



In our latest monthly letter, we look at what has driven long-term yields higher, and where they may go from here. (UBS)

Monthly Letter: Return of the bond vigilantes?

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In our latest monthly letter, we look at what's been driving the recent rise in long-term Treasury yields, what we expect from here, and how investors should position.

The US budget deficit is growing, Treasury issuance has risen by more than expected, Fitch downgraded the US AAA credit rating, and the 10-year Treasury yield rose from 3.3% in May to 4.8% in early October. Yields have moderated in recent days, but the question remains: Are the bond vigilantes back? The term was coined in the 1980s to describe bond investors who would sell holdings in the government bonds of countries with fiscal policies deemed to be overly profligate.

But while we acknowledge that we are in a period of heightened concern about the US fiscal situation, we think the outlook for Treasury yields will depend more on the growth trajectory of the US economy than on fears around the federal deficit.

In our latest monthly letter, we look at what has driven long-term yields higher, and where they may go from here. We think about Treasury yields as a function of several factors: Supply and demand dynamics, market expectations about inflation, and overall expectations about growth and the Federal Reserve's reaction function. Looking at each of these in turn:

We expect demand for Treasuries to meet rising supply. Higher-than-expected supply of Treasury securities to fund the US fiscal deficit does appear to have contributed to higher bond yields in recent months. But although higher Treasury supply could put some near-term upward pressure on yields, we ultimately think the demand for Treasuries is likely to remain sufficiently strong to meet the additional supply. We believe concerns that Japanese and Chinese investors may sell their holdings are overdone. A significant portion of Treasury demand is also insensitive to price—driven by regulatory requirements or collateral needs. And importantly, the Fed has the ability, and willingness, to step in as a buyer if needed to ensure the stability of the market.

Inflation expectations have remained contained. While persistent and surprisingly high inflation was clearly an initial cause for higher central bank rates and bond yields, we do not think that inflation has been a major factor in the recent rise in yields. Ten-year US breakeven inflation rates have remained stable over the past few weeks, and were 2.31% at the time of writing. The headline US consumer price index rose 3.7% year-over-year in September, unchanged versus August, but core inflation (which excludes food and energy prices) slowed to 4.1% from 4.3%.

Robust US growth has been a key driver of the recent rise in yields. With structural demand for Treasuries likely to keep pace with supply, and inflation not being a major contributor to the recent moves in yields, by process of elimination we are left with economic growth as the primary yield driver. As the US economy has shown resilience, investors have priced in “higher for longer” interest rates from the Fed and priced out the likelihood of a recession. But we still expect growth to slow. US consumers are likely to tighten their purse strings as the effect of higher interest rates continues to feed through to the economy and the labor market cools. Business investment is also unlikely to be sustained at the current pace given higher borrowing costs.

What does all this mean for investors? Looking ahead, we expect yields to fall as US growth slows, the Fed finishes tightening, and starts to ease policy later next year. In our base case, we see the 10-year Treasury yield declining to 3.5% by June 2024. We maintain our preference for higher-quality segments of the fixed income market, including high grade (government) and investment grade bonds.

We also see upside potential in the equity market. Although we have a least preferred view on the US relative to other markets where we see better value (e.g., emerging markets), in our base case we expect the S&P 500 to reach 4,500 by June next year. Our sector preferences include global energy stocks, which we believe are attractively valued and can act as a geopolitical hedge.

Overall, we continue to believe that this is a good environment for investors to start to put money to work in balanced portfolios, with attractive prospective returns across asset classes and diversification benefits from holding a combination of equities, bonds, and alternatives.

Read more in our latest monthly letter, “[Return of the bond vigilantes?](#)” and watch a short video on the main themes [here](#).

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