

Bond Boost

If you look at the change in the yields on U.S. 10-year Treasury bonds over the last couple of months (since the first of July), the chart is eye-opening. This may be the economic story of the hour. The press seems focused on whether the U.S. stock market is moving up or down on a daily basis, but under the waves, there seems to be something happening on a structural level.



What could cause such a dramatic surge? Some say the \$40 trillion federal deficit is spooking longer-term bond investors, who wonder how the government is ever going to pay its way out of this massive fiscal hole. A default seems unlikely, but it also seems a bit unlikely that any future Congress will authorize an annual budget that collects more than it pays out. (This last happened during the Clinton Administration.)

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Another factor that is undoubtedly contributing to the higher rates is competition, specifically, from the tech companies that are hungry for outside capital to fund construction of their massive (and massively expensive) data centers. Very few borrowers have the scale to compete with Treasuries, but this year the various AI-related firms will issue \$489 billion in high-yield bonds, and they're paying 2.25% a year more than comparable Treasuries. By one estimate, the total AI-related debt issuance could reach \$4.1 trillion through 2030. Put another way, the tech industry is outbidding the government for investment dollars.

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Then there's inflation. Core inflation has been steady at 3.7%, which is nearly twice the goal of the U.S. Federal Reserve Board. Investors calculate the 'real' return on their bond holdings by the simple exercise of subtracting the inflation rate from the yields. The current 5.3% yield on 10-year Treasuries offers a 'real' return of 1.6% a year—which some investors might say is pretty skimpy. And the renewed U.S.-Iran conflict has raised concerns about how energy prices might impact that inflation rate, which means the 1.6% return could be considered unusually risky.

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How will this affect ordinary investors like us? If rates continue to rise, and even if they hold steady, the government will have to pay out considerably more on its gargantuan borrowings than it has been over the last 20 or 30 years. Interest payments already consume more of the government's budget than military spending—and, it should be noted, interest payments eat away at the government's ability to spend on its priorities.

Another effect could hit consumer wallets. Banks and lending institutions base the rates they offer consumers on the 10-year note, which means rates for home equity, auto loans and other debt are rising basically in lockstep. A typical 30-year mortgage is now priced at 7.26%, nearly a full percent over what home buyers could have gotten at this time last year.

Finally, when bond rates are this high, they start to compete with stocks for the attention of investors. Does the market offer a guaranteed 5.3% annual return over the next ten years? Stocks generally outperform bonds, but the margin tends to tighten when bond rates go up—meaning that some conservative stock buyers could decide to become bond buyers instead. If the upward trend continues for bond rates, it could eventually start to affect the stock market's performance.

None of this signals a crisis. It's an underlying story that will eventually resurface in the press—and if the past is any indication, the headlines will suggest that this is leading to an incipient catastrophe. When you encounter that breathless clickbait, you'll know what's actually going on.

Sources:

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