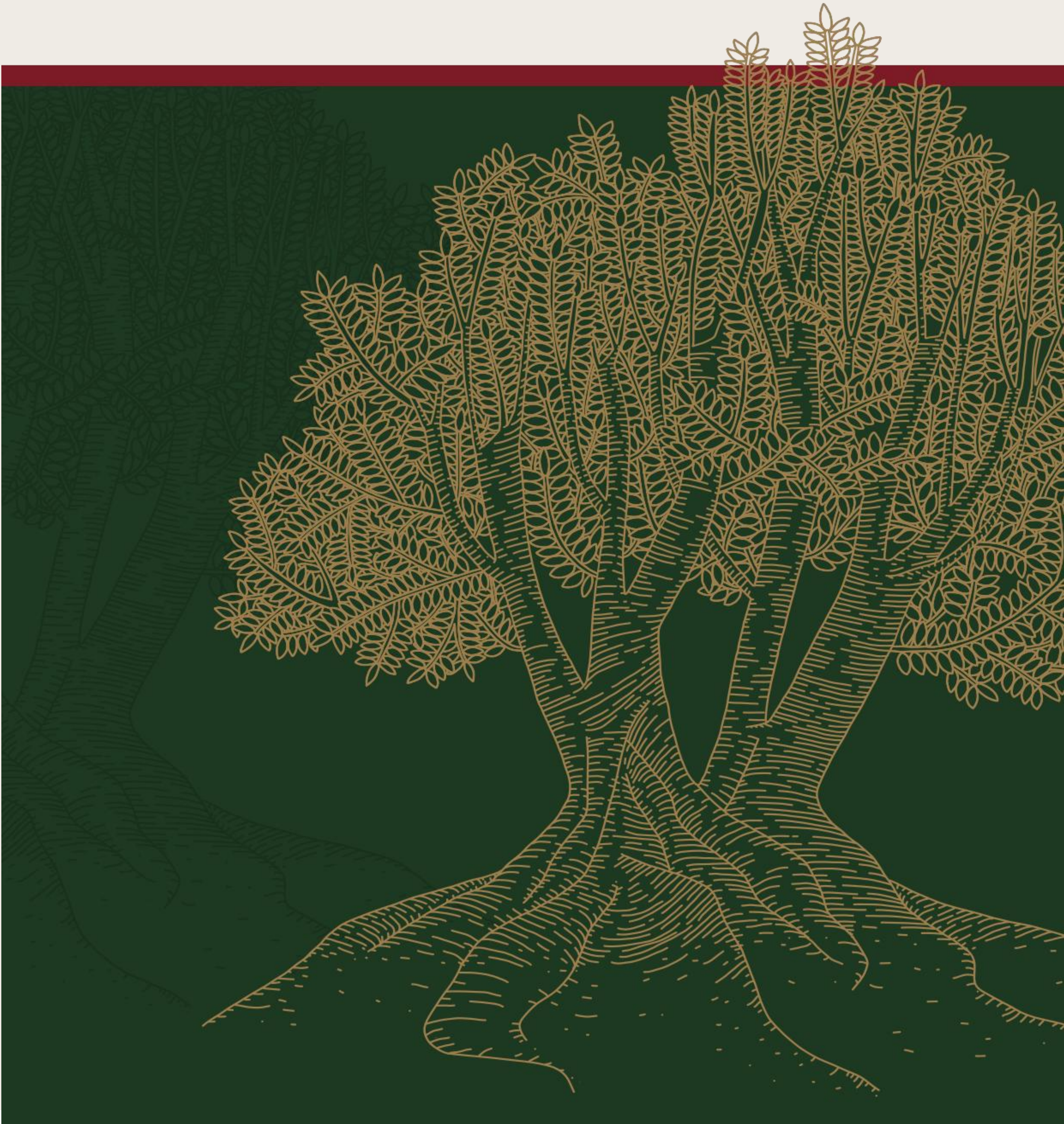
US FISCAL VULNERABILITY

Bond Market Blow Up or Treasury Tornado…?

