

Impossible Things

Could 'Speculation' Investment Regime Be Extended By More 'Treasury QE'?

"Alice laughed. 'There's no use trying,' she said. 'One can't believe impossible things.' 'I daresay you haven't had much practice,' said the Queen. 'When I was your age, I always did it for half-an-hour a day. Why, sometimes I've believed as many as six impossible things before breakfast.'" — Lewis Carroll, Alice Through the Looking-Glass

Markets are being asked to accept three widely held assumptions: that rising US bond yields reflect a **loss of confidence** in US assets, that higher rates are **inherently bearish**, and that recent US Treasury and Federal Reserve interventions amount to **disguised yield curve control** (YCC). The evidence suggests otherwise. Rather than signalling dysfunction, higher yields largely reflect stronger nominal economic growth, while the current policy regime is aimed at limiting volatility and preserving market liquidity.

The first test of this interpretation is whether global business activity is accelerating fast enough to justify the move in yields. The chart below uses daily World GDP estimates to show that the current growth tempo is both high and still rising.



Subscribed

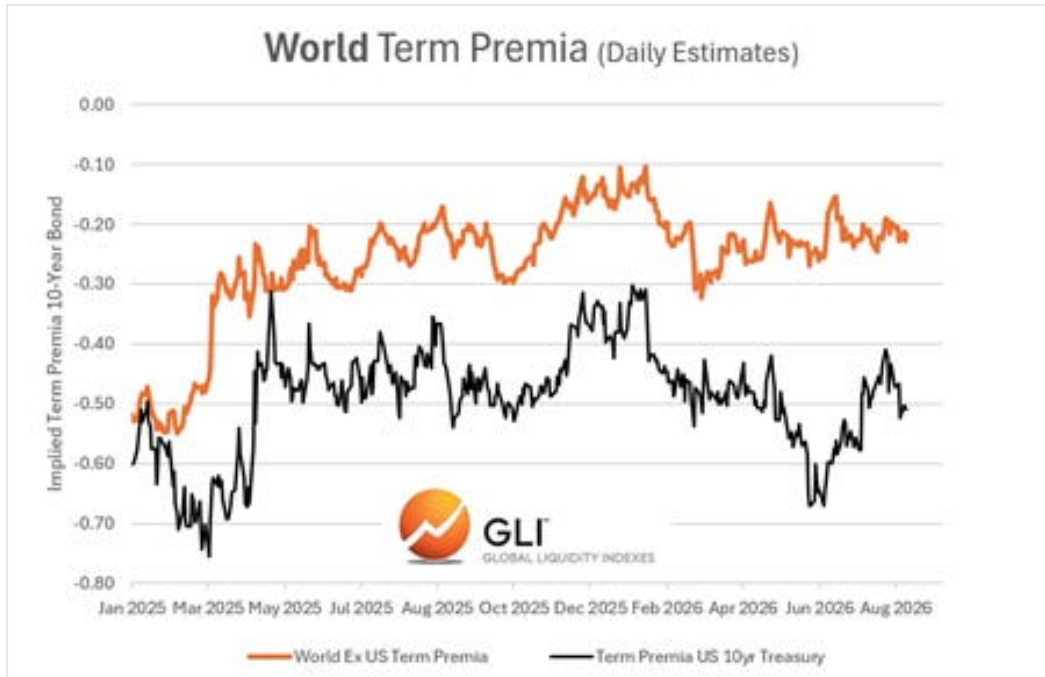
TL;DR

- **Rising yields are constructive, not necessarily bearish:** Bond markets are repricing for a faster-growth environment. There is little evidence of a broad investor abandonment of US Treasuries
- **“Treasury QE” is supporting liquidity:** Treasury buybacks, Treasury bill issuance, TGA drawdowns, and related measures are acting as a form of “Treasury QE”. This is yield volatility control (YVC), not classic yield curve control (YCC)
- **US growth remains supported:** Treasury QE and the AI investment boom are helping drive economic growth. But US 10-year yields may continue moving higher and test 6% in this strong growth environment
- **Japan is the biggest risk area:** rather than the US, Japan is the potentially fragile part of the global rates complex. Rising Japanese yields could create broader market stresses
- **Longer-term inflation risk is building:** By shifting Treasury issuance toward short-dated bills that are absorbed by banks, policymakers are ‘monetizing’. The long-term danger is renewed monetary growth and eventually higher consumer inflation

US Yields: Re-pricing, Not Abandonment

Interest rates are rising for reasons that may be constructive rather than destructive. Term premia and convenience yields remain broadly stable, and there is little indication that US term premia are rising relative to foreign equivalents. If anything, the relative move suggests that global markets are adjusting to stronger nominal activity rather than repudiating US credit.

