US Rates Watch

Tariff reaction: shock to system

Tariffs hit US economy & markets hard

We discuss US tariff announcement and impacts for US economics, FX, & US rates. Tariffs risk softer US growth, higher US inflation, future Fed cuts, weaker USD, & lower US rates. US fiscal budget developments yesterday also risk worse deficits & tighter spreads.

US economics: kitchen sink tariffs

President Trump announced massive tariff hikes against nearly every US trading partner. The tariffs are far larger than what we or markets were expecting. If the tariffs stay in place, we think they would add 1-1.5pp to inflation (the core PCE is currently at 2.8% y/y) and subtract a similar amount from GDP growth over the next couple of quarters, pushing the economy to the precipice of recession. With potentially a 4-handle on PCE inflation, it would become even harder for the Fed to cut. Inflation could fall quickly next year if aggregate demand deteriorates sufficiently, and the economy goes into recession. Then the Fed would most likely cut rates substantially, by 200bp or more.

FX: the dollar frown

The FX reaction to the sizeable tariff announcement is perhaps more noteworthy for what did not happen, rather than what did. Namely, the dollar did not rally amid the broader global "risk off" move. Markets view tariffs of such magnitudes (and continued uncertainty) as a potential policy error emanating from the US. For many of the same reasons that have driven this latest leg lower in the USD, we remain bearish.

US rates: tariffs bad, deficits worse

The rates market is pricing increased stagflation risks & building expectation for future Fed rate cuts. We stay constructive on duration (especially in the belly, 5Y) & think longs should be a mix of real & nominal rates. We hold curve steepeners in 5s30s (current price 67bps) & like owning intermediate tenor inflation longs. Recent Senate budget developments also support our 30Y spread short & highlight need for tariff revenue to offset tax cuts. If the Senate blueprint is adopted it could accelerate concerns around US debt sustainability, especially if tariffs reduce foreign UST demand & soften US growth.

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For a complete list of our open trade recommendations, as well as our trade recommendations closed over the last 12 months, see Global Rates Weekly.

Glossary
PCE: Personal Consumption Expenditures
USMCA: United States-Mexico-Canada Agreement

US economics: kitchen sink tariffs

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Tariffs for (almost) everyone

Yesterday President Trump announced massive tariff hikes against nearly every US trading partner. Highlights include 34% tariffs on Chinese imports (which appears to be layered on top of the 20% tariffs announced in Feb and Mar), 20% against the EU and 46% against Vietnam. These tariffs will go into effect on April 9. Trump also announced a baseline rate of 10% on all imports, which will be implemented on April 5. Exceptions were only made for Canada and Mexico, which for now will not face any new tariffs.

Some relief from carve-outs

The executive order carved out certain import categories from the "reciprocal" tariffs. Autos & parts and steel & aluminum are already subject to 25% tariffs, so no additional levies will be applied. Pharmaceuticals, semiconductors, lumber and energy will be exempt, at least for now.

A shock to the system

As of April 1, the effective US tariff rate (based on all announced measures) stood at around 9%. This included the 2.3% effective rate from before the elections, nearly another 3pp from the 20% increase in China tariffs, and roughly 2pp each from i) the tariffs on autos and parts, and ii) tariffs on non-USMCA compliant imports from Canada and Mexico.

If the tariffs announced yesterday stay in place indefinitely, we estimate that they would raise the effective tariff rate by about 11pp to 20%. These figures are far larger than what we or markets were expecting. They would push the US much further along the stagflationary path, close to a tipping point where demand collapses under the weight of higher prices.

Estimating the economic impact

In theory, the tariffs would add around $650bn per year to federal revenues, reducing the deficit by more than 2pp of GDP. However, this is likely an upper bound, as firms will be incentivized to find ways to lower their tariff bill (e.g., by moving production to lower-tariff jurisdictions).

Moreover, these revenues would be derived from essentially a large, regressive tax hike on US consumers and importers. If the tariffs stay in place, we think they would add 1-1.5pp to inflation (the core PCE is currently at 2.8% y/y) and subtract a similar amount from GDP growth over the next couple of quarters, pushing the economy to the precipice of recession. The drag on growth could last longer than the boost to inflation.

Fed impact: hawkish in 2025, dovish in 2026

With potentially a 4-handle on PCE inflation, it would become even harder for the Fed to cut this year. But inflation could fall quickly next year if aggregate demand deteriorates sufficiently, and the economy goes into recession. Then the Fed would most likely cut rates substantially, by 200bp or more.

