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Why It's Hard to Work Out Bond Signals

STREETWISE |

By James Mackintosh

The future is always clouded in markets. But even the past isn't as clear as it seems.

Sure, we know how prices have moved. Figuring out *why* they moved is crucial to having any hope of accurate predictions. And it is much harder to be sure than it seems—even in Treasury bonds, the foundation of pricing for almost everything.

This year's move in longdated bond yields is a case in point. Treasury yields are up sharply, with the benchmark 10-year rising from 4.17% to just above 5% before pulling back a bit.

Did they rise so much because the economy is strong, jobs are plentiful and money is pouring into the artificial intelligence sector? Interest rates need to be higher to keep the resulting inflationary pressures under control, and traders extrapolate out higher rates for longer into higher bond yields.

Or did yields rise because America's credibility is on the line? The Fed hasn't hit its inflation target in five years, the president is pushing for lower rates, government debt is high and rising inexorably, trade wars and erratic policymaking have deterred some foreign buyers of Treasuries and geopolitical shocks mean investors want compensation for volatile inflation.

The difference really matters. If yields rose for the good reason of a strong economy, that should help stocks. If they rose because U.S. credibility is crumbling, that should be a headwind to stocks. Investors seem to be locked in a wrestling match over these extremes, contributing to big swings in bonds last week. Bond geeks have lots of measures that ought to allow us to tease apart the two stories.

The simplest is to look at what has happened to bonds maturing soon compared with those maturing in many years. Yields on the shortdated bonds have gone up a lot more, which tends to support the idea that the surge in yields is about the Fed raising interest rates in response to inflationary pressures. Since interest rates apply overnight, higher rates have more effect on bonds maturing soon than those maturing further away.

We can get fancier. A 10-year bond can be thought of as two five-year bonds, one maturing in five years plus another that starts when the old one matures. We can measure this in markets by comparing yields on five-year and 10-year bonds to get an implied yield for what's known on Wall Street as the "five-year, five-year" (a five-year bond starting in five years).

Yields for the first five years are up a lot this year, more than a full percentage point. Those for the five years starting in five years are up only half a percentage point. So one way to think of what has happened is that investors expect a bunch of rate rises

from the Fed in the near term, but some cuts in the longer run.

We can also decompose bond yields into the expected inflation rate plus the real yield above inflation, measured by TIPS, or Treasury inflation-protected securities. Looked at this way, there has been only a small rise (from 2.25% to 2.33%) in the bond market's best guess at 10-year average inflation, known as the break-even. Most of the rise in yields is a rise in the real rate. The obvious interpretation is that investors believe Fed Chairman Kevin Warsh when he says he will bring inflation back down to 2%, but they think a stronger economy will require higher rates to achieve that.

Where it gets trickier is when we look at the best guess of credibility, the term premium. This is the extra yield a Treasury offers above where interest rates are expected to be between now and maturity.

It bakes in a bunch of things, including Fed bond buying, but can be thought of as the extra amount the government has to pay to lock in long-run loans compared with what it could in principle do with a series of short-run debts.

When credibility falls, the term premium, and so yields, should increase.

The problem is that the term premium is a theoretical construct, not something we can easily observe. Handily, Fed researchers have produced two ways of modeling it, known from their authors as Adrian, Crump and Moench (ACM) and Kim and Wright (KW). Not so handily, they tell completely different stories about what's happened this year.

The KW model shows the term premium rising sharply, up 0.4 percentage point to the highest since just after the 2008-09 financial crisis. This is about half the rise in the 10-year yield, and if that much is compensation for the risk of erratic policy, volatile inflation, less-willing foreign buyers and other bad stuff, that should be deeply concerning to the government, voters and investors.

The ACM model is much more reassuring. It suggests the term premium has actually fallen this year. In other words, investors think all the (waves hands) bad stuff is slightly less bad than before.

