



What's Driving Rates Up and Bonds Down?

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"It ain't what you don't know that gets you into trouble. It's what you know for sure that just ain't so."

-Mark Twain

As we round the three-quarter pole and head into the final stretch of 2026, the prevailing investment narrative has, of course, been AI, along with its pros and cons. Since March, when the Iran conflict began, there has been a secondary drumbeat that continues to get louder and louder: the narrative surrounding bond prices, interest rates, inflation, and the economy. Over the past few months, bond prices have fallen as yields have climbed, with many laying the blame squarely on the shoulders of the Iran conflict and increasing energy prices. That's only partially correct. While many are attributing the rise in yields to increased inflation expectations, empirically, that's only part of the story. In reality, inflation is a secondary, or even tertiary, influence. Other theories range from an expanding term premium tied to the U.S. fiscal path and increasing debt levels, to rising yields in Japan contributing to de-dollarization. Those factors have played a role, but only a minor one. The answer is much simpler, and quite frankly, more anti-climactic than what many would have you think. We'll explore each of these factors and more in this quarter's Market Insights: What's Driving Rates Up and Bonds Down?

Brass Tacks on Rates

First, let me acknowledge the influence that recency bias has on all of us. Just a few years ago, inflation reached 9%. The Fed insisted that inflation was transitory, kept rates low for too long, and then raised short-term rates from essentially zero to 5.5%, dragging down stocks and ushering in the worst bond market in history. That happened just four years ago. So, it's natural to listen to the popular media and accept the simple explanation that rising energy prices due to the war in Iran have created inflation and this is simply a repeat of 2022. I'm here to tell you that it isn't—at least at this point. That narrative is incorrect.

While it seems like eons ago, markets ended 2025 concerned that the economy might be slowing. Unemployment was ticking up ever so slightly, and the popular belief was that the Fed could reduce rates, if not to stimulate the economy, then at least to become less restrictive. Accordingly, markets priced in more than six 25-basis-point cuts throughout 2026, driving rates down and bond prices up in real time. You see, when something is expected, markets price it in preemptively rather than waiting for the event to actually occur. The old saying, "buy on the rumor, sell on the news," turns out to be sound advice. As that expectation changed—from a slowing economy and lower rates narrative to a higher-rates narrative—what had been priced in needed to be walked back. Therefore, the simple explanation is this: markets incorrectly assumed we would get rate cuts. Once that became clear, rates needed to adjust.

Now, the world is full of unsubstantiated claims and opinions. Let me not contribute another. The standard decomposition of a nominal Treasury yield breaks it into four building blocks:

Nominal Yield = Expected Real Short Rate + Inflation Expectations + Real Term Premium + Inflation Risk Premium

First, let me clarify some of these terms. The nominal yield is simply the stated yield on a fixed-income instrument. When we say "nominal," it includes an inflation component, when we say "real" it excludes inflation. Following the formula, the total or nominal yield—which includes inflation—is essentially the real yield, or inflation-adjusted yield, plus inflation. Hardly controversial. We're simply breaking the yield into pieces so we can isolate the before- and after-inflation effects.

Now, term premium is the extra yield required by an investor to invest in long-term versus short-term bonds. Why lock up your money for 10, 15, 20 or more years if investors could rely on the yield of each one-year instrument being equal to the yield on the longer-term instrument? After all, if we're going to commit our dollars for a long time, we might need a little extra incentive. The last term, inflation risk premium, is simply the extra yield required by an investor because we don't know exactly what inflation will be in advance. If we invest in a bond today with a yield of 5%, that may or may not be enough to cover inflation over the life of the bond. If inflation is 1%, that bond was a great deal. We grew our money by 4% per year after inflation. If inflation is 10%, we lost 5% of our purchasing power every year. We'd have been better off spending the money. That uncertainty requires a little extra compensation.

