

WEEK ENDED MAY 23, 2025

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## Riding Herd on a Budget Deal

*"I could end the deficit in five minutes. You just pass a law that says that anytime there is a deficit of more than 3% of GDP, all sitting members of Congress are ineligible for re-election."*

– Warren Buffett

**The Through Line:** As U.S. House Speaker Mike Johnson tried to herd the cats toward passage of a budget reconciliation deal, bond vigilantes kept a close eye on the details. The U.S. budget deficit run rate – and the accumulated total debt – already stands at a peacetime high and bond holders are watching carefully to be sure the next budget doesn't materially add to the pile. While equity markets had largely shrugged off the machinations until recently, the devilish details will matter for long-term fundamentals and market health.

### Third time's NOT a charm

Late last Friday, Moody's became the last of the big three credit ratings agencies to pull the plug on the U.S.A.'s AAA credit rating. Whether they were late to the party (the first to downgrade U.S. paper – S&P – did so back in 2011) or merely exasperated from over a decade of waiting for the country to get its fiscal house in order matters less than the fact that the world's largest debt pool now has a credit rating a notch or more below a dozen other countries including Canada, Australia, Germany and the European Union trading bloc.<sup>i</sup>

Each year, the U.S. overspends the revenue it takes in (a.k.a. creating the budget *deficit*) by approximately \$2 trillion. The aggregate amount of this overspending from the nation's inception to present day (a.k.a. the total *debt*) is now over \$36 trillion, amounting to 124% of GDP.<sup>ii, iii, iv</sup> It is not uncommon for countries to deficit-spend during wartime, recessions or exogenous shocks. Throughout those periods, revenues typically decline, while spending on other priorities increases (war materiel, social safety nets for larger numbers of unemployed workers).

### The bond vigilantes ride back to town

However, **the current level of both deficits and total debt in the U.S. is highly unusual in peacetime**, particularly when viewed relative to GDP. Imagine if you were able to regularly spend \$1.25 for every dollar of income you brought home, funded readily by your neighbors for a couple of cents on the dollar. Super sweet gig if you can get it.

And therein lies the rub. This spending is funded, of course, by issuing sovereign bonds, creating the largest, most liquid pool of capital on the planet. U.S. Treasury securities owned by the public are the largest component of the aggregate debt – over \$28 trillion worth of bills, notes and bonds at year end 2024.<sup>v</sup> A top-tier credit rating and belief in the reliability of the U.S. as a trustworthy borrower (and ally)

who would never default on obligations means the country has been able to sustain this level of overspend for decades – and relatively easily issue its paper to a willing global audience.

Problem is, **deficits are growing** (the run rate through April is \$1.05 trillion, up 23% from the same period last year).<sup>vi</sup> **Correspondingly, total debt is growing** as well (it was \$5.7 trillion on December of 2000 and "just" \$28.6 trillion in December of 2019). Bond investors are starting to take note. A few prior "sloppy" auctions where yields had to push higher than expected to entice buyers already had fixed income investors on edge. Then came this week's 20-year paper sale where a paucity of demand forced yields up across longer-dated maturities including 30-year paper which went over 5.1% – nearing levels not seen since the early 2000s.

Higher yields exacerbate the deficit spending issue as the total outlay to finance the debt grows. **Last year for the first time, the U.S. spent more on debt service than on defense.**<sup>vii</sup> If the current trajectory continues, it is estimated that within the next decade debt service will become a larger proportion of the budget than social security.<sup>viii</sup>

The enormous size of the current run rate of overspending presents a problem. Until the most recent quarter, U.S. GDP had been growing at above-average levels for years. At the same time, high productivity joined forces with multi-decade low unemployment. **Theoretically, this well-balanced cocktail of positive economic attributes should have produced smaller deficits and a reduction in aggregate debt – not growth in both measures.** Bond investors are clearly fretting: if the U.S. economy were to hit an air pocket, with shrinking revenue and increased safety-net payments, the pressure on debt and deficits would mount. This fragile situation is precisely why the bond market is watching all the machinations in Washington – from tariffs to geopolitical action and the progress of Congress budget negotiations – so very, very closely.

