Q3 2025
Global Economic Perspectives
from the Desk

Macro Market Trends: Impact of Evolving Structural Forces

Today's global financial environment is shaped by the following major themes: heightened geopolitical tensions, concerns around public debt sustainability and loose fiscal policies, investor sentiment on asset allocation in USD-denominated assets, and uncertainty about the short- and medium-term impacts of tariffs on inflation. Western Asset CIO Michael Buchanan examines the broader macroeconomic implications of these developments with the Firm's key macro decisionmakers and offers insights into how investors might best approach portfolio construction given this backdrop.

Western Asset CIO Michael Buchanan, CFA

KEY TAKEAWAYS

- Diversification away from the US dollar and US assets is not a new phenomenon. The reallocation to non-US assets has intensified since "Liberation Day."
- As central banks have gradually increased reserves in gold and other non-USD currencies, the euro, Swiss franc and Chinese renminbi are emerging as key beneficiaries.
- The persistent relative strength of the US economy over the last several years has led investors to overweight US holdings relative to their long-term asset allocation strategies. However, the potential improvement in eurozone growth, the rise of China as one of the world's largest economies and opportunities in emerging markets (EM) have prompted investors to seek opportunities for diversification away from a heavy US bias.
- The trend of diversifying away from US assets reflects, among other factors, growing concerns over the impact of US trade and defense policies on the future valuations of US assets; however, the US fixed-income and equity markets remain the largest and most liquid worldwide.
- Global inflation rates fell dramatically as Covid-induced supply chain disruptions dissipated and short-term energy price volatility moderated. Despite higher tariffs having some impact on goods prices, longer-term inflation expectations remain well-anchored. Policymakers generally expect inflation to trend toward central banks' respective targets within their forecast horizon. As a result, we expect volatility in short-term government bond yields to wane.

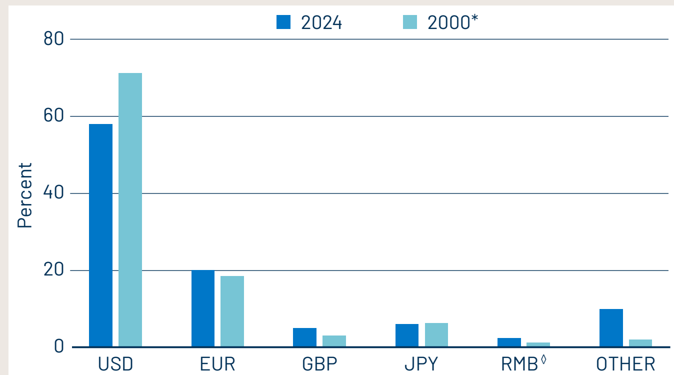
OVERVIEW

US government policy has caused heightened volatility in global financial markets as US President Donald Trump looks to reshape global trade dynamics and instill an "America first" attitude among US citizens. Reports suggest that the recent government policy-induced volatility has led to a decline in demand for US assets. In Western Asset's view, recent market dynamics need to be viewed in a wider context.

1. The US dollar has strengthened for the last 20+ years, during a time when the US economy was particularly resilient and outperformed much of the rest of the world.
2. As the US dollar strengthened and US equity markets outpaced other markets, investors became increasingly overexposed to the US. Consequently, we're now seeing some rebalancing.
3. With globalization, and particularly China's increased footprint in the global economy, we have seen a diversification away from the US dollar. For example, China's investment in Africa and the mining industry has increased the desirability of the Chinese renminbi, one of the main beneficiaries of this diversification pattern.

Some central banks have been diversifying foreign currency reserves into gold, given concerns about sanctions on foreign currency reserves in the wake of Russia's 2022 invasion of Ukraine. Short-term uncertainty due to US trade and fiscal policies has undoubtedly caused concern among investors, but Western Asset does not believe that this represents a seismic shift in attitudes away from the US dollar and US assets. The US dollar continues to be the main currency of foreign reserves, and US financial markets remain the largest and most liquid. These factors are not likely to change in the coming months. Positive rhetoric about trade negotiations should help uncertainty subside. Short-term US inflation expectations have spiked due to US trade policy posturing and changes. However, longer-term US inflation forecasts remain anchored and suggest a belief that inflation will return to the Federal Reserve (Fed) target.

