

Interest rates have problems, but the US dollar has bigger problems

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Efforts to contain long-term Treasury yields may ease rate volatility—but could put more downward pressure on the US dollar, raising import costs and inflation risks.

US policymakers appear to be trying to contain volatility in the long end of the curve, particularly around the 30-year Treasury. The problem is that stabilizing rates does not eliminate the need for markets to absorb high public debt, persistent fiscal deficits and high volumes of Treasury issuance. It may simply shift more of that adjustment onto the dollar. Japan is a useful reference point. Its fiscal expansion was absorbed for years, in part, through a structurally weaker currency. The lesson is not that the United States will follow Japan's path exactly. It is that when public debt rises too far, the adjustment can show up through the exchange rate and imported inflation rather than only through higher yields.

Reasons US rates could stabilize

- Treasury buybacks under Treasury Secretary Scott Bessent. The expanded buyback program should improve liquidity in the long end by removing older, less-liquid securities from dealer balance sheets. It cannot solve the fiscal deficit, but it may reduce market dysfunction and provide a technical ceiling for the 10-to-30-year sector.
- US support for the Japanese yen. If the United States helps stabilize the yen, Japan may have less need to intervene by selling Treasury reserves. That would limit an additional source of supply and reduce upward pressure on yields, particularly at the long end.
- Attractive valuations. The 10-year Treasury Inflation-Protected Securities (TIPS) real yield is around 2.4%, while the 30-year real yield is close to 3%. These levels should attract pension funds, insurers and other long-term investors. As their name indicates, TIPS have also historically provided inflation protection, with long-term breakevens around 2.2–2.4%.
- Short positioning and a potential unwind. The market is short duration after the recent selloff. Better inflation data, fiscal policy, Treasury buybacks or changes in Federal Reserve (Fed) expectations could trigger short covering, leading to a strong technical rally and reducing rate volatility.
- A more credible and hawkish Fed. After the Jackson Hole Economic Policy Symposium, Fed Chair Kevin Warsh delivered a clearer and more hawkish message: inflation remains too high, the labor market is resilient, and the Fed is prepared to raise rates if price pressures do not ease. The initial reaction was higher expectations for a September rate hike and a sharp rise in two-year Treasury yields, while the long end moved more modestly, consistent with a bear-flattening move. A more credible Fed can anchor inflation expectations and prevent break-evens from becoming unmoored.

Reasons that US rates could remain under pressure

- Large and persistent fiscal deficits. The US government's budget deficit remains structurally large and requires continued borrowing even if growth slows. Markets are demanding a higher term premium to absorb the additional supply, particularly at the long end.
- Heavy Treasury issuance. The Treasury Department must refinance maturing debt while raising new cash to fund the deficit. This creates a persistent supply overhang, especially as the Fed reduces balance-sheet support.
- AI-related corporate borrowing. The AI investment cycle is generating a new wave of corporate borrowing for data centers, power infrastructure, chips and equipment. This competes with the Treasury for long-duration capital and can keep upward pressure on long-term yields.
- Energy-driven inflation risk. The main risk to the recent improvement in the Consumer Price Index (CPI) is that higher energy prices reverse the disinflation trend. The risk is no longer limited to crude oil. Diesel and other refined products are increasingly important transmission channels. Diesel feeds directly into trucking, agriculture, construction and industrial logistics. A sustained increase can therefore pass through into goods and services prices. Attacks in the Russia–Ukraine war can also reduce refined-product availability even if crude production is not materially impaired. The risk would be much greater if an escalation around the Strait of Hormuz affected export terminals, refineries, pipelines, storage facilities or tankers. If energy pushes inflation expectations higher, breakevens could widen, the Fed would have less room to ease, and the long end could sell off alongside the front end. That would create a bear-steepening or renewed curve-volatility scenario.

The central tension: Anchored rates, a weaker dollar

Policymakers can try to contain 30-year Treasury volatility through buybacks, support for the yen, more credible Fed communication and active curve management. But none of these measures removes the fiscal problem; they may simply change where the adjustment takes place. If nominal yields remain relatively contained while deficits and issuance continue to rise, the dollar may absorb more of the pressure. A weaker currency would reduce the real value of debt, but it would also raise import costs and could revive inflation.

Bottom line: Rates have problems, but the dollar may have bigger problems

The long end could enter a period of technical stabilization, but that stabilization may come at the expense of a weaker currency. Japan's experience shows that prolonged fiscal expansion can coexist with relatively controlled yields when the adjustment occurs through a cheaper exchange rate.

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