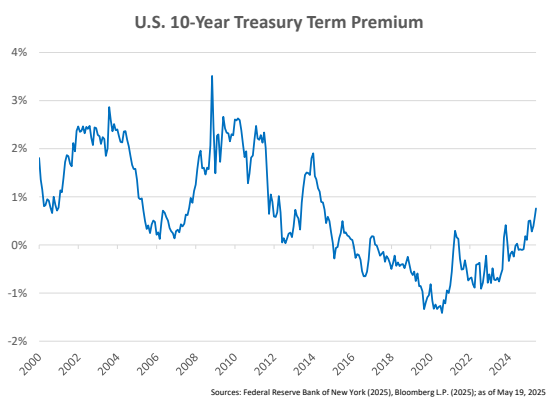
## The Big Beautiful Budget

When the Moody's downgrade hit the newswires after last Friday's close, investors were braced for another rocky Monday. Instead, stocks had issued a collective yawn by close of trading, although bond investors took note and pushed the 30-year yield briefly above 5% intraday. Equity traders tend to search for the next new hot growth opportunity; fixed income investors are more apt to lean into a staid assessment of creditworthiness and ability to return capital at a future date.

Politicians, on the other hand, are most focused on what will get them re-elected and keep their constituents happy. Tax increases or spending cutbacks do neither – making the path of trying to close the budget gap that much more difficult. While a lot of moving parts must fit together before a budget can be finalized, core decision-makers lean toward cutting selected taxes, removing the sunset clause on others and increasing spending on key Republican priorities like defense and border security.

**In a release late Tuesday afternoon, the non-partisan Congressional Budget Office (CBO) estimated that passage of the One Big Beautiful Bill Act in its current form would add \$3.8 trillion to the annual deficit over the analysis period of 2026 to 2034.**<sup>ix</sup> Not exactly what the vigilantes were looking for, we suspect. In issuing its downgrade last week, Moody's calculated that if Congress is successful in preserving the 2018 TCJA cuts that are set to expire at the end of the year (as part of the reconciliation package), it will add \$4 trillion to the deficit over the next decade and push the profligacy to 9% of GDP.

Ironically, Congress is acting like it has all the agency in the matter – although we suspect the fixed income markets may ultimately have a bigger vote. We saw a hint of the bond markets' influence following the "Liberation Day" tariff announcements when yields moved higher/ prices declined rather than the inverse that should have happened if Treasuries had been playing their traditional safe-haven role. As the chart illustrates, the premium that investors demand for holding longer-dated bonds – called the term premium – has been moving up for some time.



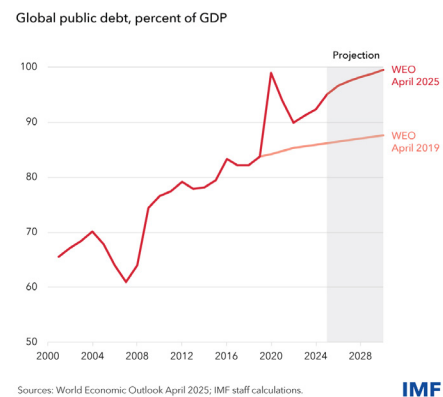
## The U.S. is far from alone

To be fair, the U.S. is not alone in this strained fiscal predicament. A recent IMF Blog post notes that running deficits is ubiquitous and that "in a severely adverse scenario global public debt could reach 117 percent of GDP by 2027. This would represent the highest level since World War II, exceeding reference projections by almost 20 percentage points."<sup>x</sup>

A chart from the most recent International Monetary Fund (IMF) World Economic Outlook (WEO) report shows that even the current

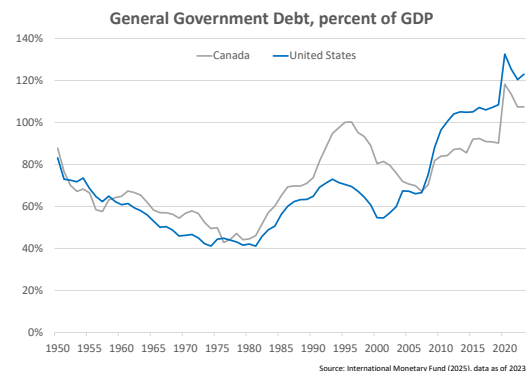
run rate of aggregate global debt (a.k.a. without a severely adverse event) is now projected to approach 100% of global GDP versus the less than 90% projected in the 2019 (pre-pandemic) report.

**Global public debt is high and likely to keep rising**



Interestingly, Canada and the U.S. are fairly similar in total relative debt, although Canada's current financing costs are nearly 100 basis points lower than those in the U.S. Furthermore, the outstanding debt is only one side of the equation: the annual additional deficit funding is the other. The U.S. deficit is roughly 6% of GDP, while Canada's is closer to 3%. Notably, U.S. Treasury Secretary Scott Bessent's "3,3,3 framework" has receded from public commentary (cut the budget deficit to 3% of GDP by 2028, boost GDP growth to 3%, and increase U.S. energy production to the equivalent of an additional three million barrels of oil per day). The Big Beautiful Budget outline as it stands today could well push the annual deficit higher.

