

The Long Bond Paradox

14 October 2026

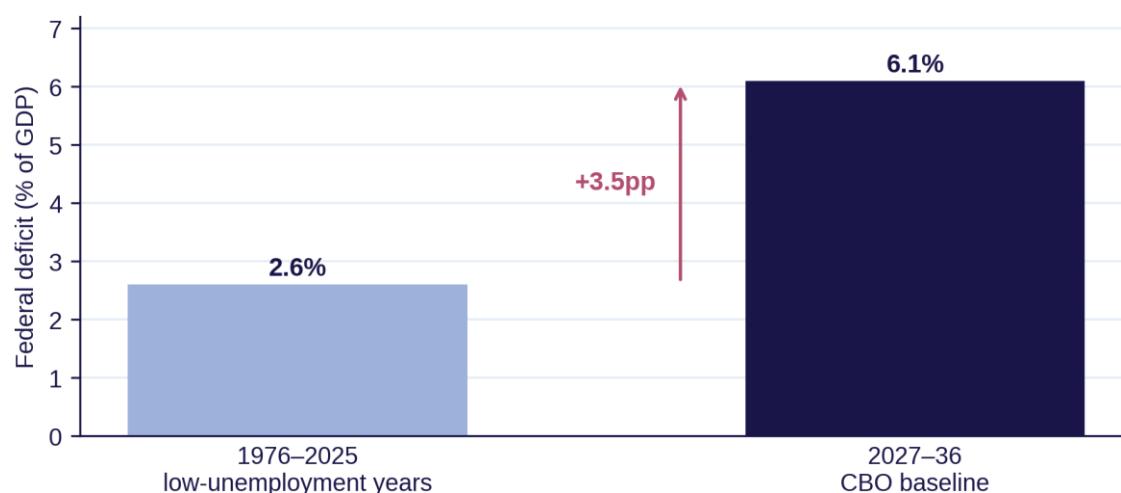
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The year began with a plausible assumption: if Washington wanted lower interest rates, it would eventually have to borrow less. The arithmetic was straightforward. The harder question was how governments would respond to the constraints it implied.

The assumption was that a major developed economy could not indefinitely run budget deficits of 6-7% of GDP, with unemployment low and inflation still above target, while also expecting lower interest rates. If Washington wanted cheaper money, fiscal policy would eventually have to adjust: reduce demand pressure, ease inflation and give the Federal Reserve (Fed) more room to cut rates.

That was the expected bargain. Governments could borrow heavily during recessions, wars and emergencies, but once growth returned the deficit should narrow. The United States has broken that pattern. The Congressional Budget Office (CBO) projects a federal deficit of 5.8% of GDP this year, rising to 6.7% by 2036, even with unemployment below 5%. Debt held by the public rises from about 101% to 120% of GDP over the same period. CBO describes sustained deficits of this size with unemployment this low as historically unusual.

A very different fiscal regime

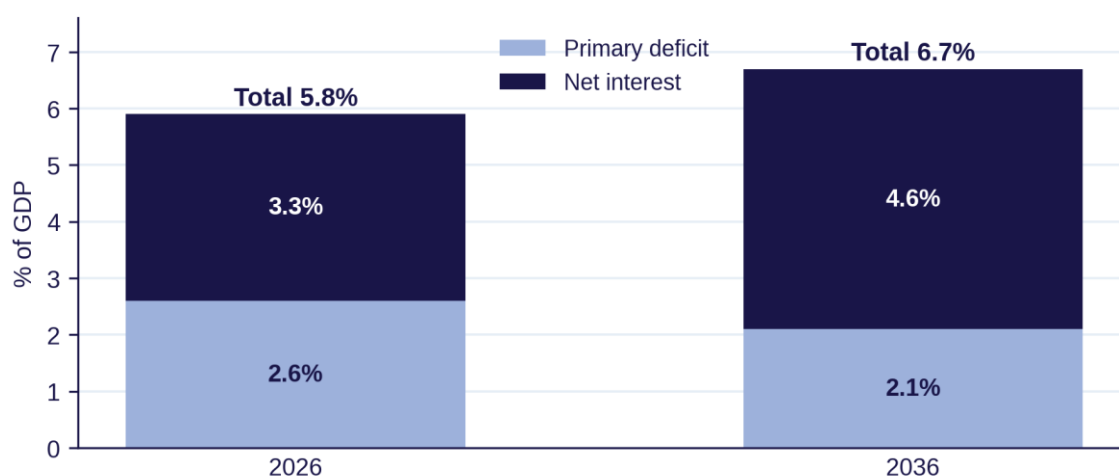


In the 14 years since 1976 when unemployment was below 5%, the federal deficit averaged about 2.6% of GDP. CBO projects unemployment below 5% through 2036 while deficits remain close to 6% of GDP. Source: Congressional Budget Office, data as at February 2026.

