THEMATIC RESEARCH · SOVEREIGN DEBT

The US Deficit: $2 Trillion and the Price of Borrowing

The federal government closed fiscal 2026 with a deficit of $1.99 trillion, 6.2% of GDP, and for the first time spent more on interest than on defence. With the ten-year yield at its highest since 2002, this report examines the numbers, the bond market and the policy options before the midterms.

Global Markets Research · Rates and Fiscal Desk Prepared by ANDRA MARKETS

Coverage summary. The September Treasury statement, released on 16 October, confirmed a fiscal 2026 deficit of $1,992.5bn, up 12% on the year and the third largest on record. Unlike 2009 or 2020, it came without a recession; the Iran war has cost about $38bn so far according to CBO, a small part of the total. Net interest reached $1,051.8bn, more than the $965.2bn spent on national defence, as the average rate on Treasury debt rose to 3.5% and long-term yields climbed above 5%. Moody's Analytics' chief economist Mark Zandi now warns of a "fiscal reckoning".

FY2026 deficit	Net interest	10-year yield, 5 Oct	Total public debt
$1.99tn	**$1.05tn**	**5.31%**	**$40.4tn**
6.2% of GDP (Treasury)	*19.5% of revenue*	*highest close since 2002*	*16 Oct 2026*

Exhibit A. Federal budget, fiscal years 2025 and 2026 ($bn)

Item	FY2025	FY2026	Change
Receipts	5,234.6	5,403.3	+3.2%
Outlays	7,010.0	7,395.8	+5.5%
Deficit	**1,775.4**	**1,992.5**	**+12.2%**
Social Security	1,580.7	1,667.1	+5.5%
Medicare	996.7	1,072.6	+7.6%
Net interest	970.4	1,051.8	+8.4%
National defence	916.6	965.2	+5.3%
Corporate income tax	452.1	381.4	−15.6%
Customs duties	194.9	173.2	−11.1%

Source: US Treasury, Monthly Treasury Statement (September 2026), Table 9; Andra Markets calculations. FY2025 defence derived from the reported growth rate.

1.0 Executive Summary

Key takeaways

A crisis-size deficit without a crisis. At 6.2% of GDP with unemployment low, the deficit is far above what the economic cycle would explain, and war costs account for only a small part of it. Revenue grew only 3%: corporate taxes fell after the 2025 tax law and customs receipts dropped as the Supreme Court struck down the emergency tariffs and refunds were paid.

r rising on a bigger D

Interest is now the fastest-growing item. Net interest has tripled since 2020 and absorbs almost a fifth of federal revenue. The problem compounds: CBO estimates that rates 1.5 points above its baseline would add $6tn to deficits over ten years.

The bond market is charging more. The ten-year yield closed at 5.31% on 5 October, the highest since 2002, and the term premium, the extra return investors demand for holding long bonds, is the highest since 2010. Mortgage rates are at 7.4%.

term premium ~1%

no crisis yet

But demand is holding. Recent ten- and thirty-year auctions were well covered and foreign holdings rose to $9.33tn in August. This is a pricing problem, not yet a funding problem.

2.0 The Deficit

Size and composition

3rd largest ever

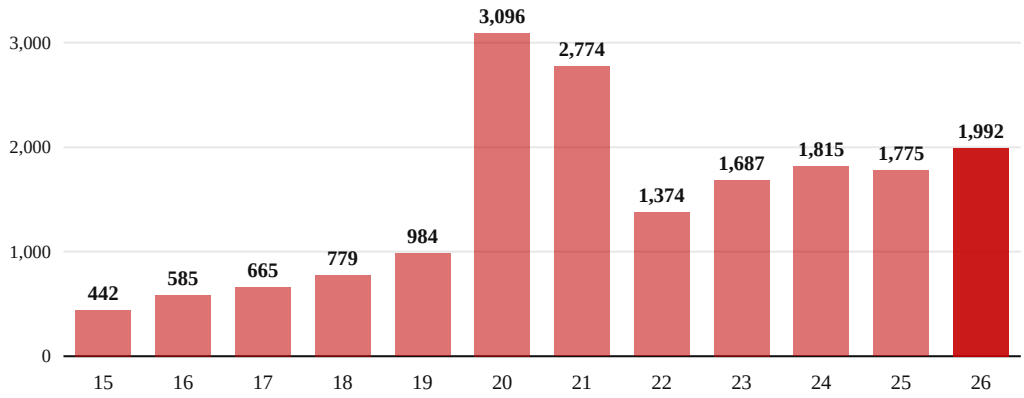
The deficit has stayed between $1.7tn and $2.0tn for four years despite full employment. In fiscal 2026 outlays rose 5.5% to $7.4tn while receipts rose only 3.2% to $5.4tn. September, usually a surplus month thanks to quarterly tax payments, ended $27bn in deficit. CBO had projected about $1.9tn in February; the outturn was about $135bn worse, according to the CRFB.

