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Rate and Credit View

The Fiscal Fuse Is Getting Shorter

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Executive Summary

- Rising rates and rapid Treasury refinancing are increasing interest costs and further tightening Washington's already limited fiscal flexibility.
- Treasury buybacks can improve market liquidity, but their limited scale cannot offset growing supply or persistent inflation concerns.
- Several warning signs are emerging, although current conditions still fall short of a full-fledged Treasury market crisis.
- Investors should favor high-quality, short-to-intermediate bonds while remaining cautious toward long-duration exposure and lower-rated credit.

The Crisis Checklist: What It Would Take for Normalization to Break

In last month's Rate and Credit View, we argued the move higher in Treasury yields looked like normalization, not a crisis. We added one word at the end: yet. Last week gave that word more weight than we would have liked.

Last Wednesday's 5-year auction was ugly. The $70 billion sale cleared at 5.033% and tailed by 3.1 basis points. The bid-to-cover was 2.21 versus a 2.33 average. Indirect bidders took 54.3% versus a 65.2% average, and dealers were left with 15.8% versus a 12.9% average. In plain English, the Treasury had to pay up to find buyers, foreign demand stepped back, and dealers were stuck holding more than usual. At the same time, the MOVE index, which tracks expected Treasury volatility, jumped from around 80 on Tuesday to 104 on Thursday, and the 10-year yield briefly touched 5.2%. All of this came a week after the Fed raised rates for the first time in three years, to a 3.75% to 4% range.

So, this month we want to take a different approach. Rather than argue about whether we're in a crisis, we'll describe what one would look like, what policymakers can realistically do about it, and whether all roads ultimately end at the Federal Reserve (Fed). But first, with rates higher across the curve, the fiscal math continues to change, making debt service costs a larger (and growing) share of the federal outlays.

The Math has Changed

At roughly $1.0 trillion this fiscal year, interest costs now exceed what the government spends on defense or Medicaid. Congressional Budget Office (CBO) expects net interest to climb from 3.3% of GDP to 4.6% over the next decade. That projection was built on a 10-year yield averaging 4.1% this year and settling around 4.4% longer term, and we are above that path. By CBO's own estimate, rates one percentage point above its baseline would push debt to 222% of GDP by 2056 instead of 175%.

The bigger near-term risk isn't the 10-year, though. It's the front end.

As of August, $7.25 trillion of Treasury debt, about 22% of the total, sits in Treasury bills. Bills mature in a year or less, so they reprice quickly when the Fed moves, typically within a few months. The average interest rate on

marketable debt was about 3.1% in August. Every dollar that rolls over now rolls into a world where bills yield between 3.95% and 4.52% and coupons pay between 5% to 5.50%.

The bill math is simple:

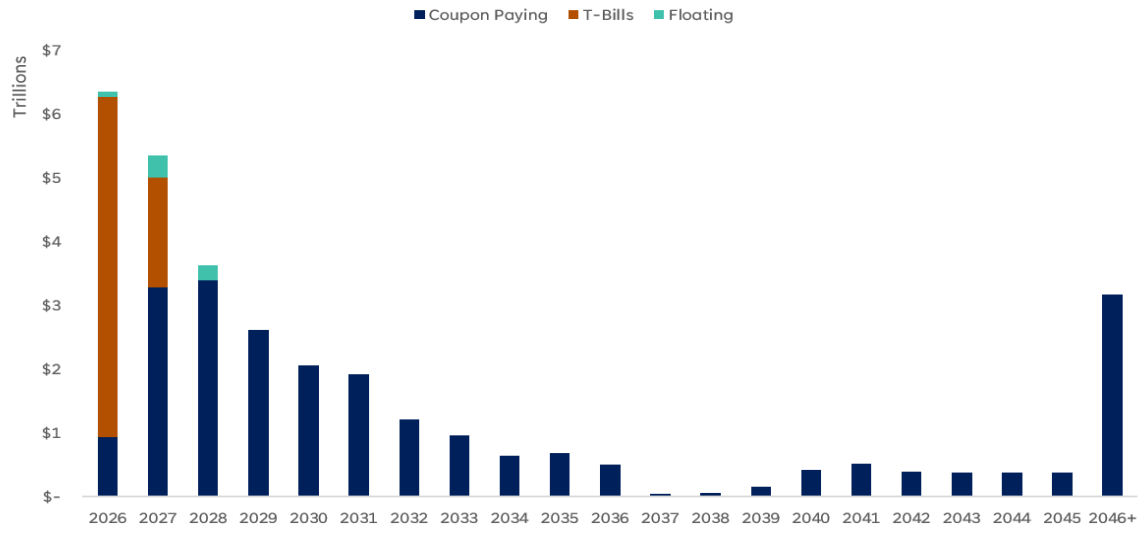
Additional Fed Hikes	Added Annual Interest Cost	% of GDP
25 bp	$18 billion	0.06%
50 bp	$36 billion	0.11%
75 bp	$54 billion	0.17%
100 bp	$73 billion	0.23%
150 bp	$109 billion	0.34%

