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ECO

Bonds

In a High-Yield World, the 'Why' Is Key

Before chasing today's higher rates, buyers need to figure out the reason they want to invest in bonds in the first place

Are you a bond trader or a yield farmer?

That question has taken on added significance for investors enticed by Treasury yields at multidecade highs, even if a successful 10-year note auction on Wednesday momentarily cooled the feverish market. Answering it confronts investors with some very different considerations than what goes into buying stocks.

An important place to start is to ask why an investor is interested in bonds in the first place. One could make the case for Treasuries today because those high yields mean prices are cheap, while stocks remain historically expensive. That is, essentially, a trading decision.

Or it could be that the income generated by a bond is attractive. It is enough to cover a needed expense over the life of the bond or to induce investors to lock up their rainy day money rather than leaving it in a money-market fund or bank account. That is what a yield farmer is thinking about.

Considering the "why" of bonds can help investors decide exactly how to buy them. Because, unlike when it comes to buying stocks, there is a lot more to consider than whether to go with single issues or an index fund.

Yes, individual bonds can be more complicated than exchange-traded bond funds to buy and sell. But that isn't even the most important difference.

That comes down to bonds' essential feature of maturity. At the end of its life, a bond promises to pay back the principal invested, with interest payments doled out along the way. While a corporate bond might not repay if the company goes bust, a U.S. Treasury is a virtual certainty to deliver on that promise.

By contrast, many popular bond ETFs—with some key exceptions—don't have a maturity date. They hold a portfolio of individual bonds and pass along the coupon payments to investors. If bonds in the fund mature, they will repay principal just like any bond. But that goes back into the fund, to roll into new bonds.

Investors can still cash out at any time by selling their shares of the fund. But the thing to know is that they will get the current market price of the bonds currently in the fund, not their original principal.

So, if market yields have risen since they bought in, the price of the bond fund's shares might have gone down. Likewise, if yields have fallen, the price of the fund's shares can rise.

In this way, the returns from a bond fund are uncertain. The yield can move as older bonds mature and new ones come in. The value of the fund can also go up and down. So to predict what the ultimate returns will be, or what the fund's price might be at a future point in time, an investor would have to have a trader's view on the direction of yields and bond prices.

By contrast, owning a bond with no plans to ever sell it before maturity provides a certainty of returns. You know what the interest payments will be, and you know how much money you will get back at maturity.

In many cases, “the trade off between a fund and a single bond is between liquidity and convenience, and certainty of cash flows,” said Elisabeth Kashner, director of ETF research and analytics at FactSet.

However, this doesn’t mean buying a bond and holding it to maturity in a rising-rate environment is riskless. In a fund, maturing bonds roll into newer ones.

So if yields are rising, maybe because inflation is running hot, the fund’s distributions will steadily rise. Over a longer time horizon, that additional income could more than compensate for a fund’s loss in price.

Consider, for example, the performance of the iShares 3-7 Year Treasury Bond ETF from October 2020 through this week, a period that included a leap in yields when the Federal Reserve took short-term rates from near zero to above 5%. The fund’s price has fallen by about 15% over that period. But its total return, which includes reinvested payouts, is nearly flat.

An individual bond, meanwhile, also bought in 2020 at what would have been a superlow yield, would have provided no such protection. Without reinvesting the interest payments along the way, that bond isn’t providing any additional compensation for the fact that the principal, and the coupon payments, could be worth a lot less at the time of maturity.

And, if an investor for some reason decides to cash out before maturity, there is a risk of doing so at a loss. Unless investors can be certain they won’t need that money at any time before maturity, or that a bond’s income perfectly covers a fixed cost—also known as asset-liability matching—they are exposed to the same price risk as fund investors.

“When yields go up, people see that their bond fund prices decline. With a regular bond, they couldn’t care less. It’s a comforting optic,” says Stephen Laipply, global co-head of iShares fixed income ETFs at BlackRock. “In both cases, though, bonds are maturing. The difference is whether that is then rolled into higher yields.”

Thinking through these differences and an individual’s unique needs and financial circumstances will help investors navigate the sometimes dizzying menu of Treasury options available.

Beyond individual bonds, there are what are known as definedmaturity ETFs. These aim to closely replicate the experience of buying a bond outright by holding the fund’s bonds until maturity, then returning that principal to investors. For example, BlackRock offers a series of iBonds ETFs, and Invesco offers BulletShares ETFs, with a range of maturity dates.

