

# The Deficit is the Biggest Risk for the Bond Market, Says Matt Eagan of Loomis Sayles

"Inflation is in the system irrespective of tariffs. Tariffs just add to the fuel."

Jun 5, 2025 | by Leslie P. Norton

It's an unusually eventful time for the bond market. Prices have been roiled by the United States' trade war against the world, Moody's downgrading the country's credit rating, and a tax bill that stands to add trillions to the federal budget deficit.

These concerns aren't misplaced, and the growing deficit is unsustainable, posing a greater risk than tariffs, according to Matthew Eagan, a fixed-income veteran who runs the Full Discretion Team at Loomis Sayles. Eagan oversees funds including Silver-rated Loomis Sayles Investment Grade Bond LIGRX and Silver-rated Loomis Sayles Bond LSBRX. And even without tariffs, inflation is stubbornly rooted in the economy. What's a bond investor to do? "There's structural risk in bonds, but that doesn't mean you can't profit from managing that risk," says Eagan. For people averse to owning bonds, "the next steps will be easier," he says.

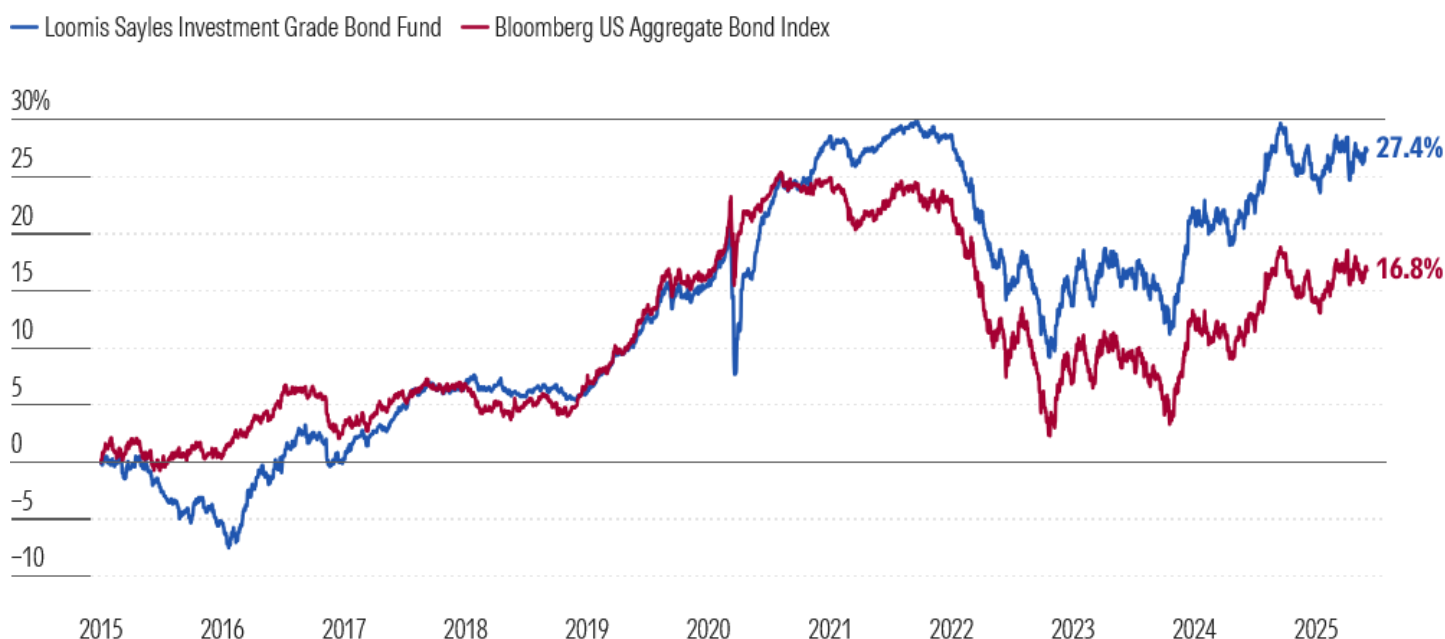
To learn more of Eagan's views, keep reading the condensed, edited excerpts from our conversation.