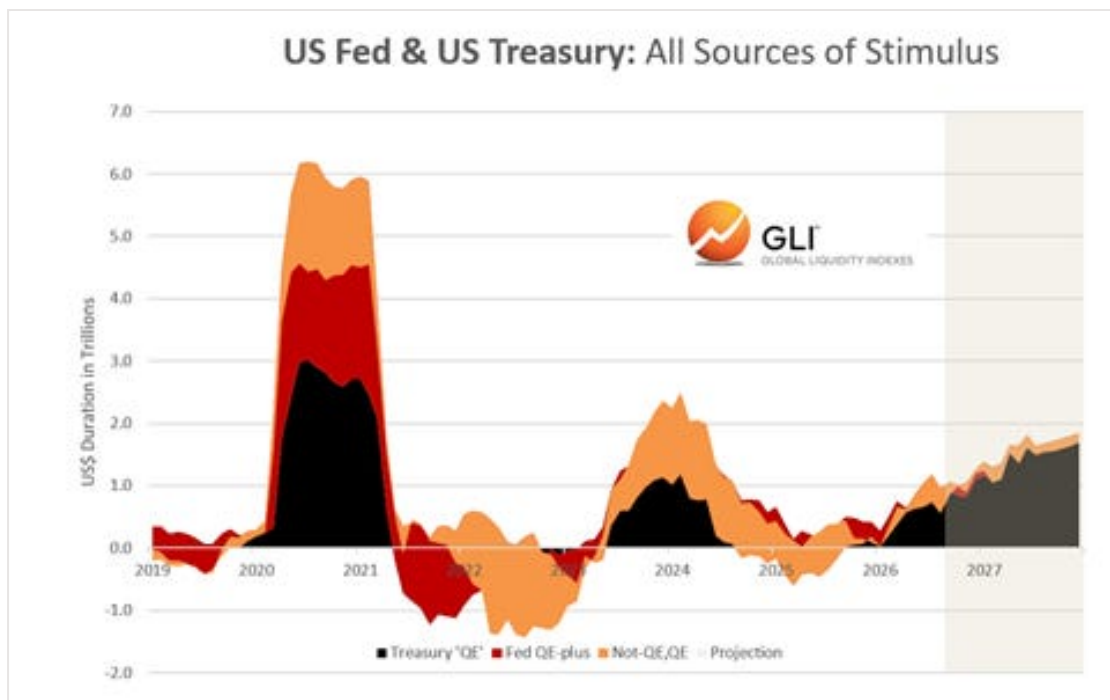
The chart below presents our estimates of daily bond term premia for US and non-US 10-year benchmark bonds. Non-US markets may show a slight upward drift, but US term premia remain remarkably stable and have lately moved lower. This pattern does not support the loss-of-confidence argument.



Treasury QE and Yield Volatility Control

More importantly, the Treasury/Fed policy regime of “Treasury QE”, in place since 2025, appears to be working. We use the term “Treasury QE” to describe policies that alter the composition and maturity structure of outstanding government debt in a way that supports liquidity and economic activity without requiring a direct expansion of the Federal Reserve’s balance sheet. Treasury Secretary Scott Bessent’s measures to protect the bond market are therefore better understood as *yield volatility control* (YVC), not the more sinister-sounding *yield curve control* (YCC). The distinction matters: **the aim is not to dictate the level of yields, but to prevent disorderly funding conditions from turning a repricing into a market accident.**

