

What We Are Watching: Midterm Elections

Debt, Deficits, and the Limits of the Ballot Box
Interest Costs, Treasury Supply, and the Discount Rate on Everything Else

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In the months before a midterm election, a great deal of investment commentary is devoted to which party will control Congress and what that implies for markets. Whoever wins in November will inherit the same federal balance sheet: gross debt of roughly \$40 trillion, an interest bill that now exceeds defense spending, and a budget in which roughly three-quarters of spending is either interest or set by formula in existing law¹. That inheritance is the subject of this paper.

Deficits have widened under divided and unified governments and under both parties, which points to structural causes rather than to who holds the majority. More to the point, the CBO projects the primary deficit will stay near 2% of GDP over the long run, which means essentially all of the projected deterioration ahead is interest on debt already issued. That part is not on any ballot².

Three things follow, and they strike us as having more durable consequences for a long-term investor than the composition of Congress: the path of the primary deficit, the Treasury issuance that path requires relative to GDP and global

savings, and the yield private investors demand to absorb it. We take no position on the outcome of the election or on the merits of any policy.

The third item, global savings, and the yield private investors demand to absorb it, is where fiscal policy becomes a portfolio risk. The bond market does not set tax rates or reform entitlements, but it prices the consequences. And deferral compounds, since higher yields raise the interest bill, which raises the primary surplus needed to stabilize debt-to-GDP, which makes the eventual adjustment larger than the one postponed. The repricing tends to be episodic rather than gradual: term premium (the extra yield investors demand for holding a longer-term bond instead of rolling over short-term ones) can sit inert for years, then move a long way in weeks. Since the long end of the yield curve anchors the discount rate for nearly everything an institution owns, assets and liabilities both, the effect is not confined to fixed income.

Key Takeaways

- › Investors spend far more effort forecasting elections than analyzing the fiscal constraints that bind whichever party wins. For a long-term investor, the deficit path and the yield the market demands to finance the deficit matter more than the near-term composition of Congress.
- › Borrowing costs below the economy's growth rate act as a subsidy that makes elevated deficits manageable, but that dynamic is disappearing. The average rate on outstanding federal debt, 3.45%, remains below nominal gross domestic product ("GDP") growth, but new 10-year notes yield about 5%, and the Congressional Budget Office ("CBO") projects the two will cross around 2031 at roughly 3.8% each.³
- › Roughly three-quarters of federal spending is mandatory and cannot be changed, including the interest paid on the national debt. This leaves Congress little room to change or amend existing government commitments. This structural fact may be a key factor in rising government debts regardless of who controls Congress.⁴
- › Investors are demanding more yield to hold long-dated Treasuries. The 10-year real yield has reached levels not seen in close to 20 years. The repricing has been in real rates, not inflation, which raises the discount rate applied to every asset and leaves the government less fiscal flexibility.⁵
- › The appropriate response by investors depends on identifying the driver of rising yields. It matters because when yields rise on fiscal or supply pressure rather than on growth, equities and bonds reprice off the same higher discount rate, and duration becomes a less reliable offset to equity risk in that regime.

When the Arithmetic Turns

For most of the period between the financial crisis and 2022, the average interest rate the Treasury paid on its debt sat below the economy's nominal growth rate. That gap is why large deficits drew relatively little attention: when the rate on the debt is below the growth rate, the existing stock shrinks relative to GDP on its own, and only new borrowing adds to the burden.

That gap has closed at the margin. The weighted average rate on outstanding federal debt was 3.45% as of July 31, 2026, but new 10-year notes now yield around 5.00% and new 30-year bonds around 5.36%, with both at levels not seen in decades⁶.

Roughly \$10 trillion of marketable Treasury debt, about a third of the marketable total, matures within 12 months, and every security refinanced at current levels pulls the average up. Much of that maturing stock is bills that will be reissued as bills, at rates above the 3.45% average but below what investors now require for longer-dated debt, so the average rises either way. How quickly depends on how much is refinanced at the long end of the yield curve⁷.

The budget already reflects it. Net interest is projected at roughly \$1.04 trillion in fiscal 2026, about 3.3% of GDP and 19% of federal revenue, more than the government spends on national defense, and the CBO projects this number will rise to nearly 26% of revenue by 2036⁸.

The average rate on the debt is still below nominal growth, but the marginal rate is not. The CBO expects the two to cross around 2031, with both near 3.8% in nominal terms, after which stabilizing debt-to-GDP requires a primary surplus rather than merely a narrower deficit⁹.