## Why the Budget Deficit is the Biggest Risk for Investors

**Leslie Norton:** Let's talk about what you call the core structural risk in the market today.

**Matthew Eagan:** The Treasury market underpins all other bond markets, and traditionally is the risk-free rate. Today, the structural risk is the fiscal deficit. A lot of people, including me, saw the subprime crisis coming. We didn't know how bad it would be. We're in a similar stage in that the fiscal deficit is not sustainable.

## Loomis Sayles Investment Grade Bond Fund Performance



Source: Morningstar Direct. Data as of Jun. 3, 2025.

Most people in this business have only seen, until very recently, a one-directional play in interest rates and a disinflationary world. Previously, you always wanted to be long duration and ride it. The key risks you face as a fixed income investor are twofold: principal risk and reinvestment rate risk. During that post-Volcker era that lasted 30-40 years, your chief risk was reinvesting at lower and lower yields. That got painful, especially at the end. What wasn't painful was maintaining principal.

**Norton:** How about today's market?

**Eagan:** It's the mirror image: higher highs and higher lows in yields for at least the next 10 years, underpinned by structural changes. One is demographics. Another is the decoupling between China and the US, and security concerns for these two global powers. Another is the massive investment boom in AI, in electrification, and climate solutions. A lot of these structural themes show up in the US fiscal deficit, including entitlements, defense spending, and industrial policy initiatives.

We're running a budget deficit of 6.4% of GDP. Over time, we're adding more debt. Historically, when a government does not balance its budget—or in the case of the US, get it down to a more manageable level—or when the tax base doesn't want to get taxed, then the other form of tax is inflation. You debase the bond market, the fiat currency, which is why gold and other things are sending a signal about the value of fiat currencies. This isn't just a US phenomenon. Other developed markets face these same structural issues.

## Preserving Principal in Bond Investing

**Norton:** How are you responding?

**Eagan:** Now, principal risk is more of a concern than reinvestment rate risk. The nice thing about being a bond investor is you can build your coupon now. In a nutshell, across all my strategies, I'm trying to achieve a higher level of yield while preserving principal. You do that through active investment management. A very basic strategy on this theme that some investors did back in the day was laddering out maturities. When one year came due, they reinvested on the yield curve at a higher yield.

The first big step in this series was in 2022, when we had a big spike in inflation. The reason it was so painful was that the starting carry [the income a bond investor earns from holding the bond over time] was too low, something like 1% on a high-quality portfolio of bonds. Carry can be a shock absorber, but not at 1%. The breakeven yield on the 10-year in 2020 was something like 10-20 basis points. So if yields went up by from 50 basis points to 60, your total return went negative.

Our duration management did pay off by ultimately protecting our investors' principal over the entire adjustment to yields. We succeeded in getting to the new, higher level of yields while preserving principal, which was our ultimate goal. It's a different story for the Bloomberg Aggregate Bond Index, which has yet to recover back to its high-water mark.

## Are Bond Investors Misjudging Inflation?

**Norton:** What do you say to people who don't want to own bonds?

**Eagan:** You're getting a positive, real yield. The next steps are going to get easier, meaning you won't have big drawdowns, because now you're getting 5% in a diversified portfolio. You can take more pain on the upward yield without losing principal. That's not something that's understood or thought about. There's structural risk in bonds, but that doesn't mean you can't profit from managing that risk.

Maybe you're not getting enough compensation in the very long part of the curve, the 10-30-year part. The market is still underestimating how much inflation is in the system for at least the next 10 years. To make it a better risk-reward, I think you should get 5%-plus on 10-years and 30-years.

**Norton:** What looks attractive on the yield curve?

**Eagan:** The 5-year is very nice. It's hard to lose money in a 5-year instrument over a full year. The 5-year yield can go up by 85 basis points or so. You're still going to walk away with at least breakeven. If you go out to five years, or seven for the more intrepid, you'll capture most of the return if yields were to come down. Or let's say inflation comes down and the 30-year rallies to 4.0% [it currently yields 4.9%], and you missed a 20% return. Oops. But you still capture a double-digit return in the five- and seven-year part of the curve. When I talk to financial advisors and similar investors, they say, 'I don't mind missing that opportunity.'

