

## Dangerous Brew Rattles Bond Markets

CAPITAL ACCOUNT

By Greg Ip

The question for bond markets isn't why yields rose so much in the past week, but why this didn't happen sooner.

Government borrowing— everywhere, and especially in the U.S.—has been out of control for years. Inflation in the U.S. has been stuck above the Federal Reserve's 2% target since 2022. Add in heavy corporate borrowing to fund the AI build-out, and you wonder why long-term interest rates aren't higher.

To be sure, the selloff (when bond yields go up, their prices go down) has been mild in the scheme of things. The 30-year Treasury yield hit a 19-year high of 5.18% Tuesday before falling back the next two trading days. Meanwhile, the more closely watched 10-year yield, at 4.584% on Thursday, was lower than in October 2023.

Yields reached 5% in 2023 in great part because the Fed's short-term interest rate target was even higher, at 5.25% to 5.5%. Today, the Fed's rate target is 1.75 percentage points lower. Fading hopes of more Fed cuts drove the recent surge in yields. But the bigger driver over the past year is that investors want more compensation for lending over many years instead of a few months.

That reflects a judgment that debt, inflation and populism— all prominently at work in the past week—are going to be around for a while. They don't mean a bond-market crisis in the offing. But together they are likely to put upward pressure on interest rates for years to come.

Before 2020, elected leaders usually preached the virtues of austerity even if they didn't practice it much. Since then, they have responded to almost every shock by borrowing more.

President Joe Biden's 2021 stimulus was followed by President Trump's 2025 tax cuts. His administration projects the budget deficit rising 16% this fiscal year to \$2.1 trillion. Trump has requested a record \$1.5 trillion for the Pentagon for next year. That is a lot of debt for investors to absorb.

From 2023 through 2026, U.S. deficits will have averaged 6.2% of gross domestic product, unprecedented outside war, recessions or emergencies. That's up from the 4.8% average from 2010 to 2019, and 2.3% from 2002 to 2007.

The response to the inflation increase from the war with Iran may bring about yet more borrowing. Sanae Takaichi was elected prime minister of Japan last year with a formidable majority but hasn't used the resulting political capital to shrink Japan's massive debt. Indeed, in the past week she said a new budget might be in order, to extend relief to families hit by higher energy prices, which sent Japanese bond yields up sharply.

In the U.S., Trump has proposed suspending the federal gasoline tax, which would cost \$3.5 billion a month according to the Committee for a Responsible Federal Budget.

The rise of populists on --the left and right make any serious attempt to reduce deficits even more remote. Despite a huge parliamentary majority, British Prime Minister Keir Starmer faces stiff resistance to spending cuts from his Labour Party's left wing. His leadership may soon be challenged by Greater Manchester Mayor Andy Burnham, a socialist who has said Britain should not be "in hock to the bond market." That prospect fed the recent rise in British yields.

Until 2020, big economic shocks tended to push inflation lower: China's entry into the World Trade Organization, the U.S. mortgage crisis, the euro crisis, the shale oil revolution, the initial wave of the Covid-19 pandemic.

Central banks often fought to keep inflation from slipping below their 2% targets by keeping shortterm rates near zero and buying bonds. Investors accepted low returns on bonds because bonds acted like insurance, rising in price when stocks fell and central banks intervened.

Since then, shocks have tended to push inflation higher: the supply-chain disruptions following Covid, Russia's invasion of Ukraine, Trump's tariffs, and the closure of the Strait of Hormuz.

We think of these as "one-off" events after which inflation will naturally return to 2%.

But what if they are symptoms of a world more prone to supply shocks because of war, geopolitical rivalry, protectionism, populism and extreme weather? As the shocks accumulate, the public may expect higher inflation indefinitely.

In the latter scenario, central banks will regularly need to raise rates to return inflation to 2%, the opposite of before 2020. Bonds won't insure against falling stocks, so investors will demand higher yields.

Deficits and inflation, treated so far as separate and distinct, may feed off each other. Anxiety about the cost of living has eroded politicians' popularity everywhere, making them even less willing to propose cuts to government benefits or higher taxes.

If the Fed must repeatedly raise rates, that adds to deficits. The Committee for a Responsible Federal Budget estimates the recent rise in rates, if sustained for a year, would add \$200 billion to deficits over a decade. Leaders might pressure central banks against raising rates, which would also lead to higher inflation.

