GEORGETOWN UNIVERSITY

Psaros Center for Financial Markets and Policy
McDONOUGH SCHOOL of BUSINESS

What is the Bond Market Telling Us?

Ernie Tedeschi
Visiting Fellow

Georgetown University's Psaros Center for Financial Markets and Policy

McDonough School of Business

May 2025

Executive Summary: U.S. Treasury Market Turmoil and Structural Shifts (May 2025)

Historically a symbol of global financial stability, the U.S. Treasury market has recently experienced rising yields and investor unease despite a weakening domestic economic outlook. Unusual market behavior, particularly after the April 2 tariff announcement, suggests deeper structural changes in how investors assess U.S. assets.

Key Points:

- **Rising Yields Amid Weak Growth:**
    - 10-year Treasury yield has risen 80 basis points since Sept. 2024; 30-year yield surpassed 5%—levels unseen since 2007.
    - This comes despite a downgraded 2025 GDP forecast (now 0.9%, from 2.0% in Nov. 2024).

- **Tariffs and Policy Shocks:**
    - April 2 ("Liberation Day") tariff policy announcement marked a structural break.
    - Yields rose *despite* increased economic risk and dollar depreciation which is opposite the usual pattern.

- **Drivers of Yield Surge:**
    - Inflation expectations explain only ~25% of the yield rise.
    - Risk-neutral rate remains flat; **term premium** (investor risk compensation) explains the bulk—up 69 basis points since Sept., with a sharp 44-point jump post-April 2.

- **Fiscal and Market Confidence Erosion:**
    - TCJA extension and growing deficits may contribute, but the timing doesn't fully align.
    - Foreign investors increasingly reluctant to finance U.S. debt, indicating a "buyer's strike."

- **Implications:**
    - Erosion of the U.S.'s "exorbitant privilege" to borrow cheaply.
    - Bond market signals concern over U.S. fiscal sustainability, currency role, and institutional strength.

Bottom Line:
The bond selloff reflects not just temporary policy shifts but a fundamental reappraisal of U.S. creditworthiness and global financial leadership, with potentially long-term consequences for interest rates and fiscal policy.

Introduction

The U.S. Treasury market has long been considered the world's most stable and liquid sovereign fixed-income (or commonly referred to as “bond”) market. In recent months, the bond market has experienced turmoil and rising yields despite a deteriorating U.S. economic outlook. Since September 16, 2024, the 10-year Treasury has risen 80 basis points. The 30-year Treasury yield closed above 5% in late May 2025, levels not seen pre-pandemic since 2007, while the 10-year yield nearly touched 4.6%. Meanwhile, the 30-year Treasury Inflation-Protection Security (TIPS) closed at 2.65%, just 10 basis points below its all-time high, and the 10-year TIPS 10 years forward reached its all-time high on May 23, at 3.26%.

Ten-Year US Inflation Compensation
Percentage points

Source: FRB, Haver, author's analysis.