The arithmetic has not changed. Fiscal policy has proved more persistent, and private borrowers less immediately exposed to higher rates. Households had locked in cheap fixed-rate mortgages, companies had termed out debt and government spending continued to support demand while the Fed tightened. The private sector therefore absorbed higher policy rates with less immediate damage than the conventional transmission mechanism implied.

Government debt is exposed progressively as borrowing matures and deficits require fresh financing. As rates rose, so did Washington's interest bill. Net interest expenditure is about 3.3% of GDP today and CBO expects it to reach 4.6% by 2036. Yet the primary deficit falls, from 2.6% of GDP in 2026 to 2.1% in 2036, while the overall deficit rises. Interest increasingly does the work.

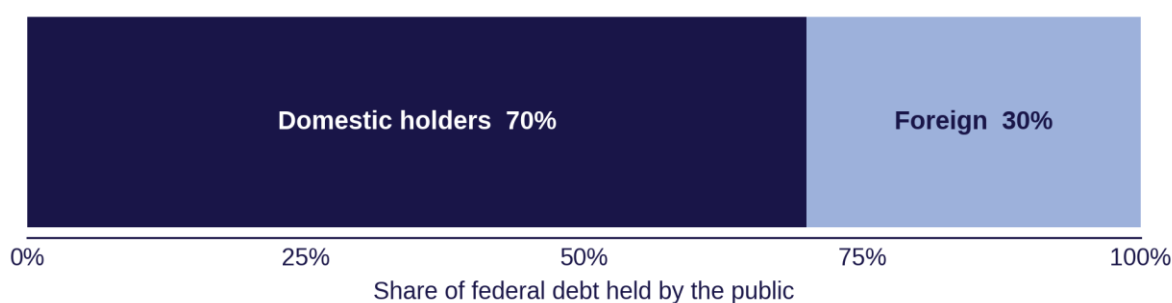
Interest increasingly drives the deficit



The primary deficit is projected to narrow between 2026 and 2036, while net interest rises sharply enough to push the overall deficit higher. Components may not sum to totals because of rounding. Source: Congressional Budget Office, data as at February 2026.

Those payments also provide income to bondholders. Roughly 70% of federal debt held by the public is owned domestically, with the Fed, mutual funds and financial institutions among the largest holders. A substantial share of higher government interest payments is therefore recycled through the US financial system rather than flowing abroad, partly offsetting the squeeze on borrowers, although how much returns to spending is uncertain. That does not make higher rates expansionary: borrowers still face tighter conditions, housing activity weakens and leveraged investment becomes less attractive. But it does make the monetary transmission mechanism less clean than the textbook version suggests.

Most US Treasury debt is held at home



Around 70% of federal debt held by the public is owned domestically. That means a substantial share of higher US Treasury interest payments is recycled through the US financial system, while foreign investors still matter for the market-clearing yield. Source: Congressional Budget Office and US Treasury; holdings data as at September 2025.

Inflation fell sufficiently for the Fed to ease. Now it has reversed course and started tightening again. In September the Federal Open Market Committee raised its target range by 25 basis points to 3.75-4%, citing solid economic activity, resilient domestic spending and inflation that remained elevated.

There is a temptation to read that resilience as a simple risk-on signal: sell government bonds and buy risk assets. But the conclusion is too neat. Strong growth supports earnings and cash flows; a rising risk-free rate, higher refinancing costs and a larger term premium do not. The question is whether asset prices can tolerate the interest rate required to restrain it.

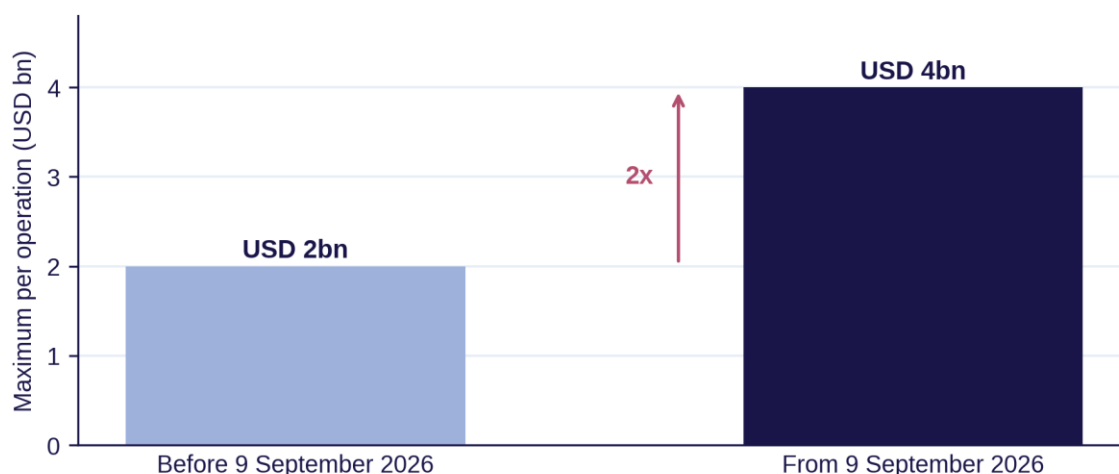
The fiscal position makes that question harder. The debt-interest feedback loop is already under way. Higher rates increase the government's interest bill; borrowing to meet that bill adds to the debt stock; the larger debt stock then generates still more interest expense. The United States is not yet in an uncontrolled debt spiral, but the mechanism that could produce one is already operating.

