

# Understanding The Bond Sell-Off

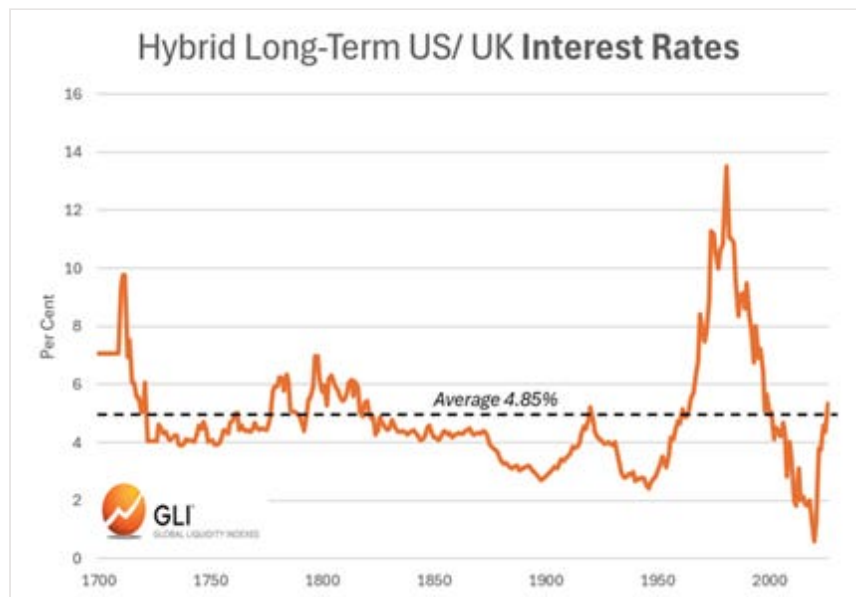
The Post-COVID Madness Is Over

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## ‘Normal’ Interest Rates Return

Sidney Homer’s classic *A History of Interest Rates* (1963) examined interest rates across five thousand years. Its great lesson for modern investors is that the ultra-low and sometimes negative rates that followed the 2008/09 *Global Financial Crisis* were historically unique.

Long-term UK and US interest-rate data tell much the same story. Over very long periods, government borrowing costs have tended to settle at levels considerably above those seen after 2008. Evidence data from US Treasury and Bank of England archives used to create a hybrid Anglo-American long-term government bond yield.



US 10-year Treasury yields have now climbed far above the sub-1% levels reached during the COVID emergency. Bonds once again offer meaningful income.

That raises an important question: **after years of financial repression, are bonds finally worth buying again?**

To answer it, we first need to understand why yields are high.

Subscribed

The popular explanation is fiscal excess. Large government deficits and heavy Treasury issuance, it is argued, are frightening investors, who are demanding a higher return for holding US government debt.

**We think that explanation misses the main point.**

The rise in Treasury yields is primarily a **nominal-growth story**, not a fiscal-risk story. That distinction matters enormously for what happens next.

A long-term bond yield can be thought of simply as:

***10-year Treasury yield = expected future short-term interest rates + term premium***

Today, our evidence suggests something more specific:

***'high' Treasury yield = 'unusually high' expected interest rates + 'unusually low' term premium***

That is counterintuitive, but it leads directly to our investment view:

- *Slower nominal growth → lower expected interest rates*
- *Tighter liquidity → greater demand for safe collateral → low or falling term premium*
- *Put the two together → lower Treasury yields*

## Fast Growth, Not A Fiscal Panic

The comparison between US and Chinese government bond yields is revealing.

The two markets have diverged dramatically. US yields are high while Chinese yields are low. It is tempting to interpret this as evidence that investors have become worried about US government finances.