**Plenty to see here in the days ahead.**



## Implications for investors

Bond investors are nervously watching congressional progress on the One Big Beautiful Bill closely – as well as how events ultimately resolve themselves on other issues including trade, government cutbacks and growth-enhancing moves such as regulatory relief and investment-friendly tax credits. Equity markets struggle when yields on 10-year paper near 5% (even if fixed income investors enjoy that level of coupon). Another messy longer-dated auction this week put even the stock market on edge and will hopefully get congress' attention as they close in on a final bill.

The current trajectory of growing deficits is unsustainable; the gap is simply too large to tariff or grow out of. Hard decisions lie ahead, with the definition of compromise meaning no one will walk away 100% satisfied. Equity markets have so far shrugged off the budget machinations, but in the long term will need resolution on taxes and tariffs to chart a sustainable path forward.

## In focus in North America

Jon Borchardt, Sr. Analyst

George Trapkov, CFA, VP and Portfolio Manager

### This week

**U.S. consumers still not feelin' it** – Last Friday, the University of Michigan released preliminary results for its monthly Consumer Sentiment survey. The initial index reading for May was 50.8 compared to 52.2 in April. Respondents were once again concerned about the potential impacts of U.S. tariff policy on inflation, employment and the broader economy. Twelve-month forward inflation expectations rose from 6.5% in April to 7.3% in May, with concern mounting across the political spectrum. America's largest retailer, Walmart, said last week that despite best efforts, tariff-related costs would likely not be fully absorbed and consumers are likely to see higher prices on certain items in the coming months. Other consumer-focused companies delivered a similar message during their calendar Q1 earnings calls. Posting on Truth Social, President Donald Trump called on Walmart to "EAT THE TARIFFS" – a remark that, at a minimum, acknowledges the cost of U.S. trade policy will not be fully borne by exporters. In an interview last weekend, Treasury Secretary Bessent argued that while goods prices may rise in some areas, lower tax rates and gasoline prices will help offset inflationary pressure elsewhere.

**U.S. earnings season wrap** – Calendar Q1 financial reporting season for S&P 500 companies has now passed the 90% mark. As of May 16, 78% of companies reported better-than-expected earnings results; blended EPS growth came in at 13.6%. FactSet's most recent Earnings Insight report analyzed every earnings transcript to identify the most frequently used words of the quarter. At the top of the list was "tariffs," mentioned on 411 (91%) of calls for those that reported. These concerns are expected to negatively impact forward earnings growth. Notably, 100% of consumer staples companies addressed tariffs, as analysts sought to assess potential inventory problems, cost pressures, consumer price inflation and demand risks. "Uncertainty" fell to second place but still made a strong showing; 381 companies referenced a lack of clarity. Taking bronze on the podium was "recession," which appeared on 121 company calls – up sharply from just 13 mentions during all of calendar Q4's earnings season. This trifecta of concerns has led Wall Street to expect forward earnings growth will slow from Q1 levels. **According to FactSet, for each of the next three quarters through year's end, S&P 500 blended earnings are projected to grow by 4.8%, 7.0%, and 6.1%, respectively.**

**U.S. energy patch: peak oil?** – The term "peak oil" was popularized in the mid-2000s to describe a geological theory that conventional global oil production was approaching a maximum, after which it would enter irreversible decline, leading to widespread supply shortages. However, the combination of horizontal drilling and hydraulic fracturing unleashed the U.S. shale revolution, unlocking previously uneconomical resources and driving a new wave of oil production growth. Global ambitions to reduce greenhouse gas emissions – punctuated by the 2016 Paris Climate Accord – led to a redefinition of "peak oil" as the point at which global oil demand

would reach its apex. Now U.S. producers are once again invoking the concept of "peak oil" – this time referring to supply – as the most geologically favorable shale prospects are increasingly tapped out. In a Q1 letter to shareholders, Diamondback Energy (FANG) CEO Travis Stice wrote, "It is likely that U.S. onshore oil production has peaked and will begin to decline this quarter." While that assessment may seem aggressive, there is a growing view that shale's days are numbered as the primary driver of oil production growth. This comes at a time when President Trump is calling on oil companies to "drill, baby, drill," and recognition is growing that the world will need all sources of energy supply for the foreseeable future to meet rising demand.