The Part Nobody Votes On

The next constraint is the composition of federal spending (see Figure 3). Measured against outlays rather than revenue, mandatory programs and net interest together accounted for a majority of fiscal 2025 spending, leaving a small portion for discretionary spending, split roughly evenly between defense and everything else¹⁰. Importantly, mandatory spending is not discretionary in the ordinary sense: Social Security, Medicare, and Medicaid pay out by formula as the eligible population grows and medical costs rise, without Congress voting on the amount¹¹.

Figure 1
Average versus
Marginal
Borrowing Cost (%)

Source: Treasury Data as of
July 2026.

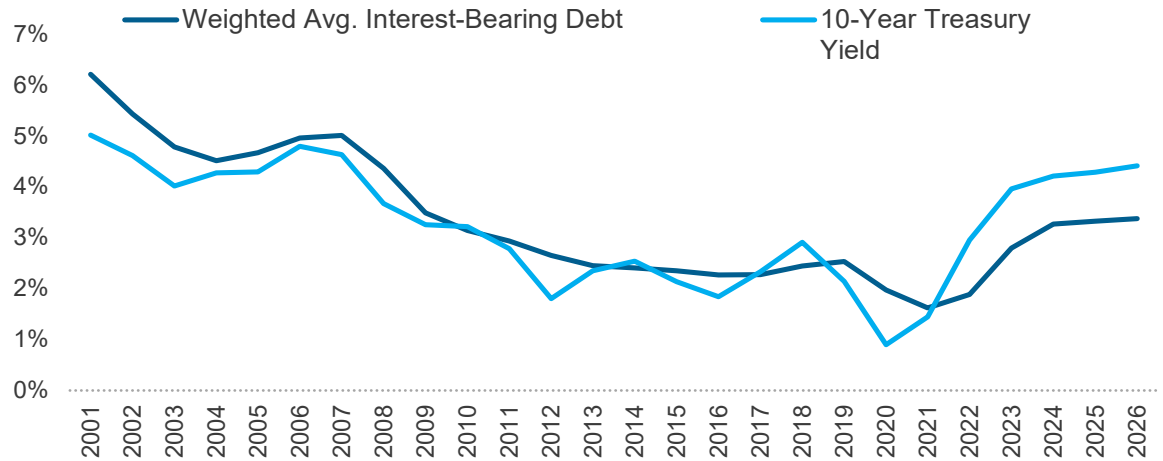


Figure 2
Net Interest Cost
(% of Federal
Revenue)

Source: Treasury Data,
Congressional Budget Office
and Budget and Economic
Outlook 2026 – 2036. July 2026.

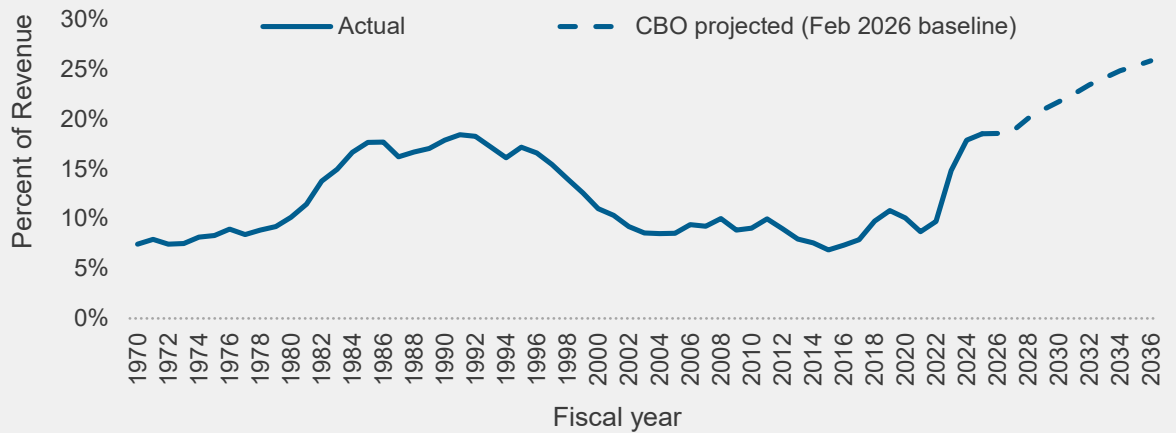
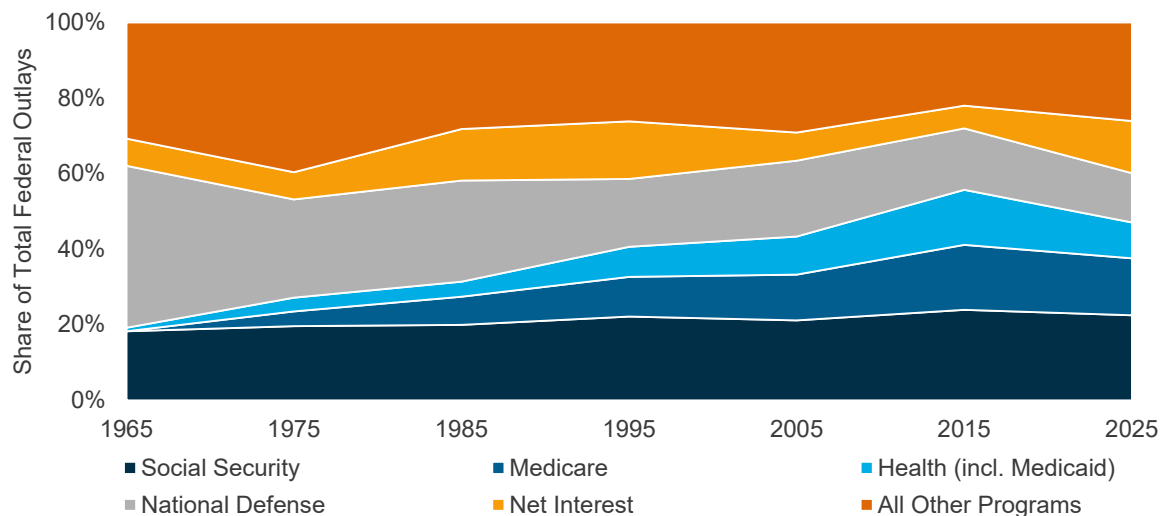