May 2025



OVERVIEW

"The US fiscal deficits are too large and they need to be brought down," Gita Gopinath, the IMF's first deputy managing director, told the Financial Times.

Comments like this have become more frequent and more explicit since Trump's administration unleashed a rethink of the way in which the USA taxes, spends, borrows and trades. But these worries are not new. For years now market participants, government officials, economists and frankly anyone who half understands basic economics has been worrying about the ever-growing US deficit and what that could mean for the US economy, US stocks, US Treasuries and importantly the US Dollar as the dominant global trading currency and reserve currency.

In this piece we unpack some of the facts and discuss what the "looming" tax reforms could mean in conjunction with the recent tariff volatility. Is this the year of reckoning for US or will the can be kicked down the road a little further? And how long is this road before the cliff ?

EQUITY MARKETS HAVE REBOUNDED STRONGLY

More than 6 weeks have passed since Trump's "reciprocal tariff" announcement on Wednesday (2 April), which triggered a rout on US stock markets followed by global indices with the S&P500 falling as much as 15% (to 7th April) only for the S&P 500 to then experience its best day since 2008 (+9.5% on 9 April). Subsequently (as of Friday 23rd May) the S&P500 is up 16.5% from its 2025 lows.

Although the news flow has been relentless, uncertainty has been contained by various announcements of successful tariff negotiations.

USA-UK: 8 May 2025 - The UK became the first country to reach an agreement with the U.S. under the new tariff regime. The hurdle was not particularly high, however, because US-UK trade imbalances were largely inexistant. This deal related to 100,000 vehicles, steel and aluminium from the UK and ethanol and agricultural products (including 13,000 tons of US beef).

USA-China: 12 May 2025 – After earlier escalation, a temporary truce was reached with U.S. tariffs on Chinese goods reduced to 30%, Chinese tariffs on U.S. goods lowered to 10% and both countries maintained 25% tariffs on specific sectors like cars, steel, and aluminium.

USA-India: 6 April 2025 - India signalled willingness to negotiate and refrained from retaliatory tariffs.
17 April 2025 - India considered removing import taxes on U.S. ethane, indicating progress in talks.
6 May 2025 - India proposed a "zero-for-zero" tariff on auto parts to advance negotiations.

USA- Canada: 15 April 2025 - In response to U.S. tariffs, Canada announced: A six-month pause on tariffs for U.S. goods used in critical sectors and exemptions for automakers maintaining production in Canada.

USA-Ukraine: 30 April 2025 - The U.S. and Ukraine signed the Mineral Resources Agreement, establishing a Reconstruction Investment Fund with joint investment in Ukraine's natural resources, including rare-earth elements, oil, and gas with Ukraine to contribute 50% of future revenue from government-owned natural resource assets. The U.S. committed to long-term financial support for Ukraine's economic stability.

USA-EU: 26 May 2025 – President Trump delays 50% tariffs until 9 July, following a number of earlier escalatory announcements, starting with Steel and Auto tariffs imposed by Trump shortly after he moved into the White House.

There have been announcements from Japan, South Korea, Vietnam and a number of others about ongoing trade talks.

TARIFFS, BUDGET AND DEBT LEVELS

ROUGH INITIAL ESTIMATES ON TARIFF REVENUES

With the exception of the UK deal, none of the agreements mentioned have been formally ratified and thus the end of the 90-day pause poses risks to markets outside of the tax reforms we discuss below.