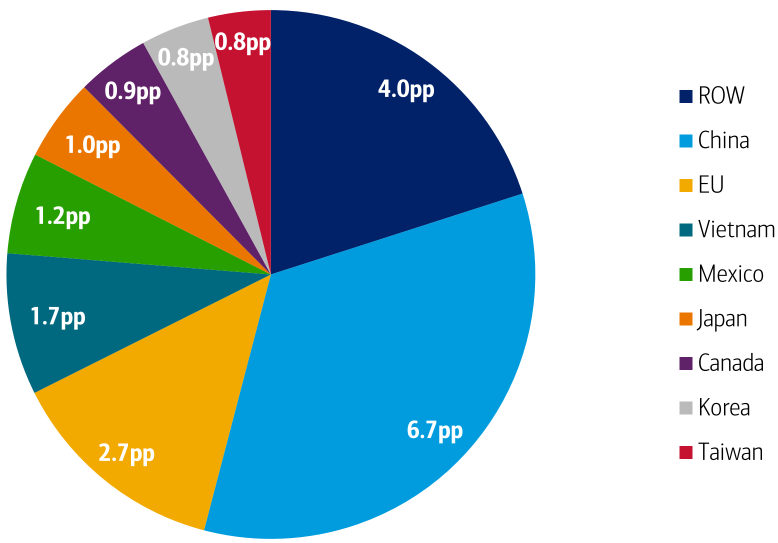
Risk factors

Our base case remains that some of these tariffs will be negotiated away. We will wait to see how other countries react to the announcement, including their willingness to negotiate, before incorporating the upside/downside risks to inflation/growth into our forecasts.

Dollar appreciation and absorption of tariffs in margins could also mitigate the final effect of the measures announced yesterday. Rising inflation expectations or price hikes by domestic manufacturers could increase the impact on inflation and lead to a more hawkish Fed policy path. On the flip side, a larger-than-expected uncertainty shock to business investment could create greater downside for growth, and more room for Fed cuts.

Exhibit 1: If the tariffs announced yesterday stay in place indefinitely, we estimate that they would raise the effective tariff rate by about 11pp to 20%

Contributions by country to the effective tariff rate



Source: Census Bureau, BofA Global Research, Haver Analytics. Note: this calculation includes the prior 20pp tariff increase on China, the 25% tariffs on autos and parts, and the tariffs on non-USMCA compliant imports from Canada and Mexico.

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FX: the dollar frown

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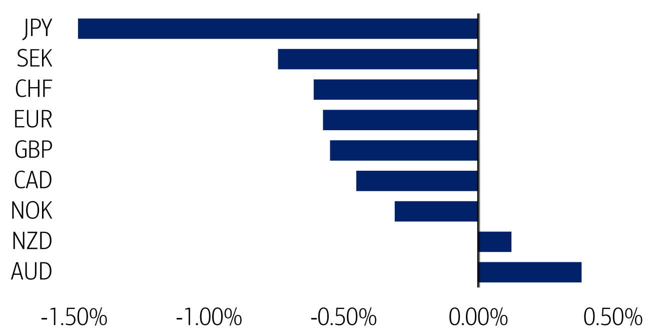
The FX reaction to the sizeable tariff announcement is perhaps more noteworthy for what did not happen, rather than what did. Namely, the dollar did not rally amid the broader global "risk off" move, with the DXY 0.8% lower since pre-announcements. Bi-laterally, the JPY unsurprisingly is the biggest outperformer at +1.5%, while the EUR and other European currencies have appreciated 0.3-0.7%, as has CAD. The main outlier has been AUD, which has depreciated 0.4% likely given its still relatively tighter correlation to equities and the CNY. (Exhibit 2)

Exhibit 2: Dollar mostly net lower on back of the sweeping tariff announcements
USD performance vs. G10 FX since 4PM (EST)



Source: Bloomberg; BofA Global Research

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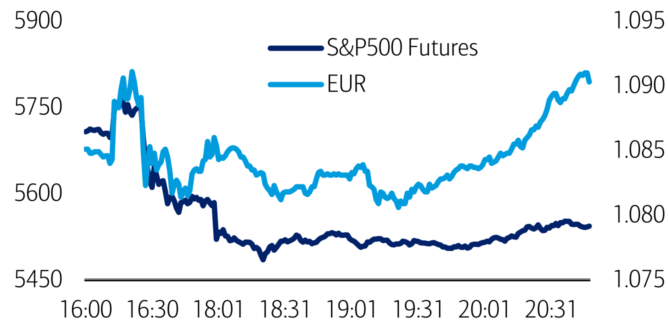
Exhibit 3: EUR traded higher vs. USD as S&P futures sold off notably post announcement
S&P Futures & EUR/USD from 4PM



