Big and (Not So) Beautiful Fiscal Slippage

The new U.S. fiscal legislation and the deteriorating outlook for the U.S. fiscal position

→ The new U.S. fiscal legislation is forecast to lead to marked deterioration in the U.S. fiscal position, prompting credit rating agencies to further downgrade the United States sovereign credit rating.

→ Mounting debt, limited appetite for fiscal responsibility, and higher long-term interest rates risk permanently damaging the attractiveness of U.S. assets.

The new U.S. fiscal legislation seeks to extend tax cuts and introduce additional spending

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Markets have responded to the new United States fiscal bill with volatility and an increase in long-term bond yields. The fiscal legislation, also referred to as the "Big Beautiful Bill", which was passed by both the House and Senate and signed into law by President Trump on July 4th, seeks to extend most of the tax cuts introduced in 2017 under the Tax Cuts and Jobs Act (TCJA), in addition to introducing several other tax breaks and spending measures.

Days after the new legislation was unveiled to the United States House of Representatives, Moody's – the last major credit rating agency to do so – downgraded the U.S. credit rating to Aa1 from Aaa. The downgrade took place amid a sharp increase in U.S. sovereign yields, particularly on long-dated bonds, with the bill adding to investor unease over U.S. assets and follows volatility and uncertainty fueled by abrupt trade policy shifts since January. While various political and technical factors have been behind rapid swings in U.S. yields since January, there has been a steady upward drift in 10 and 30-year Treasury yields since last fall, with rates on the 30-year settling near to 5% since mid-May.[1]

The U.S. fiscal position is expected to deteriorate significantly

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Moody's estimates that the fiscal legislation would see the size of the U.S. federal deficit widen from 6.4% of gross domestic product (GDP) in 2024 to almost 9% by 2035.[2] Accordingly, Moody's projects that the total U.S. federal debt burden will increase from about 98% of GDP in 2024 to about 134% in 2035.[3] Note that Moody's estimates are based on the initial version of the bill introduced in May. There have been some changes to the bill that would see the amount of additional debt increase compared to Moody's May assessment - but

Moody's has not updated their projections. In dollar terms, the non-partisan congressional budget office (CBO) anticipates that the new law will add an additional 3 trillion dollars to the federal debt including interest costs by 2034 compared to pre-bill forecasts.[4]

The growing deficit will be increasingly driven by non-discretionary spending, including interest expense, with new revenue generation expected to be minimal. Mandatory spending is estimated to reach 78% of total U.S. federal expenditures in 2035, up from about 73% in 2024.[5] Notably, interest payments on the U.S. federal debt are on track to account for 30% of revenue by 2035, compared to about 18% in 2024, and less than 10% in 2021.[6]

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Equally concerning to Funcas are the limited macroeconomic benefits expected from the new spending. The Budget Lab at Yale forecasts that the bill's additional spending will boost GDP growth by just 0.2 percentage points annually over 2025-2027, before its impact lowers growth. Similarly, the Penn Wharton Budget Lab envisions only a 0.5% increase to the level of GDP by 2034.[7] The limited effect on growth is partially due to the expectation that the Federal Reserve would have to tighten monetary policy in order to keep inflation anchored near 2%.[8]

The limited effects for growth are in part due to the anticipated inflationary nature of the bill, which will require tighter monetary policy from the Federal Reserve to keep inflation anchored near 2%

The shifting fiscal landscape signals a structural shift in risk perceptions
Rising yields and the credit rating downgrade also signify eroding confidence in the capacity to respond to future shocks along with a structural shift in risk perceptions.[9] While ratings agencies continue to recognize the economic and financial strengths of the U.S., including strong macroeconomic policy institutions, and the U.S. dollar's dominance as the global reserve currency, which generates significant demand for U.S. assets, the shift toward increasingly large deficits point to an erosion in fiscal sustainability and flexibility. Indeed, in recent years, with limited appetite for fiscal responsibility across the political spectrum, analysts have noted declining demand for U.S. bonds.[10]

If adverse developments or policy shifts were to trigger a change in investor preferences, prompting a rapid migration out of dollar denominated assets and a sharp rise in borrowing costs, interest expenses could rise rapidly. Such a move, if sufficiently large, could alter the trajectory of the debt, raising concern among investors and sparking a vicious feedback loop of rising rates and larger deficits, coupled with contagion to private credit markets and financial sector balance sheets.[11] Likewise, current forecasts for U.S. deficits do not factor in extraordinary events or crises, which could see GDP contract and debt swell further – especially if a robust fiscal response were required. This could include the fiscal and growth impacts of increased military spending and a spike in oil prices that might result from an escalation in conflict in the Middle East or elsewhere. Indeed, the deteriorating U.S. fiscal position has potentially placed the U.S. on a similar path to many European economies just prior to the eurozone's debt crisis, where default expectations morphed from zero to a small, yet positive number, causing an outsized increase in sovereign yields.[12]

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The precipitous rise in debt will also push U.S. policy makers up against the legal debt ceiling with the 5 trillion dollar increase in the debt celiing included in the final bill only providing temporary relief. Should the balance of power change in Congress, political brinksmanship, fraught down-to-the-wire negotiations, and government shutdowns will likely resurface. Some episodes of negotiations have even culminated in credit rating downgrades, including in 2011, when Standard & Poor's downgraded its U.S. rating citing political polarization and insufficient steps to right the fiscal outlook. [13]

