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ECONOMIC RESEARCH – SEPTEMBER 2025

INVESTMENT INSIGHT US

- ✓ A decline in yields remains the main scenario
- ✓ Divergence in monetary policies favorable to the USD
- ✓ Risk/return ratio unfavorable to US equities

Q4 LOOKS MORE VOLATILE

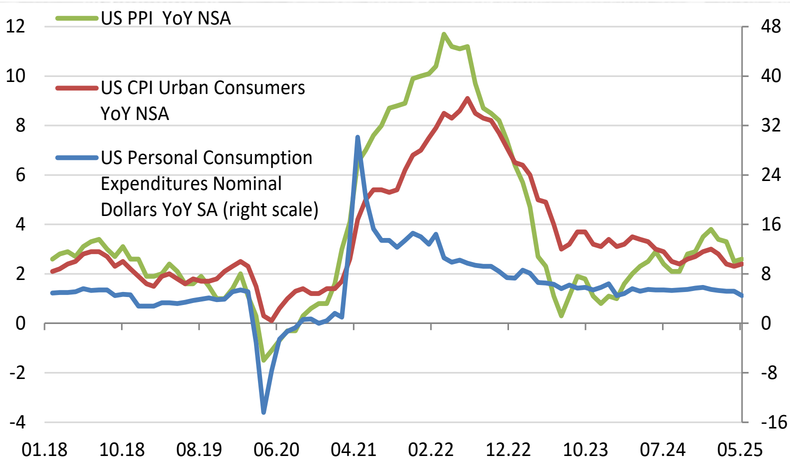
Fixed income: Stagflationary headwinds

This stagflationary cocktail (stubborn core inflation, visible rate pass-through, and early labor market weakness) is immediately exacerbated by the U.S. government shutdown, which suspends the publication of crucial economic statistics and injects pervasive uncertainty into investment decisions. While recession risks argue for lower yields, the structural supply factors combined with persistent inflation pressures mean long-term rates remain in a high fluctuation band, complicating the outlook for capital preservation and growth.

Treasury supply and term premium

Structural supply pressures continue to exert an upward bias on long-term rates. U.S. Treasury financing needs remain colossal, generating a continuous flood of bond issues required to fund the deficit and refinance maturing debt. This supply shock is occurring while the Federal Reserve pursues its Quantitative Tightening (QT) program, remaining a net seller and reducing market liquidity. This dynamic supply pressure, coupled with investor demand for greater compensation for inherent risk, is forcing a higher term premium on bonds. The significant volume and the Fed's stance are therefore structural impediments to any sharp, sustained drop in yields.

CPI, PPI & PCE Index



Sources : Bloomberg, BBGI Group

Equity risk premium compression

Equity markets appear largely overvalued, diminishing their relative attractiveness compared to high-quality fixed income assets. The Equity Risk Premium (ERP)—the excess return expected from equities over risk-free bonds—is currently at a two-decade low. This compression suggests that U.S. stocks are becoming less compelling compared to government bonds that now offer yields exceeding 4%. Although the potential for significant capital gains on Treasuries remains, this potential is subject to conflicting forces. A significant easing of yields, offering the best opportunity for capital gains, would likely increase only if statistical flows unequivocally confirm a sharp economic slowdown, thereby forcing the Fed's hand toward a more accommodative stance.

FX: Policy divergence supports USD

The initial expectation was that the Fed's recent rate cut would mark the beginning of a dovish cycle unfavorable to the dollar. However, the Federal Reserve is now likely to prove more cautious and delay further easing. Consequently, the reduction of the rate differential between the U.S. dollar and other major currencies is expected to be less pronounced than initially estimated by the market. This unanticipated policy divergence, where the Fed maintains a relatively higher-for-longer rate posture compared to peers, is an unexpected factor that could provide renewed and sustained support for the greenback in the near term, contrary to earlier forecasts.

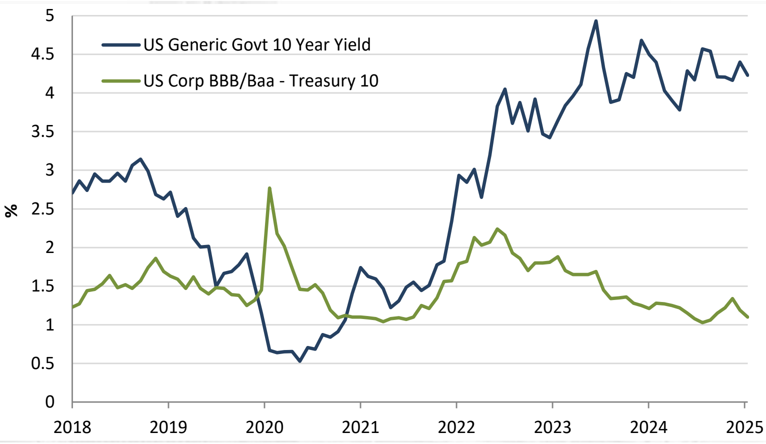
USD safe haven amid shutdown

Paradoxically, the government shutdown may reinforce the dollar's strength. By creating general uncertainty and temporarily depriving markets of reliable economic data, the internal political turmoil triggers an international flight to quality. Despite concerns surrounding the U.S. debt financing problem, international investors typically favor the exceptional liquidity and perceived security of the dollar in times of global economic doubt. The shifting risk perception, focusing on the potential effects of a slowdown on volatile equity markets, benefits the dollar, allowing it to temporarily regain its status as a premier safe haven currency among global assets. This risk-off sentiment suggests a possible unexpected rebound in the dollar over the coming months.

Equity: Margin pressure & overvaluation

The current risk/return ratio for U.S. equities appears particularly unfavorable in the short term. The market has not yet factored in the full burden of customs duties now in force, which will inevitably weigh on corporate margins and earnings. The upcoming Q3 earnings season is expected to starkly reveal this cost pressure. Valuations are historically stretched, with price/earnings (P/E) ratios for the S&P 500 trading above 25x, well above historical averages. This high valuation leaves virtually no safety margin to absorb negative surprises. The primary catalyst for a correction remains the Fed: a longer-than-expected pause or tougher rhetoric, disappointing market hopes for two further rate cuts, could trigger a sharp reassessment of risk and a subsequent price decline.

US Treasury yields and BBB bonds (spread)



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