US Economic Viewpoint

Fiscal policy: no respite for the deficit

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Fiscal: the other lever to pull

Tariffs have dominated the limelight since Inauguration Day, but attention is starting to shift towards fiscal policy. Republicans in Congress are working on a bill to extend the expiring 2017 tax cuts and enact new changes to spending and tax policy. We expect the bill to be signed into law in July, although there are risks of a delay.

The fiscal package should boost the deficit…

Despite rhetoric about reducing deficits, the reconciliation bill will likely add to deficits. Our baseline expectation is for deficit- and primary-deficit-to-GDP ratios of 6.9% and 3.5%, respectively, in FY26. We see two-sided risks to this scenario depending on the degree of spending cuts included in the final bill.

…spurring near-term growth…

The bill will likely spur near-term growth owing to increased defense spending and front-loaded tax cuts. Under our baseline scenario, we estimate the bill to have a fiscal impulse of ~0.6%, although this will depend on the burn rate of new defense and immigration spending. This should help offset the drag from tariffs.

…but increasing the risk of a bond-buyer strike

But with Debt-to-GDP already at 98%, the bill raises the risk of a bond-buyer-strike, in our view. Adding more supply to the market at a time when demand is softening could result in a spike in borrowing rates, a decline in the dollar, and a drop in equities. This could overwhelm any growth effects from the bill itself.

Higher deficit = cheaper long end USTs

We favor a 10s30s steepener and 30y spread short to position for continued cheapening pressure at the back end as the market grapples with more supply and the limited scope for back end demand. The UST back end will absorb much of the fiscal risk as Treasury has yet to show responsiveness to this supply/ demand imbalance and market signals from term premium, spread curve shape, and 20y cheapness. While we are hopeful WAM UST/ TBAC (weighted average maturity/US Treasury/Treasury Borrowing Advisory Committee) discussion will be included in coming refunding meetings, we have limited conviction on what levels will garner enough concern for action.

US equities > bonds on real return, quality

We prefer US large cap equities to bonds. Why?: (1) real return: ~75%/40% percent of S&P 500 stocks have a higher FCF yield/div. yield than the real 10y Tsy. yield of 2.1%. (2) Earnings are nominal/levered to inflation, bond yields are not. The opportunity cost of owning 10y govt. bonds during the stagflationary '70s translated into a 50% loss. (3) Leverage: US debt/GDP sits at record highs, corp. debt at record lows. The strong historical relationship between S&P 500 leverage and earnings yield applied to govt leverage implies a 10yr Tsy yield of ~7% (or a mega-boom in GDP). (4) There is no magic number for rates hurting equities, but historically S&P 500 multiples have held up until 7% on the 10yr. Energy, Financials, select Tech and dividend growth are best-positioned for higher rates, long-duration (back-end loaded growth/negative earnings) most vulnerable.

The other big policy lever: Fiscal

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Tariffs have dominated the news since Inauguration Day, but attention is starting to turn toward the other major policy lever: fiscal. The House is debating its own proposal and hopes to have a floor vote on the bill this week. In this note, we discuss what this could mean for deficits, growth, and financial markets. Here we argue:

1. The only portion of the policy bill that matters for our outlook is the new changes in tax and spending policies. We had always assumed Congress would extend TCJA (Tax Cuts and Jobs Act of 2017).

2. We expect the bill to be passed in 3Q, and for new tax cuts to be front-loaded, which could help offset the drag from tariffs and push deficits higher.

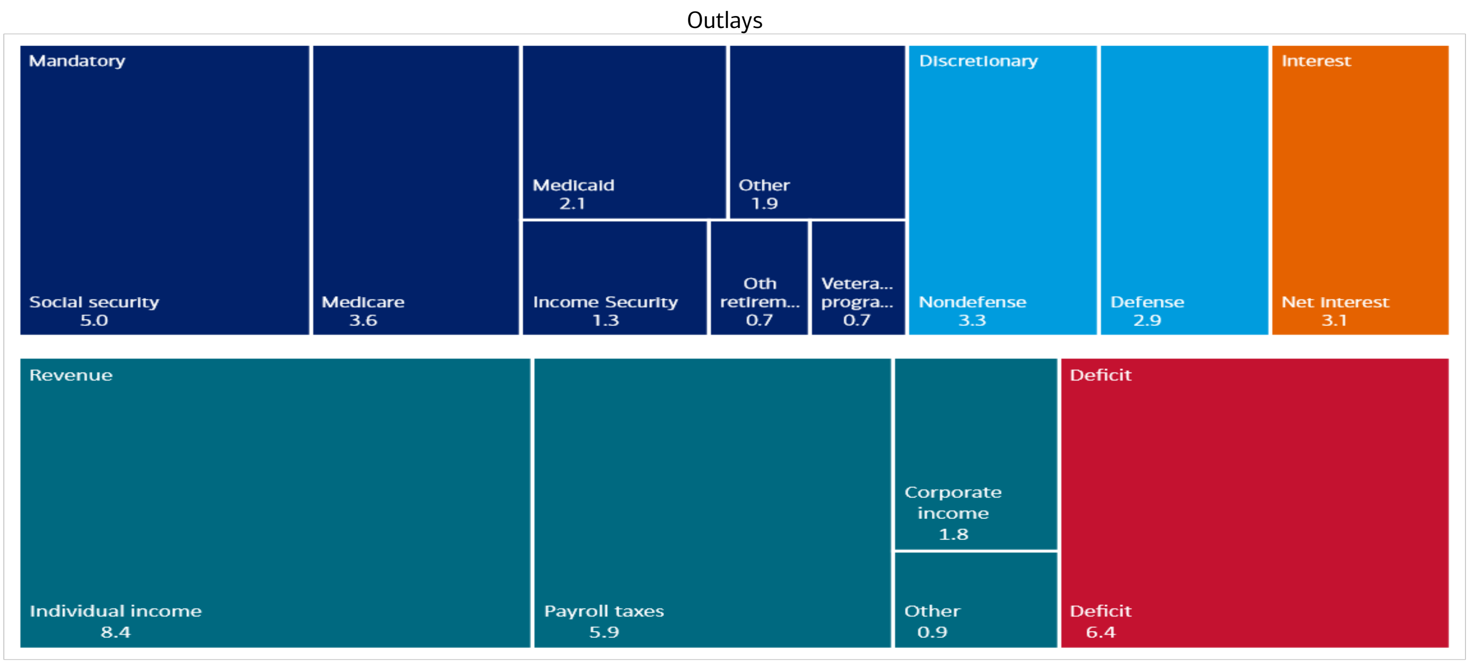
3. The risk is that a deficit-financed tax bill will result in a spike in borrowing costs as investors demand higher yields to hold Treasuries. This could overwhelm any stimulative effects from the policy changes and result in weaker long-run growth.

The current state of fiscal policy

Heading into this year, the US fiscal position was already precarious. Public Debt-to-GDP stood at 98% in FY 2024, which is up from 79% from FY 2019, though little changed in recent years. And the US Treasury reiterated that debt is on an unsustainable path in its most recent financial report of the US government.