**Norton:** A moment ago, you mentioned a manageable level of debt for the US. What is it?

**Eagan:** [US Treasury Secretary] Bessent has talked about 3-3-3: 3% growth, a 3% fiscal deficit, and increasing daily production by 3 million barrels of oil. The 3% deficit is not an accident. That's the level you [need] to be the reserve currency of the world. You have to maintain a deficit. And you gain way more benefits as the reserve currency and the exorbitant privilege that goes with that. So a 3% deficit is sustainable and brings your 10-year yield back down to something like 3%, but 6%-7% is not, particularly if your interest costs go up and down.

### Will the Fed Cut Interest Rates?

**Norton:** What do you expect from the Fed?

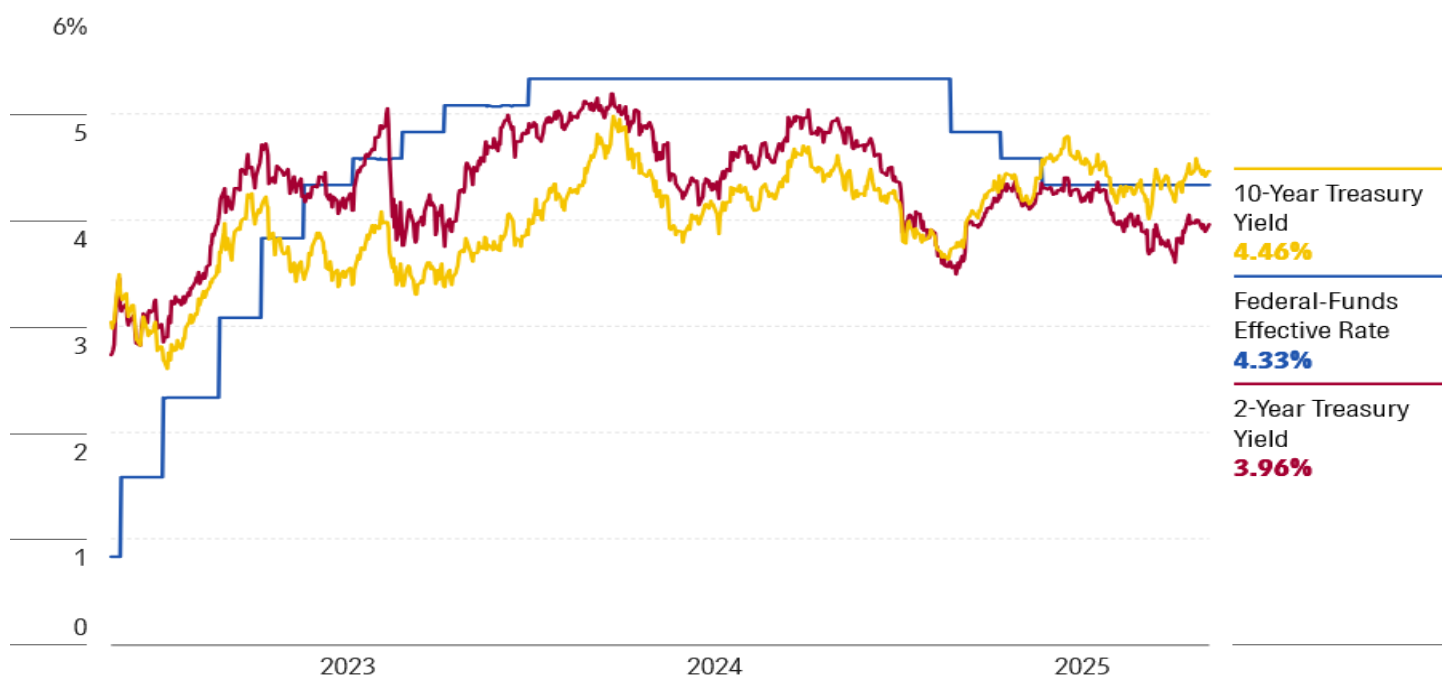
**Eagan:** The market is pricing in rate cuts. It's probably the right bet. But the Fed is in a tough position. They have to maintain credibility on inflation and their independence. The politics aren't unfamiliar territory if you go back in history. I read that President Johnson physically shoved his Fed chair.

