Think Strategically

From Rally to Reality As Markets Confront U.S. Debt, Downgrades, Tariffs and Trump's Budget

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Francisco Rodríguez-Castro, President & CEO

Markets Stall as Lurking Risks Resurface

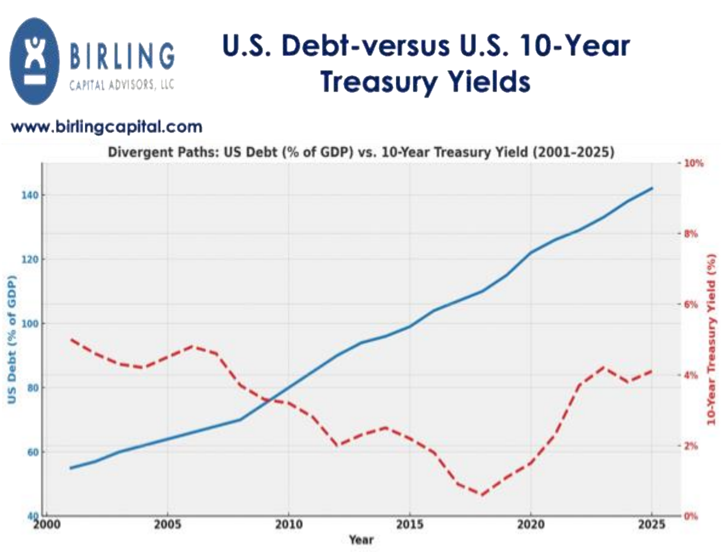
Last week marked a pause in the bullish momentum that had driven equities nearly 20% higher since early April when President Trump paused the tariffs madness. Investor sentiment was dented by renewed fiscal concerns, sovereign credit downgrades, and fresh tariff threats, which reignited fears about policy volatility and long-term debt sustainability.

Stocks, bonds, and the U.S. dollar all pulled back as attention turned squarely toward the growing federal budget deficit. The House of Representatives passed a sweeping tax package dubbed the "One Big Beautiful Bill" that aims to extend and expand the 2017 tax cuts, raising questions about its impact on future deficits that could reach as much as $4 trillion.

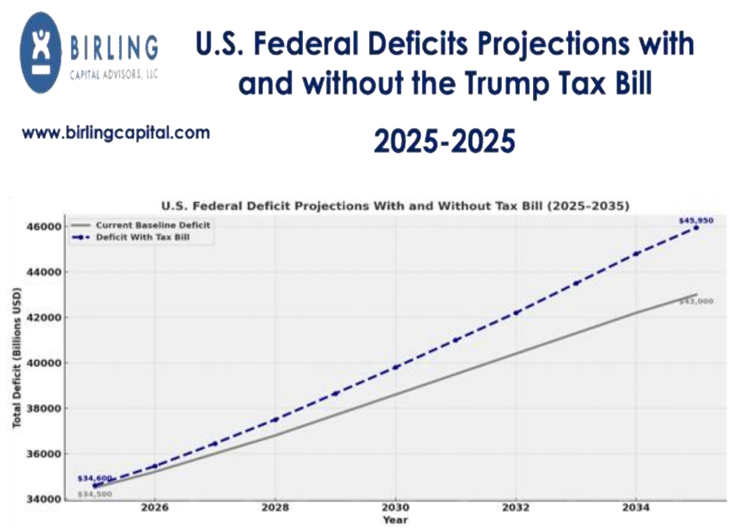
Meanwhile, just before the House approved the bill, Moody's downgraded U.S. sovereign debt, aligning itself with earlier actions by S&P and Fitch. Late in the week, President Trump's threat to impose 50% tariffs on European imports and a 25% levy on Apple devices manufactured abroad reminded investors that trade remains a dominant risk factor heading into the second half of 2025.