Exhibit 1: Foreign Currency Reserve Holdings as a % of Total



Source: IMF COFER, Bloomberg, Western Asset. As of 31 Dec 24.
** RMB data is for 2016. ◊ Prior to 2016, RMB data was included within "Other."*

GLOBAL PERSPECTIVES

UNITED STATES

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Portfolio Manager

Many factors currently shape the US Treasury (UST) market, including persistent inflation, widening fiscal deficits and rising global trade tensions. At the same time, the concept of "de-dollarization," or the idea that foreign investors will reduce their holdings of US assets, has emerged. Longer-dated US interest rates have risen and the yield curve has steepened, prompting debate about the drivers and sustainability of these trends.

April 2, dubbed "Liberation Day" by President Trump, marked a key turning point. New tariffs were set in motion, and the historical correlation between 10-year UST yields and the US dollar deteriorated. This led to speculation that foreign investors were selling USTs and reallocating into other currencies or alternative assets like gold and Bitcoin. As real-time data on foreign holdings is limited, this narrative is difficult to confirm. Another factor is the recent outperformance of non-US equities, which has prompted reallocations away from US assets. This has exerted downward pressure on the US dollar and potentially contributed to the decoupling of yields and the US dollar.

Long-End Volatility and FX-Hedged Yields

Since April of this year, 30-year yields in major developed market (DM) countries have risen and become more volatile. While some suggest this reflects "de-dollarization," the data indicates that the foreign exchange (FX) hedged yield advantage of USTs has largely disappeared. Even among Japanese investors, whose domestic yield advantage remains, as Japanese government bond (JGB) yields have risen in tandem with US Treasuries, there is little evidence of a major shift of capital from the US to Japanese bonds.

Who Holds US Treasuries?

Ownership of USTs has evolved: while foreign holdings surged during globalization, their share has declined post-Covid as UST supply expanded. Households and the US financial sector have absorbed much of the new issuance, but as foreign investors still hold about 33% of marketable USTs, it is important to monitor their behavior. Our view is that foreign investors are not actively selling USTs but rather allowing shorter-dated bonds to mature and reinvesting proceeds elsewhere. Most foreign holdings are concentrated at the front end of the yield curve, with little evidence

UNITED STATES
continued

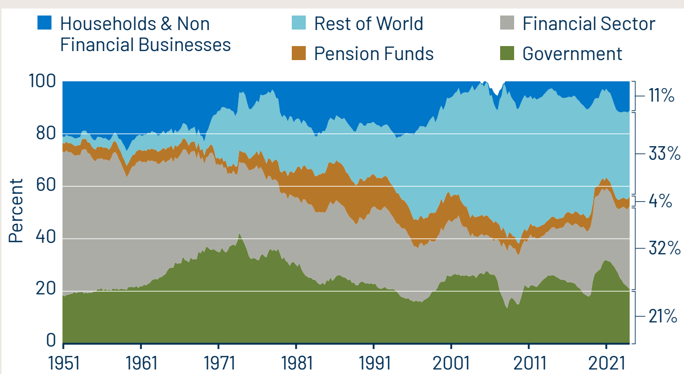
of large-scale selling of longer-dated bonds. Major holders like Japan and the UK have maintained or increased their positions in recent years, while China's reported decline may be offset by shifting holdings to Belgium via Euroclear.

Foreign participation in 5-year UST auctions has declined but remains stable in 30-year auctions. US domestic investors have filled the gap in shorter maturities. Given the bias of foreign investors to hold shorter-maturity USTs, waning foreign participation at 5-year auctions supports our hypothesis that foreign investors are letting bonds mature and reinvesting proceeds elsewhere rather than being active sellers. We would argue instead that the rise in yields is linked to an increase in the term premium or the extra yield investors demand for holding long-term bonds. This has risen since post-Covid lows, with estimates suggesting a rise of between 2.0 and 2.5 percentage points to +0.75%. We would also note that the term premium remains below historical averages, reflecting ongoing uncertainty but not extreme risk. The US seizure of Russian assets in 2022 is regarded by many as a potential watershed moment in the story of demand for UST assets. Other countries now know that the US has the potential to "weaponize" holdings of USTs, which could mean that the rest of the globe will continue to look for ways to diversify reserves.

