

Bond yields at 5 Questions investors should ask now

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Key points:

- A 5% Treasury yield changes the risk-return trade-off. High-quality bonds may now provide enough income to play a larger role for investors focused on income, capital preservation or nearer-term financial goals.
- But 5% is a nominal yield. Inflation, taxes and, for non-US investors, currency movements can materially change the return investors actually experience.
- This is not simply a choice between bonds and equities. Time horizon, required return and tolerance for losses should determine the mix, while other diversifiers can also matter when stocks and bonds fall together.

The US 10-year Treasury yield briefly crossed 5% on 14 September, the first time since October 2023. Higher energy prices, renewed inflation concerns, expectations for tighter Federal Reserve policy and concerns around US government borrowing have all contributed to the rise.

At the same time, equities have faced fresh volatility as calls from leading AI executives to slow the pace of AI development triggered a sharp selloff in semiconductor and AI-linked stocks.

Together, these developments are reviving an important portfolio discussion: what role should bonds play when high-quality government debt offers yields around 5%?

1. What pushed the US 10-year Treasury yield to 5%?

Higher energy prices have revived inflation concerns, while resilient economic activity and stronger inflation data have increased expectations that US interest rates may need to remain restrictive. August consumer inflation accelerated to 3.4% year-on-year.

Investors are also being asked to absorb substantial amounts of new debt. Large US fiscal deficits continue to increase Treasury borrowing, while the AI investment boom is adding another source of supply. Technology companies and other borrowers are issuing significant amounts of debt to finance data centres, power infrastructure and AI-related investment.

This means today's yield move is about more than the next Federal Reserve decision. Inflation, fiscal borrowing and a growing demand for capital are all competing for investors' money.

2. Could bond yields rise further?

Yes. Five percent is an important psychological level, but it is not a ceiling.

Yields could move higher if inflation remains persistent, oil prices stay elevated, growth remains resilient, the Federal Reserve tightens further or investors demand greater compensation for absorbing heavy government and corporate debt issuance.

Equally, weaker economic growth or a more convincing moderation in inflation could eventually pull yields lower.

Yields around 5% change the relative return available from high-quality bonds and therefore provide a useful point at which to reassess the trade-offs between fixed income, equities and other assets.

3. Does a 5% yield mean investors will earn 5% every year?

A bond's quoted yield provides an indication of the annualised return available under certain assumptions, including holding the bond to maturity and receiving the promised payments.

But its market price can fluctuate considerably before then.

If an investor buys a bond when yields are 5% and yields subsequently rise to 5.5%, the existing bond becomes less valuable and its price falls. An investor who has to sell before maturity could therefore realise a loss.

If yields fall, the reverse occurs and the bond's price could rise.

So 5% should not be interpreted as a guaranteed 5% portfolio return each year, unless the bond is held to maturity and assuming the issuer makes all promised payments and coupon income can be reinvested at the assumed rate.

4. Should investors consider securing today's 5% yields for longer?

For investors looking for income or greater visibility over future nominal cash flows, current yields may warrant consideration.

However, identifying the exact peak in yields is extremely difficult. Inflation, fiscal risks and additional bond issuance could still push yields higher.

Rather than making an all-or-nothing timing decision, some investors may consider spreading exposure across different maturities or gradually building a bond allocation.

The appropriate approach depends on when the money will be needed and how much interest-rate volatility the investor can tolerate.

5. If I hold the bond to maturity, haven't I removed the risk?

You have removed some uncertainty, but not all of it.

Holding an individual high-quality bond until maturity can reduce the importance of interim price movements. If the issuer makes all promised payments, the investor receives the coupons and principal repayment.

But there is another risk that is easier to overlook: purchasing power.

Suppose \$100 buys a certain basket of goods today. If inflation averages 3% for ten years, that same basket would cost roughly \$134. Receiving \$100 back at maturity therefore does not give the investor the same spending power they had ten years earlier.

The investor has received exactly the number of dollars promised — but those dollars buy less.

This is why capital preservation in nominal terms is not the same as preserving wealth in real terms.

6. If bonds yield 5%, why still own equities?

Because bonds and equities solve different investment problems.

Bonds generally provide greater visibility over nominal income and repayment. Equities offer much less certainty but greater potential for revenues, earnings and dividends to grow over time.

That growth becomes particularly important for investors with long horizons because inflation compounds as well.

A 5% bond yield against 3% inflation, for example, leaves roughly 2 percentage points of return before tax in simple inflation-adjusted terms.

Equities are not guaranteed to beat inflation. High inflation can squeeze company margins, raise financing costs and put downward pressure on valuations.

But over long investment horizons, companies have the potential to grow earnings and prices, giving equities greater potential to build real purchasing power.

