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# Decoding the (Almost) 5% 10-Year Treasury Yield

Investors debate whether borrowing benchmark has finally topped out

**Treasury yields**

Sources: Ryan ALM; Tradeweb ICE Closes

*By Sam Goldfarb* Follow

Updated Oct. 30, 2023 12:33 pm ET

The yield on the benchmark 10-year U.S. Treasury note touched 5% for the first time in 16 years last week, spurring debate about whether it has peaked or just taken another step in its long and disruptive climb.

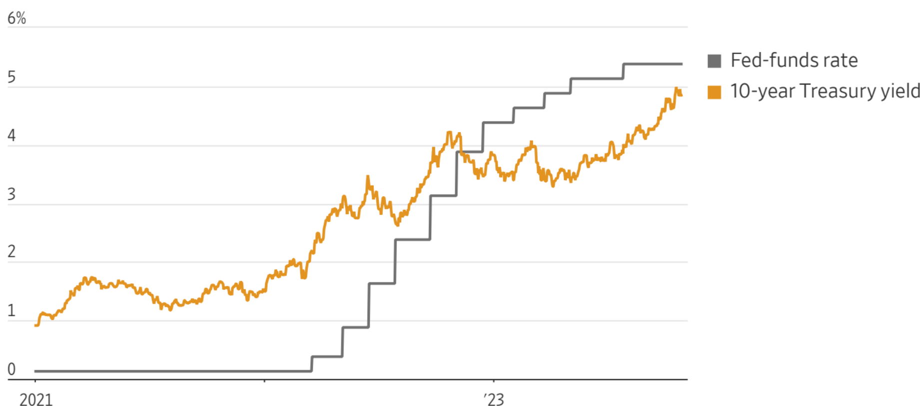
Treasury yields play a critical role in determining borrowing costs across the economy. Their nearly two-year surge has driven 30-year mortgage rates close to 8%, weighed on stocks and stirred anxieties that the surprisingly resilient economy could finally fall into a recession.

Here is a look at how yields got here and their possible paths forward:

## The Fed sets the tone

Yields on Treasurys largely reflect investors' expectations for what short-term interest rates set by the Federal Reserve will average over the life of a bond. As a result, the 10-year yield never quite got all the way down to zero, where short-term rates effectively sat during most of 2020 and 2021. And they started climbing in 2022 before the Fed ever raised rates.

**Borrowing benchmarks**




Note: Fed-funds rate reflects midpoint of target range

Sources: Tradeweb ICE Closes (10-year yield); St. Louis Fed (fed-funds rate)

Since late last year, the 10-year yield has been sitting below the federal-funds rate, reflecting bets that the Fed will cut rates in the future. But the overnight borrowing rate still establishes its rough parameters.

## The inverted yield curve and the forces against it

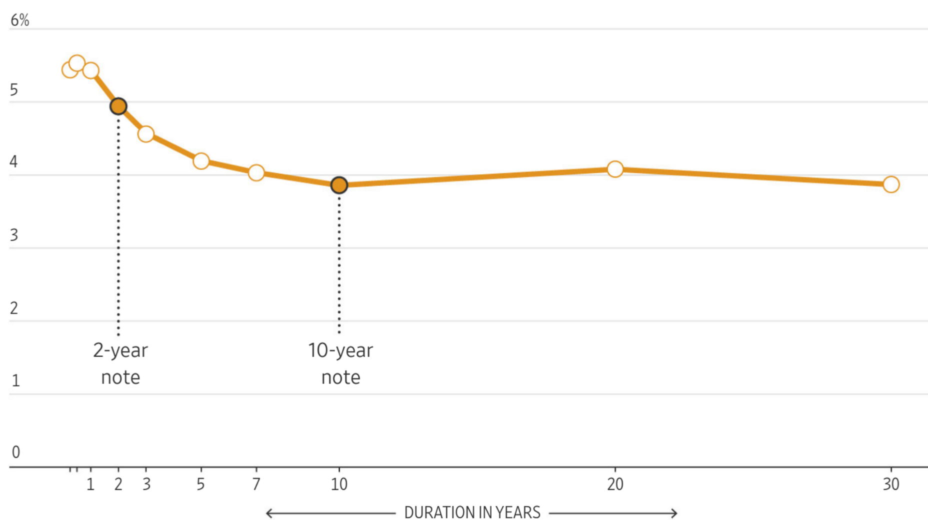
For much of 2022 and 2023, longer-term Treasury yields were well below short-term ones.

That anomaly, known as an inverted yield curve, is infamous for a reason. To accept lower yields on longer-term Treasurys, investors need to have a strong conviction that interest rates will fall in the future, most likely because of a recession.

Even modest doubts, or impatience, can tempt investors into the higher-yielding short-term Treasurys, driving longer-term yields up and shorter-term yields down.

Another reason to avoid longer-term bonds under these conditions: Holding them can cause investors to lose money just because of the passage of time. Bonds become increasingly short-term as their maturity dates draw closer. With the curve inverted, that means, for example, that the price of a three-year note will fall as it becomes a higher-yielding two-year note.

