12-16-25

WSJ Print Edition

Will Bonds Squeeze U. S. Middle Class?

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Sometimes a newspaper story's juiciest detail is buried way below the first paragraph.

The Wall Street Journal's exclusive interview with President Trump in the Oval Office on Friday was a bombshell for those following the race to become the next Federal Reserve chair. It's now a head-tohead contest again between the "two Kevins," Hassett and Warsh, rather than Hassett being the clear favorite.

A bit lower down, though, was a telling nugget: "Asked where he wants interest rates to be a year from now, Trump said, '1% and maybe lower than that.' He said rate cuts would help the U.S. Treasury reduce the costs of financing $30 trillion in government debt."

Note

Ever since the Fed began its many interventions during the financial crisis, the central bank has insisted that they in no way were meant to help Washington pay its bills. But last week, a day before the Fed meeting, noted bond investor Jeffrey Gundlach told clients continued rate cuts could be "an unspoken strategy" to lower the government's interest expense since overnight rates affect shortterm Treasury bill costs directly.

Trump saying the quiet part out loud didn't help ease jitters. The 10year Treasury yield jumped to the highest since early September, despite three rate cuts since then.

Rate cuts usually draw cheers. Political pressure to keep lowering them could be a triple-whammy for middle class Americans, though.

Slashing rates would eat into income on trillions parked in moneymarket funds and could worsen inflation. Meanwhile, longer-term bond owners getting spooked raises the cost of mortgages, corporate debt and the yields investors use to value companies. The result: a higher cost of living, more expensive housing and a headwind for stocks.

With interest on federal debt over $1 trillion—more than military spending—reducing the average 3.4% yield on marketable debt could be meaningful. Cuts could trim the federal interest bill by hundreds of billions of dollars.

Besides squeezing households, though, helping out the Treasury that way today would handcuff the Fed tomorrow since debt will just keep rising: Raising rates with so much short-term debt could imperil federal finances.

No wonder bond markets are nervous.

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Spencer Jakab

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