Moody's Downgrade Completes the Credit Rating Trilogy

With Moody's latest move, all three major credit rating agencies have downgraded the U.S. government's long-term debt from its former pristine AAA status. Moody's cited mounting fiscal deficits and soaring interest costs as key drivers. The downgrade had been widely anticipated—Moody's had placed the U.S. on negative watch as far back as November 2023—and markets had already priced in much of the risk. Nonetheless, the symbolic weight of losing the last AAA rating underscores Washington's persistent inability to confront structural imbalances in the federal budget.



Importantly, the downgrade will not trigger a wave of forced selling by passive investment vehicles since most index providers already use the lowest or median credit rating to determine index eligibility. Still, the downgrade highlights the rising cost of inaction, especially as Congress advances deficit-expanding legislation.



Bond Market Signals: Caution Without Panic
Yields across the Treasury curve rose sharply last week, with the 10-year Treasury surpassing 4.5% and the 30-year breaking above 5%, levels not seen since before the 2008 financial crisis. The upward pressure on yields reflects a blend of factors: greater expected issuance, recalibrated Federal Reserve rate-cut expectations, and broader concerns about fiscal sustainability.

Higher yields tend to attract more investor demand, slow economic activity, and ease inflation—setting the stage for potential Fed policy shifts and perhaps even fiscal restraint from lawmakers seeking to mitigate the debt load.

We like intermediate maturities, particularly the 7-to-10-year segment—as a spot for locking in higher yields without excessive duration risk. For investors with maturing CDs or idle cash, this environment offers an opportunity to build a laddered fixed-income strategy.

Debt and Deficits: A Long-Term Risk, Not a Short-Term Threat
Federal deficits are rising rapidly. From $472 billion or 3% of GDP a decade ago to $2 trillion (6.7% of GDP) last year, the trajectory is troubling. Interest payments on the debt now account for about 3% of GDP—the highest level since the early 1990s. Projections indicate that the debt-to-GDP ratio could reach 150% by the mid-2030s.

Still, history tells a nuanced story. During the Clinton-era surplus years, the 10-year yield hovered around 6%. In contrast, during the post-pandemic period—with massive deficits, yields fell to historic lows. The key takeaway? Economic growth, inflation expectations, and Fed policy remain the dominant forces driving interest rates, not just headline debt levels.

While deficits do not immediately threaten portfolios, they do carry planning implications. Taxes are currently low by historical standards, and investors may want to explore proactive tax strategies in anticipation of possible future increases.

Trade Still Rules the Market Narrative
Despite months of optimism and equity gains, trade policy remains a potent disruptor. President Trump's tariff threats last week, especially a proposed 25% levy on Apple devices manufactured abroad, rattled tech stocks and raised concerns about supply chain resilience.

While the market reaction was swift, it was not panicked. Nonetheless, key tariff deadlines loom, as the 90-day moratorium on earlier tariffs expires in July, and the lower rates on Chinese goods are set to sunset in August. Combined with ongoing debt-ceiling talks, these developments could inject renewed volatility into summer markets.

A Cautiously Optimistic Outlook
Investor sentiment is recalibrating after a powerful two-month rally. As the market digests Moody's downgrade, surging yields, and tariff rhetoric, we expect volatility to persist in the near term. However, history offers some comfort: rallies of this magnitude often lead to strong 12-month forward returns. Deficits, credit downgrades, and trade policy may dominate headlines, but they don't alter the structural drivers of U.S. markets. As long as economic growth holds and inflation remains contained, equity and bond investors have room to navigate the turbulence with discipline, diversification, and a long-term lens.

The Final Word: The Trump Tax Bill Focused on wealthy individuals at the expense of the poor
On May 22, the House narrowly passed the new tax bill along party lines. The package extends key provisions of the 2017 Tax Cuts and Jobs Act and introduces additional cuts tailored to wage earners, retirees, and high-income households. Notably, it raises the state and local tax (SALT) deduction cap to $40,000 for families earning under $500,000, compared to the current $10,000 limit.

