Bond markets are asking questions; a soft USD is the answer

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As bond markets challenge rising government debt and monetary policy uncertainty, the US dollar is likely to act as the pressure release valve.

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There is a moment in every debt cycle when the bond market stops listening and starts talking. We appear to have reached it. The US 30-year government bond yield has broken out to a new cyclical high – its highest level in almost two decades – and, tellingly, it did so during a period of stability in short-maturity yields and while near-term Fed expectations were drifting more dovish, not less. That is not a growth story. That is a risk-premium story.

The moves in the bond market are structural. The rise in long-end yields reflects a widening term premium, driven by some combination of greater uncertainty about the long-run economic outlook, fiscal concerns, and a US Federal Reserve that has become deliberately more opaque. Technical explanations, including crowding out from the surge in bond issuance financing AI datacentres, and deteriorating liquidity, are minor drivers as corporate spreads have widened only modestly.

What makes this consequential for currency investors is a simple accounting identity: if the compensation demanded by bondholders cannot be expressed in yields, it will be expressed somewhere else. That somewhere else is the US dollar's exchange rate.

Three structural screws, all turning

The primary structural driver of higher bond yields is the fiscal deficit. US public debt has doubled over the past decade to USD 40tn. Among major economies, the US debt-to-GDP ratio of 123% is only exceeded by Japan and Italy. With effective nominal borrowing costs near 4% and interest payments on the debt now ranking third among government spending – after healthcare and social security payments – a significant fiscal tightening is urgently needed. No administration will deliver that. The only realistic path left is to boost growth and drive real rates very low, which means financial repression and currency depreciation.

Meanwhile, the fiscal deficit is deteriorating again: the loss of tariff revenue following the Supreme Court decision has stripped away the offset to falling corporate tax receipts, leaving the fiscal deficit in the first 10 months of the current financial year at the same level as the entire year before. Interest payments are now growing faster than GDP.

The second structural driver is arguably populism. This is no longer a temporary election-cycle risk; it is a perennial, structurally embedded feature of Developed Market politics. In Europe, term premia are widening as political risk expands beyond France and the UK into Germany and Italy. In the US, four out of five voters want substantial change in government. And even the AI buildout – the one genuine engine of US exceptionalism – now faces bipartisan populist pushback over data centres. Policy uncertainty of this kind is precisely what a term premium is designed to price.

Third, the Fed. Fed Chair Kevin Warsh's unwillingness to articulate his reaction function – how long he is willing to tolerate above 2% target inflation – has raised risk premia and lifted long-term yields. Tough rhetoric unmatched by policy action has led investors to question his resolve to hike, and that ambiguity is starting to weigh on the dollar. If Warsh is more forthcoming with his views, some of this premium could unwind. Until then, it accumulates.

Dollar as the release valve

How should the markets react against this structural backdrop? The Treasury's surprise decision to double buybacks of long-term bonds was intended to cap yields. But with no evidence of liquidity stress, and the government still operating a procyclical fiscal policy, the market read it as an attempt to suppress the price of long-term yields by fiat – financial repression in all but name.

With term premia artificially compressed, the only release valve left for investors was the dollar, which duly weakened. The message from the bond market is blunt: if you run procyclical fiscal policy, show no desire to consolidate, drag your feet on hiking and undermine the very idea of doing so, we will require compensation. If you deny that compensation in yield, we will take it in the currency.

The mechanics reinforce this. Rising inflation-adjusted yields have not supported the dollar because the uptick reflects a wider term premium, not higher core real yields. A rising term premium is bearish for the exchange rate; rising core real yields, signalling better growth, would be bullish. However, core real yields have rolled over. The Treasury's ability to fix this is minimal; only the Fed's balance sheet could genuinely cap yields, and Warsh has consistently sought a smaller one.

What is holding the line

The result is likely a modestly, not violently, bearish dollar. Why 'modestly'? The reason is the artificial intelligence (AI) boom. The greenback has not yet depreciated materially against developed-market currencies because surging foreign net purchases of US equities, approaching USD 900bn over twelve months and driven by the AI boom, have financed a USD 1trn current account deficit. Thus, the sustainability of the AI-driven stock market rally is critical for the pace of the expected US dollar depreciation.

Japan removes the other support

The second driver of the dollar's path likely resides in Tokyo. Japanese long-term inflation expectations have finally reached 2%, services selling-price inflation is the strongest since 2014, and the BoJ's reaction function appears to have changed, with at least one member arguing the focus has shifted from lifting inflation to target to preventing an overshoot. A September BoJ rate hike now looks likely, with a terminal rate plausibly near 2%. That raises the global anchor for long-end bond yields and erodes the rate differential underpinning yen-funded carry trade that has supported dollar assets. The yen, significantly undervalued against the dollar on several measures, looks like a loaded spring.

Asia to benefit from a softer dollar

Released dollar pressure has to land somewhere, and Emerging Markets (EM) are the natural recipients. Conditions for EM outperformance – strong external fundamentals, decent risk sentiment, contained volatility – are broadly being met, and a weaker dollar should benefit the rest of the world. This argues for non-US bonds, especially EM debt. Asia ex-Japan, home to the current-account-surplus backed currencies most exposed to the AI supply chain, looks best placed among equity markets, with China and Taiwan equities our top preferences.

The bond market is asking questions. A softer dollar is the answer. Asia stands to benefit.

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