January 8, 2025

Global Bond Yields: Duck, Duck, Duck, Goose!

UST 10-Year Yield Analysis — A Growing Disconnect: This week we've seen significant rallies in UK Gilts, German Bunds, and Japanese JGBs. Today alone, 10-year UK Gilts surged 11.1 basis points—a hefty move for a single session—leading to chatter about fiscal sustainability, shrinking fiscal space for Chancellor Reeves, and a weaker pound. But these moves don't surprise us.

Increases in bond yields have tracked their respective central bank benchmark rate futures. This aligns with the expectations hypothesis, which holds that long-term yields reflect anticipated future short-term rates. Gilt yields track BOE rate expectations for August 2025, Bund yields follow ECB expectations for July 2025, and JGB yields align with BOJ expectations for July 2025.

As we pointed out in our 2025 Outlook, we're not surprised that these currencies have weakened at the margin against the dollar as their yields rise. But what's puzzling is the recent behavior of UST long-term bond yields, which seems disconnected from Fed rate expectations.

The Anomaly in UST Yields: Before Christopher Waller came out this morning with optimistic comments on inflation and Trump tariffs (which he downplayed as inflationary risks), the UST 10-year yield rallied to 4.7%. Curiously, this rally occurred despite little movement in 2025-2026 Fed funds futures.

Instead, the action has centered on the January 2027 Fed funds futures contract. While UK, German, and Japanese yields are responding to 2025 rate expectations, UST yields are reacting to 2027 expectations. This suggests markets see something beyond near-term Fed moves driving yields higher.

Currently, Fed futures suggest the Fed funds rate will stabilize at around 4% by September 2025, with a single 25-basis-point cut expected by December 2026. That's a 120-basis-point jump compared to four months ago, when the December 2026 contract implied a 2.8% Fed funds rate.

What's Driving UST Yields Higher: We see three main factors:

> **1) Pro-Growth Policy Expectations** - The biggest driver is the incoming administration's pro-growth agenda: tax cuts, energy abundance, deregulation, and geopolitical stability. These policies are enough to get markets anticipating faster economic growth and less urgency for the Fed to cut rates.
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> **2) Higher Neutral Rate Expectations** - This agenda is likely feeding a perception at the FOMC that the neutral rate—the Fed's long-term target rate—is higher than previously thought. Equity markets have remained resilient despite rising UST

yields, suggesting that investors aren't overly concerned about a hard landing. This resilience may give the FOMC confidence to raise their estimate of the neutral rate.

3) Term Premium Adjustments - Lastly, we're seeing adjustments to the term premium—the additional compensation investors demand for holding long-term bonds in an uncertain environment. Rising term premiums suggest that markets expect structural economic strength to persist.

A Closer Look at the Term Premium: In her exit interview with CNBC, Janet Yellen noted that the term premium is "normalizing." She attributed the rise in long-term yields to positive economic data, indicating that markets are adjusting their risk expectations for holding long-term debt.

If the term premium continues to rise, borrowing costs could remain higher than intended, further tightening financial conditions. The December unemployment report, set for release on Friday, will be critical. If the jobless rate surprises to the upside—say 4.3% or 4.4%—it could inject dovish sentiment into markets and lead to lower yields. But if the labor market remains strong, the Fed may pause further rate cuts at its January 29 meeting, offering some relief to the UST 10-year yield.

The Miran-Roubini Thesis on Treasury Issuance: The Miran-Roubini thesis suggests that Yellen's short-term issuance strategy has suppressed long-term yields by limiting the supply of longer-dated bonds.

With Yellen's departure on January 20, Miran and Roubini expect the next Treasury Secretary to shift toward more long-term issuance, increasing supply and pushing yields higher. This shift would increase the supply of longer-dated bonds, driving prices down and yields up.

We can't dismiss this thesis outright. Yields have been rising steadily since early December, suggesting that markets may be pricing in a shift in issuance strategy. But we're skeptical that Treasury issuance expectations are primarily responsible for the current yield environment. The timing suggests that the expectations hypothesis remains the lead driver, with shifts to perceptions of the term premium also factoring in. What's more, we don't believe the capable Scott Bessent would choose to lock in longer-term funding at higher yields, when a gradual phase out of Yellen's issuance strategy could be done so long as longer-term yields decline.

What Will It Take to Lower UST Yields & Mortgages?: President-elect Trump noted on *Truth Social* yesterday that rates are too high. We agree. But to see 30-year mortgage rates drop to 5%, we'd need at least another 100-basis point drop in long-term yields. But based on recent history, further rate cuts could push UST yields higher, not lower.

The current path of 50-basis-point rate cuts from the FOMC is unlikely to reduce the 10-year yield by the same amount. In fact, it might have the opposite effect. The last 100-basis-point reduction in the Fed funds rate coincided with a 100-basis-point rise in the UST 10-year yield.

So, what would actually bring UST yields down? It may take a clear sign of economic weakness—or even a recession—to convince markets that long-term yields should decline.

A Cautionary Tale from the UK: Finally, it's worth noting the parallels between current UST yield dynamics and the UK gilt crisis during Liz Truss's premiership in 2022.

Truss and Chancellor Kwasi Kwarteng introduced supply-side tax cuts to drive growth and investment. The IMF led a full-court press against the plan, framing it as a fiscal sustainability risk.

The result? Gilt yields surged, the pound weakened, and the UK government was forced to abandon its pro-growth agenda in favor of austerity.

The parallels to the incoming Trump administration's agenda are striking. Markets may be pricing in fiscal loosening, but investors should remain wary of institutional pressure. If global institutions begin a coordinated campaign to underscore US fiscal profligacy, we could see a coordinated effort to push UST yields higher, in an attempt to give a market veto to supply-side reforms. We believe such an attempt would fail in this new zeitgeist. Mark Zuckerberg is emulating Elon Musk on content moderation, and a significant number of Democrats have already crossed party lines to support the first major piece of legislation in the New 119th Congress.

But the lesson from the UK is clear: markets and institutions can be weaponized to sabotage pro-growth policies under the guise of fiscal discipline. Investors should remain vigilant as the first 100 days of the new administration take shape.

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