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Are Treasury Yields Flashing a Warning Signal?

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Bond yields and borrowing costs are at the highest point in years. In fact, as of this writing the 10-Year Treasury just hit the all-important 5% level, the highest since 2007 (before the Global Financial Crisis). It is expensive to borrow. It would be a tough pill to swallow locking in a fixed-rate mortgage right now at nearly 7%.

Higher yields should equate to lower equity valuations overall due to the opportunity cost of attractive fixed income investments and the potential for a slowing economy as higher borrowing costs restrain investment. President Trump has continued to argue for lower rates, while his appointed Fed Chairman, Kevin Warsh, now faces a difficult inflation backdrop.

Stubborn inflation is the key issue, with energy prices as the linchpin. Higher inflation impacts the average American perhaps even more than a recession. The traditional way to combat persistent inflation is to raise borrowing costs and slow demand, but that becomes much more difficult when the source of the problem is energy. The latest CPI report showed inflation running at 3.4% year-over-year, while energy prices were up 14.7% and gasoline prices 24.6%. Higher bond yields may reflect not only expectations for future Fed policy, but also higher inflation expectations, heavier Treasury supply, and concerns about the fiscal outlook.

High energy prices are being fueled in part by the wars in Iran and Ukraine. Ukraine has continued to attack Russian refining and energy infrastructure, contributing to disruptions in Russian fuel production and exports. In Iran, what was initially expected by some to be a relatively short conflict is now going on seven months, with no clear end in sight and continued disruption around the Strait of Hormuz.

Stock prices are still near highs because of a resilient economy and strong earnings fueled in part by AI infrastructure spending. Up until now, it seems that market participants have largely anticipated that Trump could control the situation in Iran much like he did with the tariffs, meaning that he has the option of reversing course and capitulating to the desires of the markets.

What if it is different in this scenario because Iran refuses to negotiate and Trump is forced to escalate despite market worries? The situation in Iran could be a test. If Trump does not maintain the initiative in Iran and cannot navigate a

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reasonable exit, then oil prices could remain higher for longer than many investors are anticipating. Brent crude recently moved above $100 per barrel as attacks and shipping disruptions intensified. If the conflict persists through the November midterm elections, markets may have to reassess the assumption that this is a temporary disruption. What initially looked like a conflict with a definable end could instead become a much more persistent problem.

Should it come, a period of volatility could be an opportunity for many investors after a particularly strong bull market over the past three years. High yields are giving bond investors an opportunity to lock in attractive income levels that simply were not available for most of the past decade. A pullback in stocks could allow an attractive entry point for those allocating fresh capital. If volatility elevates and persists, then tactical risk management strategies could buffer portfolios by reducing exposure to risk assets and boosting liquidity in accounts. Volatility and disruptions are normal and should be expected over time. Investors that are taking too much risk in their portfolio should consider a rebalance. The danger is not the market; it is complacency and overconfidence leading to portfolio allocations that are not appropriate for financial plans.

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