Congress, however, has been unfazed by fiscal sustainability concerns as the US recorded a deficit- and primary-deficit to GDP ratios of 6.4% and 3.3%, respectively (Exhibit 1). These are levels more common during recessions not when the economy is growing by ~3% in real terms.

Exhibit 1: The deficit-to-GDP ratio was 6.4% in FY 2024
A breakdown of the FY 2024 Government budget (% of GDP)



Source: CBO

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How did we get here? A quick comparison to FY 2019, shows mandatory spending and interest are the culprits. Indeed, mandatory spending and net interest as shares of GDP were 1.2pp and 1.3pp higher in FY24 v FY19. Discretionary spending was little changed, and revenue-to-GDP increased by 0.6pp. While revenues may not currently be to blame for the rise in deficits, the upcoming reconciliation bill could change that.

Early days, but the reconciliation bill will add to deficits

Q: Why use reconciliation to pass tax policy changes in the first place?
A: Reconciliation bills can be passed in the Senate by a simple majority.

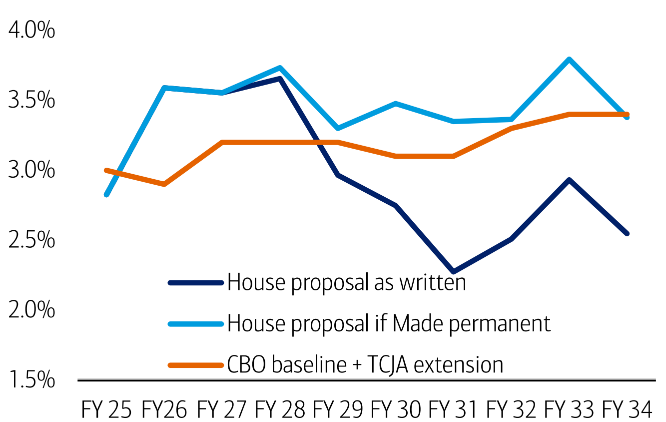
The House is the first mover and currently debating key policies

Republicans in Congress are currently making their way through the reconciliation process (see The reconciliation road map section of the report for more details). As of this writing, Republicans in the House of Representatives are hoping to vote on an omnibus bill by the end of the week.

The proposal extends the expiring tax cuts and makes additional cuts for both households and businesses. Household tax cuts include the campaign promises about no tax on tips, overtime, a deduction for seniors, and no tax on auto loan payments. These policies will expire at the end of 2028. Meanwhile, the business tax cuts are mostly a temporary restoration of previously expired TCJA provisions. To offset some of the revenue losses from these tax cuts and the extension of TCJA, the bill calls for partial repeal of the Inflation Reduction Act and cuts social welfare programs.

In terms of deficit implications, we compare the plan against a current policy baseline (i.e., we assume TCJA does not expire). Exhibit 2 shows that the House plan would result in higher deficits in the near term, and lower deficits as provisions sunset. In a scenario where expiring provisions are extended (which we think is more realistic), primary deficits would be higher than the CBO counterfactual through most of the 10-year budget window (Exhibit 2).

Exhibit 2: The House plan, if made permanent, would yield higher deficits than simply extending the expiring TCJA provisions
Primary deficit-to-GDP ratio



Source: CRFB, CBO, BofA Global Research

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Exhibit 3:The House plan as written would add the least to the deficit
Primary deficit implications over the FY25-34 budget window ($bn)

	House plan		Senate	
	As written	If permanent	Instructions	TCJA extension
Tax changes*	3.8	5.3	5.3	3.8
Spending increases	0.3	0.6	0.5	
Spending cuts	-1.6	-0.16	-0.04	
Primary deficit (10yr)	2.5	5.74	5.76	3.8

Source: CRFB, CBO

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Changes are likely to be made in the Senate

If the bill passes the House, then it will go to the Senate where it could undergo more changes. This is because the reconciliation instructions passed by both chambers allow the Senate and the House to operate on different tracks. The Senate instructions allow for $1.5tn in new tax cuts, more spending on defense & immigration, and very modest cuts to mandatory spending programs (Exhibit 3). Whereas the House instructions require at least $1.5tn in cuts to mandatory programs and allow for $4tn in tax cuts against a current law baseline. We think the Senate will water down spending cuts, particularly Medicaid cuts, in the House proposal, which would mean higher deficits at the end of the day.

While it may not be smooth sailing over the coming weeks, we expect a bill to be finalized and signed into law in late July. There is a risk that the bill falls apart given narrow margins in both the House and the Senate, but we think the likelihood is relatively low.

It sets a new precedent for future bills

The bill is likely to add to deficits over time, which will increase concerns about debt sustainability. Moreover, we worry that Senate Republicans' decision to score the bill on a current policy basis sets a dangerous precedent for future reconciliation bills.

> The Congressional Budget Office and Joint Committee on Taxation are the official scorers of bills proposed by Congress. A score is the estimated deficit impact from proposed changes relative to a baseline, typically current law. These scores matter more for reconciliation bills since the provisions must adhere to the reconciliation instructions.

A current policy baseline assumes policies in place today remain in place. What this means for the current bill is the score does not need to include the cost of extending expiring provisions of the 2017 Tax Cuts and Jobs Act (TCJA), and these provisions can effectively be made permanent, whereas a current law baseline reflects expiring policies. So, the cost of extending expiring provisions must be included in the official score.

While current policy has been used for bipartisan bills before, this is the first time it would be used for a reconciliation bill. We worry this becomes the norm moving forward, which could increase the slope of debt-to-GDP.

The deficit should remain elevated in all scenarios

The reconciliation bill obviously affects our deficit outlook, and the impact depends on the details. How large will spending cuts be? Will the tax cuts be front-loaded? Will the tax cuts skew towards higher multiplier more pro-growth options? How will the Fed respond? And how will the market respond? Tariffs are also critical to the deficit outlook. In this section we address these factors and argue that deficit-to-GDP ratios are likely to climb over time, although the risks around our baseline are two-sided.

Tariffs could be a big source of revenue

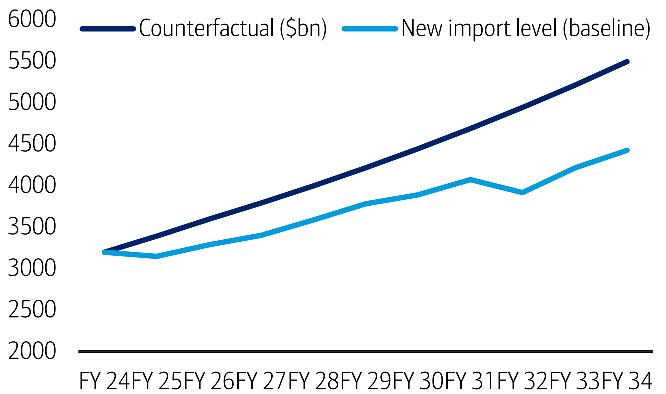
Starting with tariffs, the administration has generally taken steps in recent weeks to de-escalate the trade war. That said, tariff rates remain elevated compared to a year ago, and the administration has highlighted the revenue that tariffs have raised. Given these actions, we make the following country-specific assumptions on tariff rates:

- China: ~40% on most imports through FY 27. Imports of computers, smart phones, and semiconductors face a 25% tariff rate.
- Mexico and Canada: 5% effective tariff rate for the remainder of FY 2025 through FY 2027.
- Rest of World (RoW): 10% effective tariff rate for the remainder of FY 2025 through FY 2027.

