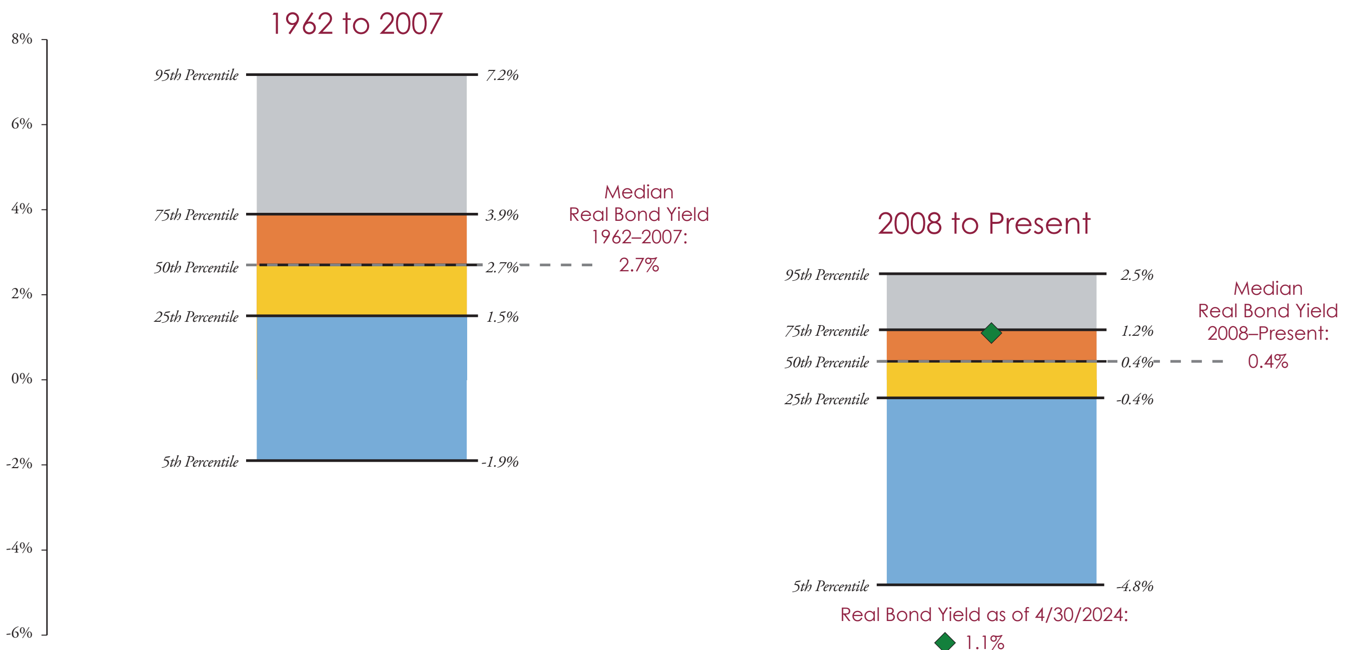
Where Will Real Yields Go?

The "real" yield on 10-year U.S. Treasury bonds (yield minus the rate of inflation) has tended to stay at unusually low levels since the 2008 Global Financial Crisis. If real yields revert to longer-term averages, bond yields may trend higher going forward.

The chart below illustrates the range of real yields on 10-year Treasury bonds during two separate periods: the 45-year period from 1962 to 2007 and the more recent 16-year period since the 2008 Global Financial Crisis (GFC). The GFC was marked by an unprecedented zero-interest rate policy (ZIRP) by the Federal Reserve that the Fed is only now gradually abandoning. The difference in the range of real yields in the two periods is dramatic.

Real Bond Yields



Data from 12/31/1962–12/31/2007 and 12/31/2007–4/30/2024.
Source: Federal Reserve Bank of St. Louis

For investors viewing the past 16 years as predictive of the future, the median real yield figure of 0.4% implies a possible 10-year Treasury yield of 2.4% (the 2% inflation target of the Fed plus 0.4%). The past 16 years includes the ZIRP policy by the Federal Reserve, which contributed to bonds offering a negative real yield over 25% of the time. For investors viewing the 1962–2007 period as being more predictive, the median real yield figure of 2.7% implies a possible 10-year Treasury yield of 4.7% (the 2% inflation target of the Fed plus 2.7%). Of course, if the Fed is unsuccessful in achieving an inflation rate of 2%, the Treasury yield would be higher in both instances. Currently, the 10-year yield is approximately 4.5%.

Hopefully, the inflation shocks of the early 1980s will never be repeated, but inflation has clearly moved higher in recent years. In addition, rising Federal deficits could require a significant increase in the issuance of bonds. Both factors may result in bond yields trending higher than recent levels along with a reversion to more normal levels of real yields (i.e., 1962–2007).

Higher real bond yields do not necessarily mean low stock market returns. The S&P 500 achieved an annualized total return of 10.7% over the 1962–2007 period even in the face of high real yields, actually higher than

the 10.0% return from 2008 through April of this year. However, the composition of stock market leadership will likely be impacted if real yields move higher. The impact of low bond yields since 2008 has been most beneficial to companies with high levels of financial leverage, as well as to unprofitable companies which have been able to continue to grow and expand using cheap debt. It is likely that high-quality companies that are able to internally finance growth through generation of cash flow from operations will be the relative beneficiaries of higher bond yields.

An interest rate environment of "higher for longer" may appear new to some investors, but not to those who have a longer-term historical perspective.

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REFERENCED INDEX

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