**Canada housing update** – Canada's housing market remains quite subdued, with weak consumer confidence continuing to negatively impact sales activity. Borrowing costs are still not low enough to improve affordability or rekindle investor demand. In April, existing home sales were effectively flat in seasonally adjusted terms, following four consecutive months of decline, leaving sales down 9.8% from a year ago. Nationally, prices continued to fall in April, accelerating to a year-over-year decline of 3.6%. Prices were particularly weak in Toronto and Vancouver while Edmonton, Montreal and Winnipeg saw higher prices.

**Higher GDP growth expected in Canada** – BMO Economics increased its GDP growth projection for Canada to 1% GDP growth for 2025 (up from 0.7%) and 1.2% GDP growth in 2026 (from 1%). Extreme uncertainty continues to hover around the outlook, and we could see significant revisions in either direction over the coming months. Indeed, BMO Economics is still projecting negative growth for Q2 and Q3 (though a shallower contraction), which would qualify as a so-called technical recession (two consecutive quarters of negative GDP growth). **The growth outlook is a bit brighter**, but risks remain for Canada.

**Mixed Canadian inflation reading** – Canada's Consumer Price Index fell 0.1% month over month in April, carving the headline inflation rate to 1.7% from 2.3% the prior month. However, the Bank of Canada's two main measures of core inflation both pushed uncomfortably back above 3% last month; trim rose 0.2% to 3.1% and median jumped 0.2% to 3.2%. These measures had been expected to hold about flat – so not good. Food was a big driver here; CPI ex food & energy was less troubling at 2.6% year over year (up from 2.4%). Some of that upswing in underlying prices appears related to the simmering trade war, with food and vehicle prices showing some real power. After a weak jobs report handed the bank a good reason to cut, this back-up in core above 3% pretty much washes away that likelihood. **Given a weak growth outlook for much of 2025, BMO Economics continues to expect further rate reductions, but the central bank may need more time to gain comfort from the inflation outlook.**

## Next Week

A holiday-shortened week in the U.S. but a few core readings on sentiment, manufacturing pace and GDP in both countries. Fed FOMC meeting minutes are out on Wednesday, and the group's preferred inflation measure, the PCE, out Friday.

- **Monday 5/26** – U.S. markets closed for Memorial Day holiday | Canada Manufacturing sales
- **Tuesday 5/27** – U.S. Durable goods orders, Consumer confidence | Canada Wholesale sales
- **Wednesday 5/28** – U.S. FOMC April meeting minutes
- **Thursday 5/29** – U.S. jobless claims, GDP
- **Friday 5/30** – U.S. PCE, Trade balances and inventory data, Consumer sentiment | Canada GDP

## Data scorecard as of May 21, 2025

Equity Market Total Returns						
	5/21/2025 Level	WTD	YTD	2024	2023	2022
S&P 500	5,845	-1.9%	-0.1%	25.0%	26.3%	-18.1%
NASDAQ	18,873	-1.8%	-2.0%	29.6%	44.7%	-32.5%
DOW	41,860	-1.8%	-1.0%	15.0%	16.2%	-6.9%
Russell 2000	2,047	-3.1%	-7.8%	11.5%	16.9%	-20.5%
S&P/TSX	25,839	-0.5%	5.6%	21.7%	11.8%	-5.8%
MSCI EAFE	9,443	2.2%	16.8%	3.8%	18.2%	-14.5%
MSCI EM	633	0.2%	10.3%	7.5%	9.8%	-20.1%
Bond Market Total Returns						
		WTD	YTD	2024	2023	2022
Bloomberg U.S. Aggregate		-0.8%	1.2%	1.3%	5.5%	-13.0%
Bloomberg U.S. Treasury		-0.7%	1.4%	0.6%	4.1%	-12.5%
Bloomberg U.S. Corporate		-0.8%	0.8%	2.1%	8.5%	-15.8%
Bloomberg U.S. High Yield		-0.3%	2.1%	8.2%	13.4%	-11.2%
Bloomberg 1-10 Year Munis		-0.1%	0.5%	0.9%	4.5%	-4.7%
Bloomberg Canada Aggregate		-1.3%	-0.2%	4.0%	6.5%	-11.3%
Bloomberg Canada Treasury		-1.2%	-0.2%	2.9%	5.0%	-9.9%
Bloomberg Canada Corporate		-0.9%	0.9%	6.9%	8.2%	-9.5%
Government Bond Yields						
	5/21/2025	Last Month End	Last Quarter End	2024	2023	2022
U.S. 10-Year Treasury	4.60%	4.16%	4.21%	4.57%	3.88%	3.88%
Canada 10-Year Government	3.40%	3.09%	2.97%	3.23%	3.11%	3.30%
U.K. 10-Year Gilt	4.76%	4.44%	4.67%	4.56%	3.53%	3.66%
German 10-Year Bund	2.64%	2.44%	2.74%	2.36%	2.02%	2.57%
Japan 10-Year Government	1.52%	1.31%	1.49%	1.09%	0.61%	0.41%
Currencies & Real Assets						
	5/21/2025 Level	WTD	YTD	2024	2023	2022
USD Index	99.56	-1.5%	-8.2%	7.1%	-2.1%	8.2%
CAD:USD	\$0.72	0.8%	3.8%	-7.9%	2.3%	-6.7%
Bitcoin	\$108,282.41	4.4%	15.5%	120.5%	157.0%	-64.3%
Gold	\$3,314.96	3.5%	26.3%	27.2%	13.1%	-0.3%
Oil (WTI)	\$61.57	-1.5%	-14.2%	0.1%	-10.7%	6.7%