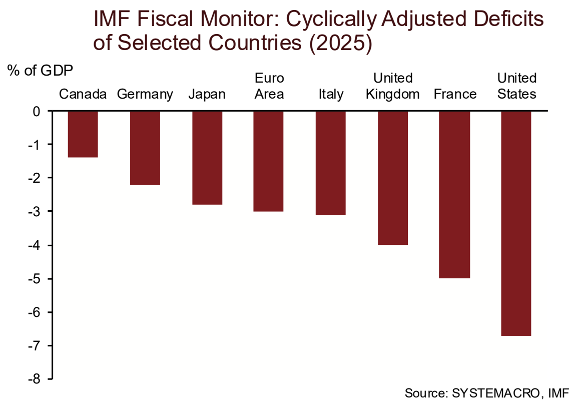
Taking a step back, Trump's tariff policy is subject to important internal conflicts. One important aim of imposing tariffs on US imports is to raise fiscal revenue for his tax reform (more on this below). However, import tariffs directly increase import prices and hence inflation, which in turn leads to higher bond yields, hence funding cost for the huge pile of government debt. Trump also seems to be willing to use tariffs to cut deals on unrelated issues. But this in turn would mean reduced fiscal revenues. Estimates on potential tariff revenues for the US government range from less than $100bn per year to as much as $500bn.

Among the most reputable estimates, the Tax Foundation projects increased fiscal revenues of about $130bn per year on average, or $1.3tn over the next 10 years (a typical reference point when talking about US fiscal policy).

But is it enough? Will $1.3tn be sufficient to offset the tax cuts Trump is currently trying to get through congress? And will it change the currently unsustainable trajectory of US fiscal policy ?

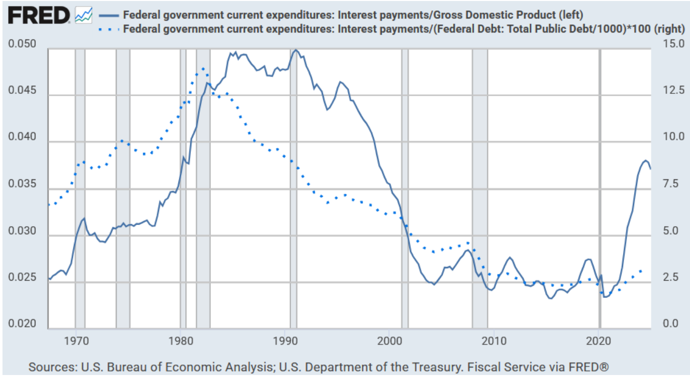
The simple answer is no, but let's look at the details, first.

TOO MUCH DEBT, TOO LARGE A DEFICIT



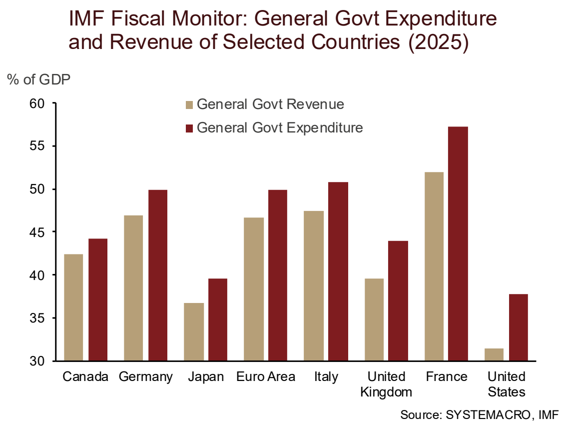
There is really only one major issue with regards to US fiscal policy: the deficits are far too large which puts debt levels on an unsustainable trajectory. In recent years, US budget deficits have been running in the 6-7% of GDP area, which is a historical record by some distance for a period without a major war or recession. Half of this amount is interest payment and the other half is a primary deficit. In the tradition of Keynesian anticyclical fiscal policy, a country should run a primary surplus during an economic growth period, not a large deficit as the US currently does. The extent to which current US deficits stand out is also visible internationally (see chart). No other fiscal "sinner" among the major economies is coming even close to the US budget gap. Gross government debt in the US has reached 120% of GDP, and even when subtracting debt held by other Government agencies, including the Fed, net debt held by the public still stands at close to 100% of GDP.

