Daily: Higher yields put currency fundamentals to the test

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From the studio

Podcast:Signal over Noise: Positioning for the physical AI era, on Apple and Spotify. (6 mins)Video: Why yields are rising and what it means for the dollar (4 mins)Video: 4 reasons to take a closer look at Taiwan equities (5 mins)

Thought of the day

Global bond markets have continued to reprice higher this week, with the latest leg driven by rising oil prices in response to renewed US strikes on Iran. US Treasury yields on Wednesday climbed back toward levels not seen since before the Global Financial Crisis, with the 10- and 30-year yields rising to 4.8% and 5.28% respectively. Internationally, Japan's 10-year government bond yield surpassed 3% for the first time since 1996. Markets are also assigning a high probability to a September Bank of Japan rate hike, and Federal Reserve pricing is tilted to tightening in September following Fed Chair Kevin Warsh's more hawkish Jackson Hole remarks.

Ordinarily, such a backdrop would support both the US dollar and the Japanese yen. Instead, the relationship between yields and currencies has become less straightforward. The DXY US dollar index has weakened since late July despite elevated Treasury yields, and USDJPY remains close to 160 even as Japanese government bond (JGB) yields rise to multi-decade highs.

The common thread, in our view, is that investors are becoming more selective about the types of yields they are willing to reward.

Not all high yields are created equal. Rising yields are a global phenomenon, but currencies are responding very differently depending on what is driving them. Investors appear increasingly willing to reward yields associated with stronger fiscal positions, stable policy frameworks, and attractive carry. By contrast, yields driven by concerns over fiscal sustainability or rising government financing needs appear less supportive for currencies. The experiences of both the US dollar and Japanese yen illustrate this shift. Despite sharply higher Treasury and JGB yields, neither currency has enjoyed sustained support, suggesting markets are demanding more than simply higher nominal returns.

Fed policy remains a key wildcard. Following Chair Warsh's Jackson Hole remarks, markets have shifted to price in a higher chance of Fed tightening this year. Our base case remains that the Fed stays on hold through year-end, with labor and manufacturing data yet to make a compelling case for tightening policy. However, we also think risks have become more balanced. Rising oil prices, ongoing supply-side pressures, and the possibility that inflation proves more persistent than expected could reinforce the Fed's increasingly hawkish rhetoric. Market-implied odds of a September hike have risen sharply in recent days, highlighting how sensitive expectations remain to incoming data. Friday's labor report and next week’s inflation data could be pivotal: Continued moderation in inflation would likely see markets pare back hike expectations, while a firmer reading, particularly alongside resilient labor-market conditions, could strengthen the case for rates remaining higher for longer and potentially even a pivot to Fed hikes.

Carry still stands out. In a world of moderate US dollar weakness, investors are still being rewarded for holding currencies that combine attractive yields with stronger fiscal foundations. We continue to favor currencies such as the Norwegian krone and New Zealand dollar, while sterling and the Chinese yuan also remain Attractive. Norway offers one of the highest yields in the G10 and benefits from its status as a net energy exporter. Higher oil prices could provide an additional near-term tailwind if energy markets remain tight. New Zealand remains supported by the prospect for additional Reserve Bank of New Zealand tightening, albeit with a more gradual policy path now being priced after its September decision to hike. We also continue to view sterling positively, supported by improving confidence in UK assets, a more fiscally credible political backdrop, and the potential for investors to reduce still-substantial short positions. In China, persistent trade surpluses and continued People's Bank of China tolerance for gradual appreciation should support the yuan, particularly if broader USD weakness resumes.

So, rather than focusing simply on where yields are highest, investors may increasingly need to consider why those yields are available in the first place. For many investors, this supports the case for continued diversification away from concentrated US dollar exposure. Within FX, we favor currencies that combine attractive carry with stronger fiscal foundations, including the NOK and NZD, while the GBP and CNY also remain Attractive. We continue to expect broader dollar weakness to support EURUSD over time, with the pair moving toward 1.18-1.20 as markets ultimately scale back Fed tightening expectations and as the European Central Bank potentially delivers another rate increase.

While our base case is for the Fed to stay on hold this year, labor and inflation data in the coming days may prove pivotal in determining whether the hawkish shift in Fed market pricing is excessive or necessary.

Given greater bond market and currency volatility, we believe investors should focus on building robust, diversified, and risk-managed portfolios. We see merit in reviewing currency allocations versus longer-term spending and investment needs, rebalancing away from excess US dollar exposure, and potentially using structured strategies to diversify or harness pockets of volatility to generate yield. We still like short- and medium-maturity government bonds for both income and as a portfolio diversifier, but also see merit in diversifying liquidity positions across tools including fixed-term deposits, certificates of deposit, diversified fixed income approaches, and select structured strategies to balance returns against risks. And we also see value in maintaining a strategic allocation to gold, which can complement these positions with robust central bank demand, and its role as a portfolio hedge against currency debasement and US fiscal pressure.

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