To calculate tariff revenues based on these rates, we use import price elasticities from Boem, Levchenko, Pandalai-Nayar (2022). The elasticities are less than 1 in the initial years and climb to around 2 over time. Compared to a counterfactual where tariff rates were unchanged from last year, we estimate imports decline by roughly 10% initially and

20% over time (Exhibit 4). Based on these assumptions, the effective tariff rate converges toward 10% over time, which would generate close to 1% of GDP of new tariff revenue in the short run (Exhibit 5).

Exhibit 4: Our tariff assumptions imply a drop in imports relative to a counterfactual without tariffs.
US goods imports ($bn, FY)



Source: BofA Global Research

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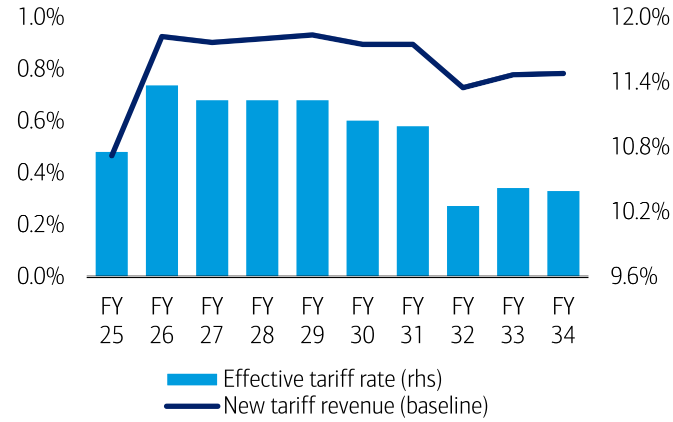
Exhibit 5: Tariff revenue is likely to be significant
Tariff revenue by FY



Source: BofA Global Research

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To be sure, these estimates are dependent on the elasticities we use, and estimates of elasticities vary widely in the literature. It's also dependent on these tariff rates remaining unchanged and in place, which may be an unrealistic assumption. Still, we think our revenue estimates are reasonable until we learn more.

Reconciliation scenarios

Turning now to the reconciliation bill, we provide three scenarios: a low deficit, our baseline, and a high deficit option given the fluid nature of the bill. In each scenario we assume TCJA is extended. Therefore, the only differences result from new tax and spending policies. Again, this is the portion of the bill that matters most for the economic outlook and markets. We outline our assumptions below.

Low deficit scenario

We base this scenario on the current tax proposals being considered by House Republicans. We assume spending cuts of $1.5tn are evenly distributed.

Baseline scenario

Our baseline scenario assumes $1.5tn in new tax cuts are front-loaded in the first half of the budget window (FY 25-FY29). We also assume that spending cuts are $750bn, half of our low deficit scenario, and they are spread out evenly over the budget window.

High deficit scenario

Finally, our high deficit scenario differs from our baseline scenario in two ways: (1) we assume no spending cuts; and 2) we front-load tax cuts even more aggressively.

Front-loading misrepresents true cost

No matter the size of the new tax cuts, they are likely to be front-loaded. This inevitably makes the "fiscal cliff" a problem for a future Congress, but it also misrepresents the true cost of these tax cuts, as they are almost always extended. Therefore, market participants are likely to look through these budget gimmicks and assume these policies remain in place indefinitely.

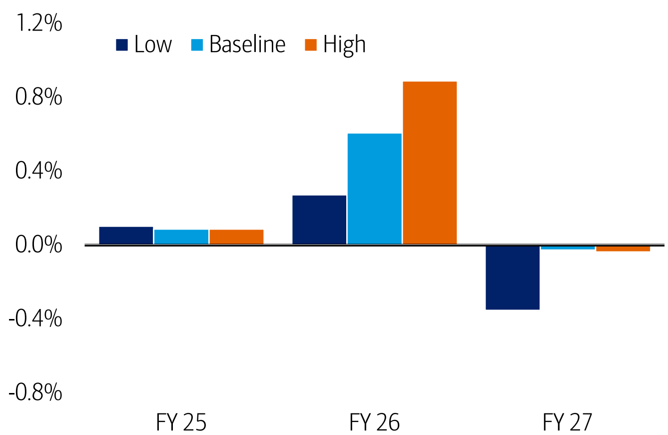
Dynamic effects likely to be a partial offset

Each of our scenarios will also affect deficits through its effects on growth, inflation, and interest rates. To assess these impacts, we estimate the fiscal impulse for each scenario using multipliers outlined in "Understanding the Relationship Between Changes to: Federal Fiscal Policy and Near-Term Real GDP Growth" (Nelson and Wilson 2025).

Under our assumptions, we estimate the fiscal impulse to be positive in FY 26 for each scenario (Exhibit 6), although that is before accounting for the drag from tariffs, which we think will peak in the next two quarters. The positive impulse reflects front-loaded tax cuts and spending increases on defense, immigration, and law enforcement. Stronger growth should yield modestly higher tax revenues; a simple rule of thumb from CBO suggests tax revenue increase 8bp for every 0.1pp increase in GDP.

While better near-term growth due to higher deficits may pay for themselves to an extent, the revenue boost will be offset by a couple other factors. First, faster growth is likely to keep inflation above the Fed's target for longer, which puts upward pressure on inflation-indexed mandatory spending and on short-term rates. Second, larger deficits put upward pressure on longer-dated borrowing costs resulting in more crowding out effects over time. Indeed, research shows a 1ppt increase in debt-to-GDP pushes the 10yr up by 2-5bps, and there are likely non-linearities that emerge at higher debt-to-GDP levels (Exhibit 7).

Exhibit 6: The reconciliation bill will likely boost growth in FY 26
Fiscal impulse estimates for our three reconciliation scenarios (%)



Source: BofA Global Research

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Exhibit 7: Estimates of the impact of debt-to-GDP levels on interest rates
Academic research generally finds that higher debt levels lead to higher interest rates

	Change in 10y UST for each 1pp increase in debt-to-GDP ratio (bp)
Engen and Hubbard (2004)	2.8-4.7
Laubach (2009)	2.9-5.2
Gamber and Seliski (2019)	1.5-2.4
Tedeschi (2019)	4.2
Cotton (2021)	4.3
AEI (2022)	4.5
CBO	2.5

Source: Peterson Institute for International Economics.

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Putting all the pieces together

Accounting for all these effects, we expect deficit-to-GDP to be around 6.9% of GDP in each of the next two fiscal years in our base case (Exhibit 8). We see two-sided risks to our baseline owing mostly to uncertainty over spending cuts. But even with more significant spending cuts, deficits should remain elevated compared to historical levels. As a result, we expect public-debt-to-GDP to continue its ascent towards 110%, putting upward pressure on borrowing costs.