Source: Bloomberg; BofA Global Research

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Lacking safe haven alure

It would not have been too long ago, when a tariff announcement of this magnitude would have sent the USD soaring higher vs most G10's (ex-JPY). Not today. The FX market is increasingly coalescing around the view that while tariffs pose economic risks to the US's trading partners, the biggest incremental macro risk is a more protracted US (stagflationary) slowdown.

Markets view tariffs of such magnitudes (and continued uncertainty) as a potential policy error emanating from the US. As such, the typical inverse equity/USD correlation continues to break down, with S&P futures -2.7% in overnight trading. (Exhibit 3) We covered this most recently in US tariffs: are markets complacent, or forward-looking? 02 April 2025, and USD & S&P – The times they are a changin' 20 March 2025.

Outlook: Bearish

For many of the same reasons that have driven this latest leg lower in the USD, we remain bearish. (FX Viewpoint: G10 FX outlook update: against the consensus 27 March 2025) While the dollar's selloff up to now has been somewhat moderated by the resilient hard data (labor, retail, sticky inflation), the downside risks and prospect of deeper rate cuts later on are mounting.

Meanwhile, the so-called "White House put" still appears well out-of-the-money (if it exists at all) and it will be increasingly difficult to put the toothpaste back in the tube. That said, key questions remain as to how the tariff story plays out. On one hand, It does seem like there is scope for negotiation, which should moderate the ultimate impact compared to today's announcements. But at the same time, retaliation and escalating trade wars cannot be ruled out either. How global investors react with FX allocations after years of US outperformance is becoming an omnipresent theme.

US rates: tariffs bad, deficits worse

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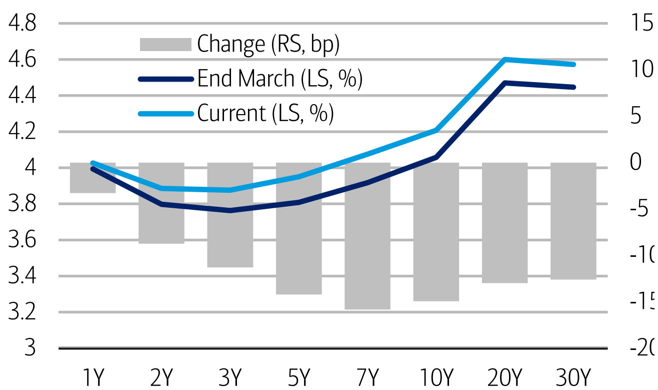
US rates focused on to 2 key developments yesterday: (1) tariff news (2) Senate budget resolution. Each reinforced our core rate views & risks lower rates. Details below.

Tariff news: downside growth risks drive lower rates

The Trump tariff announcement was much more restrictive vs our US economist & market expectations. The set of tariff announcements reinforced the Trump administration desire to lower persistent US trade deficits & increase US manufacturing production but at the risk of higher inflation & lower US growth. Consistent with these concerns, US rates across the curve declined 8-14bps since the announcement with intermediate tenors leading the move (Exhibit 4). The rate move reflected lower real rates & higher breakeven inflation, especially at the front end of the US rates curve.

The rates market is pricing increased stagflation risks & building expectation for future Fed rate cuts. The rates market prices 75bps of rate cuts in '25 & nearly 110bps through '26. The market believes the Fed will overweight downside risks to growth vs upside risks to inflation in justifying a relatively brisk path of rate cuts especially in 2H '25 & 1H '26. The cutting cycle trough is near 3.25% and the US rates team sees risks this could extend to or below the Fed's 3% longer run fed funds neutral rate projection. The tariff news & Fed cutting risks pose downside risks to our recently revised US rate forecasts.

