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Inflation, Fiscal and Governance

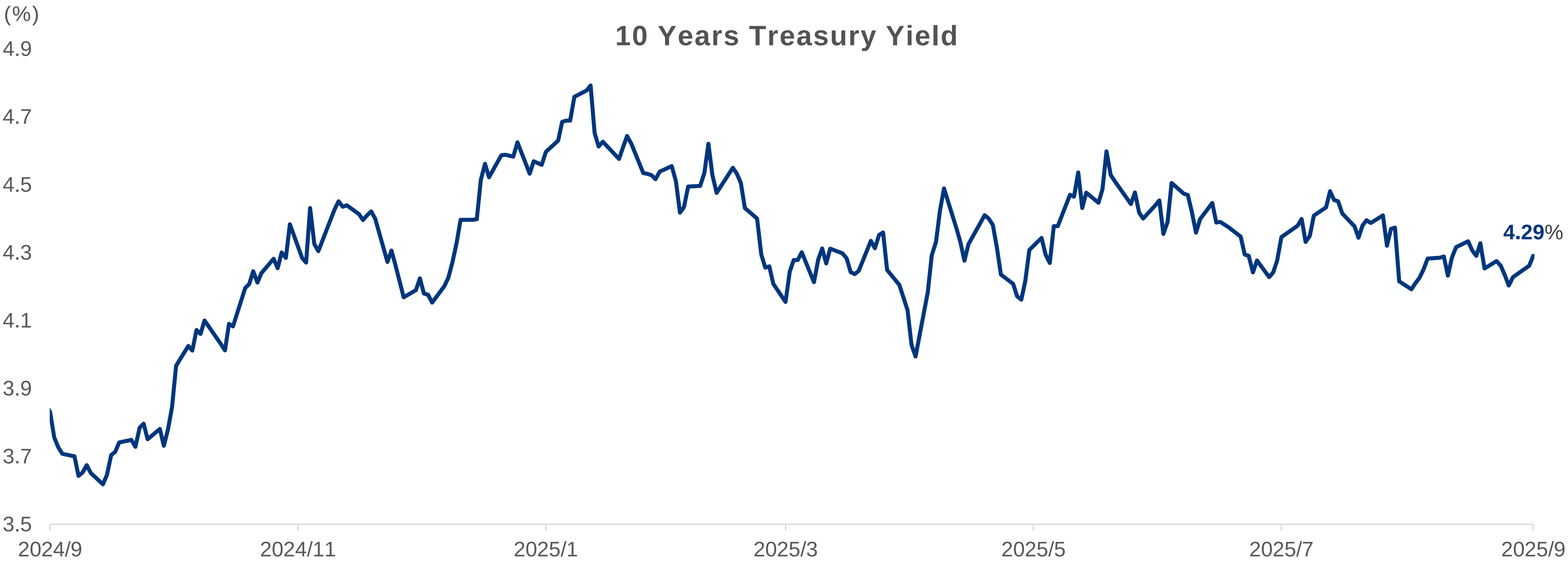
US Treasury at a Cross-Road

5 September 2025

Beyond Rates Expectation, What Drives the Long-Dated Treasuries?

