

Treasuries regain their hedge as AI investment faces a reality check

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Treasuries shrugged off stronger-than-expected inflation as mounting questions over AI financing and investment returns brought growth risks back into focus.

- Treasuries rallied despite hotter-than-expected CPI and PPI, with the 10-year yield around 5.10%, roughly 20 basis points below its early-October peak.
- Investors appear to be questioning the pace, funding model and returns of the AI infrastructure buildout, as evidenced by the weakness in CoreWeave, Elice, Nscale-related financing and other AI-linked debt.
- Higher real yields and tighter credit conditions could constrain future data-center investment, with broader implications for growth, semiconductors, utilities, energy and infrastructure.
- The Treasury market is beginning to hedge risk assets again, although inflation and fiscal concerns remain sources of risk.
- This week's focus is on technology earnings, AI capital-spending guidance, housing data and next week's FOMC meeting.

Treasuries rally despite hotter inflation

After all the consternation surrounding the rise in bond yields during the third quarter, October has started on a surprisingly firm footing for Treasuries, despite two materially hotter-than-expected inflation reports. The 10-year yield is currently around 5.10%, roughly 20 basis points below its early-October peak near 5.30%. This resilience is notable given that in September the Consumer Price Index (CPI) rose 3.7% year over year, with core CPI at 2.6%, while producer prices [as measured by the Producer Price Index (PPI)] jumped 1.3% month over month—the largest monthly increase since March 2022. The data initially pushed yields higher and increased expectations of further Federal Reserve (Fed) tightening, but the move subsequently reversed as investors focused more heavily on the risks to growth and financial conditions.

AI-related credit comes under pressure

Normally, these inflation reports would have pushed yields higher as investors priced a more restrictive Fed. Instead, bonds rallied as markets began to focus more on the sustainability of growth—particularly the debt-financed AI investment boom. The catalyst was a sharp deterioration in sentiment toward AI-related assets. The Nasdaq 100 fell 5.5% last week, CoreWeave bonds fell below 80 cents on the dollar and debt linked to major data-center projects also weakened.

Figure 1: CoreWeave cash bonds, credit-default swaps (CDS) and stock under pressure as investors reassess AI financing complex

Source: Schroders, Bloomberg, as of 10/20/26. Past performance offers no guarantee of future results

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CoreWeave provides cloud-computing capacity for AI applications through highly capital-intensive, debt-financed data centers. The sharp rise in its bond yields and credit-default swaps (CDS) suggests investors are reassessing the pace, financing model and eventual returns of the AI buildout. The weakness is not isolated. Shares of Elice, a South Korean neocloud company specializing in dedicated AI-computing facilities, fell 32% on the company's market debut. Meanwhile, Microsoft withdrew from an agreement to anchor a planned UK data center being developed by Nscale, a British AI infrastructure company, after grid delays pushed the site's expected power connection into the 2030s

Together with slowing token spending, which could temper demand for the computing capacity these data centers provide, these developments indicate investors are becoming more selective about companies that are dependent on substantial future AI revenues. (Note: The mention of individual companies or securities is for illustrative purposes only and does not constitute a recommendation to buy, sell or hold any security.)

The market questions the economics of the AI buildout

The question is shifting from whether the industry can build sufficient compute capacity to whether customers will be willing to pay enough to justify that investment. If the payoff from AI investment remains uncertain and funding costs stay significantly higher, the economics of new data centers will become more challenging, potentially constraining both the pace and scale of the compute buildout.

This matters well beyond technology, given AI's growing importance to economic growth and its central role in investment themes spanning semiconductors, utilities, energy, construction and infrastructure. There are also early signs of stress in CCC-rated debt and other lower-quality funding markets. This is not yet evidence of a broad credit crisis, but it suggests that higher real yields and tighter financial conditions are beginning to matter for highly leveraged borrowers.

Constructive outlook with greater two-way potential

For Treasuries, any moderation in the AI investment cycle could be supportive through three channels: slower growth, less AI-related debt issuance competing for capital and renewed safe-haven demand if risk assets weaken. Last week therefore provided an important test of whether bonds still hedge risk assets. Despite hotter inflation data, investors bought Treasuries as AI-related equities and credit came under pressure.

Our broader view on rates remains constructive. We believe inflation and fiscal concerns can still push yields higher, but today's elevated starting yields provide attractive carry and meaningful protection if growth, earnings or capital spending disappoint. Investors no longer need a recession or aggressive Fed easing for fixed income to perform well: bonds offer income today, with the potential for capital gains if tighter financial conditions weaken growth or risk assets.

What to watch

The focus this week will be on corporate earnings, particularly technology companies' guidance on AI capital expenditure, expected returns and financing needs. The key reports will arrive later in the week and should provide an important test of whether strong AI demand is translating into sufficient revenues and returns. Housing starts and building permits are due Tuesday, followed by jobless claims and the Leading Economic Index on Thursday, with October manufacturing and services PMIs on Friday.

Attention will then turn to next week's October 28 Federal Open Market Committee (FOMC) meeting. Markets are pricing only around a 15% probability of a rate hike this month, but approximately an 87% probability of a move by December. The US midterm elections are now two weeks away and could influence the fiscal and Treasury-supply outlook. Continued Republican control of Congress would preserve the party's current trifecta and raise the prospects for further tax cuts and spending initiatives. Results that bring a split government, with Democratic control of one or both houses, would increase the likelihood of gridlock over the final two years of the Republican president's term, and thereby limit new deficit-financed measures.

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