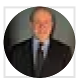
Bonds are Boring … Until They're Not!

Overall, my guess is it's more likely bond yields will decline significantly during the balance of 2026 than it is that a bond vigilante will bring justice to the financial markets.



JIM PAULSEN
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High-quality bonds usually provide steady predictable income and small price movements and consequently are considered safe but boring investments. But bonds are boring … until they're not!

Recently, bond yields have risen aggressively and taken center stage in the financial markets. Since the end of February, the 10-year U.S. Treasury yield rose from under 4% to almost 4.75% while the 30-year Treasury yield jumped from about 4.6% to 5.3%. Several reasons have been offered for why the bond market recently stopped being boring and suffered a relatively severe decline.

First, total U.S. government debt has surpassed $40 trillion causing many to fear that the government bond supply is surging out of control. Evidently, this has awakened the elusive "bond vigilante" that supposedly periodically steps in as an uncoordinated, market-driven check on government spending and inflation by selling off government bonds. Like Big Foot here in Minnesota, although nobody has ever seen the "feared" bond vigilante, he nonetheless is often held responsible whenever bond yields rise.

Second, disruptions from the conflict with Iran have again driven oil prices higher adding to persistent inflationary fears. Third, a massive wave of corporate borrowing—including heavy debt issuance for artificial intelligence infrastructure—has flooded the market and tested investor capacity. Fourth, higher borrowing costs in the U.S. have dragged up government bond yields in major economies across the globe including the UK, Japan, Germany, and France. And finally, newly seated Federal Reserve Chairman Kevin Warsh has impacted the rise in bond yields primarily by moving away from traditional forward guidance and leaving investors uncertain about how the central bank will respond to inflation.

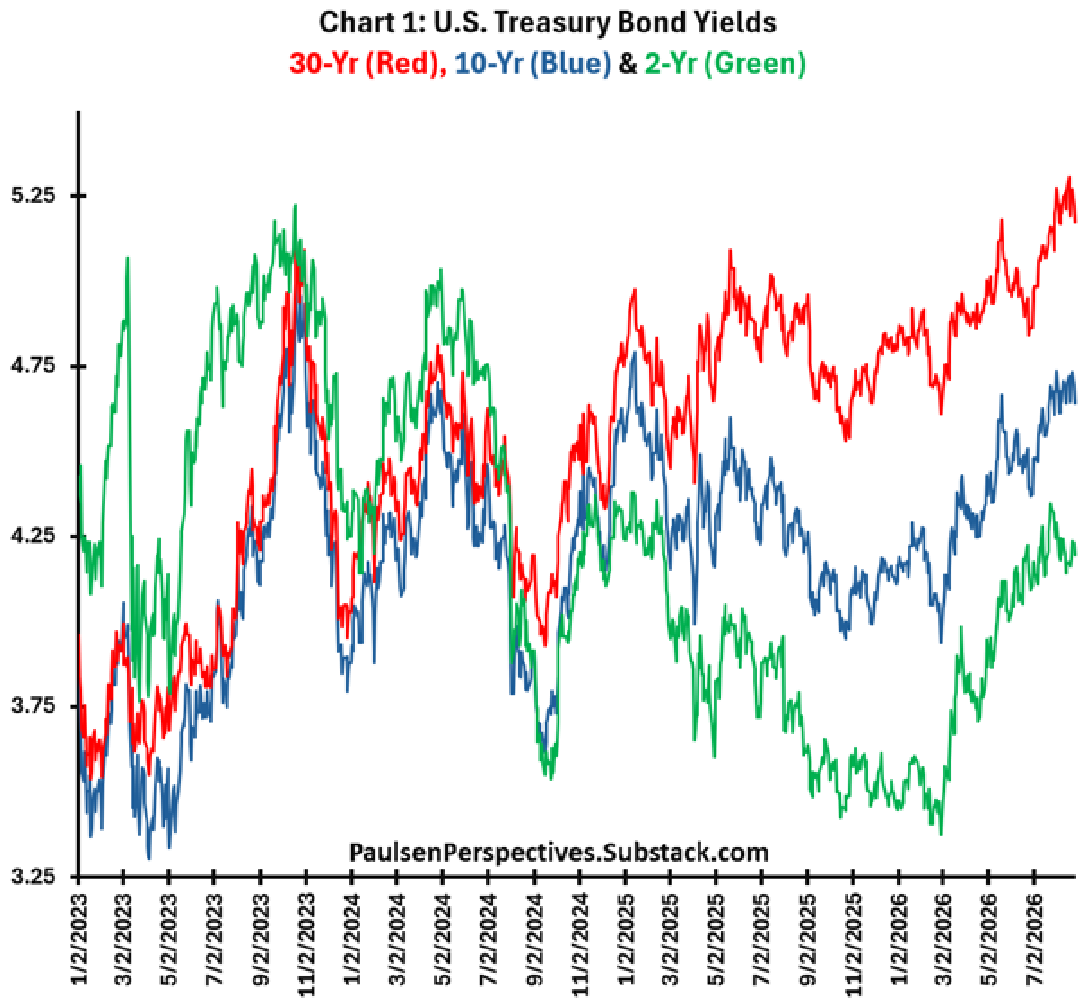
This all sounds disturbing and investors now fear that the 30-year bond yield could soon breach 5.5% and attack 6% leading to increased borrowing costs and much greater economic uncertainty. Far too much excitement for boring bond holders!

