

2026-9-16 -

Gen RE
ECO

Bond Market Signals That Yield Rises Are Reversible

Expectations for what the Fed will do are driving the moves in long-term yields

Sometimes, the simplest explanation for something works. And in the case of the Treasury market, it appears that the main reason bond yields are rising is because short-term interest rates are likely to rise. Note

There are many risks that can frighten the bond market. Runaway inflation. Unsustainable fiscal deficits. Excessive bond issuance by tech companies. And as 10-year Treasury yields have climbed toward 5%, there has been no shortage of headlines about those threats.]

But another reason investors sell longer-term bonds and demand a higher yield to hold them is because they believe that rates on shorter-term bonds are going to be paying them more for a while. So to agree to lock up their money for longer, they need more payback. Note

Based on available market signals, this appears to be the main factor behind the move in recent weeks. And that in turn is determined by what the Federal Reserve is expected to do. Note

That may be little comfort to anyone hoping to get a mortgage or borrow money. Yet it does suggest that at least some of the recent move is reversible, too. Note

Measures of inflation expectations, for example, haven't jumped dramatically very recently. The gap between the yield on a nominal 10-year Treasury bond and the yield over inflation paid on 10-year Treasury Inflation Protected Securities is around 2.4%. This so-called "break even" inflation rate is higher than it was in 2019 or early 2020, when it was under 2%. But it is well within the range of where it has traded since 2021. Note ?

This yield gap isn't a perfect measure of expectations for inflation, since it can also reflect differences in liquidity between the two markets and other factors. However, it matches what other measures of expectations show. For example, there is a so-called five year-five year forward rate that measures what investors expect inflation to be in the five-year period starting five years from now. It is now around 2.4%, according to Fed data. Goldman Sachs economists, using a composite that includes surveybased measures, in August wrote that the recent five-year period of higher inflation, following a long period of low inflation, has "left long-term household expectations back where they were in the mid-2000s before the last two cycles." Note !!

Then there is the yield demanded by investors to hold longterm bonds instead of short-term ones that is beyond the expected path of interest rates. This is known as the term premium. It acts as a gauge of investors' views of longer-term risks to bonds, such as increased government issuance. Note

This risk premium has risen considerably in recent years. It is meaningfully higher, for instance, than it was in early 2022, just before the Federal Reserve began raising rates postpandemic, according to an estimate calculated by the San Francisco Fed. Note

But it doesn't seem to explain the latest move higher in longterm rates. Since the end of July, the San Francisco Fed's measure of the term premium is down slightly, while 10-year yields have risen.

All of which leaves a higher near-term path for short-term rates as the key driver of rising yields over the past few weeks. A month ago, futures markets were pricing in a 16% chance for three or more quarter-point increases by next September, according to CME Group's FedWatch. This would bring the Fed's target range up to 4.25% to 4.5% or higher. Now, the market is putting a roughly 85% weight on that likelihood.

"The biggest repricing recently has been the market's understanding of where average policy rates might sit," says Jonathan Hill, head of U.S. inflation market strategy at Barclays.

Perhaps the single biggest factor pushing the Fed to increase at the moment is oil prices. Any letup in tensions in the Middle East could therefore provide a release valve for the Treasury market. It is also possible that a couple of rate rises now, paired with reassuring language from the Fed, could lower long-term yields by allaying fears that the central bank is behind the curve on inflation.

Finally, a pullback in AI spending could bring long-term yields down by reducing bond supply and possibly slowing economic growth. An outright recession would bring them down fast.

In other words, despite what some deficit hawks have insisted in recent weeks, it won't take an outbreak of fiscal responsibility in Washington to bring yields down from their recent highs. Many other things could do it.

This also doesn't mean that 5% yields are a ceiling that should be a signal for bond buyers to stampede into Treasuries. But the prospect of lower yields in the relatively near future isn't quite as remote as the worst-case scenarios would suggest.

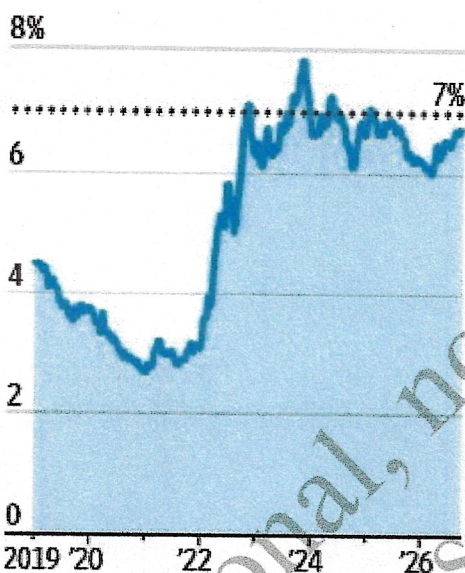
—Telis Demos

85%

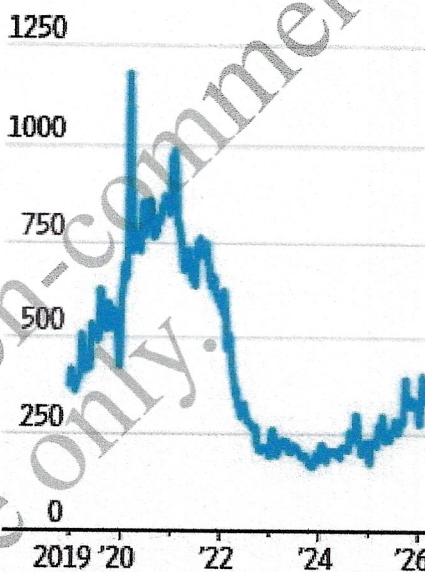
Market bet of three or more quarter point Fed increases by next September

The following is a digital replica of content from the print newspaper and is intended for the personal use of our members. For commercial reproduction or distribution of Dow Jones printed content, contact: Dow Jones Reprints & Licensing at (800) 843-0008 or visit djreprints.com.

Average rate on a 30-year mortgage



MBA Mortgage Application Volume Index*



*Relative to 1990

Sources: Freddie Mac (mortgage rate); Mortgage Bankers Association (application volume index)

The following is a digital replica of content from the print newspaper and is intended for the personal use of our members. For commercial reproduction or distribution of Dow Jones printed content, contact: Dow Jones Reprints & Licensing at (800) 843-0008 or visit [djreprints.com](https://www.djreprints.com).

