# Signal over noise #10: The fiscal tightrope

## Global equity strategy

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- The "One Big Beautiful Bill Act" risks further widening US deficit on top of a debt/GDP ratio already exceeding 120%, with CBO projections indicating over USD 3 trillion in additional US debt over the next decade.
- History shows that fiscal discipline, low/stable rates, sustained growth, credible institutions, and positive external factors can reduce debt/GDP without haircuts. Despite the current lack of consensus on budget cuts, strong Fed credibility, reserve-currency status, and deep markets suggest the US's ability to repay debt is not in question.
- Ultimately, growth remains the key lever: prudent trade and tariff policies must balance revenue and recession risks, while AI-driven productivity gains, power infrastructure investments, and demographic tailwinds are essential to drive GDP growth and stabilize or reverse the debt trajectory.

Financial markets continue to be buffeted by the twists and turns in US policy. On trade, the US and China have come back to the negotiating table after accusing each other of breaching their recent trade agreement, while the legality of the Trump administration's tariffs is being questioned in the courts. On fiscal policy, President Trump's "One Big Beautiful Bill Act" (OBBBA), which was passed by the House of Representatives on 24 May, is making its way through the Senate.

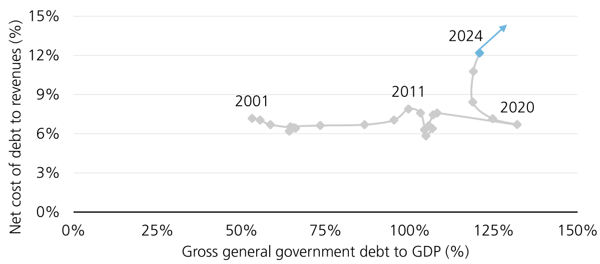
Despite the noisy headlines, the Trump administration has little room to maneuver, even if the rhetoric suggests otherwise. The US economy needs to grow to keep the fiscal deficit manageable, so trade policies that risk a recession are likely to be negotiated lower. Pronouncements that suggest otherwise are noise, in our view. At the same time, higher tariff revenues are needed to help offset the spending provisions in the OBBBA. It is not in the administration's interest to have tariffs so high they destroy trade, ultimately raising less revenue and pushing the economy into recession. So the policy path is likely to be along a fiscal tightrope. In summary, what others may see as bearish indicators for the equity markets we see as guardrails for an economic policy that needs to be growth oriented while fiscally prudent.

### The deficit looks set to get even bigger

While the bill may be revised as it moves through the Senate, the Congressional Budget Office (CBO) estimates that, in its current form, it would add more than USD 3 trillion to US debt over the next decade. This would be on top of the existing USD 36.2 trillion in debt, which already exceeds 120% of US GDP. The CBO also projects that, under the bill's provisions, budget deficits will rise from the already elevated levels of 6.4% of GDP in 2024 to about 7% in 2027.

## Figure 1 - US public debt is on a deteriorating trajectory

US gross general government debt to GDP vs. net cost of debt to revenues

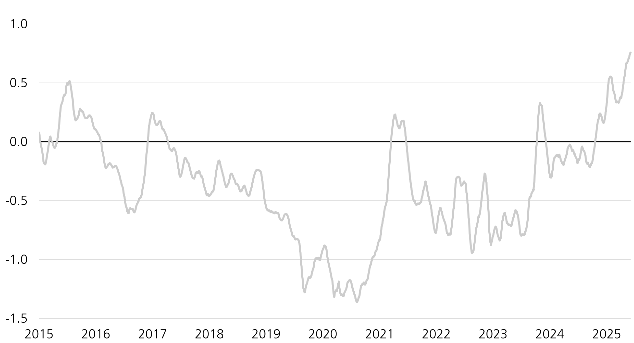



Source: IMF, UBS

Amid rising investor concerns about the trajectory of US debt, term premia for long-term US Treasuries have started to edge higher. Debt worries are also a concern for equity investors, given their impact on financing costs and the implications for future tax levels.

## Figure 2 - Long-term US term premia are trending upward

Adrian Crump & Moench 10 Year Treasury Term Premium (20 Day Moving Average)




Source: Bloomberg, New York Fed, UBS, as of June 2025

**So, what needs to be done?**

Improving a country's debt position, based on historical comparisons, has required a combination of five factors: fiscal discipline, stable and low interest rates, economic growth, credible institutions, and positive external factors.

For example, in the US and the UK in the decades following WWII, and in Canada in the 1990s, significant reductions in debt-to-GDP ratios were achieved through high real GDP growth rates, the running of persistent budget surpluses, and low interest rates.

