

9-8-25

WSJ Print Edition

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What's Making Bond Markets Anxious?

MARKETS

STREETWISE |

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The past week's stock-market wobble had an immediate cause: suddenly higher longer-dated bond yields, with the 30-year Treasury briefly passing 5%. The logic for the selloff in long bonds—and subsequent recovery all the way back—was much less clear.

There was no obvious trigger, and fund managers and market reporters threw out lots of explanations.

Was it the court ruling against most of President Trump's tariffs? Was it concern about Federal Reserve independence? Worry about the government borrowing way too much? Perhaps the French government's impending collapse? The British budget? Dutch pension reform? September?

The answer is deeply unsatisfactory, but one that honest market reporters should accept more often: No one really knows.

Contrast that with Friday's sharp drop in bond yields, clearly a response to the surprisingly weak jobs figures.

Still, it is worth going through the putative explanations and exploring why they might be a good reason to get out of the longest Treasuries.

Tariffs

They are under threat after a federal court ruled that Trump couldn't claim emergency authority to impose tariffs, which the administration is seeking to appeal.

In principle, billions of dol--lars of tax income could have to be refunded, which would worsen the already grim outlook for federal finances.

One day, maybe, America will struggle to pay back its bonds, making the longestdated ones less attractive.

The timing is the one thing this otherwise superficial explanation has going for it: The ruling came on a Friday, and markets were closed last Monday, while the selloff was at its worst on Tuesday.

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Yet if companies were going to be refunded billions of dollars, there should be gains for stocks, which there weren't.

If the tariffs disappear, the main barrier to much bigger Fed interest-rate cuts—fear of tariff-induced inflation—goes away, so markets should price in lower rates, which they didn't.

Plus, if Treasury yields were rising because of fears about government finance, foreign investors would probably be selling dollars, too. Instead, the dollar rose strongly.

Fed independence

It's a serious concern. Political dominance of central banks typically means politicians set rates too low, raising long-run inflation and leading to a selloff of longdated bonds.

Yet, bond markets didn't raise their expectations of long-term inflation, embedded in the difference between inflation-linked and nominal Treasuries. This "break-even" inflation rate for the five-year period starting in five years was the same at the end of Tuesday as on Friday—2.34%— and well within the range it has moved in this year.

Government borrowing

Worries about it are part of the reason for the reset higher in yields after the pandemic, with a large deficit meaning U.S. debt is expected to keep rising as a share of the economy.

Higher bond yields are required to attract investors to lend ever more money to the government, instead of the private sector, which results in higher yields above inflation.

The yield on the 30-year inflation-linked Treasury did rise slightly last Tuesday, but not a lot.

And the much-more-liquid 10-year inflation-linked Treasury is down sharply from its peak during April's inflation panic, back to levels before last year's election.

French politics...

...is nastily intertwined with the country's bonds because the minority government can't persuade either left- or right-wing parties to back a tax-raising, holiday-cutting budget in order to reduce its deficit, as it has promised it will.

The French prime minister might be forced out in a vote of confidence over cuts on Monday. Not surprisingly, French 10-year bond yields recently rose to their highest premium over safe German bonds since the euro crisis in 2012, and are barely below indebted Italy.

But when investors worry about troubled European countries, they typically buy German bonds for safety, something they didn't do recently. Japanese politics is wobbling, too.

Gilts

The British government's bonds have been a focus of investors since Liz Truss's brief spell as prime minister caused a bond-market crisis.

The City of London's central role in finance and financial media helped put the focus on the selloff in 30-year gilts in the past week, attributing it to the financial puzzle the government faces of whether and how to raise taxes to fix its self-imposed budget problems later this year.

Long-dated gilts face severe pressure as pension fund demand weakens, and there are few other obvious buyers. But there was no particular trigger in the past week, other than the setting of a date for the next budget.

Dutch pension reform...

...is leading to big changes in Europe's financial markets, as some of the continent's biggest investors will switch from using longdated derivatives to more conventional stocks and bonds. The Dutch have about 80% of all pension-fund assets in the eurozone, according to Goldman Sachs, and are in the process of switching from traditional definedbenefit funds that promise a particular pension to a form of defined contribution, where the pension depends more on investment performance. The result is a lot less need for the long-dated derivatives they use to guarantee future income, and probably more investment in stocks—bad for bonds. But the reforms are spread out over years.

September?

It's a popular nonexplanatory explanation. Investors came back from the long weekend in the U.S. refreshed and ready to re-examine their portfolios and decided they really needed to pay more attention to all these issues—so sold long-dated bonds. The fact investors then bought them back over the rest of the week (still September, after all) driving yields lower than where they started rather undermines this seasonality idea.

The old market-reporter joke is that prices fell (so yields rose) because there were more sellers than buyers. In this case, it might just be the best explanation we have. But taken together, all these factors suggest weaker demand for long bonds, which isn't great for their prospects.

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