Warsh said at his news conference that the rise in yields was mainly because of a strong economy, competing bonds issued to finance AI, and geopolitics (i.e., the latest war in the Gulf pushing up oil and other commodity prices). I think this mix of the good and bad stories is probably right, although I'd add to the list foreign buyers steering clear of the U.S.

One final bit of geekery that can help us understand whether bond yields are up for good reasons or bad is what happens to stocks when yields rise. For the first two decades of the millennium, stocks and bond yields typically rose and fell together. The simplest explanation is that what mattered to both was the strength of the economy, and a stronger economy bolstered stocks more than they were hurt by the accompanying higher yields. Inflation was pretty stable and not worth worrying about.

Since 2020, as before 2000, investors have been much more concerned about inflation, and stocks have tended to fall when bond yields rise, and vice versa. Higher inflation means higher bond yields, but doesn't (reliably) bring the accompanying higher profits that a stronger economy does, so it doesn't offset the headwind to stock prices brought by higher yields.

Indeed, comparing the daily changes in the S&P 500 and the 10-year Treasury shows the correlation is now the most negative over a 200-day period since 1997. In day-to-day trading, stocks really don't like higher yields, even though over the year they have managed to rise anyway.

Given all these contradictory findings, it's tempting just to give up on rational explanations.

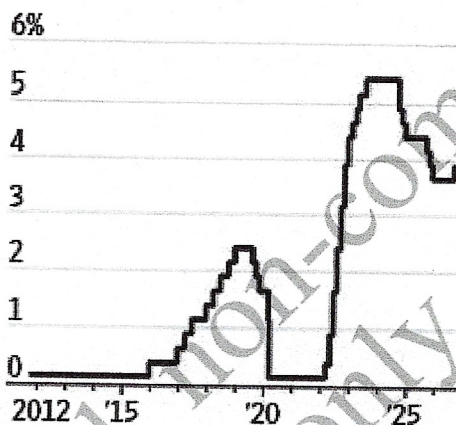
In fact, they show just how hard it is to be sure what's going on—and should make us question confident predictions of what's going to happen next.

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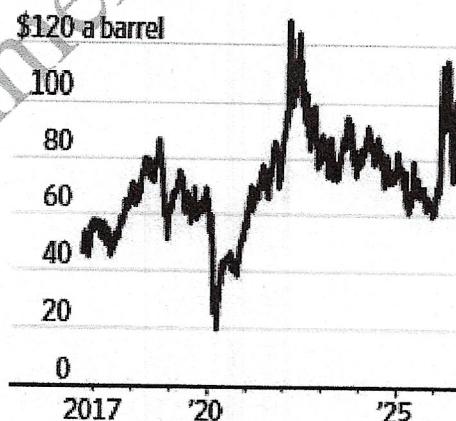
Core personal-consumption expenditures price index, change from a year earlier*