Exhibit 8: Debt-to-GDP should continue to climb in the coming years
Summary table of our deficit scenarios

Scenario	Fiscal year	Deficit	Primary deficit	Interest	Revenues ex tariffs	New tariff revenue	Outlays ex interest	Debt-to-GDP
Low	FY 25	6.3%	3.1%	3.2%	16.7%	0.5%	20.2%	101%
	FY 26	6.2%	2.9%	3.3%	17.1%	0.9%	21.0%	104%
	FY 27	5.3%	2.1%	3.2%	18.1%	0.9%	21.1%	106%
Baseline	FY 25	6.3%	3.1%	3.2%	16.7%	0.5%	20.2%	101%
	FY 26	6.9%	3.5%	3.4%	16.6%	0.9%	21.2%	105%
	FY 27	6.8%	3.4%	3.5%	17.1%	0.9%	21.5%	108%
High	FY 25	6.3%	3.1%	3.2%	16.7%	0.5%	20.2%	101%
	FY 26	7.1%	3.8%	3.4%	16.6%	0.9%	21.3%	105%
	FY 27	7.1%	3.6%	3.5%	17.0%	0.9%	21.7%	108%

Source: BofA Global Research

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The downside risk: a bond-buyers' strike

While we see the fiscal policy bill as your typical deficit-financed tax cut that offsets the "tax-hike" from tariffs, there is an increasing risk that it could lead to a bond-buyers' strike. The incremental increase to the deficit from the fiscal bill may not be much larger than previous bills. However, global demand for US Treasuries has softened, which raises the risk of a bond vigilante event.

In this risk scenario, we would expect the spike in borrowing rates to overwhelm any of the near-term pro-growth nature of the fiscal bill. Therefore, it poses downside risks to our growth outlook next year. It would also generate downside risks to long-run growth. If markets lose confidence in the sustainability of the US government, then we would experience more severe crowding out effects as we shift to an ever-higher rate regime. Ultimately this could result in financial repression or force Congress to reverse course quickly and adopt policies that make a significant fiscal adjustment. But even if Congress walks back deficit-expansion, there could be lasting effects from the market move.

US rates: trouble for the back end

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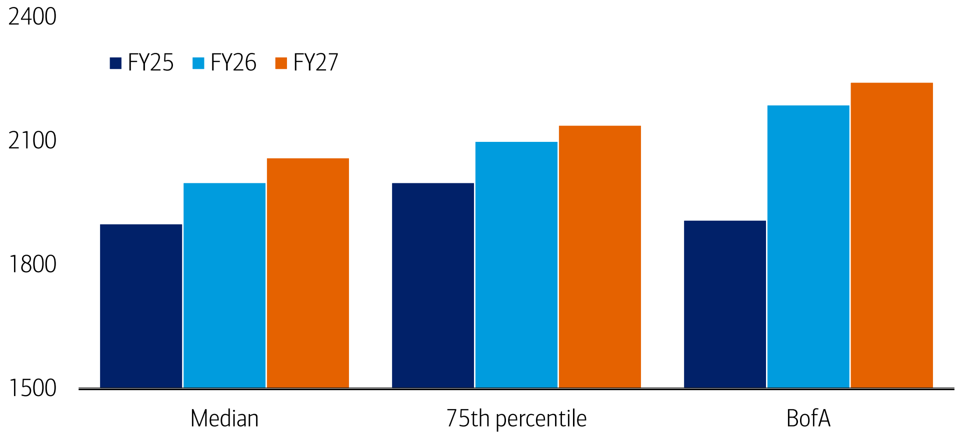
Market deficit expectations rising

While the current spending proposals by the House do not change our base case deficit forecasts, the market may be moving closer to our expectations for around a 7% deficit in FY '26 & '27. The market is likely realizing lower effective tariff revenues, limited scope of DOGE spending reductions and potential incremental tax cuts on top of TCJA extension support a higher deficit trajectory in both the medium and longer term. We recommend being short 30y spreads and in 10s30s steepeners to position for growing supply/ demand challenges.

Exhibit 9: BofA deficit forecasts vs primary dealer forecasts ($bn)
As of May refunding meeting, BofA was at top end of dealer deficit forecasts for FY '26 & 27 deficits



Source: BofA Global Research, US Treasury

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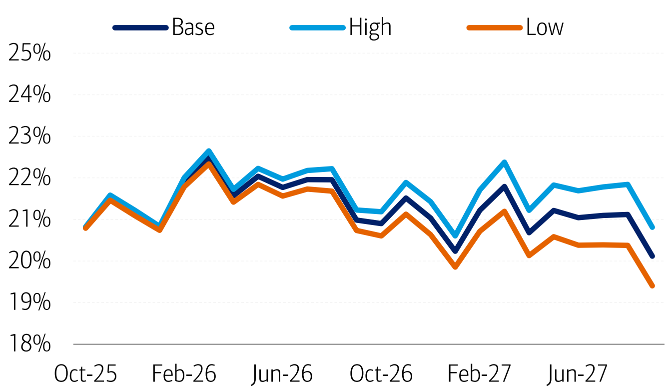
UST will likely need to grow auction sizes

In our base case, we assume UST (US Treasury) grows coupons starting at the February refunding. A proactive UST has room to grow coupons sooner than February, but deficit uncertainty will likely push coupon increases out to 2026.

In Exhibit 11, we show bills as % of marketable debt assuming $280bn growth over four quarters starting in February 2026 (similar to $300bn in four quarters in '23-'24). Even under the lower deficit scenario, the auction growth we forecast is required for bills to not persistently exceed 22% of marketable debt in FY 2026. It is possible UST allows higher bill supply growth vs Treasury Borrowing Advisory Committee (TBAC) guidance; we interpret TBAC guidance as recommending a soft cap of bills as % of total UST debt around 22%.

Exhibit 10: Bills % marketable debt assuming baseline coupon growth across curve starting in February
Assuming coupon growth we expect, bills stay below 23% through FY '27 under base & alternate deficit scenarios



Source: BofA Global Research

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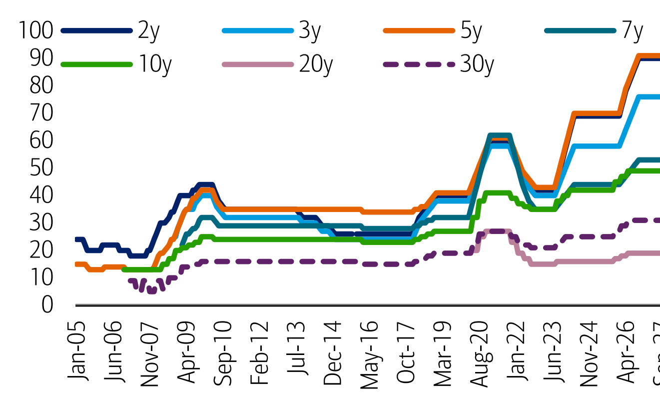
Exhibit 11: Treasury auction sizes by tenor with projections through FYE '27 ($bn)
We forecast that Treasury note auction sizes will grow starting in Feb '26 through Oct '26