Inflation, Fiscal and Governance

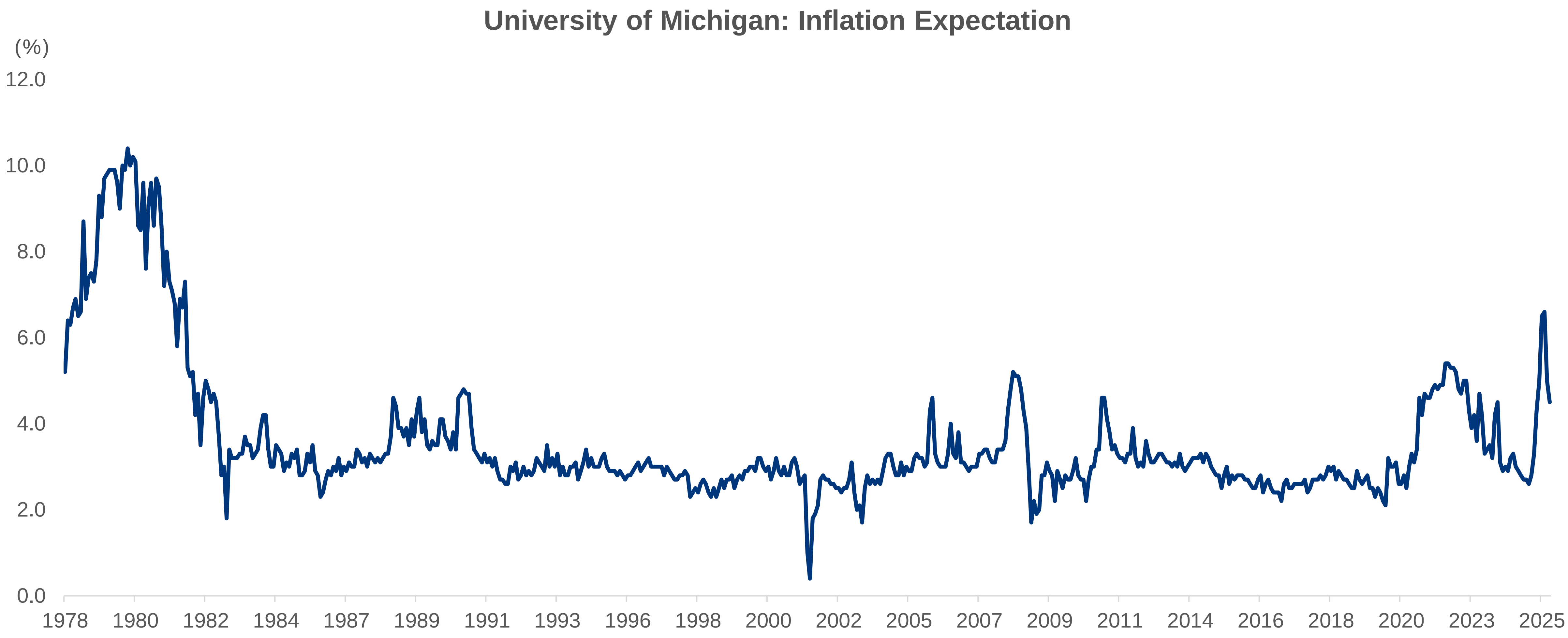
The US 10-years has been hovering at 4.2% - 4.5% for the last few months when the short yields are declining on rate cut expectation. The bond market is confused. What is the driver?



Source: Bloomberg, KGI

Inflation Expectation Is Coming off From Its Peak

It Is Still at Relatively High Level Assuming the Economy Is Still Running at Constant Pace



