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Strategic fixed income investments: Navigating opportunities amid tariff turbulence

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The Trump administration's recent activity around global tariffs has significantly roiled the markets, elevating volatility to levels not seen since the global pandemic. The increased uncertainty is impacting businesses and consumers, and fixed income markets are not immune. To seek some clarity around market turmoil, we asked three of Franklin Templeton's senior fixed income investment professionals to provide their perspective.

Key takeaways

- Markets are seeking a more coherent explanation of tariff policy and a more strategic approach toward implementation from the Trump administration. Until then, we expect volatility to persist.
- Technical factors alone do not really explain why bonds and the US dollar have been behaving strangely for several weeks. Part of the explanation is likely that international investors might be changing how they view the United States in a global context.
- Recent concerns have emerged that China could retaliate against Trump's tariffs not only through tariffs of their own, but also by offloading some of its US Treasury holdings and devaluing its currency. While there is no direct evidence that China has taken this action, this likelihood has underscored the risks of a trade war escalating into financial market stress.
- From a spread and yield perspective, high-yield markets have shown resilience in the face of instability.
- The front end of the fixed income curve has experienced significant spread widening, reaching the widest level in almost two years. We believe investors selling short high-quality paper to meet outflows is largely driving this volatility, along with dealers' reluctance to hold short-term paper, exacerbating the spread movements.
- The two-year Treasury has been rangebound between 3.5% and 4%, with a brief spike above 4% following the tariff announcement. Despite compressed spreads, recent widening has brought valuations to a fairer level, and we believe the market remains stable on the front end of the curve.
- Despite the volatility, the spread widening may be viewed as a buying opportunity, particularly for high-quality issuers impacted by the selloff. Companies with strong balance sheets and durable capital structures could do well.
- We believe the market may be overestimating Fed-easing expectations. Coming into the year, the market was anticipating one or two interest-rate cuts, and now it is three. We think this is too high. We anticipate rates remaining around 4.5%.
- The municipal bond market appears more resilient to the impact of tariffs, and credit quality is often underestimated. For example, when you consider the more idiosyncratic credits like seaports or airports, many have very diverse revenue sources, making them less vulnerable to tariff-related shocks. In addition, municipalities have maintained elevated levels of "rainy-day" funds since the pandemic.
- The municipal bond market has repeatedly faced threats to its tax-exempt status, but these proposals typically fail due to the strong lobbying power of municipalities and the critical role they play in infrastructure funding—essential for rebuilding America.
- The importance of maintaining liquidity in portfolios cannot be overstated.

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