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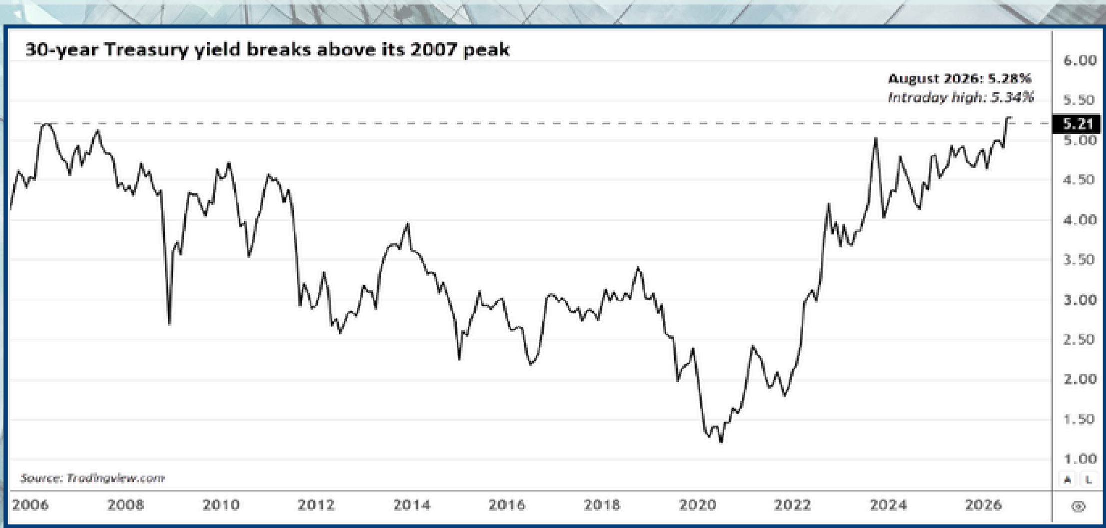
The long bond strikes back

The world's biggest bond market sent a warning last week. The yield on the 30-year US Treasury climbed to 5.34 percent, its highest level since 2007. The rise came as oil prices pushed inflation concerns higher and investors grew increasingly worried about America's deteriorating fiscal position.

US government debt has now crossed $40 trillion for the first time. Interest payments already exceed $1 trillion annually. With deficits remaining large and borrowing needs continuing to rise, investors are demanding greater compensation to lend money to the US government for 20 or 30 years. This matters because long-term yields influence borrowing costs across the economy, from mortgages and corporate bonds to infrastructure projects and the valuations of growth stocks.



A global bond selloff

The pressure is not confined to the US. Japan's 10-year government bond yield climbed to 2.95 percent, its highest level in three decades. Germany's 30-year yield reached 3.79 percent, the highest since 2011, while France's approached 5 percent, a level not seen in 18 years.

The Philippines has not escaped the move. The Philippine 10-year government bond yield closed last Friday at 7.23 percent after reaching roughly 7.6 percent in late July. Higher global yields, elevated oil prices and domestic inflation concerns have kept local borrowing costs high despite the slowing economy.

Warsh puts inflation first

Investors hoping that the Fed will quickly come to the rescue may be disappointed. Fed Chairman Kevin Warsh has repeatedly stressed his commitment to bringing inflation back to the central bank's target. At his July press conference, he said: "There is only a target, and it is 2 percent." With higher oil prices complicating the inflation outlook, Warsh appears determined to restore the Fed's inflation-fighting credibility before cutting rates more aggressively.

AI's debt binge

At the same time, another big borrower has entered the bond market: artificial intelligence. The AI buildout requires hundreds of billions of dollars for data centers, chips, power generation, networking and cooling. US corporate AI-related debt issuance has already reached about $220 billion this year, compared with only $12.5 billion last year. Amazon, Alphabet, Meta, Oracle and other technology giants have issued huge amounts of debt as the AI infrastructure race accelerates. Investors are beginning to demand higher yields to absorb the unprecedented supply.

A higher hurdle for AI

Many AI projects require huge upfront spending while the revenues and productivity gains may take years to materialize. The longer investors must wait for those returns, the more important the cost of capital becomes. Higher rates raise the hurdle rate and reduce the margin of error. Companies will increasingly have to show that their massive AI investments can translate into revenues, earnings and free cash flow. This pressure will be greatest on weaker companies that rely heavily on external financing.

Treasury fights back

The sharp rise in long-term yields prompted the US Treasury to increase its bond buyback operations. It doubled planned buybacks of certain 10- and 30-year securities from $2 billion to at least $4 billion per operation. The announcement initially calmed the bond market but yields soon moved higher again. JPMorgan warns that buybacks alone will not solve the problem. Without credible fiscal consolidation, the move could undermine confidence, raise the term premium and ultimately push long-term yields even higher.

Gold, silver and crypto surge

The most interesting signal last week came from other asset classes. Gold rose 5.2 percent, while silver climbed 6.6 percent. Bitcoin surged about 25 percent and Ethereum jumped 35 percent, with both cryptocurrencies posting their best week in more than two years. Meanwhile, the VanEck Semiconductor ETF (SMH), a widely followed proxy for AI-related chip stocks, fell 4.7 percent.

Normally, higher bond yields would be a headwind for non-yielding assets like gold. Yet gold and silver still rose sharply last week. With government debt rising around the world and the dollar strength waning some investors appear to be turning to gold, silver and cryptocurrencies as hedges against inflation and fiscal deterioration.

Respect the long bond

The first phase of the AI boom rewarded those building the infrastructure. The next phase will increasingly reward those that can monetize it. The surge in long-term bond yields makes that distinction even more important. The message from the bond market is not to abandon AI, but to respect the cost of capital. Higher rates may not end the AI boom, but they may distinguish and separate the winners from the losers.

Philequity Management is the fund manager of the leading mutual funds in the Philippines. Visit www.philequity.net to learn more about Philequity's managed funds or to view previous articles. For inquiries or to send feedback, please call (02) 8250-8700 or email ask@philequity.net.