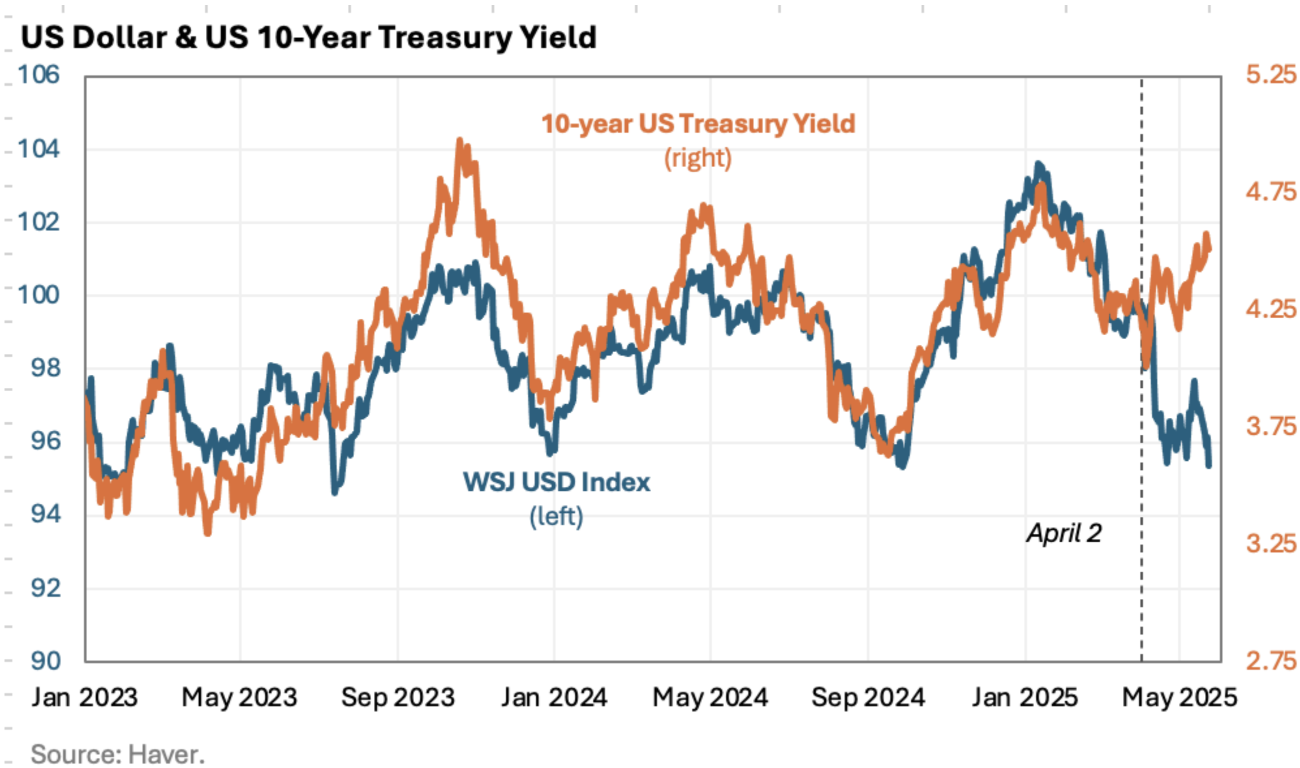
The recent rise in yields is particularly concerning given the weakening economic outlook. In November 2024, the Philadelphia Fed’s Survey of Professional Forecasters (SPF)—a composite private forecast similar to the Blue Chip—projected 2.0% real GDP growth over 2025. Now, the median SPF forecast is only 0.9% growth this year. The primary driving factor behind the growth downgrade is the dramatic shift in U.S. trade policy. Before the agreement with China to temporarily lower tariff rates, The Budget Lab at Yale estimated that all 2025 tariffs would have shaved 1.1 percentage points off 2025 growth if they stayed in place in perpetuity, in line with the May 2025 SPF (whose forecasts were collected before the China pause). Even post-China pause, the hit to 2025 GDP growth is still -0.7 percentage point.

Exploring Potential Causes of the Bond Selloff

The selloff of U.S. Treasuries in this environment, leading to the rise in yields, is unusual. U.S. Treasuries are considered safe, liquid assets, making them a risk-on trade (investors are more likely to buy during periods of higher risk).

Moreover, fundamentally a Treasury yield ought to be equal to investor expectations of overnight Federal Reserve policy rates plus a term premium. If the U.S. economic outlook is weakening, that implies *looser* monetary policy, *lower* policy, and neutral interest rates in the future than expected. Growth fears ought to otherwise put *downward* pressure on yields.

The uniqueness of the environment is illustrated in the figure below, which aligns the 10-year Treasury yield with a measure of the trade-weighted U.S. dollar. While the dollar and Treasury yields do not always move in tandem, they saw a strong correlation over 2023 and 2024. This was a signal of the risk-on nature of Treasuries: as the dollar strengthened—indicating a more robust U.S. economic outlook—demand for Treasuries would weaken, causing prices to fall and yields to rise. The pattern is exactly what one would expect from an advanced economy issuing safe bonds.