Although nobody, including myself, knows for sure where bond yields are headed, for a number of reasons discussed below, I think the upside risk in the yields is far more limited than currently feared. Indeed, my guess is bond yields may be poised to surprisingly "decline again" during the balance of this year.

Bond yields essentially still remain range-bound

Despite all the recent hubbub, Treasury yields continue to trade within the same range they have since 2022. Yes, during this time they have fallen to the low end of this range and have sometimes scared investors by rising to the upper end of this range -- as they are again recently.

Chart 1 shows the 2-year, 10-year, and 30-year Treasury bond yields since 2023. While the 2-year yield has risen significantly since the end of February, it still resides near the mean of its trading range since the end of 2022. The 10-year Treasury yield reached a high of 5% in October 2023, reached about the same level as today in April 2024, and rose to a peak of 4.8% in January 2025. Yes, the 10-year yield has again risen to the high end of its multi-year trading range but, like the two-year yield, has not broken out of this range. Finally, although the 30-year yield has risen to a new-high in recent weeks, it currently is still not much higher than where it has traded different times during the last four years. For example, currently the 30-year yield is about 5.17% -- it reached 5.11% in October 2023 and since has breached 5% several times



Rather than breaking out to a significant new higher trading range, “Treasury bond yields” appear to simply once again be trading near the upper-end of a prolonged 4-year trading range as it has several times in recent years. Since 2022, whenever bond yields have risen to the upper end of this range, investors have feared they may be breaking higher, but as discussed below, contemporary downside pressures may prove too great for yields to rise much further.

Real U.S. Economic Momentum is Slowing

Bond yields will have a difficult time rising much further given that significant aspects of the economy have recently begun slowing again. In recent months, retail sales growth has moderated, and employment gains have slumped near zero again, consumer sentiment declined in August despite already being near post-war lows, and housing activity remains punk. Sluggish real activity should at least keep a lid on further yield gains and may open the possibility of a surprising decline in yields. Consider the following charts.

Chart 2 overlays the Citi U.S. Economic surprise index (red line, right scale) with the 10-year Treasury yield since 2023. Throughout this bull market, there has been a fairly close relationship between changes in real economic momentum (as proxied by movements in the surprise index) and movements in the 10-year yield. Indeed, often the U.S. surprise index has been a leading indicator for the 10-year yield. From late last year to its peak in June, the U.S. surprise index surged from about -5 to +63 suggesting that stronger real economic momentum helped push the 10-year yield from below 4% in February to near 4.7% today. Nonetheless, from its June high, the surprise index has collapsed and is currently near 25 suggesting a significant slowdown in real economic momentum. It appears doubtful bond yields can keep rising much higher – and indeed they may succumb to slower growth and soon surprising decline – with real economic momentum now downshifting. Rather than surging above 5%, the current U.S. economic surprise index suggests the 10-year yield may soon fall close to 4.25%.