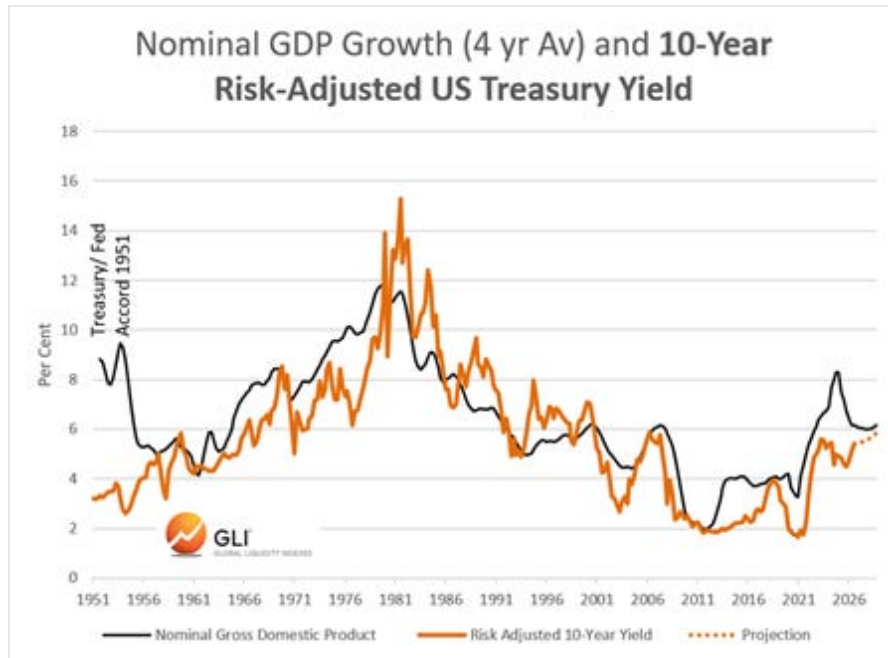
But there is a simpler explanation: **their economies are behaving very differently.**



Over time, nominal bond yields are strongly influenced by nominal economic growth. An economy experiencing stronger real growth and inflation can support higher interest rates than one suffering from weak demand and falling price pressures.

That is essentially what we see today.

Our analysis that compares nominal US GDP growth with the underlying Treasury yield suggests that current American interest rates are not particularly surprising given recent nominal economic performance. US NGDP growth is again testing levels last seen in the mid-1980s. The high pace is slated to continue.



Seen this way, the gap between US and Chinese yields says less about which government is considered safer and more about their radically different economic backgrounds.

**Low Chinese yields are principally a symptom of weak Chinese activity, not evidence that Chinese bonds have become a superior safe haven.**

## Key Points

- **The bond sell-off is mainly a growth story, not a fiscal-crisis story.** Strong US nominal growth, meaning real growth plus inflation, helps explain why Treasury yields have stayed high
- **The alleged fiscal-risk premium is simply not there.** Our estimates put the US Treasury term premium at around **1-50 basis points**. Yields are high despite a low risk premium, not because of a high one
- **Liquidity matters.** As financial conditions tighten, investors need more safe and liquid collateral. That supports demand for US Treasuries and can keep the term premium depressed
- **The cycle is becoming more favourable for bonds.** If nominal growth slows, expected policy rates should fall. If tighter liquidity simultaneously increases demand for safe assets, the term premium could remain low. **Both forces would push Treasury yields lower**