Okay, now that we have that out of the way, let's dive into our framework. There are several observable market inputs that help us quantify where the change in yields came from. First, the 10-year nominal Treasury yield rose 127 basis points, from 4.03% to 5.30%, from March through the end of September. As we've established, the move was overwhelmingly driven by the real-rate complex, meaning the change in investor expectations from cuts to hikes. Inflation played a much smaller role. Let's illustrate.



Observable Market Inputs

Series	Mar. 1, 2026	Sep. 30, 2026	Change (bps)
10Y Nominal Yield	4.03%	5.30%	+127
10Y TIPS Real Yield	1.74%	2.93%	+119
10Y Breakeven Inflation	2.30%	2.37%	+7
ACM 10Y Term Premium	0.62%	0.89%	+27

Now let’s interpret this. First, this is not entirely additive as the term premium overlaps with the other components. The 10-year Treasury Inflation-Protected Security, or TIPS, yield was 1.74% on March 1, 2026, and increased to 2.93% on September 30—a change of 119 basis points. The TIPS yield can be further broken down into Expected Real Short Rate + Real Term Premium. We’ll need that in just a second.

Now, we can see that the 119-basis-point increase in the real yield represents the lions share of the move, while the inflation component represents only a small component. The NY Fed ACM term premium increased 27 basis points over the period. We can allocate that increase proportionally between the real and inflation sides using that 94%/6% split, yielding approximately +25 basis points of Real Term Premium and +2 basis points of Inflation Risk Premium. The result is listed in the table below.

Decomposing the Move

Component	Mar. 1, 2026	Sep. 30, 2026	Change (bps)	Share of Total
Nominal Yield (GT10)	4.03%	5.30%	+127	100%
Expected Real Short Rate	—	—	+94	74%
Real Term Premium	—	—	+25	20%
Inflation Expectations	—	—	+6	5%
Inflation Risk Premium	—	—	+2	1%

In essence, the yield increase since March 1 is largely a real-rate story. The Expected Real Short Rate alone accounts for more than 70% of the move, reflecting markets pricing in a higher-for-longer Fed path and/or stronger real-growth expectations. The Real Term Premium, at +25 basis points, which grabbed some headlines as US debt crossed \$40 trillion recently, adds a secondary fiscal component, but it’s nowhere near the driver some made it out to be. Finally, inflation expectations were essentially anchored despite the fact that many were blaming higher energy prices and rising inflation for the jump in yields. The 10-year breakeven inflation rate moved only 7 basis points over the entire six-month period. That’s a pretty important distinction: the market wasn’t saying, “We expect a significant inflation problem.” The market was saying, “We expect real rates to be higher.” And that difference is at the heart of what has driven rates up and bonds down.

Exploring the Term Premium

Now let me spend just a moment on the term premium. While we saw just a moment ago that the increase in the term premium was a relatively small contributor to the scope of our recent change, there is a delicate balance that exists between long-term rates, economic growth, inflation, and our role as the world’s reserve currency. That last part is very much overlooked when it comes to our increasing debt levels.

Being the world’s reserve currency essentially means that the US provides foreign nations with a safe store of value for their currency reserves, while also facilitating a medium of exchange. The vast majority of global trade, including commodities like oil, precious and industrial metals, and agricultural products, are priced and transacted in dollars. The USD is the medium of exchange in nearly 90% of all foreign currency transactions. When a European company pays an Asian supplier, that transaction typically crosses through the USD.

For trade, both buyers and sellers seek stability. In many cases, margins might be slim, or the price of the next-lowest supplier might be just pennies away from the low-cost bidder. Transacting in a currency that is anything other than stable carries risk. The USD provides that stable medium of exchange.

For reserves, our relatively stable political climate and near-zero risk of default are appealing to foreign nations for a variety of reasons. Take Japan, for example. Japan, as a nation of exporters, seeks to maintain a relatively weak yen. A weaker currency helps Japanese companies provide goods at a lower export cost than they could if the yen were strong. To facilitate and manage this, Japan could theoretically sell Japanese yen, which weakens the yen, and buy USD reserves as a mechanism for maintaining that weaker currency.