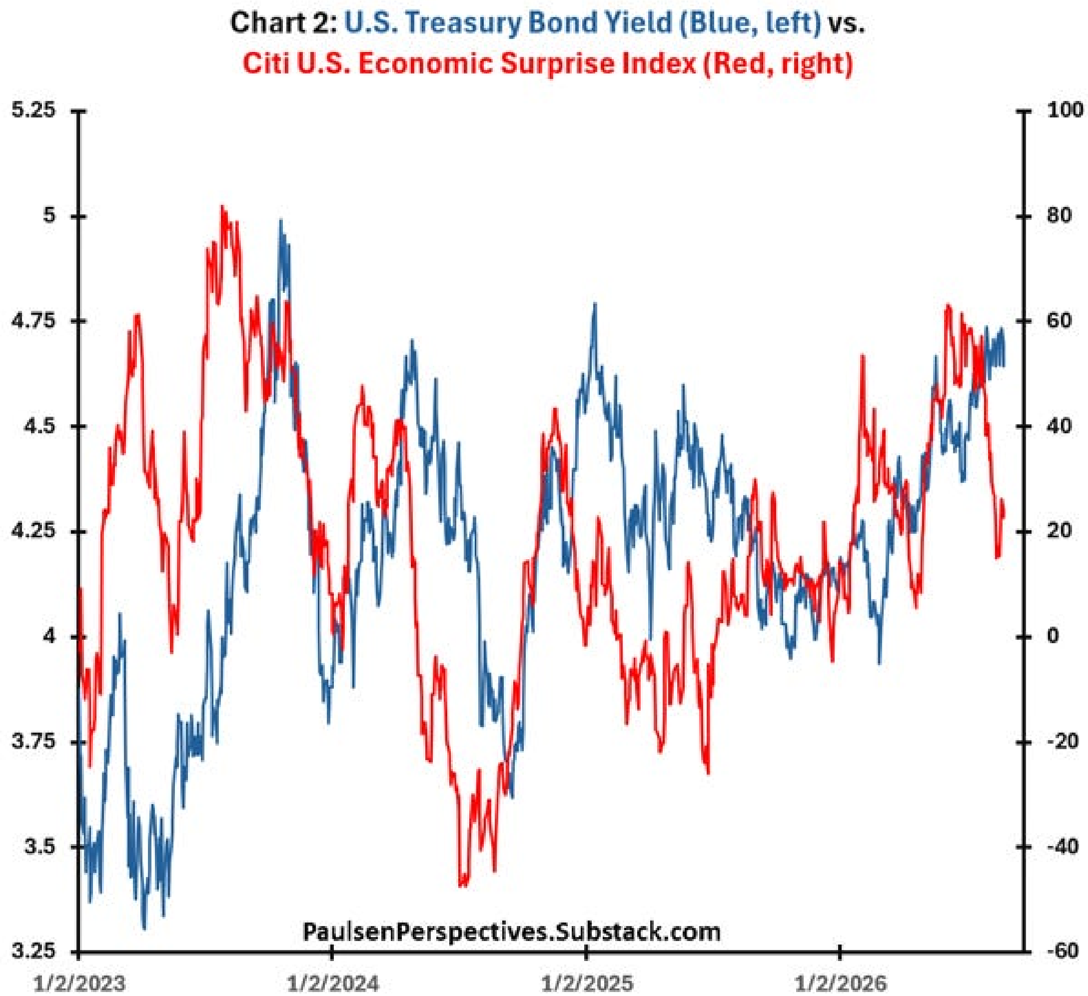


Chart 3 compares the annual growth in the Conference Board's Coincident Economic Indicator (COI) based on four key economic variables which track real economic activity – payroll employment, personal income less transfer payments, manufacturing & trade sales, and industrial production. It's relationship to the 10-year yield has had a fairly close "directional" relationship. That is, the directional movements in the annual growth of the COI Index have tended to move closely with the directional movements of the 10-year yield. At its peak in late-2023, the COI index was growing close to 2.5% but has subsequently weakened to just 0.5%. Currently, the 10-year yield is nearly equal to its level in late-2023, despite the fact that the COI annual growth has slowed from 2.5% to 0.5%. If yields do keep rising (unlikely in my view), the annual growth in the COI index will likely be forced below zero perhaps indicating recessionary possibilities.

