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Markets are not pricing a Trump-controlled Fed

- **Trump's political pressure on a key economic institution is raising concerns among economists and, to a lesser extent, investors.**
- **Political interference in monetary policy is likely to have significant economic consequences**
- **One would expect higher inflation expectations as well as higher long-term interest rates as the term premium rises**
- **So far, markets have remained relatively calm despite the ongoing attacks on the Fed**
- **However, we judge that markets are underestimating the impact this situation may have (and is already having) on the economy and market rate expectations**
- **This is also happening against the background of high fiscal deficits and a coming sure in the supply of Treasury securities**
- **Given the deteriorating fundamentals, we think markets are now essentially "priced for perfection," discounting scenarios where US Treasury yields could rise significantly**
- **As a result, we remain bearish on US rates and expect higher term premium, driving long-term bond yields higher and a steeper yield curve**

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Introduction

Since the re-election of President Trump, democratic institutions have been shaken in the US. Outside the normal fear of losing a piece of democratic power, the recent acts from the White House could also have tremendous effect on its economy and financial market. A notable example is Trump's decision to fire the labor statistic chief at the BLS, after disappointing employment statistics. In addition, Trump has intensified his attacks on the Fed's board (as discussed in a previous note). After sustained pressure on Chair Jerome Powell, attention has now turned to Fed Governor Lisa Cook, with allegations of mortgage fraud and calls for her resignation. Although a recent court ruling rejected Trump's attempt to dismiss Cook, the mere effort by the White House to target a member of such a critical economic institution should raise concerns. With Waller and Bowman quite openly aligning with Trump's monetary policy wishes, another governor slot would lead to four out of seven board governors blatantly supporting Trump's wish to cut rates, and some might go further in supporting Trump's policy wishes.

The last US president who was able to influence the Fed was Richard Nixon, who leant on Arthur Burns, then chair, to lower interest rates ahead of the presidential election in 1972. It was a calamitous move. Inflation rose even before the oil shock of 1973, and took another decade to contain. Such an event should serve as a cautionary tale—one the markets would be keen to avoid. However, the current market response suggests otherwise. Markets appear largely indifferent to political pressure on the Federal Reserve, failing to take these risks seriously. In our view, this is concerning, as President Trump is unlikely to change his approach unless pressured by the bond market.

In this note, we examine the potential consequences of Trump "taking over" the Federal Reserve and the implications for the trajectory of US interest rates. A dovish shift in the Fed's stance would lead to more monetary policy easing in 2026 than may be warranted,. This could also partly explain the extent of rate cuts currently priced in by market. However, the loss of the Fed's independence would have far-reaching consequences beyond near-term policy adjustments. In the short

term, a more stimulative monetary policy would likely drive inflation and inflation expectations higher. If investors lose confidence in the Fed's commitment or ability to control inflation, longer-term interest rates could rise significantly, posing risks to economic stability. In the long-term, the US would face significant economic instability with monetary policy ill-aligned with the business cycle, easing depending on who's in political power, rather than what's best for the economy.

Market Confidence in the Fed is essential to maintaining stable US Rates

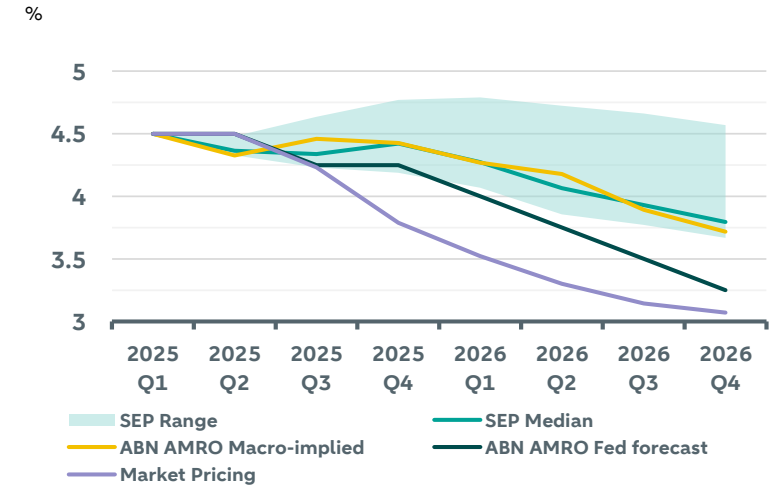
The influence of the executive branch on the Federal Reserve's monetary policy extends beyond the increase in the US term premium. It also goes deeper into the core of US interest rates. Indeed, several studies have already acknowledged the impact of political pressure on market-implied Federal Funds rates.