Source: University of Michigan via FRED®, KGI

Tariff Is Taxation and Taxation Is Contractionary to the Economy

Inflation Risk Under a Contractionary Economy Could Potentially Be Overestimated

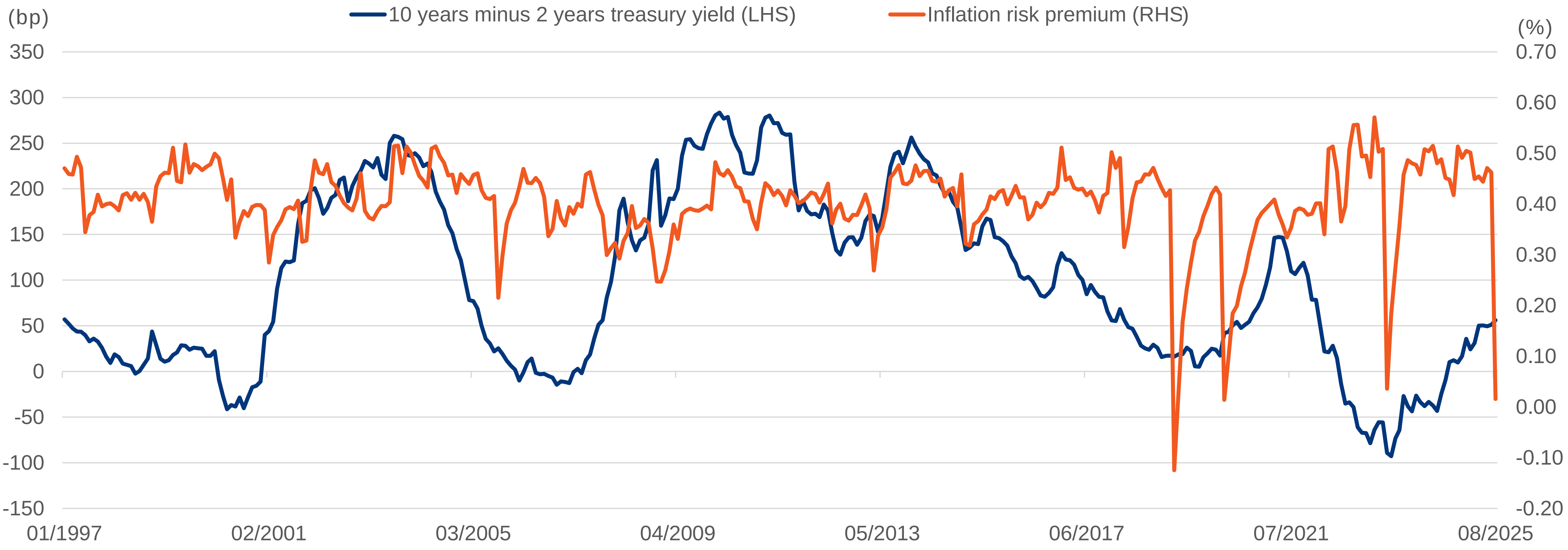
	Assume 100% tax pass-through to consumer		If producer is willing to eat the tariff by: US$10	
		Consumer's point of view		
	US$	**Before tax**	**US$**	
	50	**At a price of**	50	
	500	**Quantity demand**	500	
	25,000	**Total spending**	25,000	
		After tax		
	70	**At a price of**	60	
	357	**Quantity demand**	417	
	25,000	**Total spending doesn't change**	25,000	
		Producer's point of view		
	20	**Taxation**	20	
	50	**Producer's price**	40	
	70	**Total price**	60	
US$50x500	25,000	**Revenue to producer before tax**	25,000	US$50x500
US$50x357	17,857	**Revenue to producer after tax**	16,667	US$40x417
US$20x357	7,143	**Tax revenue**	8,333	US$20x417
	7,143	**Consumer paid**	4,167	US$10x417
		Producer paid	4,167	US$10x417

Source: KGI

The Risk of Deviation From Downward Inflation Expectation

The Steepening of the Yield Curve Is Hard to Be Justified by the Inflation Fear

The 10-year inflation risk premium (IRP) is the extra yield investors require on a 10-year nominal bond to compensate them for the risk that inflation will deviate from their expectations over that 10-year period.



Source: Bloomberg, KGI

Tariffs Is Major Source of Revenue to the US Government

The Concern on the US Fiscal Deficit Should Be Alleviated Which Is Positive to the Long-Dated Treasuries

Projections of tariff revenue from different bodies

	US$ trn 2026-2035 Tariff revenue forecasts
Tax Foundation Estimates	2.3
Congressional Budget Office	3.3
The Budget Lab at Yale	2.7
Penn Wharton Budget Model	5.2
Average	3.4
Actual revenue to 28 August (US$ bn)	183

- Our estimates of the tariff revenue could be simplistic but the estimates by different non-partisan bodies does highlight the previous concern on fiscal deficit is inaccurate.

Projection from CIO Insight 11 Jul 2025

	US$ trn
US import in 2024	33
Average tariff rate	15%
Tariff revenue	4.95
Tax cut from 'Big Beautiful Bill'	4.10
Net revenue to the US government	0.85
Tariff revenue per year (US$bn)	850

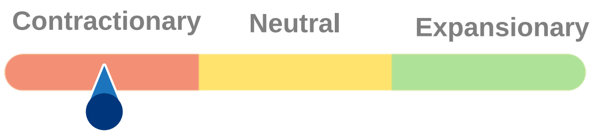
- The bottom line as we highlighted in July was that the fiscal deficit resulting from the passing of the “Big Beautiful Bill” will be largely be offset by the tariff revenue
- The worry in the treasury market about the unsustainable fiscal debt of the US was grossly overstated

Source: Tax Foundation, Congressional Budget Office, The Budget Lab at Yale, Penn Wharton, KGI

US Austerity in Disguise

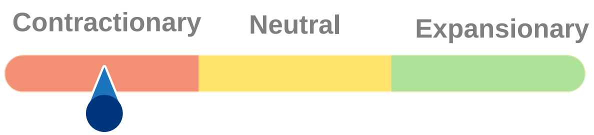
Make America Great Again = Restoring US Budget Imbalance