Figure 3
Federal Budget
Outlay by Major
Program

Source: Office of Management
and Budget (OMB) Historical
Tables.



Any given Congress can adjust a minority of total spending, and a shrinking one at that, since interest and mandatory programs are the fastest-growing claims. The categories growing the fastest are also the most politically protected. Which is the point: the spending that determines the primary deficit is largely the spending that elections do not touch¹². For scale, eliminating all non defense discretionary spending, roughly \$995 billion, would not quite close the fiscal 2026 primary deficit of about \$1.06 trillion¹³.

The Marginal Buyer

Attention centers on the annual deficit, but the bond market must absorb the deficit plus everything maturing alongside it. What matters for long-term yields is even narrower still: how much long-dated debt investors have to hold.

The Treasury has focused on issuing shorter-dated debt to help manage the amount of longer dated debt. Bills now stand at roughly 22% of marketable debt outstanding, above the 15% to 20% range the Treasury Borrowing Advisory Committee recommended. The Treasury can lean further into issuing T-bills, and probably will, since issuing bills avoids selling long bonds at current yields. But it trades a lower coupon today for

more frequent rollover and a funding cost tied to the front end of the yield curve¹⁴.

The buyer base has meanwhile rotated toward investors who care about price. Foreign official holdings sit below their 2014 level (roughly 50% of marketable outstanding at the time, versus 32% today) even as marketable debt grew roughly two and a half times, and money market funds, households, and leveraged investors have taken their place (see Figure 4). That matters because the price-insensitive foreign buyers absorbed duration (interest rate risk) without asking much for it. Their replacements (money funds, households, and leveraged investors) do not¹⁵.

A long-term yield splits into what investors expect short rates to average over the period and the additional compensation they require for committing to a long bond instead (see Figure 5). That term premium reached roughly 0.80% in August, back to levels last seen in 2011. As with the repricing of the debt stock, the direction and persistence of the shift matter more than the level on any given day¹⁶.

Treasuries will always find buyers at some yield. The relevant question is what that yield turns out to be, and what it implies for every other asset priced against it.

Figure 4

Treasury
Ownership by
Holder Type (\$T)

Sources: Federal Reserve
March 2026 and U.S. Treasury
International Capital (TIC)
System.