Multiple papers documented that Trump's attacks on the Fed during his first term affected market perceptions of monetary policy. A National Bureau of Economic Research (NBER)[1] working paper, which conducted an analysis using high-frequency data, investigated the effects of President Trump's 2019 tweets criticizing the Federal Reserve on market expectations for future monetary policy. The study found that such criticism reduced expected Federal Funds futures rates and short-term interest rates. Interestingly, the effect appeared to intensify over time. Initially, market reactions to Trump's tweets were muted but as the pressure on the Fed persisted, the effect became stronger and began to filter through to long-term market rate expectations—impacting expectations for up to nine Federal Open Market Committee (FOMC) meetings in the future. This suggests that markets were slow to react at first but grew increasingly sensitive to ongoing political pressure, reflecting a growing acknowledgment of its influence on monetary policy.

These findings imply that financial markets do not view the Federal Reserve as being fully independent of the executive branch.

In conclusion, isolating the specific impact of Trump's influence on bond yields is no straightforward task, as much of this effect is likely embedded in market-implied rates. The fact that political pressures are already priced into market rate expectations poses a broader problem: markets are increasingly diverging from macroeconomic fundamentals, as evidenced in the graph below. This misalignment suggests that any future market correction may be sharper and more abrupt than it otherwise would be if markets were less reactive to political pressure and more grounded in economic fundamentals.

Market pricing diverging from macro fundamentals



Source: BBG, ABN AMRO Group Economics.
Note: SEP = Summary Economic Projections from the Fed

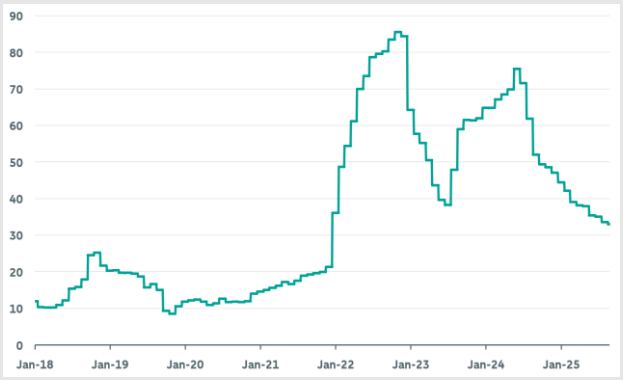
[1] https://www.nber.org/system/files/working_papers/w26308/w26308.pdf

Lessons from Turkey: The Economic consequences of losing central bank independence

The implications of a central bank losing its independence can be contextualized through examples like Turkey, where political interference in monetary policy significantly impacted yields and macroeconomic stability. Between 2019 and 2021, Turkey saw repeated changes in central bank leadership under pressure from President Erdoğan, who believed higher interest rates caused inflation. In 2019, Murat Çetinkaya, then governor of the CBRT, was dismissed for resisting rate cuts despite high inflation. His successor, Murat Uysal, implemented rapid rate cuts but later was removed after eventually tightening the policy. Naci Ağbal, appointed to restore credibility, raised rates sharply to combat inflation but was dismissed after just four months in March 2021. This triggered a 15% lira depreciation in a single day and a spike in 10y bond yield from 14.06% to 18.89%, which peaked at 25.72% by June 2022. Inflation soared from 16.70% at Ağbal's dismissal to 85.50% in October 2022.

Inflation in Turkey hiked after CBRT failed to tighten...

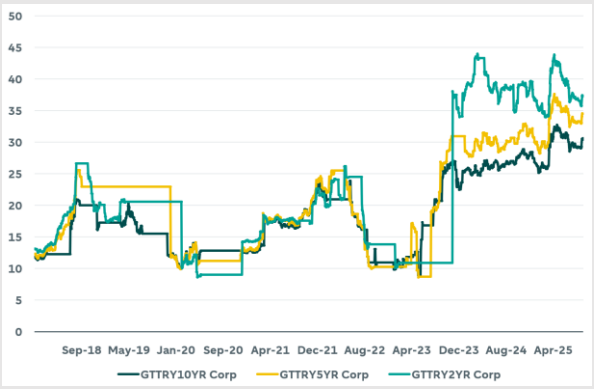
Inflation, %



Source: Bloomberg, ABN AMRO Group Economics

... while bond yields rose reflecting policy risks

Yield, %



Source: Bloomberg, ABN AMRO Group Economics

Rising yields reflected not only leadership changes but also policy missteps, such as rate cuts in late 2021 despite inflation exceeding 20%. This eroded investor confidence, prompting foreign capital outflows and higher yields as investors demanded greater returns to offset inflation risks.

