The Misunderstood Move in Bond Yields: A Closer Look

Recent price action in the bond market, specifically the movement of the 10-year yield from 3.6% to 4.45% following the Federal Reserve's rate cut, has led to a flurry of market interpretations. Some see this as a sign of a policy mistake, but in reality, it reflects the unwind of “recession insurance” buyers rather than a harbinger of economic trouble.

Understanding the "Recession Insurance" Unwind

When the Federal Reserve indicated at its September meeting that it was ready to backstop the economy aggressively, it reduced the necessity for investors to hold onto recession insurance. This signal, combined with a commitment to rate cuts, prompted a wave of selling, driving yields higher. The message was clear: the Fed is standing by to support growth, which obviates the need for portfolios to brace for a downturn.

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In the current environment, the fair value for the 10-year yield appears to lie between 3.75% and 4.25%, but this range comes with a significant caveat. This "fair value" is contingent on the Fed's projections being correct, particularly the assumption of a terminal rate around 3%. Yet, market indicators suggest a more conservative estimate closer to 3.8%, reflecting some skepticism about the trajectory of rate cuts.

The Recession Narrative: Not So Fast

There’s been much debate about whether this rise in yields signals an impending recession. Making a definitive call on this front, however, is risky. Beyond some soft spots in the labor market, the broader economic data remains resilient. Even the housing market, often cited as a weak point, hasn’t deteriorated to the degree that would justify recessionary fears. Yes, it’s plausible to extrapolate weakness here, but doing so would be a stretch at this juncture.

Relying on rate movements to make a recession call is tenuous because it involves a two-step prediction: first, you need to accurately forecast bond yields, and then you must guess how the economy will absorb those rates. If persistently higher yields start to weaken demand—manifesting through sluggish hiring and

[1] Chart provided by Bloomberg database.

wider mortgage spreads—it will eventually be evident in housing statistics. Until then, the data doesn't support a near-term recession.

The Overblown Bond Vigilante Narrative

With the recent steepening of the yield curve following the Fed's September cut, there's been renewed chatter from certain macro voices about the U.S. economy's doom. Terms like "bond vigilantes" have resurfaced, evoking fears of a government debt crisis. But if history has taught us anything, it's that betting against the U.S. government's creditworthiness is a losing game.

The core errors in the hyperbolic analysis around bond vigilantes are twofold. First, the concern over interest payments is misplaced. The Fed has a dial it can turn to manage these payments, and higher rates can actually help suppress inflation. Second, assuming high inflation must result from government deficits overlooks a crucial point: government spending today, at 23% of GDP, is not excessive by historical standards. It's been at this level since 1982, and inflationary pressure comes from a mix of factors, with only a fraction driven by government action.

Sure, we saw what happens when government spending balloons to 45% of GDP, as it did during the pandemic in 2021, resulting in significant inflation. But this isn't today's reality. The U.S. economy is still primarily driven by other sectors, most notably the private sector, which has consistently demonstrated efficiency and adaptability.

Inflation and the Bigger Picture

The bond vigilante narrative suggests that government spending is setting the U.S. up for disaster, but this interpretation misses the nuance. It's important to manage inflation risk, but that doesn't mean we should buy into apocalyptic scenarios about U.S. bankruptcy. Historically, government spending hasn't been the sole driver of inflation, and it's unlikely to become one in an economy where it comprises less than a quarter of GDP.

So, where does this leave us? Investors should certainly be mindful of inflation and consider protection strategies, even in a low-inflation environment. However, the narrative that the U.S. is on the brink of a debt crisis simply doesn't align with the data. The recent moves in bond yields are a reflection of evolving market expectations around the Fed's policy path, not a sign of an imminent collapse.

Stay Focused, Not Fearful

The bond market is complex, and interpreting its movements requires careful consideration of various factors, from Fed policy to economic fundamentals. Recent shifts in the 10-year yield do not herald a recession or policy error. Instead, they reflect the market's recalibration of risk in light of new information. The talk of bond vigilantes and government insolvency makes for dramatic headlines, but it's not a prudent investment thesis. As always, a balanced approach—one that acknowledges potential risks without succumbing to exaggerated fears—will serve investors well in navigating this environment.

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