INTEREST PAYMENTS AS CHOKE POINT



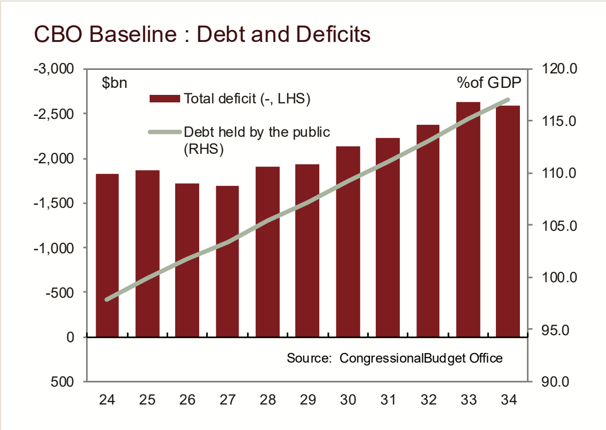
The longer-term issue is that unsustainable debt leads to higher interest rates and government interest expenses. The chart below shows that the US government already spends more than 3.5% of GDP on interest (left scale), despite average interest rates still only being slightly higher than 3% on outstanding debt (right scale). As existing bonds mature and get rolled into new issues, this average interest rate will creep up. Here is a simple back-of-the-envelope calculation of this dynamic: The average maturity of US government debt is about 6 years. If interest rates stay at about 4.5% across maturities, in 6 years' time, the average interest rate incurred by the Treasury will be half the difference higher at about 3.75%. In addition, the accumulation of deficits means the gross debt level will also be some 10% higher at 130% of GDP, eventually resulting in Government interest payments of about 4.9% of GDP. That's the historic peak level reached in the 80s and early 90s, which triggered forced fiscal tightening in the early Clinton years. All this assumes a stable "term premium", which is defined as a risk premium reflecting the dangers of much higher inflation and weaker currency as a way to "pay back" the excessive debt. However, back in the 80s and 90s, the term premium was at least a 100bp higher than now. And it has been rising again, meaning bond yields can rise further even when the Federal reserve cuts rates. In other words, the interest payment "choke point" will likely come earlier in a negative feedback loop, where higher debt leads to a higher term premium and higher interest rates, which in turn leads to higher debt.

US TAXPAYERS HATE PAYING TAXES (EVEN MORE THAN EVERYONE ELSE)



It is important to highlight that the key fiscal challenge in the US is NOT cutting expenditure. In international comparisons US fiscal expenditure is very low but tax revenue is even lower (see chart). Fiscal consolidation is obviously very difficult when trying to cut already low expenditure, as Elon Musk and his largely failed DOGE effort has already indicated. It sounds obvious, but in a low-tax-and-low-govt-expenditure economy like the US the only real option for significant fiscal consolation is raising taxes. That's the opposite to a high-tax-high-fiscal-spend economy like France, where the only rational choice would be cutting government expenditure. But rational choice is politically the most difficult, obviously. It is therefore not surprising that budget negotiations among House Republicans almost failed over finding ways to cut expenditure even more. Everyone agreed on lower taxes, despite the obvious negative impact on the budget. The upcoming fiscal debate in the Senate will almost certainly again highlight the struggles of further cutting already low expenditure.

CONFUSING FISCAL NUMBERS AND THE CBO BASELINE



It is common in US fiscal negotiation to refer to a confusing range of alternative numbers when quantifying the budget impact. The key measures are the annual budget impact (nominal in $bn), the cumulative budget impact over 10 years (nominal, $bn), and finally, the impact on debt levels after 10 years (net debt in % of GDP). The importance of the next 10 years seems to largely be the result of the work of the Congressional Budget Office (CBO) which has been tasked by Congress with regularly updating 10-year budget projections, the so-called CBO baseline. The latest baseline published by the CBO is the universally accepted reference point when calculating the impact of anything related to fiscal policy, including changes to the tax code, ageing population dynamics, expected DOGE savings, or any other changes in discretionary spending. Two key areas of confusion for occasional observers of the US budget process are the following. First, given the CBO baseline uses current legislation, it's often far behind the political reality. For example, the current baseline (see chart) still incorporates the expiry of the 2017 tax cuts at the end of 2025. Second, and most confusing, people frequently switch between the annual impact and the cumulative 10-year impact. The choice largely depends on whether it seems appropriate to make the number look bigger or smaller. Expenditure savings are often presented as bigger 10-year cumulative sums. Increases in expenditures are frequently quoted in annual terms by those who promote the extra spending.

