THE PRICE OF PROGRESS

As the new U.S. administration prepares to take office, financial markets have responded by pushing up the cost of longer-dated bonds. This reflects investor concerns about potential policy shifts and their impact on future inflation and growth. The term premium, which has been relatively low in recent years, could serve as a key indicator of the new administration's success in fostering economic growth while keeping inflation in check.

One of the key concerns under the new administration is the potential for higher tariffs. Such measures could disrupt global trade flows, leading to higher costs for imported goods and raw materials. This, in turn, could reignite fears of a stagflationary environment. In that context, the policy desire to shift the trade balance more in favor towards the U.S. could come at a greater cost in the form of higher refinancing costs to support the large government spending programs. Unsurprisingly, these concerns have also started to weigh negatively on the U.S. stock market in the form of lowering their valuation premium.

Markets currently seem to be assuming a gradual transition regarding changes in tariffs. However, this assumption could prove to be overly optimistic. If tariff changes are implemented more rapidly or aggressively than expected, the resulting economic shock could be more significant. This highlights the importance of assessing the specific proposals that are likely to be announced in the coming months.

Another factor contributing to market uncertainty is the anticipated release of new fiscal plans throughout the year. These plans are likely to take time to be fully implemented, which means their impact on the economy could be gradual and spread over an extended period. Investors will need to stay vigilant as these policies are rolled out, assessing their potential effects on growth, inflation, especially with regards to their impact on growth in 2026.

Given the high levels of debt, rising interest rates create additional constraints on policymakers who might wish to pursue more expansionary policies. The cost of servicing this debt increases as rates rise, leaving less fiscal space for other initiatives. This can limit the government's ability to stimulate the economy during periods of slow growth or recession, adding another layer of complexity to economic policy planning.

POLICY AND THE TERM PREMIUM

The potential growth and inflationary impact of the Trump administration's policies could be reflected in the term premium.

Source: Northern Trust Asset Management, Bloomberg. Tobias Adrian, Richard Crump, and Emanuel Moench (ACM Model). Data from 1/18/1994 through 1/14/2025. Historical trends are not predictive of future results.

BASE CASE EXPECTATIONS

Soft Landing

Global growth will settle around trend, supported by ongoing U.S. economic strength and labor market/consumer resilience. Inflation will continue to ease toward 2%.

Central Bank Easing

Lower inflation has allowed major central banks to start cutting policy rates. We expect central bank easing to continue, though the timing and trajectory may vary depending on regional economic conditions.

RISK CASE SCENARIOS

Reflation

Policies of the incoming U.S. Administration have a net stimulative effect, leading to above-trend growth, persistent inflation and a pause in the Fed rate-cutting cycle.

Supply Restraint

Supply-side disruptions from immigration restrictions and higher tariffs weigh on economic activity and halt the disinflationary process until a recession takes shape.