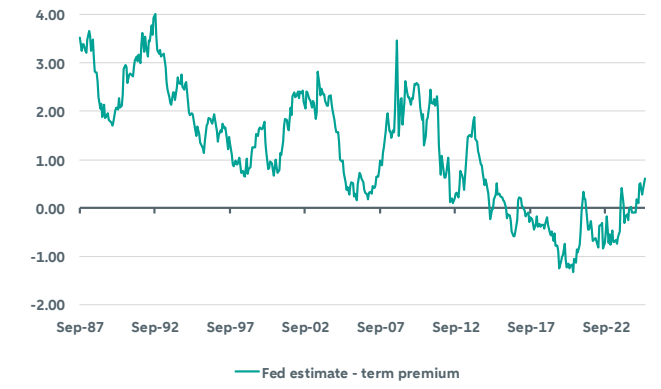
Is market pricing this risk at all?

There are several ways to assess how markets are pricing the risk of a less independent Federal Reserve. One direct approach is to examine the US term premium. As illustrated in the graph below (on the right), there is evidence of a higher premium being priced into long-term bonds. The 10y and 30y bond yields have begun to diverge slightly from short-term market rate expectations (measured here by the 1y rate 3y ahead), which usually serve as the key driver of bond yields. The divergence suggests that although markets are pricing in additional rate cuts along the forward curve, long-term bond yields are not declining proportionately due to higher term premiums—particularly in the 30y segment of the yield curve. We see a similar picture when looking at the US term premium estimate of the Fed, where it has indeed been trading upward since the re-election of Donald Trump.

Having said that, despite this upward trajectory in both nominal bond yields and the term premium, those are still minor moves compared to how the fundamentals are unfolding. The US term premium is still trading well below its historical average and remains under 1%. By contrast, other developed economies have experienced a faster and stronger rebound in their term premiums, despite having stronger economic fundamentals than the US. Let's remember that the US runs a fiscal deficit closer to 7% of GDP, three times as high as in Nixon's day, and that debt-to-GDP stands at around 100%, and is expected to continue rising. Compounding these fiscal challenges are concerns about weakening democratic institutions and the potential erosion of credibility for the Federal Reserve, the country's most crucial economic institution.

US term premia is rising but remains historically low

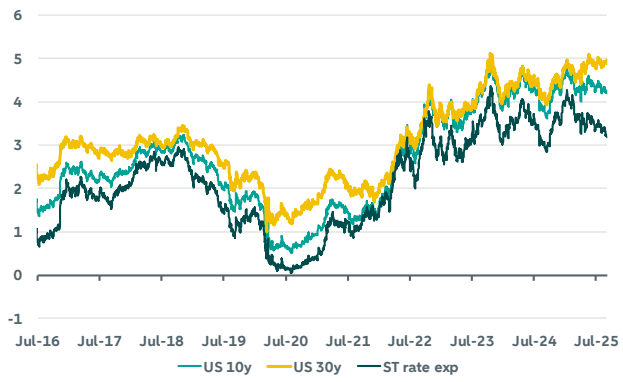
US term premium, %



Source: Federal Reserve, ABN AMRO Group Economics

US LT rates not falling to same extent that market rates

Yield, %



Source: Bloomberg, ABN AMRO Group Economics

Now, turning to a different approach in evaluating the market's stance on the Fed's credibility, we decomposed the 10-year nominal bond yield using the Fisher equation as follows:

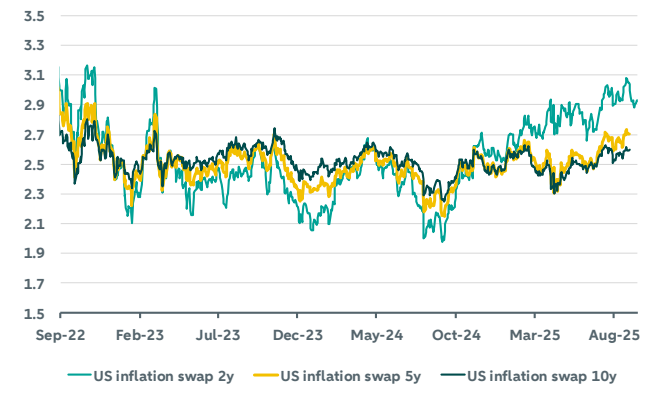
Nominal Bond Yield = Real Rate (reflecting market-implied trend growth and debt supply)
+
Breakeven Rate (reflecting market inflation expectations)

What we know from theory and practice is that when there is a perceived pressure or a lowering of the degree of central bank independence in a country, typically expectations about inflation increase. In such scenarios, households and forecasters anticipate higher future inflation, which should translate into higher breakeven rates.

