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Seeking Certainty Amid Treasury Volatility

George Bory discusses reasons for the recent sharp price fluctuations in stock & bond markets, including in U.S. Treasuries, and identifies actionable approaches fixed income investors may pursue in today's environment.

Authors	Date	Topic
George Bory, CFA	4/16/2025	Market Events

Key takeaways

- Recent tariff-induced sharp price fluctuations in stocks and bonds have left investors questioning the safety and predictability of U.S. Treasury investments.
- With today's inflationary pressures and historically high Treasuries volatility, it's crucial to understand what forces are driving the market volatility.
- There are a number of actionable approaches bond investors can consider for increasing yield and broadening diversification in this environment.

The current state of the U.S. Treasury market
The U.S. Treasury market, often called the backbone of global finance, plays a major role in the U.S. government's borrowing—which currently sits at $36 trillion in outstanding debt. An estimated 25–30% of this amount is held by international investors.

However, the tariff-induced sharp price fluctuations in both stocks and bonds over the past several weeks have left investors questioning the once-reliable safety and predictability of Treasury investments. Today, with inflationary pressures squeezing returns and U.S. Treasuries experiencing historically high volatility, it's more crucial than ever to understand the forces driving these changes.

Why is Treasury volatility high today?
There are a few reasons for this turbulence:

- **Foundational issues**: Global demand for U.S. Treasuries is under question due to the rapidly changing landscape for U.S. fiscal and trade policies. That said, U.S. Treasuries remain the largest and most liquid bond market in the world, supported by the U.S. Federal Reserve and the full faith and credit of the U.S. government. In addition, about 60% of the world's currency reserves are held in U.S. dollars.
- **Cyclical issues:** The recent announcement by the U.S. administration to significantly increase tariffs creates a high degree of uncertainty in the economic outlook. Most expect growth to slow and inflation to rise in the near term, but the longer-term outlook is much less clear. U.S. Treasuries responded with lower yields at the front end of the curve (fears of slower growth) and higher yields at the long end (fears of higher inflation).
- **Technical issues:** The U.S. Treasury's substantial funding requirements today and in the future have created concerns about the market's ability to absorb continued issuance without additional volatility.

It's difficult to understate the significance of the U.S.'s evolving tariff and trade policies. U.S. Treasuries remain one of the world's highest-quality and safest investments, but they're not immune to price volatility. A mix of foundational, cyclical, and technical issues are all in play at the moment, resulting in elevated levels of volatility.

Investment themes for today's market

Income is your friend during periods of high price volatility in bonds, and duration diversification can help reduce the overall volatility in a portfolio. Here’s a breakdown of actionable approaches investors may pursue to increase yield and broaden diversification:

- **Position for a steeper yield curve**
  Short-term Treasuries offer enhanced liquidity and lower exposure to inflation risk compared with longer-term bonds. Allocating a portion of a fixed income portfolio here could help reduce volatility.
- **Consider mortgage-backed securities**
  Mortgage-backed securities historically have done well compared with other sectors of the bond market due to their relative insulation from Treasury-issuance challenges. These securities are backed by direct and implied government guarantees, offering a balance of stability and returns.
- **Focus on quality corporate bonds**
  Amid economic uncertainty, consider prioritizing investment-grade corporate bonds. The debt of companies in sectors like communications and health care is well positioned to potentially withstand increased inflationary and tariff pressures.
- **Diversify with municipal bonds**
  Explore the value being created in municipal bonds, which provide tax-exempt returns and remain attractive despite recent sell-offs. Keep an eye on opportunities in the intermediate range of the yield curve.

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