SMITH AFFILIATED CAPITAL

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The Not-So Boring Bond Market Takes Center Stage

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With the dog days of summer over, the economy has entered a new season that, hopefully, will be more tranquil than the last. Sadly, that prospect is looking less likely with each passing day. The Iran war is still raging, energy prices are still elevated, trade tensions are still ramping up, and households are still downbeat, particularly in the budget-constrained lower-income cohort. In addition to these lingering stressors, the U.S. is bracing for the midterm elections, with the usual onslaught of negative campaign ads, and the beginning of what is likely an interest-rate hiking cycle by the Federal Reserve. The first hike took place on September 16, and all indications are that more will come.

Despite the turmoil over the summer, the economy has weathered the storm quite admirably. With two months of critical data on the books, it looks like it will expand at a healthy pace of around 4-5 percent in the third quarter, which would double the growth rate over the first half of the year and is solidly faster than the long-term trend. The job market is holding up as unemployment continues to hug near-historic lows. Consumers, the economy's main growth driver, are still spending, fueled by wealth gains in the stock market accruing to affluent households. An equally powerful contribution is coming from the AI buildout, generating hundreds of billions of dollars for construction spending on data centers, semiconductors, and other tech-related projects.

Unsurprisingly, amid the economy's solid performance and an inflation rate that has remained stubbornly above the Fed's 2 percent target, the bond market has grabbed more headlines than the usually sexier stock market. Long-term interest rates have surged, with the bellwether 10-year Treasury yield piercing the 5 percent threshold on a sustained closing basis for the first time since before the Global Financial Crisis. While that has taken center stage, yields throughout the maturity spectrum have risen appreciably, as the fixed income market has become a viable alternative to stocks in the search for lucrative portfolio returns. Indeed, the 2s/30s spread had flattened by as much as 50 basis points (bps) this year before modestly steepening in the final days of September. Markets are pricing in close to four rate hikes through next October — a bit aggressive in our view, but energy-driven inflation risks and heavy Treasury and corporate supply should keep yields biased higher over the near term. For corporate treasurers, that combination of hawkish repricing and elevated issuance points to further upward pressure on borrowing costs into year-end.

The Normalization Process

There are many explanations for the rise in bond yields over the past three months. To some, passing the 5 percent psychological level could be the tipping point for a U.S. economy that has become accustomed to twenty years of low interest rates. Before jumping to that conclusion, however, it's important to recognize that while 5 percent seems high to the current generation, it is below where it was for almost all of the forty years prior to 2007. True, times and conditions are different, but we caution that there is no magic number that determines whether the economy expands or sinks.

From our perspective, the selloff has been largely driven by a renormalization process from the 2010s, when deleveraging, oversaving, ZIRP, liquidity traps, QE, and deflation dominated the G7 world, producing negative real rates most of the time. This process persisted steadily throughout September, but the final leg up was particularly sharp, with

10-year yields hitting 5.25 percent in the last few days of the month. The direct culprits behind the most recent spurt were strong economic data, highlighted by Flash Purchasing Managers' Index (PMI) Reports, upward revisions to GDP, and continued muscular consumer spending leading the markets to price in a more hawkish Fed policy.

While inflation expectations on Main Street have increased somewhat, reflecting primarily the climb in oil and gas prices, they have not on Wall Street. Unexpectedly and interestingly, the inflation breakeven rate has fallen noticeably since early September. In late September, the 10-year breakeven, the 5-year breakeven and the 5-year, 5-year-forward breakeven rates all stood at 2.34 percent, about 5-10 bps lower than two weeks earlier. Hence, real yields have led the rise, with the 10-year TIPS yield surging by a half- percentage point during the month. The crucial question today is how close is the renormalization process to an end?

Reflective Versus Restrictive

Conceptually, rising bond yields can be decomposed into two distinct phases. The first phase is "reflective" in nature, as rising real yields often reflect strengthening nominal growth and expectations that the Fed will need to raise rates more than previously thought to keep inflation under control. That phase is clearly where we are now, as incoming data have been surprisingly strong, and Fedspeak has turned decidedly more hawkish. However, bond prices can fall too much, pushing yields into a "restrictive phase" where the underlying economy begins to slow because borrowing costs have become too high.

There is no hard-and-fast way to tell precisely where the cutoff point is between these two phases, but investors can always get a sense of how close the economy is to a "choke point" by observing market action. Typically, when the Treasury yield curve begins to flatten and eventually invert, the message from the bond market is that we are either close to or already at that "choke point." Stock prices also tend to fall hard, and more often than not, the economy falls into a recession. That said, it is not a foolproof indicator as the economy held up throughout the 2022-2024 inversion, fueled by unprecedented fiscal stimulus.

Fast-forward to today: Our hunch is that we are fairly close to the endpoint of the bond market renormalization process. First, the yield curve has flattened by 40 bps since early this year, and now there are about 30 bps to go before the curve inverts. The short end of the curve has priced in four additional rate hikes. In all likelihood, the Fed may not tighten that much. Should the Fed indeed follow the forward market, the fed funds rate would climb back to levels close to those in 2022, when core inflation was running at more than 5 percent and nominal GDP growth at 10-12 percent. Currently, both inflation and nominal growth are running at roughly half the rates seen in 2022-23. In our view, the forward market does look excessive in discounting 100 bps of additional rate hikes by the end of 2027.

