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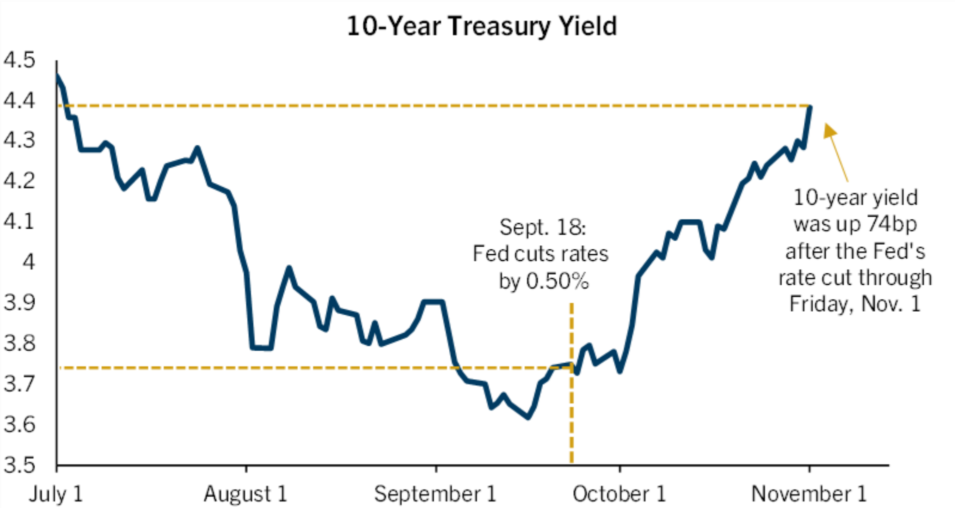
The Fed Cut Rates. Why Are Bond Yields Higher?

Six weeks after the Federal Reserve cut interest rates by 0.50%, bond yields have moved higher, not lower. The 10-year Treasury yield – which matters for longer-term rates like mortgages – was up by 0.74% from the rate cut through Friday, November 1. This is more than in any of the previous 6-week periods following an initial interest-rate cut since at least 1989. Why?

Exhibit 1: The 10-Year Treasury Yield Has Moved Up Sharply Since the Fed's Rate Cut



Source: Bloomberg

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1. Short- vs longer-term rates.

When the Federal Reserve raises and lowers the overnight federal funds rate, it directly affects short-term rates as well as any borrowing rates benchmarked to prime and SOFR[1] rates. These rates have indeed fallen, as expected. But longer-term rates depend on a whole host of other factors. Not only are they difficult for investors to predict, but they also remain largely out of the control of conventional monetary policy. In 2005 Federal Reserve Chairman Alan Greenspan famously described this frustrating reality as a "conundrum."

2. Evolving expectations.

Interest rates (and financial market prices generally) follow expectations for the future more so than what has happened in the past. When the Federal Reserve cut interest rates by 0.50% on September 18, investors and policymakers harbored relatively skittish views on the economy and labor market. With unemployment up by about 1.0%, it seemed the Fed might be late to the game, and its 5.5% monetary policy rate looked conspicuously offsides compared to roughly 2.5% inflation rates. But in the weeks since, incoming labor market and other economic data has assuaged concerns about the outlook. Now, federal funds rate futures see nearly three fewer quarter-point FOMC cuts before year-end 2025 compared to prior to the October 4th employment report. The intensity of these swings in expectations is abnormal and driving significant volatility in interest rates.

[1] Secured Overnight Financing Rate

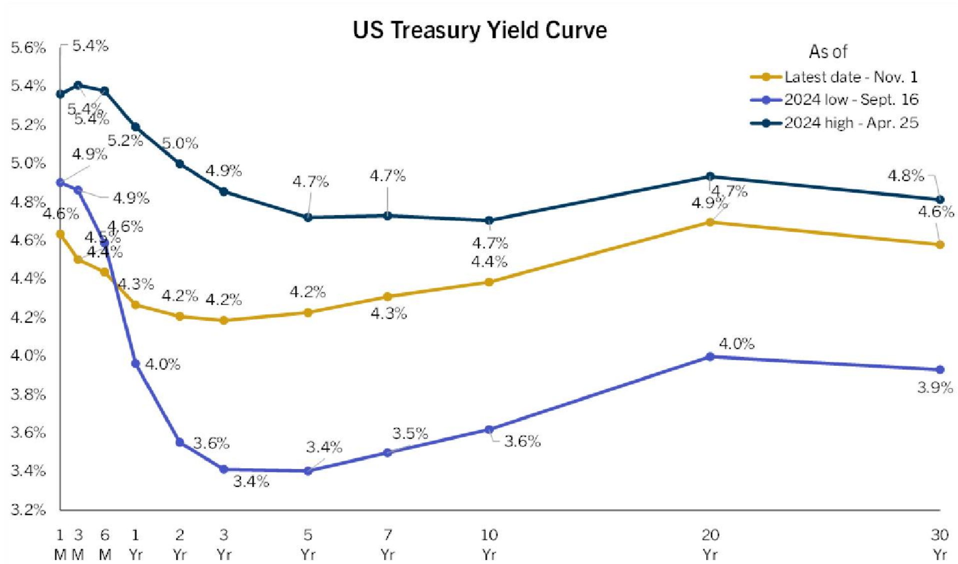
3. Debt, and more debt.

It is possible that markets have adjusted somewhat in recent weeks to prepare for greater issuance of US Treasury debt in the future. All else equal, a greater supply of Treasury notes and bonds means a higher borrowing cost. Debt and deficits as a share of GDP are elevated compared to history, and this trend may remain in coming years.

4. Greater resilience, higher inflation.

One possible result of better-than-expected economic data might be stubbornly higher inflation. Investors, consumers, and fixed income markets might have to adjust to a new normal of 2-3% inflation rather than the subdued 1-2% inflation we saw during the economic cycle between the Global Financial Crisis and the pandemic. This is not outside of long-term historical inflation rates and not inherently all that problematic, but it may put a floor under how low interest rates can go.

Exhibit 2: US Treasury Yield Curve Inverted, but Has Shifted Lower Since April



Source: Bloomberg

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