ETFs offer portfolios of bonds with varying maturity ranges, say, one to three years. In that case, bonds may be sold before they mature, but the proceeds are still rolled into new bonds. Investors can also buy so-called ladders of individual bonds or defined-maturity ETFs, with staggered maturity dates. There are also Treasury inflation-protected securities, which are bonds whose principal is adjusted to reflect the rate of consumer-price index inflation.

Some investors might be surprised to learn that their objectives fit more with a strategy that isn’t just buy-and-hold. Trading isn’t always the wrong answer.

—*Telis Demos*

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Bonds

Contagious Selloff In Bonds Is Fizzling

Impact of rising yields on mortgage debt and Treasury futures peters out

BY SAM GOLDFARB

The battered U.S. bond market is finally getting a dose of good news.

A confluence of market quirks blamed for deepening the recent selloff may be running out of steam, stirring hope that the rise in bond yields will also peter out. Surging yields in recent weeks have distorted other markets, extending the life expectancy of two other popular flavors of debt securities: mortgage bonds and Treasury futures. The longer the life of a debt instrument, the more investors are left exposed to changes in interest rates.

Investors adjusted in ways that led to selling of longerterm Treasuries, including 10-year notes and 30-year bonds. A vicious cycle was set in motion. But there are also mechanical limits to how far that cycle can go, and investors and analysts are seeing signs of a slowdown.

"I think we're closer to the end in terms of some of these technical factors, and just the speed of the move," said Leah Traub, a fixed-income portfolio manager at Lord Abbett. From here, the direction of yields will come down more to "fundamental factors," such as shifts in oil prices, she added.

Investors are especially optimistic about the pressure coming from the mortgage bond market.

Rising rates have chilled homeowners' interest in re-financing their mortgages. As that has happened, the average expected life of the loans underpinning mortgage-backed securities has been pushed out. But the bonds have now been extended about as far as they can go, analysts said.

There now is less pressure on holders of those bonds to hedge their portfolios by entering into derivatives contracts with counterparties who often then offset their own position by dumping Treasuries.

Hedging by mortgage bondholders has helped drive Treasury yields higher in recent weeks, but, increasingly, "it's not going to continue to be a factor," said Amrut Nashikkar, head of interest rate derivatives strategy at Barclays Treasury yields, which rise when bond prices fall, have generally been on an upward trend since March. But there have been a couple of periods of particularly big jumps, including at the end of September. October has been choppy, and there have even been tentative signs recently of some stabilization.

Yields on 10-year and 30-year Treasuries have touched 24-year highs this week, but they fell on Wednesday after a government auction of new 10-year notes met with strong demand.

Yields then drifted higher overnight as oil prices climbed, only to reverse course again on Thursday. Importantly, Thursday's rally was led by longer-term Treasuries—a departure from the recent trend, which has seen longer-term yields climb even as

short-term yields have held steady.

By the end of the session, the yield on the 10-year U.S. Treasury note was 5.232%, according to Tradeweb, down from as high as 5.365% early Wednesday before the 10-year note auction.

Brent crude, the international benchmark, rose 4.1% to \$104.28 a barrel. Stocks slumped. The S&P 500 fell 0.5% and the Nasdaq composite slipped more than 1%. Both benchmarks had closed at record highs earlier this week.

The Dow Jones Industrial Average added 0.1%, or around 52 points.

While still cautious, some investors say they are looking for opportunities to buy bonds.

For months, investors have ramped up expectations for how high the Federal Reserve will raise interest rates to fight inflation, going so far as to bet that the Fed would raise rates four more times by the end of next July.

However, the Fed itself has signaled fewer hikes, and several officials have said recently that they don't expect to raise rates this month. That has caused a modest shift lower in the market's rate expectations that some believe has further to go.

Significant threats to bonds remain including growing fiscal worries in Europe, the continuing U.S.-Iran conflict and the ever present risk of another hot inflation report.

Investors and analysts are also divided over just how much risk remains from technical factors.

In recent weeks, most agree that selling pressure has emanated not just from mortgage bondholders but also from investors in U.S. Treasury futures. The issue there is that these futures contracts are underpinned by baskets of actual Treasuries, and the specific Treasury that the futures contract mirrors changes as bond yields move up and down.

The differences can be meaningful. Focus recently has been on one contract that is backed by 15- to 25-year Treasuries. If yields climb further to 6%, the underlying security would jump from a bond due in 2045 to one that matures five years later.