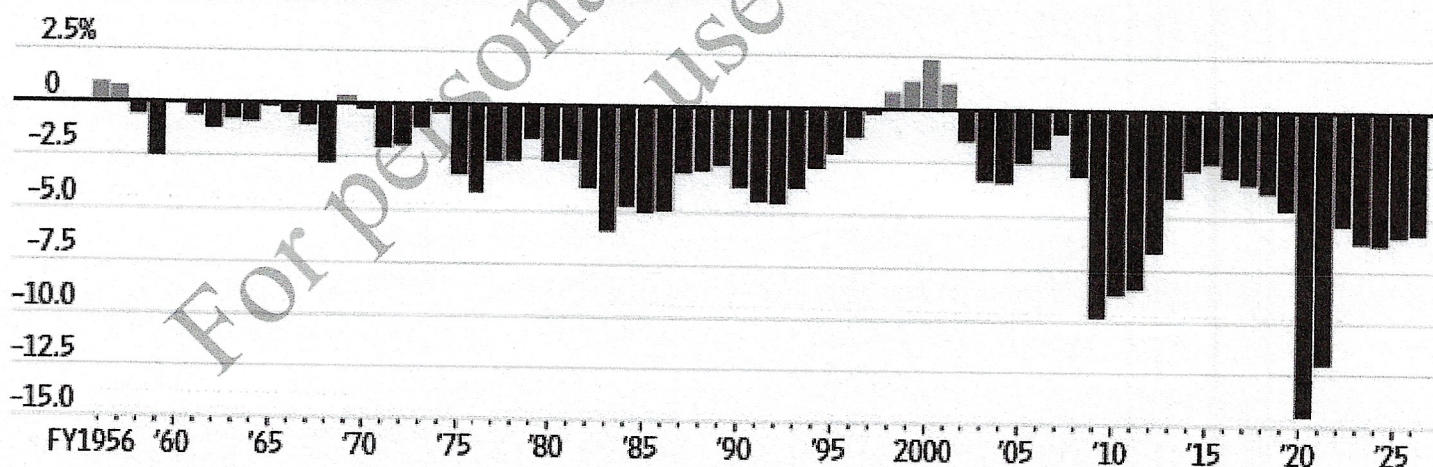
Federal funds rate†



Brent crude-oil futures‡



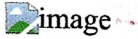
Annual U.S. budget surplus/deficit as a share of GDP**



*Seasonally adjusted; excludes food and energy †Shows midpoint of target range. ‡Continuous contract. **Negative values are deficits. 2026 data is through June 30.

Sources: Commerce Department via the Federal Reserve Bank of St. Louis (PCE); Federal Reserve Bank of St. Louis (Fed funds rate); FactSet (crude futures); Office of Management and Budget (1940-2025 budget); Treasury Department and Commerce Department (latest budget)

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What Sent the 10-Year Treasury Yield on Its Wild Ride to 5%

BY JACK PITCHER AND SAM GOLDFARB

The bond market has caught one bad break after another over the past several years, and it finally pushed the 10-year Treasury yield to a 19-year high above 5% this past week.

First the Covid-19 pandemic and then war have restricted the supply of goods, pushing inflation higher. At the same time, government deficits have flooded the market with bonds and fueled consumer spending.

Supply constraints and deficit-fueled demand delivered a double blow to bonds, said Steve Boothe, head of global investment grade at T. Rowe Price. "I don't think you can look at one without considering the other," Boothe said.

The new high for the critical borrowing benchmark has created starkly different conditions for markets and the economy from the beginning of the decade, when yields dipped well below 1%. Here's how we got here: The 10-year yield was last this high in 2007, before the Federal Reserve began slashing interest rates in response to early signs of what would become the global financial crisis. That ushered in a long period of ultralow rates, as the economy grew slowly and inflation remained low for most of the 2010s.

Many on Wall Street started to believe low rates had become a permanent fixture and borrowing would always be cheap. Tech startups with easy access to capital pursued lossleading strategies to acquire customers, and private-equity firms went on an acquisition binge powered by cheap debt.

When inflation started surging in 2021, a consensus held that it would be temporary, the result of many pandemic-related supply disruptions and temporary government stimulus that spiked demand. Then-Fed Chair Jerome Powell said the inflationary episode would be "transitory."

But by the end of the year, he had retired the word. In a November 2021 congressional hearing, Powell signaled that the central bank would need to raise short-term borrowing costs to temper an overheating economy. In the coming weeks, bond yields began to jump.

In 2022, the Fed embarked on the most aggressive rateincrease campaign in decades. Existing, longer-dated bonds that paid out comparatively low interest dropped in value.

Many expected rapidly rising borrowing costs would break something and spark a recession. The S&P 500 dropped 19% that year, its worst since 2008, as traders positioned accordingly.

Sure enough, in early 2023, Silicon Valley Bank collapsed after a customer panic tied to losses on the bank's bondholdings during the rate-increase campaign.

Not

But the recession never came. The American consumer remained resilient, corporate profits held up, and companies began investing heavily in artificial-intelligence technology.

