

Daily: Treasuries face a challenging reset

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Thought of the day

US Treasuries sold off for a seventh consecutive session on Wednesday, with the 10-year yield hitting 5.3% for the first time since 2007 and the 30-year yield rising to the highest level in 24 years. Global government bonds also recorded their worst quarterly loss since 2024, according to the Bloomberg Global Aggregate Total Return index.

The sell-off reflects a combination of cyclical and structural pressures. The conflict in the Middle East shows little sign of an imminent resolution, and the price of Brent crude remains around USD 100/bbl. Robust US economic activity and the surge in debt issuance by hyperscalers to fund AI expansion have added to upward pressure in yields, against a backdrop of persistent fiscal deficits. Hedge fund repositioning has also amplified the volatility.

Such volatility is likely to remain elevated in the near term, but we also see several potential catalysts ahead that could help stabilize the market.

Further disinflation could challenge aggressive expectations for Fed tightening. Current market pricing implies nearly four more 25-basis-point interest rate hikes from the Federal Reserve by the end of next year, which we believe is too aggressive. The core Personal Consumption Expenditures (PCE) price index came in below consensus for August, and the annual revisions by the Bureau of Economic Analysis pointed to a more benign inflation backdrop than previously thought. The three-month annualized rate for core PCE stood at 2.05% in August, the lowest level since July 2024. With the share of products with inflation above 3% also declining, we continue to expect incoming data to show further disinflation over the next six months. We also note that compared with the hiking cycle in 2022, current Fed policy rates are much higher. Given the potential impact of restrictive rates on growth and favorable inflation base effects in the first half of next year, a long sequence of hikes looks unlikely, in our view.

Improved energy flows could ease one source of inflation pressure. Now entering its eighth month, the war in the Middle East has lasted longer than many expected, and forecasting when a de-escalation could be achieved is challenging. But both the US and Iran retain economic incentives to come to a deal. With higher energy prices partially responsible for driving yields higher, the US and other governments have an increasing motivation to improve hydrocarbon flows. An Iranian proposal to reopen the Strait of Hormuz was rejected by US President Donald Trump, but recent headlines indicated that Washington had responded to Tehran's proposal. Since the UN General Assembly, diplomatic activity appears to have increased again, which is a positive sign. We do not expect a quick full normalization, but this conflict, as well as prior instances of geopolitical stress, has shown that high-pressure situations tend to focus minds on finding offramps. Greater visibility on the recovery of traffic through the waterway could help ease inflation concerns and provide some support for Treasuries.

Policymakers may take further steps to contain long-term borrowing costs. The US administration has made clear its intention to bring down long-term borrowing costs, and the Treasury surprised markets by doubling the size of its buyback operations in August. The effect was short-lived, and history suggests that bond market interventions have limits. But policymakers may consider additional measures if rising

yields threaten economic or financial stability. The US may have limited scope to reduce the weighted average maturity of its debt further, but the government could consider tweaks to bank or insurance liquidity rules to create a captive demand for sovereign debt. Such measures would not remove concerns over deficits or bond supply, but they could help moderate disorderly increases in long-term yields.

So, we continue to rate fixed income as Attractive and see opportunities across regions and market segments. Current elevated outright yields offer a carry cushion against potential further volatility that was not available in 2022. Our analysis indicates that US Treasury yields in the two-, five-, and 10-year tenors would need to rise by around 255, 110, and 65 basis points, respectively, from current levels for capital losses to offset the income earned. We still stress that investors should calibrate both credit risk and duration to their objective and investment horizons. More income-focused investors, for example, should focus on short-maturity bonds to reduce duration risk, while those who are willing to tolerate volatility may consider select tactical opportunities in medium- to long duration high-quality bonds. We remain cautious on the longest maturities given fiscal concerns and rising AI-related issuance.

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