Some of this is already locked in. September's hike alone adds roughly $18 billion a year once the bill stack turns over. Markets are pricing one more hike this year and another two to three in 2027. That's 75 to 100 basis points from where we started in September, or $54 to $73 billion a year from bills alone. For context, $73 billion is more than the federal government spends on most individual cabinet departments.

Then there's the longer-dated debt. Notes and bonds don't reprice right away, but they do mature. For every $1 trillion of coupon debt that rolls over at 1.5 percentage points above its original rate, annual interest rises by about $15 billion. If the whole marketable stack eventually repriced to today's roughly 5%, interest costs would rise by about $440 billion a year compared with the current average. That won't happen overnight, but it is where the math is heading if rates stay elevated.

This is why higher for longer is a fiscal story, not just a Fed story. The Fed is hiking to fight inflation, and every hike lands directly on the government's financing bill. The more Treasury leans on bills, the faster that happens.

Rollover Risks: Treasury's Debt Distribution is Increasingly Geared Towards T-Bills



Source: LPL Research, Bloomberg 09/28/26
Disclosure: Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

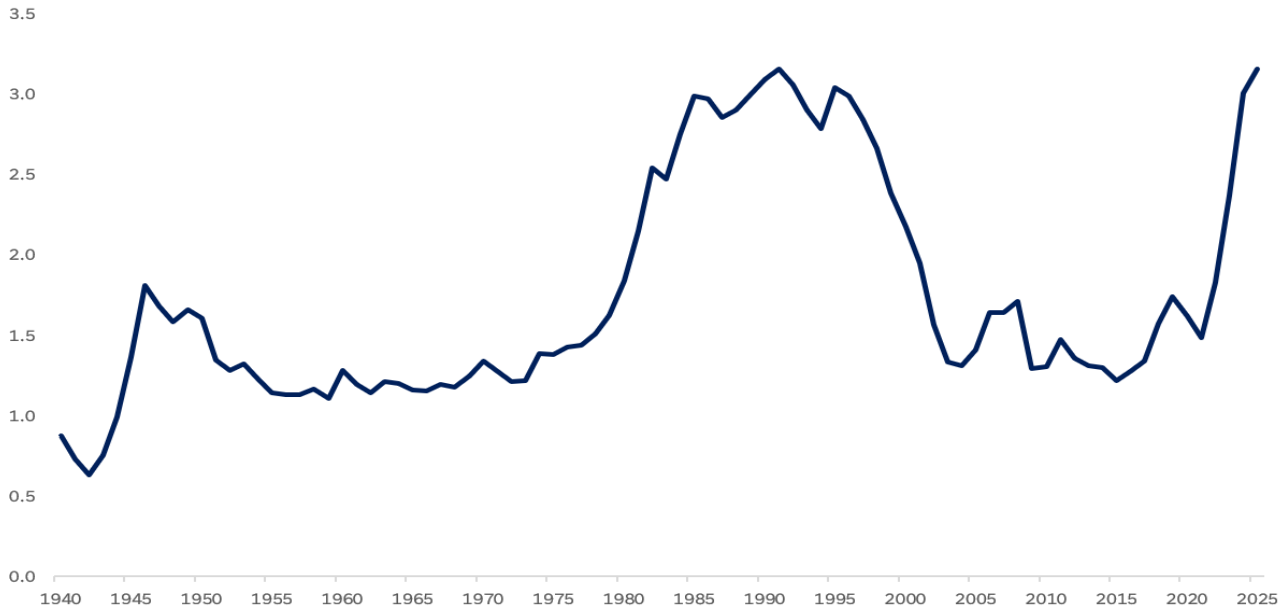
The 1990s: Same Burden, Very Different Math

We've been here before, but only in one important respect. The 1990s offer a useful mirror, even if history is unlikely to repeat exactly. Debt held by the public was less than half today's level, but the interest burden was similar. Net interest costs are projected to reach 3.3% of GDP in fiscal 2026, surpassing the previous peak set in 1991.