Short-term inflation forecasts have undoubtably risen due to the anticipated economic impact of tariffs. The impact of tariffs on inflation is a one-off hit rather than a persistent increase. Short-term uncertainty remains high, but longer-term expectations of inflation remain anchored, in our view, and should not limit the Fed's capacity to ease monetary policy from its current restrictive stance. Investors' long-term inflation expectations align with this thesis and suggest confidence that US inflation will return to the Fed's target.

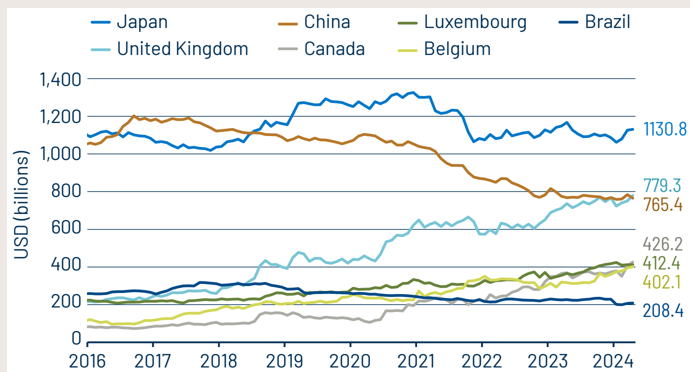
Despite headlines about de-dollarization and foreign selling, there is little evidence of a disruptive exit from the UST market. The rise in yields is driven more by domestic factors—persistent inflation, fiscal uncertainty and a higher term premium—than by foreign flows. The US dollar remains the dominant reserve currency, and while gradual diversification continues, the long end of the UST curve still warrants caution given ongoing uncertainties.

Exhibit 2: US Treasury Ownership Since 1951



Source: Federal Reserve Flow of Funds, Bloomberg, Western Asset. As of 31 Dec 24. Percentage may not sum to 100% due to rounding.

Exhibit 3: Foreign Holdings of US Treasuries



Source: Treasury International Capital (TIC) Reporting System, Bloomberg, Western Asset. As of 31 Mar 25.

EUROPE

Richard A. Booth
Portfolio Manager

Early 2025 marked a turning point in market optimism toward the US relative to the deeply pessimistic view on the eurozone. Initial concern arose in reaction to a feared reduction in US support for Ukraine, highlighting the need to increase defense spending markedly across Europe. The soon-to-be German Chancellor Friedrich Merz seized the opportunity and moved to secure further defense spending and a €500 billion infrastructure package combined with some dilution of very strict German debt restrictions. This was remarkable for the fiscally austere Germany. The euro rallied, German bund yields jumped close to 3% and eurozone risk assets outperformed their peers. With the past two years' average budget deficit in Germany running at 2.6% and a debt-to-GDP ratio of 62.5%, the fiscal impulse was deemed large but acceptable.

The scale of the so-called "Liberation Day" tariffs sharply increased the likelihood of a US recession and quashed lingering pro-growth aspirations that had supported the US dollar and US assets in 4Q24. Volatility rose and risk assets underperformed, yet the US dollar did not rally. Tariffs are not a positive for European growth with the near-term impact being much more negative than the slower-moving infrastructure benefits. Lower energy prices, a feared excess of global consumer goods dampening domestic pricing power and a stronger euro have helped contain both forward-looking market-based inflation expectations and have anchored survey-based expectations close to the European Central Bank's (ECB) 2.0% target.

In aggregate, the eurozone owns €7.2 trillion of portfolio investment assets in the US, according to 4Q24 ECB International Investment Position statistics; €4.6 trillion in equities and €2.6 trillion in fixed-income. Equity

EUROPE
continued

investment rose sharply in 2H24, even accounting for valuation and FX translation. Some flow back into the eurozone given better relative growth prospects makes sense. From a fixed-income perspective, the German fiscal package is seen as a manageable necessity, whereas the current US spending bill adds further to the budget deficits which have run at -6.3% over the past few years, with a total debt-to-GDP ratio of 121%. There seems a clear bias from the US administration to reduce the trade deficit. Should the tariff path prove too costly, economically or politically, the onus may move toward US dollar weakness and/or policies aimed at lessening the appeal of the US as a destination for overseas capital. Both scenarios pose questions for eurozone holders of US assets. Direct investment into the US from the eurozone is clearly welcome (i.e., opening a factory as opposed to buying a US company) and this will act as a counterpoint, yet on a much smaller scale.