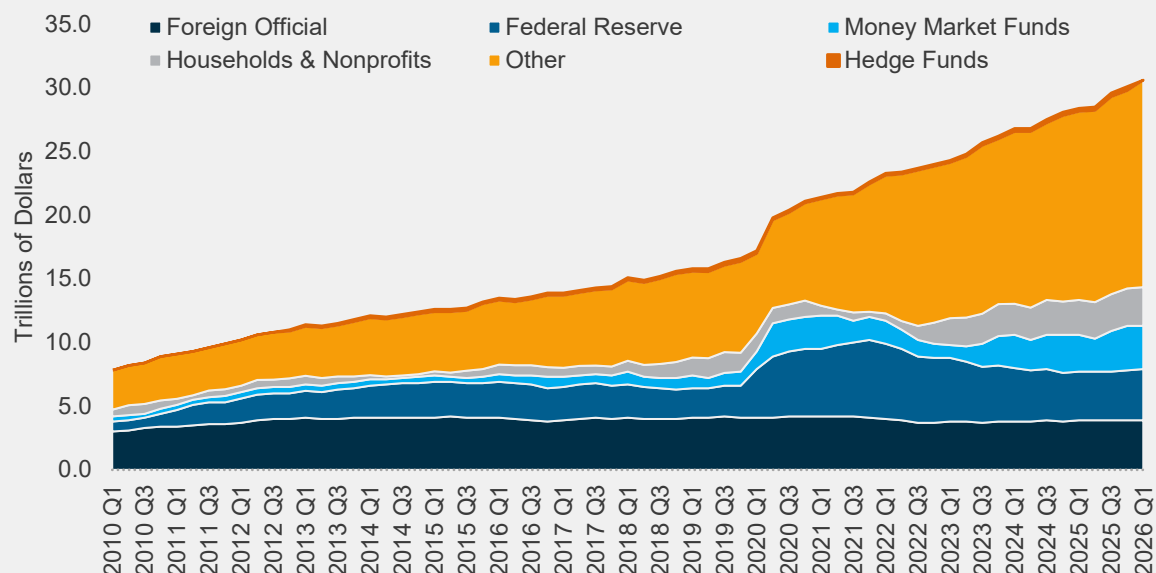
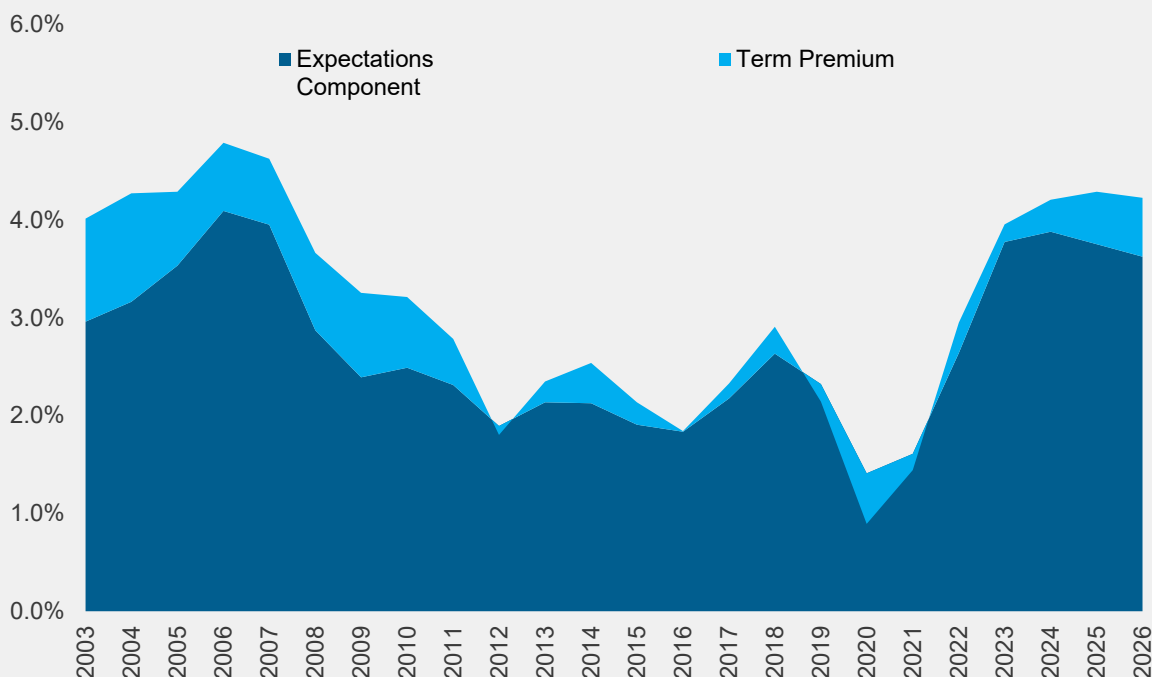


Figure 5
10-Year Yield
Decomposition

Source: Federal Reserve Board three-factor (Kim-Wright) term premium estimate, FRED series THREEFYTP10, observation August 21, 2026. Term premium is a model estimate, not an observable price; competing models differ by 20 to 50 basis points. On the New York Fed's longer series the 65-year median is nearer 1.4%, so the direction and persistence of the move matter more than the level.



Already Locked In

Deficits have widened under divided and unified governments and under both parties, which points to structural causes rather than a failure of will in any Congress. The Republican majorities are currently narrow (218 to 214 in the House¹⁷, 53 to 47 in the Senate¹⁸), reconciliation rules limit what can pass on a simple majority, and the largest outlay categories are politically and legally protected.

