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How high could the 10-year U.S. Treasury yield go?

From the Field

Key Insights

- U.S. Treasury yields have climbed despite Federal Reserve rate cuts, and a further rise may be on the way. Stock and bond markets both have felt the pain.
- A 10-year Treasury yield above 5% would not be historically unusual. Our Asset Allocation Committee remains underweight to Treasuries and broader fixed income.

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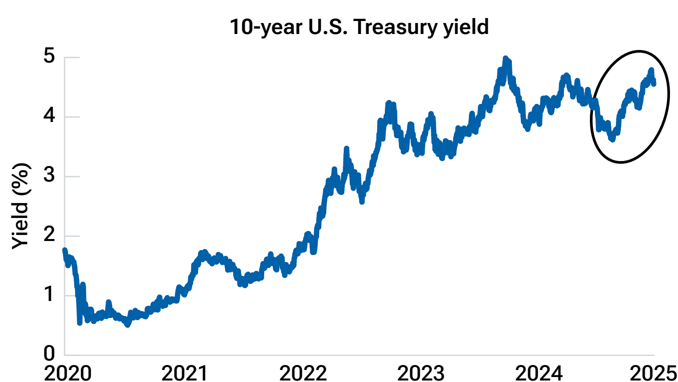
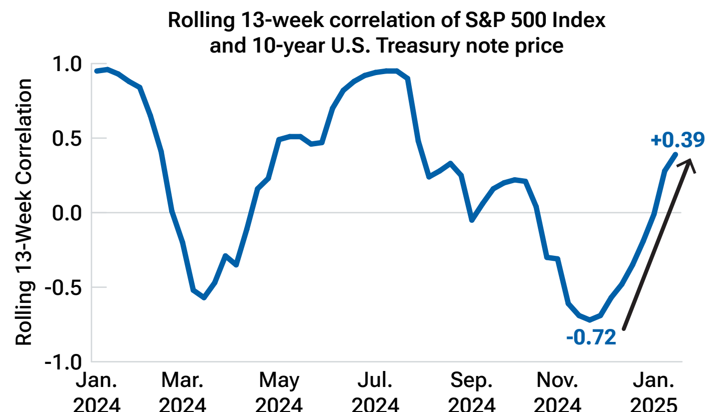
There is an alarming trend that has developed over the past few months: U.S. Treasury yields have been climbing despite continued rate cuts from the Federal Reserve. The yield on the 10-year U.S. Treasury note reached a recent peak of 4.79% on January 14, 2025. While there has been a recent partial reversion in this trend, the broader path appears to remain upward.

Equally as concerning is the fact that the pain from higher rates is being felt not only in bond markets but in equity markets as well. Since mid-December, the correlation between U.S. bonds and U.S. stocks also has been on the rise—indicating that prices for the two asset classes tended to move together, rather than in opposite directions, during the period (Figure 1).

Bond yields and correlations both rose in late 2024

(Fig. 1) 10-year U.S. Treasury yield and U.S. stock-bond correlations





U.S. Treasury yield: 5 years ended January 21, 2025. Rolling 13-week correlation: January 1, 2024, to January 21, 2025.
Source: Bloomberg Finance L.P.

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Markets and the Fed both see a higher federal funds rate

(Fig. 2) Futures contract yields and Federal Reserve estimates

Implied end point: January 1, 2024, to January 21, 2025. Longer-run federal funds estimate: 5 years ended December 2024.
Source: Bloomberg Finance L.P.

Inflation expectations and "real rates"

An effective way to examine the upward trend in yields and correlations is to break the 10-year yield down into its two component parts: inflation expectations and the "real" yield—what's left after subtracting the expected inflation rate.

The inflation expectations component can be estimated from the so-called break-even rate on 10-year U.S. Treasury inflation protected securities, or TIPS. This is the difference between the current 10-year TIPS yield and the yield on regular 10-year Treasury notes. Historically, that number typically has been close to 2%. But more recently, inflation expectations have driven the break-even rate higher, to 2.40% as of January 21, 2025.

Real yields can be measured simply by looking at the current yield on the 10-year TIPS, which was 2.15% as of January 21. This could be considered elevated on a historical basis. However, TIPS have only been around since the late 1990s. Average real yields in previous decades probably were equal to or even higher than current levels.

Fed expectations and the "term premium"

Another popular model assumes that the 10-year Treasury yield reflects 10-year expectations for the Fed's key short-term policy rate, the federal funds rate, plus a term premium that compensates investors for the risk that rates could be higher than expected.

Federal funds rate expectations also have been on the rise recently. Interest rate futures contracts indicate that the expected end point for the Fed's current rate-cutting cycle has risen to almost 4%, up from 2.69% in September 2024 (Figure 2).

The Fed's own long-term estimate for the federal funds rate also has increased steadily over the past year, and markets appear to expect it to move even higher in 2025. So, it seems reasonable to assume that Fed expectations will contribute 3%–4% to the 10-year Treasury yield going forward.

There are numerous ways to estimate the term premium, including a popular methodology developed by researchers at the Federal Reserve Bank of New York. Unfortunately, this calculation shows that the term premium is also rising and may be poised to continue that trend.

Estimates of the term premium go all the way back to 1962, so we can better judge what it could look like in different environments. Clearly, the recent low or negative levels are outliers. The long-term average is a positive 1.48%, and the term premium has been above 1% for almost 60% of its history and above 2% for more than a third of that history.

Conclusion

Numerous forces are pushing U.S. Treasury yields higher, including sticky inflation, ballooning budget deficits, and political uncertainty. Historically, a U.S. Treasury yield well above 5% would hardly be considered an outlier. As a result, our Asset Allocation Committee currently holds underweight positions in both long-term U.S. Treasuries and the broader fixed income category.

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