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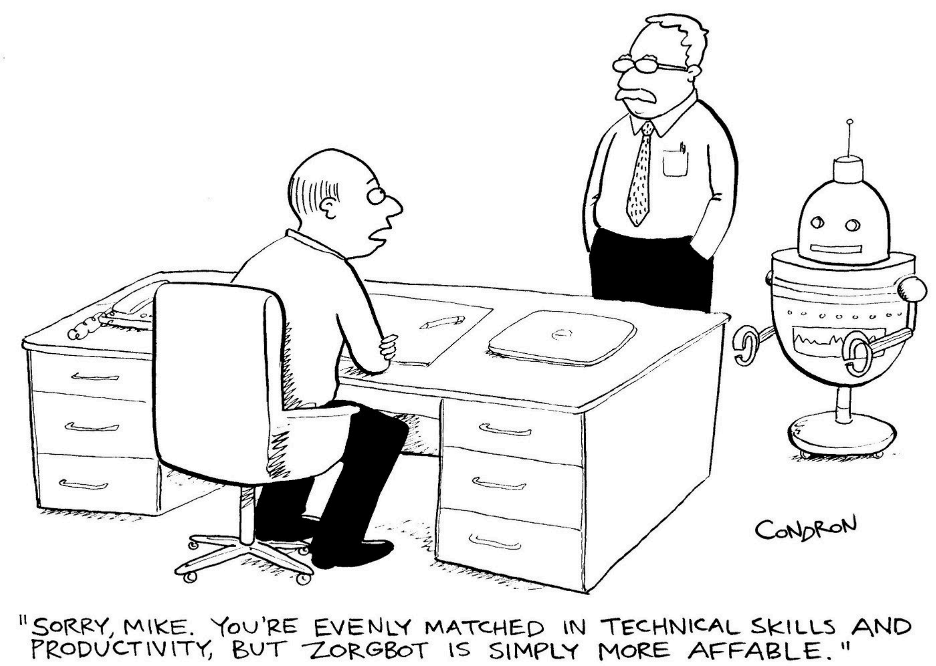
CAPITAL MANAGEMENT

Bond Yields and the AI Buildout

"Science and technology revolutionize our lives, but memory, tradition and myth frame our response." – *Arthur Schlesinger (Historian)*



Over the past few weeks, several clients have reached out with questions regarding the U.S. bond market as yields drifted higher led by the long end (30 year sector) of the yield curve. Some of move has to do with inflation expectations, however with both CPI and PCE (Consumer Prices) trending lower, my sense is that this has not been the main factor.

Then just a couple days ago, the U.S. Treasury Department led by Treasury Secretary Scott Bessent surprised the market by announcing a significant increase in government bond purchases under its buyback program. Starting September 9th, the Treasury will double the maximum purchase amount of 10 year and 30 year Treasurys per operation to a least $4 billion. This move to intervene follows an uncomfortable rise in longer-term interest rates, as the 30 year U.S. Treasury Bond reached its highest yield in nearly two decades.

So, what's this all about? For a good explanation see article below courtesy of James Mackintosh from The Wall Street Journal, who I believe provides a good opinion on what could be brewing below the surface.
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Why Scott Bessent Is Playing With the Treasury Market
By James Makintosh
August 19, 2026
The Wall Street Journal

Scott Bessent got bang for his buck on Wednesday. The decision to double to $4 billion the size of buybacks of the longest-dated bonds led the 30-year Treasury yield to plunge 0.1 percentage point, a bigger move than any day in the past year and lit up leveraged areas of the stock market.

But Bessent is fiddling around the edges. Long-dated yields have been climbing amid a toxic mix of fiscal profligacy, a capital spending boom for the ages in artificial intelligence and geopolitical pressures.

On Monday, the 30-year yield hit its highest since before the global financial crisis, despite Bessent's previous efforts to keep yields down. The 10-year yield remains below the panicked near 5% it hit in late 2023, but this shouldn't reassure: Look at the inflation-adjusted "real" yield for the five years starting in five years, to strip out the ties to the overnight rate, and this year it reached the highest since 2009.

The simple explanation for all this is that the world is going into a new era of capital need, for data centers, the military and reshoring. That means a higher reward for suppliers of capital, in the form of higher yields.

It's also important to understand what isn't driving the rise in yields.

Long bonds aren't being dumped because investors are worried about inflation. Sure, there's slightly more concern than a couple of months ago, but the bond market's expectation of inflation, known as the break-even rate, isn't particularly elevated and remains close to the Fed's 2% goal. Investors think that, despite five years of overshoots, the central bank will keep inflation on target in the long run.