Consumer Spending



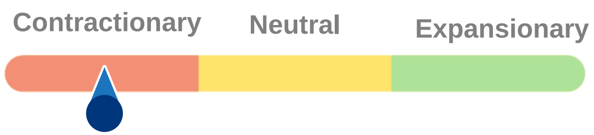
1. Higher prices due to tariffs
2. Demand contracts
3. Importers' profitability decrease
4. Less corporate investments

Federal Spending



1. Cutting of government spending
2. Cutting of social welfare
3. Cutting of financial supports to allies

US dollar



1. Weak US dollar drives more expensive imports
2. Demand for import reduces
3. Cheaper US export
4. Improving trade balance

Source: KGI

Governance

This Is the Key Overhang for the So-Called Risk-Free Status of the US Treasuries

- **Financial markets have not fully priced in the risks** posed by Donald Trump's attacks on the Federal Reserve which could induce a loss of confidence in US government debt – according to a survey conducted by the Financial Times.

- In the poll of 94 economists based in the US and Europe, many feared the assaults would lead to a **permanent shift at the Fed towards prioritizing jobs** and lowering government borrowing costs once chair Jay Powell's term as chair ends next year.

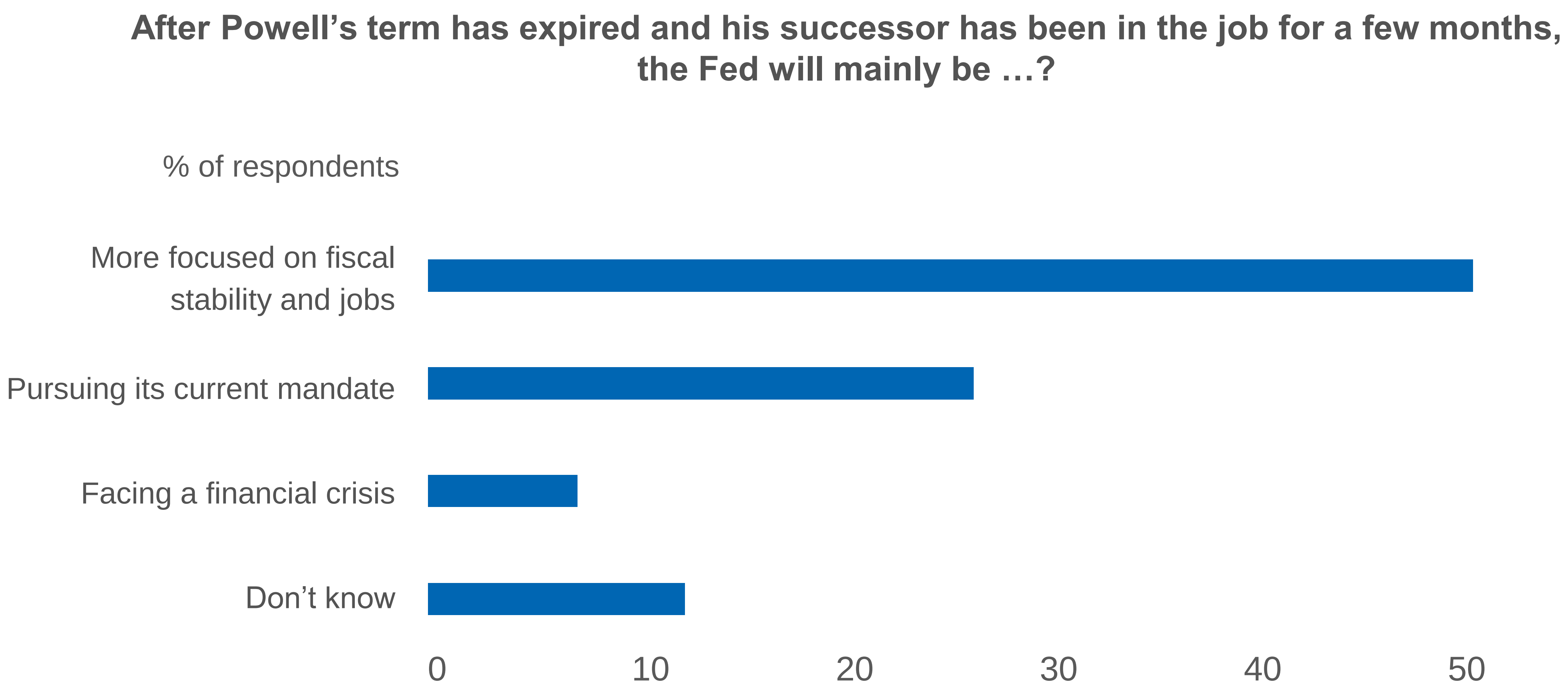
- More than a quarter of the economists fear that by the end of Trump's term in 2029, the Fed will **be unable to fulfil its mandate to set US borrowing costs free from political influence**, although 45 per cent think it is too early to tell in what shape the central bank will be by then.