THE PROCESS OF CHANGING THE US TAX CODE – QUITE A MISSION AND FAR FROM DONE!

Changes to the US Tax code require the agreement of the House, the Senate and the President on one common legislative text. Both chambers of Congress have to approve the same text individually, which can be a challenge if the majorities are narrow. Technically, the Republican leadership uses a "reconciliation bill" for the current 2025 budget to enact major changes to the tax code, in particular the extension of the 2017 tax cuts. A "reconciliation bill" is a special legislative process devised to avoid a "filibuster" in the Senate, which could render passage of the budget bill impossible. "Reconciliation" can be used for the specific purpose of changing revenue (taxes), mandatory spending (e.g. Social Security, Medicaid) or the debt limit. The timeline of this reconciliation process stretches out over many months, but there are effectively 5 major stops.

February: President Trump signaled to Republicans in Congress his broad fiscal priorities. This is important because at the end of this complex process the President could veto the new tax legislation.

Early April: After some back and forth between the two chambers of Congress. House of Representatives and Senate both approved the same "final resolution", which is really only a draft bill with rough headline budget items.

May: House committees worked on a detailed bill that filled all the blanks and they produced an actual legislative text that would amend current law. After all committees were done, the entire House of

Representatives voted on this draft. Because the Republican majority was so narrow, lots of last-minute changes were put through to appease all special-interest groups.

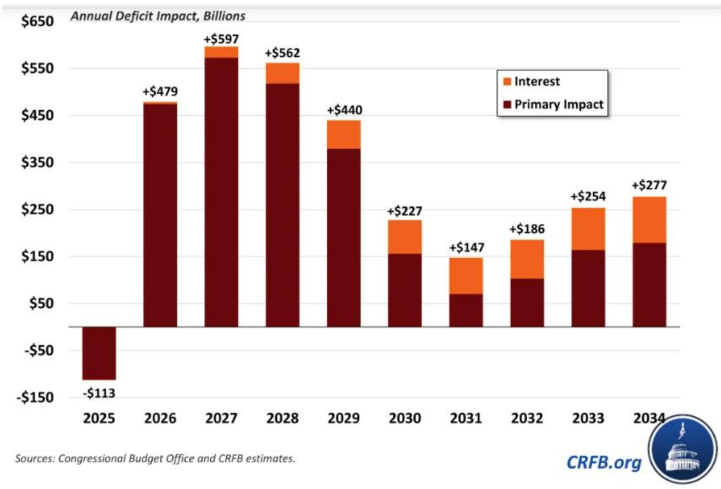
June: Senate committees will use the House bill as draft for their own variant of the final legislative text. Again, special interest groups may force changes favouring their constituents.

July: Once the Senate has approved its variant of the bill, any differences have to be ironed out in a special joint "conference committee" involving both chambers. The finally agreed-upon text will get signed by Trump into law.

HOUSE BILL – NOT SMALL NUMBERS!

As a result of last-minute negotiations and changes, the exact budget impact of the finally approved House bill is not clear yet. However, estimates from the CBO and the non-partisan CRFB watchdog regarding an earlier draft suggest that the deficits will grow by about $150bn and $600bn per year over the next 10 years for a total of slightly more than $3tn. The chart shows the annual profile, which has to be added to the CBO baseline shown earlier. Last-minute changes, in particular the modifications to State and Local Tax deductions (SALT), will likely add another $150bn, which brings the total over 10 years, to about $3.1tn. With only about $1.3tn raised from tariffs over the next 10 years, it is already clear that tariff revenue would be vastly insufficient to fund the extended (in time and scope) tax cuts in the draft House bill

