Bond Yields: The Long and Short of It

Government bond yields have risen roughly 70 basis points over the past six months, and investors hoping for relief are learning an uncomfortable lesson: not all forces moving markets pull with equal strength. Tellingly, the recent decline in expected inflation brought no reprieve. Nominal yields held firm, so the entire adjustment fell on real rates, which have continued to climb.

Yields are shaped by two sets of hands. Longer-term secular factors – the structural supply and demand for capital – grind slowly but powerfully. Short-term cyclical forces – the ebb and flow of growth and inflation – tug in the opposite direction. Right now, the market is a tug of war, and the cyclical camp is losing.

On paper, the cyclical case for lower yields is respectable. Inflation prints have softened, labor markets are cooling, and the global manufacturing cycle is softening. In an earlier era, that trio would have been enough to rally bonds convincingly.

Yet the secular team is simply stronger. Fiscal dynamics across most major economies point to relentless issuance, with deficits structurally embedded and little political appetite to shrink them. This arrives just as the technology sector ramps up debt-funded capital expenditure, competing for the same pool of savings. The buyer base has shifted, too: the once-reliable bid from international investors is fading, replaced by domestic holders who invest at shorter horizons and are more swayed by sentiment than by yield.

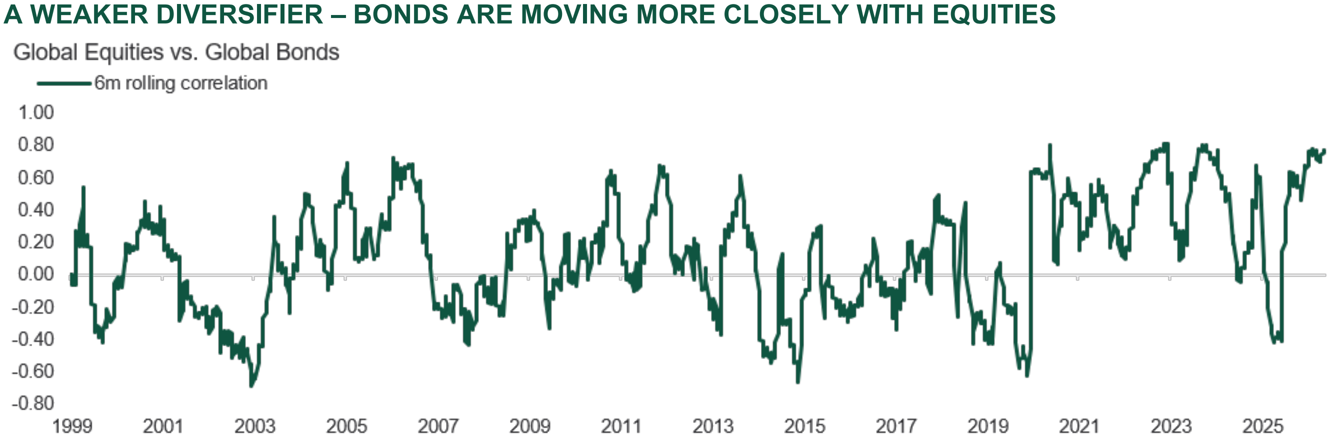
The cyclical bulls also face a nagging doubt. Markets increasingly fear second-order inflation effects, as tighter energy markets, firmer fertilizer and oil distillate prices, and rising shipping costs feed through the system. Central banks offer reassurance by stressing vigilance on inflation risks, and several larger ones have already lifted rates, hardly the posture of an easing cycle.

For those tempted to buy the dip, the valuation case is only lukewarm. Term premium, compensation for the risk of holding longer-dated paper, has risen, but merely back to its historical average. Fair, not cheap.

The deeper worry for asset allocators is subtler. The correlation benefit of owning bonds has reversed. For most of the post global financial crisis (GFC) era, bonds rallied when equities fell, providing dependable diversification. That insurance policy has lapsed.

This leaves investors holding an asset that is neither compellingly cheap nor reliably protective, in a market where the strong forces push one way. For now, our team's recommendation remains to be underweight bonds relative to stocks.

A WEAKER DIVERSIFIER – BONDS ARE MOVING MORE CLOSELY WITH EQUITIES



Source: Northern Trust Asset Management, Bloomberg. Six-month rolling correlation in weekly returns between MSCI AC World Index and Bloomberg Global Aggregate Index from 6/12/1998 until 8/14/2026. Historical trends are not predictive of future results.

POSITIONING SCENARIOS

Productivity Upside (25% probability)

AI-related investment drives broad-based productivity gains that support above-trend economic growth without generating meaningful inflationary pressure.

Two-Speed Expansion (50% probability)

Changing labor force dynamics and a bifurcated economy govern what would otherwise be a stronger growth environment, resulting in a trend-like expansion and eventual disinflation next year.

