First Trust
Monday Morning OUTLOOK

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The Blame Game About Rising Yields

James Carville, Bill Clinton's chief political advisor, once quipped that if he could be reincarnated he wanted to come back as the bond market because "You can intimidate everybody."

He's being proven right. The yield on the 30-year Treasury Bond finished Friday at 5.27% – 55 basis points higher than six months ago, and near the highest level since mid-2007.

This rise in yields has the Treasury Department in a tizzy. Treasury Secretary Scott Bessent let Japan use a special repo facility to support the Yen without having to sell any US bonds. Then the Treasury did a version of Operation Twist, buying back long-term debt and funding it by issuing more short-term debt.

The financial press, and other analysts, are gravitating toward a few reasons for the rise in yields. One theory is that markets are increasingly worried about higher inflation. And because new Federal Reserve Chairman Kevin Warsh is too loyal to President Trump, he won't increase interest rates to stop it.

The big problem with this theory is that the market's expectation of long-term inflation, based on the gap between yields on regular nominal Treasury debt and inflation-indexed debt, hasn't moved higher. The five-year forward inflation rate starting five years from now is about 2.34%, almost exactly where it was six months ago. Moreover, why would markets freak out about inflation now? Jerome Powell, Warsh's predecessor, presided over an inflation rate that reached 9.0%, the highest since the early 1980s and the bond market didn't go haywire then.

Another theory is that markets are getting more optimistic about an improvement in long-term economic growth, given productivity gains tied to AI. The AI/data center build out also requires lots of capital investment, meaning more types of debt fighting for the same dollars, which could be raising yields for other borrowers, in this case the US Treasury Department. It will take time to see if this is a correct interpretation, but if it is, then we shouldn't be worried unless the AI/data center build-out doesn't help boost economic growth.

Another theory is that the fiscal chickens are finally coming home to roost. After years of massive deficits, the bond market vigilantes are finally on their horses chasing down the bad guys.

There are plenty of reasons to be worried about the long-term budget situation. The national debt is now $40 trillion. Meanwhile, net interest on the debt is now back above 3% of GDP, like it often was in the 1980s-1990s (after multiple decades at much lower levels). We are also creeping ever closer to a full depletion of the Social Security Trust Fund.

It is long overdue for lawmakers in both parties to get our fiscal house in order through systematic reductions in the future path of spending, and the sooner the better. However, some are using the recent move in yields as a misleading indictment of the Trump Administration's budget measures, in particular making the 2017 tax cuts permanent.

Yes, this year's budget deficit (for the fiscal year that ends September 30) is likely to be about 6.4% of GDP, even larger than the last two deficits under President Biden. But the current fiscal year includes unique one-time tariff refunds of about $166 billion. Without those, the deficit would be about 5.9% of GDP.

When you focus on spending, the Trump Administration has been relatively frugal. Total spending in the past twelve months is up only 3.8% compared to the last twelve months of the Biden Administration, in spite of temporary calendar effects that artificially boost that growth rate by about 2 percentage points. In addition, inflation has averaged about 3%, interest costs have risen, military spending is up, Social Security and Medicare spending are rising on the backs of the baby boomers, and health care costs are driving Medicaid spending higher.

We are certainly not saying that the US fiscal position is good; it's not. When the US is paying 3.8% of GDP on net interest payments and the saving rate is just 2.8%, we have a problem that will only get worse. It's not sustainable at this point; the deficit would have to be brought down substantially just to call it minimally acceptable.

But a 55 bp increase in long-term yields is not highly unusual and it doesn't signal that the current Administration is uniquely irresponsible. Big changes need to come from Washington, DC, but we hope that means even more of a focus on reducing spending, not a lurch toward broader tax hikes.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
8-25 / 9:00 am	New Home Sales – Jul	0.620 Mil	**NA**		0.628 Mil
8-26 / 7:30 am	Personal Income – Jul	+0.2%	**+0.2%**		+0.2%
7:30 am	Personal Spending – Jul	+0.1%	**+0.1%**		+0.3%
7:30 am	Durable Goods – Jul	+0.4%	**+1.1%**		+0.5%
7:30 am	Durable Goods (Ex Trans) – Jul	+0.6%	**+0.7%**		+0.7%
7:30 am	Q2 GDP Second Report	+1.5%	**+1.5%**		+1.5%
7:30 am	Q2 GDP Chain Price Index	+6.2%	**+6.2%**		+6.2%
8-27 / 7:30 am	Initial Claims – Aug 22	209K	**205K**		206K
8-28 / 8:45 am	Chicago PMI – Aug	57.9	**57.9**		57.6