Now, for the US, what do we get? Well, that steady stream of capital from yen to dollars ultimately comes to rest in the US Treasury market. This results in two primary benefits to the reserve currency nation. Number one, we get a steady buyer of our bonds, which helps depress rates. So, lower rates are a benefit. Second, in order to supply the world with enough bonds to park their reserves, we get to deficit spend. That deficit spending provides a boost to economic growth. The consequence, of course, is an ever-increasing debt level.

Now, I know what you're thinking. What happens when the bill comes due? For the reserve currency, that debt is never repaid in aggregate. Don't get me wrong, we make interest payments and repay principal to the holders of those bonds, but we do that by issuing new debt. The check and balance for this is the ratio of debt-to-GDP. As long as debt-to-GDP remains reasonable, other nations will remain confident that their reserves are safe and that their trade is being conducted in a stable currency. But if debt continually and meaningfully outpaces GDP growth, skewing that ratio higher, then your ability to repay that debt and fulfill your obligation of stability comes into question. The consequence is that investors start to demand higher yields to invest in your bonds.

So, what does this mean for us today? Well, I think the market got caught up in a big headline-generating number: \$40 trillion in US debt. The more important number is our ever-climbing debt-to-GDP ratio and the fact that, in the last three years, for every dollar we've borrowed, we've only added ~65 cents of GDP. That's a bad path for sure.

But for now, keep in mind that being the reserve currency requires us to supply the world with Treasury bonds. To do that, we need to deficit spend. The check here is that deficit spending needs to be reasonable—which it probably hasn't been for the better part of the last 8–10 years.

Conclusion

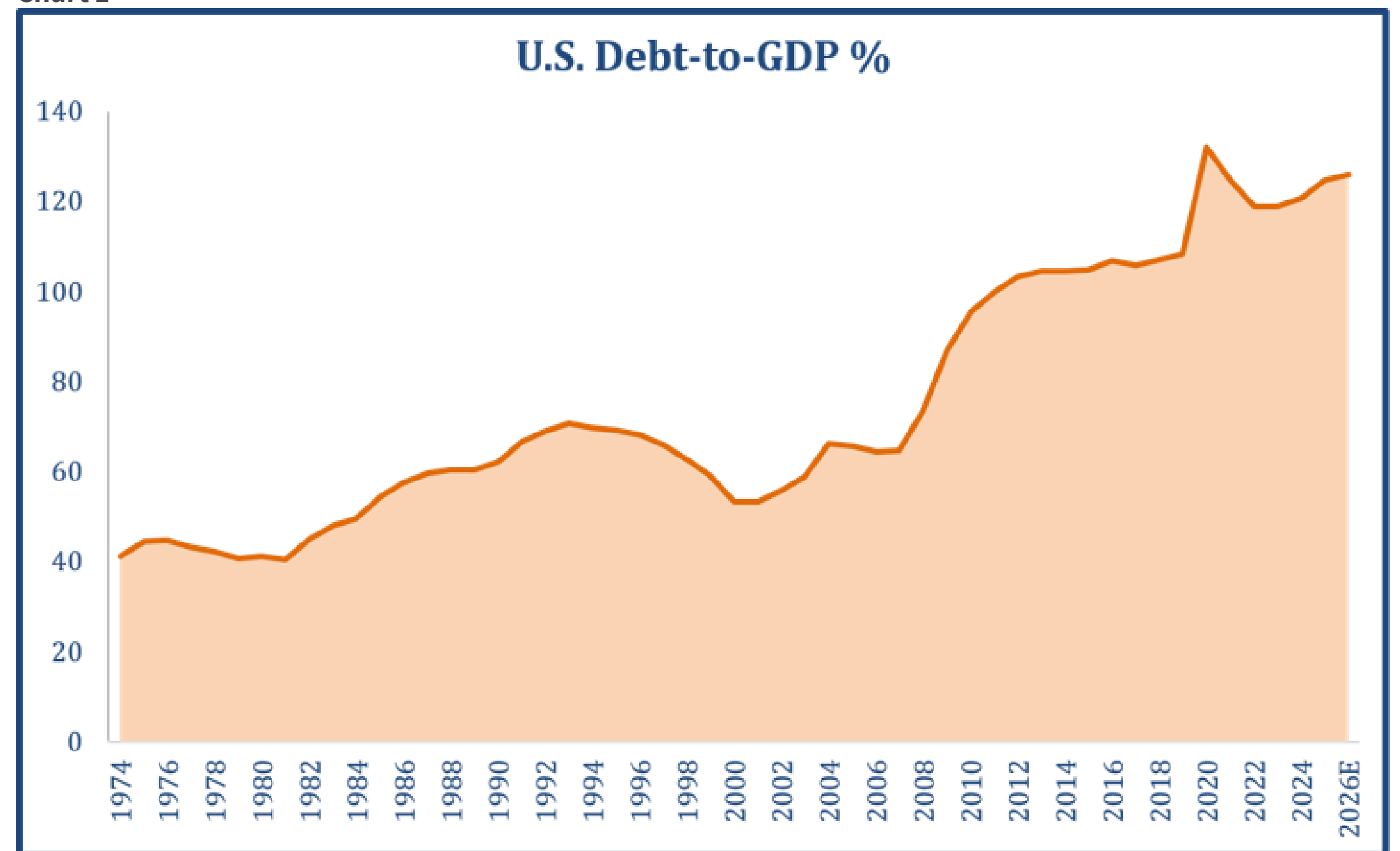
So, what's driving rates up and bonds down? Well, the answer, at least for now, is actually much simpler than the headlines would have you believe. This isn't 2022 all over again, at least not yet. While inflation and higher energy prices certainly deserve a seat at the table, the data just doesn't support the idea that inflation is the primary driver of higher yields. The overwhelming driver has been real rates. Markets went from expecting an easier Fed and potentially six rate cuts in 2026 to realizing that rates may need to stay higher for longer. That repricing is what did most of the damage to bonds.