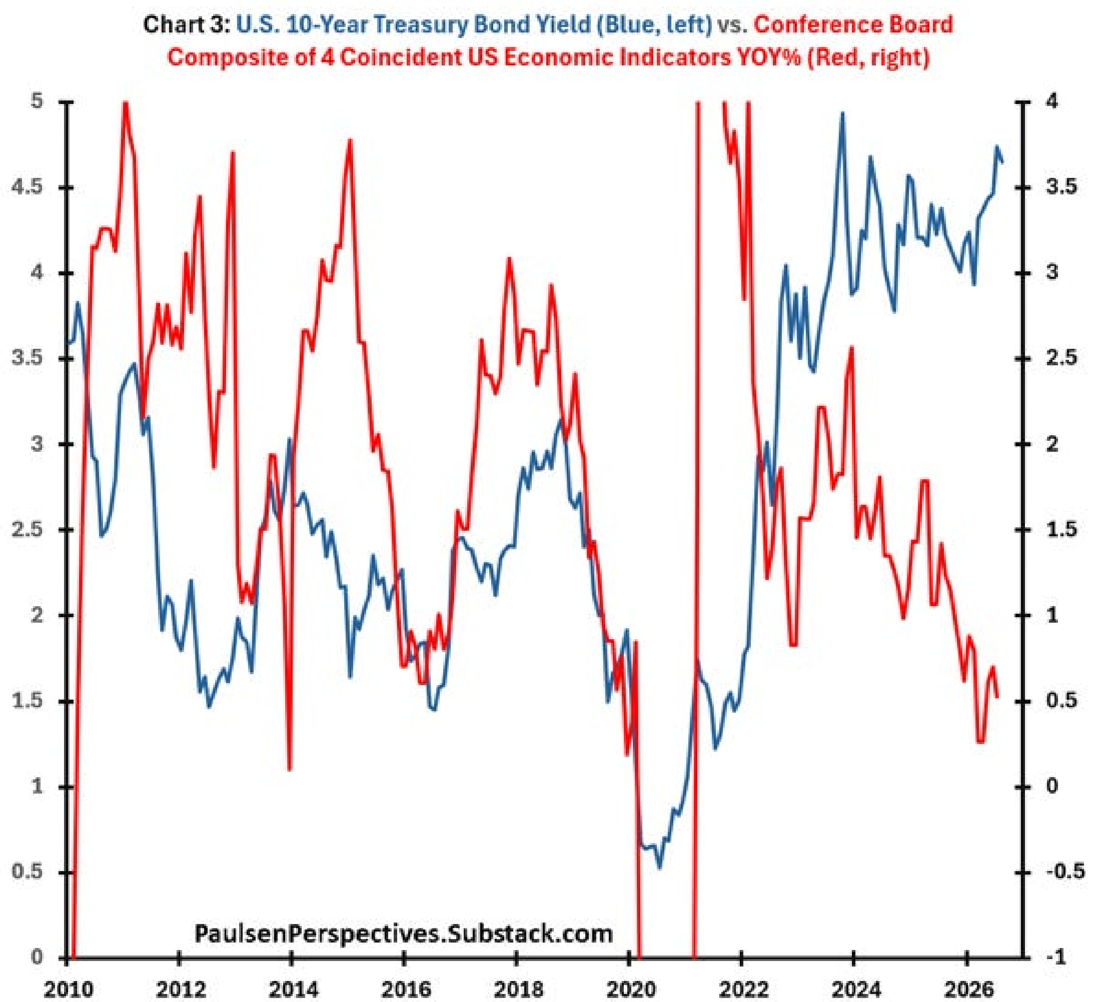
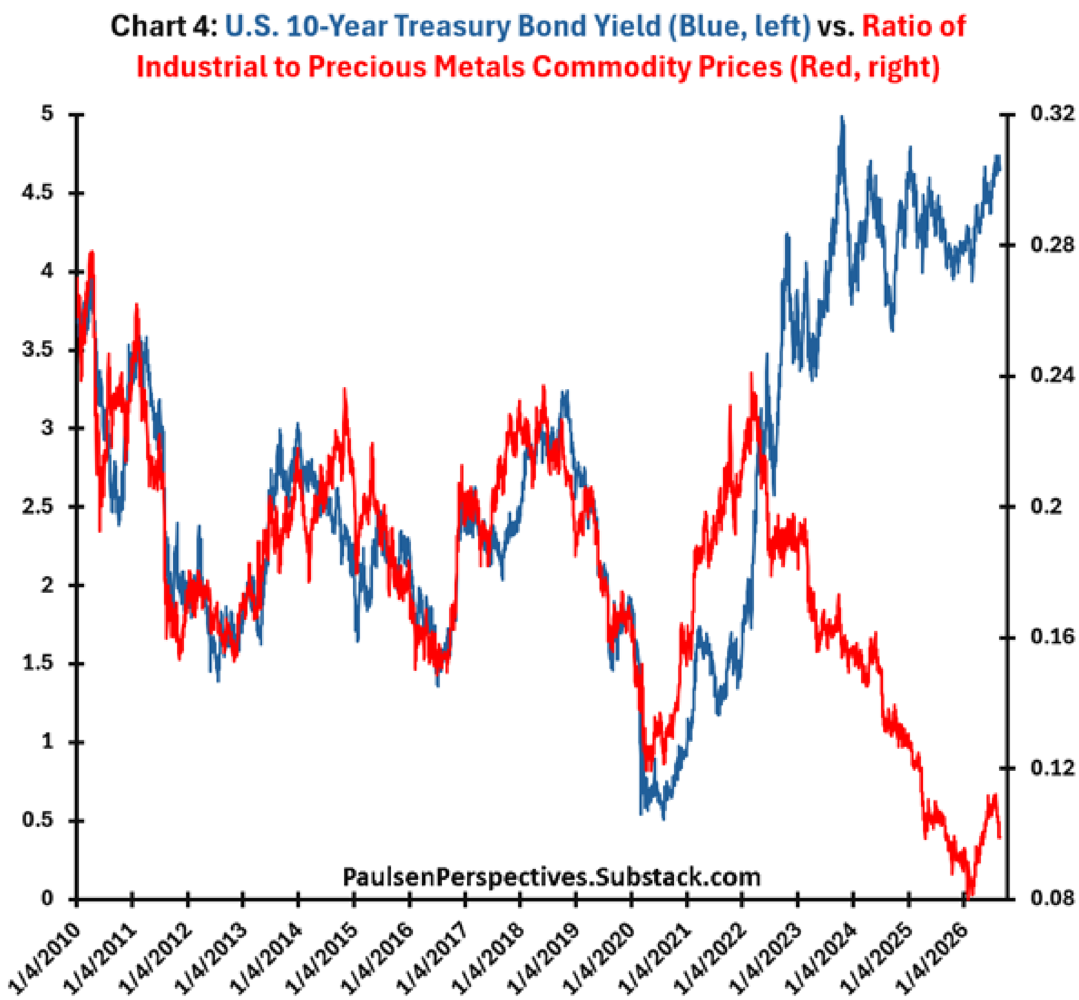