The scale is worth focusing on. The fiscal 2025 deficit was 5.8% of GDP against a 50-year average of 3.8%, and the rolling 12-month figure now exceeds 6%. These dynamics are in peacetime, with a growing economy, and unemployment at 4.1%. That is what the deficit looks like at the favorable end of the economic cycle, with no recession adding to it¹⁹.

None of which is to say elections do not move fiscal policy. They move revenue, and both the 2017 tax law and the 2025 reconciliation bill mattered. But the CBO projects the primary deficit will stay near 2% of GDP over the long run, which means essentially all the projected deterioration from here is interest on debt already issued²⁰. That part is not on any ballot.

The largest fiscal event of 2026 makes the point. It was not an election or a budget vote but the Supreme Court striking down the International Emergency Economic Powers Act ("IEEPA") tariffs in February, which removed roughly \$250 billion of expected fiscal 2026 revenue²¹.

Where It Lands

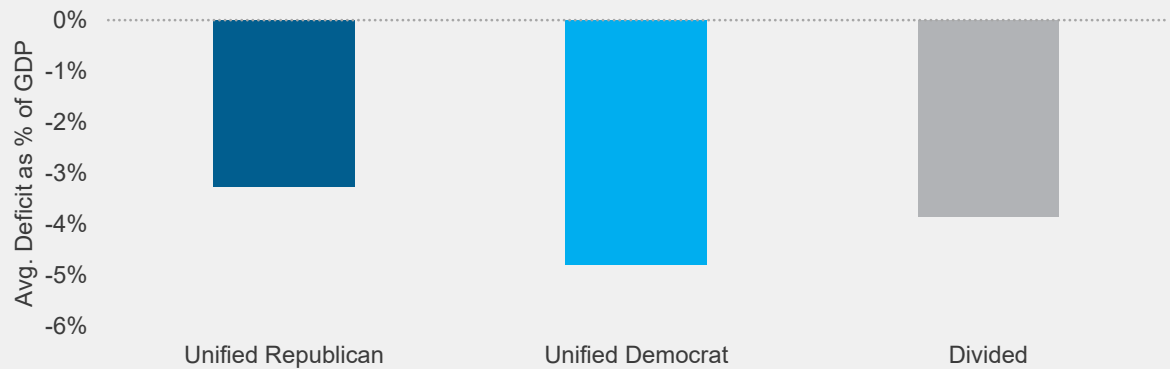
The Treasury curve is not only the government's cost of borrowing. It is the benchmark from which most other borrowing is priced, though different maturities drive different channels: the long end sets mortgage, corporate, and municipal rates, while credit cards and floating-rate debt follow the short end and the Federal Reserve.

Housing. Mortgage rates price off the 10-year Treasury plus a spread. That spread is currently wide, near 1.8% against a historical norm closer to 1.5%, so it is compounding the Treasury move rather than cushioning it. The 30-year fixed-rate mortgage reached 6.97% in the week ending September 11, 2026, its highest level since May 2025²². Higher rates raise the monthly cost of a given loan and discourage existing borrowers who hold low-rate mortgages from moving. The result is lower transaction volume rather than an immediate fall in prices, since the same lock-in that suppresses demand also withholds supply.

Figure 6

Average Deficit
by Congressional
Control
1980 – 2026 FY
(% of GDP)

Source: OMB Historical Tables.



Corporate borrowing. Companies that issued debt at 2020 and 2021 rates will refinance at prevailing rates when those bonds mature. S&P Global Ratings estimates roughly \$12.4 trillion of corporate debt maturing between 2025 and 2029²³. The effect arrives on a schedule set by the maturity profile rather than all at once, and it weighs most heavily on weaker credits. Floating-rate borrowers are the exception, since they reprice immediately.

State and local government. Municipal borrowing costs generally follow Treasury yields, which raises the cost of infrastructure and capital projects at exactly the point when federal support may be constrained by the same arithmetic.

The federal budget. Higher rates raise interest expense, which widens the deficit, which requires more issuance. The practical consequence is likely less room for a fiscal response when the economy next weakens, which matters more at a starting point than this far into an expansion.

Except for floating-rate debt, none of these channels operates quickly. Each depends on refinancing schedules, so transmission runs over years. Which is the asymmetry worth holding onto: yields can reprice in weeks, but the economic consequence arrives over a decade. The market event comes first and the evidence comes later.

Whether It Pays Enough

A rise in the 10-year yield can come from stronger real growth, or from something other than growth. That distinction matters more than any finer taxonomy,

because risk assets have historically absorbed growth-driven rate increases, and there is correspondingly less to hedge.

When the rise in yields is not about growth, the same observation admits two readings. Term premium has risen without a corresponding change in the growth, inflation, or policy-rate outlook, which means investors are being paid more to hold duration for the same underlying economic risk.