The problem with tariffs and the [new] policies is we're marking down growth, raising [inflation] price targets for this year. That's a recipe for so-called stagflation, or I might call it 'stallflation,' because I don't think it's going to be a recession. The Fed has targets for both employment and inflation, and both sides could move out of their preferred ranges. My guess is the Fed will lean to the labor component and say the tariff price increases are transitory.

**Norton:** Are they transitory?

**Eagan:** In my mind, inflation is in the system irrespective of tariffs. Tariffs just add to the fuel. Maybe we peak at 4% inflation, and maybe it drops back a bit after that. But that's how inflation will be. It's inflation that forces a slowdown as people's real income goes down. And then, with a lag, their real incomes rise because they get wage lifts, and then the process starts again. The Fed knows this. During quantitative easing, the Fed begged the government to spend. They wouldn't do it. Finally they did it. You have to be careful what you ask for. They're now involved in a similar situation except that, this time, fiscal spending has been providing too much stimulus.

## Treasury Yield and Federal-Funds Rate



Source: Federal Reserve Economic Database. Data as of June 04, 2025.

**Norton:** Let's talk about corporates. How do these look to you?

**Eagan:** When you're investing in credit, the risk you're getting paid for is losses from downgrades and defaults. So we look at understanding and estimating those losses. Credit health has held up better than people expected. When rates rose, people assumed higher rates would be bad for credit. It wasn't, because borrowers locked in a lot of their funding. Pricing power is another reason for this fueling of inflation. When you have more inflation, nominal GDP growth can stay positive even in a recession. Earnings are tied to nominal growth rates. Real growth might not be that great, but nominally you're growing, and your debt is in nominal terms, and your funding costs lag so earnings can actually hold up very well. Even in a recession, we think credit losses would remain very low. When you look at credit spreads, and subtract the losses we see over the coming 12 months, the market looks fairly valued.

**Norton:** Let's talk about Europe, including Germany lifting its debt brake so it can spend on defense and infrastructure.

**Eagan:** Germany and the rest of Europe have a really good opportunity here and it's theirs to lose. Europe has to solve its growth problem. If they can get growth going structurally, they need to deregulate in a big way, and free the private sector. Any company says that going into Europe is a nest of problems.

The good thing is Germany will be able to fund it because they're in a good position budget wise. There should be ready buyers of high-quality risk-free debt.

## Private Credit's Impact and Opportunities

**Norton:** How about high yield? How has it been affected by growth in private credit?

**Eagan:** Private credit has de-risked the high-yield market. The high-yield market hasn't really grown for the last seven or so years. The bank loan market has grown significantly, and gone down in quality from BB to single-B. The bank loan and high yield markets have converged from a risk perspective. Bank loans have experienced higher credit losses than high yield corporate bonds. This hasn't been a disaster for bank loans because there's a pickup in spread versus high yield, the defaulting issuers have been small and they aren't a significant portion of the market value of outstanding bank

loans. I think there will be more losses in the private bank loan area than are actually visible. Nobody really has to show what they own, but we do get glimpses. We see strains in the private loan portfolios owned by business development companies. It comes in the form of more pay-in-kind obligations, which to me is a sign of weakness in that the company can't service their debt in cash.

**Norton:** Do you invest in private credit?

**Eagan:** Yes, primarily in investment grade private credit, maybe down to a double-B. I cleared the deck of Business Development Companies. Every cycle has its excesses. This time, it's in the very low single-B, B-minus bank loans that were LBO financing. Private credit always says, 'Well, we work with issuers.' I started my career as a commercial bank lender, and that's what banks used to say. We would provision for the nonperforming loans. The only saving grace is that the private equity folks have a lot of free excess capital. The money won't flee because it's locked up. You won't get the washout you'd get in the public market. My hunch is that it won't shake the foundations of the entire credit market or the banking market. The traditional banks are all derisked. You'll just see a period of bad returns for those investors who thought they were going to get a great deal with in the low-quality bank loan, private credit direct lending.