- According to the survey, 28 per cent are cautiously optimistic, predicting that while the Fed's independence will be reduced by 2029, it will still be able to do its job.

Source: KGI

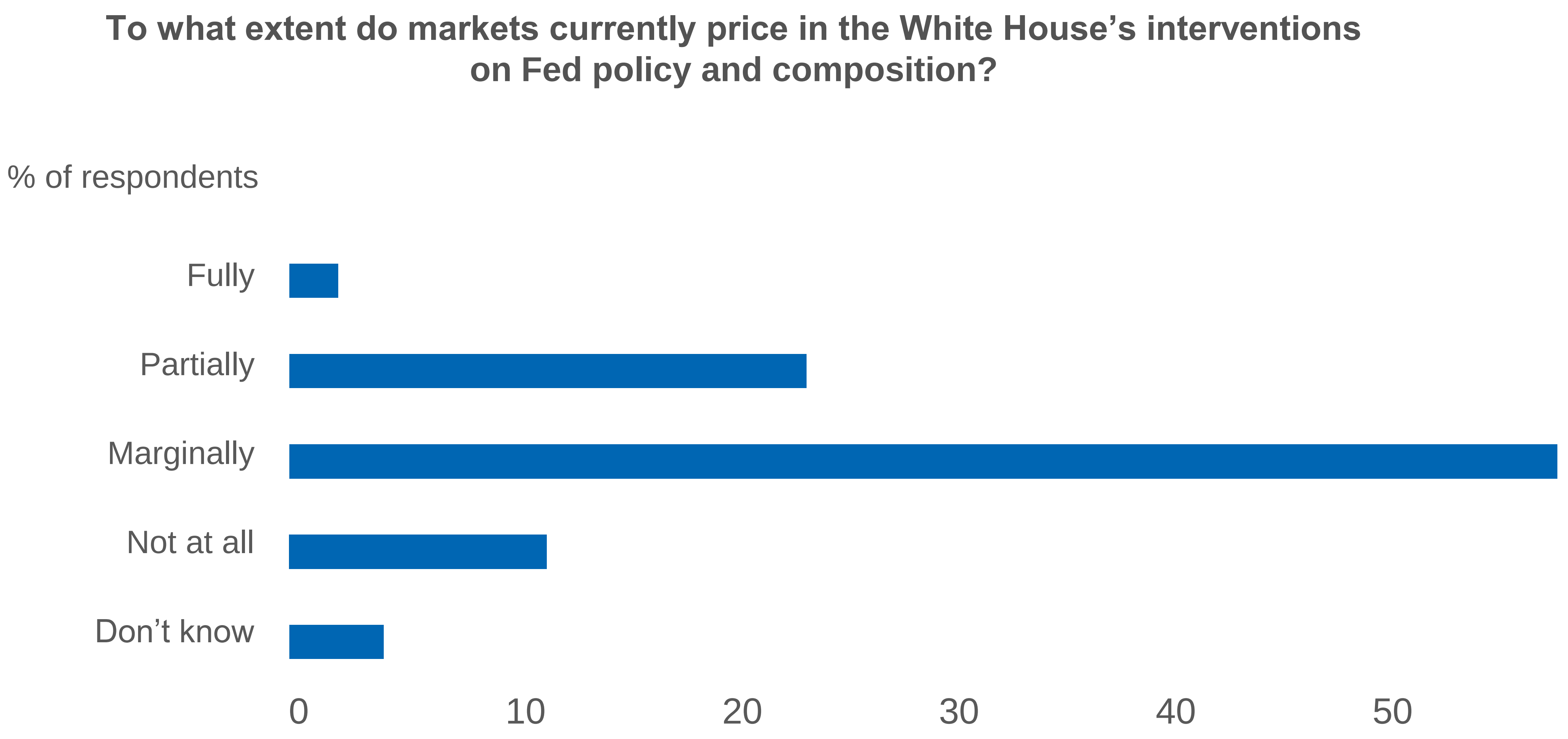
Fed Is Expected by the Majority of the Economists to Prioritize Jobs

This Runs the Risk of Interest Rates Being Pushed Down to Unnecessarily Low Level



Source: Financial Times, KGI

Most Economists Believe the Market Has Not Priced in This Risk



Source: Financial Times, KGI

If the Risk Is So Obvious, Why the Market Has Not Priced In?