Big Unanswered Question: Whither Goes Energy and Productivity

President Trump said that there will be a deal with Iran after the midterms. No one knows what the deal is, but rational analysis suggests that Iran's incentives to drive up oil prices will wane after the November elections. Should oil prices fall hard, both stocks and bonds could rally explosively, unwinding the hawkish sentiment both in financial markets and among Fed officials. That unwinding will get a big boost if diesel prices also retrace their astonishing surge, which exceeded the climb in crude. That surge is being deeply felt at grocery stores and many other establishments where consumers shop, as the goods sold there are mostly transported by diesel-powered trucks.

How the energy shock is resolved remains to be seen. But markets are also facing a standoff between surging productivity, which tends to compress inflation, and the inflationary consequences of an AI-related investment boom that exceeds anything the U.S. has ever experienced. The latter is having a bigger impact now, driving up costs of energy and computer chips and delivering knock-on effects that are feeding through to broader inflation.

The AI boom is also juicing the stock market, which, in turn, is boosting the wealth of affluent households, who are the main drivers of consumer spending. Lower-income households have exhausted the outsize tax refunds that supported spending over the spring even as inflation has outpaced wage growth for five consecutive months, eroding real purchasing power. This cohort is struggling with depleted savings and high borrowing costs that will take an increasing

toll on spending in the coming months. We expect that the robust growth tracked for the just-completed third quarter will mark the peak for the cycle, easing inflationary pressures coming from the demand side of the ledger.

Structural Forces Will Keep Rates Higher for Longer

But the AI boom is also delivering productivity gains that have had a powerful influence on growth. Indeed, productivity improvements have accounted for more than half of the economy's growth over the past two years. That includes the recent upward revisions to GDP, all of which were due to stronger productivity, as previously reported estimates of hours worked were virtually unchanged. We believe that the improving productivity trend is in its early stages and will accelerate in the coming years as AI adoption rates increase and firms become more competent managers of the rapidly evolving technology. Hence, by next year, the disinflationary influence of productivity should become as visible as the growth and inflationary impact it is having now.

That said, the strength of recent economic data supports the case that Fed policy isn't especially restrictive. The Federal Reserve is still focused on the upside risks to inflation from higher energy prices, which will be on display in the September inflation data. The lags between rises in diesel prices and broader core inflationary pressures mean that upside risk will persist at least through the end of the year. We therefore expect the Fed to keep its hawkish bias and to raise rates at least once more this year.

But incoming data, new and revised, also underscore that the economy's resilience depends heavily on AI and the strength provided by higher-income households. A sharp unwinding of AI-related optimism and a large correction in the stock market are among the biggest threats to the outlook in 2027. At the same time, the enormous AI-related borrowing needed to fund the insatiable investment-spending appetite of the hyperscalers is competing with the ever-growing financing needs of the government. This toxic combination is a structural influence that will sustain upward pressure on bond yields.

Little relief from that pressure will come from the supply side as the administration's deglobalization policy via tariffs aimed at reducing trade deficits – and, hence, capital inflows that reliably flow into and hold Treasury securities – is rechanneling that demand into more volatile, price-sensitive hands. This suggests that a higher term premium will offset at least part of the real yield decline normally associated with a slowing economy and lower inflation. With bond yields expected to remain higher for longer, there should be ample opportunity to obtain attractive returns by adding high-quality securities to the portfolio mix in 2027.

Rates and Total Returns Quarterly And Annual Comparison

U.S. Treasury Market	Yield %			Total Return (%)	
	12/31/2024	12/31/2025	9/30/2026	3rd Qtr.	12 M 2026
3 Mo Bill	4.32	3.63	4.12	0.92	3.72
2 Year Note	4.24	3.48	4.89	-0.22	1.42
5 Year Note	4.38	3.73	5.09	-2.63	-1.86
10 Year Note	4.57	4.17	5.29	-5.17	-4.25
30 Year Note	4.78	4.85	5.63	-8.74	-8.53

Municipal Bonds	Yield (%)			Total Return (%)	
	12/31/2024	12/31/2025	9/30/2026	3rd Qtr.	12 M 2026
BB General Obligation Index	3.53	3.34	4.60	-6.30	-2.88
BB New York Bond Index	3.74	3.66	4.83	-6.72	-2.77
BB California Bond Index	3.50	3.36	4.61	-6.04	-2.74
BB Revenue Index	3.84	3.70	4.85	-6.40	-2.61

Equities	Levels			Total Return (%)	
	12/31/2024	12/31/2025	9/30/2026	3rd Qtr.	12 M 2026
S&P 500	5,882	6,846	7,652	2.30	15.72
Dow Jones	42,544	48,063	50,906	-2.34	11.50
Nasdaq 100	21,012	25,250	30,409	0.58	24.00

Commodities	US $			Total Return (%)	
	12/31/2024	12/31/2025	9/30/2026	3rd Qtr.	12 M 2026
Comex Gold Future ($ per oz)	2,641	4,341	4,156	2.00	2.58
Commodity Futures (CRB) Index	297	299	410	16.02	36.48
W. Tx Int. Crude Future ($ per bbl.)	72	57	90	46.33	88.33

Currencies	Levels			Percent Change (%)	
	12/31/2024	12/31/2025	9/30/2026	3rd Qtr.	12 M 2026
DXY	108.49	98.32	101.45	0.26	3.76
Yen	157.20	156.71	157.41	-3.16	6.42
Sterling	1.25	1.35	1.33	0.02	-1.35
Euro	1.04	1.17	1.13	-0.81	-3.44

Global Bond Markets	Levels			Total Returns USD (%)	
	12/31/2024	12/31/2025	9/30/2026	3rd Qtr.	12 M 2026
German 10 year	2.36	2.85	3.59	-4.96	-6.91
Japanese 10 Year	1.09	2.06	3.05	1.29	-12.85
UK 10 Year	4.56	4.48	5.42	-2.78	-1.07

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