Market Watch

Compelling risk-reward in US 10-year bonds

Summary

Event: The US 10-year government bond yield has surged past 5.0% to a 19-year high and has now entered our three-month forecast range of 5.0-5.25%. At the time of writing, the 10-year yield is trading at 5.2%, its highest since June 2007's high of 5.32%. The next resistance levels are the 2002 high of 5.47% and the 2001 high of 5.53%.

We view the **risk/reward for the US 10-year government bond after the recent yield spike as compelling and we are initiating a long opportunistic idea at the current yield**. As the table on the right shows, if the 10-year yield rises to 6%, investors would face less than 1% in negative total returns over a one-year period, whereas if the yield falls below 5.0%, they would gain at least 6% in total returns.

While we continue to prefer the 3-7-year bond maturity range for income generation (the US 5-year bond yield is also above 5%), and broadly prefer corporate over government bonds amid solid corporate fundamentals, the US 10-year government bond yield has finally reached reasonable levels for investors looking for slightly longer maturities.

Rationale: We expect the US 10-year government bond yield to ease to 4.75-5.0% over a 12-month period due to:

Easing oil prices and inflation over next 12 months: While the yield is likely to remain elevated in the next three months due to elevated oil prices caused by geopolitical uncertainty, heavy AI investment-driven bond issuance and a resilient US economy, it is likely to ease towards the 4.75-5.0% range over 12 months as oil prices moderate either due to a resolution in the Middle East or a rerouting of Middle East energy supplies and as the impact of tariffs fade.

We expect shallower Fed rate hikes than markets: We expect a total of 50bps of Fed rate hikes by June 2027, before a cut in H2 as US inflation eventually eases towards the Fed's 2% target. This rate trajectory is shallower than c. 95bps of further hikes priced by markets over the next 12 months.

The benchmark US 10-year government bond yield has risen to its highest since 2007, offering medium-term investors a compelling risk-reward trade-off

US 10-year government bond yield and previous highs

Source: Bloomberg, Standard Chartered

At current levels, the US 10-year government bond yield offers investors compelling risk-reward trade off

Implied 1-year FX-hedged total returns (%) on various 10-year Developed Market government bonds from shifts in their yields; grey dotted lines roughly denote current spot yield levels

Expected yield in 12 months	US	Germany	Japan	UK
7.0%	-7.4	-17.9	-20.3	-5.3
6.5%	-4.1	-15.1	-18.6	-2.0
6.0%	-0.6	-12.0	-16.7	1.5
5.5%	3.0	-8.8	-14.4	5.2
5.0%	6.9	-5.3	-11.9	9.0
4.5%	10.9	-1.7	-9.1	13.1
4.0%	15.1	2.2	-6.1	17.3
3.5%	19.5	6.3	-2.7	21.6
3.0%	24.1	10.6	0.9	26.2
2.5%	28.9	15.1	4.8	30.9
2.0%	33.8	19.8	9.0	35.8
1.5%	38.9	24.7	13.4	40.9
1.0%	44.2	29.9	18.2	46.2
0.5%	49.7	35.2	23.2	51.6
0.0%	55.4	40.8	28.5	57.3

Source: Bloomberg, Standard Chartered

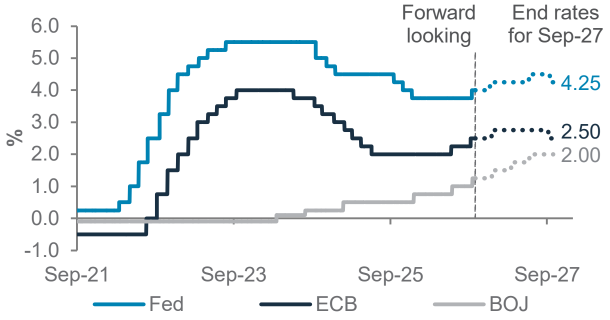
Investor positioning adjustment: In the very near-term, the US 10-year bond yield has room to move lower as hedge funds using systematic strategies (CTAs) are extremely short US government bonds, raising the chance of short-covering if upcoming jobs and inflation data miss estimates.

A shallow Fed hiking cycle

We expect the shallowest Fed hiking cycle in almost three decades. This should enable the US 10-year yield to ease towards 4.75-5.0% over a 12-month period. Following this month's increase, we forecast two further 25bp hikes by June 2027, followed by a cut in H2 2027. Markets price at least three more hikes by June and a strong probability of a fourth by September. Our projected 75bps of total hikes this cycle compares with 525bps of hikes in 2022–23, 225bps in 2015–18, 425bps in 2004–06 and 175bp in 1999–2000. The last smaller mid-cycle move was a single 25bps hike in 1997.

We expect a shallower Fed rate hiking cycle compared with market expectations

Our policy rate outlook for the Fed, ECB and BoJ



Source: Bloomberg, Standard Chartered; *dotted lines reflect our expected rates path over the next 12m

Why we expect a more cautious Fed

The latest hike restored the Fed's credibility after renewed oil-price pressures, elevated inflation and a balanced labour market prompted a unanimous policy vote. However, the following factors argue against aggressive tightening:

Supply-driven inflation: Energy costs and AI-infrastructure constraints, rather than excess demand, are driving prices. Higher rates cannot repair supply and may weaken growth.

