



Market Commentary
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Insigneo Weekly Dispatch

The Aftermath of a Late Move

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The Aftermath of a Late Move

Moody's cut the US sovereign rating, citing worsening fiscal metrics and limited prospects for reform, while warning that future ratings will hinge on policy changes amid a worsening fiscal backdrop.

The House passed its tax-and-spending bill, which is expected to widen deficits and increase debt. With Senate revisions pending, market participants remain skeptical of any potential fiscal tightening.

The Treasury yield curve has steepened significantly, with long-term yields rising as investors demand greater term premium amid anticipated higher debt issuance. This reflects concerns over procyclical fiscal policy, persistent inflation, and constrained Fed policy flexibility.

Despite market fears around fiscal policy, implementing a full underweight to US assets may not be the most prudent investment strategy to weather the current uncertainty.

On May 16, Moody's announced it was downgrading the US's sovereign rating after it had downgraded its outlook to 'negative' the year before. Since Moody's was the last agency to downgrade the US from its 'AAA' rating, many saw this as *fait accompli*. Even if the rating action was considered marginal, it has triggered a mixed reaction amongst markets and investors that are worth considering.

Moody's stated its main argument for the move was a long-term deterioration in the country's fiscal metrics since the COVID-19 pandemic. **The agency expects further deterioration of government and interest payment ratios in the future, on the back of higher rates that are starting to feed into higher borrowing costs, and the lack of capacity from successive administrations to rein in spending.** On this front, the agency stressed that it expects the US's spending will continue to rise, and that reforms would be needed to bring it down. Moreover, **Moody's highlighted that it does not expect significant changes in fiscal policy going forward, even if the current economic growth environment should lend itself to the implementation of countercyclical fiscal policy.** Furthermore, the agency emphasized that any future rating changes would depend on any changes in fiscal policy, against a backdrop of a potential faster and larger deterioration of fiscal metrics that could result in higher interest rates.

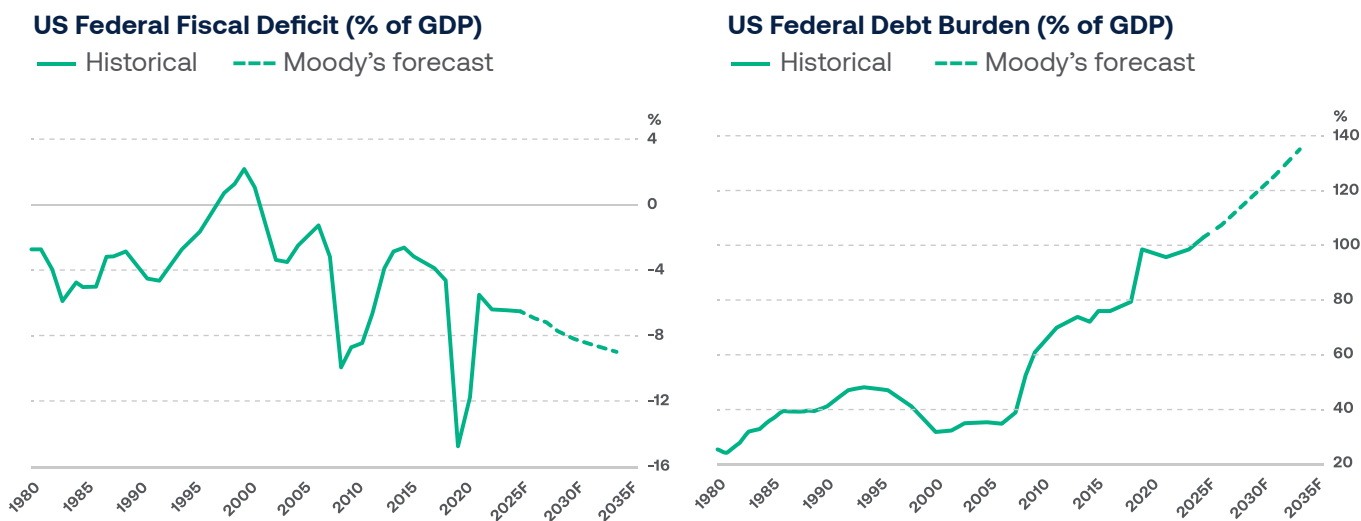
The fiscal situation in the US has increasingly gained relevance in the current environment, as the market shifts its attention from the tariff impact to longer-term issues, such as the US's fiscal deficit and debt burden. In its most recent developments, the House passed President Trump's tax-and-spending bill that includes several tax and spending priorities. Some of these worth highlighting are the extension of expiring tax cuts that contrast with spending cuts in Medicaid, clean energy programs, and nutrition assistance. The new bill also increases the cap on the