The near-term weaker economic outlook for the eurozone is predicated on tariffs—the scale, scope and timing of which remain in flux—and the eurozone response, should higher tariff rates come to fruition. The uncertainty will likely hamper growth and investment on both sides of the Atlantic in the near term. As we move into 2026, however, the fiscal stimulus tailwinds will likely strengthen, the impact from higher policy rates should fade and lower energy costs can all potentially support industry, as should capital inflows. From a portfolio perspective, investors could consider reducing eurozone duration, adding to credit and holding a modest overweight to euro or FX pairs with a high beta to eurozone growth.

JAPAN

Hiroyuki Kimura
Head of Investment Management, Tokyo

The short-term impact of tariffs on Japan's economy is clearly negative. The Bank of Japan (BoJ) lowered its outlook for growth and inflation for 2025 and 2026 at the May monetary policy meeting and noted that risks to the economy and inflation were expected to be on the downside. The pace of growth is expected to slow as overseas economies are slowing and profits of Japanese firms are pushed down, mainly due to the trade policies of each country. Regarding inflation, the effects of higher import prices and the rise in prices of food products, such as rice, will be waning, and the slowdown in the pace of growth will exert downward pressure on inflation. The outlook for underlying inflation was unchanged, however, against the backdrop of structural labor shortages. The BoJ is expected to continue tightening monetary policy due to a structural inflationary environment and normalization from the current accommodative financial conditions. However, due to concerns about downward economic pressure and inflation due to tariffs, the next rate hike will likely be postponed. We expect additional rate hikes at the end of the year and into early 2026.

There was a remarkable rise in 20-year JGB yields and significant steepening of the yield curve in May. The move was driven by:

- Concerns about the BoJ being "behind the curve" against the backdrop of a delay in additional interest rate hikes due to tariff impacts on the economy.
- Increasing concerns about expansionary fiscal policy such as consumption tax cuts ahead of the July upper house election.
- Deterioration of the supply/demand environment for super-long JGBs as demand from life insurance companies declined.

There were concerns that a rise in JGB yields would also drive US bond yields higher. In addition to worries about the potential selling of US assets triggered by Trump tariffs, there were concerns that Japanese investors could make a significant shift from US bonds to JGBs. Contrary to these assumptions, however, flow data shows that Japanese investors bought foreign bonds, investing ¥4,645 billion ($32 billion) over the six weeks spanning April 21 to May 30. In other words, there has been no confirmation of the feared repatriation of investment to Japan as Japanese investors' optimistic outlook for US and European bonds remains intact due to the expectation of additional interest rate cuts. On the other hand, if concerns about persistent fiscal expansion increase and the optimistic outlook for US and European bonds recedes, it is highly likely that Japanese investors will then move to repatriate. In the meantime, our view is that fiscal discipline in major Western countries will be critical.

AUSTRALIA

Anthony Kirkham, CFA
Deputy CIO & Head of Investment Management, Asia Pacific

In Australia, the impacts of the Trump administration tariff policy introduced on April 2 have been less disruptive than in most countries and regions where trade and manufacturing with the US is vital to growth. The fact that Australia runs a trade surplus with the US and arguably shouldn't be caught up by this policy speaks to the size of the direct impact. That's not to say it has zero impact—it is meaningful for businesses in the steel and aluminum sectors.

The indirect impact could be of greater concern. China is in the crosshairs of the policy, and a slowing of its economy could affect Australia. The breadth of its significance will depend on the extent of the tariffs, and on whether Chinese policies can successfully stimulate domestic growth and drive consumption.