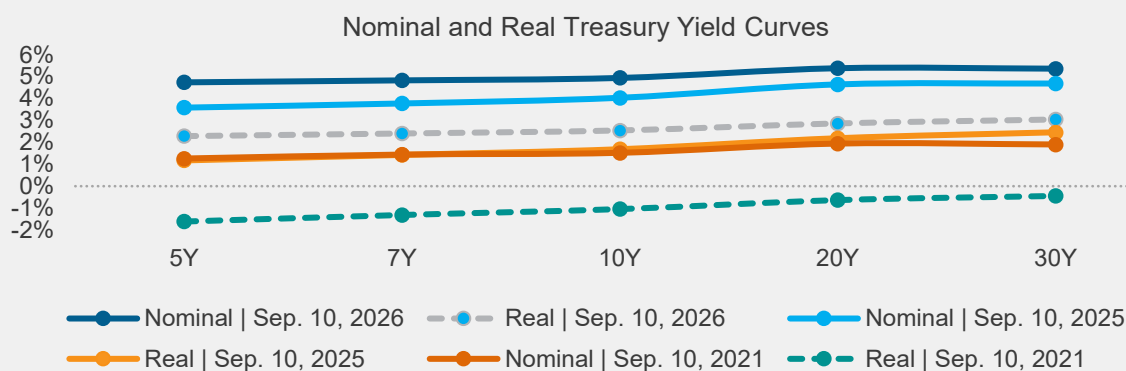
Read one way, that is better compensation. Read another, it is deteriorating fiscal credibility, which implies a higher discount rate across assets and a less reliable hedge. The same data supports both. Adjusting duration or inflation protection before deciding which reading applies is, in our experience, a common error.

Duration. Term premium generally rises because the perceived risk of holding duration (long interest rate exposure) has risen. The question is not whether duration pays more, which it does, but whether it now pays enough.

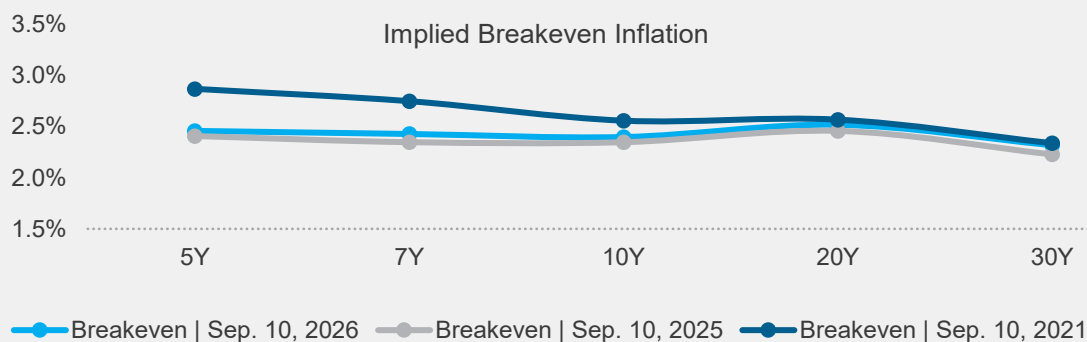
Short-term Treasury Inflation-Protected Securities

(**"TIPS"**). Fiscal stress has historically resolved through higher inflation, higher real yields, consolidation, or some mix. TIPS pay off in the first case. Short-dated TIPS carry little real-rate duration, so they neither suffer much nor gain much when real yields move, which means they offer little against the second and nothing against the third. That structural point matters more than any directional view, and it matters now: breakeven inflation sits near 2.40% while the 10-year real yield reached 2.55% as of

Figure 7
Nominal and Real Treasury Yield Curves



Source: St. Louis Federal Reserve.



September 10, 2026, the highest in nearly 18 years, even as realized inflation over the past decade averaged 3.4% (see Figure 7)²⁴. The market is pricing the real rate, not the price level. Short TIPS should be understood as an inflation hedge, not as protection against fiscal deterioration that resolves through higher real yields.