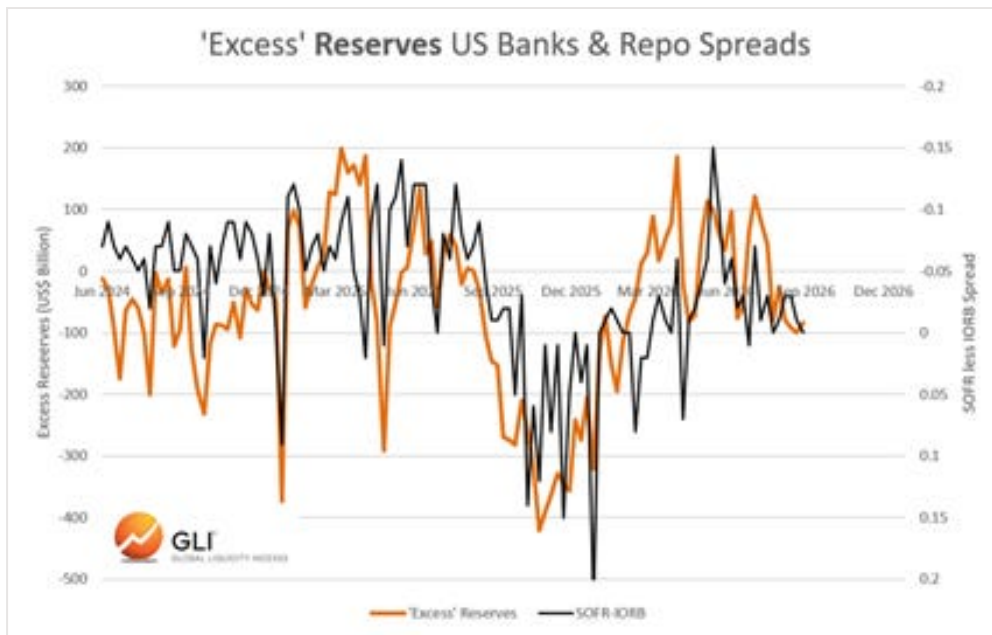
The following chart illustrates the shift from ‘Fed QE’ to ‘Treasury QE’. Fed QE changes the size and asset mix of the Fed’s balance sheet, whereas Treasury QE changes the size and composition of outstanding public debt. Our calculations use the approximation that ‘liquidity’ is proportional to net assets divided by duration. The data indicate the recent dominance of Treasury QE, which has involved more directed State spending in the real economy, funded increasingly through Treasury bills.



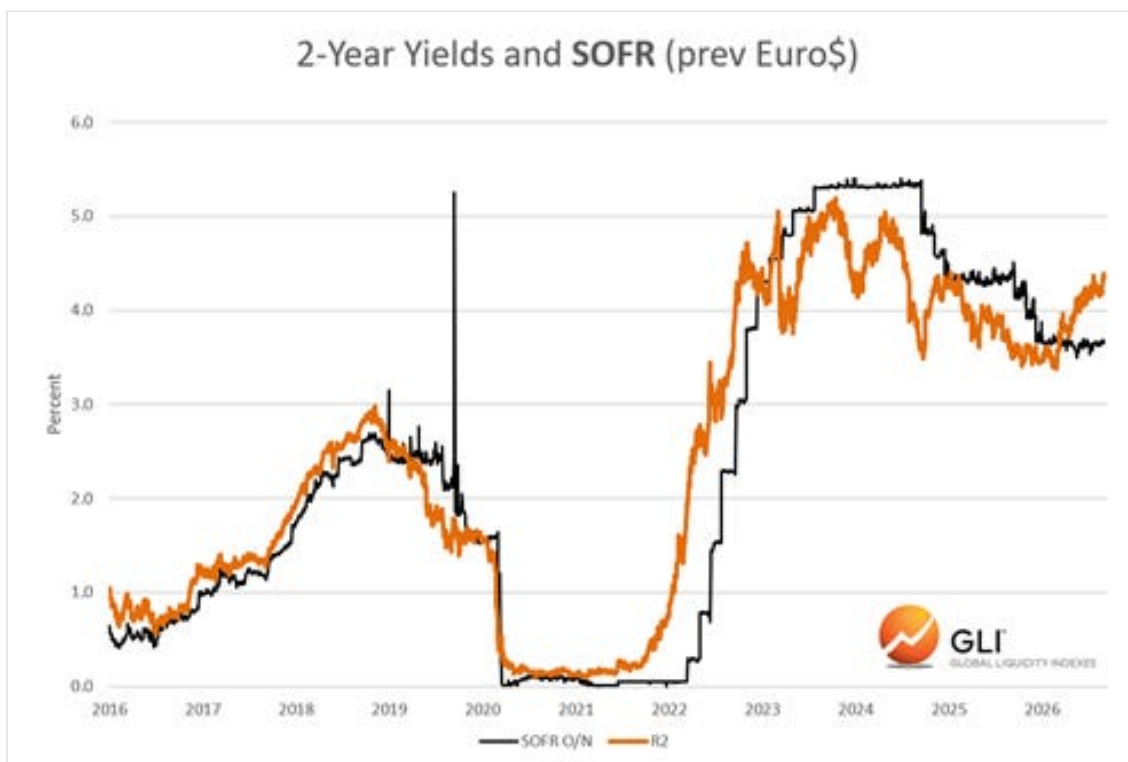
Treasury buybacks provide liquidity support for this funding policy by removing more volatile, harder-to-finance, longer-dated ('off-the-run') bonds from the market. They also add to money market liquidity and bank reserves through a rundown of the Treasury General Account (TGA), helping to prevent SOFR spreads from spiking. The recent joint foreign-exchange operation with Japan may even have been intended to reduce the risk of forced Treasury selling by Japanese investors.