Yields began to climb anew in the summer of 2023, as traders unwound recession bets. The federal government surprised traders with several larger-than-expected auctions of new bonds, putting more attention on the growing national debt and pressuring yields further. That October,

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the 10-year yield touched 5% for the first time since 2007, but fell back below the symbolic threshold almost immediately.

In November 2024, Donald Trump was elected president for the second time, triggering what Wall Street called a Trump trade 2.0, with yields rising on expectations for faster economic growth, higher inflation and larger deficits.

That initial trade faded before Trump even assumed office. But investors' expectations were largely on point, as Trump has pursued a policy of tariffs and tax cuts that have kept both deficits and inflation elevated.

Deficits put upward pressure on yields in two ways. They translate to more government borrowing and a greater supply of Treasuries, which will drive yields higher unless demand can keep up. They can also act as stimulus, pressuring the Fed to keep rates higher so the economy doesn't overheat.

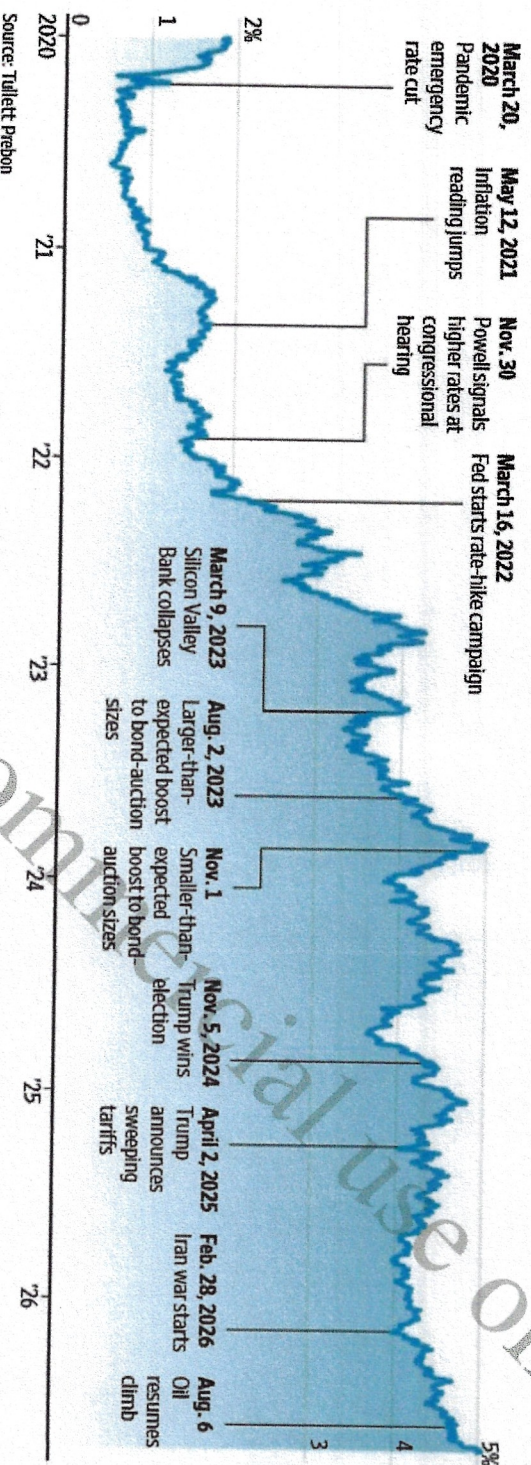
The annual budget deficit has been hovering around \$2 trillion, or 6% of gross domestic product, in recent years, a level previously reserved for the World War II era and severe recessions.

The Fed was still hopeful enough about inflation and worried enough about the labor market that it gradually lowered rates in 2025, keeping yields in check. The 10-year Treasury yield hit a recent low of just under 4% in late February. The next day, the U.S. launched strikes on Iran, starting a war that has limited oil-tanker traffic through the Strait of Hormuz, sending both oil prices and inflation higher.