Fiscal consolidation could interrupt that loop. Lower government borrowing would reduce demand pressure, make inflation easier to contain and potentially allow both policy rates and long bond yields to fall. That was the original assumption: a government that wanted cheaper money would eventually accept the fiscal restraint required to achieve it.

But what if it does not? The US Treasury cannot make the financing requirement disappear, but it can change the maturity of the debt the market is asked to absorb. Issuing more bills and fewer long bonds reduces duration supply. Buybacks can reinforce that shift if they are financed with shorter-dated borrowing. They change the maturity of the debt, not the amount of it.

The US Treasury is already expanding the machinery. In August it announced that the maximum size of liquidity-support buybacks in the 10-to-20-year and 20-to-30-year nominal sectors would at least double, from \$2 billion to \$4 billion per operation from 9 September. The US Treasury is explicit that these purchases are intended to support liquidity, not suppress yields, and the current amounts are small relative to the market. They should not be described as covert yield-curve control.

The US Treasury is expanding long-end buyback capacity



The maximum size of liquidity-support buybacks in the 10-to-20-year and 20-to-30-year nominal sectors doubled from USD 2bn to at least USD 4bn per operation from 9 September 2026. The US Treasury describes the programme as liquidity support, not yield targeting. Source: US Department of the Treasury, 19 August 2026.

Even so, the Fed can raise the short end to restrain demand while the US Treasury reduces the amount of long-duration government debt the market must absorb. One arm of policy can therefore tighten financial conditions at the front end while another alters supply at the long end.

That does not mean the two institutions are pursuing a coordinated strategy. Central-bank purchases would be a separate and far more contentious step, requiring the Fed's participation. Political pressure for cheaper financing does not guarantee its co-operation. Nor does reducing duration supply ensure that long yields fall: if investors believe debt management is being used to avoid fiscal adjustment at the expense of price stability, inflation expectations and the term premium could rise instead.

Nevertheless, the incentive is clear. The market-clearing yield is not necessarily the politically tolerable yield. Rising long rates increase mortgage costs, corporate refinancing costs, property discount rates and, progressively, the government's own interest bill. Higher interest costs widen the deficit, increasing future issuance and potentially pushing yields higher again.

Deteriorating public finances are not inherently bullish for long bonds. Left alone, they point the other way: more borrowing, more duration supply and more inflation uncertainty should command higher yields. The market could become very uncomfortable before policy changes.

But fiscal deterioration may also provoke a response that changes the investment outcome. If long yields rise far enough to push debt-service costs materially higher, the pressure to contain them increases. The US Treasury can shorten issuance; buybacks can remove selected long bonds from the market; regulatory treatment can influence domestic demand for government securities. At the extreme, if market functioning or financial stability were threatened, the Fed could again become a buyer.

There is a spectrum between ordinary debt management and explicit yield-curve control, and the United States is not about to cross it. But the worse the deficit gets, the stronger the incentive to stop long-term borrowing costs rising far enough to make it worse still.

Policies that reduce the supply of duration can leave long yields lower than they would otherwise have been, even with inflation elevated. If inflation also falls while short rates remain restrictive, the case for a flatter curve and lower long yields strengthens. If intervention instead undermines confidence in price stability, the opposite can happen.

The original assumption was that Washington would reduce the deficit to bring borrowing costs down. If it refuses, it may eventually try to bring borrowing costs down without reducing the deficit.

That is the long bond paradox. The fiscal problem we once expected to force restraint may, eventually, become the reason policymakers cannot tolerate much higher long-term yields.

Either way, the case for owning the long end is stronger than the fiscal headlines suggest.

Sources

- Congressional Budget Office, The Budget and Economic Outlook: 2026 to 2036, February 2026.
- Federal Reserve Board, FOMC statement, data as at 16 September 2026.
- US Department of the Treasury, "Treasury Announces Increased Sizes of Nominal Long-End Liquidity Support Buybacks Beginning September 9", data as at 19 August 2026.

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