CBO Estimates House Bill Adds Significantly to Deficits



EVER LARGER DEFICITS SCENARIO – MORE GIVEAWAYS

The risks to this fiscal outlook are firmly on the downside, meaning larger deficits. First, early comments from Senate Republicans suggest that the key issues that almost blocked the bill in the House will pop up again. In particular, many Republican senators worry about a backlash from relatively poor Trump supporters who rely on Medicaid health insurance. One of the attempted fiscal savings in the current process is removing Medicaid support for people who could work but can't find a job. Quite a few working class MAGA supporters are in that group – and they may be deeply disappointed ahead of the next Mid-term election in 1.5 years. In addition, Trump himself has already used explicit language to voice his concerns about changes to Medicaid. Another source of projected savings comes from the removal of some of Biden's green subsidies, which have been very popular with farming communities in traditional Republican states. And then there is the problem that many tax reductions are – once again – limited in time. This is a typical "gimmick" to make lowering taxes look less expensive. For example, Trump's popular campaign promises to remove tax on tips would expire after 2028. But when the expiry of these "temporary" tax cuts approaches, new legislation typically makes them permanent. This is exactly what currently happens with the 2027 tax cuts. They were meant to expire at the end of 2025 but the currently debated bill will keep them in place. Assuming a similar trajectory, independent fiscal watchdogs now assume that the deficits would rise by about $600-700bn throughout the entire 10-year period. In such a reasonably likely scenario, the total deficit over 10 years would increase by roughly another $2tn, bringing the total to some $5tn, far offsetting the revenue raised from tariffs over that period.

FISCAL TIGHTENING SCENARIO - HAWKS BLOCK EVERYTHING

As part of the last-minute negotiations, a small group of fiscally conservative House Republicans eventually withdrew their objection to the bill. While they did not want to raise taxes, they certainly were not worried about using ever deeper and ever more painful expenditure cuts to reduce the deficit. The same battle lines will likely play an important role in the upcoming Senate negotiations, too.

However, Senators enjoy more political independence than Representatives in the House, who depend to some extent on support from President Trump in the local primaries. If the fiscal hawks in the Senate block the legislation long enough, it is possible that (1) the Debt Ceiling is getting breached in August, bringing the US Treasury close to a technical default and (2) the 2017 tax cuts expire at the end of this year, leading to further fiscal tightening in addition to the tightening via the import tariffs. Growth could get hurt quite badly in such a scenario and this could weigh on equities albeit appease bond markets.

SCENARIO ANALYSIS AND MARKET IMPACT

The large deficits in the US, that have led to the accumulation of the huge debt pile have been one of the important drivers of “US Exceptionalism” of recent years. As illustrated at the beginning, no other major country had fiscal deficits of the same magnitude. The difference in fiscal policy stance can probably explain most of the growth difference between Europe and the US over the last decade.

The problem for the US is that ever-larger debt piles make it ever more difficult to boost growth with larger fiscal deficits. That is because the fiscal risk premium in the bond market leads to potentially sharply higher rates. In other words, any boost to GDP from fiscal expansion will get offset (and maybe more) by much higher bond yields. Longer-dated maturities affect the valuation of equites via the discount factor of future earnings and they also affect interest sensitive sectors like real estate via mortgage rates.

To illustrate this in a traditional economic policy quadrant chart, we can show how high debt levels change the outlook for growth, inflation, the Dollar and equities. The ever-rising term premium in bonds, makes Treasuries less attractive for foreign investors. And with foreign capital inflow slowing, the Dollar comes under pressure. Equities also struggle to rally.

The key point is that with excessive debt levels any fiscal policy choice leads to currency weakness. In the case of fiscal consolidation, weaker growth leads to lower interest rates and a weaker currency in a normal relationship. But in case of further fiscal stimulus, bond vigilantes also lead to slower growth, this time via a sharp rise in bond yields. Importantly, this rise in bond yields is purely a sign of a rising debasement risk for the local bond market, it therefore does not make US bonds more attractive for international investors and the currency also weakens.

