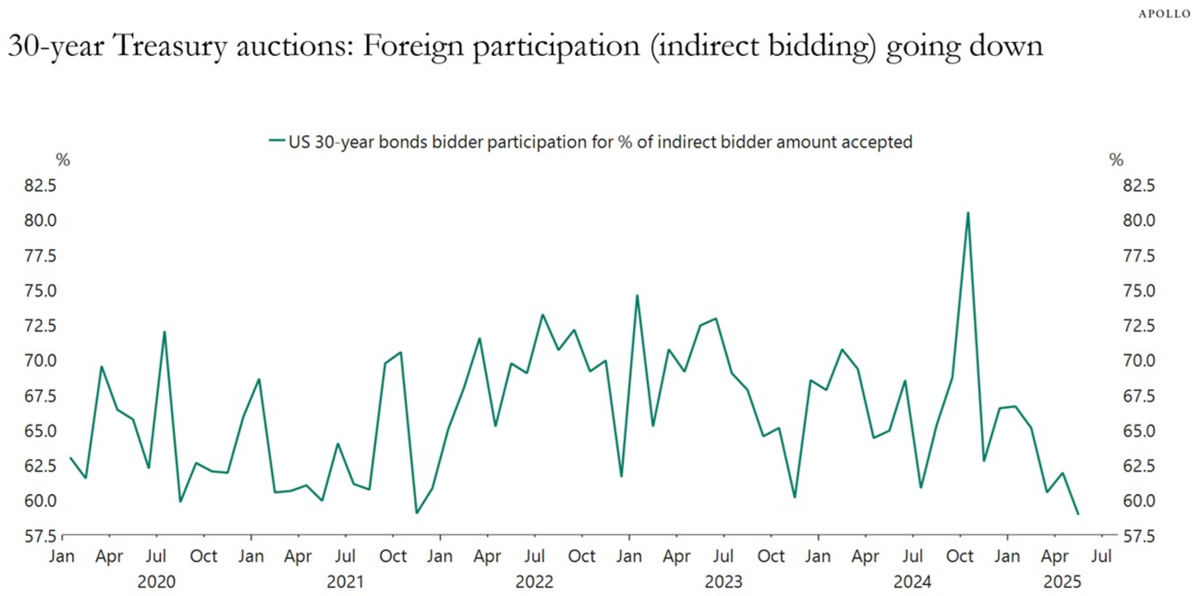
It was a similar bond issuance story in Japan this week where yields climbed to multi-decades highs as the Bank of Japan refrains from Quantitative Easing and elects to continue tapering its bond purchases.

Japanese Prime Minister, Shigeru Ishiba, is facing the prospect declining support ahead of a key upper house election in July, has been grappling with calls to slash taxes, including a levy on consumption, and increase spending. This week he rejected rolling out tax cuts funded by additional debt issuance and suggested that the country's financial situation is worse than Greece's.

Not exactly a ringing endorsement and the administration's popularity was not helped by his now-ex farming minster who suggested he never had to buy rice as it is gifted to him for free, amid a cost-of-living crisis. Inflation has subsequently been reported at its highest level in 2 years.

The Japan situation may feel a little far removed but it is very important is the context of the US. The Bank of Japan is steadily normalising monetary policy having held interest rates at artificially low levels, and each high inflation print drives the pace of that agenda. Many Japanese investors hold US Treasuries to achieve higher yields, instead of these low domestic returns.

As Japanese bond yields rise, the case for repatriating this capital back into Japanese government bonds increases, and the resulting drain on US treasury demand and the dollar is not insignificant.



In addition, many US investors use these low yields to borrow cheap money and leverage their returns. This works as long as the Yen remains weak, and bond yields remain relatively low. Both outcomes appear to be under pressure. We saw a rapid unwind of this leverage following a bout of Yen strength in August 2024 and equity markets briefly tanked.

This time we don't expect such a rapid bout of volatility, but instead higher yields may remove the attractiveness of this "carry" trade altogether and reduce the demand for risk assets, putting downward pressure on currently high valuations.

UK inflation also came in higher than expected at 3.5% with higher utility bills and council tax to blame. The energy price cap will be lowered in July, but energy costs remain elevated compared to before the invasion of Ukraine.