## Table 1 - Five key factors to manage high debt levels: historical examples and current conditions in the US

| | US post-WWII | UK post-WWII | Canada 1990s | US today |
|---|---|---|---|---|
| Peak debt level (% GDP) | 106% | 250% | 100% | 121% |
| Economic growth | ca. 4%-5% p.a. | ca. 3%-4% p.a. | ca. 3%-4% p.a. | - Current forecast: 1%-1.5% p.a.<br>- Upside for debt: rapid tariff de-escalation, strong productivity gains from AI |
| Stable low rates | Financial repression via rate pegging and regulation Q. Zero-to-negative real yields | Financial repression and strict capital controls. Negative real yields | Gradually declining rates remained below US levels | - Interest rates: Declining, 2026 forecast of 3.0-3.25%<br>- Upside for debt: Temporary financial repression measures to contain interest expenses |
| Fiscal discipline | Primary budget surpluses averaged 1.1% | Primary budget surpluses averaged 1.6% | 1995 spending cuts. Turned budget deficits into surpluses, which were sustained for more than a decade | - Fiscal spending: USD 3 trillion debt addition<br>- Upside for debt: Partial revision of tax cuts, higher-than-expected tariff revenue or DOGE efficiency gains, eventual fiscal consolidation |
| Credible institutions | 1951 Fed-Treasury Accord | 1944 Bretton Woods currency peg | Credible central bank. Formal inflation-targeting regime introduced in 1991 | Credible Fed, data dependent with transparent communication |
| Positive external factors | Baby-boom demographics, Marshall Plan spillovers | Gradual restoration of pre-war markets. 1944 GATT and GBP depreciation led to export growth | 1994 NAFTA agreement. 2000s commodity boom | Structural drivers: Rising labor productivity from AI, increased capital spending on power infrastructure, higher spending from the aging economy |

Source: USDT, UK OBR, Public Accounts of Canada, IMF, Refinitiv, UBS

**Fiscal discipline**

In the US, government debt levels peaked at 106% of GDP in 1946 but declined to a low of 23% by 1974. According to a recent study by Acalin and Ball [1], the primary drivers of this decline were fiscal discipline and low interest rates. By cutting wartime expenditures and maintaining budget discipline, US governments achieved a primary budget surplus on average (excluding interest expenses) of 1.1% of GDP between 1947 and 1974, steadily reducing the debt ratio. Additionally, financial repression—most notably the Federal Reserve's policy of pegging interest rates near zero—helped lower borrowing costs and further eased the debt burden.

The US situation today is not analogous to the post-war period. There is no political consensus in Washington DC for the degree of spending cuts and/or tax increases that would be required to achieve a primary budget surplus. As noted above, if the OBBA legislation passes largely intact, the CBO estimates that the federal deficit would increase from an already elevated 6.3% of GDP in 2024 to more than 7% in both 2026 and 2027.

[1]Acalin, J. and Ball, L.M., 2023. *Did the US really grow out of its World War II debt?* NBER (No. w31577).

However, while not part of the legislation, tariff revenue will serve to offset the rise in deficits from the current budget reconciliation package. Economists at The Budget Lab at Yale University estimate the current tariffs in place today will raise roughly USD 2 trillion in revenue over the next decade after accounting for negative economic effects of the tariffs, largely offsetting the reconciliation bill's deficit increase.

Legal challenges to the legitimacy of Trump's tariffs pose a risk to these revenue streams. But, in our view, even if the Supreme Court permanently upholds the Court of International Trade's (CIT) 28 May ruling to invalidate the vast majority of the Trump administration's second-term tariffs, the administration has many legal pathways available to rebuild the tariffs. We therefore expect these tariffs to remain in place.

It's worth noting that from a revenue perspective, lower tariffs may raise more income than higher tariffs. The Peterson Institute for International Economics has estimated that a 10% tariff would net around double the revenue raised from a 20% tariff (which would reduce imports more significantly).

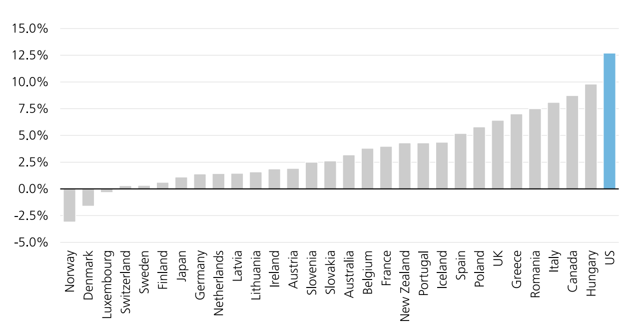
So, while the budgetary implications of the OBBBA may seem concerning at first glance, in practical terms, the offsets provided by other areas of the Trump policy agenda could leave the overall impact more neutral.

**Stable low interest rates/credible institutions**

This discussion naturally leads to a consideration of debt financing. One consequence of the rise in US interest rates to combat the post-pandemic surge in inflation is that debt-servicing costs have increased significantly, exacerbating the size of the problem.

Figure 3 - US spends highest share of revenues on interest

2025E net cost of debt to general government revenues




Source: UBS, IMF, as of May 2025

When assessing debt affordability, the net cost of debt relative to government revenues is more important than the debt-to-GDP ratio. We estimate the net cost of debt-to-general-government revenues will be 12.7% this year for the US, a doubling from 2020 levels.

