First Trust
Monday Morning OUTLOOK

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Debt Downgrade Drama and the Budget

Moody's finally downgraded US government debt on May 16th to Aa1, its second highest rating. With the US $36 trillion (and rising) in debt, it's not hard to see why. But Moody's was late to the party with S&P and Fitch (the other two major ratings agencies) having done so long ago.

The financial media went berserk, but long-term bond yields have not exactly soared. The 10-year Treasury yield closed at 4.43% the night before the downgrade and 4.51% this past Friday, eight days later. The 30-year Treasury yield moved up more but, again, didn't skyrocket, closing at 4.89% on the eve before the downgrade and 5.04% as of last Friday.

What has received more attention is the gap between the yield on the 30-year and the 10-year, which has grown to 50+ basis points, noticeably higher than the 20 basis points it averaged in 2024. However, the yield gap averaged 44 bps in the year prior to COVID, so not much change.

It's hard to separate the impact of all the moving parts affecting the bond market. For example, Federal Reserve officials have made it clear that near-term rate cuts are, from their perspective, not warranted. So, was it the downgrade or the Fed that put pressure on the market?

S&P downgraded US debt back in 2011 and Fitch in 2023, with no calamity as a result. S&P's downgrade came in the Obama Administration, Fitch's during Biden/Harris.

Like then, the downgrade is being used to bash politicians, this time the Trump Administration and Republicans in Congress for moving ahead with efforts to extend the tax cuts originally enacted back in 2017. Moody's criticizes the extension as being fiscally irresponsible. Wider deficits, according to the analysts, lead to higher interest rates on higher debt and a greater interest burden for the government to finance, leading to even bigger deficits, and so on and so forth.

The problem with this theory, though, is that the policies being pursued are not going to lift budget deficits beyond the policies that are already in place. In other words, why wait until now to downgrade debt based on current policies?

Spending soared *after* COVID, even with the economy opening up and unemployment at 4% or less. It was the spending that created $2 trillion deficits and the Biden Administration never talked about tax hikes.

The Big Beautiful Bill includes some spending cuts. According to the Tax Foundation, a non-partisan think tank, the bill recently passed by the House will *reduce* the deficit by roughly $1.9 trillion in the next ten years compared to a simple alternative of passing a bill that merely extended the 2017 tax cuts for the next ten years. That's because the latest bill includes both higher expected revenues as well as some reforms to entitlements, like Medicaid.

In addition, tariffs should generate some extra receipts and the Trump Administration has proposed steep cuts to non-defense discretionary spending for Fiscal Year 2026 (starting October 1), calling for 32% less spending on these programs versus what the Congressional Budget Office assumed back in January. If those cuts happen, the "baseline" for future spending could be a few trillion lower in the next decade.

None of this is to suggest that the US fiscal position is good; it's certainly not. In spite of record tax revenue, spending is so high that budget surpluses are nowhere in sight. Back in 2007, the budget deficit was only about 6% of federal spending. In other words, it wouldn't have taken many spending cuts to get to a balanced budget.

But by 2019 (the year before COVID), the budget deficit was 22% of federal spending. Now it's 27% of federal spending. Imagine cutting your household budget by 27%!

The good news is we don't have to run surpluses to make our debt position manageable. At a minimum we want overall debt to grow no faster than nominal GDP.

The more we reduce the deficit by cutting spending, the more resources stay in the private sector, setting off a virtuous cycle of more growth, more revenue, and smaller deficits. It happened under President Clinton. Now that the Senate has the bill, can we do it again?

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-27 / 7:30 am	Durable Goods – Apr	-7.8%	**-9.1%**	-6.3%	+9.2%
7:30 am	Durable Goods (Ex-Trans) – Apr	+0.0%	**-0.1%**	+0.2%	0.0%
5-29 / 7:30 am	Initial Claims – May 24	230K	**229K**		227K
7:30 am	Q1 GDP Preliminary Report	-0.3%	**-0.3%**		-0.3%
7:30 am	Q1 GDP Chain Price Index	+3.7%	**+3.7%**		+3.7%
5-30 / 7:30 am	Personal Income – Apr	+0.3%	**+0.3%**		+0.5%
7:30 am	Personal Spending – Apr	+0.2%	**+0.3%**		+0.7%
8:45 am	Chicago PMI	45.1	**43.8**		44.6

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.