The burden may look the same, but the engine is different. In 1991, Washington carried less than half today's debt ratio at roughly twice the effective interest rate. Today, debt held by the public is approximately 101% of GDP, while the government's average borrowing cost is around 3.1%. At that debt ratio, every one-percentage-point increase in the government's average borrowing cost eventually adds roughly 1% of GDP to annual interest expense, about twice the sensitivity of the early 1990s. That average cost is likely to keep drifting higher as lower-cost debt matures and is refinanced at rates well above the existing portfolio's average.

The 1990s ended well because of two major deficit-reduction agreements, a post-Cold War peace dividend, stronger productivity growth, and eventually budget surpluses. The bond market reinforced the pressure for fiscal discipline, most memorably during the 1994 selloff. Today, however, the primary deficit, which excludes interest costs, is still projected at 2.6% of GDP, even with unemployment below 5%. In the 1990s, discipline ultimately came from Washington. This time, the market may have to provide the catalyst.

Federal Outlays: Interest as Percent of Gross Domestic Product



Source: LPL Research, Bloomberg 08/31/26
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Treasury is Paying Attention

Washington has noticed. On August 19, Treasury announced it would at least double its long-end buybacks, from $2 billion to at least $4 billion per operation in the 10 to 30-year sectors, through early November. Secretary Bessent argued that yields didn't reflect fundamentals and said Treasury would make a market in longer-dated bonds. The first reaction was what he wanted: the 10-year fell almost 6 basis points and the 30-year dropped 9. The first enlarged operation, sized at up to $6 billion, then failed to stop the selloff on a day when oil prices surged.

The question is scale, and the numbers here help at least on the margin. The current refunding quarter, which runs from August through early November, has 18 scheduled buyback operations with a combined maximum of about $79 billion. That breaks down as:

- Cash management: 2 operations, $25 billion total, in debt maturing within two years. These are about smoothing Treasury's cash balance around tax dates, not about rates.
- Liquidity support: 16 operations, about $54 billion total, spread across the curve.
- Long end, 10 to 30 years: 8 operations, at least $32 billion total. Before the August upsizing, the same schedule would have capped out at $16 billion.

Now compare that with supply. At current auction sizes, which Treasury has held steady, it sells about $231 billion of 10, 20 and 30-year debt each quarter, or roughly $924 billion a year. Even after doubling, long-end buybacks absorb about 14% of that new supply, up from about 7% before. At the new pace, buybacks would take out around $128 billion a year of long bonds while Treasury sells more than $900 billion.

Buybacks make a difference, but at the margin. They also don't shrink the debt. Treasury funds them by issuing more bills, so each long bond bought back becomes short-term debt exposed to the Fed hikes in the table above. The same tool that relieves the long end adds, slightly, to the front-end problem.

There are also two things buybacks can't do. They can't reach the belly of the curve, where last week's 5-year auction stumbled. And they can't change why investors want more yield in the first place: inflation, supply and uncertainty about policy.

So, the buybacks are more of a signal than a solution. Treasury is telling us it cares about the level of long rates. That's reassuring in one sense. It also tells the market where the pain threshold is.

What can Treasury actually do?

Less than people think. Treasury controls how it borrows, not how much. The toolkit:

- Shift issuance toward bills. This reduces long-end supply, but as the table shows, it trades duration risk for Fed risk. With the Fed hiking, that trade is more expensive than it was a year ago.
- Buybacks. Helpful for liquidity, limited for the level of rates. Roughly one dollar bought for every seven sold.
- Guidance on auction sizes. Promising not to raise coupon sales can calm nerves, but only if it's credible.
- Encourage new buyers. Bank capital changes and stablecoin demand for bills help at the margin.

The group best placed to tell us what's coming is the Treasury Borrowing Advisory Committee (TBAC), the panel of dealers and investors that advises Treasury each quarter. Its August report was not a rescue plan. TBAC recommended keeping coupon auction sizes unchanged. It said current projections could justify larger coupon sales next fiscal year as funding gaps widen, and suggested Treasury soften its guidance to keep that option open. It also stressed that regular, predictable issuance matters most, and it had previously cautioned that buybacks should stay focused on market liquidity rather than become a policy tool.

Reading between the lines and the message is clear: more supply is coming, and the best Treasury can do is avoid surprises. Treasury can help shape the curve. It can't set the level.

Do All Roads Lead to Yield Curve Control?

If Treasury can't bring rates down, the natural question is whether the Fed eventually will, by capping long-term yields the way Japan did for most of the last decade. Not all roads lead there but more do than a year ago.

