Market Commentary 6/02/25

An Oxford Harriman & Company Market Commentary

Impact of Trump's Big Beautiful Bill on the Bond Market and Dollar

Trump's 'Big Beautiful Bill': U.S. Bond Yields Surge and the Dollar Slips

President Trump's "One Big, Beautiful Bill" is an extensive legislative package funding and enacting much of his second-term agenda. It bundles together a continuing resolution to keep the government funded through the end of fiscal 2025, along with major tax and spending provisions.

Key components of this legislation include:

- **Extended Tax Cuts:** Permanent extension of the 2017 Tax Cuts and Jobs Act (TCJA) provisions, preventing individual and corporate tax rates from rising in 2026. This covers income tax cuts and business incentives that were set to expire, resulting in no significant tax increases next year. The bill also modifies some tax rules, such as enhancing the deduction for pass-through business income and other credits and raising the state and local tax (SALT) deduction cap from $10,000 to $40,000.
- **Border Wall & Immigration Funding:** Financing for border wall construction and enforcement on illegal immigration. The bill funds tens of thousands of new Border Patrol agents and increases deportation capacity, aiming to remove up to 1 million people annually
- **Defense Spending:** A substantial increase in defense expenditures, highlighted by funding for a "Golden Dome" missile defense system. This expensive initiative, along with higher overall military outlays, reflects Trump's focus on bolstering U.S. defense capabilities. These defense increases are expenditures without immediate offsets, contributing to some of the deficit concerns we will address later in this commentary.

Oxford Harriman Offices

Astoria, New York
Boston, Massachusetts
Buffalo, New York
Chagrin Falls, Ohio
Cleveland, Ohio
Detroit, Michigan
Fairfield, New Jersey
Kingston, New York
Lorain, Ohio
Madison, Wisconsin
Mentor, Ohio
Newport News, Virginia
Park Avenue, New York
Rhinebeck, New York
Sarasota, Florida
Saratoga County, New York
Short Hills, New Jersey
St. Joseph, Michigan
Syracuse, New York
Westlake, Ohio
White Plains, New York
Woodcliff Lake, New Jersey

oxfordharriman.com

- **Entitlement & Spending Reforms:** The package introduces cost-saving measures to entitlement programs. It tightens eligibility for social safety net programs like Medicaid, SNAP, and Affordable Care Act subsidies. In effect, certain benefits would be curtailed or have stricter work requirements. These cuts were intended to partially offset the tax cuts, but even lawmakers note the reductions "don't come close" to paying for the bill's expensive provisions. Despite some spending reductions and additional savings like repealing unused COVID funds, the net result is expected to be larger fiscal deficits.

By combining appropriations into this legislation, Congress avoids a near-term government shutdown. Essentially, this year's federal funding is locked in. This maneuver ensures the government stays open, but it also sidesteps the normal budget process, a sign of how urgent and sweeping the legislation is.

- **Continuing Resolution to Prevent a Shutdown:** Procedurally, the bill leverages a continuing resolution to fund government operations through September 30, 2025. By combining appropriations into this legislation, Congress avoids a near-term government shutdown. Essentially, this year's federal funding is locked in. This maneuver ensures the government stays open, but it also sidesteps the normal budget process, a sign of how urgent and sweeping the legislation is.

Taken together, the bill is an omnibus blend of tax cuts, spending increases, and policy initiatives. The market was quick to realize that the plan has the potential to significantly expand the fiscal deficit in the coming years since the tax extensions and new outlays lack offsets.

The Congressional Budget Office and others estimate the tax provisions alone could reduce federal revenues by roughly $4 trillion over the next decade.

The Congressional Budget Office and others estimate the tax provisions alone could reduce federal revenues by roughly $4 trillion over the next decade. In return, proponents argue the bill would prevent a broad tax increase on approximately 62% of U.S. taxpayers that would occur if TCJA expired as scheduled. Additionally, proponents argue the new legislation will spur investment growth, leading to additional revenue. Below, we discuss how markets have reacted.

One of the most contentious debates around the bill, and a source of market jitters, was over the SALT deduction cap. The initial draft sought to make the $10,000 SALT cap permanent. Eventually, the cap was extended to $40,000, with new income phaseouts for high-income earners. For markets, the SALT drama had two implications.

First, it increased volatility as traders handicapped the bill's odds. Each update in the SALT negotiations, from rumors of a deal to reports of an impasse, prompted volatility in the bond and currency markets as the bill's fate and the fiscal trajectory of the U.S. hung in the balance.

