DIAMOND HILL

INVESTED IN THE LONG RUN

Tariffs, Downgrades and Debt: The Fiscal Dominoes Driving Market Turbulence

May 2025

The past couple of months have been quite trying on financial markets, fueled by the uncertainty created by Liberation Day, the One Big Beautiful Bill, the final major rating agency downgrade of US debt, a normalized yield curve and tensions rising in the Middle East. The volatility experienced by anyone invested in the financial markets is enough to make one's hair grey. Still, when we step back and look at the longer-term picture, hopefully, we can find solace that, as much as things have changed, some remain the same.

Liberation Day

Liberation Day (April 2) was a momentous event for markets as the reaction to the most recent global trade war was extreme across nearly all asset classes. As illustrated in Exhibit 1, spreads across risk assets widened considerably from April 2 to April 8, and equity markets were down more than 10%. But it didn't happen all at once.

The initial reaction to Liberation Day was tough on markets, with the S&P 500 Index dropping roughly 5% on April 2 and spreads across risk assets widening by roughly 5%, led by high yield spreads widening almost 16% on that day. However, markets didn't reach their two-month low point until April 8, when President Trump announced additional tariffs against China in response to that country's retaliatory tariffs, bringing the total level to 104%. Tariffs remained the primary focus of financial markets through the middle of May, when the US and China stepped back from the brink to lower reciprocal tariffs, with levels higher than pre-Liberation Day.

The main takeaway from the tariff-inspired volatility in April and early May is that financial markets had stabilized by the end of May, and most sectors ended May in a better position than on the first day of April. While spreads in the investment grade and high yield markets tightened despite the chaotic two-month journey, agency RMBS spreads widened. However, this was due more to fiscal uncertainty and the US downgrade than anything else, as yields on the longer end of the curve pushed higher. Both non-agency CMBS and ABS finished at tighter levels, and issuance resumed after a brief slowdown in the middle parts of April. Equity markets recovered nicely, with the S&P 500 returning 5.6% for the two months ending May 31.

Exhibit 1 — Treasury Yield Changes (%)

		Treasury Yield (%)		Option Adjusted Spread (bps)					Level
Note		2Y	10Y	IG Corporate	HY Corporate	Non-Agency CMBS	ABS	Agency RMBS	S&P 500
March 31		3.88	4.21	93.9	346.9	140.4	60.2	36.3	5,664.0
April 2	**Liberation Day**	3.86	4.13	93.1	334.1	140.7	59.5	35.7	5,630.6
April 3	**Post-Liberation Day**	3.68	4.03	101.6	387.1	145.9	60.4	36.0	5,465.5
April 4	**China Retaliation**	3.65	3.99	108.9	433.8	158.7	67.0	44.6	5,374.2
April 7	**US increase to 50%**	3.76	4.18	115.8	449.4	155.5	63.2	40.9	5,214.5
April 9	**China increases to 84%**	3.73	4.29	112.1	452.7	155.8	63.9	45.4	5,112.8
April 10	**US increases to 145%**	3.86	4.43	114.4	426.5	154.5	63.8	39.0	5,573.4
April 11	**China increases to 125%**	3.96	4.49	113.5	433.8	158.7	67.0	44.6	5,374.2
May 12	**US/China Cool-off**	4.01	4.47	93.9	305.5	143.6	67.6	38.0	5,897.9
May 30		3.90	4.40	88.1	314.6	139.2	59.8	41.6	5,969.6
Change March 31 – May 30		0.01	0.20	-5.8	-32.3	-1.2	-0.4	5.3	305.6
2-month Performance (%)				-0.4	1.7	0.7	0.5	-0.6	5.6

Source: Source: Bloomberg. IG = Investment Grade, HY = High Yield, ABS = Asset-backed securities, CMBS = Commercial mortgage-backed securities, RMBS = Residential mortgage-backed securities.

The Big Beautiful Bill and a downgrade

The House of Representatives passed the Administration's One Big Beautiful Bill Act on May 22 and proceeds to the Senate for approval. As it was approved, the bill delivers or extends expansive tax cuts, launches a new child savings account and increases spending on immigration reform and military spending. To offset the cost, the proposed bill will reduce health coverage for millions. However, the reductions don't meet or exceed the spending increase, adding additional debt to the already substantial US budget deficit. According to the Congressional Budget Office, the impact of the bill's passage would increase the deficit by $1.7 trillion over the next five years and $2.4 trillion over the next ten years. The US is already spending more on interest payments on the national debt (roughly $1 trillion over the last year) than on national defense.

Anticipating the potential impact of the bill on the national debt, Moody's Ratings downgraded the United States' credit rating on May 16 from Aaa to Aa1, finally bringing the agency in line with the other major rating agencies, S&P (AA+) and Fitch (AA+). Specifically, Moody's stated that, "Successive US administrations and Congress have failed to agree on measures to reverse the trend of large annual fiscal deficits and growing interest costs. We do not believe that material multi-year reductions in mandatory spending and deficits will result from current fiscal proposals under consideration. Over the next decade, we expect larger deficits as entitlement spending rises while government revenue remains broadly flat. In turn, persistent, large fiscal deficits will drive the government's debt and interest burden higher. The US' fiscal performance is likely to deteriorate relative to its own past and compared to other highly rated sovereigns." S&P was the first agency to move on US debt, downgrading from AAA to AA+ in August 2011, while Fitch shifted its rating in August 2023. The market had very different reactions to the downgrades (Exhibit 2), and this time was no different, with the yield curve shifting slightly lower across tenors in the subsequent weeks.