In our base case, we expect the Federal Reserve to cut interest rates toward 3.00-3.25% by mid-2026 and yields across the curve to decline moderately, which should help to contain the debt service cost to 13.5% of general government revenues by 2026. If instead Treasury yields were to rise across the curve toward a weighted average of around 5% and stay there, the net interest cost would rise by almost one percentage point of revenues every year, reaching about 17.2% by 2030.

However, we expect future US government and Fed policies would seek to put downward pressure on yields, mitigating the cost of debt servicing. Talk that the administration might consider forcing certain holders of US Treasuries into zero-coupon bonds points in this direction. That said, the reemergence of a positive term premium in US bond markets means that yields are unlikely to drop as low as they did in the decade following the global financial crisis.

Looking ahead, the US enjoys a number of advantages that should allow it to continue to finance a large deficit and an elevated debt-to-GDP ratio over the medium term. The Federal Reserve, committed to formal inflation targeting, is a credible central bank. Thus far, comments from President Trump that the Fed should be doing more to cut interest rates have been followed by reassurances that there is no desire by the administration to remove the central bank's independence. Of course, the next Fed governor might be more inclined to a dovish approach, but President Trump has also shown sensitivity to bond market turbulence, suggesting that the administration attaches some value to the Fed's credibility. In addition, deep US capital markets, the dollar's reserve currency status, and the significant wealth held by US households mean that the US's ability to repay debt is not in question, in our view.

**Economic growth/positive external factors**

These advantages, however, while they help finance the deficit, do not help with resolving the underlying problem of a large primary budget deficit. That leaves economic growth as an important means of improving the country's debt-to-GDP ratio.

While the Acalin and Ball study attributes the majority of the 83-percentage-point (pps) reduction in the post-WWII debt ratio to budget surpluses and financial repression, they found that strong growth still accounted for a significant 32pps of the decrease in debt.

The growth imperative has been recognized by the Trump administration. US Treasury Secretary Scott Bessent has stated that, "What is important is that the economy grows faster than the debt […] If we change the growth trajectory of the country, of the economy, then we will stabilize our finances and grow our way out of this."

It is worth noting that the OBBBA legislation would avoid a large automatic tax increase at the end of 2025 when the 2017 individual income tax cuts sunset. The bill, by extending tax cuts, avoids a fiscal contraction that would be damaging to growth.

Looking longer term, we believe the US economy will benefit from positive external factors, with AI acting as a key catalyst for higher labor productivity and GDP growth. Further upside could come from increased capital spending on power and clean energy, as well as faster growth and increased spending from the aging “silver economy.”

On AI, the McKinsey Global Institute has estimated that it could increase labor productivity in the US by 20-40% by 2030, depending on the level of adoption across industries. This translates to an annual GDP growth boost of 0.8-1.4%, with AI-driven automation and augmentation enabling workers to focus on higher-value tasks. Thus far, adoption is proceeding quickly. US Census Bureau data suggest the AI adoption rate could cross the 10% threshold by the end of this year. For comparison, it took US e-commerce 24 years to reach such market penetration. Similarly, PwC estimates that AI could contribute up to 14% additional GDP growth globally by 2030, with advanced economies like the US seeing the largest gains.

**Conclusion**

The political will to cut the deficit is lacking, but the combination of the unique advantages the US enjoys, and likely financial repression, means that the debt burden remains manageable, in our view. This leaves growth as the best option for the US to reduce the deficit over time. The administration knows this and so the US fiscal position creates a constraint on their policy agenda. For us, this is the signal for equity markets—whereas pronouncements like the “Liberation Day” tariffs, which would hurt growth, are noise.

Markets have recovered strongly from their lows in the wake of those announcements, in part because President Trump has reverted to the pattern from his first administration of negotiating back from initial starting points. This more pragmatic approach is likely to continue, given the need for economic growth.

Nonetheless, short-term market swings in reaction to news headlines on US fiscal and trade policy look set to continue, and we expect continued volatility. We maintain a Neutral view on US equities following strong recent performance and amid ongoing trade, economic, and fiscal uncertainty.

But longer term, we caution against taking portfolio decisions based around policy noise. We continue to see potential for further upside into 2026, supported by structural earnings growth, a more stable policy environment, and lower Fed interest rates.

Given the importance of growth in helping improve the US fiscal position, we retain strong conviction in the long-term potential of our Transformational Innovation Opportunities—*Artificial intelligence*, *Power and resources*, and *Longevity*—which we expect will help drive higher GDP growth in the coming decades.

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**Attractive** – We consider this asset class to be attractive. Consider opportunities in this asset class.

**Neutral** – We do not expect outsized returns or losses. Hold longer-term exposure.

**Unattractive** – We consider this asset class to be unattractive. Consider alternative opportunities.

**Least attractive** – We consider this asset class to be among the least attractive. Seek more favorable alternative opportunities.

Note: For equities, we have collapsed "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive" from the five-tier rating system that is found in the Equity Compass into three tiers.

# Appendix

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