The Reserve Bank of Australia (RBA) has successfully fought inflation. It took a more moderate approach to the post-pandemic inflation spike and appears to have achieved the goal of reducing trimmed mean (core) inflation without losing the gains accrued on the unemployment front. Prior to the pandemic, unemployment was at 5.1%; it is at

AUSTRALIA
continued

4.1% as of June 2025. At this juncture, few DM economies have unemployment rates 1% lower than where they were prior to the pandemic. The RBA's view on the tariffs is that in the medium term, the "tariff war" will be deflationary for Australia. While there could be some short-term inflationary impacts from supply-chain disruptions, high tariffs around the world mean less global trade, less global growth and ultimately lower prices. Therefore, the RBA sees current events as a drag on inflation, and we believe lower rates will follow. This is reasonable because Australia isn't broadly or directly impacted, as there is no direct push back on its companies to find other avenues to pass on costs. Also, product dumping from countries directly impacted to clear inventory is likely and is also deflationary.

The fiscal concerns shaping markets give great pause to long-term bond investors. After the post-pandemic inflation spike pushed yields sharply higher, investors have been obsessed about avoiding the next spike. Long-end bond auctions are now highlighted by market observers with scrutinized bid-to-cover and tails. The "Big Beautiful Bill" in the US only increases this scrutiny. The issue for Australian investors remains that despite the large differences in debt-to-GDP ratios between Australia and the US, of 50% versus 121%, respectively, the Australian 10-year bond, at least initially, was tracking higher with the UST 10-year bond. This correlation has reversed more recently. The 10-year government bond yield differential between Australia and the US was positive in mid-April; however, this reversed back into negative territory later in 2Q25 as Australian bonds outperformed their US counterparts. We haven't seen any global clients adjusting benchmarks to reduce their exposure to US bonds at the long end, but some are asking the question about their exposure as investment committees want to understand the risks. Hopefully, fiscal responsibility will prevail.

LATIN AMERICA

Wilfred Wong, CFA
Trader

The potential rotation away from US dollar assets presents a significant opportunity for Latin American markets. As global investors reassess their allocations amid US tariff uncertainties, Latin American fixed-income securities and currencies stand to benefit from capital inflows. This shift is already visible in the strengthening of several Latin American currencies versus the US dollar in 2025, with the Brazilian real and Mexican peso showing notable resilience despite domestic challenges.

The region's real interest rates—among the highest rates globally—provide an attractive yield differential compared to those of DM countries. Fading US exceptionalism and differing tariff policies may potentially weaken US growth prospects, while Latin American assets currently offer compelling value. Foreign ownership of Latin American local debt remains below historical averages, suggesting significant room for increased allocation as the rebalancing away from US assets accelerates.

Latin American central banks have demonstrated remarkable vigilance in anchoring inflation expectations. Many of these banks initiated tightening cycles earlier than their DM counterparts, and most regional central banks have successfully brought inflation under control. Brazil remains an exception, though its hiking cycle appears to be nearing completion as inflation pressures moderate.

The tariff environment creates divergent inflation impacts across the region. While US tariffs on Chinese goods could prove deflationary for most Latin American economies as China redirects exports to alternative markets, Mexico stands apart due to enacting reciprocal tariffs on Chinese imports to signal alignment with US trade policy. This regional divergence in inflation dynamics allows for differentiated monetary policy approaches as most central banks maintain a dovish bias.

The current environment supports several strategic positions for long-term investors in Latin America:

- **Duration exposure:** With declining inflation and as central banks pivot to easing cycles, local currency government bonds offer attractive total return potential.
- **Currency appreciation:** Latin American currencies, particularly those of commodity exporters with improved current account positions, should benefit from US dollar weakness and capital inflows.
- **Nearshoring beneficiaries:** Countries positioned to capture supply chain relocations—notably Mexico, Panama, Chile and Costa Rica—offer compelling investment opportunities in both sovereign and corporate credit.
- **Political transitions:** There is a political shift toward the center-right in Latin America. The upcoming electoral cycle (Chile in 2025; Colombia, Peru and Brazil in 2026) could drive policy shifts toward fiscal consolidation, potentially improving sovereign credit profiles. While near-term fiscal positions remain challenging in Brazil and Colombia, new administrations may prioritize fiscal discipline to enhance credibility with international investors.