This support is essential because repo-market funding is highly levered, especially where tiny haircuts support Treasury *basis trades* and *swaps*. These conduits make it imperative for the Fed and Treasury to backstop repo markets using every available liquidity tool: buybacks, TGA drawdowns, SLR reform, Reserve Management Purchases (RMP) and, where necessary, other balance-sheet channels. **This liquidity support is arguably far more important than the setting of Fed funds policy rates.**

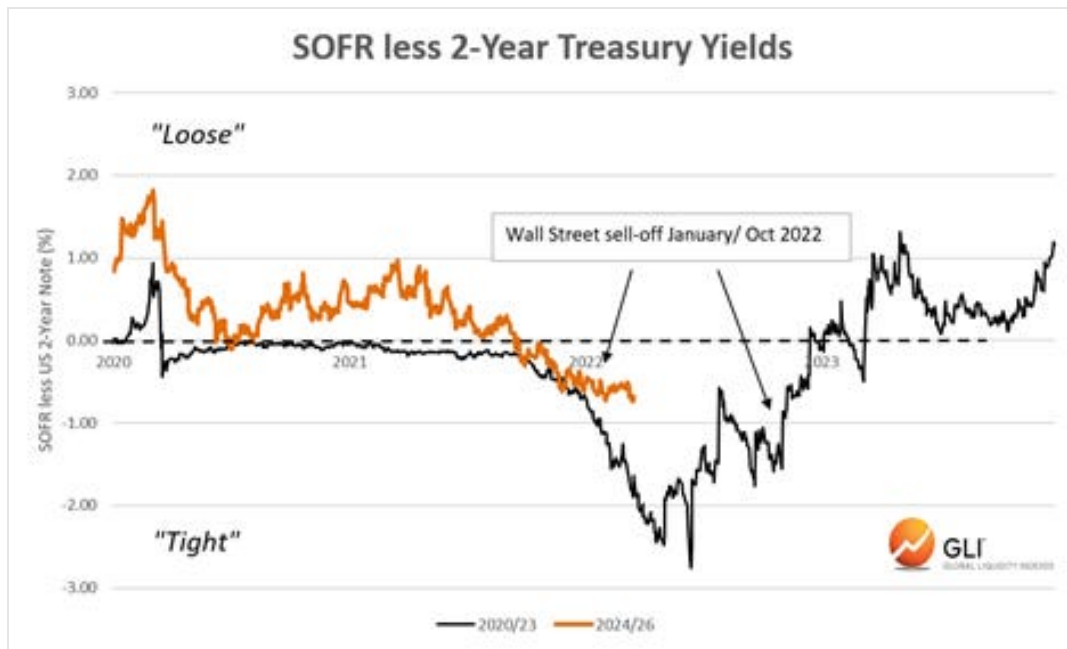
A useful test of policy success is the co-movement, shown below, between US banks' excess reserves, based on our estimates, and SOFR spreads. Excess reserves are a reasonable proxy for the surplus liquidity available in money markets. So far, the close relationship remains reassuring.



We have recently argued that a bellwether for the US policy stance is the difference between SOFR rates and 2-year US Treasury yields. The latter yield has a long history of successfully signposting the direction of policy interest rates. We noted previously that AI-based searches suggest the 2-year note is an accurate predictor around 85% of the time. The following chart sets out the relationship.

