LOOMIS | SAYLES

FULL DISCRETION TEAM

Extra Credit

Moody's Downgrade, Potential Tax Cuts Keep Spotlight on the US Fiscal Deficit

We believe Moody's decision to downgrade the US credit rating will not, by itself, have a meaningful impact on the US Treasury market in the short term. The US holds a unique position among countries given the reserve currency status of the US dollar (USD) coupled with the breadth and depth of the Treasury market. The debt obligations of the US are issued in USD and there remains no question of the government's ability or willingness to pay. Furthermore, while about one-third of the stock of Treasury debt is held by non-US investors, there are no real alternatives to the USD or the Treasury market, even if there was a desire by foreign investors to reduce their exposure. It is evident from a recent US Treasury report that foreign buyers are still showing up, and we suspect this will continue.

We believe the significance of the rating action is that it highlights some of the structural economic and demographic factors that are weighing on the US fiscal deficit. Large nondiscretionary spending, mostly related to entitlements and defense, has led to a deficit that is structural rather than counter-cyclical. Debt servicing costs have also increased significantly as interest rates have risen and the overall debt burden has expanded, especially following the government's fiscal boosts following the 2008 global financial crisis (GFC) and the 2020 COVID-19 crisis. The fiscal deficit is currently running close to 7% and Moody's estimates it could widen to 9% by 2035 if left unchecked. This level of deficit is clearly not sustainable in the longer term. Ultimately, the government will be forced to rein in the deficit through some combination of spending cuts and tax hikes, though fiscal tightening is not on the political agenda at the moment.

Key Takeaways

- We believe the impact of the Moody's downgrade is minimal but highlights long-term deficit concerns.
- The passing of the One Big Beautiful Bill Act on May 22nd by the House of Representatives has the potential to exacerbate the fiscal gap, which remains a long-term threat to yield stability.
- With the uncertainty around tariff escalation and a global trade war, we believe it will become increasingly more important to look for structural sources of domestic demand to support Treasury Bill issuance.
- We believe bond investors should stay vigilant and maintain flexibility with regards to interest rate risk in our current environment.

Tax Cuts Exacerbate the Problem, Bond Market at Risk for "Higher for Longer"

On May 22nd, the House of Representatives had just passed the One Big Beautiful Bill Act of 2025 by a slim vote of 215-214. The bill is a budget that sets taxes and spending for fiscal year 2026 and beyond. It extends most of the tax provisions of the 2017 Tax Cut and Jobs Act (TCJA), raises the debt ceiling by $4T and potentially increases the annual deficit over the next decade. Unless there is significantly higher growth (which we believe is unlikely), expenditures are reduced (projected Department of Government Efficiency (DOGE) savings have been questioned) or another large source of revenue materializes (tariffs), we do not see a stabilization or contraction of the deficit occurring in the near term. This dynamic creates a growing risk to the bond market – the fiscal gap remains a long-term threat to yield stability. Furthermore, if politicians refuse to curb the deficit and if taxpayers balk at paying higher taxes, then inflation can become an alternative form of tax on society. Our overarching view is that inflation is structurally embedded in the system – the result of our fiscal deficit as well as trade protectionism, deglobalization, decarbonization and aging demographics. This may lead to more unstable or potentially higher inflation in future cycles.

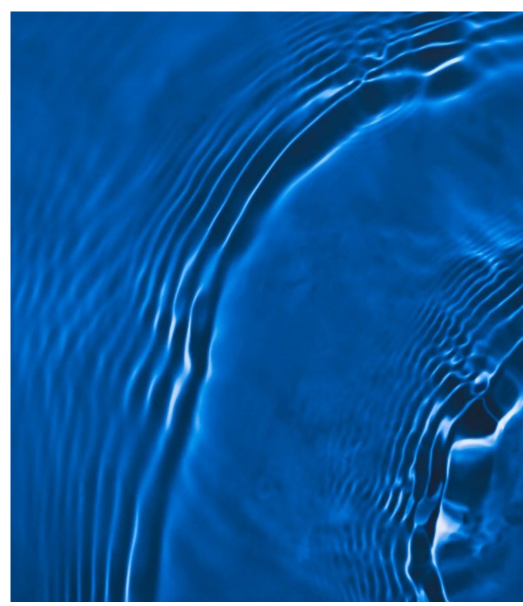
We believe bondholders need a sufficient premium to compensate for the increasing uncertainty of supply/demand dynamics as the government's borrowing needs grow as well as stubborn inflation. As a result, interest rate volatility could increase, and these factors could potentially put a floor under long-term Treasury yields. We believe the long end of the curve in particular, at this point, is not adequately pricing in potential risks – thus the push of "higher for longer", both in real and inflation-adjusted terms.