While higher UST yields pose a risk, Latin American assets can outperform in an environment where US growth moderates without tipping into more than a mild recession. In our view, the combination of attractive valuations, improving fundamentals, and the potential for increased global allocations creates a favorable backdrop for Latin American fixed-income and currencies in this shifting global landscape.

ASIA (EX. JAPAN)

Desmond Soon, CFA
Head of Investment Management, Singapore

Asian currencies traded with a heavy tone versus the US dollar throughout 1Q25. However, Asia FX investors and market participants were shocked by the 9% appreciation of the Taiwanese dollar versus the US dollar over the first two days of May. While this outsized move could be attributed to a confluence of factors, including illiquidity, the significantly unhedged USD-denominated asset portfolios of Taiwanese life insurance companies and discussions on FX manipulating policies in Asia-US bilateral trade negotiations, the US dollar versus Asia FX downshifted significantly. The narrative moved to diminishing faith in the US dollar and US assets amid erratic and self-serving policies under the Trump 2.0 administration. The US dollar/Asia FX downtrend was most pronounced in the economies of North Asia, which have large underhedged USD-denominated assets, and the undervaluation of Asia FX in current account surplus countries. This also led to the Hong Kong dollar trading to the strongest end of its undertaking band, necessitating the Hong Kong Monetary Authority to intervene to buy US dollars and inject Hong Kong dollar liquidity.

Asia local currency government bond yields have trended lower since the beginning of the year as UST yields remained range-bound. This divergence can be attributed to the lack of inflationary impulse in Asia ex-Japan (AsiaXJ) and concerns over the economic headwinds emanating from Trump 2.0 tariffs on Asia's export-dependent economies. The downtrend in AsiaXJ rates accelerated in 2Q25 as Asia FX strengthening provided headroom for central banks in Asia to cut rates. In North Asia, the Bank of Korea cut its policy rate, while the People's Bank of China guided its key lending rates lower. Central banks in Southeast Asia joined the rate-cutting cycle (e.g., Bank of Thailand). The Monetary Authority of Singapore, which uses FX policy, also reduced its band of appreciation to cushion its open economy from the tariff shock.

Unlike the US, AsiaXJ has seen a low inflation impulse. With the trade tariffs imposed on China, the diversion of cheap China exports to other parts of Asia could lead to further disinflation.

Our AsiaXJ portfolios are positioned with a significant overweight to duration to benefit from a continued decline in inflation and government bond yields. The strengthening of Asia FX provides headroom for central banks in Asia to continue their rate-cutting cycles. The downtrend in the US dollar versus Asia FX is intact and supported by fundamentals, particularly for current account surplus economies in Asia with significant net international investment position surplus. That said, Asia FX markets can be highly volatile on Trump-related news and the geopolitical economy rivalry between the US and China. Hence, we maintain a calibrated long exposure in Asia FX, focusing on the Singapore dollar, Malaysian ringgit and Indian rupee.

CONCLUSION

"The greatest risks we see right now are closely linked to the broader macroeconomic outlook, with the latest geopolitical tensions adding significantly to overall levels of uncertainty. These factors are driving volatility across markets, so we're keeping a close eye on developments and actively adjusting our portfolio positioning as needed."

— Michael Buchanan, CFA, *Chief Investment Officer*

US government policy has caused severe volatility in fixed-income markets over the last several months. Global growth is expected to slow given heightened unpredictability but should remain positive. US growth is downshifting due to a myriad of factors including tariff uncertainty, waning benefits from immigration and reduced government spending in recent years. A significant fiscal boost from European defense and German infrastructure spending should support eurozone growth and provide relief from tariff-related uncertainty. Deflationary pressures in China persist and confidence is weak amid property market concerns, but sentiment is improving with fiscal stimulus and policy easing. Overall monetary policy remains restrictive, and we believe that central banks will continue to cut rates. The Fed remains well positioned to provide support if the US economy falters. Public debt levels continue to rise and yield curves may steepen further given concerns over fiscal policies. While we retain a modest overweight to interest-rate duration, we are concentrated in shorter maturities and biased to select countries and regions such as core Europe and the UK. While fundamentals remain positive, spreads are at the tight end of historical ranges in some sectors and warrant caution. We will continue to look for further periods of volatility to add to spread risk.

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