Kevin Warsh, to be sworn in as Fed chair Friday, thought he could cut rates as AI boosted productivity and cut costs. And he might yet. One supportive sign: There is no cost pressure coming from the labor market.

Remarkably, despite debt, tariffs, oil and Trump's attacks on Fed independence, bond investors remain sanguine about inflation. Beyond the next few years, they see it returning to around 2%.

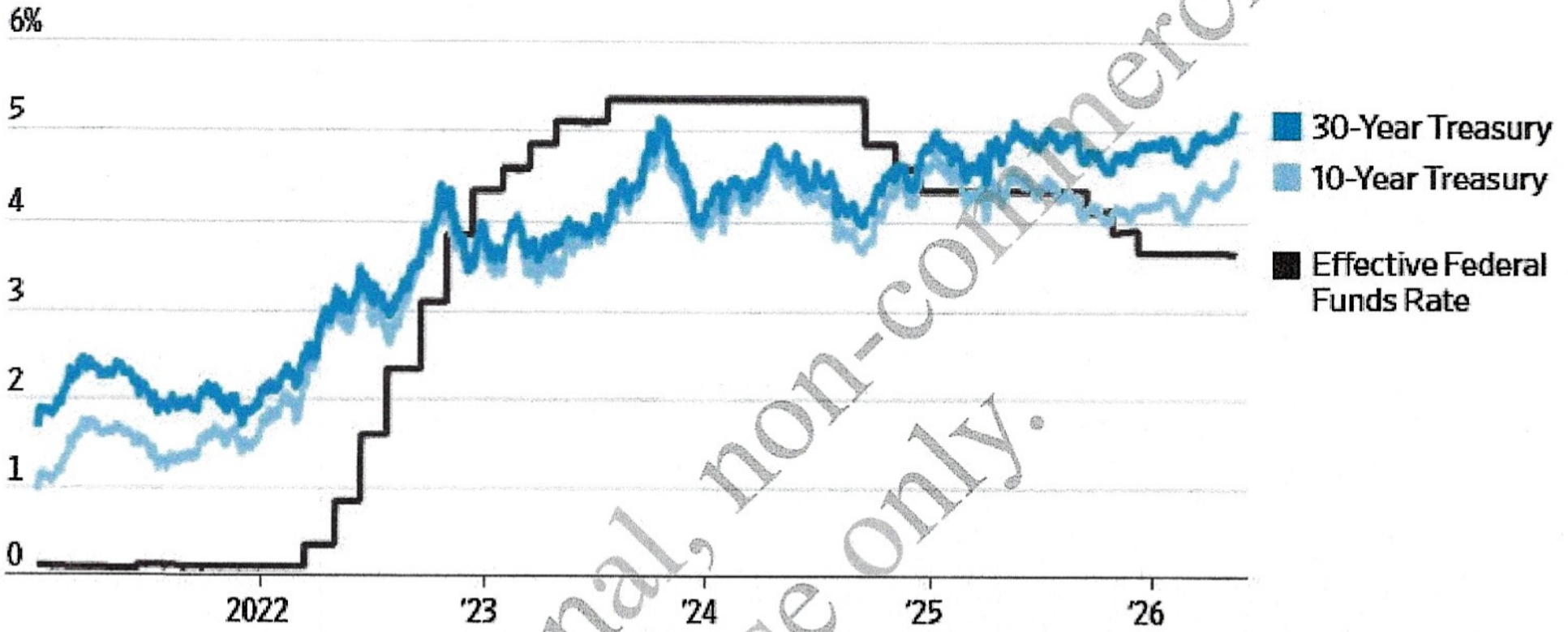
That's a comforting vote of confidence in Warsh. But earning that confidence may mean overseeing higher rates than either he or Trump thought likely. Which a mixture of debt, populism and inflation just might require.