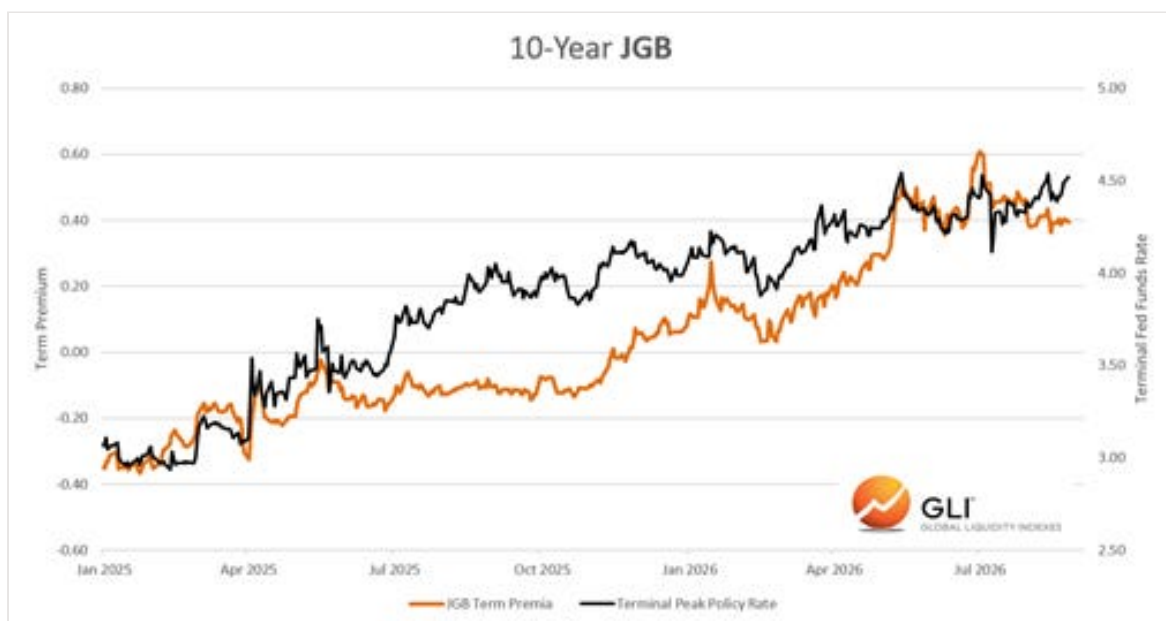


The data suggest that the bond and money markets are gunning for a US policy tightening. However, the scales still looks modest when compared to the previous 2021/22 monetary squeeze. The time to get more worried is when the orange line in the next chart drops sharply.