Labour is no longer the main inflation source: Labour supply and demand are better balanced, wage growth has moderated and unemployment is near full employment. AI further weakens the traditional Phillips Curve relationship between unemployment and inflation.

Disinflation should resume: Energy pressures may fade after the US mid-term elections, while the one-off inflationary effects of tariffs should diminish after 2025–26.

AI raises the neutral rate, but dampens inflation: Investment and productivity may lift the neutral rate (r*), the rate consistent with stable inflation and full employment, while efficiency gains limit wage-price spirals.

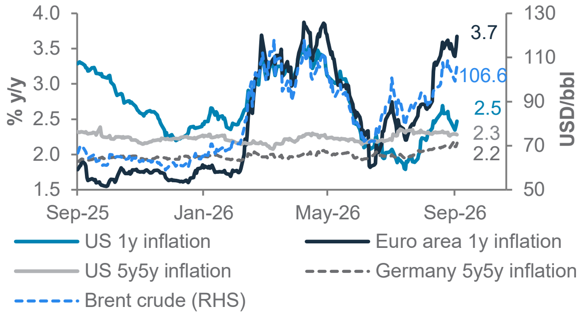
Markets are already tightening financial conditions: Higher bond yields have raised borrowing costs and restrained activity, doing part of the Fed's work.

The cycle began from a higher base: The Fed funds rate started at 3.75%, versus 0.25% in the previous two cycles and 1% before that, reducing additional tightening required.

Monetary transmission has weakened: Wealthier households drive more spending but are less rate-sensitive, while lower-income consumers are already constrained. Further hikes may, therefore, curb demand less effectively while causing disproportionate harm to low-income families.

While near-term inflation is lifted by oil prices and tariffs, long-term inflation expectations remain subdued

US and Euro area near-term and long-term inflation expectations



Source: Bloomberg, Standard Chartered

Small business conditions are deteriorating: Higher financing and energy costs are weakening sentiment, as reflected in the latest Beige Book. The renewed underperformance of US small capitalisation (S&P 600) and mid capitalisation (S&P 400) equity indices versus the large cap S&P 500 index over the past couple of months also show rising pressure on small businesses.

Fiscal and financial-stability risks are rising: Aggressive Fed tightening would increase US debt-servicing costs as the US Treasury seeks cheaper funding through shorter-maturity issuance, while potentially amplifying financial-system stress.

Upside risk to bond yields

Our view of lower bond yields carries the following risks:

Persistent inflation: Repeated supply shocks, strong AI-related investment demand and tighter immigration controls could keep inflation above target and force steeper Fed rate hikes. With unemployment near the Fed's estimate of full employment, a sharp drop in labour supply could intensify wage pressures and destabilise inflation expectations. We note that long-term expectations remain contained for now.

Geopolitical escalation: An intensification of geopolitical conflicts after the mid-term elections could lift energy prices and inflation. However, a Democrat-controlled or divided Congress may constrain US foreign-policy initiatives through tighter budgets, while Republicans could turn less supportive as attention shifts to the 2028 presidential race.

Higher neutral rate: AI investments could raise the neutral rate (r*), turning current monetary policy settings accommodative. This could necessitate further rate hikes. However, the Fed has barely raised its nominal neutral rate estimate, lifting it to 3.2% in September from 3.0% a year ago.

Bottomline: The outlook for rates remains geopolitics dependent, with all Fed meetings live. However, based on our core scenario, we see the US 10-year yield settling lower in the 4.75-5.0% in 6-12 months. A shallow Fed hiking cycle due to expected disinflation offers investors a reasonably attractive risk-reward in US 10-year government bonds.

US 30-year government bonds, on the other hand, may continue to see elevated yields as the US fiscal deficit is unlikely to have improved next year, and may look much worse. As a result, "term premium" may keep the ultra-long end elevated. Short of some unorthodox policy to artificially cap them lower, the 30-year yield is likely to continue to drift higher towards the 5.5-5.75% range into H2 2027.

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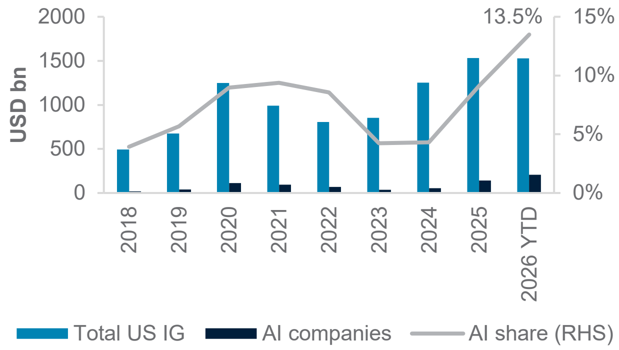
AI-related bond issuances are a key factor keeping US bond yields elevated in the near term; we oil and tariff effects on inflation to fade over 12 months, offsetting AI-driven effects on bond yields

AI issuance (total & share of total), US IG gross issuance



Source: Bloomberg, Standard Chartered

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