To manage risks to their portfolios, investors have already been reducing their positions in that contract, a step that has led other investors to sell actual Treasuries. But it is not clear how much further they have to go on aggregate.

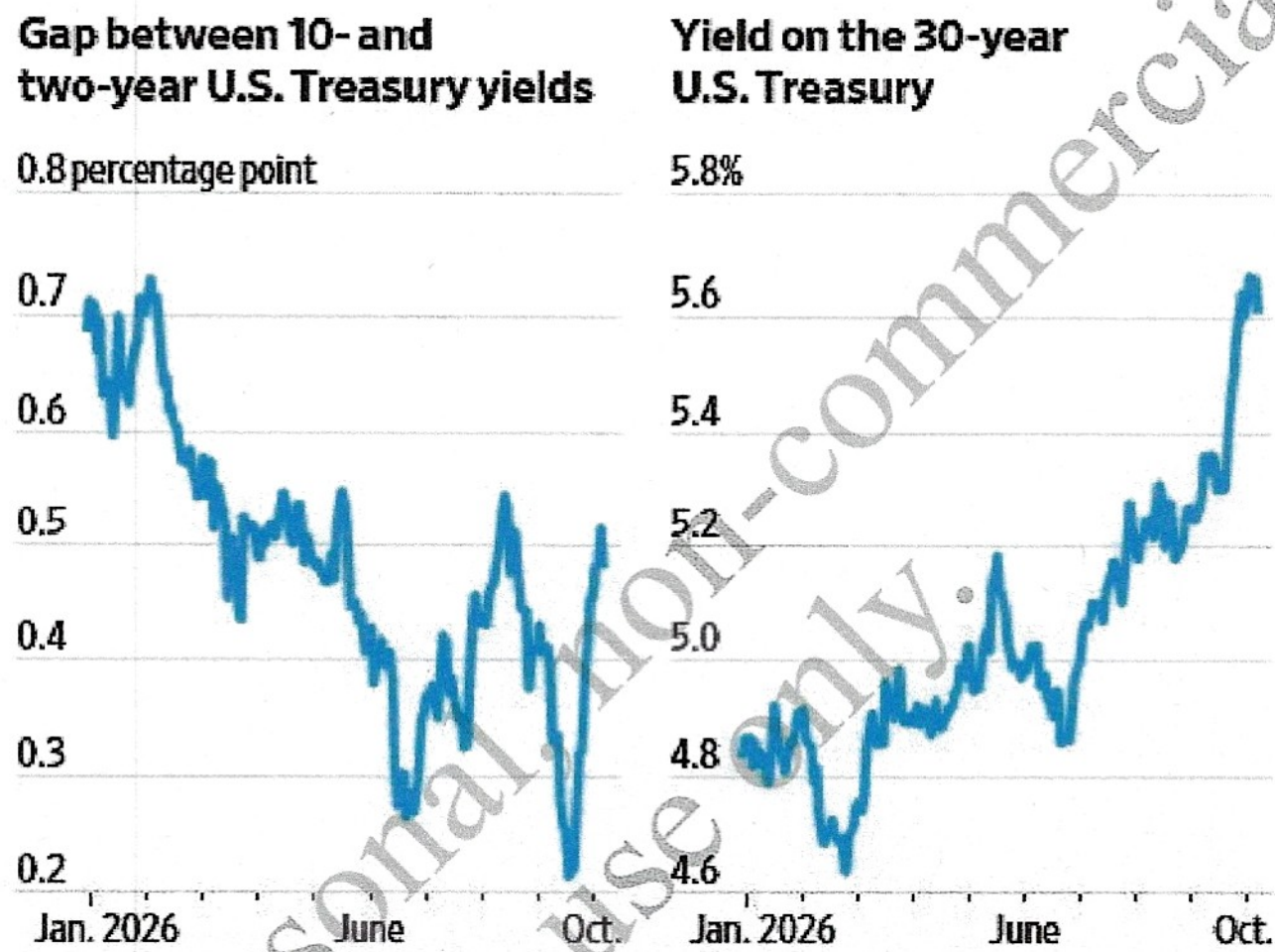
Some believe that investors have been active given the attention on Wall Street to the issue, meaning that the pressure that they are putting on Treasuries may already largely be in the past.

Other analysts are skeptical that asset managers as a whole have been that proactive.

"It's likely that the peak extension hedging comes later" said Eli Carter, U.S. rates strategist at Morgan Stanley.