Source: BofA Global Research, US Treasury

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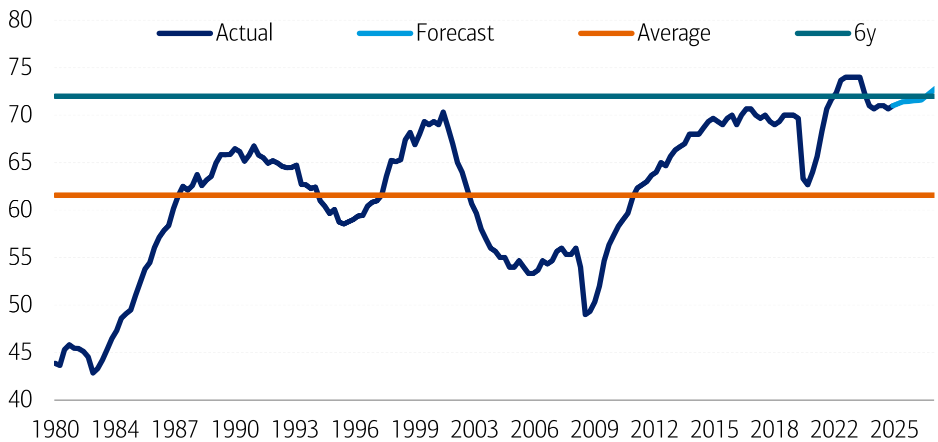
Our base case for coupon growth is shown in Exhibit 12. We reflect coupon increases across the curve consistent with observed growth in '23-'24. We anticipate that UST will view bill supply above 22% as too high and then look to grow coupons. UST may argue for persistently higher bill supply if stablecoin is more broadly adopted, which could structurally increase demand for bills (see report: Stablecoins & USTs). Treasury Secretary Bessent may also prefer to fund the deficit via bills to limit upward pressure on longer-term USTs (despite his prior criticism of former Treasury Secretary Yellen for a similar approach).

WAM adjustment a potential consideration

UST has capacity to shorten UST WAM (Weighted Average Maturity) but has yet to show willingness. In our May refunding preview (see report), we discussed the options that UST has for shifting WAM of issuance to the front end and belly of the curve. Because UST WAM is at historically elevated levels (Exhibit 13), UST can consider alternate coupon supply growth that only modestly shift WAM lower and keep WAM above longer term average. We perceive the likelihood of a lower UST WAM as rising.

Exhibit 12: Actual and expected WAM through FY '27 (months)
WAM expected to rise unless Treasury adjusts issuance allocation



Source: BofA Global Research, US Treasury

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Assuming coupons grow across the curve consistent with recent adjustments, WAM will continue to shift higher. If back-end cheapness remains into the end of the year, UST may be motivated to consider keeping bill share elevated or managing gross issuance across shorter-dated coupons.

Higher deficit = cheaper long-end USTs

Both the Moody's US downgrade and expected fiscal deterioration spell trouble for the UST back end. As discussed in *Global Rates Weekly* we favor a 10s30s steepener and 30y spread short to position for continued cheapening pressure at the back end as the market grapples with more supply and the limited scope for back end demand (see: Flows report). The UST back end will absorb much of the fiscal risk, as Treasury has yet to show responsiveness to this supply/ demand imbalance and market signals from term premium, spread curve shape, and 20y cheapness (see: Signal miss). While we are hopeful WAM/ UST/ TBAC discussion will be had in coming refunding meetings, we have limited conviction on what levels will garner enough concern for action.

Equity market implications – buyer's strike in bonds

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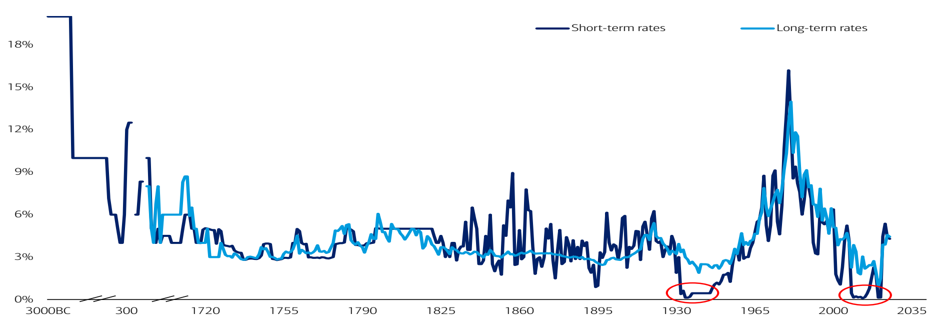
Real rates likely to go higher rather than lower

We have seen the bubble created in long-term Treasury bonds deflate but still see at least three reasons for higher rather than lower long-term real interest rates, First, mean reversion based on historical trends would argue for higher, not lower, rates. Moreover, bond buyers of the 2000 to 2020 era (China, Japan and the Fed) are no longer buying US bonds. Finally, sovereign risks are significantly higher following years of outsized fiscal stimulus, with the US debt to GDP ratio having reached levels consistent with emerging rather than developed economies.

Exhibit 14: Just coming off 5000-yr lows, rate cycles last for decades
Interest rates since 3000 BC



Source: BofA Global Investment Strategy, Bank of England Global Financial Data, Homer and Sylla "A History of Interest Rates" (2005)
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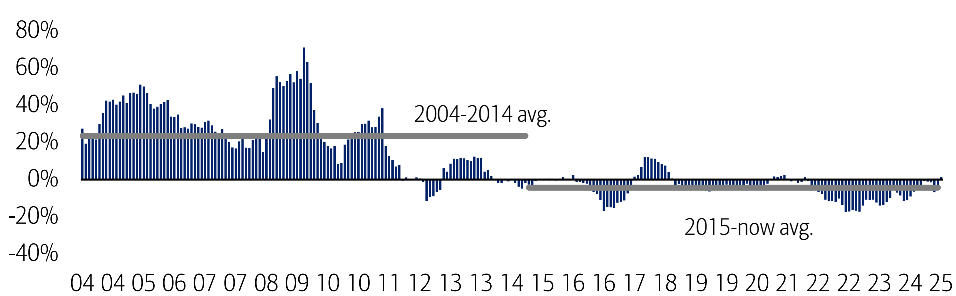
Exhibit 14: China selling since 2015, Japan & Fed not buying anymore
YoY change in China holdings of Tsy (2004-2/2025)



Source: Bloomberg, BofA Global Research
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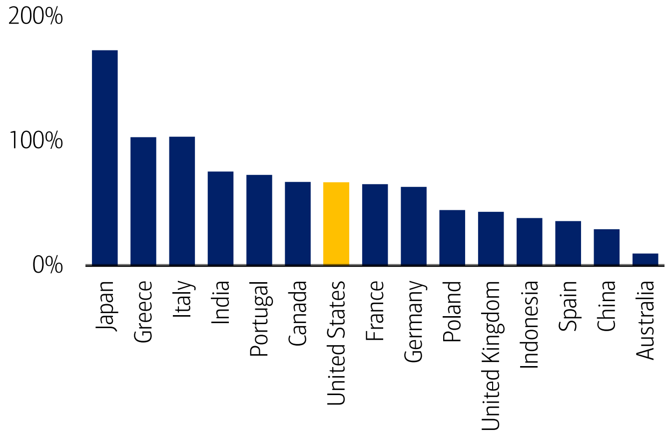
Exhibit 15: US Debt was ~67% of GDP in 2007...
Government debt as a percentage of GDP, 2007