Exhibit 4: US rate price action following tariff announcement
Rates declined led by belly outperformance



Source: Bloomberg

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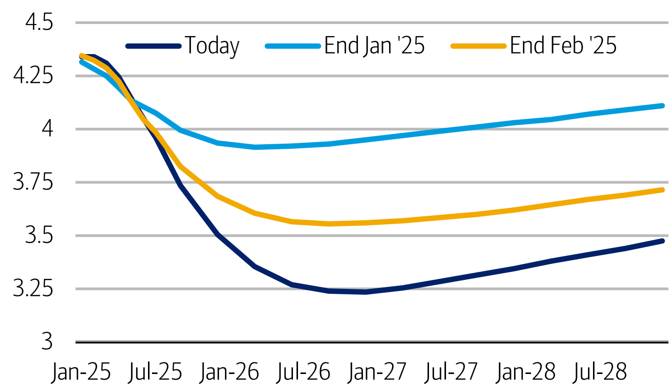
Exhibit 5: SOFR curve moves over recent months (%)
A lower cutting trough implies a steeper curve out to '27 & '28



Source: Bloomberg

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Tariff developments support our core rate views. **On duration** we have recommended clients trade rates with a soft long duration bias with positions targeted in the belly of the curve. Rates have broken below the low end of recent trading ranges but we still hold our duration bias given downside growth risks & the possibility of swift Fed cuts if hard data weaken. **On the curve**, we continue to like 5s30s nominal steepeners as it may take until later for Fed cuts to materialize (risk: bear flattening on hawkish Fed); we also recommend being paid June '25 FOMC OIS with a Fed that may be unwilling to cut until there is a clearer softening in the hard data. We add a new front-end curve trade to position for a market that may price a relatively rapid pace of Fed cuts over next 1Y if hard data weakens: M6M7 SOFR curve steepener. We enter the trade at 1bps, target 30bps of steepness, and a stop at -20bps. Risks to the trade are a Fed that cuts later & slower + dovish new Fed chair in mid '26. **On inflation**, we continue to see risks for lower intermediate tenor (5Y) real rates & higher similar tenor inflation (especially in forward space 1Y ahead 4Y inflation); we think duration longs should be expressed via a mix of nominal & real rates.

Budget news: larger US deficit risks drive short spreads

Yesterday Senate Republicans unveiled a budget blueprint designed to speed tax cuts & raise the debt limit. The Senate blueprint reinforces our short 30Y swap spread trade & less constructive front end spread view because risk of much larger US fiscal deficits.

Most notable in the Senate blueprint was the use of "current policy" to assess the impact of Trump tax cut extension. The "current policy" approach does not require the Trump tax cut extension to be accounted for in reconciliation, which then allows for more room to cut taxes & expand the deficit. The Senate approach essential works around the long standing "Byrd rule" that requires any reconciliation law be deficit neutral by the end of the typical 10Y budget window.

The deficit impact from the Senate budget blueprint could allow for up to $5.8tn in additional primary deficits through 2034 vs current law, according to the Committee for a Responsible Federal Budget (CRFB). Specifically, CRFB notes the Senate blueprint includes "up to $2,021 billion of deficit-increasing instructions, at least $4 billion of deficit reduction instructions, and the implicit inclusion of $3.8 trillion of tax cut extensions by adopting a 'current policy' baseline." If adopted, the use of "current policy" baseline would also likely be applied by Democrats in the future if they control government & want to use reconciliation. The current practice raises risks for a worse deficit trajectory than many in the market have likely expected.

As a reflection of the deficit risks, the Senate blueprint also seeks to raise the debt limit by $5tn. The US rates team estimates that a $5tn debt limit increase could be exhausted in 1H '27 or later (see: Funding notes). In essence, a $5tn debt limit increase may only buy Congress 2Y before it needs to be raised again.

The timing of yesterday's tariff news & Senate budget blueprint may not be coincidental. The larger-than-expected tariffs may be seen as a key tool to raise revenues to offset the larger potential deficits implied by the Senate budget blueprint. Fiscal hawks will likely need to be convinced of material tariff revenues to support the Senate budget blueprint.

The rate impact of the Senate budget blueprint supports our existing 5s30s curve steepening view, short 30Y swap spread trade, & less constructive front end spread view. If Senate blueprint is adopted it could accelerate concerns around US debt sustainability, especially if tariffs reduce foreign UST demand & soften US growth.

Bottom line: tariffs were far larger than what we or markets were expecting. If the tariffs stay in place, we think they would add 1-1.5pp to inflation (the core PCE is currently at 2.8% y/y) and subtract a similar amount from GDP growth over the next couple of quarters, pushing the economy to the precipice of recession. As inflation subsides weaker growth could push the Fed to cut rates substantially, by 200bp or more. For FX, tariff developments reinforce our bearish USD view. For rates, risks skew to lower rates & a steeper curve; Senate budget developments also point to tighter asset swap spreads, especially at the 30Y tenor.

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