- On the one hand, the Trump's administration will want to push down the borrowing cost. On the other hand, the risk premium of the entire US yield curve will be lifted up. This could potentially offset most of the rate cut efforts, if this is proven to be unnecessary.
- Rate-cut induced US dollar weakness is manageable and calculatable. Loss-of-confidence induced US dollar weakness will be out of control. In order to restore the order in the US dollar, rates might have to be raised again.
- 77% US government debts are less than 7 years. Refinancing risk is high and it cannot risk a potential sharp rise in risk-premium.
- Trump's administration style – TACO. Talk big and results are always questionable.

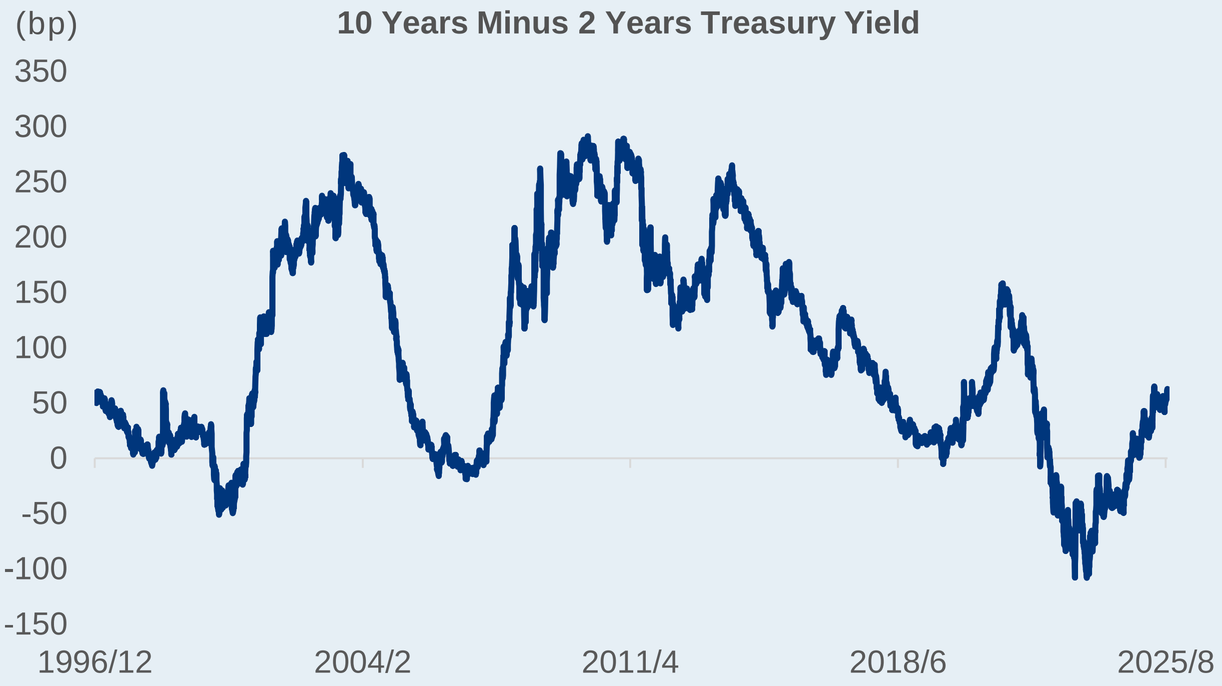
Source: KGI

The Notable Yield Curve Steepening Over the Last 28 Years…

They All Happened During a Crisis. The Current Steepening Is Different – Its All Driven by Fear

- Given the rapid credit spread contraction in the IG corporate debts, we recommend investors to shift weights to US treasuries in the space of 7-10 years which offers better relative value.

- To buffer any potential downside risk in case the governance risk materialize, we recommend the Link note structured products for investors to gain exposures to the US treasuries.



Source: Bloomberg, KGI

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