To offset some of the projected costs, the bill also includes targeted spending cuts and eligibility restrictions for food, healthcare, and energy programs. But these are mostly backloaded, while the tax benefits are front-loaded. The Congressional Budget Office (CBO) estimates the package could add up to $3 trillion to the deficit over the next decade, pushing the federal shortfall to as high as 7% of GDP by 2027. Though the bill still needs to clear the Senate and will undergo substantial revisions, it offers a preview of the fiscal path ahead, including more borrowing, even as debt-servicing costs approach historic highs.

What does the Trump administration prioritize
- **Total Spending**: $1.691 trillion
- **Defense**: +13% to $1.01 trillion
- **Cuts**: $163.3 billion or -22.6% in non-defense discretionary programs
- **Focus**: Wealthy Americans, Security, Sovereignty, and Space

New Programs and Increases
- **Department of Defense**: Increase of $113.3 billion, totaling more than $1.01 trillion
- **Department of Homeland Security**: Increase of $42.3 billion, reaching $175 billion
- **Missile Defense Initiative "Golden Dome"**: Initial investment of $25 billion; projected $542 billion over 20 years
- **America First Opportunity Fund**: $2.9 billion to support strategic allies
- **U.S. International Development Finance Corporation**: Increase of $2.82 billion, including $3 billion for a new revolving fund
- **NASA – Lunar Program**: Over $7 billion allocated
- **NASA- Mars-focused programs**: $1 billion in new investments
- **Total New Funds**: $194.3 billion

Cuts and Eliminations
Health and Human Services (HHS)
- **National Institutes of Health (NIH)**: Cut of $17.965 billion
- **Centers for Disease Control and Prevention (CDC)**: Cut of $3.588 billion
- **Complete elimination of**:
  - National Center for Chronic Disease Prevention
  - National Center for Environmental Health
  - National Center for Injury Prevention

    - Global Health Center
    - Public Health Preparedness and Response
    - Block Grant for Preventive and Human Services

Education

- **Federal Supplemental Educational Opportunity Grant (FSEOG)**: Cut of $910 million; program eliminated
- **Federal Work-Study Program (FWS)**: Cut of $980 million

Housing and Urban Development (HUD)

- **Community Development Block Grant (CDBG)**: Cut of $3.3 billion; program eliminated
- **HOME Investment Partnerships Program**: Funds eliminated

Justice Department

- The proposed elimination of approximately 40 grant programs

Cultural Agencies

- **Corporation for Public Broadcasting**: Funds eliminated
- **National Endowment for the Arts**: Funds eliminated
- **National Endowment for the Humanities**: Funds eliminated
- **Institute of Museum and Library Services**: Funds eliminated

Foreign Aid and Environmental Programs

- **USAID**: Proposed elimination
- **U.S. Institute of Peace**: Proposed elimination
- **Global Environment Fund and Climate Investment Funds**: Cut of $275 million; funds eliminated
- **Atmospheric Protection Program**: Cut of $100 million

Total Cuts/Eliminations: $195 billion

Impact on Puerto Rico

Health

- **Medicaid**: Around 72% of the program's funding comes from federal sources, benefiting nearly 50% of Puerto Rico's population. Any significant reduction could severely limit access to healthcare for approximately 1.5 million beneficiaries.
- **Medicare Advantage**: Payments in Puerto Rico may decline compared to projected increases in other states, affecting the quality and availability of services for older people.

Housing

- The proposal includes eliminating over **$26 billion** in rental assistance programs via HUD, including **Section 8**, which supports low-income residents of Puerto Rico.

Disaster Recovery

- Of the funds allocated by Congress through **FEMA** for recovery after hurricanes Irma and María, about **$23 billion** has been spent. The remaining funds may be at risk.

