Goldman Sachs The Markets

How Inflation and Fiscal Policy Are Driving Treasury Markets

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Mike Washington: This is The Markets. I'm Mike Washington. Today is Wednesday, August 12th, and I'm on the Goldman Sachs trading floor, joined by Mike Mitchell. Mike is the head of US Treasuries and Inflation Trading within Global Banking & Markets. Mike, it's great to have you.

Mike Mitchell: Thank you for having me.

Mike Washington: So, we're through the heart of earnings season, and I can tell you from the equities floor, there's been a material shift from the micro into macro. We had a CPI print this morning. To me, it looked like it was right down the fairway. What did you take away from the print?

Mike Mitchell: Yeah. The report was roughly down the middle. 21.5 basis points for core CPI, but the read-through, I think to core PCE was a little softer than that.

Specifically the software category has a bigger weighting in PCE than it does in CPI. That category was softer

today. And so most forecasters were revising their forecasts lower off the back of today's reading.

I think for the Fed, it should give them some comfort. They still have to get through a PPI report tomorrow without a big surprise to the high side. They have to get through another month of inflation data in September, and that's all ahead of the next meeting in September.

So the market reaction today I thought was appropriate. We had a little bit of a rally in the bond market. We had a couple of basis points shaved off of the September meeting, which is now pricing nine basis points. Given that you still have to live through several other inflation readings before you can be confident about that September meeting, that felt about right to me.

Mike Washington: Yes, we have to go through a couple inflation prints, but I think we also got to go through some employment prints, right?

If you think about NFP last week, NFP came in much weaker. How do you sort of think about this dual mandate in the sense that we have been focused on inflation, but do we now need to think about employment and maybe hiking isn't prudent at this time?

Mike Mitchell: Of course, there's a dual mandate. We had a soft report on the employment side last Friday, negative payroll growth for the first time in a little while.

If you look at a three-month or a twelve-month average rate of payroll growth both those numbers are in the context of sort of 20,000 or 30,000 jobs a month. So reasonably tepid job growth. But what I would also say is

that changes in immigration policy as well as an aging population, demographic changes, you don't really need much in the way of job growth to maintain a steady unemployment rate.

And if you look over the last 12 months, the unemployment rate has been almost perfectly unchanged. And so really I would say the job market is sort of not that interesting. It is not booming. Equally, it's not flashing warning signs about recession. It's not the focus of investors. It's not the focus of the Fed.

It was a soft report. I don't think that will be a significant driver of the upcoming meeting in September. And I don't think the labor market is the story at all. It's all about the inflation data.

Mike Washington: Okay. So it remains inflation is the focus. That's the monetary policy side.

When you think about the fiscal policy side, there's a lot going on there too. What are you focused on from a fiscal perspective, and how is it impacting Treasury markets right now?

Mike Mitchell: Yeah, the fiscal side, it has a lot of focus. We've been on a problematic fiscal path for some time, and we're likely to be for the foreseeable future.

And it's not just this country, it's a global phenomenon. It's been driving increasing term premium in the bond market. It's my view that it will continue to drive further increases in term premium in the coming years. It's an issue that's not going away. I guess there's a question of like will the Fed's response be something that could give comfort to longer term yields?

I think we saw in the aftermath of the July meeting, back-end Treasuries trade badly. That was in response to a more dovish press conference than the market expected. Chair Warsh also made some comments about longer term yield implying perhaps higher longer-term yields could be a substitute for raises in the policy rate.

The back end of the bond market didn't like that. So, I think you could see a shift from the central bank to a more hawkish reaction function that gave the back end some comfort. But that would be a little the opposite of what we saw in July.

Mike Washington: In addition to CPI data today, we also got a 10-year Treasury auction, which was actually the highest yielding 10-year Treasury auction since 2007. We get 30-year auction tomorrow. At these levels, how are you thinking about the supply dynamic as it relates to the US Treasury trade?

Mike Mitchell: Yeah. So the 10-year auction today, it was reasonably smoothly digested despite the high yield level that we have prevailing in the marketplace generally.

I think the smooth digestion today was probably helped by the CPI data being a little bit on the softer side and I think we could see a similar story play out tomorrow with the 30 year auction assuming we don't get a hot PPI print tomorrow. I think the comforting inflation data brings buyers off of the sidelines in the bond market, gives them comfort owning longer term duration.

So I, you know, I would expect base cases, we see a similar story tomorrow. But I think generally it is

certainly true that the amount of supply in the Treasuries market is very heavy. It has weighed on the bond market over a longer period of time. It has driven higher term premium in the bond market too.