## Where Is the Missing Fiscal-Risk Premium?

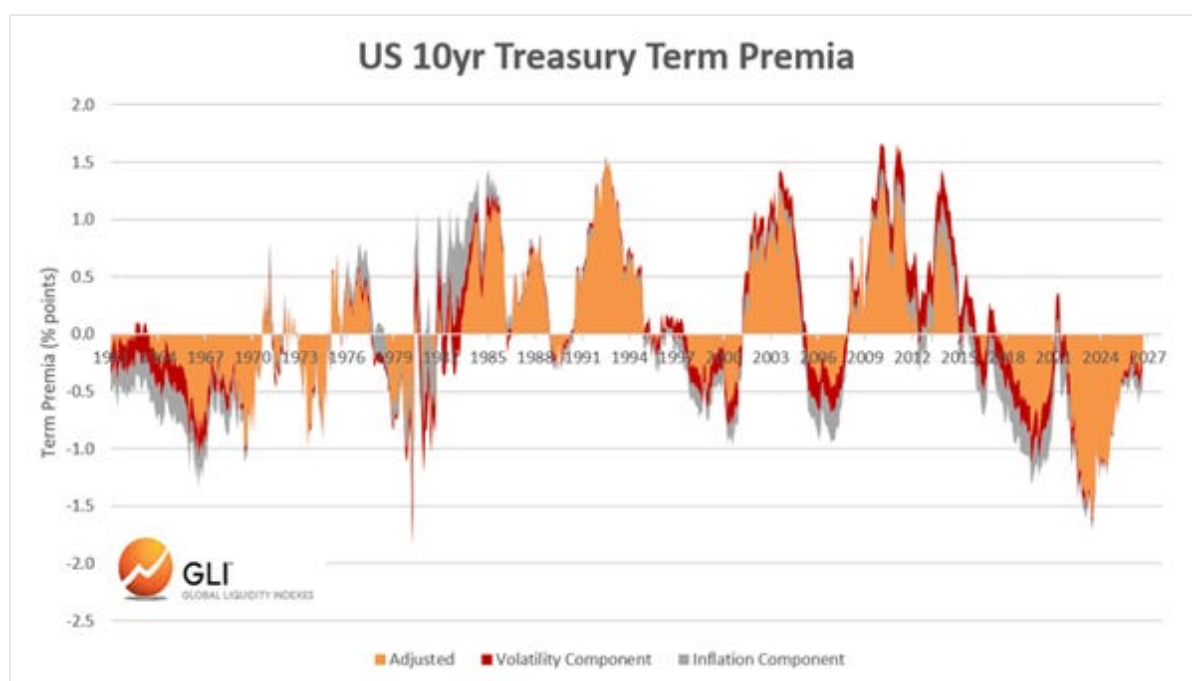
The second part of a long-term bond yield is the **term premium**. In simple terms, this is the extra return investors demand for committing their money to a long-term bond rather than repeatedly investing at short-term interest rates.

The premium should reflect uncertainties such as future inflation, bond-market volatility and whether investors are being asked to absorb too much government debt.

If the prevailing fiscal-crisis argument were correct, we would expect to see a large and rising term premium on US Treasuries.

### But we don't!

Our latest estimates suggest that the term premium is currently around **-50 basis points** and may have become more negative. This is an important result.



Hence, US Treasury yields are high despite a negative term premium, not because investors are demanding unusually high compensation for US fiscal risk.

Other approaches to measuring the term premium, including the widely followed New York Fed ACM model, differ in their construction. But after allowing for longer-term macroeconomic trends, our analysis reaches a similar conclusion on the part that matters most for today's fiscal-risk debate.

**There is little evidence of the large, persistent rise in risk compensation that the fiscal-crisis narrative requires.** The argument fails.

## Why Are Term Premia So Low?

There are two important reasons:

1. **US Treasury issuance policy** has limited the amount of long-duration debt that markets must absorb by relying more heavily on short-term bills
1. (potentially more important) **US Treasuries are not simply investments. They are the core collateral of the global financial system**

When Global Liquidity becomes tighter and refinancing becomes more difficult, financial institutions need safe, easily traded collateral. Demand for Treasuries can therefore increase precisely when financial conditions are deteriorating.

This creates an apparent paradox: **The same liquidity squeeze that creates financial stress can increase demand for Treasury collateral and push the term premium lower.**

That helps explain why worsening liquidity conditions need not produce higher long-term government bond yields.

## Why Bond Volatility Matters

Yet, there is one important complication: bond volatility.

When bond prices become more volatile, investors naturally demand more compensation for taking duration risk. That tends to push the term premium upward.

But volatility also affects the functioning of the financial system.

Treasuries support borrowing and leverage because they are widely accepted as collateral. When Treasury prices become more unstable, lenders become more cautious, require bigger safety margins and extend less balance-sheet capacity against that collateral.

In other words, **higher bond volatility reduces the amount of financial liquidity that a given stock of Treasuries can support.**

This is why the MOVE index, which measures Treasury-market volatility, matters for our Global Liquidity framework.