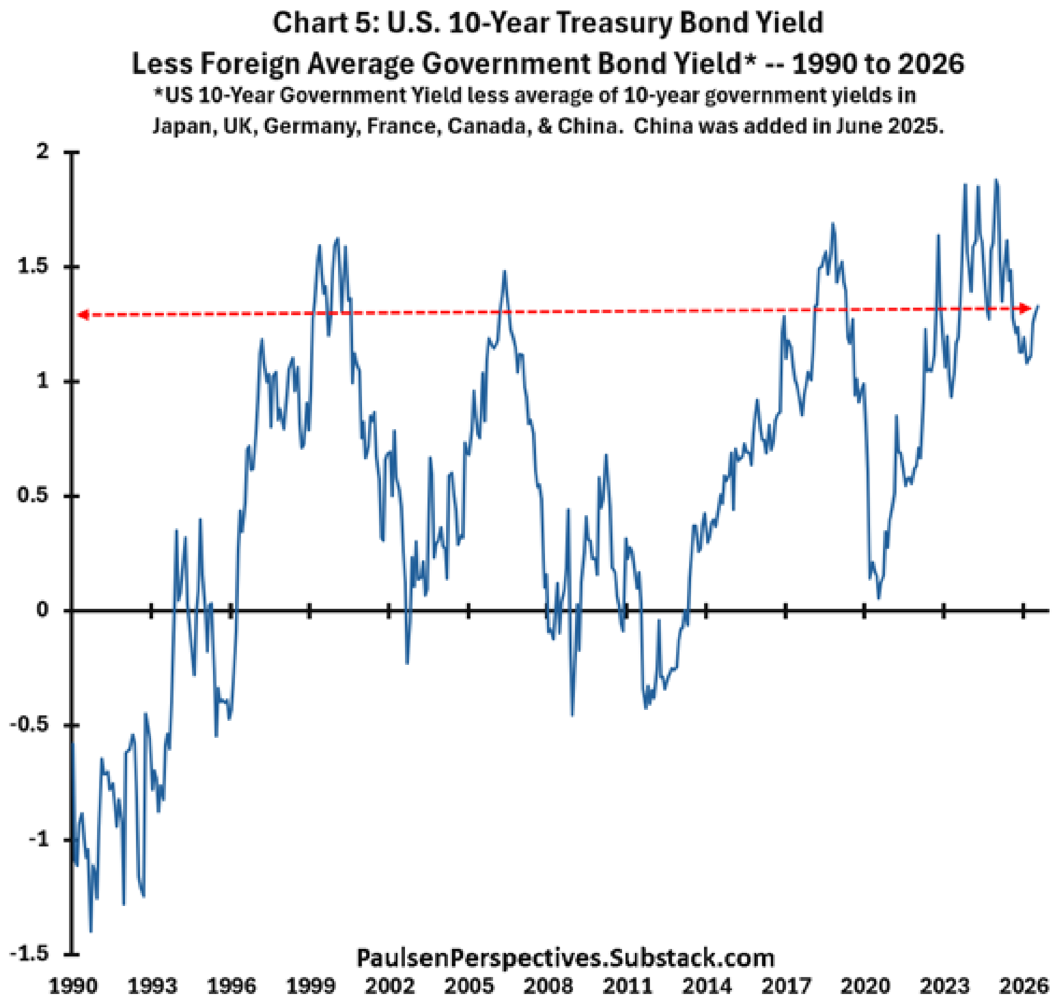
Chart 4 provides another indicator suggesting that yields are becoming increasingly “out of whack” with the temperature of real economic activity. This chart overlays the 10-year yield with the ratio of industrial to precious commodity prices. The ratio of industrial to precious commodity prices is a proxy for real economic activity. Typically, when real economic growth is improving, precious metals prices like gold & silver decline as fears dissipate while industrial commodity prices tend to rise as economic activity becomes more robust. That is, this ratio rises as economic momentum improves and declines when real economic growth weakens. As demonstrated, between 2010 to 2023, bond yields and the industrial/precious commodity price ratio were joined at the hip. Since 2023, however, bond yields have remained mostly between 4% to 5% despite the commodity price ratio perpetually declining signaling weaker economic activity. Note that the commodity ratio did rise strongly from the end of last year until the end of July but has subsequently been declining again. If the commodity ratio keeps declining indicating a weaker trend of economic activity, the 10-year bond yield should eventually start declining to reconnect with the commodity price ratio.



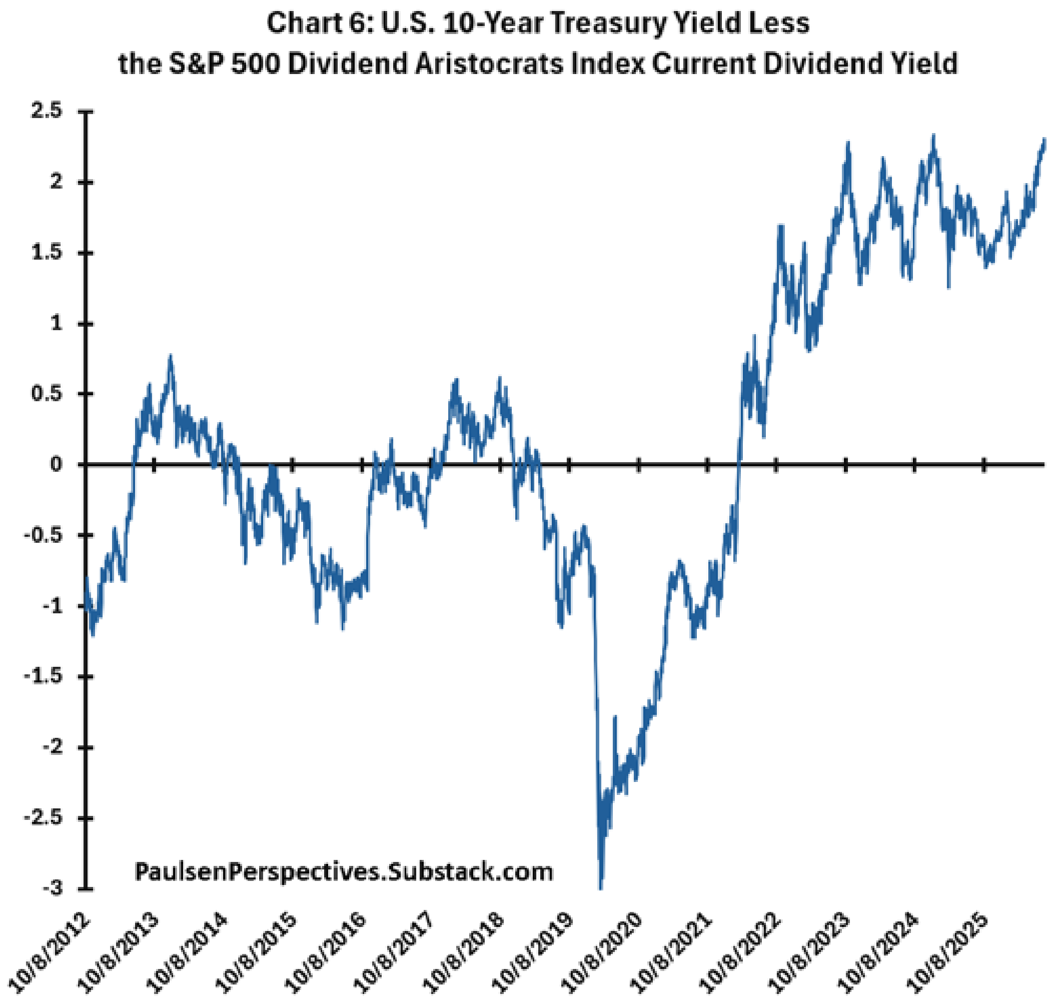
Overall, unlike earlier this year when the surprise index and the commodity ratio were both rising, these three real economic indicators are now simultaneously suggesting it will be difficult for yields to rise much further when real economic activity is again slowing.

