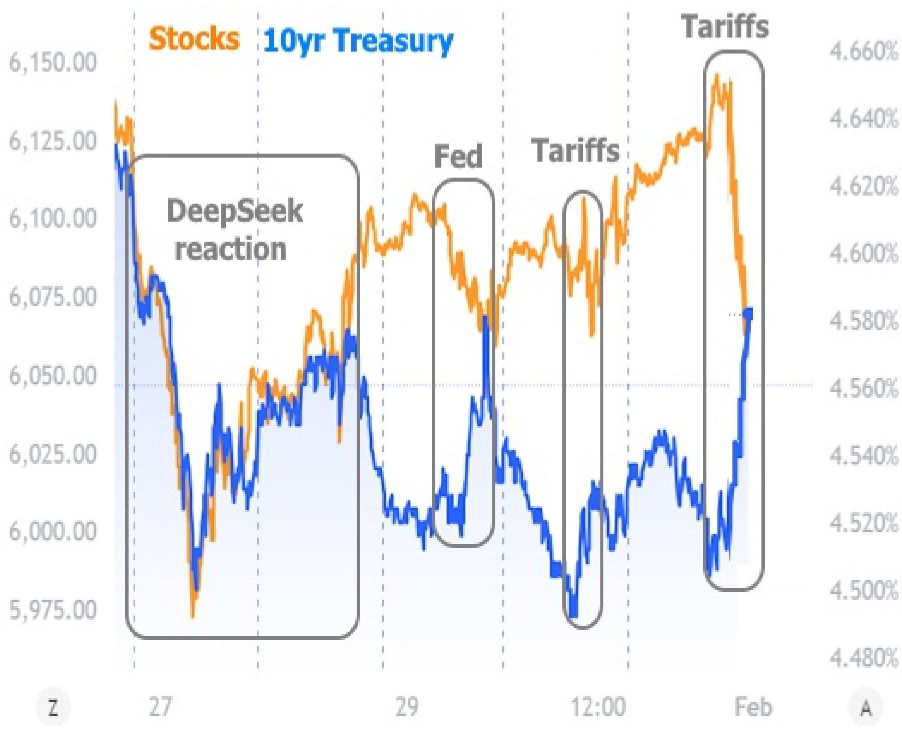
Bonds Brace For Tariff Impact, Just Like Last Time

Spoiler alert: no one really knows how tariffs are going to impact the market yet. Much is left to be decided, and the outcomes can vary depending on the details.

Markets were certainly willing to react to tariff headlines this week with Thursday and Friday overshadowing Wednesday's Fed announcement. In general, both stocks and bonds are treating tariffs the same way they treat the Fed Funds Rate. Lower is better. Higher is worse.

The result: stock prices and bond yields (aka "rates") moved in opposite directions. In this case, each new dose of news brought stocks lower and rates higher, but if the news had been good, stocks would have rallied and rates would have fallen.

Contrast this to the pattern we saw at the beginning of the week when markets were reacting to news of the new kid on the AI block, DeepSeek. The story goes that DeepSeek was built much faster than ChatGPT, cost much less, and is just as good. This made investors fear that domestic AI stocks were overvalued. Heavy selling ensued, pulling the entire market down. But as that money fled the stock market, it found a home in bonds, thus helping rates move lower and making for the directly correlated movement between stocks and bonds.



Friday's tariff reaction was obviously the bigger deal, but keep in mind that we're looking at relatively small movement in the bigger picture. Here's how this week compared to the past few months:

1st Choice Mortgage
Mortgage Broker, 1st Choice Mortgage Company, LLC
375Loan.com
P: (208) 375-5626
3023 E Copper Point Dr
Meridian ID 83642
380736

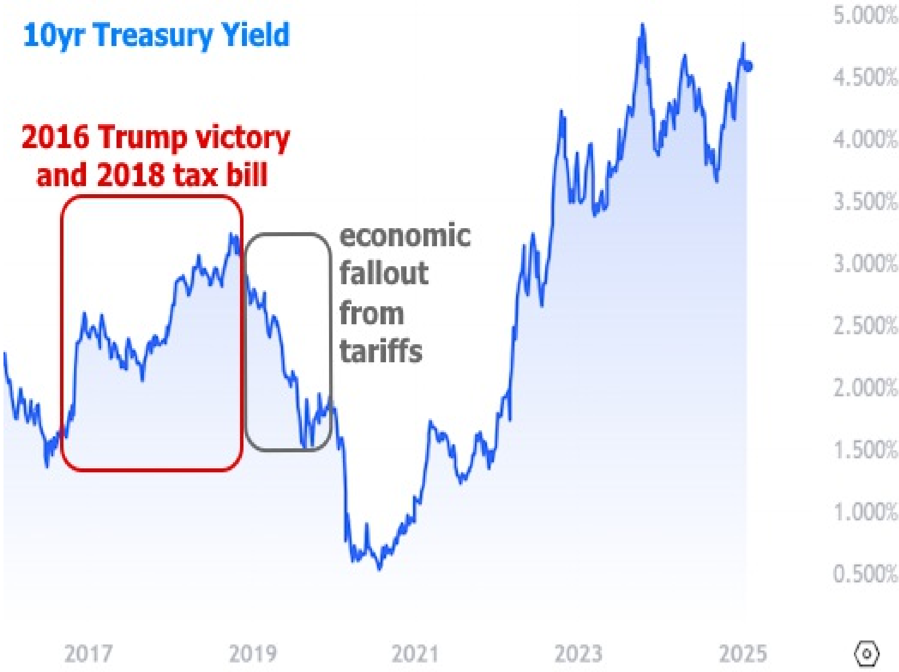
Still, tariffs are a hot topic of conversation. So what do we know?