Funding the Deficit: Potential New Sources of Demand

A key question revolves around how the Treasury will fund the deficit. It is hard to fund a growing deficit at scale with uncertain foreign demand; this uncertainty is a byproduct of the escalation in tariffs and global trade war. Provoking major trading partners who also finance our debt is especially risky with no credible plan to rein in the deficit. In the near term, we think the Treasury will continue to increase issuance primarily in Treasury Bills (T-bills), but it will become increasingly more important to look for structural sources of demand to support T-bill issuance. The Treasury has signaled that it's working to boost domestic demand within the US (as an offset to weaker foreign demand), potentially through stablecoin adoption or offering regulatory incentives to banks. We believe the Treasury Department can continue to rely on T-bills to fund additional borrowing needs and avoid upsizing coupon auctions through the middle of 2026. After that, they will have to push more issuance into the coupon curve, which could periodically test the market's appetite to absorb longer-date Treasury notes. The Treasury will clear the market at its auction, but the only question is – at what yield?

"Glass Half-Full" Outlook for Bondholders

In the near term, we believe the Treasury can likely manage the supply/demand imbalance, however, the fiscal gap remains a long-term threat to yield stability. Unless there is a material shift toward more orthodox fiscal policy, investors will need to be compensated for the rising risk of a yield spike at the long end, in our view. We have already begun to see this dynamic take place, with the 30-year Treasury yield peaking above 5% at 5.09% on May 21st. We believe bond investors should stay vigilant. Treasurys offer liquidity and a ballast in downturns, however, tarnished credibility and rising inflation may reduce those benefits. Fortunately, bondholders can manage through this uncertainty. In this environment, we believe that reinvestment rate risk is on the side of the fixed income investor, but the challenge is getting to progressively higher step-ups of yield while maintaining or growing principal. We believe Treasury supply will continue to be a topic of heavy discussion and potentially increase interest rate volatility going forward. In today's environment, we believe bond investors should maintain flexibility with regards to interest rate risk, considering the risk/reward of the intermediate part of the curve against the long-term risks associated with long-end curve exposures.



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About the Team

The Full Discretion team brings decades of expertise and collaboration to create tailored solutions for their clients.

28	Investment Professionals
23+	Avg. Years of Industry Experience (Portfolio Management Team)
$79.1	Team Assets Under Management (Billion USD)

Team Philosophy

We have a legacy of independent thinking and leaning into the market when others may be pulling away. We take a deep-value, equity-like approach to credit selection across global fixed income markets. Our disciplined process helps gives us confidence in seeking to identify macro trends, formulate a clear view on market sectors, and invest throughout the credit cycle.

For more than 40 years, we have been applying our distinctive style of bond picking to deliver portfolios designed to provide excess yield potential and have low correlations to traditional benchmark-focused fixed income strategies.

Source: Loomis Sayles, as of 3/31/2025
Average years of expertise reflected at portfolio management level

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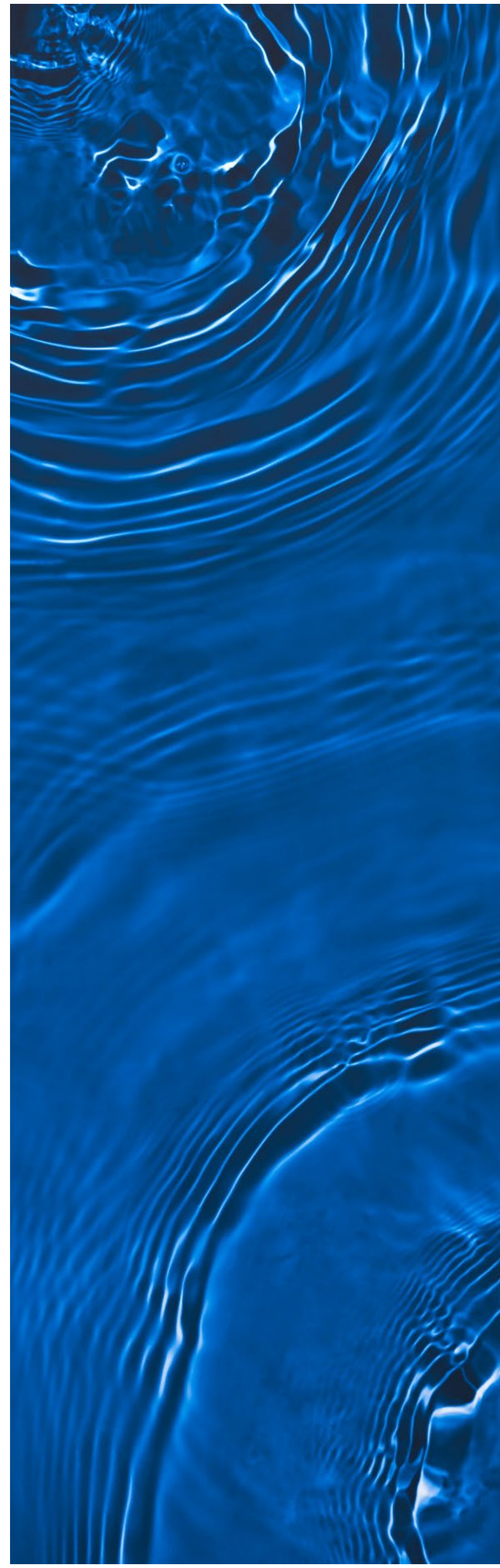

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