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STRATEGIC PARTNERS

Market Narrative Brief

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RISING LONG-TERM YIELDS AND INVESTMENT IMPLICATIONS

The rise in long-term bond yields has been making headlines lately. As shown in the first chart, 30-year government bond yields have increased over the past year in several regions. In the US, the increase is about 80 basis points (bps), while the most significant rises are in Japan and the UK, at 118 and 111, respectively, as shown in the second chart. Although there are some common themes, subtle differences are worth noting. Overall, uncertainty is growing related to debt levels and inflation, which is contributing to a rising term premium and putting pressure on long-term rates.

DEBT SUSTAINABILITY

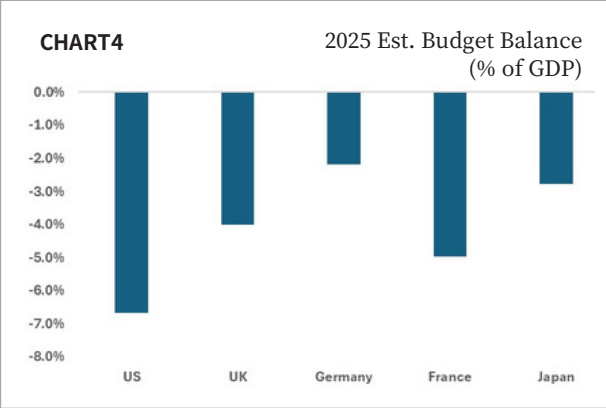
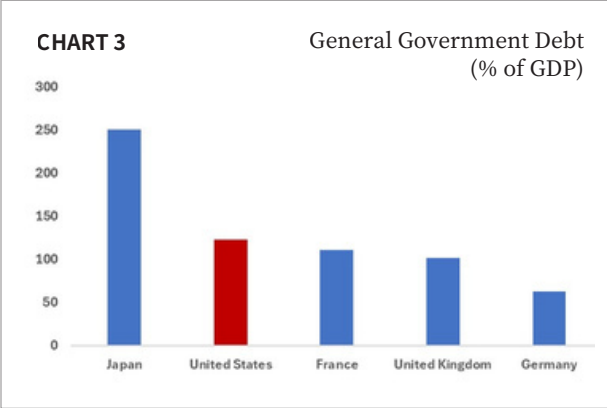
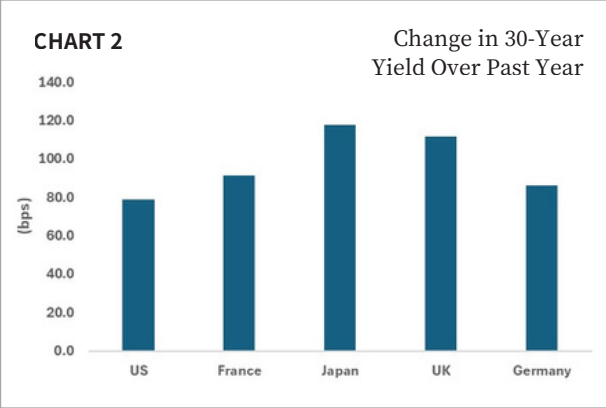
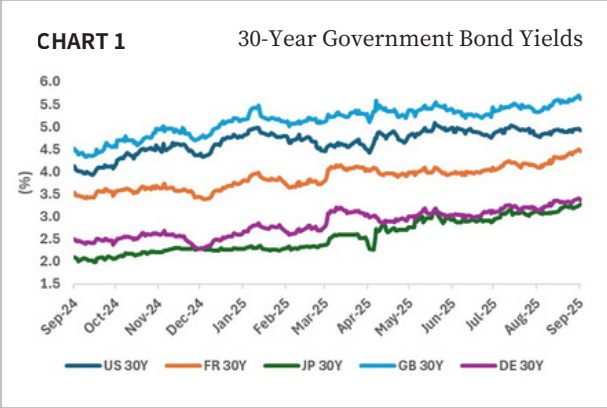
Rising debt levels and persistent large budget deficits in the developed world are becoming an increasing concern. The third chart shows Japan as the outlier in terms of general government debt to GDP; however, most of its debt is internal, making it less vulnerable to external “bond vigilantes.” Instead, Japan’s story has been one of improving growth and inflation that significantly exceeds the Bank of Japan’s (BoJ) 2% target. With monetary policy extremely loose, markets are pricing in an eventual shift by the BoJ toward more sustained tightening. Besides Germany, the US, France, and the UK all have debt levels exceeding 100% of GDP, with the US leading at over 120%, followed by France at 110%, and the UK at 100%. France and the UK face political instability as they try to balance the need for reforms to reduce debt while avoiding excessive hardship for their citizens. Although the US faces similar issues and has significantly larger projected budget deficits for 2025, as shown in the fourth chart, the US dollar being the world’s reserve currency has helped keep the rise in US long-term yields more controlled compared to other countries. Still, with the judicial system striking down President Trump’s use of the International Emergency Economic Powers Act (IEEPA) to implement broad tariffs, with the case likely headed to the Supreme Court, uncertainty has increased regarding roughly \$250 billion in annual projected tariff revenue that would offset spending, and is also adding pressure on longer-term yields in the US. For Germany, it’s partly due to its association, since being part of the broader Euro area means its yields will be correlated with those of its neighbors, despite having better budget conditions.

INFLATION

Specifically in the US, inflation remains sticky, and tariffs are not helping. While the Federal Reserve’s (the Fed) preferred inflation measure at about 3% is 100bps above its target, which is itself concerning, consumer expectations for inflation next year seem entirely out of sync with reality at 4.8%, nearly 300bps above the target. In other words, inflation uncertainty is also contributing to the rise in long-term rates.

INVESTMENT IMPLICATIONS

For U.S. investors, we believe short-term yields will decline as the Fed cuts its policy rate; however, the trend at the long end is less certain, but we see a reasonable chance of rising term premiums, which could keep long-term rates high. Therefore, in such environments, our preference is to maintain a yield-curve steeper by overweighting short-duration and underweighting long- duration fixed income assets. Additionally, focusing on the 0-2 year segment of the curve to maximize gains from falling yields, while floaters also make sense to protect against rising yields. Finally, holding some inflation protection through Treasury Inflation-Protected Securities (TIPS) is sensible, given that inflation is likely to stay above target over the tactical horizon.



Source: YCharts for Charts 1 and 2 (both as of 9/3/2025), IMF for Charts 3 and 4 (both based on IMF April Fiscal Monitor).

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