Currently, however, market-based inflation expectations remain well-anchored and have only increased marginally in the short-term (for instance in the 2-year maturity), as shown in the graph on the left below. This short-term rise may be attributed to economic factors, such as the pricing of tariff-related inflation effects, rather than concerns over central bank credibility. Based on those observations, we can conclude that the market has begun to timidly price in a higher term premium in the US, but it does not yet fully reflect a loss of the Federal Reserve's credibility.

Short-term inflation is coming up...

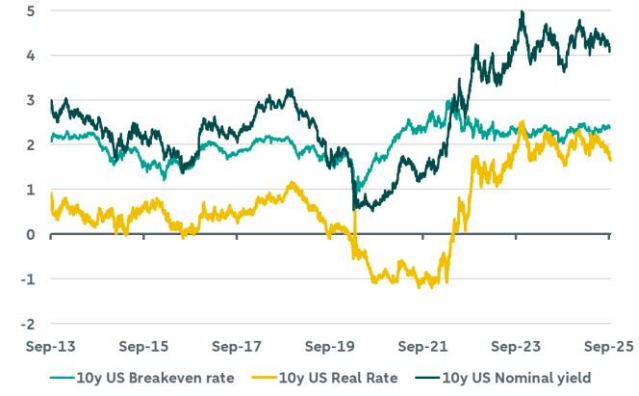
Inflation swap rates, %



Source: BBG, ABN AMRO Group Economics

... but LT inflation expectation remains well anchored

Yield, %



Source: BBG, ABN AMRO Group Economics

In our view, the markets are not priced for a Trump-controlled Fed. Broadly speaking, US assets continue to show resilience—stocks remain near all-time highs, US treasury yields remain well behaved, and US credit spreads are at historically tight levels. Despite risks being skewed towards higher US Treasury yields. So, why are markets so calm?

In our view, two reasons could explain this:

1) The battle for control over the Fed is far from over:
President Trump still faces numerous obstacles before he can gain full control of the Federal Reserve. While the probability of interference is rising, it is fair to say that we have not yet reached a point where the Fed's independence is compromised, nor where Trump is in control of its policies.

2) The questionable role of the TACO effect:
Another explanation often cited by market participants and international commentators is the so-called TACO effect. However, we believe this argument is flawed. For the TACO effect to materialize, markets would first need to push back against Trump's political behavior. Trump's habit is to keep pushing until he meets resistance.

Even if a complete Federal Reserve takeover is not the most likely scenario, the president's ongoing antagonism toward the central bank could still inflict significant damage. His actions have the potential to influence markets in profound ways, as discussed in the previous section.

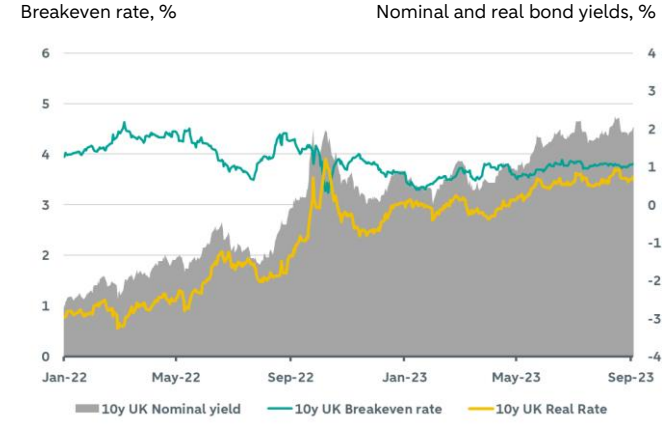
How bad can it get?

Let's consider a hypothetical scenario in which the Federal Reserve loses its credibility. What would this mean for the trajectory of US interest rates? To explore this, we can revisit the mini-budget crisis in the UK in September 2022 and decompose UK nominal bond yields evolved during the "Liz Truss moment" with the 10y yield increasing by more than 150bp over the September month.

Markets were reacting to fiscal policy stimulus, which typically drives the real rate. The real rate historically serves as the market's implied neutral rate and reflects both the country's trend economic growth and supply-demand imbalances. In this case, the fiscal policy was perceived by the market as stimulative, leading to expectations of increased bond supply that would need to be absorbed.