Energy and Environment

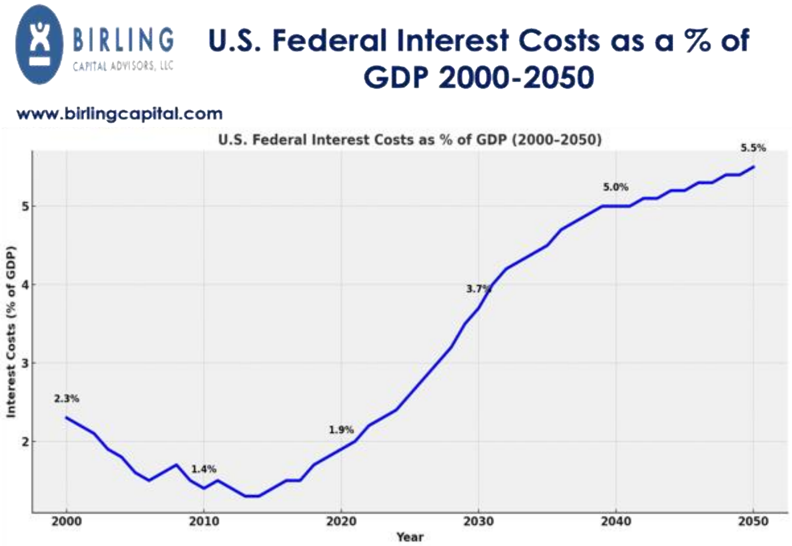
- The proposal includes cuts of **$2 billion** in Department of Energy funding for renewable energy projects and **$80 million** from Department of the Interior programs promoting solar and wind energy—potentially impacting clean energy initiatives on the island.

Top 3 Takeaways from the Trump 2026 Budget Proposal

1. **A Budget Tilted Toward the Wealthy:** The proposal continues a trend of policies that disproportionately favor high-income individuals—extending tax cuts and reducing regulatory

oversight—while enacting deep cuts to social programs that primarily benefit low- and moderate-income Americans.

2. **Inequality Deepens as Poverty Spreads:** Rather than promoting broad-based prosperity, the budget risks redistributing poverty instead of wealth. By slashing federal support for healthcare, housing, and education, it places the greatest burdens on the most vulnerable populations, threatening to widen the gap between rich and poor.
3. **Millions at Risk of Losing Health Coverage:** Proposed reductions to Medicaid and Medicare Advantage and eliminating preventative care subsidies could leave more than **7 million Americans** without health insurance—hitting hardest in areas like Puerto Rico that rely heavily on federal healthcare funding. With over half of Puerto Rico's population relying on Medicaid, the proposed reductions threaten to undermine access to essential healthcare services for more than 1.5 million citizens. Cuts to Medicare Advantage could further strain the island's fragile healthcare infrastructure, disproportionately affecting older people.



The 2026 Federal Budget proposal represents a fundamental reshaping of fiscal priorities in the United States. It includes sweeping increases in defense and security spending but unprecedented cuts to critical social, educational, healthcare, housing, and environmental programs.

The consequences are particularly severe for Puerto Rico. In addition to healthcare, the elimination of rental assistance programs, including Section 8, jeopardizes housing stability for thousands of low-income families, while reductions to energy and environmental funding stall Puerto Rico's transition to a resilient, clean-energy future.

These changes risk exacerbating existing socioeconomic inequalities and threaten to reverse the progress made since the devastation of Hurricanes Irma and María. With billions in reconstruction funds still at stake, Puerto Rico's long-term recovery, sustainability, and self-sufficiency hang in the balance.
This is not merely a fiscal proposal—it is a pivotal moment that demands urgent attention, coordinated leadership, and a unified voice from Puerto Rico's public and private sectors to protect the island's most vulnerable communities and secure its future.

When dealing with the Federal Government's Budget, I remember Thomas Sowell's words: **"The first lesson of economics is scarcity: there is never enough of anything to fully satisfy all those who want it. The first lesson of politics is to disregard the first lesson of economics".**

BIRLING CAPITAL ADVISORS, LLC
Francisco Rodríguez-Castro, President & CEO • frc@birlingcapital.com
PO Box 10817 San Juan, PR 00922 • 787.247.2500 • 787.645.8430