Fed Chairman Kevin Warsh's change of communications strategy has confused lots of investors, but it isn't obvious that it is behind the rising yields. In principle, less clarity about the Fed's direction of travel should push up bond volatility and so raise yields as investors demand compensation for the higher risk. But the bond market's equivalent of the VIX gauge of implied volatility is slightly lower than a year ago, after a brief spike when the U.S. and Israel first bombed Iran. So far, at least, this isn't the issue.

Instead, yields are rising because of the need for more capital. There's a nasty combination of three trends leading to higher bond sales, only one of which Bessent has any ability to control.

Government deficits. The U.S. government, including state and local, is expected by the International Monetary Fund to borrow 7.5% of GDP this year, the most in the Group of Seven developed economies and a level that used to be reached only in deep recessions.

Now it's become the norm, with the government loading on debt even as the economy grows fine. Because investors don't think politicians of either party will make the painful decisions needed, that means more and more bonds to sell in future.

Making this worse is that much the same is true in the rest of the world. Big government came back into fashion in the pandemic, and politicians in Europe and Asia are also grappling with the need to spend a lot more on defense, while keeping voters happy by maintaining social spending. They want swords and plowshares, and that means borrowing.

The artificial-intelligence boom. AI companies have moved from being capital-light software specialists to capital-hungry operators of gigantic data centers, spending enough to have a noticeable impact on the economy. Tapping bond markets is one of the ways this is being financed, and already that has led to higher yields for the big companies raising the most cash, as investors worry about exposure.

One example: The yield on Alphabet's 2075 bond issued last year has jumped from 6% at the start of July to 6.78% on Tuesday, far more than the jump in the longest-dated government bonds. More issuance means a lower price and higher yield.

Geopolitics. The breakdown of the U.S.-led international order on trade is pushing other countries to be less reliant on cross-border supply chains, while security concerns about China are making the U.S. rethink access to critical minerals and components. Such reshoring means duplicative and less-efficient capital spending.

All of this has led to a rise in inflation-adjusted “real” yields as suppliers of scarce capital anticipate more demand for capital, and so charge more.

Bessent’s buyback expansion is best seen as the next step in his strategy of issuing a larger share of short-dated debt and T-bills, reducing the need for long-dated sales that push up yields.

But this creates risks. It can help contain long-dated yields, but more short-dated issuance makes government finances even more exposed to any rise in interest rates, which would quickly feed through into even higher borrowing costs.

The Treasury’s odd decision last month to intervene to prop up the yen by selling euros, and Bessent’s encouragement of the Japanese to borrow from the Fed to finance its own intervention, are best seen as more fiddling, preventing the need to sell Treasurys.

The good news is that higher yields are in part self-correcting. Faced with higher borrowing costs, profit-driven executives choose not to invest so much, or cut other areas to finance projects. Would-be home buyers are deterred by higher mortgage rates, and higher savings mean less spending. Around the edges this is visible in AI, with heavy job losses at Meta Platforms to offset some of the costs.

The bad news is that so much of AI is driven by hope rather than cash profits that higher yields are likely to do little to crimp spending. And governments, at least those that borrow in their own currency, can ignore higher yields until it becomes clear to voters that government debt is squeezing out parts of the economy they care about.

We can think of higher long yields as part of the reckoning for excessive borrowing. The more it goes on, the more the private sector is squeezed, until eventually—hopefully—politicians realize that spending needs to be cut or paid for with taxes. Bessent, so far, hasn’t been willing to do either.

The one consolation for investors: They can earn 2.5% above inflation on Treasurys while they wait, in an asset that might even do better if AI turns out to be a bubble and pops—or really badly if Bessent loses control.

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How will this affect financial markets? Traditionally, liquidity operations tend to be a net positive for risk assets. If the Federal Reserve decides to join the party and coordinate with the Treasury Department, which I think becomes more likely from a political standpoint, then I believe this will be a net positive for stocks, followed by commodities, and then to a lesser extent bonds.

Additionally, from a fundamental perspective corporate earnings have come in strong growing approximately 49% year over year which marks the strongest quarterly gain since the second quarter of 2021. Couple this with future earnings estimates revised higher and I wouldn't be surprised to see the broad market rally into year end.

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OVERWEIGHT	**NEUTRAL**	**UNDERWEIGHT**
Cash & Money Markets	Healthcare	Mortgage-Backed Securities
U.S. Treasury Notes & Bonds	Consumer Discretionary Sector	Investment Grade Corporate Bonds
Large Capitalization Technology	Communication Services Sector	Leverage Loans (Floating Rate Debt)
Energy Related Equities	Materials Sector	Treasury Inflation Protection Securities
Utilities	Financial Services Sector	High Yield Corporate Bonds
Aerospace & Defense	Consumer Staples	Local Currency EMG Bonds
Precious Metals	U.S. Real Estate & Related Equities	Leisure & Hospitality
International Developed Market Equities	Small Capitalization Stocks	
Emerging Markets Equities		

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Justin Kobe, CFA
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