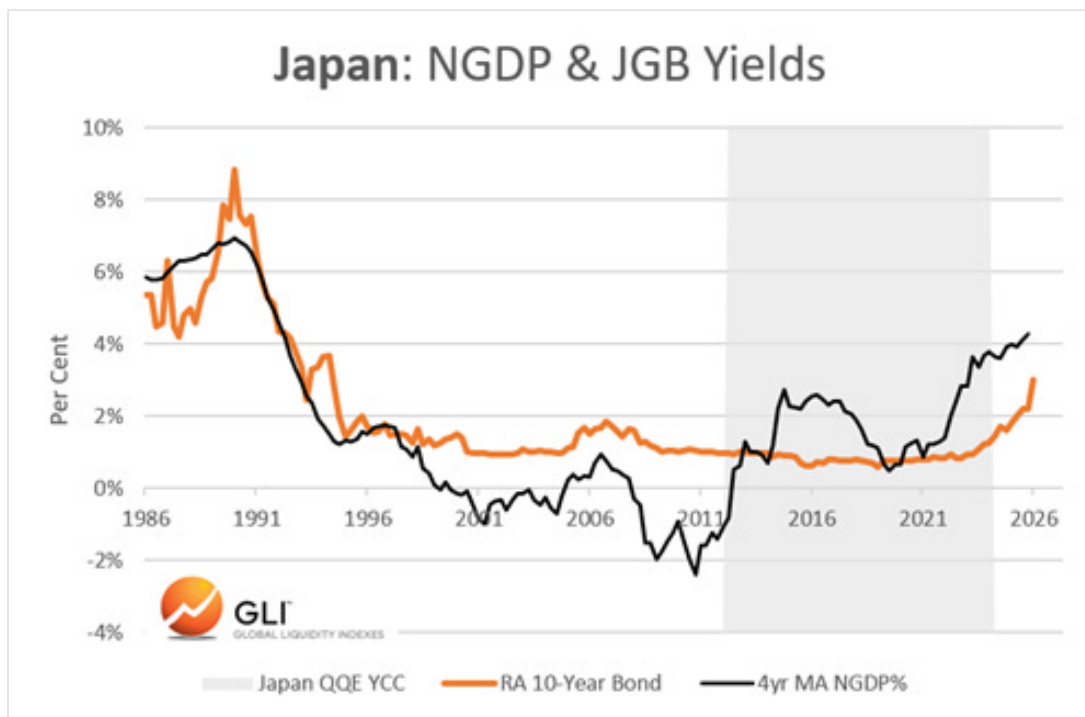
Japan: The Real Pressure Point

While the US bond market remains the focus of most investors, the greater vulnerability may now lie elsewhere. **Japan increasingly appears to be the most fragile segment of the global rates complex.** Despite joint US-Japan intervention, the yen remains under pressure and markets continue to push JGB yields higher. As in the US, this does not necessarily signal a collapse of confidence in Japanese debt. The chart below shows that Japanese bond term premia have lately flattened. A more plausible explanation is a mismatch between the economy's tempo and an equilibrium interest rate that remains far below the level markets consider appropriate.



Aided by Abe-nomics, the Japanese economy is revving faster. This plainly necessitates a higher level of bond yields. Generally, the markets are adjusting to this faster growth trend more quickly than policy makers.

Evidence the scale of the adjustment still required by Japanese yields: 10-year JGBs deserve to be testing 4% not 3%. This could throw bond investors a further 10% into the red.