NORMAL GOVERNMENT DEBT LEVELS (OPTIMISTIC "LOW DEBT" CASE)

Fiscal Policy (Low Debt)		Monetary Policy: Restrictive	Monetary Policy: Easy
	Tight	• Disinflationary/Recession • Weak Equities	• Low bond yields • Weak growth • Capital outflow, USD down
	Expan-sionary	• Normal "Term Premium" • High bond yields • Strong growth • Capital inflow, USD up	• Inflationary • Strong Equities

HIGH GOVERNMENT DEBT LEVELS (CURRENT CASE)

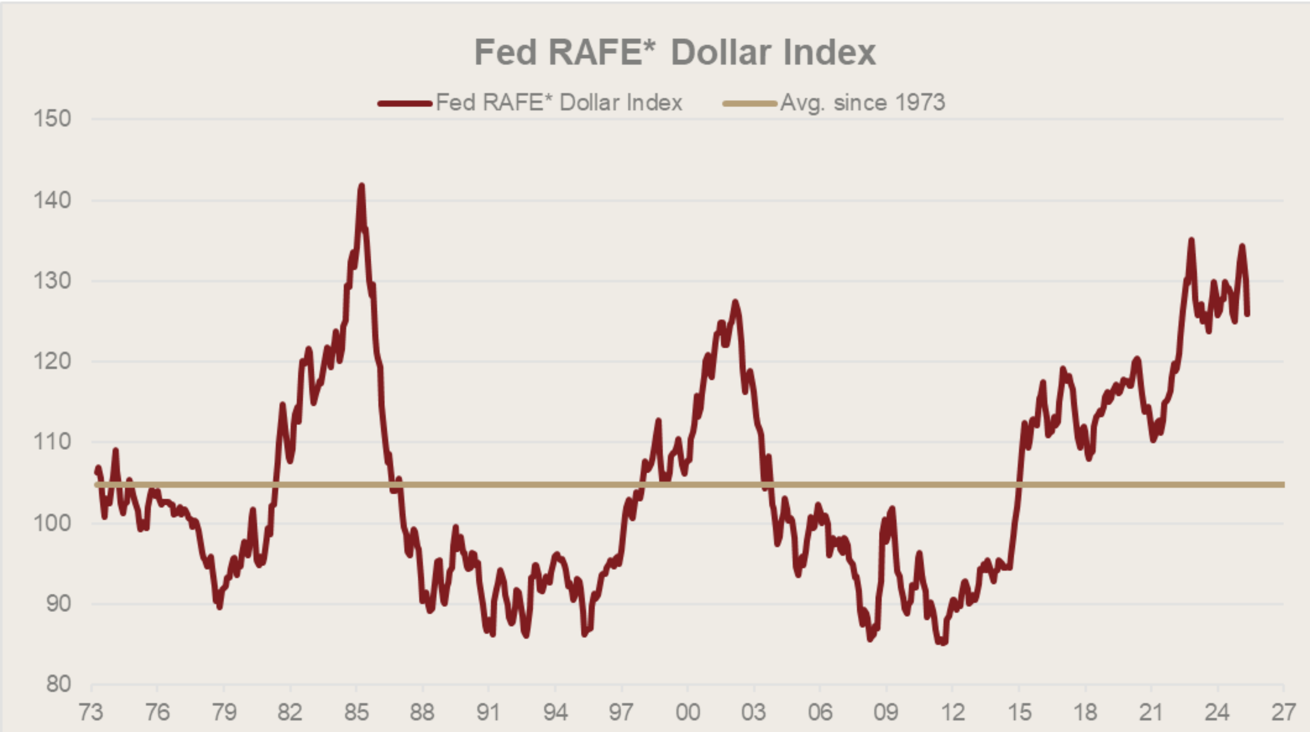
Fiscal Policy (High Debt)		Monetary Policy: Restrictive	Monetary Policy: Easy
	Tight	• Disinflationary/Recession • Weak Equities	• Low bond yields • Weak growth • Capital outflow, USD down
	Expan-sionary	• High "Term Premium" • Very high bond yields choking growth • Capital outflow, USD down	• Ultra Inflationary • Capital outflow, USD down • Equities down in FX terms

US DOLLAR CONSIDERATIONS

Of course, it is possible that the US continues to run deficits for many years to come further increasing their debt burden with no default or other "blow up". It is worth noting that one way out of a burdensome debt problem is to inflate one's way out of it. By deliberately allowing higher inflation the real value of debt declines over time. While this will make the Fed's job increasingly challenging it is a possible longer-term outcome for the US – policies which deliberately create higher inflation or allow for sustained higher inflation. In such a scenario, it is likely the USD weakens further (staying true to the Purchasing Power Parity (PPP) theorem).

