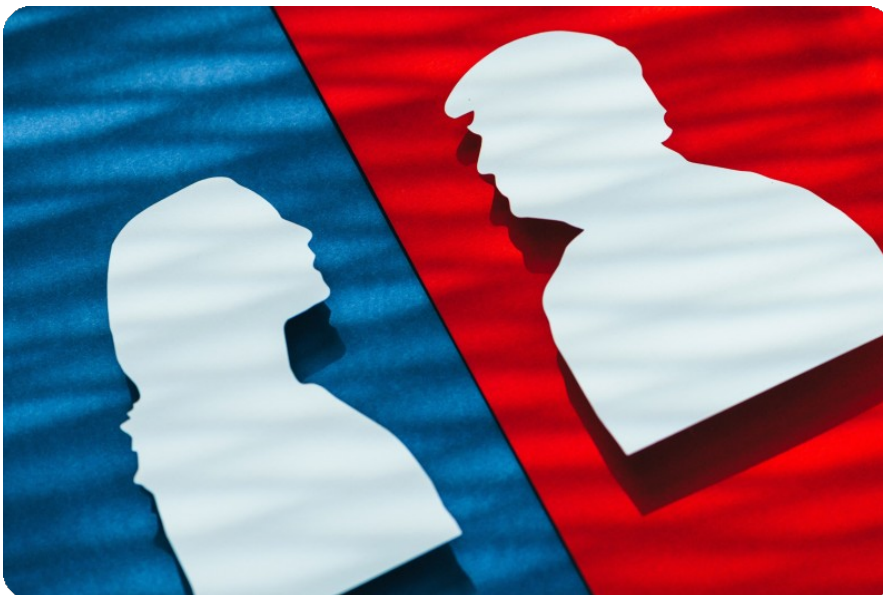


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UNITED STATES

How the US election will impact deficits, debt, and the yield curve

Government borrowing and the national debt are barely getting a mention in the US election campaign, yet a failure to change trajectory risks further debt downgrades, more market volatility and higher borrowing costs



Trump vs Harris. Whoever wins the election will have to get to grips with the national debt issue

This year's election is set against a backdrop where the government is borrowing the equivalent of 6% of GDP and the national debt totals \$35tr. This poor fiscal position risks being exacerbated by structural factors, such as an ageing population, and cyclical factors, such as cooling economic growth. Failure to get to grips with the issue runs the risk of more debt downgrades, more market volatility, higher borrowing costs and slower potential economic growth.

Long-term challenges of the US budget

Huge fiscal expenditure during the pandemic under both the Trump and Biden presidencies has been the major factor responsible for the deterioration in government finances. That has abated, but even if the candidates were seriously motivated to shrink the deficit, there are major structural issues that make it difficult to get a real grip on expenditures.

Mandatory spending, or spending mandated by existing laws, represents nearly two-thirds of expenditure. It is predominantly healthcare and social security spending, largely determined by the number of recipients and has been growing by 0.1-0.2pps as a share of GDP per year historically, driven by demographic trends. In the past, the growing mandatory outlays were offset by shrinking discretionary spending (voted on in the annual appropriations process). However, this component, of which defence constitutes half, is already close to historical lows in real terms, suggesting limited scope to generate significant spending cuts. The third and smallest component of government spending is interest expense. Having spiked by 0.5pps in 2023 due to higher interest rates, this reached 2.4% of GDP last year.

Given these constraints, the non-partisan Congressional Budget Office's June projections suggest an average annual deficit of 6.3% of GDP between 2024-34 with public debt projected to increase from 99% to 122% of GDP. The assumptions included Trump's 2017 Tax Cuts and Jobs Act (TCJA) expiring and a solid economy maintaining an average growth rate of 1.8%YoY, employment rising nine million over the period and incomes growing solidly. A more detailed analysis of the budget trends can be found [here](#).

Trump versus Harris: fiscal decisions

In terms of direct fiscal decisions, a Harris administration is expected to let Trump's TCJA income tax cuts expire. There would be additional tax increases for businesses (7pp hike of the corporate tax rate), and wealthy individuals, but this would be more than offset by tax credits for families and lower-income households plus subsidies for first-time home buyers. Spending activities will be focused on improving access and lowering costs related to healthcare, childcare, housing and education.