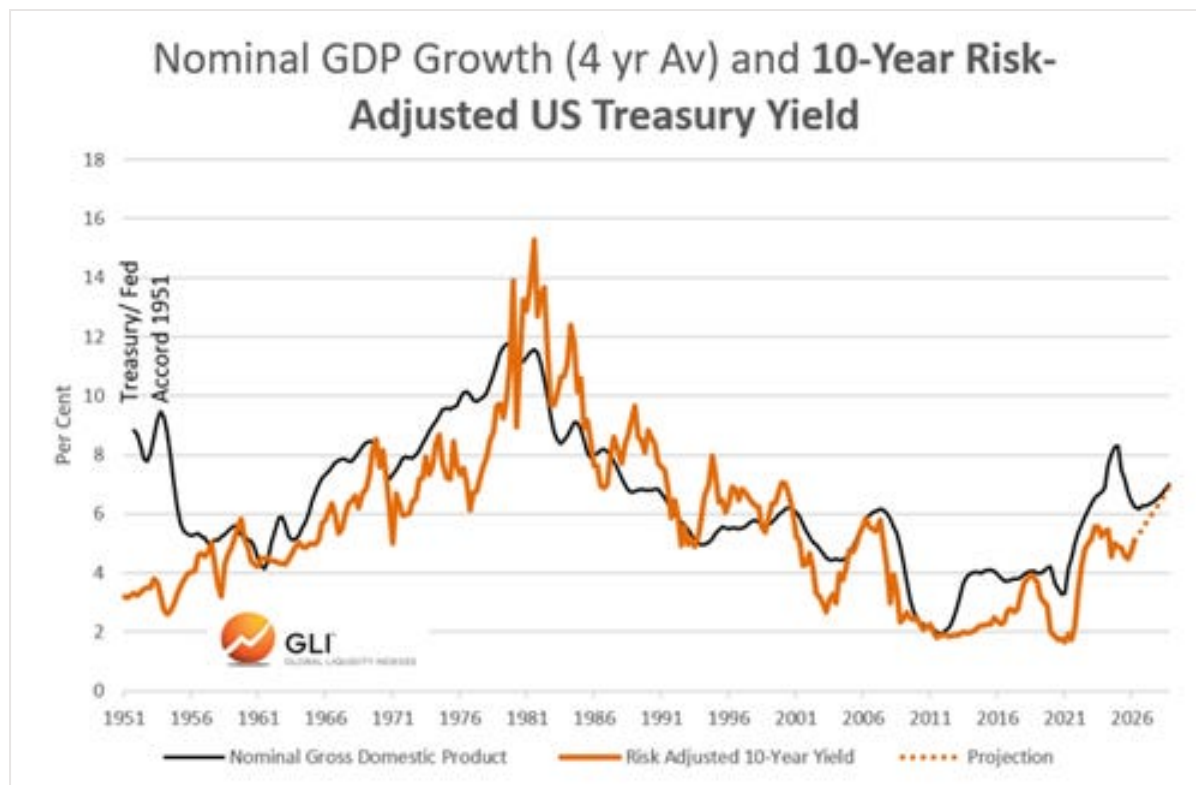


Despite these pressures, the Bank of Japan still appears reluctant to raise policy rates, yet Bessent hinted strongly at the G20 that tightening is approaching: *"I do think that we probably reached the end of Abenomics, which was a reflationary program."* But, if markets are asking for higher interest rates, why slow the economy through fiscal tightening instead?

The 1987 Parallel

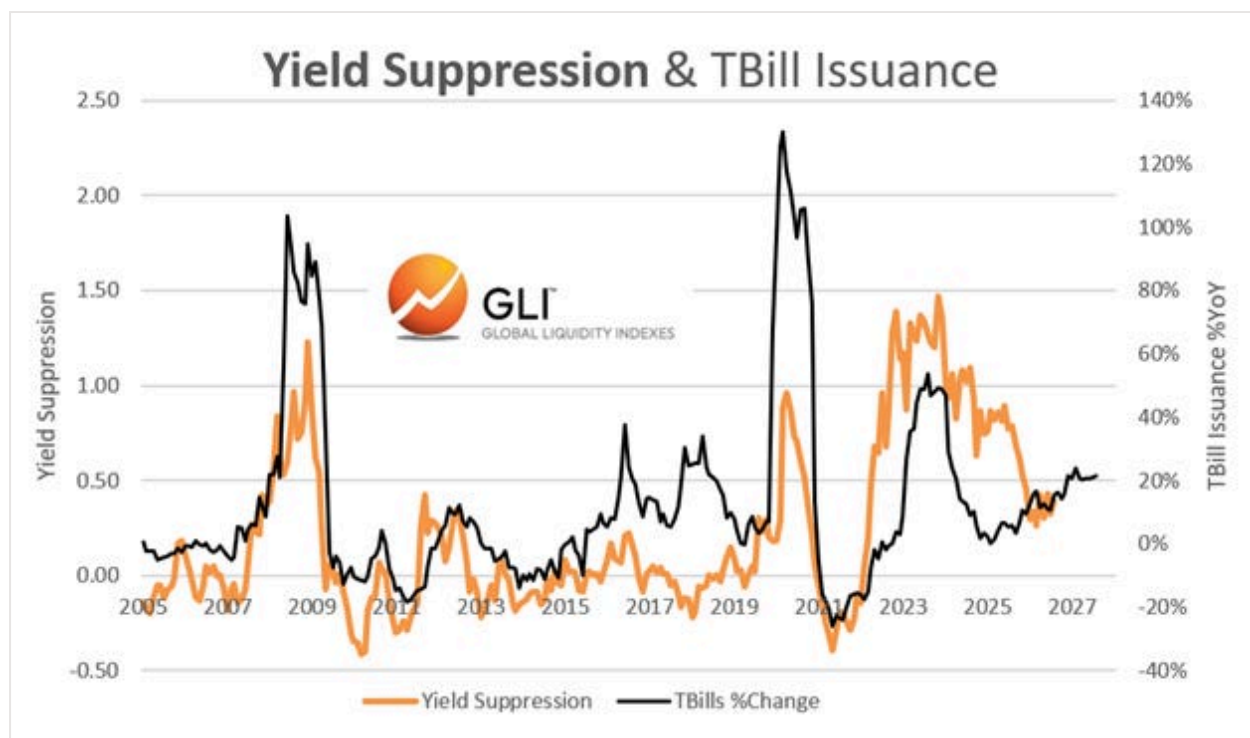
The comparison with September 1987 is uncomfortable but useful: an accelerating economy, rising inflation pressure, buoyant oil and commodity markets, higher bond yields, a weakening currency, and growing pressure from investors and foreign policymakers to raise policy rates. Crude prices, although distorted, are already equivalent to a striking US\$165/bbl when diesel prices are used for conversion. The difference this time is geography. In 1987, the stress centred on the United States. In 2026, Japan may be the focal point.