Source: International Monetary Fund, BofA US Equity & Quant Strategy

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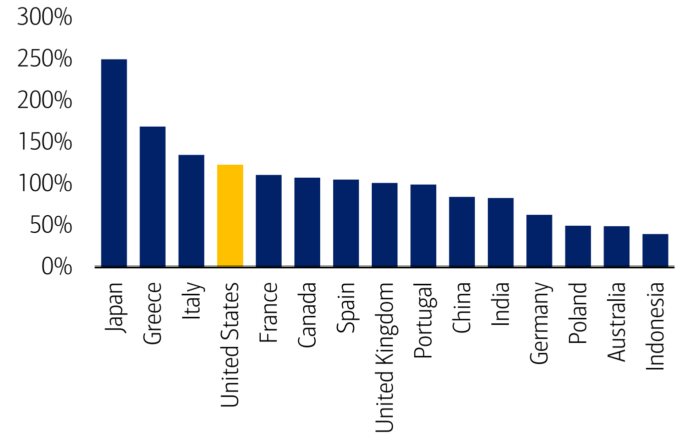
Exhibit 16: ..but US Debt now ~120% of GDP, worse than other EM and DM sovereigns
Government debt as a percentage of GDP, 2023



Source: International Monetary Fund, BofA US Equity & Quant Strategy

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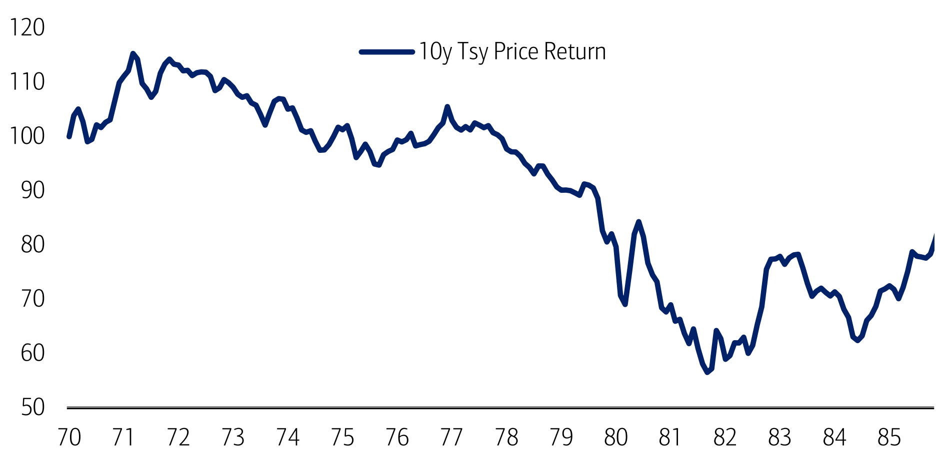
If stagflation is the enemy, bonds don't make sense

Stagflation fears have hit risk assets, but bonds don't make sense with stagflation – the opportunity cost of owning 10y government bonds from early 70s to early 80s translated to a 50% loss. If stagflation is the enemy, companies helped by inflation with less global exposure, stable EPS/dividends are more attractive as evidenced by value equities outperforming bonds during that period. Cash flow and inflation-protected income help in a higher rate world. 2022's jump in real rates saw the S&P 500 High Dividend Yield decile lead by >15ppt (see: 2022 QP).

Exhibit 17: The opportunity cost of owning 10-year government bonds from early 70s to early 80s translated to a 50% loss, proxied by price decline from 3/31/71 to 9/30/81 of -51%
10yr bond price return, indexed to 100 at start of 1970 through 12/31/85



Source: Bloomberg

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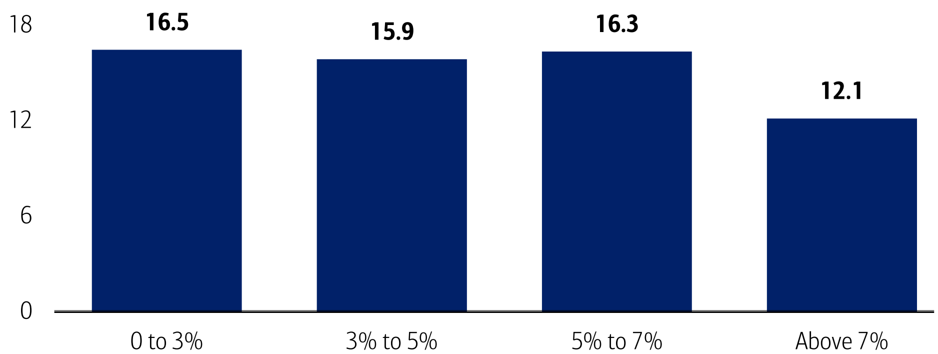
What level of rates hurts equities?

> "5% Treasury yields will drive an equity sell-off" is a popular platitude, but this is likely based on anchoring to the recent cycle of ultra-low rates. In reality, there is no magic number, but, in our analysis, S&P 500 multiples tend to hold up reasonably well until around 7% on the 10-year Treasury.

Exhibit 18: If there were a line in the sand for good vs. bad rates, it would be about 7%
Median S&P 500 Fwd P/E based on different levels of the nominal 10yr Tsy yield (1986-04/2025)



Source: BofA US Equity & Quant Strategy, FactSet, Bloomberg

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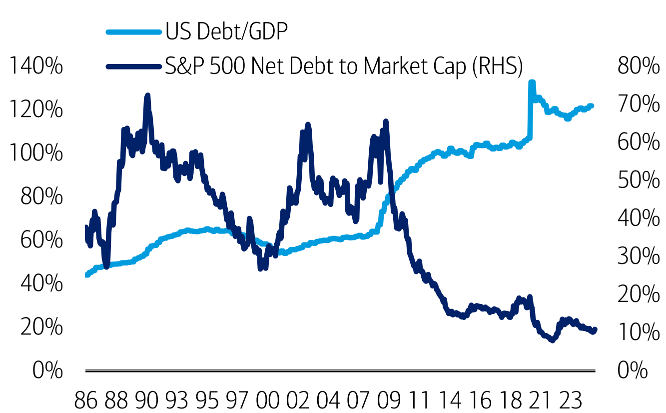
Stocks>bonds; current US Debt/GDP implies 7% Treasury yield

Leverage risk has been one of the biggest drivers of the equity risk premium since the GFC (Global Financial Crisis), explaining more than 60% of fluctuations in the cost of equity capital. So, whereas a simple comparison between US earnings yield and 10y Tsy. bond yields would argue for an overweight in bonds, we disagree. S&P 500 debt to market capitalization is 1.7x std deviations below average, whereas government debt is near all-time highs. Applying the strong historical relationship between S&P 500 leverage and earnings yield to current US debt to GDP implies a 10yr Tsy yield of~7% (or a mega-boom in GDP). See our latest S&P 500 Relative Value Cheat Sheet.

