5-24-25

WSJ Print Edition

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Bond Market Is Making Washington Pay

CAPITAL ACCOUNT

By Greg Ip

Let's put the bond turmoil in perspective. At 4.52%, the 10-year Treasury yield is roughly back to where it started the year, and still below the 5% hit in the fall of 2023.

So this past week's rise in yields doesn't signal panic, prelude to a crisis or a lender's strike.

Note

But it matters. It adds to the evidence that something fundamental has changed in financial markets. The prepandemic era, when too much savings chased too few bonds, is over. Governments everywhere must pay up, and big budget deficits are more dangerous.

U.S.

The trend is global, but the U.S. is an especially big piece of the story because of annual deficits likely to top $2 trillion on the way to $3 trillion, and potential erosion of the dollar's reserve status. !

To understand what's happening, you need to look at how various bonds are interacting.

The biggest influence on bonds is where the Federal Reserve will set short-term interest rates. If that were moving the market now, we'd see it most in the twoyear bond yield. But it's up 0.1 percentage point since April 2, just before President Trump's dramatically higher tariffs (later partly rolled back). By contrast, the 10year yield is up 0.3 point and the 30-year yield 0.5 point.

So investors aren't worrying about inflation or the Fed; they simply want more compensation for owning bonds. The simplest explanation is that governments are issuing a lot more of them. Note

Ordinarily, investors would expect a higher return from a 10-year bond than simply holding Treasury bills for 10 years, because locking up your money for 10 years is risky. That difference is called the term premium. But from 2016 through 2024 the term premium went negative, according to the New York Fed. Investors were giving up returns in order to own government bonds.

Since October, though, the term premium has gotten steadily more positive, reaching 0.9 percentage point Wednesday—in line with the pre-financial crisis norm.

* There are country-specific elements at work. In Japan, lackluster demand at an auction of 20-year government bonds helped set off this past week's bond turmoil. Germany is borrowing more to finance defense and infrastructure. Britain is still grappling with inflation.

Still, the big picture is that prepandemic, inflation was low and central banks kept interest rates at zero while buying bonds. Corporations cut capital spending because of lackluster sales or "asset-lite" business models. Jason Thomas of Carlyle Group estimates U.S. businesses switched from net borrowers to net savers in this period. Together, these factors made it easy for governments to borrow.

All of that has changed. Inflation is around or above target in advanced countries. Central banks are no longer buying bonds. Companies are pouring billions into artificial intelligence, and their cash flow is down 75% from the previous economic expansion, Thomas figures.

Deficits are an issue everywhere, but the U.S. is an outlier. The federal shortfall topped 6% of GDP last year, and under the House GOP budget plan is expected to top 7% for a decade. That would be higher than any other sustained stretch and more than almost any other advanced economy. Before 2023, the U.S. accounted for half of advanced economies' deficits, according to the International Monetary Fund. From 2023 through 2030, it will be two-thirds.

Note

Meanwhile, the U.S.'s "exorbitant privilege" as issuer of the world's reserve currency may be eroding. Since early April, the dollar has fallen as yields rose, the opposite of the normal pattern.

Historically, investors gave up about a quarter point of yield for the convenience of owning Treasurys instead of similarly safe securities, according to Viral Acharya and Toomas Laarits of New York University. Since the trade war, they estimate long term Treasurys have lost that yield advantage.

The Moody's move to strip the U.S. of its triple-A debt rating told us nothing we didn't already know. The U.S. is a fiscal train wreck, as it was in 2023, when Joe Biden was president, Fitch downgraded the U.S. and the 10year bond yield touched 5%.

Yet recent events seem to have shifted attitudes about deficits. Elon Musk once promised his Department of Government Efficiency would slash trillions of dollars in spending. "I had clients that genuinely thought DOGE cuts would move the needle," said Ajay Rajadhyaksha, global chairman of research at Barclays. "There's no talk of DOGE now."

He said investors have also learned that Treasury will likely borrow more this fiscal year than last, and Republicans are passing a budget that entails deficits of 7% of GDP indefinitely. Foreign clients, he said, are asking if the U.S. will impose a tax, or selectively default, on their Treasury holdings. That won't happen, Rajadhyaksha said. "But after 20 years of relentless flows into U.S. dollar assets, more than one foreign investor is asking, 'Are we supposed to take some chips off the table?'"