UK government borrowing unexpectedly jumped to £20.2bn in April, well above the £17.9bn forecast. The increase intensifies pressure on Chancellor Rachel Reeves ahead of her 11th June spending review and a leaked memo from Deputy Prime Minister Angela Rayner hints at further tax increases if the Labour Party fail to adequately address fiscal discipline.

It is no surprise then that Gilt yields followed the trend and rose this week. Bond markets are putting increasing pressure on politicians to engage in the fiscal responsibility that has fallen by the wayside in recent years:

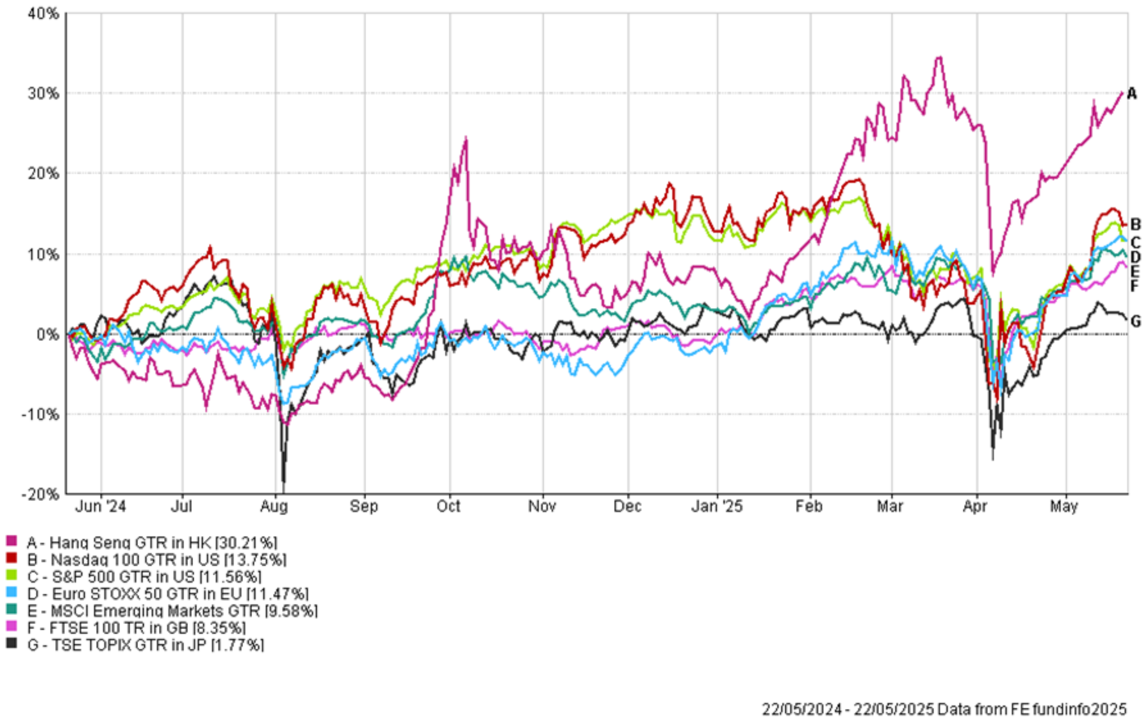
To add to UK woes, M&S reported that a recent cyberattack had cost the company £300m reducing its annual profit by a third.

While the European fiscal situation is relatively less concerning, Purchasing Manager Index data this week suggests that the region may be descending into economic contraction again. This was driven by weakness in both services and manufacturing, so the region may not prove to be the resilient economy which can be utilised as a replacement for US assets.

With all these questions over developed economies, we may find investors retreating to the relative safety of emerging markets – that's a phrase you won't hear us say very often.

Where are markets up to?

The rolling 12 month % cumulative returns in local currency from various indices is shown in the following chart:



Where are the portfolios up to?

The portfolio performance, net of fees, to close of business on Thursday is as follows:

	1 week	1 month	3 months	12 months
Cautious	-0.52%	+3.96%	-3.25%	+1.02%
Balanced	-0.61%	+6.59%	-4.45%	-0.03%
Adventurous	-0.65%	+7.95%	-5.09%	-1.00%

As ever, if you would like to discuss any aspect of your portfolio, please do not hesitate to contact us on service@blythefinancial.com.