Exhibit 2 — Market Impact of Downgrade of US Debt (%)

Source: FRED.

Inversion no more!

The basics of the interest rate yield curve are somewhat straightforward: longer maturities have higher yields to entice investors to part with their money for extended periods. An inversion of the yield curve occurs when the difference between the yield for a longer security drops below that of a shorter security; in this instance, the yield on the 10-year Treasury and 2-year Treasury. This environment could lead to economically restricting activity, such as bank lending and credit availability across the economy, and thus the (fair or unfair) symbiotic relationship between curve inversions and recessions.

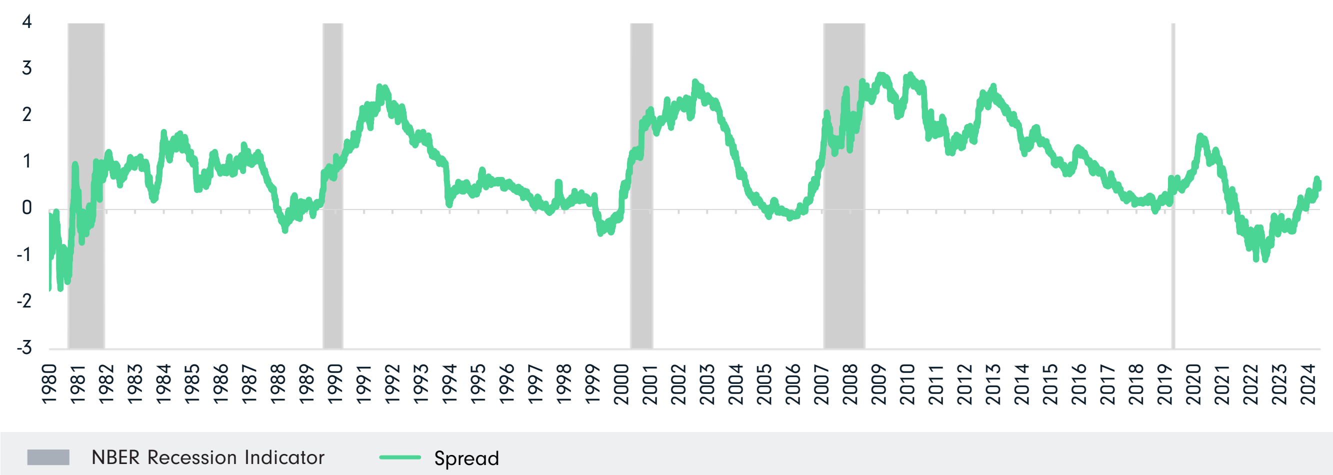
Most recently, the normal relationship between these two bellwether securities inverted in July 2022 when the yield on the 2-year Treasury reached 2.97% as the yield on the 10-year Treasury reached 2.93%. The inversion between the two lasted for nearly 800 days, well ahead of the prior record of 623 days from August 1978 to May 1980.

Historically, yield curve inversions have preceded recessions (Exhibit 3). In fact, since 1980, the past four major recessions (not counting the short-lived, COVID-induced recession of 2020) have been preceded by curve inversions, with the recession occurring shortly after the relationship between short- and long-term rates normalizes. Does this mean that a recession is imminent? While curve inversion has been an indicator in the past, one could argue that this time is indeed different.

Prior periods of inversion resulted in a contraction of bank profitability as high short-term rates (paid to depositors) clashed with lower long-term lending rates and lending tended to dry up. Coming out of COVID, long-term rates climbed, and even though the curve was inverted from mid-2022 to September 2024, banks did well (outside of the short-lived regional bank crisis). The reason being? No need to raise short-term rates on interest paid to depositors as the banks were flush with cash from stimulus-fueled depositors. As short-term rates climbed, banks didn't need to adjust the rate paid to depositors since the competition for new deposits was suppressed.

Has the yield curve inversion lost its predictive ability? It's hard to say, and we won't know for several months, if not years. The time frame from prior inversions to the National Bureau of Economic Research's (NBER) identification of a recession has varied quite a bit; the 1989-1990 recession started 267 days after the end of the inversion, the 2000-2001 recession was 123 days and the 2007-2008 recession was 256 days. We were 266 days removed from curve inversion at the end of May.

Exhibit 3 — 2Y and 10Y Treasury Yield Inversion and Recessions (%)



Source: NBER.org and FRED.

The Federal Reserve remains on hold

The FOMC continues to hold the line on "wait and see" and "data dependency" regarding the future path of rates. The meeting on May 7 reinforced the FOMC's belief that the impact of tariffs on the US and global economy is still very uncertain. The Fed specifically cited trade policy as increasing the risk for higher inflation and a weaker labor market, and Powell stated that policy, "...is in a good place." The Fed maintains the ability to respond swiftly as economic conditions evolve. The best way to summarize the most recent meeting was that the Fed believes it is well-positioned for whatever may come but has become more vigilant in monitoring developments in financial markets. You couldn't blame Powell if he decided to take a victory lap during the press conference for resisting any knee-jerk reaction to the significant market volatility, despite pressure from the administration and outside parties.

Reinforcing the focus on long-term horizons

If investors learn one thing from the volatility of the past few months, it is that we must remain focused on the longer term and try to blunt the noise of day-to-day uncertainty that arises from outside forces. While it can be unsettling, investors who stay calm and focused during periods of volatility can benefit significantly from a calm demeanor, taking advantage of dislocations in the market.

S&P 500 Index measures the performance of 500 large companies in the US.

Investment Grade is a bond quality rating of AAA, AA, A or BBB.