The Bond Bust

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The global media are gasping over "chaotic" movements in the markets for bonds, the principal instruments used to contract out loans. Across global markets, bond prices fell and their yields (or returns to lenders and funding costs for borrowers) rose. That was chaotic for the sellers of bonds who found old buyers dumping their holdings and new buyers willing to hold only if rewarded handsomely.

The problem began in and spread from US markets, where a bond sell-off has sent yields of medium- and longer-term bonds (of 10- and 30-year durations) to long-term highs. The yield on 10-year US Treasury bonds is at 4.8 per cent, its highest since end-2023, and the 30-year yield is at its highest in over two decades. Expecting interest rates to rise, investors are reluctant to lock themselves into longer-term bonds and are demanding much higher returns.

The focus of the sell-off in US markets was, surprisingly, government Treasuries. Government bonds in general are considered "risk free" (and therefore pay lower interest), since the presumption is that governments are unlikely to default. But among government bonds, those of the US Treasury are prime gilts, not only because of the perceived hegemonic strength of the US and its government but also because they are true "dollar bonds" in a world where the dollar is the dominant reserve currency. It has for long been believed that everyone is willing to hold dollars all the time, since the dollar is good as gold. Moreover, these bonds are seen as being easily tradable, making them not just safe but also "liquid" instruments, and therefore as good as cash. In this scenario, central banks outside of the US looking for "safe and liquid" assets also choose to hold a significant share of US Treasuries in their portfolio of reserves. There appear to be no binding limits on the levels to which the US government can borrow against bonds, other than those the government imposes on itself.

For the last many decades, and more so under Trump recently, the US government has exploited this special status to borrow against bonds and spend as if it was not subject to any budget constraint. There have, indeed, been periods when investors and central banks were inclined to retrench their bond holdings, but these were temporary. Most often, bond demands weakened, and yields rose when inflation was on the rise. Inflation in the prices of goods and services erodes the real value of bonds, whose prices do not rise with inflation. And since in inflationary environments central banks tend to raise policy interest rates which would raise bond rates across different maturities, investors would prefer not to be locked into lower-interest longer-term bonds. The resulting bond sell-offs raise yields and new bonds can attract investors only by offering comparable higher rates.

The other reason why investors may seek to retrench bonds of particular countries is a loss of faith in the underlying currency. If the dollar is not seen as being as strong as before and is expected to lose value not only as a result of inflation but of depreciation relative to other currencies, dollar-denominated bonds would look less attractive, prompting a sell-off.

All this spells trouble for the economic mandarins in the Trump administration. Rising bond yields would trigger increases in interest rates on mortgage and consumption loans and worsen the "affordability crisis" before mid-term elections in November. It could also disrupt the US government's budget, widen the federal budget deficit, and necessitate substantial additional borrowing that aggravates the debt spiral. The interest burden on the government's budget can explode and trap the regime in a Ponzi-like situation where it is forced to borrow large sums to finance the interest and repayment burden resulting from past debt. This would also have implications not just for bondholders' appetite for Treasuries but also for wealth-holders' faith in the dollar and in dollar-denominated assets.

Analysts claiming to speak on behalf of bondholders have been pushing for the government to cut expenditures by, for instance, "tackling rising welfare and pension costs", as the conservative Financial Times predictably wrote. But that is not the route the Trump administration wants to take just before elections. And rolling back the huge tax benefits it has given the richest layers of US society, to improve revenues and reduce the federal deficit, is also anathema to its way of thinking.

That has triggered a couple of unusual responses from the administration. One has been for it to intervene in bond markets and buy back long-term bonds. This is not altogether novel. The Treasury has in the past entered bond markets to stabilise rates. But this time around, the volume of intervention is much larger and Secretary of the Treasury Scott Bessent has not only chosen to repeat such action but appears set on using this as an instrument to stabilise yields over the coming months. However, evidence shows that while the immediate impact of bond purchases raises prices and compresses yields, rates bounce back rather quickly. When combined with the fact that large-scale bond purchases require borrowing to finance the intervention, the measure is a both problematic and a blunt instrument.

Countering Japanese shedding of US Treasury holdings

The Treasury has even gone beyond US borders to counter a tendency on the part of Japanese holders of US bonds to shed Treasury holdings. The Japanese government and its central bank are faced with a dilemma. They want to keep interest rates in Japan down to prod a recovery that has been visible for a long time but has not gathered momentum. On the other hand, the Japanese yen has been sliding sharply, raising import costs and adding to fears that incipient inflation could accelerate. An option that the Bank of Japan has to temper inflation is to intervene in the foreign exchange market, selling dollars and buying yen, to strengthen the Japanese currency. It can easily mobilise the needed dollars for that operation by retrenching part of the large hoard of US Treasury bonds it has in its vaults.

But that does not suit Scott Bessent, who wants to stall Treasury sales by the Japanese in order to prevent further declines in US bond prices and increases in bond yields. So, he has been campaigning with the Japanese to persuade them to not sell bonds. Since there are limits to the amount of yen that the Bank of Japan can purchase using stocks of currencies it holds other than US government bonds, Bessent entered into a deal where he would join the Japanese central bank in efforts to shore up the yen with purchases. Joint action, it is expected, would reduce the pressure on Japan to sell part of its Treasury stock. This, too, has had limited effect: some reversal of the yen's decline initially, followed by a loss of those gains very soon.

The Japanese government and central bank are tiring of this ineffective mode of limited intervention and want to unwind dollar reserves. But the US Treasury is seeking to get the Bank of Japan to raise interest rates instead, so as to move capital into Japanese yen-denominated securities and strengthen the currency. Though higher interest rates do not suit the Japanese, there are signs that the Bank of Japan may relent, using inflation as an excuse.

The stalemate is on and cannot last. The US will not give up its profligacy and Japan does not want to do anything that threatens its still moderate recovery. The crisis is real. It does more than drive up yields on US government bonds. It weakens the hegemonic position of the US and the dollar.

This process could accelerate because of the war in Iran. It is now clear that the US has not achieved any of its military and political objectives in Iran after months of unilateral aggression. This in itself is a challenge to US hegemony. To add to it, the costs of the war are asserting themselves in two ways. The first is by forcing the Trump administration to seek congressional approval for a large increase in defence outlays. This would ramp up the budget deficit and force the government to flood the market with bonds that would reduce prices and raise yields even further, increasing the probability of a Ponzi-style crisis that would undermine the credibility of US Treasuries. The second is that the war and its collateral fallout in the form of the closure of the Strait of Hormuz have made the spike in oil prices globally and in the US a longer term phenomenon than predicted. The resulting inflation would force the Federal Reserve, even under its Chair, Kevin Warsh, to raise policy interest rates, pushing long-term yields even higher.

There is no sign of resolution in sight. This could be the inflection point. The moment is one where the US and the dollar remain hegemonic. But the trend seems to be one that portends a loss of that hegemony.

* This article was originally published in The Frontline on September 3, 2026.