NASHVILLE NOTES

What If It Is a Breakout in Rates?

Monday, June 2, 2025 11:57 AM CT

By Jeff K. Davis

Jeff Davis is a veteran bank analyst. The views and opinions expressed in this piece are those of the author and do not necessarily represent the views of S&P Global Market Intelligence; Mercer Capital, where Davis is the managing director of the financial institutions group; or StillPoint Capital, where Davis is a registered representative.

Since "Liberation Day" on April 2, intermediate- and especially long-term US Treasury yields have climbed sharply, prompting chatter that bond vigilantes — last spotted during the 1994 bond market rout — are back. The term, coined by veteran Wall Street economist Ed Yardeni in the 1980s, refers to investors who dump bonds when they perceive fiscal and/or monetary policy is inflationary.

I'm not convinced the bond market issue today is vigilantes so much as it is a supply issue. My recollection is that when Ronald Reagan became president in 1981 and proposed tax cuts and defense spending hikes, the refrain heard at the time was "$100 billion deficits as far as the eyes can see," or something like that. The yield on the 10-year US Treasury bond would peak in the fall near 16%, while the Fed would push (or allow) the Fed Funds rate to rise to 20% the following spring. Not surprisingly, the US was mired in a deep recession then.

Today, it looks like $2 trillion deficits as far as the eyes can see, with spending levels that gapped higher in 2020 with the government's reaction to COVID. Unlike the early 1980s, when rates were high as inflation peaked, rates and inflation are low and could easily grind higher.

> ***Whether yields on intermediate- and long-term US Treasuries will break decisively higher is unclear, but the market's unease about the inflation outlook makes sense.***

Each spring, I attend a Vanderbilt business school lunch series focused on monetary policy. This year, a speaker with past roles at the New York Fed and then the US Treasury Department offered a glimpse into the plumbing of the US monetary system, both from the Fed's interaction with the bond market and from the Treasury's funding operations.

I asked about demand for US "paper." I am paraphrasing, but what I heard him say was that demand for bills (i.e., paper sold at a discount with a maturity up to one year) was extremely deep, which makes sense in the context of the global money market complex. Demand for two- and three-year coupon issues was robust, while five-year notes are borderline (my phrase). Beyond that, starting with the seven-year note, the market is not deep, as price-insensitive buyers like central banks are purchasing less while price-sensitive players like hedge funds are stepping in, at least for now.

Yields on intermediate- and long-term Treasuries have risen roughly 50 to 100 basis points since last September, when the Fed began cutting its policy rates by 100 basis points. Whether yields will break decisively higher is unclear — Jamie Dimon recently predicted a "crack" would occur — but the market's unease about the inflation outlook and the government's growing interest burden relative to tax receipts makes sense.

> ***Unrealized losses in fixed-rate bond and loan portfolios are likely to linger, and net interest***

margins might improve as market dynamics steepen the yield curve.

For banks and their investors, I see a few implications.

First, unrealized losses in fixed-rate bond and loan portfolios will linger, though time helps as maturities approach and cash flows are reinvested at higher yields. Bank of America Corp. offers a useful benchmark: Its $550 billion held-to-maturity portfolio showed a $96 billion unrealized loss on March 31, down from $108 billion at the end of 2024. Absent a reversal in the bond market, the loss should be bigger on June 30 but investors probably will not care unless rates push materially higher.

Second, net interest margins might improve, all else equal, as market dynamics steepen the yield curve. Demand for longer-dated bonds is lukewarm, while bills have strong interest. Further Fed rate cuts presumably would allow banks to reduce deposit rates, though loan yields tied to SOFR would decline, too.

A corollary point is balance sheet strategies may lean toward shorter durations in fixed-rate portfolios if intermediate and long-term rates remain under pressure. While fixed-rate bonds and loans are part of a broader balance sheet picture, many banks blew it in 2020 through the first half of 2022 by taking on too much duration in fixed-rate portfolios at generational low yields. Duration is less dangerous today given the lift in rates, but the experience of thrifts in the 1970s points to the need to keep durations shorter if the secular trend in rates is up.

There is a valuation catch for bank equity investors. If intermediate- and long-term rates trend higher, P/E multiples will compress absent a sustainable increase in per-share earnings growth — perhaps to 8x to 10x, down from 12x to 14x. For new investors, the margin of safety will be better given the lower-valuation entry point, while existing investors may have to endure a period of multiple contractions.

This article was published by S&P Global Market Intelligence and not by S&P Global Ratings, which is a separately managed division of S&P Global.

Jeff K. Davis, Managing Director of Mercer Capital's Financial Institutions Group, is a regular contributor to S&P Global Market Intelligence, formerly SNL Financial. He can be reached at jeffdavis@mercercapital.com or 615.345.0350.