With measures of inflation once again accelerating, newly appointed Fed Chairman Kevin Warsh told reporters this past week that higher rates are once again necessary to combat inflation. The central bank delivered its first rate increase since 2023, and the 10-year Treasury yield closed Friday at 4.995%.

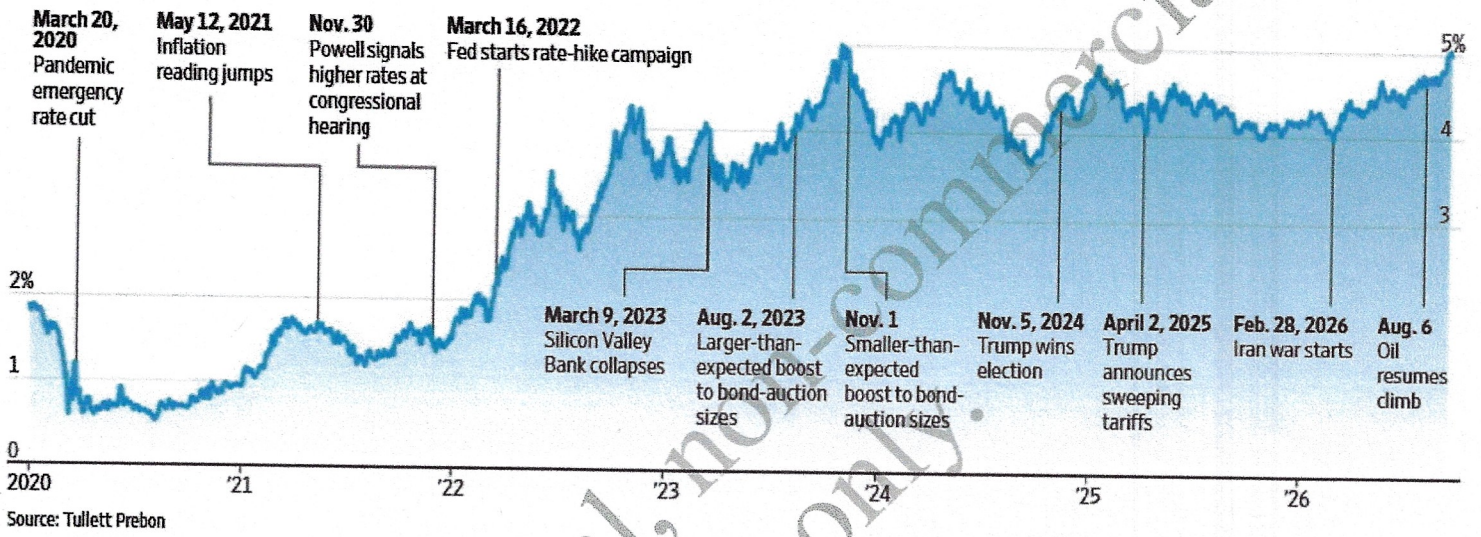
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U.S. 10-Year Treasury yield



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U.S. 10-Year Treasury yield



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The smart fix for the Treasury secretary is to dump tariffs and encourage free trade.



INSIDE VIEW

The Bessent Predicament

The yield on 10-year Treasury bonds is dancing around 5%. It was 4% in March. Treasury Secretary Scott Bessent, facing higher borrowing costs, is in a quandary as to how to lower it. Roadblocks include helping Japan, China's dumping of Treasuries, Dutch gold leaving New York, \$4.47 gasoline, continued Federal Reserve rate hikes, 7% mortgages, a frothy stock market and endless budget deficits. Turns out tariffs are bond busters too.

Most of us ignore long rates. "Artificial intelligence stocks are still popping, so get me more high-bandwidth memory exposure!" More than half of gross domestic product growth in 2026 came from AI investments, a trillion-dollar party that will eventually end. By nearly every measure—from Shiller's Cyclically Adjusted Price to Earnings ratio, and the Buffett Indicator of market cap to GDP and market concentration—the stock market is stretched. And when yields rise, bonds become more attractive than stocks.