Key U.S. Yield Spreads Point to Peak Yields

As indicated in chart 5, the current U.S. 10-year yield is already priced quite aggressively relative to foreign government 10-year bond yields. At its current level, the U.S. 10-year Treasury yield is about 1.33% above the 10-year foreign yield average which is a greater yield spread than almost 80% of the time since 1990. It's possible U.S. yields could rise somewhat higher, but unless global yields all rise together, additional upside for U.S. yields appears limited. Moreover, the 10-year U.S. bond yield could actually decline or continue trending sideways even if foreign yields rise and still be well within a conventional relative range compared to foreign government bond offerings.



Similarly, as demonstrated in chart 6, the current U.S. 10-year bond yield is at a record high relative to the dividend yield offered by the S&P 500 Dividend Aristocrats Stock Price Index. Compared to yield offering in the stock market, the 10-year bond yield appears much more likely to decline than to keep rising.

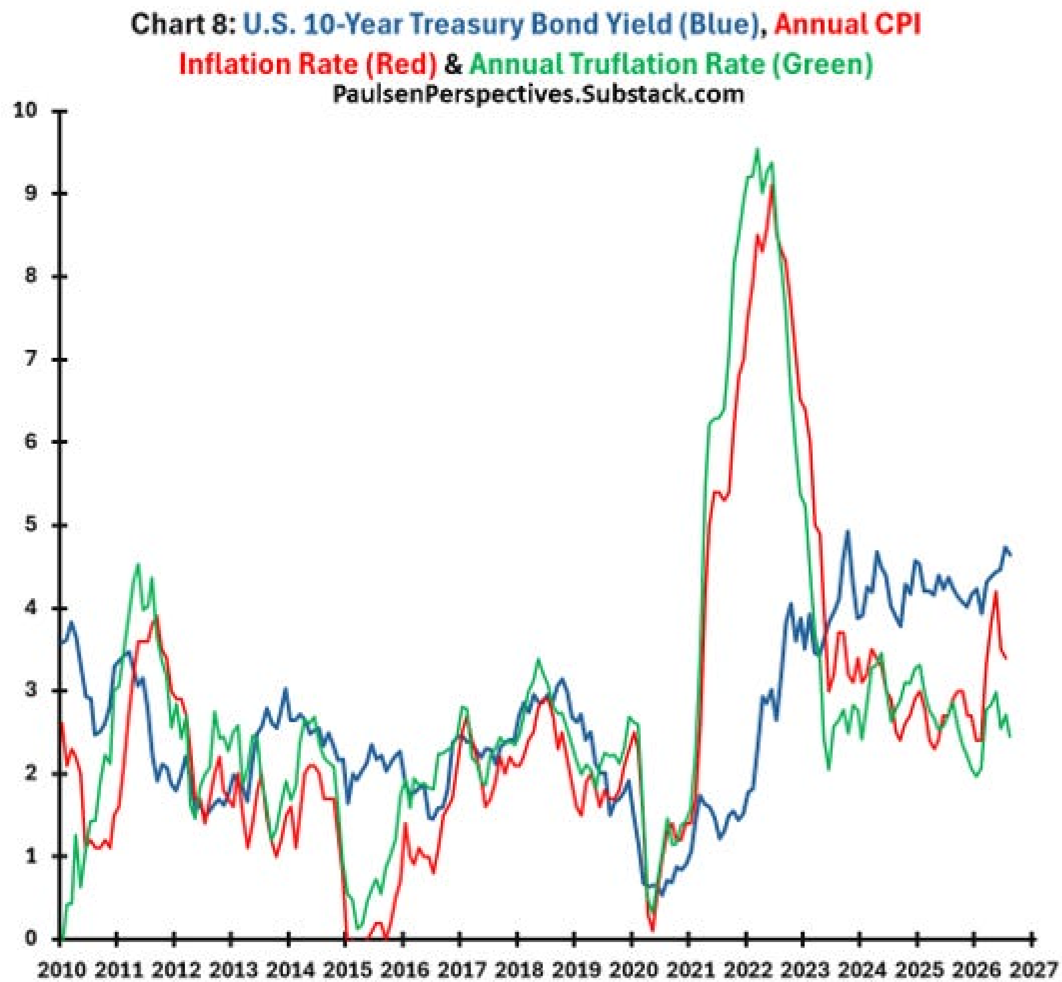


The U.S. Dollar would become Oppressive should the 10-year yield keep rising

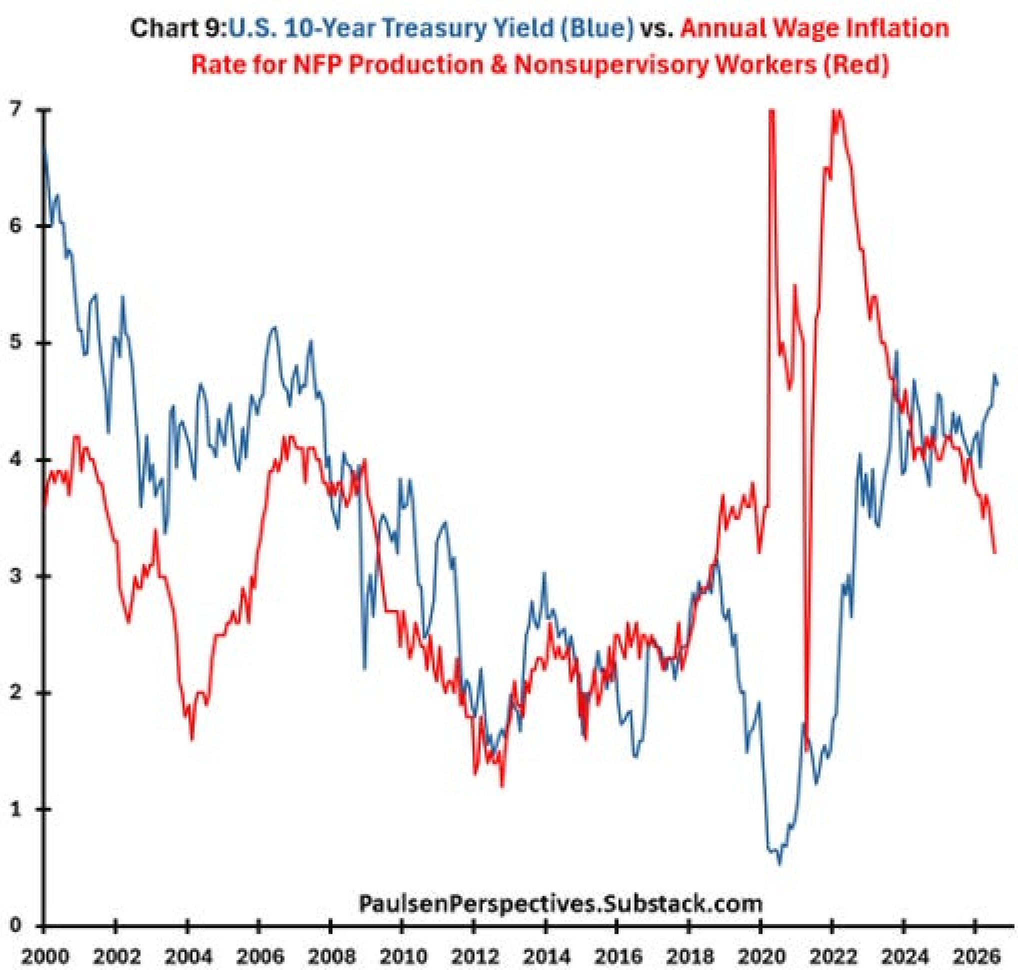
As illustrated in chart 7, should U.S. Treasury yields keep climbing the value of the U.S. dollar will likely become oppressive, severely curtailing U.S. international competitiveness and significantly further slowing overall real GDP growth. This chart overlays the "real" 10-year yield with the real U.S. dollar index since 1970. While far from a perfect relationship, higher real yields have clearly been associated with a stronger dollar and vice versa. Currently, the real U.S. dollar is only about 9% from its record high and is currently higher (more contractionary) than 91% of the time since it was first floated in the early-1970s. Continued gains in the 10-year U.S. Treasury yield (particularly when the pace of inflation appears to be moderating) would possibly send the value of the U.S. dollar to all-time records highs effectively destroying U.S. business global competitiveness. That is probably not likely to happen.