Now, that doesn't mean we can ignore the other factors. Our fiscal path, growing debt levels, the term premium, energy prices, inflation risk and the changing demand for US Treasuries all matter. In fact, I think some of these issues become increasingly important the longer our debt continues to grow faster than the economy. But there's an important distinction here. Something can be a legitimate long-term problem without being the reason a market moved 127 basis points over a six-month period. And that's really the point of this exercise. We need to separate the things that matter from the things that actually drove the move.

For investors, that distinction matters. If rates moved higher primarily because expectations for real short-term rates changed, then a change in those expectations could ultimately reverse some of the move. A slowing economy, a more accommodative Fed, or a meaningful change in growth expectations could all put downward pressure on real rates. On the other hand, if the fiscal situation continues to deteriorate and investors begin demanding more compensation to own longer-dated Treasury bonds, then we have a different and much more structural problem on our hands.

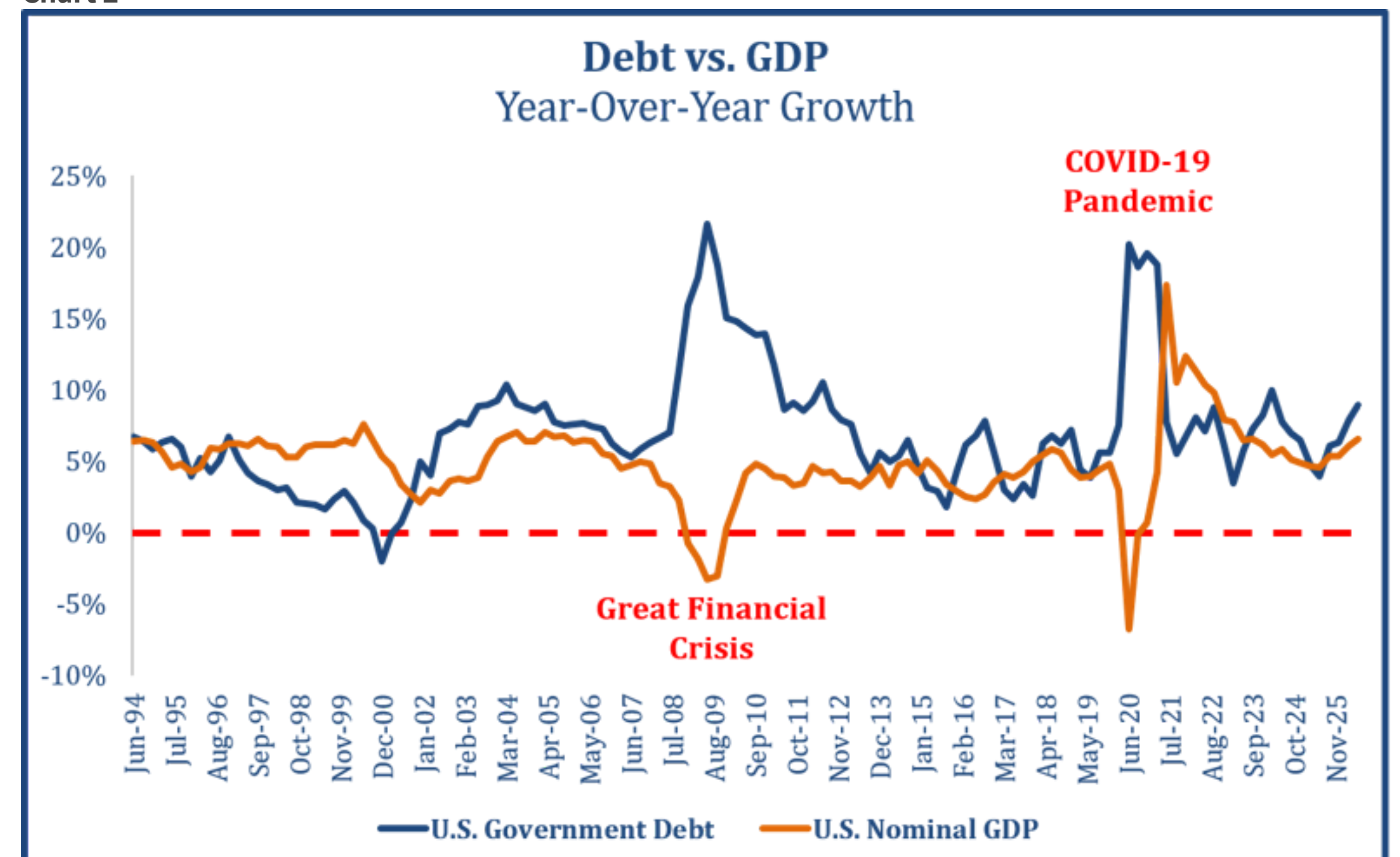
For now, though, I think the lesson is pretty straightforward. Don't confuse the headline with the story. \$40 trillion of debt makes for a great headline. Higher energy prices make for an easy explanation. Inflation makes for an even easier one, especially given what we experienced just a

Chart 1



Data Source: Bloomberg, IMF

Chart 2



Data Source: Bloomberg, IMF, ICM



few years ago. But when you actually take the Treasury yield apart and look at what changed, the story is much clearer. Rates went up because expectations changed. And maybe that's the most important thing to keep in mind as we head into the final stretch of 2026. The bond market isn't necessarily telling us that inflation is coming back. It's telling us that the market's original assumption, that rates would lower, was simply wrong. Everyone stood on one side of the boat and came rushing back all at once. That's a much less exciting story than the headlines. But as investors, our job isn't to find the most exciting story. It's to understand what's actually happening. As always, thank you for your trust and confidence.

Sources

Kim & Wright (2005) — "An Arbitrage-Free Three-Factor Term Structure Model and the Recent Behavior of Long-Term Yields and Distant-Horizon Forward Rates," Federal Reserve Board Discussion Paper. This is the most direct empirical source for the four-component decomposition as written, separating real and inflation risk premia explicitly.

Bank of International Settlements Triennial Central Bank Survey

All data as of 9/30/2026 unless otherwise noted.

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