STREET SMARTS

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RETURN OF THE BOND VIGILANTES?

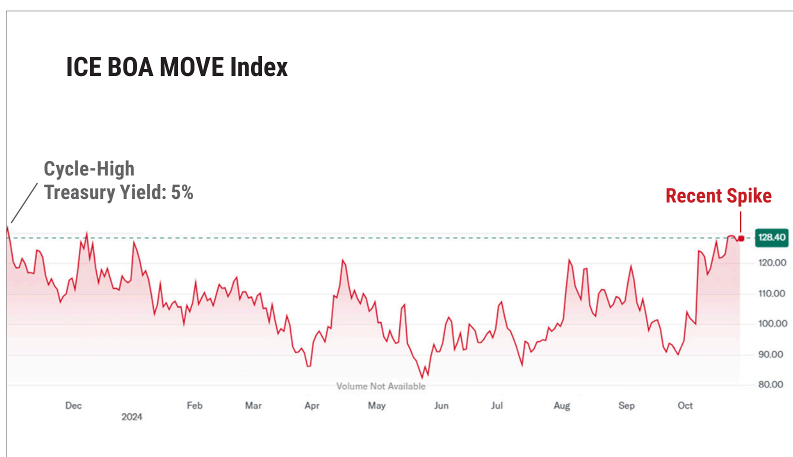
October has brought on a dramatic rise in yields in reaction to a building narrative of strong economic growth combined with fear of larger Federal deficits. The term "bond vigilantes" was coined in the nineties to refer to the combination of fiscal policy choices the bond market would tolerate. As of this writing, the benchmark 10-year Treasury yield that began October at a 3.79% yield is trading at 4.24%. This is a sizable and very fast move that presents a challenge for equities and the corresponding price sell-off in bonds. Equities can absorb higher yields to a degree, but not all at once — consequently, the indigestion in stocks. Keep in mind that the Federal Reserve controls very short-term rates, which dropped substantially by 50 basis points in September. Market forces, which are varied, determine yields on everything beyond essentially overnight rates.

A good indicator of fear around yields is the ICE BOA MOVE Index. This index indicates market-implied bond volatility. It is similar to the CBOE Volatility Index (VIX), which indicates fear in the stock market. The MOVE Index has spiked up to its highest level since last October. At that point, the 10-year Treasury yield was trading at a cycle high of 5%.

What's driving the fear?

1. **First and foremost, the rise in yields** is a correction following a dramatic decline from the early summer peak of about 4.6% on the 10-year Treasury. The September low of about 3.6% was an overshoot.
2. **A stronger GDP dynamic.** This is the growth concern, which, according to the narrative, results in the Fed maintaining its current rate policy instead of continuing its cutting campaign.
3. **Increasing fear of tariffs** and consequent inflationary effect. If broad tariffs materialize, this potentially un-anchors inflation expectations.
4. **Increased Treasury supply** due to an expansion of the Federal deficit.

Number one is part and parcel of markets and their non-linear nature. It is our viewpoint that this is also the most proximate and biggest actor in the recent run-up. Yields at current levels meet most definitions of fair value for longer-term yields. Real rates are up, and pricing is in a stronger growth backdrop that we do not see as incompatible with further progress on inflation. Numbers three and four are political wild cards. A lot can happen before campaign chatter turns into policy. One meaningful measure of debt is the ratio of debt to GDP, which has come down from a peak of 130% in March of 2021 to 120% as of the second quarter. The GDP denominator matters here as well. Federal debt and a huge shift in supply are real concerns, but it is impossible to quantify what constitutes huge or how much the market can absorb.



Source: Yahoo Finance

In summary, oversold bonds should have technical support around current levels. A bounce in price would constitute lower yields. A lot has been priced in with the recent move.

All market performance figures are sourced from Bloomberg.

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