This policy mix could amount to a higher deficit to the tune of \$1-1.5tr over a decade relative to the CBO baseline, but it would be even larger if the additional tax hikes don't get passed by Congress.

A Trump administration will focus on a "second phase" of tax cuts in addition to an extension of the 2017 TCJA. This will involve sizeable tax cuts for corporates paid for by spending cuts/efficiency savings and tariffs placed on imported goods. The second major Trump initiative is the imposition of 10% tariffs on all goods imports with 60% levies on Chinese-made products together with a four-year plan for phasing out Chinese imports of electronics, steel, and pharmaceuticals.

Extending the 2017 tax cuts (\$4tr alone), plus additional tax cuts offset by revenues raised from tariffs are, we believe, set to result in deficits increasing by perhaps \$5.5tr relative to the CBO's baseline – nearly triple that of Harris' proposals.

Economic Impact

We sense that Trump's policy proposals could help to support domestic demand via lower taxes, but there are upside risks for inflation relative to Harris' proposals. Tariffs and trade barriers will push up business costs, while intensified immigration controls may limit labour supply growth. This environment is likely to mean monetary policy needs to be kept tighter than would otherwise be under Harris, where tax hikes could weigh on activity. Our longer-term projections with a more inflationary environment under a Trump presidency could lead to a 50-75bp higher neutral Fed funds rate (3.25-3.5% versus the Fed's 2.8% assumption) over the long run. Under Harris, it may remain closer to 3%.

The [CBO analysis](#) suggests that the variation in the interest rate environment has potentially the biggest impact on the budget deficit scenarios. Each 10bp of deviation from the baseline results in around 0.1pps of GDP p.a. increase in the expected fiscal deficit over a 10-year period, due to higher expenses on debt servicing.

Under both presidential candidates, the deficit will remain uncomfortably wide, with debt levels continuing to rise rapidly. However, the combination of direct decisions on tax policy and the macro conditions plus higher borrowing costs suggests that a Trump administration could lead to up to 1.2-1.3% GDP wider annual deficits starting in 2027 compared to a Harris administration. We have a stronger GDP growth profile with Trump in our long-term growth forecasts, which helps improve the appearance of the fiscal ratios, but even so, we are likely to see the deficit average nearly 7% of GDP under Trump while vs. slightly below 6% under Harris.

Implications for US Treasuries and markets

The US Treasury market is currently not particularly bothered by the extra issuance supply resulting from the higher deficit.

There are three reasons for this. Firstly, we're on the eve of a Fed rate-cutting process and this is dominating market direction with markets expecting 200bp+ of Fed rate cuts over the next 18 months.

Second, the Treasury has managed to curb the effect of the extra issuance by morphing the more significant increases towards shorter maturities.

Third, there is a risk-on market theme out there with equities at record highs, implying the market believes there is little to worry about.

Going forward, a lack of market concern about the size of the deficit can easily pivot to it being

top of the list of worries. The transmission mechanism here is a few poor bond auctions that become a trend, requiring the build of a material new issue concession that gets built into structurally higher absolute yields. That could happen slowly, or it could be more abrupt. Our base is for a slow creep. But it's an impactful one. We see the 10-year yield heading for 5% as a base case in 2026.

In fact, a 5% 10-year yield call is a conservative one all things considered. It's just a 150bp curve to a Fed funds rate that's been cut to 3.5%. While the fiscal deficit difference between the two candidates favours a Harris policy mix (lower than a Trump deficit), it's not big enough to be materially impactful. We have a baseline view for a 5% 10-year yield and a 150bp curve from the funds rate out, which we feel is fair given the size of the deficit, and broadly agnostic to the election outcome. If it's a Trump administration, yields are likely to be higher and the curve steeper, but probably on a delta of no more than 50bp for the 10-year yield and the curve.

Market pressure to eventually refocus politicians' minds

In the current environment, where markets are calm, politicians see little threat from the current trajectory of the US's fiscal position. But that will quickly change if ratings agencies and markets start to see it as an issue.

If markets become dysfunctional, it will force governments to take more rapid and painful action. That may not happen in the next four years – but as a minimum, the higher, steeper yield curve we expect will put up costs for households and businesses and prove a headwind for the economy more broadly.

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