And these will be ongoing themes. The market's very focused on the Treasury's need to increase auction sizes further in the coming years. It's clear that they will need to. We think when Treasury does that, it'll be focused, almost exclusively on sort of the front end and belly of the curve, uh, maybe out to the tenure10-year point.

We think they'll leave long in auction sizes as they are unchanged.

Mike Washington: When you talk about issuance and supply, the other thing that I think about as a key feature of 2026 has been supply in obviously Treasuries, but also in credit markets. As you think about tapping into debt markets to now build out AI as a thematic, how have the issuance that we've seen across credit spaces played into how you think about your trades in Treasuries?

Mike Mitchell: Yeah. There's clearly been an impact from the corporate supply backdrop on the Treasuries market too. The amount of supply that's come to market to support the AI infrastructure build-out has been quite impressive. We think it'll be upwards of $250 billion this year, perhaps as much as $400 billion next year.

And it's pointing in the same direction as the heavy Treasury supply, in the same direction as the longer-term fiscal issues that we already talked about. And so

it's another factor important to the Treasuries market too and pushing in the same direction as these other factors.

Mike Washington: Real yields are elevated.

How are you thinking about real yields from the perspective of maybe the short-term investor and risks that are inherently that the short-term investor will face, whether it's a hike in September or by the end of-- year-end, and then you overlay that with a long-term investor who looks at this and is like, "Hmm, some of these rates actually seem-- screen pretty attractive," maybe relative to equities or relative to other asset classes?

Mike Mitchell: Yeah. I think you framed the question well. You know, I think there's a short horizon, and there's a long horizon. Investors with a short horizon, there are clearly headwinds and things to be concerned about. The market is very focused on the Fed. Will they raise interest rates? If so, by how much?

And that, that's probably the biggest market focus currently. We talked about the fiscal outlook, we talked about the supply backdrop. These are all things that, in the near term, you know, make it feel hard to point to a catalyst for a big re-rating richer in longer term yields.

But with a long horizon, look at the market. You have real yields in the 10 sector that are almost 2.5%, in the 20-year sector more like 3%. If you look back at the TIPS market over a very long period of time, you know, those are historically elevated real yields.

If you go back to the global financial crisis between then and now, you really don't see any periods where those sorts of real yields were sustained for any meaningful

period of time. If you go back even further, before the GFC, you know, sure, the very early 2000s or the very late 1990s you had somewhat higher real yields for periods of time.

But I think, you know, the TIPS product at that stage was in its infancy. You probably had a illiquidity discount that was contributing to those yield levels. And so, we think that would suggest that there is value in these levels. The other thing I would note is that in a portfolio that has riskier assets too, I do think the treasuries provide a diversification benefit.

Maybe it didn't feel that way over the last couple of years when inflation has been a problem, and that can create a pro-correlation at times between treasuries and other riskier assets. But I think if you have a recession scenario where there's a growth shock, I think very clearly treasuries will provide a diversification benefit.

They'll perform well and sort of temper overall losses in a portfolio. So, for a product where you can earn what's now a pretty decent return and get that diversification or insurance benefit in times of stress, feels like a pretty compelling investment proposition.

Mike Washington: The treasury market in general sounds compelling right now.

If you had to package it up for us, what's the trade?

Mike Mitchell: The trade I like is the steepener. You know, I think that the front end and the belly of the curve, I think they fully price any likely action from the Federal Reserve. If not, you price, you know, a little bit extra. So I think that's an okay place to anchor along.

The back end, as we discussed, I think it will continue to experience rising term premium over time. It has longer term headwinds that we've discussed that, I think will continue to be present. And so I think that, you know, the big bang for the steepener, of course, is a recession scenario.

It's not that I think that is imminent or likely in the near term. So you get some tail that could come at some stage. And I think the grind is in your favor you know, anyway in the interim.

Mike Washington: All right, Mike, we talked about the inflation data points this week. What are you looking at next week?

Mike Mitchell: Yeah, PPI, as you said, very important still. We'll get more important source data for the PCE print. Notably the portfolio management fees, you know, go a long way to driving a wedge between PCE and CPI, and so we'll be focused on that. We have retail sales data on Friday.

Next week though, we're focused on the Fed minutes from the July meeting. You know, we're going to try to understand what the temperature in the room was, try to see if there's any read-through to how the committee might be thinking about the decision in September.

Mike Washington: Yeah. Awesome. Mike, this has been so insightful.

Thanks for your time.

Mike Mitchell: Thank you too.

Mike Washington: And that does it for this week's episode of The Markets. I'm Mike Washington. Thanks for listening.

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