This outcome led to investor concerns about the deficit, leading to bond market nervousness and a spike in rates. This uncertainty has been widening trading ranges for Treasurys and has led to short-term volatility in both yields and the dollar.

Second, the resolution of the SALT negotiations, by sweetening the tax cut further, worsened the deficit outlook. Analysts noted that raising the cap to $40,000 would cost significantly more in lost revenue than a $30,000 initially proposed cap. This outcome led to investor concerns about the deficit, leading to bond market nervousness and a spike in rates. This uncertainty has been widening trading ranges for Treasurys and has led to short-term volatility in both yields and the dollar.

"Priced In": TCJA Extension Assumptions and Growth Risks

A critical aspect for investors is that extending the TCJA cuts had been largely priced in by the market. The 2017 tax law's individual rate cuts (along with provisions like doubling the standard deduction and 20% pass-through deduction) were scheduled to expire at the end of this year. Businesses and investors have been operating under the assumption that these tax cuts would be extended, as the political costs of letting them lapse could be severe.

...equity and bond markets had mostly priced in a continuation of the tax policy put in place during Trump's first term. Some contend extending this policy will support consumer spending and corporate earnings for the next several years.

President Trump made this extension a centerpiece of his agenda. As a result, equity and bond markets had mostly priced in a continuation of the tax policy put in place during Trump's first term. Some contend extending this policy will support consumer spending and corporate earnings for the next several years.

The smooth passage of the extension in the House, therefore, did not spark euphoria since it met the market's expectations. However, it did create some important downside risk if the extension failed. In the weeks before the vote, that question gained importance amid the SALT impasse and other disputes.

Had the tax cuts been allowed to expire, the U.S. economy could face a substantial fiscal drag starting in 2026 due to higher taxes reducing disposable incomes and demand. This would likely dampen growth and inflation prospects, which, in theory, would be bullish for Treasury bonds and result in lower yields. Some experts warned if political gridlock sank the extension, Treasury yields could fall on expectations of a sharper economic slowdown.

The market's base case remains that the TCJA cuts will be permanent, supporting growth into 2026. Indeed, the Tax Foundation estimates the House tax package, as introduced, would boost long-run GDP by about 0.6% relative to letting the cuts expire.

For now, that scenario has been averted as the House outcome suggests the tax cuts are moving toward extension, barring any surprise in the Senate. The market's base case remains that the TCJA cuts will be permanent, supporting growth into 2026. Indeed, the Tax Foundation estimates the House tax package, as introduced, would boost long-run GDP by about 0.6% relative to letting the cuts expire. However, the price to pay may be additional federal borrowing. The stock market had been expecting this potential growth increase, so there was a muted response in the equity indexes.

The real story for investors was what occurred with Treasury yields and the U.S. dollar, and we will discuss this below.

Deficit Fears Surge Impacting Treasury Yields and the Dollar:

...the President's bill has introduced new concerns and focus on U.S. fiscal sustainability. The U.S. debt-to-GDP ratio is now roughly 124%, and the annual deficit is expected to increase due to higher interest costs and now additional tax reductions.

As mentioned above, the President's bill has introduced new concerns and focus on U.S. fiscal sustainability. The U.S. debt-to-GDP ratio is now roughly 124%, and the annual deficit is expected to increase due to higher interest costs and now additional tax reductions. In fact, Moody's Investors Service downgraded the U.S. credit rating one notch (from Aaa to Aa1) this month, citing the "widening budget deficit" and lack of improvement signs. This followed a similar move by Fitch Ratings (albeit their move was made in 2023), and the U.S. now carries a sub-AAA rating from all major rating agencies.

The Moody's downgrade was a wake-up call and triggered an immediate market reaction, as long-term Treasury yields jumped and the yield curve steepened on the news. Likewise, the dollar also weakened on the downgrade announcement.

Bond Market Reaction: Yields Spike

U.S. Treasury yields have surged in recent weeks as bond traders react to the implications of Trump's bill. Worries about heavy Treasury issuance, rising

Initially, the bond market did not like this new tax bill, and bond investors have been selling off holdings, driving prices down and yields up. Longer maturities have borne the brunt of the sell-off, as short-term Treasury yields are guided more by Federal Reserve policy. This has led to a dramatic yield curve steepening.

inflationary pressures from fiscal stimulus, and potential credit risk, spurred by the downgrades mentioned above, helped to push long-term interest rates higher. The yield on the 30-year Treasury bond moved above 5.0%, reaching levels not seen since late 2023. The benchmark 10-year Treasury yield also jumped, climbing over 15 basis points in the week surrounding the bill's passage, and has increased by nearly 50 basis points over the last month, reaching a high of 4.6%.

