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"Our deficit-reduction plan is simple, but it will require a great deal of money."

Earlier this month in Jackson Hole Wyoming, Jerome Powell, the chairman of the Federal Reserve, hinted strongly that an interest-rate cut was coming. When the monetary-policy committee meets on September 16th and 17th the Fed's rate (currently at 4.5%) is expected to fall by 0.25 or 0.5 percentage points.

Behind this position is disappointing data including slowing job creation. More, Congress has directed the Fed to target both full employment and stable prices. The trouble is that these two goals are now in conflict. Even as officials prepare rate cuts to support the labour market, inflation remains above target and shows worrying signs of becoming entrenched. The risk is that cheaper money will allow it to get out of hand once more, destabilizing markets.

Bondholders, especially of longer duration government debt, have been jittery for months. Among fund managers responding to Bank of America's latest monthly survey, 47% rank either "inflation prevents Fed cuts" or "disorderly rise in bond yields" as the biggest tail risk threatening markets.[1] Further evidence of investor concern is the price of gold, a classic hedge against inflation and general chaos, which has soared to an all-time high of over $3,600 USD per troy ounce.[2]

These two worries are linked. Any rise in America's enormous fiscal deficit, which is already 7% of GDP, risks fuelling inflation. Higher inflation, erodes the real value of bonds' coupons and principal repayments. Understandably, bondholders fear this scenario, and are beginning to price-in the probability that America's debt burden is so big that letting inflation rise is one of the few options available to tame its real value. The worse such fears become, the higher the odds of a disorderly rise in bond yields, with lenders demanding much more compensation for their risk.

This helps explain why over half the fund managers surveyed by Bank of America think the Fed's next chair will resort to quantitative easing or "yield-curve control" to ease the debt burden. These measures involve large-scale bond purchases using newly created reserves, suppressing yields. Plenty of rich-world central banks—including the Fed and the Bank of Japan—have done so when interest rates were near zero, to encourage growth and inflation when both were lacking. Doing so when inflation is high, with the aim of keeping borrowing costs artificially low, would risk prices spiralling out of control.

Markets create their own reality. Inflation expectations can become self-fulfilling, and so can a common belief that the bond market might crack. Investors who think others' fears might spark a sell-off will try to get ahead of the curve. If the herd follows, the sell-off would begin. All this being said, our view is that while this remains a possibility, the greater likelihood is that lower shorter-term interest rates will spur economic growth which will bring US deficits down enough to prevent runaway inflation. Higher government revenue from taxation is the inevitable result of a larger US economy (revenue from tariffs would help too).

This issue and more keeps us on our toes. But we have high conviction in our asset allocations that include considerable downside protection. We're remain, as always, eternally vigilant of Market risk -and eternally optimistic of the power of Markets to generate long term wealth.

Thanks for reading!

Martin

1-519-546-5088

Source: 1. The Economist (https://www.economist.com/finance-and-economics/2025/09/10/why-american-bondholders-are-jumpy-about-inflation)

2. Trading Economics (https://tradingeconomics.com/commodity/gold)

MARTIN WEILER, FINANCIAL ADVISOR
FIRST CAPITAL FINANCIAL / WORLDSOURCE FINANCIAL MANAGEMENT INC
50 CORESLAB DR. DUNDAS, ON L9H 0B2
P: 519-829-1331 F: 833-869-8042
MARTIN@FCFCORP.CA