Interestingly, while the real rate rose, the breakeven rate did not increase. On the contrary, it actually declined and UK inflation expectation collapsed. This suggests that, despite the market's loss of confidence in the government's fiscal policy, investors retained trust in the Bank of England's monetary policy. If the market believes that a central bank will act decisively to maintain price stability, inflation expectations can remain anchored even in the face of fiscal uncertainty. In this instance, tight monetary policy was expected to bring inflation under control.

UK mini-budget crisis led to a spike in a real bond yield



Source: BBG, ABN AMRO Group Economics

UK inflation expectation collapsed during budget crisis

Source: BBG, ABN AMRO Group Economics

Now, imagine a situation where the US experiences both a fiscal stimulus shock and a simultaneous loss of market confidence in the Federal Reserve's independence. In such a scenario, investors would demand inflation compensation, pushing up breakeven rates and thus potentially triggering a much larger sell-off in long-term bond yields than what occurred in the UK in 2022. This hypothetical situation underscores the potential severity of losing central bank credibility, as it could create significant volatility in financial markets.

Bearish US rates and steeper curve going forward

We notice a global long-term bond sell-off in the developed world, leading to sharp steepening of the yield curve, especially on the 5s30s area. The US is not immune to it, as shown in the graph below, but the steepening trend in the US remains relatively moderate despite its macroeconomics and political fundamentals deteriorating and showing much worse situation than in Europe. Particularly when looking at the 2s10s spread, the term premium in the 10y area appears to be lagging. As emphasized earlier, the US 10y is partly pressured downward due to short-term market rate expectations falling.

Ultimately, the front-end of the curve will remain low as a low policy rate would automatically force short-term rates to come down as the Fed is forced (politically) to cut rates. However, the longer-end of the curve will be the area where higher term premium will be reflected.

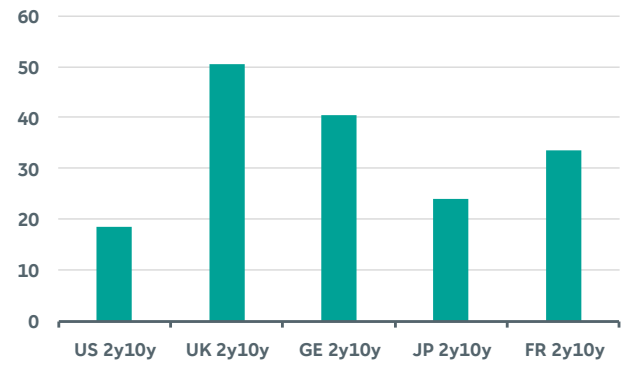
US 30y most under pressure by market ...

Spread, bp (ΔYTD)

Source: BBG, ABN AMRO Group Economics

... while 10y area remain relatively untouched

Spread, bp (ΔYTD)



Source: BBG, ABN AMRO Group Economics

As shown above, market is already aggressively pricing rate cuts for the Fed with three rate cuts seen in 2025 and 150bp priced for 2026. This implies a terminal rate now projected to fall below 3%, all while the market does not foresee a recession and expects inflation to remain close to 3%.

Furthermore, given the deteriorating fundamentals discussed earlier, we judge markets are now essentially "priced for perfection," and are not discounting scenarios where US Treasury yields could rise significantly. Markets appear to assume an ideal outcome where inflation subsides, growth remains stable, and monetary policy operates smoothly—leaving little room for adverse shocks.

From a portfolio manager's perspective, we would prioritize positioning at the front end of the yield curve while maintaining an underweight stance on long-term bonds. Unless one expects the Federal Reserve to cut rates significantly below 3%, the potential for gains from holding long-duration positions appears rather limited at this time. Additionally, a curve steepener strategy presents an attractive opportunity as we approach 2026 and the rate-cutting cycle progresses.

US Rates Forecast	Now	2025Q3	2025Q4	2026Q1	2026Q2	2026Q3	2026Q4
Federal funds rate-upper	4.50	4.25	4.25	4.00	3.75	3.50	3.25
IOER rate	4.40	4.15	4.15	3.90	3.65	3.40	3.15
2y Treasury	3.51	3.65	3.75	3.65	3.50	3.35	3.30
5y Treasury	3.58	3.75	3.90	3.80	3.65	3.55	3.50
10y Treasury	4.02	4.25	4.35	4.40	4.50	4.55	4.65
30y Treasury	4.64	4.85	5.00	5.10	5.25	5.35	5.55
Treasury 2s5s	8	10	15	15	15	20	20
Treasury 2s10s	52	60	60	75	100	120	135
Treasury 5s30s	106	110	110	130	160	180	205
Treasury 10s30s	62	60	65	70	75	80	90

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