As the figure shows, however, the dollar and yields diverged from their recent relationship around April 2—"Liberation Day"—the day the Trump Administration announced its reciprocal tariff policy. The dollar plunged on substantial revisions to the U.S. outlook as a result of the tariffs, but yields did not fall as risks rose. Instead, yields grew too, indicating a structural break in the role of U.S. Treasuries, at least in this recent market environment: investors were *fleeing* U.S. Treasuries at a time of heightened risk. This dynamic represents a departure from historical patterns where rising U.S. yields typically attracted foreign capital and supported the dollar. The fact that higher yields are coinciding with dollar weakness suggests something fundamental shifted after April 2 and overrode typical yield-seeking behavior.

Why would U.S. yields suddenly *rise* in the wake of the April 2 tariff announcement? There are several possibilities.

Nominal yields reflect expectations of real overnight interest rates, a term premium, and compensation for expected inflation. If inflation expectations rose in the wake of tariffs—say, because investors believed tariffs would be passed on to consumers and eventually show up as higher CPI price levels, that would put upward pressure on yields.

Since September 16, inflation compensation over the next ten years—the difference between the 10-year nominal Treasury and the 10-year TIPS— has risen 23 basis points. The shifts in inflation compensation explain only around a quarter in the 80 basis point rise in the 10-year. Moreover, in level terms, 10-year inflation compensation is currently at 2.32%. This is not unusually high and in fact is consistent with the Federal Reserve's 2% PCE inflation target.

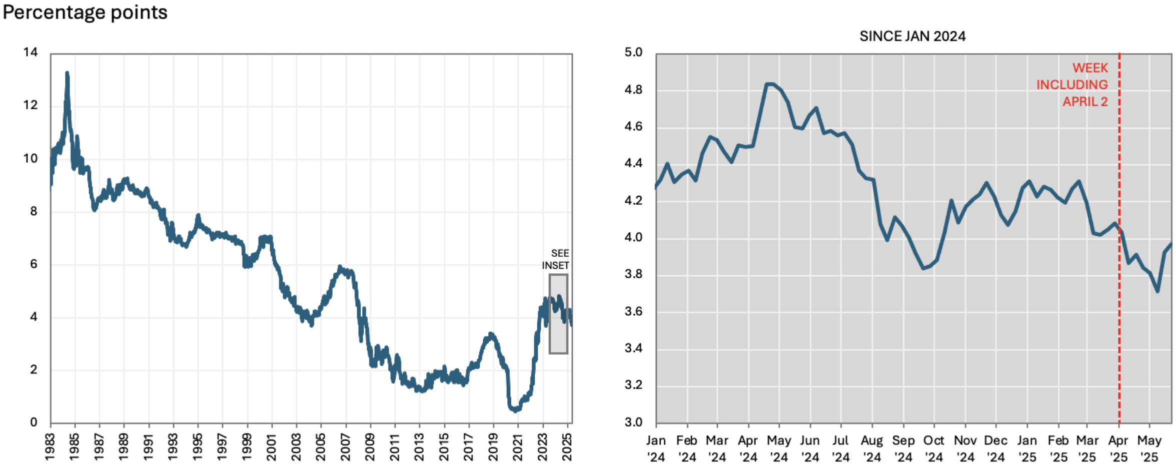
Ten-Year TIPS, Ten Years Ahead
Percentage points

Source: FRB, Haver, author's analysis.

Another possibility is a rise in the risk-neutral rate—the interest rate that would prevail if term risks were neither positive nor negative. This is essentially equivalent to investors' expectations of average Federal Reserve policy rates. To glean the recent behavior of both the neutral rate and the term premium, I use the model of Kiley (2024), which is a recursive, real-time version of regression-based term structure models in the vein of Adrian, Crump, & Moench (2013). The model uses actual short rates plus summary statistics of the level, slope, and curvature of the yield curve to forecast the risk-neutral rate, which in turn allows calculation of the term premium.