Sep: deficit not surplus

Exhibit 1. Federal budget deficit, fiscal years ($bn)

Covid peak $3.1tn

no return to pre-2020



Sources: US Treasury via FRED (FYFSD) to FY2025; FY2026 from the Monthly Treasury Statement.

tariffs: refunds $145bn

Two policy changes explain much of the revenue gap. The 2025 tax law cut business taxes, and corporate receipts fell 15.6%. Tariffs were meant to compensate, but after the Supreme Court ruled in February that emergency powers do not authorise tariffs, about $145bn was refunded during the year and customs duties fell 11% to $173bn. Spending, meanwhile, is driven by ageing and interest: Social Security, Medicare and net interest together grew by about $245bn.

3.0 The Cost of Interest

Above the defence budget

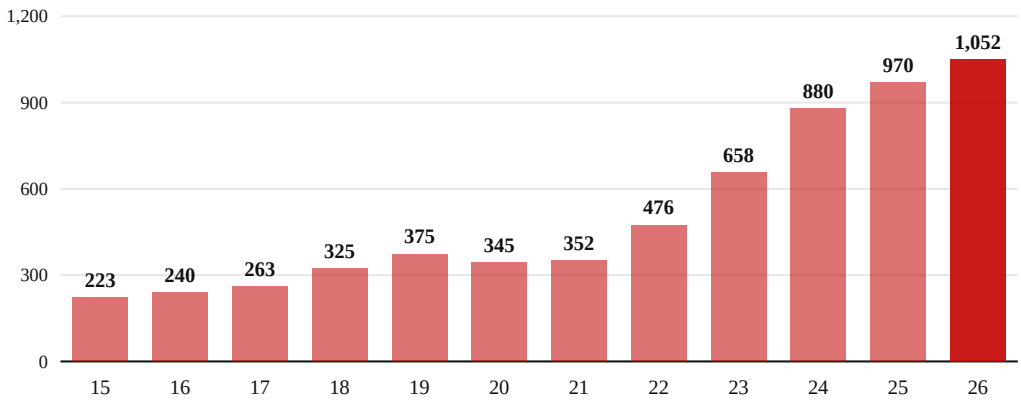
x3 since 2020

Net interest has risen from $345bn in fiscal 2020 to $1,052bn, as the debt grew and the cheap pandemic-era borrowing was refinanced at higher rates. The average rate on marketable Treasury debt was 3.52% at the end of September, with bills at 3.87%; every year more old debt rolls over into today's higher yields. Interest now exceeds spending on defence and is close to Medicare.

CBO: $2.1tn by 2036

CBO projects net interest of about $2.1tn, or 4.6% of GDP, by 2036 under its February baseline. Its new scenarios, published on 8 October, show the sensitivity: if rates run 1.5 points above baseline, deficits are $6tn larger over ten years and debt reaches 133% of GDP, against 120% in the baseline.

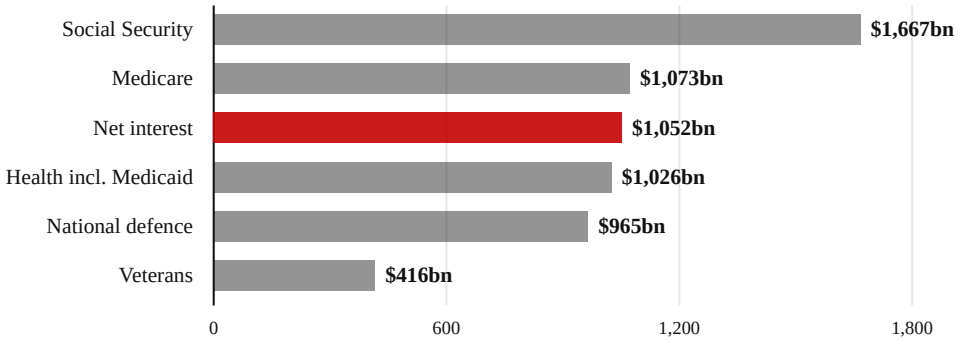
Exhibit 2. Net interest outlays, fiscal years ($bn)



$1tn+ for the first time

Sources: OMB and Treasury via FRED (FYOINT) to FY2025; FY2026 from the Monthly Treasury Statement.