Inflation is Moderating

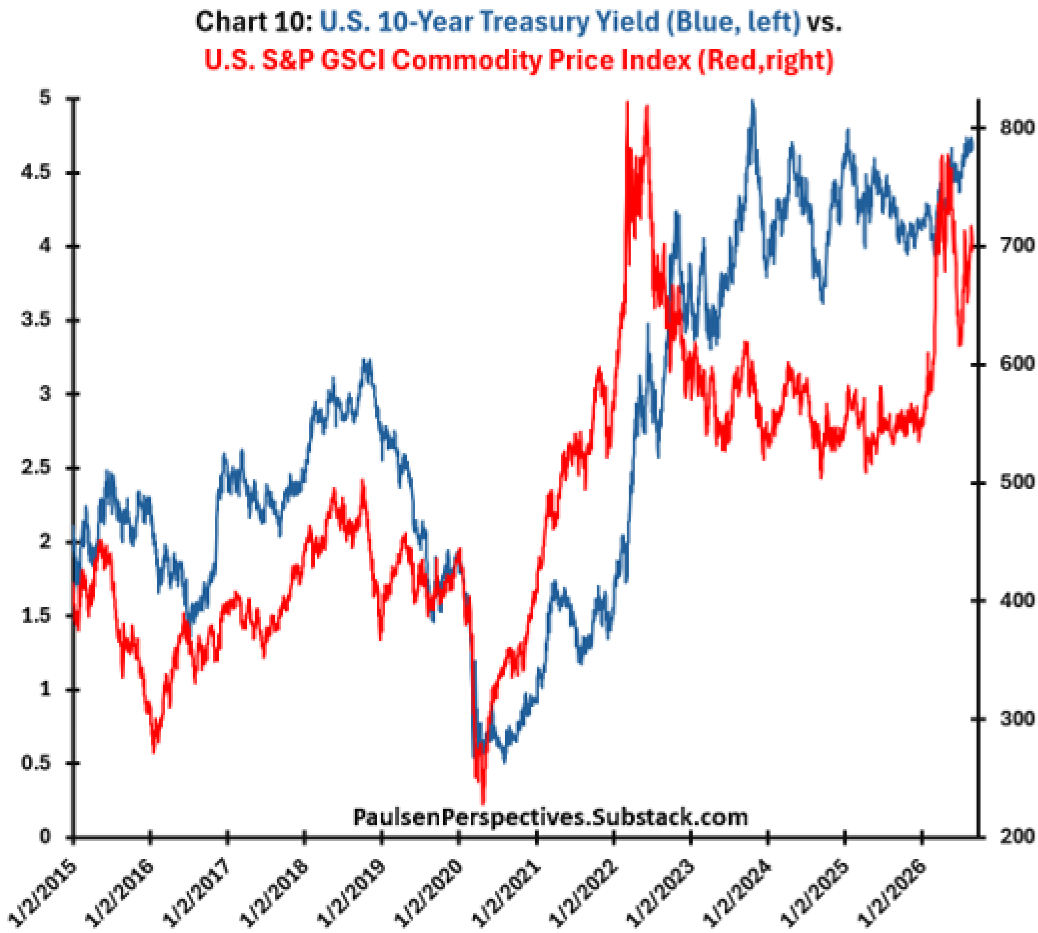
Perhaps the primary reason U.S. bond yields have remained in a trading range since 2023 is because so have most aggregate inflation measures. Chart 8 compares the 10-year yield with the annual rate of consumer price inflation and a daily measure of the CPI provided by Truflation. Yes, the CPI inflation rate rose for a brief period earlier this year but it has since moderated during the last two months to just 3.4% and is poised to moderate further in the upcoming months due both because of slowing real economic activity and because oil prices have been flat now since early March. The Truflation rate (a daily measure of the BLS's monthly CPI measure) at 2.4% has remained in the same range since 2023. It will likely prove difficult for the 10-year Treasury yield to keep rising much higher when both CPI inflation and the Truflation measure are again moderating and poised to weaken further.



In a similar fashion (shown in chart 9), annual wage inflation has been slowing rather dramatically since early-2025 and has now declined to just 3.2% suggesting there is room for 10-year yields to decline in the coming months. How are bond yields going to keep rising when real economic momentum is slowing and “both” wage and CPI inflation are moderating?



Finally, as illustrated in chart 10, the 10-year yield has a close relationship with commodity prices. Indeed, the rise in U.S. commodity prices led by a surge in crude oil prices has been a primary driver pushing yields higher this year. However, overall U.S. commodity prices have currently declined by more than 10% since they peaked in early April. If oil prices spike materially above when there peaked earlier this year, then perhaps bond yields will again feel some upside pressures. But currently, oil prices have been trending sideways since March and overall commodity prices have fallen by 10%, significantly moderating most of the pressure put on bond yields earlier this year.



Final Comments

Much of the contemporary anxiety surrounding U.S. bond yields is based on two primary worries. Uncertainty surrounding whether the Fed has the desire and the resolve to adequately lower inflation and with horror stories about how burgeoning government deficits could unleash a powerful bond vigilante myopically focused on delivering "justice and pain" in the form of much higher yields until the government finally gets its financial house in order. Fearing a lack of clarity about Fed messaging and worrying about a bond vigilante is one way to consider the future of the bond market.

However, I think a more reasonable assessment of contemporary bond yields should be based on trying to eliminate the political-biases and emotion surrounding Fed guessing and vigilante sightings. Investors should simply consider how bond yields could move much higher when real economic activity is slowing, when key yield spreads already appear too high, when the U.S. dollar is already at a contractionary level, and when U.S. inflation is already moderating and likely to slow further in the coming months?

Overall, my guess is it's more likely bond yields will decline significantly during the balance of 2026 than it is that bond vigilantes will wreak havoc by finally bringing justice to government spending and upend the financial markets.

Thanks for Taking a Peek! Jimp