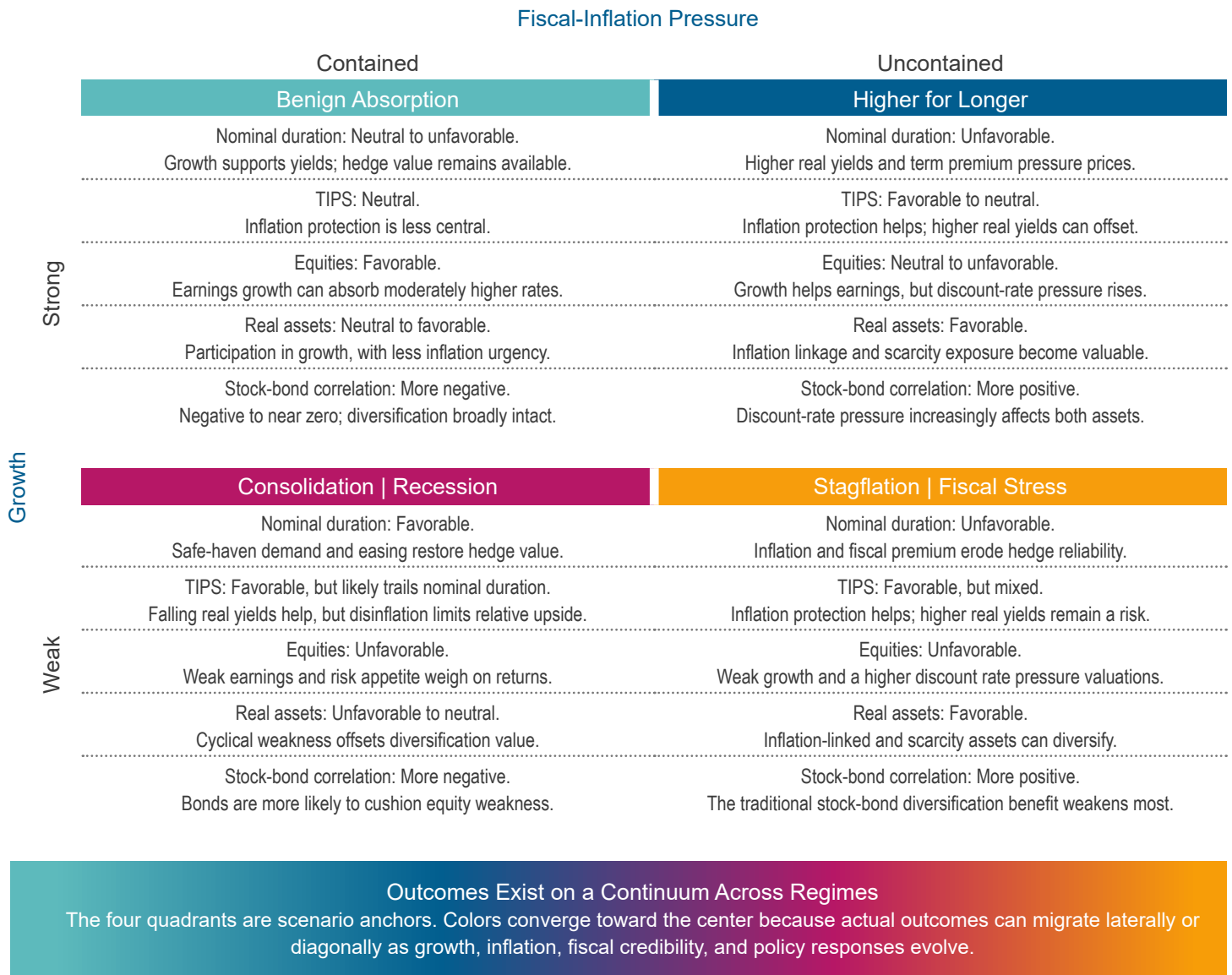
Diversification. Duration hedges equities when the two are priced off different things. When yields rise because growth strengthened, equities have earnings to offset the higher discount rate. When yields rise on fiscal or supply pressure instead, nothing offsets it, and the same discount rate reprices both sides of the portfolio at once. That is the mechanism behind a stock-bond correlation that turns positive, and it is why the hedge is least reliable in precisely the regime where it would matter most. Investors may want to examine whether their diversifying exposures sit predominantly within the equity and duration complex, and what sits outside it.

Those observations hold regardless of which path the fiscal arithmetic takes. Where the paths differ is in how

each exposure behaves, which is easier to see laid out than described. We find it useful to frame the range along two dimensions: whether growth is strong or weak, and whether fiscal and inflation pressures are contained or uncontained (see Figure 8). These are not mutually exclusive, and most plausible paths blend them.

One combination runs against the intuition this paper might otherwise create. Weak growth with contained inflation is the conventional recession, in which safe-haven demand and monetary easing can outweigh the supply effect entirely, and long-dated nominal bonds serve their traditional role against equities. High deficits do not mechanically produce higher yields. The combination least well hedged in a typical institutional allocation is the other one: weak growth with uncontained fiscal and inflation pressure. None of which turns on the election. These exposures behave according to growth and to whether fiscal and inflation pressures stay contained, and the arithmetic driving the second is largely set regardless of who wins in November.

Figure 8
Inflation & Growth Scenarios Illustration



Source: St. Louis Federal Reserve.