Here's the Bessent Predicament: Over the past five years, the yen has dropped in value, from 103 per dollar in 2020 to a low of 164 at the end of July. Since then, Japan has defended the yen, which typically means selling U.S. Treasuries and buying yen so they don't have to raise rates and hurt their economy. Mr. Bessent doesn't like the "sell Treasuries" part, so he raided an Exchange Stabilization Fund in July to help buy yen. It kind of worked—the yen is now 157 per dollar—but longdated Treasury yields keep rising. So much for his "I am the house" rhetoric.

I believe Mr. Bessent intervened to keep the party going. A chunk of the capital inflating our stock market (and paying for AI data centers) came from what's known as the yen-carry trade. Interest rates in Japan have been so low for so long, investors borrow cheap in yen and then invest in U.S. and elsewhere in riskier stuff. That game is over. Rates in Japan keep going up, and on Friday Japan's central bank raised short rates to 1.25%.

Next, China owned \$1.3 trillion in U.S. government debt in 2013. Today it's \$633 billion. Instead, they've been buying gold. Global dollar accumulation has slowed. Even European gold is being transferred out of the U.S. Currently, Japan has \$1.1 trillion of our debt.

Here's my theory: Back in 1997-98, the Asian currency crisis hit Thailand, South Korea and Indonesia and spread elsewhere. Countries borrowed in dollars to invest in local projects in their own currencies. When projects failed, their currencies plummeted, but they were stuck paying back dollar-denominated debt. It took \$118 billion in bailouts to correct.

Since then, most of these countries have ramped up exports to the U.S., "importing" U.S. Treasuries and stuffing them into central banks as reserves and a war chest against future currency weakness. Our Treasuries became

their gold. We didn't mind. We ran budget deficits and then foreigners bought our debt so we didn't have to. We could instead buy equities like the Magnificent Seven.

What changed? The Trump tariff regime is premised on limiting imports into the U.S. Perversely, this reduces the Treasuries that foreigners buy. That, and a dollar down by 10% since Donald Trump took office (not against the yen) is a deliberate attempt to make imports more expensive—one reason inflation is still more than 3% and the 10-year is at 5%. Mr. Bessent has been jumping through hoops with short-term fixes that don't work.

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Mr. Bessent knows we need new buyers of Treasuries and thinks stablecoins are the answer—a long-overdue digital dollar that can move between holders in milliseconds for cheap. It's the use case for crypto, not speculative meme coins. After the Genius Act passed last year, U.S.-based stablecoins need to be backed 1 to 1 with U.S. Treasuries or their equivalent. This week's Senate blocking of the Clarity Act may slow use.

But stablecoins are a false hope. The money to buy stablecoins (which then buy Treasuries) has to come from somewhere—typically a bank, which then needs to lower its reserves, which means less lending. And what happens to the Treasuries that stablecoin companies buy? A look at stablecoin provider Circle Internet Group shows that its Treasuries end up in a Black-Rock money-market fund, custodied at BNY Mellon bank.

Yes, Treasuries do go in a big circle back to banks, but the stablecoin-owned Treasury in custody can't create economy-friendly lending, unlike a Treasury in bank reserves. Less lending. Or higher lending costs. Nothing is free, there are always consequences.

The dollar is still dominant but less so. My advice for Mr. Bessent's predicament: Dump tariffs. Encourage free trade. Tell Japan to let markets set their interest rates. This will help lower our inflation and enable buying of Treasuries by foreign central banks as their paper gold. That's how you get long rates back to 4%. Everything else is Band-Aids.

Write to kessler@wsj.com.

By Andy Kessler

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good bond analysis

Economies Hum Despite Higher Rates

Resilience in face of steeper borrowing costs suggests AI productivity boost

BY CHELSEY DULANEY

Some economists see a silver lining to the global surge in borrowing costs: the economy is strong enough to handle them.