Other currency dynamics could also weigh on the Dollar including:

- Stalling or declining capital inflows into the USA (foreigners' willingness to buy US denominated equities and debt could wane further).
- Continued central bank reserve diversification – the USD, although by far the most widely held reserve currency has been declining as a percentage of total FX reserves for many years.
- As foreign investors become more nervous about US assets and the Dollar they could increase their hedging ratios (selling USD to buy "other") to at least remove the USD risk. This would put further pressure on the USD.
- If inflation does remain contained but the economy slows under the high tariff market uncertainty the Fed could cut interest rates faster eroding the positive "carry" advantage of higher US interest rates putting further pressure on the USD.
- The complex feedback loops of a weaker Dollar and US inflation would mean that even excluding the initial inflation uptick from tariffs a weaker Dollar would mean the cost of the goods the US imports would keep rising (as the Dollar's purchasing power declines) and this could perpetuate further USD weakness under the higher inflation scenario.



Source: Federal Reserve, SYSTEMACRO

** RAFE = Real Advanced Foreign Economies. Alternatively this index can be described as inflation-adjusted effective exchange rate for the US versus the major trading partners.*

From a long-term perspective USD weakness appears a highly likely scenario also, simply because the Dollar has been exceptionally strong over the last few years. The Federal Reserve's inflation-adjusted index versus the other advanced major economies has rarely exceeded current levels – and we are talking about the entire history of floating exchange rates since the end of Bretton Woods in 1973. If the long-term equilibrium exchange rate is the mid-point of these very long cycles, then the Dollar is currently overvalued by about 20% on a trade weighted basis. And in a particularly USD-negative scenario, similar to the forced fiscal consolidation in the mid-1990s, the Dollar could weaken further, by 40% from current levels. Obviously, such a major Dollar decline would take time, maybe a few years. Still, managing international asset exposure in time of broad and persistent Dollar weakness could remain one of the main challenges for investors in coming years.

CONCLUSION

In this piece, we have highlighted some of the key macroeconomic risks linked to US fiscal and tariff policy. This does not necessarily mean that we think they will all materialise, but we want investors to know that we are monitoring them closely.

Despite the increasingly concerning US fiscal position we're a long way from knowing where things land. The US economy may comfortably muddle through until the mid-term elections, recording anaemic growth but without any major downside acceleration. Policymakers are becoming increasingly sensitive to the fiscal risks and the growing pressure from the bond market. Our base case is that the US rights itself. There are still many smart politicians and advisors to the government who will help get the US fiscal situation on a sustainable track and to reduce macroeconomic uncertainty.

Beyond our "muddle through" base case, there are two main scenarios. First, in a high inflation scenario, where US debt is being partly "inflated away", US equities should continue to perform reasonably well in the long term. However, meaningful USD weakness could offset some of those gains in the stock market from a non-USD perspective. Also, US bonds would suffer.

Alternatively, in a forced fiscal consolidation scenario, inflation would likely drop meaningfully and growth slow, possibly leading to an outright recession. While short-term negative for equities, it would allow the Fed to respond swiftly with cuts, which in turn would help equities rebound quickly. Again, the Dollar could weaken but US bonds would perform strongly.

All told, the intensifying news flow linked to US tariffs and fiscal policy likely signals the end of period of US exceptionalism, and also of US Dollar exceptionalism. While it would be tempting to think about catastrophic outcomes, the most likely scenario remains one where US growth remains positive, where US assets continue to perform – even if the trajectory may be somewhat flatter than in recent years.

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