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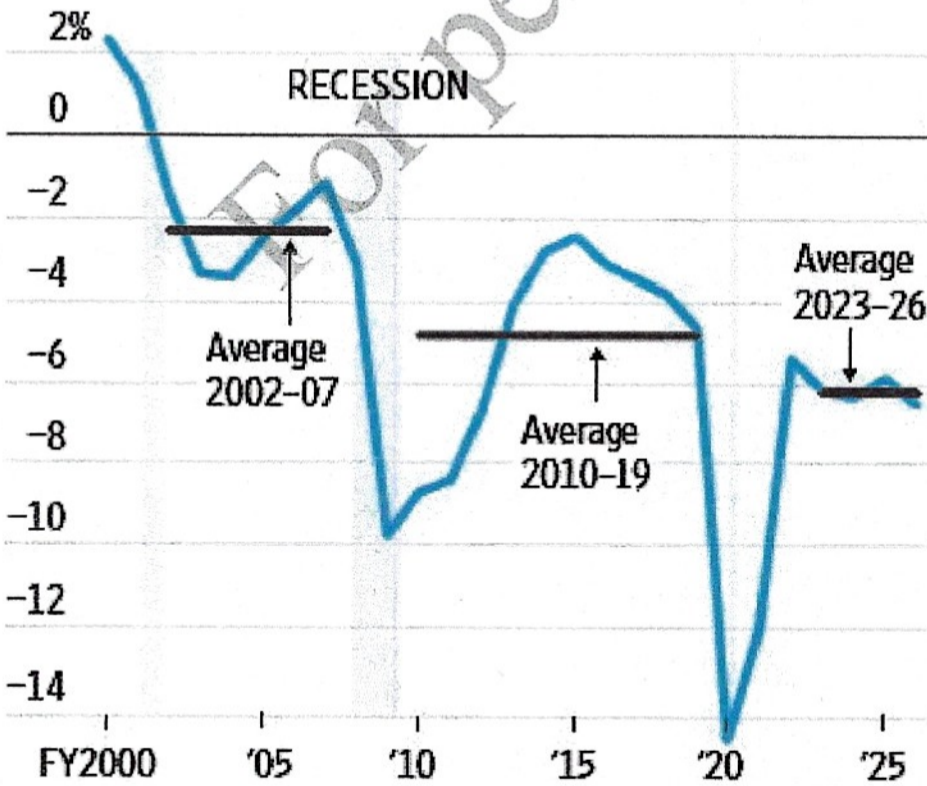
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Treasury yields and interest rates



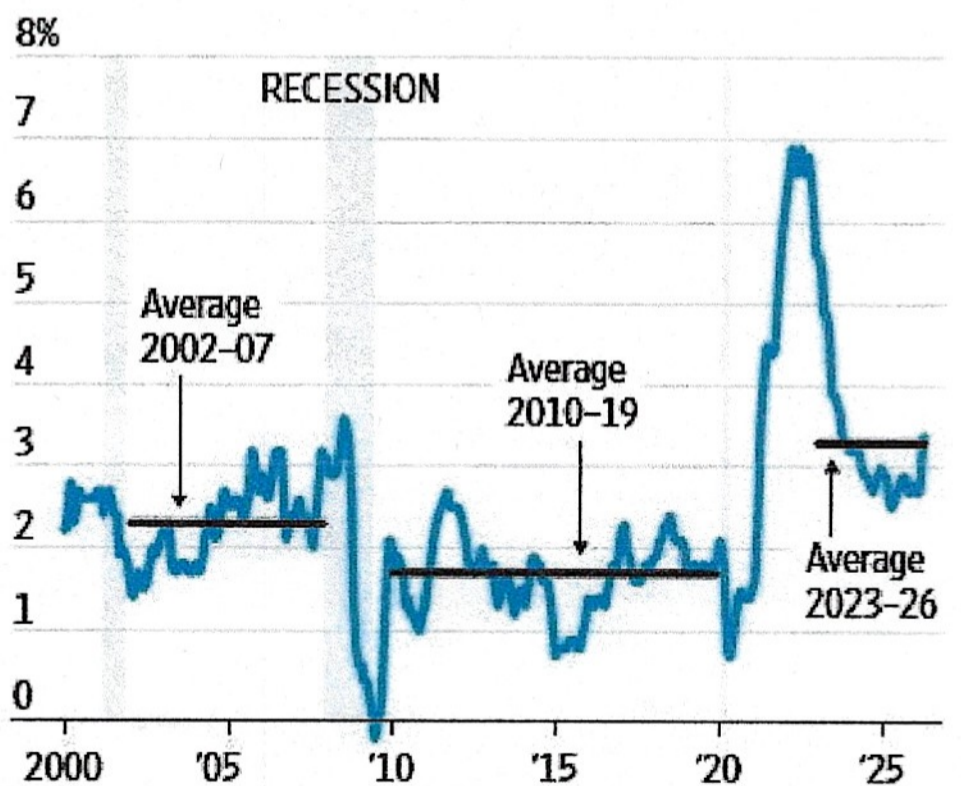
Deficit trending higher

Federal budget surplus/deficit, pct. of GDP\*



Inflation trending higher

Average of four inflation measures†



\*For fiscal years ending Sept. 30; 2026 is projected

†Consumer-price index, total and core (excluding food and energy); Personal-consumption expenditures price index, total and core.