This has consequences for both US risk markets and US Treasuries, where the story is similar. The long history of US 10-year Treasury yields confirms that NGDP growth is the key axis. A faster US economy, spurred by Treasury QE and the AI-capex boom is pushing Treasuries to test 6% yields. The US economy has not grown at its current tempo since the mid-1980s when Treasury yields sat around, what now seems an eye-watering, 8%.



Policymakers are trying hard to contain bond markets by lowering term premia. Term premia respond positively to higher volatility, greater inflation uncertainty and, particularly, an excess supply of debt. This excess remains after Treasury supply meets investor demand, which in turn is highly sensitive to liquidity. Paradoxically, tighter liquidity boosts demand for 'safe-asset' bonds and lowers term premia.

However, this would derail the vital hedge fund *basis trade*, so policymakers focus instead on limiting the supply of long-dated Treasuries. The close correlation between short-dated Treasury bill supply and the suppression of Treasury yields below their benchmark, calculated from equivalent MBS, illustrates the mechanism. Investors should expect the average maturity of US debt to fall as bills rise towards a threshold of 30% of outstanding issuance.



We have warned before that this risks *monetization* because banks and credit providers tend to be major buyers of short-dated debt. The following chart estimates the proportion of US monetary growth that now reflects banks' absorption of Treasury securities, effectively bank lending to the State. More than one-fifth of monetary growth is now down to the public sector. Put simply, banks rather than the Fed are now conducting the effective QE, a process we label 'Treasury QE'.



History shows that this process ultimately ends in faster Main Street inflation. **However, the end game may not be imminent.** Faster monetary inflation takes time to feed through into the CPI basket. Put another way, by changing the goalposts, policymakers may be able to sustain the 'Treasury QE' policy for much longer. The danger sign is faster monetary growth. The chart below shows that aside from a recent blip, the underlying

growth rate of M2 is not yet a problem. **In short, if Fed Chair Warsh becomes a money-supply hawk rather than an interest-rate hawk, Treasury Secretary Bessent may be able to continue stimulating the economy well into the presidential term.**



The central message is that bond markets are not rebelling against policymakers. Rather, markets are demanding that policymakers distinguish between healthy price discovery and genuine market dysfunction.

We continue to view the investment regime as 'Speculation'. It is possible that the US policy emphasis on 'Treasury QE' keeps markets longer in this regime. Hence, while Treasury QE supports liquidity stay constructive on growth and selected late-cycle risk assets; expect structurally higher bond yields, watch Japan closely, and monitor monetary growth for signs that the longer-term inflation risk is becoming real.

Higher bond yields may be both necessary and justified in a faster-growing economy. The real challenge is preventing that adjustment from becoming disorderly. That is the "impossible thing" investors are being asked to believe before breakfast.

Disclaimer

The information is provided for information purposes only and on the basis that it will not be relied upon. No information contained herein constitutes a personal recommendation or investment advice.

The information (including any expressions of opinion or forecast) have been obtained from, or is based on, sources believed by the author to be reliable, but are not guaranteed as to their accuracy or completeness and should not be relied upon. The information is provided without obligation on the part of the author and on the

understanding that any person who acts upon it or changes his investment position in reliance on it does so entirely at his own risk. The information does not constitute an offer to buy or sell or an invitation to make an offer to buy or sell any financial instrument.

Information is current only as at the date it is first posted and may no longer be true or complete when viewed by you. All information may be changed or amended without prior notice.

No representation, warranty or undertaking is given as to the accuracy or completeness of the information by the author and no liability is accepted by the author for the accuracy or completeness of such information. In no event will the author be liable to any person for any direct, indirect, special, or consequential damages arising out of any use of the information, including, without limitation, any lost profits.

You should be aware that the Internet is not a completely reliable transmission medium. The author does not accept any liability for any data transmission errors such as data loss or damage or alteration of any kind, including, but not limited to any direct, indirect or consequential damage, arising out of the use of the product or services referred to herein.

The materials provided here including text, photographs and other images, are protected by copyright and/or other intellectual property rights. All copyright (and any other intellectual property rights) in these materials is either owned by the author, or is used by the author under licence.