Economic Fault Lines Broaden (25% probability)

The economic expansion is cut short by persistent supply-side restraints, energy headwinds, or AI-related disruption that weakens activity and/or tightens financial conditions.

Note: Probabilities are assumed from proprietary research and are subject to change.

Additional Index Definitions:

Bloomberg Treasury Bills 1-3 Months: The Bloomberg U.S. Treasury Bills: 1-3 Months Index tracks the market for treasury bills issued by the U.S. government with time to maturity between 1 and 3 months. US Treasury bills are issued in fixed maturity terms of 4, 8, 13, 17, 26 and 52 weeks.

Bloomberg U.S. Treasury: The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The US Treasury Index is a component of the US Aggregate, US Universal, Global Aggregate and Global Treasury Indices. The index includes securities with remaining maturity of at least one year.

Bloomberg Global Treasury: The Bloomberg Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index.

Bloomberg Municipal: The Bloomberg Municipal Bond: Index is a flagship measure of the US municipal tax-exempt investment grade bond market. Included in the index are securities from all 50 US States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The index includes state and local general obligation bonds and revenue bonds. All bonds in the Municipal Bond Index are tax exempt and hence are not eligible for other indices that include taxable bonds, such as the Bloomberg U.S. Aggregate.

Bloomberg U.S. TIPS: The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.

Bloomberg Global Inflation-linked: The Bloomberg Global Inflation Linked Index (Series-L) measures the investment-grade, government inflation-linked debt from 12 different developed market countries. Investability is a key criterion for inclusion of markets in this index, and it is designed to include only those markets in which a global government linker fund is likely and able to invest.

Bloomberg U.S. Aggregate: The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, US Aggregate-eligible securities also contribute to the multi-currency Global Aggregate Index and the US Universal Index.

Bloomberg Global Aggregate: The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-seven local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

JP Morgan GBI – EM Global Diversified Composite Index: The J.P. Morgan Emerging Markets Bond Index Global Diversified tracks total returns for U.S. dollar-denominated debt instruments issued by emerging market sovereign and quasi-sovereign entities.

Bloomberg U.S. High Yield: The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices.

Bloomberg Global High Yield: The Bloomberg Global High Yield Index is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.

MSCI AC World: The MSCI ACWI captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries.

MSCI USA: The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

S&P 500: The index, a gauge of the large-cap U.S. equity market, includes 500 companies that represent approximately 80% of the market capitalization of publicly traded U.S. equities.

Russell 2000: The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe.

Russell 1000 Growth: The Russell 1000® Growth Index measures the performance of the largecap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years). The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

Russell 1000 Value: The Russell 1000® Value Index measures the performance of the largecap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years). The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

MSCI World: The MSCI World Index captures large and mid cap representation across Developed Markets countries.

MSCI World ex US: The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries*--excluding the United States. With 778 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Europe: The MSCI Europe Index captures large and mid cap representation across Developed Markets (DM) countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

MSCI Japan: The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. The index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI Emerging Markets: The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI China: The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The index covers about 85% of this China equity universe. Currently, the index includes Large Cap A and Mid Cap A shares represented at 20% of their free float adjusted market capitalization.

S&P Global Natural Resources: The index includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining.

S&P Global Infrastructure: The S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation, and utilities.

MSCI ACWI IMI Core Real Estate: The MSCI ACWI IMI Core Real Estate Index is a free float-adjusted market capitalization index that consists of large, mid and small-cap stocks across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries* engaged in the ownership, development and management of specific core property type real estate. The index excludes companies, such as real estate services and real estate financing companies, that do not own properties.

Cboe S&P 500 Dispersion Index (DSPX): The Cboe S&P 500 Dispersion Index (DSPX) measures the expected dispersion in the S&P 500® over the next 30 calendar days, as calculated from the prices of S&P 500 index options and the prices of single stock options of selected S&P 500 constituents, using a modified version of the VIX® methodology.

Caldara Iacoviello Geopolitical Risk (GPR) Uncertainty Index (GPRXGPRD): Geopolitical Risk Index (GPR) is compiled by Fed economists Dario Caldara and Matteo Iacoviello. It measures the occurrence of impactful geopolitical events/threats/conflicts since 1985 by counting the keywords used in the press. The Caldara and Iacoviello GPR index reflects automated text-search results of the **electronic archives of 10 newspapers:** Chicago Tribune, the Daily Telegraph, Financial Times, The Globe and Mail, The Guardian, the Los Angeles Times, The New York Times, USA Today, The Wall Street Journal, and The Washington Post. Caldara and Iacoviello calculate the index by counting the number of articles related to adverse geopolitical events in each newspaper for each month (as a share of the total number of news articles).