Exhibit 3. Largest federal spending items, FY2026 ($bn)



interest #3

Source: US Treasury, Monthly Treasury Statement, Table 9.

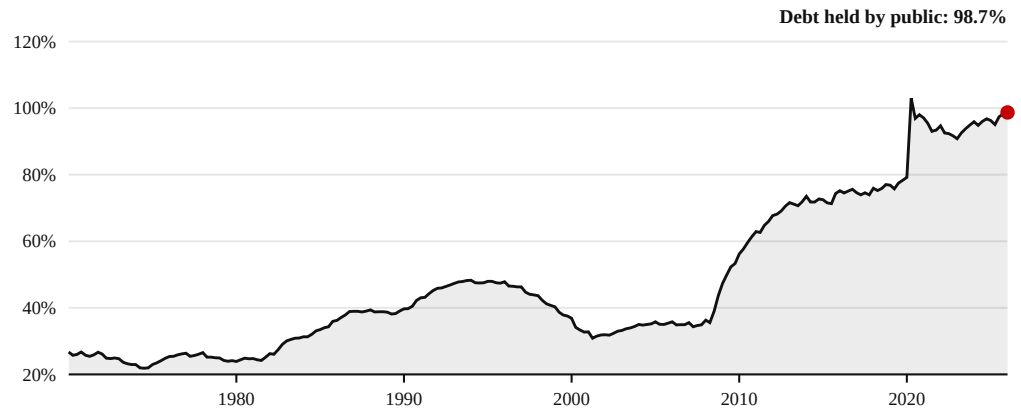
4.0 The Debt

Stock and trajectory

$40tn on 18 Aug

Total public debt passed $40tn on 18 August and stood at $40.4tn on 16 October, of which $32.5tn is held by the public. CBO expects debt held by the public to reach about 101% of GDP this year and, according to the CRFB's reading of its projections, to pass the post-war record of 106% around 2030. The statutory debt limit, raised by $5tn in July 2025 to $41.1tn, is likely to bind again in 2027.

Exhibit 4. Federal debt held by the public (% of GDP)



~99% now

1970s: ~25%

Source: Treasury and BEA via FRED (FYGFGDQ188S), quarterly to Q1 2026.

5.0 The Bond Market

Yields and the term premium

Long yields rose by as much as 1.1 points this year. The ten-year closed at 5.31% on 5 October and the thirty-year at 5.67% on 7 October, both the highest since 2002, after what Reuters called the worst quarter for Treasuries since 1994. Part of the move reflects inflation and the Fed's September hike, but a growing share is term premium: compensation for holding long-dated debt amid fiscal and inflation uncertainty.

Q3: worst since 1994 (Reuters)

5.31% = 2002 high

Exhibit 5. US 10-year Treasury yield (%)



back to 2000s levels

Source: Federal Reserve H.15 via FRED (DGS10), daily closes sampled weekly, to 16 October 2026.

Exhibit 6. Term premium on the 10-year Treasury, Kim-Wright model (%)



highest since 2010

Source: Federal Reserve Board (Kim-Wright) via FRED (THREEFYTP10). The NY Fed ACM measure peaked near 0.98% on 7 October and was about 0.75% by 15 October.

The rise passes straight to households. The 30-year mortgage rate was 7.40% on 15 October, against 6.27% a year earlier, and housing starts fell 5.2% in September; the home builders' sentiment index is at its lowest since 2012.

mortgages 7.4%

6.0 Supply and Demand

Who buys the debt

auctions: fine

Despite the headlines, demand at auction has been solid. The 7 October ten-year auction sold $39bn at 5.300%, the highest auction yield since 2000, with strong bidding; the thirty-year a day later was in line. The weak spots were the twenty-year in September and a thirty-year in August. Foreign holdings rose by $83bn to $9.33tn in August, but the mix is shifting: China's holdings are the lowest since 2008, the UK's passed $1tn for the first time.

The supply outlook is the next test. Treasury kept coupon sizes unchanged in August and has leaned on bills and buybacks, but its advisory committee warned that projections "could warrant increases in coupon issuance in FY27". The next refunding announcement is on 4 November, the day after the midterm elections.

refunding: 4 Nov

Exhibit B. Largest foreign holders of Treasuries, August 2026 ($bn)

Holder	Jul 2026	Aug 2026	Note
Japan	1,103.9	1,068.3	lowest since Dec 2024
United Kingdom	~998	1,009.5	first time above $1tn
China	618.0	590.7	lowest since 2008
Canada	~426.6	464.6	+$38bn
All foreign	9,248.4	9,331.7	+$83bn
of which official	n.a.	3,755.6	Reuters report

Source: US Treasury, TIC data (released 16 October 2026). Changes include valuation effects.