\*Benchmark data does not reflect actual investment performance but reflects benchmark results of the underlying indices referenced. You cannot invest directly in an index. Index definitions can be found at the end of this publication.

## Index Definitions

### Equity indices

**S&P 500® Index** is an index of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

**NASDAQ Composite Index** is a market-cap weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange.

**Dow Jones Industrial Average (“DOW”)** is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

**Russell 2000® Index** (Russell 2000®) is an unmanaged index that measures the performance of the smallest 2000 U.S. companies in the Russell 3000® Index.

**S&P/TSX Index** is a capitalization-weighted equity index that tracks the performance of the largest companies listed on Canada’s primary stock exchange, the Toronto Stock Exchange (TSX).

**MSCI EAFE Index (Developed Markets —Europe, Australasia, and Far East Index)** is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International. The index captures large and mid-cap representation across 21 developed markets countries around the world, excluding the U.S. and Canada.

**MSCI Emerging Markets Index** is a market capitalization weighted index representative of the market structure of the emerging markets countries in Europe, Latin America, Africa, Middle East and Asia. Prior to January 1, 2002, the returns of the MSCI Emerging Markets Index were presented before application of withholding taxes.

### Fixed income indices

**Bloomberg U.S. Aggregate Bond Index** is an unmanaged index that covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities.

**Bloomberg U.S. Treasury Index** is an unmanaged index that includes a broad range of U.S. Treasury obligations and is considered representative of U.S. Treasury bond performance overall.

**Bloomberg U.S. Corporate Bond Index** measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

**Bloomberg U.S. Corporate High Yield Index** is an unmanaged index that covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+ or below.

**Bloomberg 1-10 Year Blend Municipal Bond Index** is a market value-weighted index which covers the short and intermediate components of the Bloomberg Capital Municipal Bond Index — an unmanaged, market value-weighted index which covers the U.S. investment-grade tax-exempt bond market.

**Bloomberg Canada Aggregate Bond Index** measures the investment grade, Canadian dollar-denominated, fixed-rate, taxable bond market. It includes treasuries, government-related, and corporate issuers.

**Bloomberg Canada Aggregate Bond Index - Treasury** is the treasury sub-component of the Bloomberg Canada Aggregate Bond Index, which measures the investment grade, Canadian dollar-denominated, fixed-rate, taxable bond market.

**Bloomberg Canada Aggregate Bond Index - Corporate** is the Corporate sub-component of the Bloomberg Canada Aggregate Bond Index, which measures the investment grade, Canadian dollar-denominated, fixed-rate, taxable bond market.



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<sup>i</sup> [Credit Rating - Countries - List](#)

<sup>ii</sup> [Understanding the National Debt | U.S. Treasury Fiscal Data](#)

<sup>iii</sup> [Federal Debt: Total Public Debt \(GFDEBTN\) | FRED | St. Louis Fed](#)

<sup>iv</sup> [Global Debt Database - General Government Debt](#)

<sup>v</sup> [Fixed Income Chart - SIFMA - SIFMA](#)

<sup>vi</sup> [National Deficit | U.S. Treasury Fiscal Data](#)

<sup>vii</sup> [For the First Time, the U.S. Is Spending More on Debt Interest than Defense | Council on Foreign Relations](#)

<sup>viii</sup> [What Is the National Debt Costing Us?](#)

<sup>ix</sup> [Preliminary Analysis of the Distributional Effects of the One Big Beautiful Bill Act | Congressional Budget Office](#)

<sup>x</sup> [Rising Global Debt Requires Countries to Put their Fiscal House in Order](#)