Economies around the world are showing surprising resilience to higher central bank-interest rates and government bond yields that have jumped to multidecade highs across the developed world. The Federal Reserve, Bank of Japan and European Central Bank are among central banks that have lifted interest rates to contain inflation driven by the war with Iran.

Investors expect they will not only keep tightening policy, but hold rates at higher levels for the foreseeable future. The economy's strength in the face of higher borrowing costs suggests it has shifted into a higher gear, helped by a surge in artificial-intelligence investment that economists hope will boost productivity for years to come.

While rising rates make borrowing money to invest in a business or buy a house more expensive and depress demand, there are signs that the economy overall has the strength to withstand them.

Stocks have also weathered the rise in rates better than many had feared, with corporate profits holding up and the AI trade intact. While many on Wall Street are warning high rates could pull money out of the stock market and into higher yielding bonds, so far that hasn't materialized.

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"It is a positive sign that the economy can sustain higher rates, because there is essentially more underlying growth," said Sven Jari Stehn, chief European economist at Goldman Sachs.

Economists are raising estimates for a key indicator known as the neutral rate of interest—an elusive level where borrowing costs neither restrict nor stimulate growth.

Neutral rates are often described as a guiding light for central bankers, though policymakers say they don't directly target them. Fed Chairman Kevin Warsh on Wednesday described neutral rates as "useful academically" but not relevant to his decision-making. Neutral rates cannot be directly observed, and instead must be inferred. Rising growth and price-pressure suggest policy rates are below neutral, while weakening inflation and growth suggest rates are above neutral.

Throughout this year, some Fed policymakers described the central bank's policy as slightly restrictive. On Wednesday, Warsh said he and his colleagues were "hardpressed" to find evidence of that, with the labor market strengthening. He described the rate increase as removing a "dose of accommodation."

The Fed's latest rate projections showed the median neutral-rate estimate rose to 3.25% from 3.1%, an unexpectedly large increase, according to Goldman Sachs. The ECB's chief economist this summer estimated the eurozone's neutral rate range has risen by a quarter-percentage point, to 2.5% at the top end. Japan's neutral rate has also risen by about a quarter-point, Goldman estimated last month.

The rise in neutral-rate estimates has helped fuel the selloff in long-term government bonds, said Daniel Harenberg, lead economist at Oxford Economics.

Harenberg believes the rise in global neutral rates is just getting started. He projects the rate will rise another halfpercentage point in the U.S. over the next five years, and about a quarter-point in the eurozone.

Expectations for higher AI-driven productivity are partly responsible for the rise in both the U.S. and Europe, though Harenberg expects Europe will take longer to see the full effect due to slower adoption. "More productivity growth brings in more tax revenue, which makes higher interest rates more manageable," Harenberg said.

Other drivers of higher neutral rates are more worrying, he said, such as higher government-debt levels. Rising government debt means borrowers have to pay higher interest rates to motivate investors to buy more.

Neutral rates have been on the decline since the 1980s, --academic research has shown. Many economists attribute the fall in part to higher demand for retirement savings as populations aged, and less appetite for productive investment. That was followed by what former Fed Chair Ben Bernanke called the "global saving glut" in the early 2000s. He argued countries like China were further driving down interest rates by investing their huge trade surpluses into safe assets like U.S. Treasuries.

The Fed's Warsh last month said the savings glut is over. "This moment is one of a global investment surge," he said.

Central banks are likely to welcome higher neutral rates, sometimes referred to as r^* . It gives them more room to raise rates to fight inflation and space to cut them during a downturn to stimulate growth.

Some economists question whether growth prospects have fundamentally brightened, especially outside the U.S. "In the U.S., it makes more sense to believe the neutral rate has gone up. In Europe, I'm still struggling," said Carsten Brzeski, global head of macro research at ING. "I don't see the productivity growth story here. I don't see an increase in potential growth."

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Fed's estimated neutral rate*



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