China selling

UK / Canada up

Exhibit C. Recent long-end auctions

Auction	Size	Yield	Assessment
30-year, mid-Aug	$25bn	5.216%	weak; tailed
20-year, 15 Sep	$13bn	5.420%	weak; 2bp tail
10-year, 7 Oct	$39bn	5.300%	strong; stopped through
30-year, 8 Oct	$22bn	5.618%	in line

Sources: US Treasury; Helious; RTTNews; CRFB (secondary sources for assessments).

demand at a price

7.0 Ratings and Investors

Warnings and positioning

S&P: 2-year warning

All three major agencies now rate the US AA+ or Aa1. Moody's downgraded in May 2025; S&P affirmed AA+ with a stable outlook in June but said it could downgrade within two years if deficits exceed expectations; Fitch affirmed in August. Investors are wary: in BofA's October survey, short Treasuries was the second most crowded trade and fund managers said they would only switch from stocks to bonds at an average ten-year yield of 5.9%.

Exhibit D. What prominent investors and institutions say

Who	View
Mark Zandi (Moody's Analytics)	"fiscal reckoning"; a "vicious cycle threatens to take hold"
PIMCO (Ivascyn)	6% is possible; stocks and corporate bonds suffer above 5.5%
Ed Yardeni	"if we get to 6% very quickly, we could start to see some real cracks"
Jamie Dimon (JPMorgan)	"there will be a bond crisis" (April 2026)
Ray Dalio	the Treasury slump has "a long way to go"
Scott Bessent (Treasury)	higher yields concerning only if "idiosyncratic"
IMF	US general-government debt 127% of GDP in 2026, 145% in 2031

Sources: Fortune; Reuters; Bloomberg; Yahoo Finance; IMF via secondary reporting.

consensus: worried, not panicked

8.0 Policy Options

Before and after the midterms

There is no deficit-reduction plan in Congress. The government is funded only until 11 December by a stopgap, the midterm elections on 3 November could change control of one or both chambers, and the debt limit returns in 2027. The options are familiar: higher revenue, slower growth in entitlements, or tolerating higher inflation. Penn Wharton's Kent Smetters expects the last.

no plan on the table

Exhibit E. Scenarios for long-term yields over the next 12 months

Scenario	Probability	10-year	Trigger
Contained: Fed holds, deficit stabilises	40%	4.6% to 5.0%	softer oil and inflation; demand at auctions
Grind higher: no fiscal plan, Fed hikes in Dec	40%	5.2% to 5.6%	larger coupon issuance; term premium rises
Disorderly: buyers strike	20%	above 6%	failed auction, downgrade or debt-limit standoff

Andra Markets scenarios; probabilities and ranges are judgemental.

judgemental

9.0 What We Are Watching

Dates and indicators

Exhibit F. Calendar and indicators

Date / indicator	Latest	Why it matters
FOMC, 27-28 Oct	hold 80-85% priced (20 Oct)	December hike ~90% priced
Midterm elections, 3 Nov	control of Congress	fiscal agenda for 2027
Treasury refunding, 4 Nov	coupons unchanged since Aug	larger sizes would pressure yields
Stopgap funding expires, 11 Dec	CR to 11 Dec	shutdown risk
10-year yield	5.09% (16 Oct)	5.5% and 6% are pain points
Term premium (Kim-Wright)	0.99%	fiscal risk priced
Debt limit	$41.1tn	likely binds in 2027

Andra Markets selection; dates from the Federal Reserve, Treasury and Congress.

Nov 3-4: key week

verdict: not a crisis, but a regime change. interest above defence, yields above 5%, and no plan

Methodology and Source Notes

Method. This report uses official fiscal data from the US Treasury (Monthly Treasury Statement, debt to the penny, TIC) and CBO, market data from the Federal Reserve via FRED, and press reporting for views and auction assessments. Deficit history, interest history, yields, the term premium and debt ratios are charted from FRED; FY2026 values are from the Treasury statement. Scenario probabilities are judgemental. Handwritten notes and highlights are informal commentary by the desk. This note is analysis, not investment advice.

Principal sources. US Treasury (MTS, Fiscal Data, TIC, refunding statements); CBO; Federal Reserve (H.15, Kim-Wright term premium); FRED; Freddie Mac; Census Bureau; S&P; Fitch; Moody's; IMF; CRFB; Penn Wharton Budget Model; BofA Global Research via Yahoo Finance; Reuters; Bloomberg; CNBC; Fortune; Helious; RTTNews.

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