state and local tax – SALT – deduction from USD 10,000 to USD 40,000, while fulfilling some of President Trump’s campaign promises, such as not taxing tips or overtime at a federal level. The bill now heads to the Senate, where the Republican Party holds a majority, to undergo a budget reconciliation process. However, some Republican senators are expected to make significant changes to the bill, which could trigger additional frictions within the party. According to the latest statements at the time of this writing, the Senate aims to finish reviewing the bill by its self-imposed deadline of July 4. **Still, some market participants consider that there is limited appetite to implement countercyclical fiscal policy in the form of meaningful spending cuts or the implementation of higher taxes.** It is worth stressing that, according to figures published by the Congressional Budget Office and compiled by Moody’s in 2024, the US spent USD 6.8tn that year, of which USD 4.1tn were mandatory line items, mainly divided into social security payments, Medicare, and Medicaid. On the other hand, defense

spending totaled USD 0.9tn, roughly equal to the amount spent in servicing net debt interest. **With inflation measures still running above target and which could be pressured further in the aftermath of the announced price increases due to the tariffs, this environment limits the scope of potential Fed cuts in the future, thus feeding into a “higher for longer” setting in terms of rates.**

Against a still fluid situation regarding what the final legislation could look like, most market analysts expect this tax bill to balloon the US federal debt. Circling back to the rating downgrade, this was one of Moody’s main worries: the agency highlighted that it expects the US to post larger deficits that, in turn, will drive the government’s debt and interest burden higher, as can be seen on Graph 1. **With the X date (the day when the Treasury will not be able to meet its financial obligations) coming closer, and the observed brinkmanship around the debt ceiling negotiations, the fiscal situation in the US looks**

US fiscal metrics do not offer a positive outlook



Source: CBO, Moody's

daunting. Still, the base-case scenario does not consider a stalemate in the debt ceiling resolution, and most market participants expect a resolution in which the debt ceiling will either be increased or suspended. Until then, volatility will remain present in financial markets, with the slim probability of a credit event stemming from a refusal by Congress to lift the debt ceiling.

The Treasury curve seems to be pricing in this uncertain fiscal environment. Since Liberation Day, the UST curve has exhibited a generalized yield widening move, on the back of a bear steepening. The long end of the curve has risen an average of ~44bps, a move that some market analysts are starting to pencil in as the additional term premium investors are demanding to hold long-term US debt. This phenomenon is also visible in the UST curve steepening, as measured by its 2-10 spread, which has risen from levels close to 0bps to currently ~54bps. **It would not be surprising to see a sustained bear steepening of the Treasury curve, with current government debt levels potentially expected to increase once the tax bill is approved.** This could be explained by the potentially increased issuance of long-term Treasuries needed to finance the tax bill. Remember, increased supply tends to drive prices lower. Furthermore, if this procyclical fiscal policy remains the name of the game, then stronger growth should also increase rates on the long end of the curve.

Hence, the Fed may be finding itself between a rock and a hard place. Its room to cut rates due to slower growth may be constrained by this still persistent inflationary environment. Even if the talk about tariffs is expected to fade in the medium term, its effects may be long-lasting, especially if we consider that several US retailers are starting to discuss strategies to transfer price increases to consumers, as is the case with Walmart, Nike, and Adidas, to name a few. On

another note, if we look at the short end of the Treasury curve, it is worth highlighting that the one-month and the six-month bills are trading very closely to the Fed Funds Rate, thus signaling rate stability over the short term. **Even if the market via the futures curve is still factoring in the possibility of two rate cuts in 2025, the current stance starkly differs from the scenario we had at the beginning of the year, where a more dovish Fed was expected and fixed income was expected to overperform amid rate cuts.**

Overall, the most prudent investment strategy, even if it may sound counterintuitive, may not be to follow the guidelines of the “Sell America” trade and have a full underweight to American assets. Instead, understanding the benefits of diversification and how having exposure to other regions – such as EM – may prove beneficial at this point, where uncertainty is denting the safe-haven status of US assets. **We are not stating that the reserve status of the dollar will not be valid, or that a credit event will occur in the US. Instead, we believe that maintaining a diversified, high-quality name portfolio that favors short-to-mid duration is still an attractive alternative, while we weather the current uncertainty storm and wait for a clearer outcome out of Washington.**

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