Exhibit 19: S&P 500 debt at record lows, US government debt near highs
S&P 500 Net Debt to Market Cap and US debt to GDP (1/1986-4/2025)



Source: FRED, FactSet, BofA US Equity & Quant Strategy

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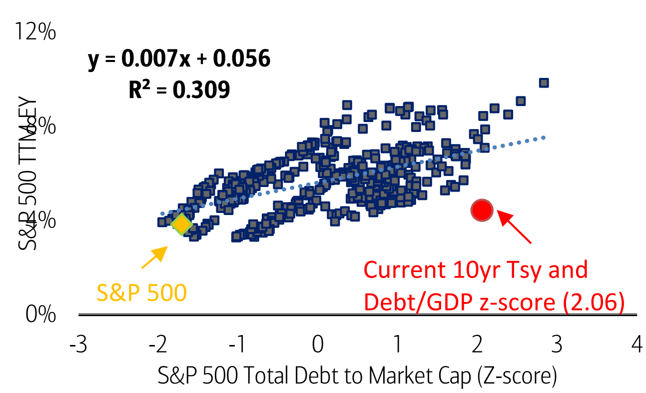
Exhibit 20: Current US Gov't Debt to GDP implies 7% yield
Relationship between S&P 500 earnings yield and S&P 500 total debt to market cap as a z-score (1/1986-4/2025)



Source: FRED, FactSet, BofA US Equity & Quant Strategy. Note: For debt to GDP, the z-score is based on the full history of the quarterly FRED time series, which begins in 1966.

BofA GLOBAL RESEARCH

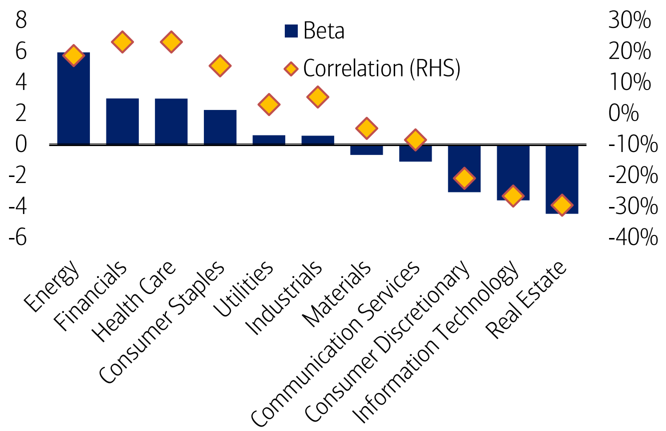
Sectors: Energy, Financials & dividend growth stocks > long duration equities

What sectors should investors want to buy when long rates are rising? Energy, Financials, and dividend growth stocks. What sectors should they sell? Anything with long duration and no options to shorten its duration risk. Long duration (back end-loaded growth stocks) are more vulnerable to rising rates. Our S&P 500 fair value model (see [Target Update](#)) suggests that every 10bp rise in real rates would translate into a 2ppt decline in the S&P 500, all else equal, with most acute pain in long duration sectors like Tech and TMT (Comm. Services).

Duration risk in large, well-capitalized equities is more manageable than in smaller non-earners: Well-capitalized companies can lower their duration risk, unlike bonds. An example is META in 1Q 2023, which lowered its duration via cash return (a big share buyback) and layoffs, cost control and capacity reduction.

Exhibit 21: Energy and Financials benefit, Tech and Real Estate most hurt by rising real rates

Beta/correlations of 120m relative price performance vs. m/m changes in real 10yr yields (5/2014-4/2025)



Source: BofA US Equity & Quant Strategy, Haver Analytics, FactSet, Bloomberg

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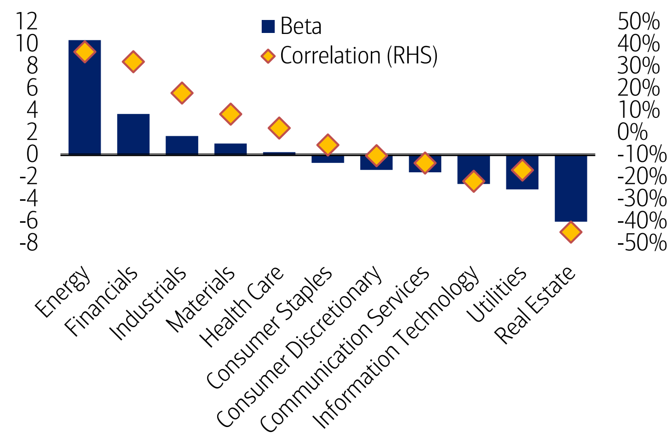
Exhibit 22: Energy and Financials benefit, Utilities, Real Estate and Tech hurt most from higher nominal rates

Betas/correlations of 120m relative price performance vs. m/m changes in nominal 10yr yields (5/2014-4/2025)



Source: BofA US Equity & Quant Strategy

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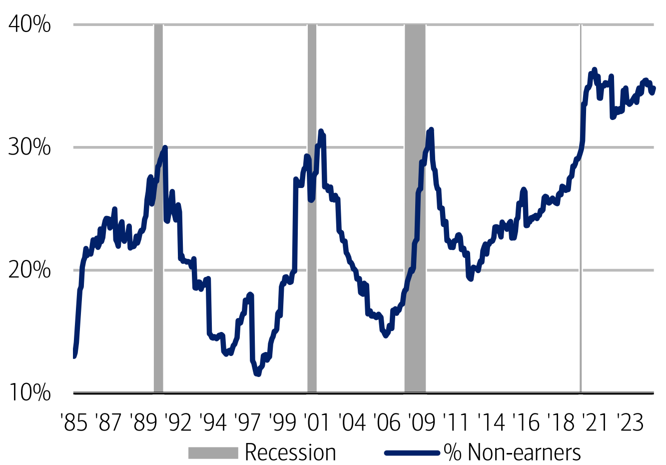
Exhibit 23: Duration risk less manageable in small caps, which have a record proportion of non-profitable stocks...