First off, we don't yet know exactly how they'll look. Even though the White House said it would roll out 25% tariffs on both Mexico and Canada on Saturday, there are questions as to how sweeping the implementation could possibly be in light of current laws and the interpretation of the Emergency Economic Powers Act (which Trump claims permits him to impose sweeping tariffs, although some legal scholars say it could be challenged in court).

But let's forget the legal "what ifs" and assume we get sweeping tariffs in short order. What people really want to know is whether tariffs are good or bad.

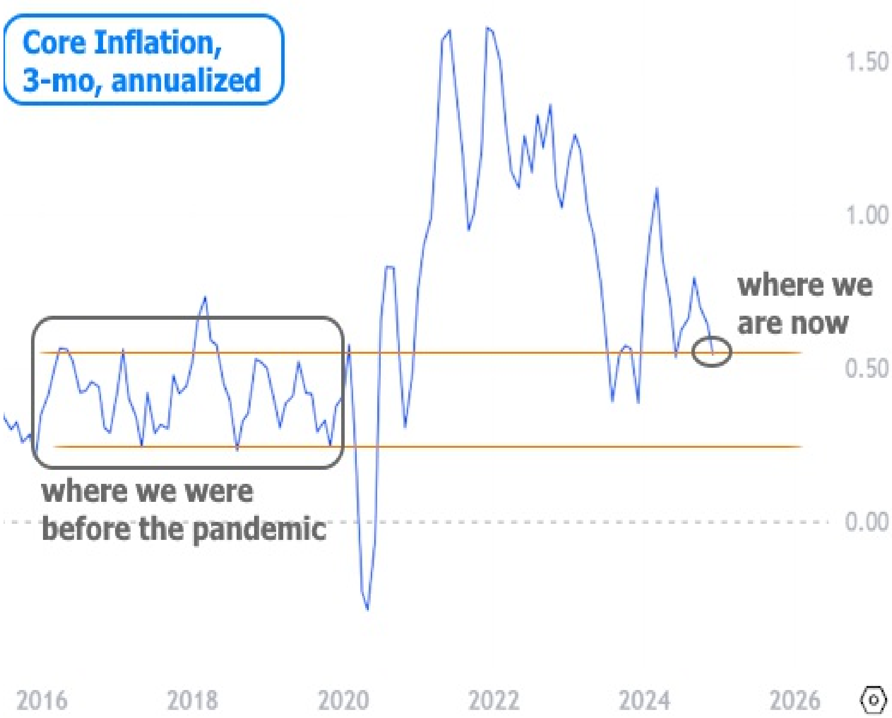
The answer is nuanced and certainty is impossible without the benefit of hindsight. Markets certainly think tariffs are bad and/or that they will put upward pressure on prices/rates in the short term. That said, history suggests tariffs are a double-edged sword that could come with an economic cost.

Granted, the economy is always acting under multiple influences, but in 2019, few could argue that the US/China tariff-driven trade war was a key consideration. At that time, the most obvious consequence was the economic malaise rather than a noticeable increase in inflation. It ultimately resulted in rates moving down whereas traders initially pushed rates up as they braced for impact from tariffs and the tax bill.



To be sure, this time could be different, but again, we won't really know until we see the specifics and have some track record of actual impacts showing up in economic data. It could easily be another case of markets bracing for impact only to find that economic fallout outweighs the inflationary impulse. Either way, we won't be able to draw any ironclad conclusions for many months, and the overall assessment will take several years.

In the meantime, we're in the same position as ever, waiting for economic data to inform the path of rates and the housing market. Inflation remains critical and this week's key report--The PCE Price Index--didn't offer any strong arguments in either direction. Over shorter time horizons, the data show ongoing progress back toward target levels. But clearly, the recent trend isn't as good as the pre-pandemic era.



A chart of year-over-year inflation makes it clear just how much we've paused on the way back to the 2.0% target. To be fair, this line should move lower simply because higher inflation readings from 11-12 months ago will be falling out of the 12 month calculation over the next 2 months. Even so, this is not the annual chart the Fed was hoping to see when it began considering rate cuts in the middle of 2024.


Core PCE Inflation, Y/Y
not a
happy
bounce
target
5.00
4.00
3.00
2.00
1.00
0.00
2016
2018
2020
2022
2024
2026