Conclusion

The more useful discipline than treating the election as the variable that matters is to observe the Treasury market's plumbing, including how auctions go, what is the bill-coupon mix in each quarterly refunding announcement, and how the term premium moves. Those signals will often tell an investor more about where discount rates are headed over the next several years than any read of the House or Senate math. This is because the fiscal path is already substantially locked in by formula, and the market's willingness to absorb it at a given yield is the mechanism that actually impacts portfolios.

The more durable takeaway is to consider the impact of allocations given a range of growth and fiscal-inflation regimes rather than for a particular electoral or policy outcome. Since the correlation between stocks and bonds depends on why yields are moving rather than on who is in office, the more relevant question for a long-term investor is not which party governs, but whether the portfolio's diversifying assets still work in the specific regime where deficits, term premium, and inflation are uncontained together. That is a question fiscal arithmetic will keep asking regardless of what happens in November, and it is one worth revisiting well before the next election cycle brings the usual distraction back around.

End Notes

- ¹ Treasury, Debt to the Penny, September 2026; CBO, Budget and Economic Outlook: 2026 to 2036, February 11, 2026.
- ² CBO, The Long-Term Budget Outlook Data: 2026 to 2056, February 25, 2026.
- ³ Treasury, Debt to the Penny, September 2026; CBO, Budget and Economic Outlook: 2026 to 2036, February 11, 2026.
- ⁴ Source: Congressional Budget Office and Budget and Economic Outlook 2026 – 2036. February 2026.
- ⁵ Treasury, Debt to the Penny, September 2026; CBO, Budget and Economic Outlook: 2026 to 2036, February 11, 2026.
- ⁶ Treasury Fiscal Data, Average Interest Rates on US Treasury Securities, record date July 31, 2026; Treasury, Daily Treasury Par Yield Curve Rates.
- ⁷ Monthly Statement of the Public Debt, Table 3, July 31, 2026. Computed from CUSIP-level maturity data; includes bills.
- ⁸ CBO, Budget and Economic Outlook: 2026 to 2036, February 11, 2026; Peter G. Peterson Foundation Interest Tracker, through July 2026. Revenue denominator reflects CBO's August 2026 downward revision.
- ⁹ CBO, The Long-Term Budget Outlook Data: 2026 to 2056, February 25, 2026.
- ¹⁰ CBO, February 2026, actual fiscal 2025.
- ¹¹ CBO, The Long-Term Budget Outlook: 2025 to 2055, March 27, 2025.
- ¹² Ibid.
- ¹³ Author's calculation. CBO's August 2026 projection of a \$2.1 trillion fiscal 2026 deficit, less projected net interest of approximately \$1.04 trillion. CBO does not publish the primary deficit as a dollar figure; its February 2026 baseline reported a fiscal 2026 primary deficit of 2.6% of GDP, declining to 2.1% by 2036, before the August revision raised the total deficit by \$200 billion on a revenue shortfall that falls on the primary balance.
- ¹⁴ Treasury Presentation to TBAC, FY2026 Q3, August 5, 2026; Treasury Borrowing Advisory Committee recommendation, November 2020.
- ¹⁵ Office of Financial Research, "Hedge Funds' Cash Treasury Holdings Reach \$2 Trillion," August 19, 2026; Treasury International Capital, Major Foreign Holders, June 2026.
- ¹⁶ Federal Reserve Board three-factor (Kim-Wright) term premium estimate, series THREEFYTP10, observation August 21, 2026. Term premium is a model estimate, not an observable price; competing models differ by 20 to 50 basis points. On the New York Fed's longer series the 65-year median is nearer 1.4%, so the direction and persistence of the move matter more than the level.
- ¹⁷ Office of the Clerk, U.S. House of Representatives, "Member Information," 119th Congress, 2nd Session.
- ¹⁸ U.S. Senate, "Party Division," Senate Historical Office. "How Midterm Elections Affect the Stock Market," January 2026.
- ¹⁹ CBO, February 2026, actual fiscal 2025; Bureau of Labor Statistics, Employment Situation, August 2026.
- ²⁰ CBO, The Long-Term Budget Outlook Data: 2026 to 2056, February 25, 2026.
- ²¹ CBO, August 20, 2026, following Learning Resources, Inc. v. Trump (February 20, 2026).
- ²² Data provided by Bloomberg September 11, 2026.
- ²³ Data provided by S&P Global Ratings as of January 1, 2025.
- ²⁴ U.S. Department of the Treasury, Daily Treasury Par Yield Curve Rates and Daily Treasury Par Real Yield Curve Rates; Federal Reserve H.15 series via FRED. Data through September 10, 2026.

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