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Treasury Yields Are Stubbornly High

Bond traders appear to be betting on a return to the status quo before long

The stock market has been the acute point of stress for investors this past week. But the bond market hasn't given them much of a break either.

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On Tuesday, as the S& P 500 tumbled for a fourth straight day, prices of long-term U.S. Treasury debt fell, too. That drove their yields, which move in an inverse relationship to prices, higher.

It was especially confounding because long-term Treasury prices in preceding days hadn't gained as much as they normally would in the face of a steep stock-market selloff. So much for government debt being a haven at a time of upheaval. *

The big question is why Treasury yields have behaved this way.

The answer may be that bond traders are "reflexively" pricing in the simplest scenario—a short-term economic shock followed by a rapid return to the status quo. Bonds also are being pulled in two different directions: fears of a recession are mounting, but tariffs raise the prospect of higher or stickier inflation.

How these competing forces play out is important for stock investors. !?

Although stocks have fallen hard—the S& P 500 on Tuesday was on the cusp of bear-market territory—they still aren't cheap. Share prices are falling, but Wall Street also is cutting profit forecasts. That has left the S& P 500 with a forward earnings yield of just 5.5%. (The earnings yield flips the typical price/earnings ratio around and produces a measure that is more comparable to bond yields.)

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With 10-year Treasury yields close to 4.3%, risk-free debt could act as a brake on a potential stock-market rebound such as the one that started to unfold Tuesday. This is even more of a risk since equity analysts haven't yet fully priced in growing recession risk.

If a prolonged downturn materializes, Treasurys would typically be big winners, especially if stocks remain highly valued. !

Of course, it could be argued that yields shouldn't go down be--cause Federal Reserve Chair Jerome Powell won't budge on interest rates even in the face of a recession. It is a reasonable worry. Trump's tariffs put the central bank in a bind because even if consumers and businesses slash spending, import prices will surge.

Yet the market is pricing in only so much monetary restraint. Derivatives actually suggest a 76% probability that the Fed will reduce borrowing costs by a full percentage point or more by yearend, according to CME FedWatch.

Indeed, 1-year and 2-year Treasury yields have come down, unlike longer-term ones, also signaling expectations for near-term Fed easing.

Contracts linked to inflation help unpack this further. Over a one-year horizon, bond yields are being pulled in two directions: investors are anticipating a surge in tariff-related inflation but also an economic slowdown joined by looser monetary policy in inflation- adjusted, or "real," terms.

Two years ahead, the inflationary shock is seen dissipating, but the Fed is still expected to be aiding the economy. Beyond that, fixed-income markets foresee inflation- adjusted rates being as high as they were expected to be before Trump's tariffs, even though they believe inflation itself will be lower.

The latter is an odd forecast. Trump's protectionism more likely points to slower productivity and higher inflation, even over the long term.

Perhaps investors think the Fed will react to that by applying today's restrictive stance to a weaker economy. This would lower average price increases.

But it is more likely that traders have given up on predicting longterm economic growth given the current chaos.

Elida Rhenals, co-head of inflation at AXA Investment Managers, pointed out Monday that "markets are conditioned for mean reversion; they are not prepared for paradigm breaks." She added that the market also has been rocked by sudden unwinds of trades, caused by the volatility of the past few days.

There are probably other forces at play. Some investors are likely rotating out of bonds to buy the equity dip, or to go into cash. The recent fall in the U.S. dollar may indicate that foreigners in particular are pulling out, and there also is anticipation of new Treasury issuances this month.

The scariest possibility is that markets are becoming concerned about the government's ability to refinance \$37 trillion of public debt. The U.S. budget deficit is already above 6% of gross domestic product, and a recession would widen it further by lowering tax revenue and raising unemployment benefits.

But such fears would likely show up in disruption to shortterm funding markets—the system's lifeblood, largely built on the safety of Treasurys. Unlike in 2007, this hasn't happened. Ultimately, the U.S. prints its own currency and can choose not to default. The central bank also could cushion the impact of big foreign holders dumping their bonds.

The bottom line is that those inclined to hedge against worstcase scenarios can take the other side of what the fixed-income prices are baking in.

Short-term bonds, which have gained on the idea that rate cuts are happening this year, could be on shaky ground: The Fed showed in 2022-23 that even when price spikes are supply driven, it prioritizes inflation over growth.

Conversely, the 2.1% yield offered by 10-year inflation-protected Treasurys, or TIPS, seems very attractive in a possible future of tepid economic growth and fragmented global supply chains.

To the detriment of stocks, investors may have places to flee after all.

—Jon Sindreu