These are notable moves. A half-percent increase in long yields within a month is significant for the $24 trillion Treasury market. It reflects a classic "bond vigilante" response, with investors demanding higher yields to compensate for greater supply and fiscal risk.

Initially, the bond market did not like this new tax bill, and bond investors have been selling off holdings, driving prices down and yields up. Longer maturities have borne the brunt of the sell-off, as short-term Treasury yields are guided more by Federal Reserve policy. This has led to a dramatic yield curve steepening.

Earlier this year, the yield curve was inverted (short rates higher than long rates), signaling fears of a recession. That inversion has now markedly receded.

In fact, after the latest surge, the 10-year yield at times exceeded the 2-year yield, a sharp change from just a few months ago. The 30-year yield rising above 5% while the 2-year holds around 4% has rapidly unwound a portion of the curve inversion, indicating a "bear steepener" pattern, which is when long rates rise faster than short rates.

U.S. Dollar Under Pressure: Weakening Despite Rising Yields

Perhaps the most surprising market reaction has been in the U.S. dollar, which has weakened significantly even as Treasury yields climbed. Normally, rising U.S. yields make dollar-denominated assets more attractive, which should strengthen the dollar.

However, this correlation has broken down recently, as the dollar has fallen concurrently with rising long-term yields, a highly unusual pattern that signals eroding confidence in the U.S.

At one time last week, the dollar index (DXY) was down over 10% even as the 30-year yield hit its highs. This divergence with a weaker dollar and higher U.S. rates is a rare occurrence. We were able to find just three instances in the last 50 years when the dollar dropped more than 2.5% in a week while the 10-year yield jumped at least 25 basis points. The first was in July 1985 (the Plaza Accord period of dollar depreciation), the second in May 2009 (post-financial crisis), and now most recently this month. Prior episodes were followed by sustained dollar declines.

The current situation reminds us of the "twin deficits" era of the 1980s when large U.S. budget and trade deficits led to a sliding dollar even as interest rates stayed high. Investors appear to be similarly concerned that fiscal concerns and trade conflicts are hurting the dollar.

The current situation reminds us of the "twin deficits" era of the 1980s when large U.S. budget and trade deficits led to a sliding dollar even as interest rates stayed high. Investors appear to be similarly concerned that fiscal concerns and trade conflicts are hurting the dollar. We believe Trump's revived trade threats last week did not help the situation and created renewed volatility in equities as we ended the week.

The current political backdrop is the key driver of this year's uncertainty and market volatility. Markets are trying to digest erratic trade policies with new tariffs and confrontational negotiations that are reducing foreign demand for U.S. assets. The "risk-off" flows that usually benefit the dollar as a safe haven are not occurring.

We believe this loss of confidence is a key reason the dollar has slipped in tandem with bond prices, a potential warning sign that the U.S. may be testing the market's patience to finance deficits without consequence.

...the cost to insure U.S. debt has risen, and credit default swap spreads widened modestly, echoing the market's caution.

Looking ahead, investors will watch the Senate's deliberations and any further changes to the bill to see if there are spending cuts or offsets added to satisfy deficit hawks. They will also monitor the economic data for signs that fiscal expansion is influencing growth or inflation.

Also, the looming debt ceiling, due to return as we approach fall, could become another focal point, especially after this increase in borrowing. Already, the cost to insure U.S. debt has risen, and credit default swap spreads widened modestly, echoing the market's caution. As always, investors are faced with every changing variable to consider.

We will continue to provide you with updates and, hopefully, clarity around major market moves.

oxfordharriman.com

Dennis P. Barba, Jr.
CEO & Managing Partner

Michael P. Finkelstein, CFA
Partner

Robert Frenkel, CFP ®
Chief Investment Officer

Sources:

abcnews.go.com
reuters.com
taxfoundation.org
tradealgo.com

The S&P 500 Index consists of 500 stocks chosen for market size, liquidity, and industry group representation. It is a market value weighted index with each stock's weight in the Index proportionate to its market value.