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2025 Fixed-income outlook: Inflation is the wild card.

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When SEI's internal fixed-income team looks at the likely impacts as the new administration in Washington shuffles the deck on policy, municipal markets, and the economy, one thing stands out to us: inflation.

The wild card: Inflation

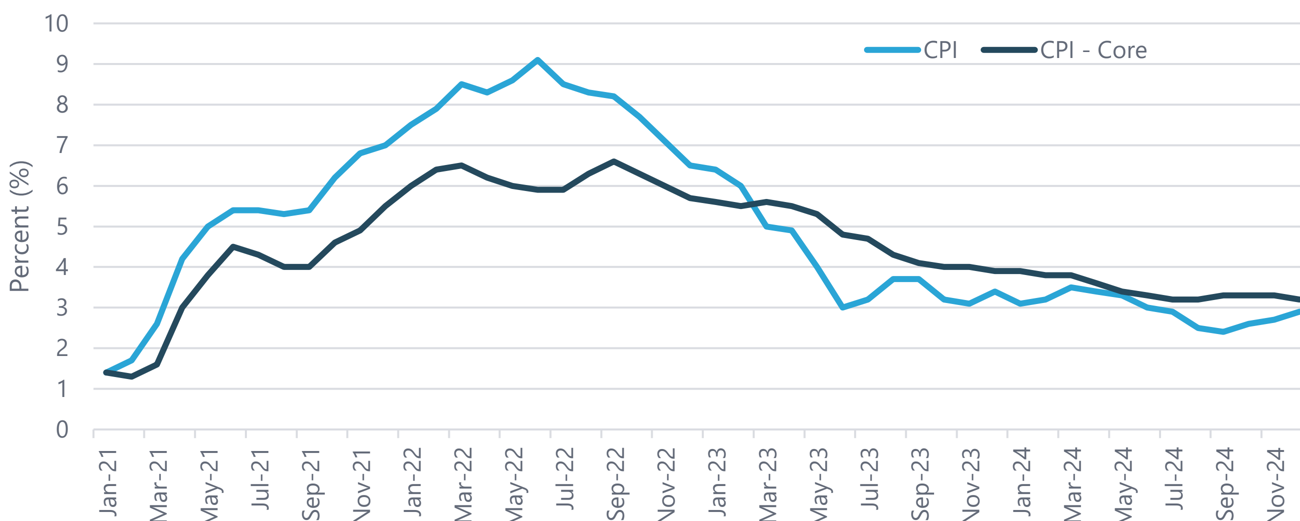
There are primarily two camps on inflation.

The first believes inflation will continue to fall, providing the backdrop for the Federal Reserve (Fed) to continue its rate-cutting cycle. Accordingly, investors were pleased by the recent decline in inflation, as registered by the December 2024 reading of the consumer-price index (CPI), which came in lower than forecast with a 3.2% rise year-over-year. Core CPI, which excludes more volatile food and energy prices, moderated slightly with a monthly increase of 0.2% after advancing 0.3% for four straight months. This easing from the recent highs—however slight—was welcome news to global bond markets as it opens the door to potential future interest-rate cuts (bond prices and yields are inversely related, so interest rate cuts increase the value of bondholders' portfolios).

The other camp remains adamant that inflation will remain sticky while wreaking havoc on consumers, interest rates, and the housing market. We're in the second camp. We believe investors and the Fed will likely have to accept higher inflation as the second Trump term begins.

Despite the recent decline in inflation, Fed officials clearly want to see more sustained progress in the inflation data before making additional rate cuts. They may have a long wait.

Exhibit 1: Year-over-year inflation



Source: Bloomberg, SEI, as of 12/31/24.

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The Trump card: Policy changes

A number of President Trump's policy initiatives—tariffs, stricter immigration policies, changes at the Food and Drug Administration, and pro-growth policies that include tax cuts, to name a few—are anticipated to be inflationary. These new inflationary pressures will combine with existing upward pressures of an already strong economy, the wealth effect of 2023 and 2024 returns from the equity markets, and still increasing wages. These policies will all make it difficult for the Fed to achieve a return to its stated 2% inflation target in 2025.

Of course, not all of Trump's policies are going to foster inflation. Pro oil-drilling policies, the Department of Government Efficiency, and support for artificial intelligence (AI) development should act as a partial counterbalance to the inflationary policies.

The Trump card: Municipal edition

The municipal bond market in 2024 was characterized by extremes. Similar to the U.S. Treasury market, we saw rates rise significantly with the most volatility coming in the shortest-maturity issues. A significant percentage of this volatility came from the supply/demand dynamics inherent in the municipal bond market. The expectation for 2025 is for another record year of issuance, with strategists calling for $490 to $550 billion of supply leading to a sizable net positive supply for the year (new issuance less coupons/maturities).

So what changes could the new administration in Washington bring? The most straightforward change to the municipal bond market would involve the general tax exemption. Simply put, the tax-exempt status of certain municipal bonds may be on thin ice with the ongoing battle between fiscal spending and fiscal restraint. If history is a guide, any changes would impact those securities that are issued after the tax change, and existing bonds will likely be grandfathered. The possibility of change could bring an influx of new debt to the market. While this potential scenario may carry a low probability, it is a possibility. The Trump administration may also look to place more onus on the states to keep their balance sheets in order with less reliance on the federal government.

From a portfolio management perspective, we anticipate significant buying opportunities given the expectation for positive supply and where we stand with overall interest rates. We expect that the best entry points will likely be in the spring and October simply based on projected supply. Tax-equivalent yields remain attractive on a long term basis.

The economy: An ace in the hole or a joker?

The U.S. economy continues to achieve impressive growth and could benefit from some of the Trump administration's initiatives. However, there are some concerns surrounding the economy. Housing activity is weak and looks to remain so with U.S. mortgage rates approaching 7%. AI will automate some workforces, and in some cases, rather quickly. A higher term premium in the bond market could keep not only the real estate market in check, but the economy overall. We will be closely monitoring economic reports this year.

Our view

Inflation remains our top concern as it has the greatest potential to increase market volatility. Government policy changes are coming; we will likely see immediate and significant changes within the administration's first 90 days. More changes could take place throughout the course of the year, but we expect to see rapid movement on key agenda items.

Looking globally, there is no doubt that 2025 will be challenging, exciting, and filled with potential opportunities outside of the U.S. Central banks will play a key role, as we will see a coordinated effort to lower interest rates across the major economies—excluding the Bank of Japan, which is in the early stages of monetary policy tightening. Even with the anticipated rate cuts, we believe interest rates will likely remain higher for longer. This is especially true of longer-term rates due to continued inflation concerns, solid economic growth, and the return of the term premium, all of which could pressure certain sectors within the fixed-income and equity markets.

We will continue to seek to position portfolios to benefit as we navigate the ups and downs of 2025.

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