Sources: Federal Reserve (yields and interest rates); CBO (2000-25, projected GDP 2026), U.S. Treasury (projected deficit, 2026); Commerce Dept., Labor Dept. via Federal Reserve Bank of St. Louis, Inflation Insights (estimated total and core PCE inflation, April 2026)

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## You're Probably Overinvested in Bonds

By Robert C. Pozen

Most financial advisers tell their clients to hold a 60-40 portfolio—60% in stocks and 40% in bonds. Stocks are volatile, and bonds can provide a counterweight when share prices fall. But after more than 20 years in the money-management business, I've concluded that many investors hold too much in bonds and not enough in equities.

Plenty of people should hold bonds. If you are retired and subsisting on your investment income, or if you would have to sell a significant chunk of your investments to cover living expenses in a bad year, you should have more in high-quality bonds. But that probably isn't true for two large groups: The six million to seven million Americans with \$1 million or more in investable assets and other households with more

than \$100,000 in investable assets whose noninvestment income covers their cost of living. (Investable assets include retirement accounts but not homes.)

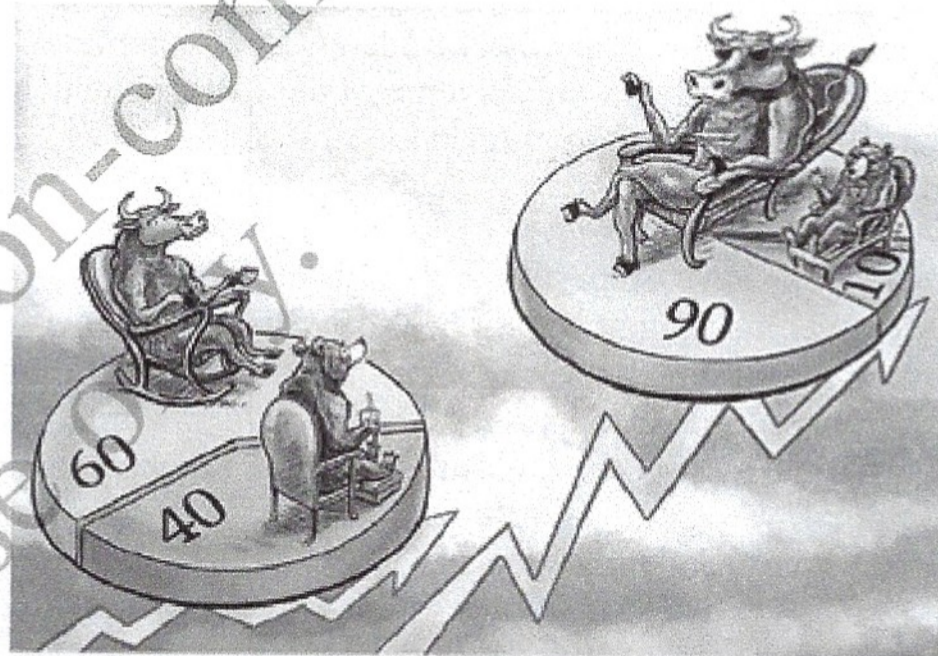
For these affluent investors, a 60-40 portfolio means sacrificing the tremendous upside potential of stocks to avoid temporary losses. Over any long period, they will likely be better off with a 90-10 portfolio—90% in a low-cost stock index and 10% in a money-market fund to pay unanticipated expenses.

Stock declines are relatively infrequent and typically are followed by increases—a recurring pattern over the past 60 years. It happened again this year. The S&P 500 was down 7.33% year to date as of March 30, largely because of the Iran war. The index bounced back to plus-5.62% for the year by May 1.