The results in the figure below show that the nominal risk-neutral rate stood at 3.97% as of the week ending May 23, only 13 basis points above where it was the week ending September 20, 2024. Moreover, as we might expect, the nominal risk-neutral rate is currently 6 basis points *below* where it was the week ending April 4—the week of "Liberation Day." All of this suggests that shifts in policy expectations do not substantially explain the recent rise in yields, and that, if anything, investors foresee greater (nominal) easing than pre-April 2.

Ten-Year Nominal Risk-Neutral Rate
Percentage points

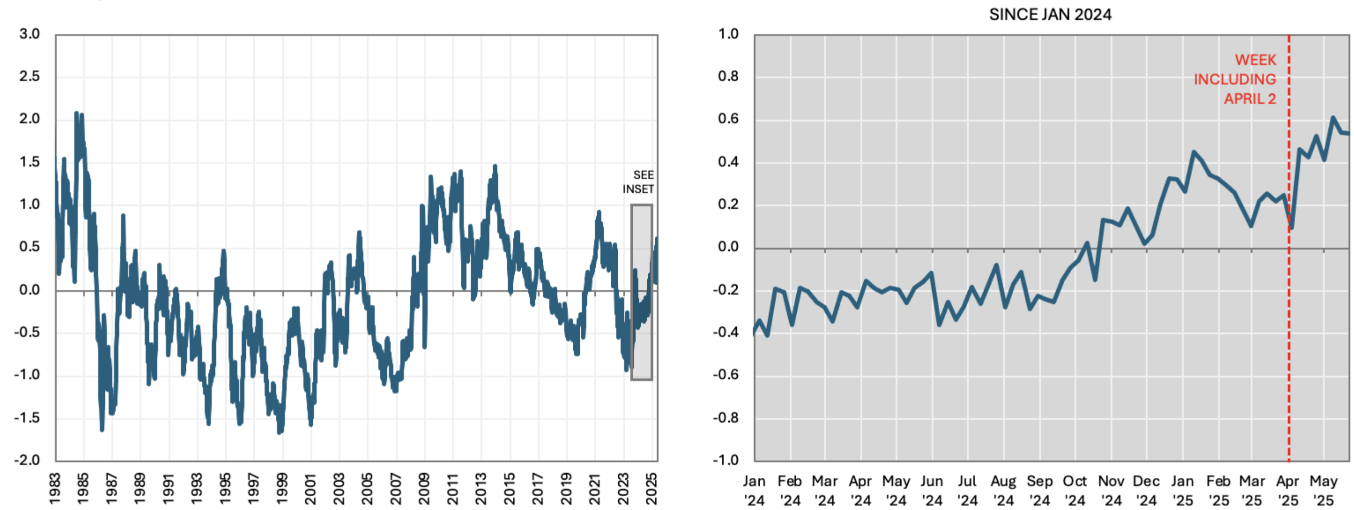


Source: FRB, Haver, Kiley (2024), author's analysis.

By accounting definition, then, the rise in the 10-year must be explained by the only component unaccounted for—the term premium, the additional compensation demanded by investors for holding a Treasury security to maturity. Since the week ending September 20, 2024, the 10-year nominal term premium is up 69 basis points. The lion's share of this rise—44 basis points—has occurred since April 2, 2025, with a 37 basis point jump in the term premium the following week alone.[1]

[1] My implementation of the Kiley (2024) model is on a weekly basis. The daily Adrian, Crump, & Moench (ACM) model confirms that the 10-year term premium reached a local trough on April 4 then began rising rapidly in the days thereafter, spiking 35 basis points in two days and up 58 basis points to date since April 4, consistent with my weekly calculations.

Ten-Year Nominal Term Premium
Percentage points



Source: FRB, Haver, Kiley (2024), author's analysis.