Current Chair Kevin Warsh wants market prices to guide policy, not be managed by it. He has criticized past Fed bond buying for enabling overspending in Washington, and his stated preference is a smaller Fed balance sheet tilted toward short-term debt, which would push long yields up, the opposite of what Bessent wants. It is one of the

ironies of this cycle that the Fed chair most philosophically opposed to capping yields is the one presiding as the pressure builds.

Still, the plumbing is being laid. Earlier this year Warsh floated a new accord between the Fed and Treasury, modeled on the 1951 agreement. We warned that tying the Fed's balance sheet to Treasury financing could start to resemble a framework for yield curve control. If we do get there, it probably won't come as an announcement though. It would likely arrive in steps:

1. Treasury intervenes with buybacks and a shift toward bills. We are here.
2. The Fed shifts which bonds it holds to longer maturity securities and/or increases liquidity purchases.
3. A disorderly episode prompts temporary Fed purchases framed as restoring market function, not controlling rates. Think March 2020, or the Bank of England during the 2022 gilt crisis.
4. Temporary becomes permanent, and a cap is formalized.

The problem is inflation. Capping long yields while inflation runs above target and the Fed is raising short rates would tell markets that fiscal needs outrank price stability. That's fiscal dominance in plain sight, and the likely response is a weaker dollar and higher inflation expectations. That's why step 3 is the one to watch. Emergency purchases for market function are defensible. Anything beyond that, with inflation where it is, would be a regime change.

What a Crisis Would Actually Look Like

Not default. A default is either an inability or unwillingness to pay its debts. Outside of the politically charged debt ceiling debates, the U.S. has neither. The U.S. borrows in its own currency and will pay. A bond crisis is the point where borrowing costs stop responding to growth and inflation and start responding to fear of supply. Five signposts:

1. Auctions fail in sequence, not once. One tail is noise. Weak results across maturities with rising dealer takedowns is a signal. Status: one clear data point but not across all maturities.
2. Term premium becomes the story. Yields rise because investors demand more to hold long bonds, not because of the Fed or growth. Status: partially flashing but term premium has fallen recently.
3. Stocks and bonds fall together, repeatedly. Status: not yet. Bond yields are higher by 1.09% this year and equities are higher by 12%.
4. Yields up, dollar down. The emerging market signature. Status: not so far. The dollar has strengthened this year.
5. Policy blinks. Status: half. Treasury has blinked with its buybacks. The Fed has not; it's hiking.

The scorecard: two out of five. Not a crisis. Normalization under real strain, but policymakers are already reaching for tools.

The Setup for Investors

Higher for longer remains the base case, but it's a different kind of higher. The front end is anchored by a Fed that's tightening. The long end is at the mercy of supply, term premium and policy experiments.

That argues for the short to intermediate part of the curve, roughly 1 to 5 years. Starting yields provide real cushion: a 5-year note at 5% can absorb about a one-point rise in yields over the next year before total return turns negative. Moreover, to generate a negative return over the next twelve months on a 2-year Treasury, its yield would need to eclipse 10.25%.

Hypothetical 12-Month Returns : Interest Rate Scenario Analysis (As of 09/28/26)

Change in Interest Rates	-1.0%	-0.50%	No Change	0.50%	1.0%	Breakeven Rate
2-Year Treasury Yield	5.94	5.45	4.96	4.48	4.00	10.25
5-Year Treasury Yield	8.77	6.92	5.11	3.33	1.60	6.53
7-Year Treasury Yield	10.07	7.54	5.05	2.61	0.21	6.18
10-Year Treasury Yield	12.73	8.93	5.28	1.79	-1.56	5.98
30-Year Treasury Yield	21.78	13.24	5.59	-1.27	-7.44	5.93

Source: LPL Research, Bloomberg 09/28/26
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Be more careful with 20 and 30-year bonds. That's where fiscal stress shows up first, and where policy intervention creates two-way risk: a buyback headline can rally them one day and a failed operation can sink them the next. Stick with quality. When Treasuries pay 5%, there's little reason to stretch into lower-rated credit. Ladders earn their keep here, since maturing bonds can be reinvested at higher rates if the stress scenario plays out. And keep some inflation protection in the mix. If the road does bend toward yield caps, inflation is the risk that gets priced, not default.

A crisis still isn't our base case. But the gap between normalization and crisis is narrower than a year ago, Treasury is already intervening, and the bond market is pushing back with higher yields. "Yet" stays in the vocabulary.

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