Moreover, the 90-10 portfolio eliminates fees to financial advisers, who charge an average of 1% of assets under management. You can build the 90-10 portfolio yourself simply by buying an index fund and a money-market fund, and rebalancing at the start of each year if stocks have gone up or down.

The argument for the 90-10 portfolio is based on many decades of stock prices. During the 10 years ending Dec. 31, 2025, the average annual total return (with income reinvested annually) of the S&P 500 trounced that of 10-

*The usual advice is to hold only 60% of your assets in stock. If you're wealthy, a 90/10 split is far better.*



CHAD CROWE

the government will have to bail out by issuing more debt at higher rates.

Higher interest rates will also adversely affect stocks, but successful companies can raise prices, increase revenue and control costs, which will lead to higher nominal stock prices. And stocks represent claims on the assets of publicly traded companies—plant, equipment and land—whose nominal replacement costs rise in inflationary terms.

Stocks also win over most bonds in terms of taxation. Interest on bonds is taxed as ordinary income, at a top federal rate of 37% (though there are tax exemptions for municipal and Treasury bonds). Dividends and long-term capital gains are taxed at a top rate of 23.8%.

There are two main arguments against the 90-10 portfolio. First, that the stock market has frequent crashes. The total annual return of the S&P 500 was negative for 13 of the past 60 years. The years with the worst total returns were 2008, 2002 and 1974. But each time, the S&P 500 posted strongly positive returns in the next two years.

In the past six decades, the S&P 500 has been negative for three consecutive years only once—in 2000-02, as the dot-com bubble burst. The S&P 500 was down a total of 37.43%, but those losses were more than recouped by the

year U.S. Treasury bonds, 14.68% to 0.89%. Although the difference was especially large in the past decade, stocks also beat bonds handily over all time periods of 20, 30, 40, 50 and 60 years ending with 2025. If you invested \$100,000 in a 90-10 portfolio for the 10 years ending on Dec. 31, 2025, you would have accumulated almost \$356,000, compared with around \$243,000 if you had a 60-40 portfolio. For 40 years, the figures were \$5.8 million and \$2.5 million.

The return on the S&P 500 isn't based on picking winners or ascertaining market sentiment. It reflects the aggregate fundamental strengths of publicly traded U.S. companies. By contrast, bond returns are driven by interest rates, which fluctuate due to macroeconomic conditions and government policies.

Notably, stocks have outperformed bonds during the two most recent bouts of high inflation. In 1972 to 1982, when annual inflation averaged over 8%, the average annual nominal total returns of the S&P 500 were 7.74%, while the figure for 10-year U.S. Treasuries were 5.71%. From 2021 to 2024, when annual inflation averaged almost 5%, the figures were 13.47% and negative 5.35%.

For more than a decade after the 2008 financial crisis, there was a bull run in bonds because interest rates fell and remained low. But that scenario is unlikely to recur soon as interest rates normalize, inflationary pressures build, and neither political party seems to have the will to reform Medicare or Social Security, which

end of 2006. The S&P 500 was also down in both 1973 and 1974, by a total of 37.25%, due to the oil embargo. Those losses were more than recouped by the end of 1976.

Second, that bonds can offset stock losses. But bond returns were positive in only 10 of the 13 years when the S&P 500 was negative. In 2022, when the S&P 500's total return was minus 18.04%, U.S. Treasuries were down nearly as much. Conventional wisdom has it that as investors approach or pass retirement age, they should hold less in stock and more in bonds. But rising life expectancy expands their time horizon, and many households with \$1 million or more in investable assets intend to bequeath a substantial portion of their assets. Because of the step-up in basis at death, if your children inherit assets that aren't in retirement accounts, they won't be liable for taxes on capital gains earned during your lifetime.

If you are going to hold a 90-10 portfolio, you'll need a plan for staying calm during market drops. First, remind yourself that the stock market's best days often follow its worst years. Second, focus on how small one year's drop in stock prices is relative to 30 years of returns, and see sharp declines in stock prices as buying opportunities. Finally, think of the 10% in your money market fund as an insurance policy in the unlikely event that the S&P 500 stays down for more than a year.

Don't miss out on the growth opportunity of a lifetime if you have a lot of investable assets. Buy and hold a portfolio composed mainly of a stock index fund with a money-market fund as an insurance policy.

*Mr. Pozen is a distinguished senior lecturer at MIT Sloan School of Management and a former president of Fidelity Investments.*

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