THURSDAY'S MARKETS

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Four signs it is about to get uglier in the bond market

Story by Gertrude Chavez-Dreyfuss, Suzanne McGee and Laura Matthews 2026-10-9

NEW YORK, Oct 9 (Reuters) - It is white-knuckle time in the bond market.

US Treasury yields have risen sharply since the war with Iran began in February, with the 10-year yield up some 135 basis points to 5.23% and the 30-year yield up around 110 basis points from its March low to 5.614%. Both are trading at levels last seen more than two decades ago.

Investors are watching whether bond selling is starting to create its own momentum. Some key technical measures suggest another surge to even-higher yields could be ahead, creating a feedback loop that amplifies the market stress, though there are also reasons to believe that buyers will soon step in, seeking to lock in yields at their most investor-friendly levels since George W. Bush was president.

"People in the market are recalibrating their expectations," said Dustin Reid, fixed income strategist at Mackenzie Investments.

Here are four signs that the selling could worsen.

VOLATILITY IS RISING IN RATE OPTIONS

Investors are seeking out protection against rising yields, referred to as the "payer skew," in the options market. Investors use these markets to insure their portfolios against a sharp move in yields without having to sell their Treasury holdings.

Demand for short-term protection against a jump in 10-year US swap rates has intensified, pushing the cost of insuring against a 200-basis-point rate rise over the next three months to 132 bps on Monday, highest since the March 2023 banking crisis triggered by the collapse of Silicon Valley Bank.

Swap rates refer to the cost investors pay to lock in a fixed interest rate instead of paying a floating rate.

While options are tied to swap rates rather than Treasury yields, the two typically move together, making the surge in payer skew an indication of concern about the risk of higher long-term Treasury yields.

Implied volatility, a key input in option prices, has climbed to 21.4 basis points for one-month options on 10-year swap rates, the highest since late March, reflecting growing uncertainty over the path of long-term yields.

CREDIT SPREADS UNDER PRESSURE

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A major contributor to the selloff has been a surge in corporate issuance to support the AI buildout, investors said. Spreads have remained tight, but buyers of longer-term bonds issued by AI hyperscalers are using the Treasury market to hedge their duration risk, a measure of exposure to rising interest rates — a practice that lately has spurred selling.

"When a transaction prices midday, in the afternoon everyone is selling Treasury futures," said Neil Sun, portfolio manager at RBC BlueBay Asset Management, who focuses on investment-grade credit. Those who aren't hedging sometimes sell Treasuries outright to make room for higher-yielding investment-grade bonds.

Goldman Sachs predicts that hyperscalers could sell a record \$420 billion in debt next year, which likely means more hedging or selling of government securities.

MORTGAGE HEDGING IS GATHERING PACE

Investors exposed to mortgage assets are also hedging against the selloff in Treasuries. As rates rise, the expected life of mortgage-backed securities extends, making them more sensitive to further moves in yields in what is known as duration risk.

Investors often respond by increasing interest-rate hedges to offset that added duration risk, a process known as convexity hedging. That includes selling of Treasury futures — which can add to selling pressure across bond markets.

"The market is carrying a substantial cohort of mortgages originated over the past three years at coupons relatively close to current mortgage rates," said Mike Riddle, chief executive officer at Eris Innovations, a Chicago-based futures and options products developer. He said that could mean still more hedging, adding that nine large trades this month show investors in mortgages scrambling to protect their positions.

YIELD CURVE STEEPENING

The renewed steepening of the 10-year/30-year yield curve is another warning, suggesting investors are demanding a greater premium to hold the longest-dated government debt. The 10s-30s spread widened to about 37 basis points this week, as the 30-year yield rose faster than the 10-year's yield.

While the curve has been steeper before, including in late July when that spread reached 52 basis points, the latest move is unfolding with these yields already near multidecade highs. That suggests the move is increasingly reflecting a rising term premium, rather than a broad repricing of the Fed's policy path. A higher term premium suggests investors are demanding higher compensation to hold long-term debt.

"There's just more interest in the 10s than the 30s on the part of investors, who see there's much more potential for things to go wrong in the fiscal picture" in the United States over the longer time frame, said Alex Morris, co-founder of fixed income asset management firm F/m

Investments. "Essentially, people are telling the Treasury, 'I don't know if you guys have got this under control.'"

(Reporting by Gertrude Chavez-Dreyfuss and Laura Matthews in New York and Suzanne McGee in Providence; Editing by Colin Barr and David Gaffen)