Russell 2000: % non-earners, 1985-4/2025



Source: FactSet, BofA US Equity & US Quant Strategy

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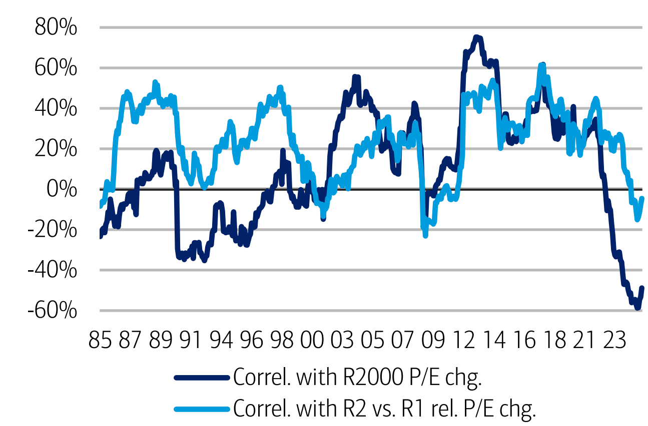
Exhibit 24: ...and small cap absolute and relative valuations have been more negatively correlated with changes in interest rates than ever

Rolling 3yr correlation of monthly chgs. in the 10yr Tsy. yield vs. monthly chgs. in the fwd. P/E ratio for the Russell 2000, and relative P/E for Russell 2000 vs. Russell 1000 (1985-4/2025)



Source: FactSet, Bloomberg, BofA US Equity & US Quant Strategy

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A deficit financed tax bill with heavy dose of risk

The reconciliation process has not been as smooth as Republicans may have wanted. Still, we expect a bill ultimately to be passed in July before the August recess. It should stimulate growth and help partially offset the drag from tariffs. However, it will also keep deficits elevated, which raises the risk of a bond-buyers' strike and a material surge in borrowing costs.

Appendix:

Glossary

Budget resolution

A plan for Congressional action regarding budgetary issues for the year. It sets targets for total revenues and outlays. It does not include actual legislation changes or funding for government agencies and programs.

Reconciliation:

A legislative process used to make changes to tax policy and spending over a 10-year budget window. It has advantages to making changes through regular order. Most notably, the bill cannot be filibustered in the Senate. So, it can be passed with a simple majority in the Senate. When Congress proceeds with a reconciliation process, it includes reconciliation instructions in a concurrent budget resolution.

X-date

The date when the US government fails to completely cover its obligations on time.

Byrd rule

The Byrd rule constrains a reconciliation bill in a few ways. First, it cannot include provisions that do not have a fiscal effect. Second, it cannot make changes to social security spending or revenue. It cannot increase the deficit in any fiscal year outside the budget window.

The reconciliation road map

Stage 1: Passing a budget resolution.

First, both chambers must pass the same budget resolution that includes reconciliation instructions. The reconciliation instructions are what matter here. These instructions set targets for legislative committees to draft legislation that either reduces spending or increases the deficit and a deadline for the proposals. We have just recently cleared this stage.

Stage 2: Legislation is drafted

Once both chambers of Congress have passed the same budget resolution and reconciliation instructions, the affected committees draft legislation that meets the target set out in the instructions. Committees in both chambers do this concurrently, and the legislation is packaged together in an Omnibus bill by a Budget committee. At this stage in the Senate, the proposed legislation is reviewed to make sure the provisions do not violate the Byrd rule.

Stage 3: Floor vote

Once packaged, each chamber conducts floor votes on the omnibus bill. There are some specific rules that govern amendments, time and more that generally expedite the process. But these details are not particularly important for the overall process.

Stage 4: Resolve differences between the two omnibus bills

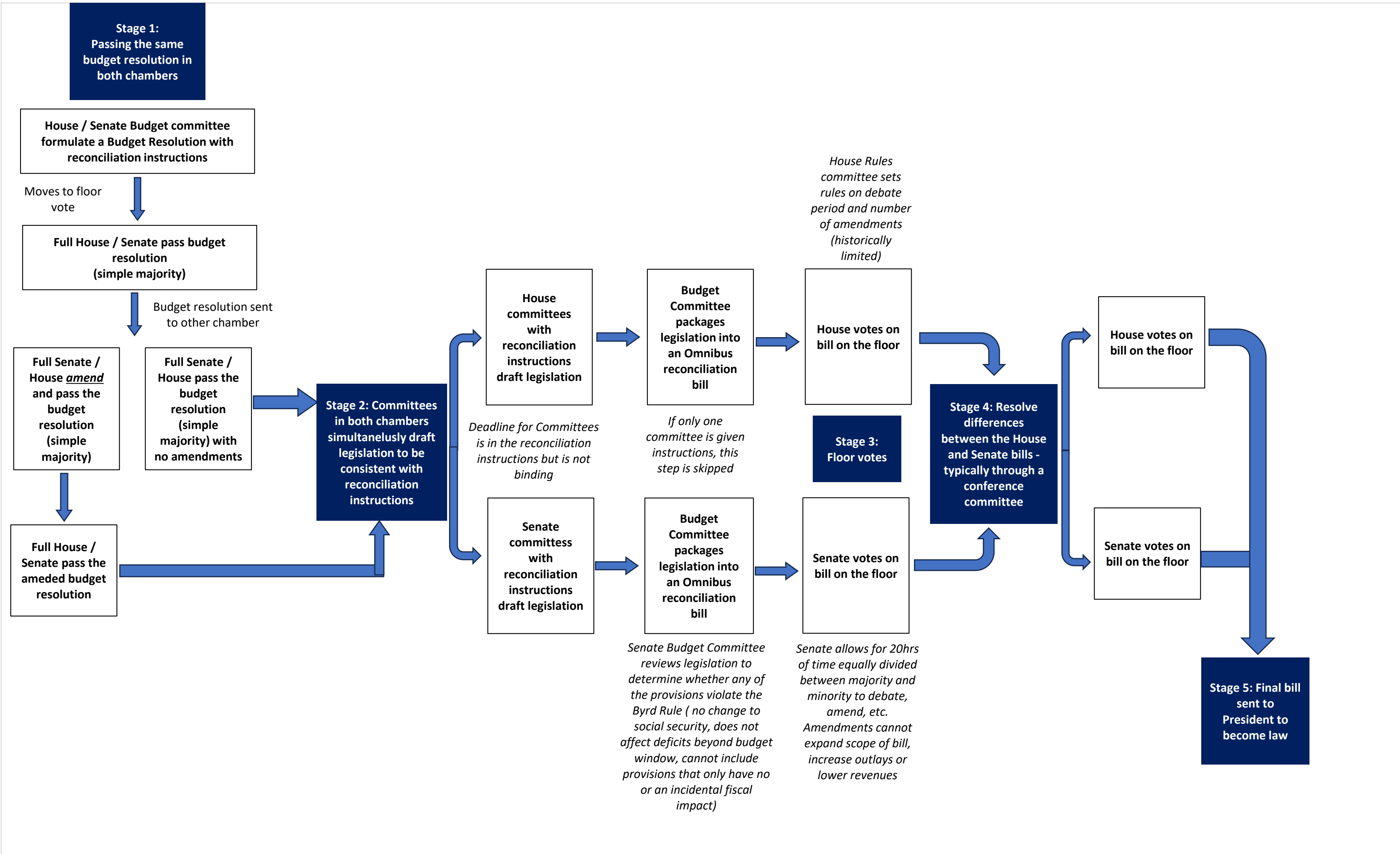
After the bills are passed by the respective chambers, a conference committee is established to resolve any differences. When this is finalized, the bill is sent back to both chambers for another floor vote.

Stage 5: Signed into law

The last stage is sending the bill to the president to be signed into law.

Exhibit 26: Congress has cleared the first stage of the reconciliation process but is still a long way from a final bill

Reconciliation bill flow chart



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