**Treasury yield curve as of July 3, 2023**




Source: Treasury Department

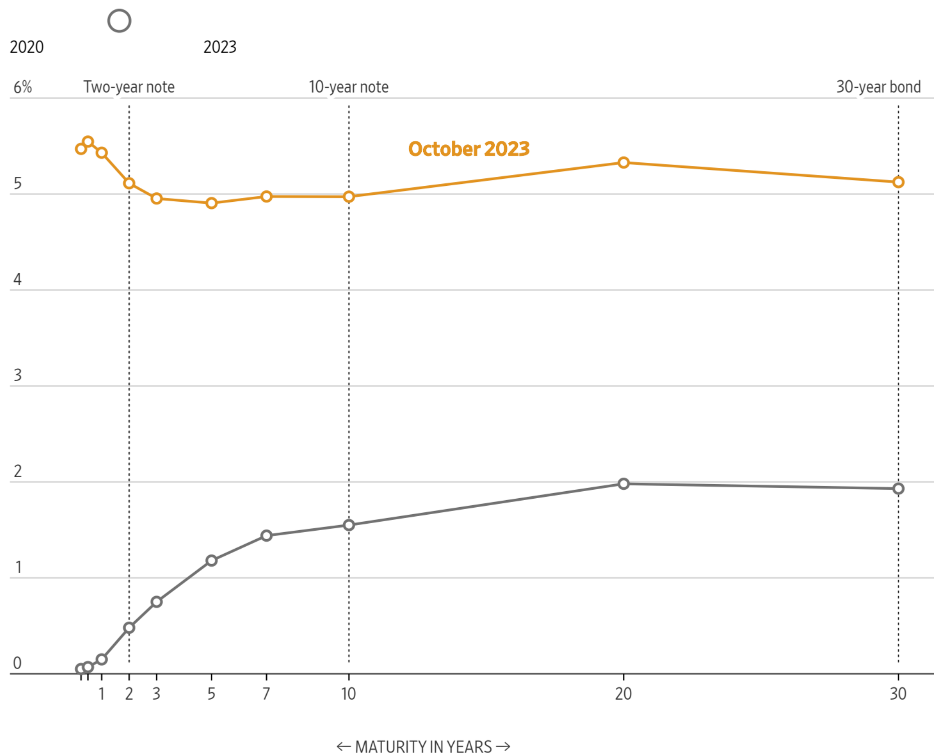
Even so, betting that the curve would become even more inverted was one of the most popular trades on Wall Street earlier this year.

Some investors didn't have a firm view on how high bond yields should be on their own. But they did feel safe wagering on their relative levels. With Fed officials raising rates to fight inflation—and openly acknowledging the risk that their efforts could cause a recession—many thought it was an easy call that rates would be higher in the near term than over the long term.

## The unwinding of a popular bet

Unexpectedly, however, economic growth started to show signs of accelerating over the summer, right around the same time that data was showing a slowdown in gauges of underlying inflation. A recession seemed simultaneously both farther off and less inevitable.

As can often happen on Wall Street, what is called crowded trade provided fuel for a huge swing in the opposite direction. Investors, having already sacrificed short-term returns by favoring longer-term Treasurys, started reducing those positions. That led to losses for those who weren't early to pivot, pushing more to throw in the towel and a big jump in longer-term yields.




Note: Values are as of month-end, except the most recent month, which is as of Oct. 23.
Source: Treasury Department

The experience of recent months is unusual. Typically, inverted yield curves un-invert because the Fed is cutting rates or close to doing so in response to a slowing economy. That, in turn, causes short-term yields to fall sharply, dropping them back down below longer-term yields.

This time, though, the gap is collapsing because of economic strength, not weakness, with longer-term yields rising instead of short-term yields falling.

## Supply-demand mismatch?

Other factors beyond interest-rate expectations may also be pushing up yields.

Over the course of just three trading sessions starting at the end of July, the Bank of Japan said that it was lifting its cap on Japan's 10-year government bond to 1% from 0.5%; the U.S. Treasury Department announced a much larger than expected borrowing forecast; and Fitch Ratings downgraded the U.S. credit rating to one notch below triple-A, citing a worsening budget outlook and governance concerns.

All three developments sparked worries that a growing supply of Treasurys might meet insufficient demand. With higher yields now available on Japan's bonds, investors in the world's third-largest economy may now have less need to invest overseas, including in the U.S.

## A 5% ceiling?

Investors have long hoped that certain key levels would serve as a ceiling for the 10-year yield, whether 2.5% early in 2022, 4% later that year, or 5% now.

Indeed, reaching 5% in early trading last Monday sparked a rally in Treasurys, with the yield dropping to 4.84% by the end of the trading session. In recent trading, it was hovering around 4.9%, according to Tradeweb.

A 5% yield strikes some investors as high, given potential threats to the economy from wars overseas to the increase in borrowing costs.

Others argue that the 10-year yield could realistically rise to the level of the fed-funds rate, which is currently around 5.3%. Any more could be difficult, with Fed officials signaling that they expect to cut rates at some point, even absent a recession, to reduce the risk of an unintentionally severe slowdown.

Uncertainty remains, however, about how much the Fed would cut rates and how quickly. Given how well economic growth has held up so far, many see a decent chance that the cuts would be modest. That, in turn, argues for yields to stay roughly where they are now—a vote of confidence in the economy, if disappointing for borrowers.

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