There are therefore two competing forces:

***Higher volatility → higher term premium***

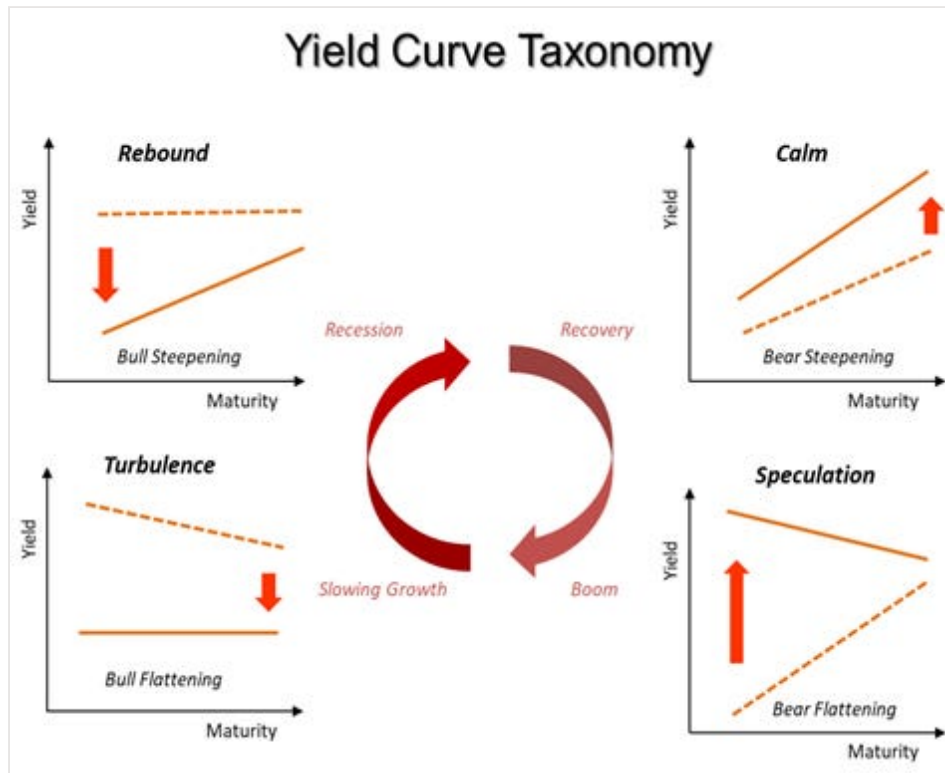
but

***Tighter liquidity and refinancing stress → greater demand for safe Treasury collateral → lower term premium***

At present, our estimates suggest that the second force is winning.

## The Global Liquidity Cycle Is Turning

This brings us to the investment cycle. Our Global Liquidity framework suggests that markets are moving from the *Speculation/Boom* phase towards *Turbulence/Slowing Growth*.



During the boom (or *Speculation*) phase, strong nominal growth keeps expectations for future interest rates elevated. That has helped keep Treasury yields high even though the term premium has remained subdued.

*Turbulence* – the next investment regime – could look very different. As growth slows, investors should begin to expect lower policy rates. Meanwhile, tighter Global Liquidity and growing refinancing pressures should strengthen demand for safe Treasury collateral.

That potentially brings **both components of the bond yield down at the same time:**

- **Slower nominal growth lowers the expected path of short-term interest rates.**
- **Greater demand for safe collateral keeps the term premium low or pushes it still lower.**

This is the key asymmetry now facing bond investors.

## Conclusion: Bonds Are Becoming Tactically Interesting Again

The latest bond sell-off does not necessarily tell us that markets have lost faith in US government finances, as many financial commentators assert.

A more straightforward explanation is that US nominal growth has been unusually strong, requiring higher underlying interest rates.

If this interpretation is correct, today's Treasury yields contain surprisingly little compensation for fiscal risk. Indeed, **yields are high despite a negative term premium.**

The bearish case for bonds therefore requires nominal growth to remain strong, policy rates to stay high and bond volatility or long-duration Treasury issuance to rise sufficiently to force the term premium higher.

The bullish case is potentially more powerful for tactical investors.

If nominal growth weakens, expected interest rates should fall. And if that slowdown coincides with tighter Global Liquidity and greater refinancing stress, demand for Treasury collateral could increase at the same time.

Already, the sensitive 10-5 year US Treasury yield spread is flattening on cue as the following chart confirms.



**A weakening economy could therefore attack today's high Treasury yields from both sides: lowering expected short-term rates while simultaneously keeping the term premium depressed.**

After more than a decade in which bonds offered plenty of duration risk but remarkably little income, the position has changed. Starting yields are once again historically respectable, while looking into 2027, the next phase of the Global Liquidity cycle increasingly points towards weaker nominal growth.

**The great bond sell-off may therefore be creating the tactical buying opportunity that bond investors have been waiting for.**

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