Interpreting the Bond Data

An obvious hypothesis is that the rise in bond yields is linked to a deterioration in expectations of the U.S. fiscal trajectory, given current negotiations over the reconciliation package in Congress extending the Tax Cuts & Jobs Act (TCJA). There is a well-studied relationship between bond yields and fiscal expectations, with Laubach (2003) being arguably the most prominent result, but with many other examples as well.[2] As deficit expectations rise, so do interest rates empirically, with an effect of anywhere from 1 to 6 basis points on long-run rates for every 1 percentage point-of-GDP increase in debt expectations. Tedeschi (2019) finds that this rise in interest rate expectations primarily runs through the term premium.

But the details of reconciliation so far, as well as the timing of the jump in the term premium and the dollar-yield decoupling, raises questions about how much pure debt expectations can explain recent yield movement. To start, while the current reconciliation bill does raise the deficit significantly against current law, the magnitude of the deficit effect is in line with what one would have projected anyway under full TCJA extension. Markets already expected an extension of the TCJA. (In 2024, Vice President Harris ran on extending the TCJA for everyone making under $400,000, and there was wide speculation during the campaign that this threshold could rise further and cover more filers in the event of a Harris victory). Over a decade, a full extension of the TCJA costs $4-5 trillion against current law. The House's "One Big Beautiful Bill" meanwhile contains $7.7 trillion in tax cuts over a decade and $3.9 trillion in offsets, for a net deficit effect of $3.8 trillion through 2035 (the bill must still go through the Senate and, very likely, conference committee or Congressional back and forth between the two chambers).

[2] Gust and Skaperdas (2024) have an excellent review.

The timing of the early-April term premium rise also does not line up with new fiscal information. Markup of committee instructions in the House did not start until April 30, well after the jump in term premium, and did not start for Ways & Means (the tax writing committee with responsibility for most of the package's gross cost) until May 13, with the first draft of tax legislation not released until the night of May 9. The Moody's downgrade of the U.S. sovereign rating to Aa1 did not occur until May 16.

An alternative possibility is that markets had been hoping for substantial tariff revenue to offset the cost of tax cuts and were disappointed with the fiscal potential of the April 2 announcement. But this is inconsistent with other market data. The S&P 500 was down 4.8% the next day and down 6% again on April 4. By all accounts, the magnitude of the April 2 tariff announcement surprised markets to the *upside*, implying *more* tariff revenue than forecasted.

None of this means that fiscal concerns are playing *no* role in recent yield movements, especially in the last few weeks, as genuinely new fiscal information has become available. But it does suggest that the story is more complex than just a further pivot in an already-unsustainable U.S. debt trajectory. As George Saravelos, head of FX research at Deutsche Bank, observed, "At the core of the problem is that foreign investors are simply no longer willing to finance U.S. twin deficits at current level of prices." This represents, as he puts it, a "buyer's strike" on U.S. assets, with foreign investors becoming increasingly reluctant to fund American fiscal expansion given growing doubts about the U.S. economic outlook and the continued central role of the U.S. in global financial and currency markets given the trade war.

Conclusion

The current U.S. bond market turmoil is different from other recent episodes—it signals a fundamental shift in how global investors view the risks of American assets, not just due to the sustainability of U.S. debt dynamics but also the durability of the dollar as the world's reserve currency and perhaps even the robustness of U.S. economy. The convergence of rising yields, credit downgrades, foreign investment withdrawal, and dollar weakness paints a picture of an economy whose economic outlook and fiscal privileges can no longer be taken for granted.

For decades, the United States has benefited from what economists call "exorbitant privilege"—the ability to borrow at lower rates than economic fundamentals might otherwise suggest, thanks to the dollar's reserve currency status and Treasury bonds' safe-haven appeal. The current market dynamics suggest this privilege is at the very least being questioned at the moment, and perhaps persistently eroding, potentially ushering in an era where fiscal discipline becomes not just economically prudent but market-mandated.