Rising long term interest rates are putting further pressure on government finances

Over the decade up to the end of 2021, yields on inflation-indexed 10-year U.S.Treasury bonds averaged just 0.09% but since 2022 the real yield has averaged almost 1.5 %

Another factor that Funcas anticipates will complicate the U.S. fiscal outlook is the marked increase in long-term real interest rates compared to the 2010s. Over the decade up to the end of 2021, yields on inflation-indexed 10-year U.S. Treasury bonds averaged just 0.09%, but since 2022 the real yield has averaged almost 1.5% (Exhibit 1). A number of factors – which are unlikely to change in the coming years – have led to rising real interest rates, including record high levels of public and private debt, geopolitical tensions, trade fragmentation, rising military expenditures, the investment needs of AI, and populism, as recently highlighted by Kenneth Rogoff.[14]

The attractiveness of U.S. assets may be at risk

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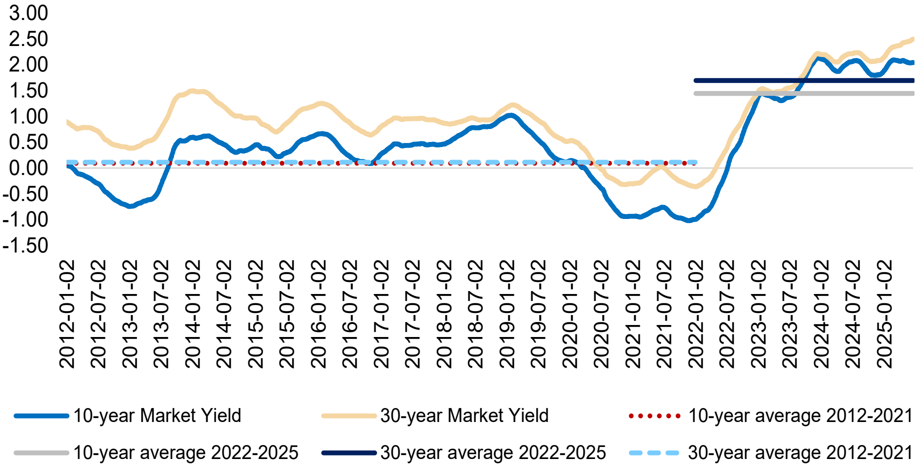
Given that as yet there are no viable alternatives to the U.S. dollar, with high debt and rising real interest rates, and elevated volatility and uncertainty, the global economy appears to be entering a “(Not So) Big and Beautiful” era. Against this backdrop, even limited capital movement away from the U.S. and subdued demand for U.S. bonds has the potential to spark difficulty in the U.S. Treasury market. Indeed, at some point falling demand for bonds is bound to come up against market scepticism about just how much additional debt the U.S. can afford, forcing some degree of a correction, potentially with serious knock-on effects for the U.S. and global financial system.[16]

EXHIBIT 7.0 – MARKET YIELD ON 10 AND 30 YEAR U.S. TREASURY SECURITIES INFLATION-INDEXED -% (90 DAY MOVING AVERAGE)



Note: The exhibit shows 90 day moving average of daily market yields on U.S. Treasury Securities at 10-Year and 30-Year Constant Maturity, Quoted on an Investment Basis, Inflation-Indexed, Percent, Daily, Not Seasonally Adjusted.
Source: Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis.

Notes

[1] https://www.funcas.es/odf/inestabilidad-reciente-en-el-mercado-de-bonos-del-tesoro-americano-treasuries/

[2] https://ratings.moodys.com/ratings-news/443154. Moody's estimates were released on May 16th, 2025

[3] *Ibid.*

[4] https://www.cbo.gov/publication/61534 and https://www.axios.com/2025/06/29/senate-big-beautiful-bill-deficits-debt

[5] https://ratings.moodys.com/ratings-news/443154. Moody's estimates were released on May 16th, 2025

[6] *Ibid.*

[7] https://budgetlab.yale.edu/research/long-term-impacts-one-big-beautiful-bill-act ; https://budgetmodel.wharton.upenn.edu/issues/2025/5/23/house-reconciliation-bill-budget-economic-and-distributional-effects-may-22-2025

[8] https://budgetlab.yale.edu/research/long-term-impacts-one-big-beautiful-bill-act

[9] https://www.funcas.es/odf/inestabilidad-reciente-en-el-mercado-de-bonos-del-tesoro-americano-treasuries/

[10] Euro Intelligence, "Will the US default?", Wolfgang Munchau.

[11] "Inestabilidad en el mercado de bonos del Tesoro estadounidense: Riesgos para la zona euro y para el sistema financiero global", Funcas, June 6th, 2025.

[12] https://www.funcas.es/odf/inestabilidad-reciente-en-el-mercado-de-bonos-del-tesoro-americano-treasuries/

[13] https://www.reuters.com/markets/us/us-credit-risk-looms-former-sp-officials-see-2011-downgrade-vindicated-2023-05-26/

[14] https://www.ft.com/content/812a06b0-2819-4a75-abaf-455722cf63e8

[15] "Una crónica financiera de urgencia de Estados Unidos", Santiago Carbó Valverde, *Cinco Días*, June 12, 2025.

[16] "Inestabilidad en el mercado de bonos del Tesoro estadounidense: riesgos para la zona euro y para el sistema financiero global, Funcas, June 6th, 2025.