**Norton:** You mention systemic risk. Do you see any out there, apart from the deficit?

**Matt Eagan:** That's the massive one. But it's not like the UK. There will be no 'Liz Truss moment' in the US [Truss was briefly prime minister during a financially unstable period]. It's going to remain the premier currency and there's no replacement for the Treasury market. I'm watching the Treasury auctions. It's boring, until it's not. Like my old boss Dan Fuss used to say, 'I just don't want to read about it in the paper.' He meant the kind of risk that when you read about it, it's too late. Could it show up at the end of this year? Ten years from now? Sure. I just want to be paid adequately for that risk. We're not there yet in the long end.

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Average Annual Total Returns (%) as of 9/30/25	3 Months	1 Year	3 Years	5 Years	10 Years
Investment Grade Bond Fund Loomis Sayles Class A at NAV	2.08	2.70	5.87	1.30	3.38
Loomis Sayles Investment Grade Bond Fund Class A with 4.25% maximum sales charge	-2.28	-1.67	4.36	0.42	2.94
Loomis Sayles Investment Grade Bond Fund Class Y	2.14	3.06	6.14	1.56	3.64
Bloomberg U.S. Aggregate Bond Index	2.03	2.88	4.93	-0.45	1.84

Gross expense ratio 0.81% / 0.56% (Class A / Class Y). Net expense ratio 0.73% / 0.48% (Class A / Class Y). As of the most recent prospectus, the investment advisor has contractually agreed to waive fees and/or reimburse expenses (with certain exceptions) once the expense cap of the fund has been exceeded. This arrangement is set to expire on 4/30/2027. When an expense cap has not been exceeded, the gross and net expense ratios may be the same.

Average Annual Total Returns (%) as of 9/30/25	3 Months	1 Year	3 Years	5 Years	10 Years
Loomis Sayles Bond Fund Retail Class	2.28	6.29	8.41	3.36	3.68
Loomis Sayles Bond Fund Institutional Class	2.23	6.07	8.16	3.10	3.42
Bloomberg U.S. Aggregate Bond Index	2.03	2.88	4.93	-0.45	1.84

Gross expense ratio 0.97% / 0.72% (Retail Class / Institutional Class). Net expense ratio 0.89% / 0.64% (Retail Class / Institutional Class). As of the most recent prospectus, the investment advisor has contractually agreed to waive fees and/or reimburse expenses (with certain exceptions) once the expense cap of the fund has been exceeded. This arrangement is set to expire on 04/30/2027. When an expense cap has not been exceeded, the gross and net expense ratios may be the same.

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### **Equity Securities Risk:**

Equity securities are volatile and can decline significantly in response to broad market and economic conditions.

### **Foreign and Emerging Market Securities Risk:**

Foreign and emerging market securities may be subject to greater political, economic, environmental, credit, currency and information risks. Foreign securities may be subject to higher volatility than US securities, due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets.

### **Small and Mid-Cap Stocks Risk:**

Investments in small and midsize companies can be more volatile than those of larger companies.

### **Growth Stocks Risk:**

Growth stocks may be more sensitive to market conditions than other equities as their prices strongly reflect future expectations.

### **Currency Risk:**

Currency exchange rates between the US dollar and foreign currencies may cause the value of the fund's investments to decline.

## **Loomis Sayles Bond Fund Risks**

### **Fixed Income Securities Risk:**

Fixed income securities may carry one or more of the following risks: credit, interest rate (as interest rates rise bond prices usually fall), inflation and liquidity.

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**Foreign and Emerging Market Securities Risk:**

Foreign and emerging market securities may be subject to greater political, economic, environmental, credit, currency and information risks. Foreign securities may be subject to higher volatility than US securities, due to varying degrees of regulation and limited liquidity. These risks are magnified in emerging markets.

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Currency exchange rates between the US dollar and foreign currencies may cause the value of the fund's investments to decline.

**Equity Securities Risk:**

Equity securities are volatile and can decline significantly in response to broad market and economic conditions.

**Past performance is not guaranteed in future results.**

Morningstar Ratings as of 9/30/25	3-Years	5-Years	10-Years
Loomis Sayles Investment Grade Bond Fund Class Y	★★★★ Out of 520 funds	★★★★★ Out of 468 funds	★★★★★ Out of 341 funds

Morningstar Ratings as of 9/30/25	3-Years	5-Years	10-Years
Loomis Sayles Bond Fund Institutional Class	★★★ Out of 360 funds	★★★ Out of 324 funds	★★ Out of 221 funds

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