The distinction is useful: bonds offer greater visibility over nominal returns. Equities offer greater potential for long-term real growth.

7. Does the AI selloff strengthen the argument for bonds?

It strengthens the argument for reviewing portfolio concentration rather than automatically moving from equities into bonds.

The recent AI selloff followed calls from industry leaders for greater caution around the pace of advanced AI development. The Philadelphia semiconductor index fell 5.9% on Monday as investors reassessed expectations around AI growth.

We would be cautious about interpreting this as an immediate end to the AI investment cycle. Competition between companies and countries remains intense, and infrastructure spending may continue even if model development becomes more regulated or deliberate.

- First, expectations embedded in AI-related equities are already high, making those stocks more sensitive to disappointment.
- Second, higher bond yields increase the return available outside equities and raise the discount rate applied to future corporate earnings.

For investors whose portfolios have become heavily concentrated in technology and AI, this may strengthen the case for broader diversification.

8. What factors should investors consider when comparing bonds and equities?

The significance of a 5% bond yield will differ across investors.

Rather than using age, retirement status or risk tolerance to prescribe a particular allocation, investors can consider how different assets behave relative to their own objectives.

Bonds generally offer greater visibility over future nominal cash flows, but their prices can fluctuate and inflation can reduce the purchasing power of those payments.

Equities offer less certainty and greater short-term volatility, but they also provide greater potential for long-term capital and earnings growth.

Other factors include when the capital may be needed, the return required to meet financial objectives, existing portfolio concentrations and exposure to inflation or currency movements.

For someone approaching retirement or funding a major expense within several years, today's bond yields may make fixed income more relevant.

For an investor saving for retirement several decades away, inflation and long-term capital growth remain bigger considerations. Bonds may complement equities rather than replace them. These considerations can help investors assess the trade-offs independently rather than assuming that one asset class is appropriate simply because yields have reached a particular level.

9. Cash, short-term bonds or 10-year bonds?

Different maturities come with different risk-return characteristics.

- Cash and very short-term bonds generally have relatively low price sensitivity and provide flexibility. However, their income is only secured for a short period. If interest rates fall, maturing investments may need to be reinvested at lower yields.
- Longer-duration bonds provide greater visibility over yields for a longer period, but their market prices are more sensitive to changes in interest rates. If yields rise, their prices can fall more sharply; if yields fall, they can experience larger price gains.

The relevant trade-off is therefore between near-term price stability, reinvestment risk and sensitivity to future changes in interest rates, rather than one maturity being inherently preferable to another.

10. How should investors think about the balance between equities and bonds?

Higher yields alter the relative trade-off between risk and return.

When bond yields were much lower, investors seeking moderate portfolio returns often had to rely more heavily on equities, credit and other risk assets.

At yields around 5%, high-quality bonds may be able to contribute a larger share of the return some investors require.

That could make a more balanced allocation worth considering, particularly for investors whose portfolios have become equity-heavy or who are moving closer to a financial goal.

Investors with long horizons and higher return requirements may still need substantial equity exposure because of its stronger potential for long-term capital growth.

Portfolio allocation therefore comes back to three factors: the return required, the time available to achieve it and the amount of volatility an investor can tolerate along the way.

11. What other risks should bond investors consider?

Several risks remain even when buying high-quality government bonds.

- **Inflation risk:** A fixed nominal payment can lose purchasing power over time. Inflation-linked government bonds can be one way of addressing this risk.
- **Currency risk:** A US Treasury pays in US dollars. For an investor whose future spending is in Euro, Singapore dollars or another currency, changes in the exchange rate can materially increase or reduce the return. A 5% yield can be partly or even fully offset by currency depreciation. Hedging can reduce this risk, although it also comes at a cost.
- **US credit and fiscal risk:** Treasuries are generally treated as one of the world's benchmark low-credit-risk assets, but they should not be described as literally risk-free. Fitch currently rates the US AA+ with a stable outlook, citing the strength of the US economy and dollar but also substantial fiscal deficits. Moody's downgrade in 2025 also left the US without a top AAA rating from any of the three major agencies. An outright US government default is not the central market expectation. The more immediate portfolio risk from deteriorating fiscal dynamics is that investors demand a higher yield to hold government debt. Higher yields mean lower prices for bonds investors already own.
- **Diversification risk:** Bonds do not always rise when stocks fall. Inflation shocks can push bond yields higher while simultaneously reducing equity valuations, causing both assets to decline together. That means diversification may extend beyond the traditional stock-bond mix. Depending on objectives and risk tolerance, investors may also consider cash, inflation-linked bonds, gold or other assets with different return drivers.

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