

Major Markets Letter #12

23rd February 2026

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US Treasury Paradox: Why yields are defying the deficit

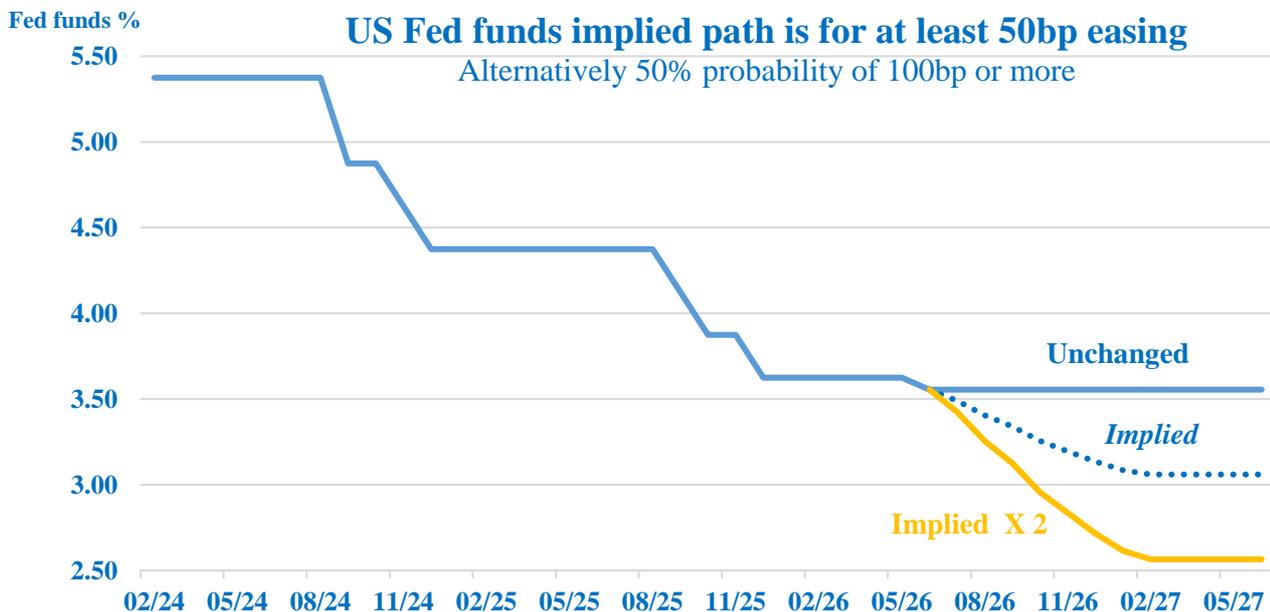
The "US Treasury question" has become a study in market contradiction. Why haven't yields risen?

Despite the prevailing bearish market narrative of a ballooning deficit, de-dollarisation, and central bank selling, the 10-year Treasury yield has defied expectations by flirting with the 4.0% mark.

Behavioural psychologists would describe this as "expectancy violation", and it happens because many investors - who positioned themselves for a spike in yields - face significant disappointment. The market is looking past immediate supply-demand imbalances to factor in a disappointing economic backdrop, the uncertainty over tariffs, and maybe even considering a fundamental recalibration of Federal Reserve expectations.

Recalibrating the rate path

To understand why yields are falling, we must first look at the starting points of the current easing cycle. The Fed initiated a rate-cut cycle in September 2024, lowering the federal funds rate by 175bp; however, the 10-year yield actually increased by 40bp over that same period.



Source: Bloomberg Fed funds (mid-point) and rates implied by futures

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Curve steepening is anyway not unusual during the early stages of an easing cycle. Furthermore, the narrative has shifted since January 2025, which was around the time of the US President's inauguration.

What matters is to compare the yields today with the expectations that were in place back then. While many analysts predicted yields would hit 5.0%, the current yield of 4.06% is almost 100bp lower. The yield today is also at least 70bp below the levels projected by forwards back then.

This suggests that the market has moved from the fear of higher yields to pricing in the possibility of a more aggressive easing path than the Fed's current trajectory suggests.

Decoding market probabilities

We've come to think of market expectations in terms of weighted probabilities. The levels implied by forwards and futures contracts are just the average of what everyone in the market thinks they should be and are not to be confused with a single path.

Take the Fed funds futures in our chart, for example. If we were to assign an extremely low probability to rate hikes over the next year, a forward curve that implies around 50bp of rate cuts is similar to one that implies close to a 50% probability of at least 100bp of rate cuts.

Our chart shows the history of the Fed funds rate these last two years, what's implied by the Fed funds futures over the next year, and finally what it might look like if the amount of implied easing was doubled. Note that the market starts to fully price the first cut in the second half of this calendar year.

Current forward and futures contracts represent an average of market sentiment, which now increasingly leans towards back-loading the rate cuts into the second half of the calendar year. There is perhaps a growing belief that with a new Chair at the helm, rates may fall more quickly than the futures contracts currently imply.

The judiciary and the tariff fog

The economic landscape has shifted from a narrative of resilient growth to one of disappointing reality, and at the centre of this shift is a significant legal roadblock. The US Supreme Court's recent decision to rule against the Administration has injected a level of uncertainty into the fiscal outlook. This legal friction is compounded by the President's use of alternative executive means to impose a global tariff, which was hiked to 15% this past Saturday. Companies are subject to the tariffs and they are scrambling to understand specifics of new import obligations.

Uncertainty around tariffs creates new challenges for the Treasury market:

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- **Disinflationary hope:** In theory, the removal of tariffs could provide a disinflationary impulse - potentially stripping up to 1.0% from CPI - which would clear a path for the Fed to cut rates.
- **Growth headwind:** The administrative and legal chaos serves to overwhelm near-term sticky inflation concerns, especially as GDP growth for Q4 2025 at 1.4% was exactly half what was expected.

The supply-demand imbalance myth

Coming back to the paradox, why aren't investors worried about the supposed supply wall in the bond market?

The narrative is fuelled by the size of the US deficit, reduced holdings by overseas central banks and, at the margin, added to by concerns that tariff revenues will have to be refunded.

It's not fantastic news but the US budget deficit has at least stabilised over the last year, albeit supported by strong growth and tax receipts. There's no evidence from the Treasury auctions of a decline in demand so in the meantime markets grasp other insights, for example from reduced central bank holdings.

For every seller there is a buyer. It's true that some central banks and some regions of the world are buying less Treasuries than in previous years but it is also true that some regions have increased their holdings. Someone has to buy, it's just a question of price. US domestic investors may increase their holdings of bonds versus equities and gold may have replaced both in the portfolios of some investors.

A final leg to the bearish narrative has been the idea that investors are diversifying away from the dollar, sometimes referred to as de-dollarisation. It's true that the broad-based dollar index (USD_X) has fallen since this time last year but most of the move came through March to April, and it has since consolidated. Broader context matters. The dollar is higher than it was five years ago and whilst there has no doubt been some increased diversification, it's too early to be speculating about secular decline and the end of reserve currency status.

The reality of expectancy violation

Ultimately, it's not about a wall of bond supply. The decline in US Treasury yields is a classic case of market positioning hitting a wall of reality. When a critical mass of investors moves into a bearish stance - convinced that yields must climb due to supply concerns - it ironically becomes much harder for those yields to actually rise.

The so-called bad news is already priced in. Between a cooling GDP, the cloud of legal uncertainty surrounding tariffs, and a domestic appetite for fixed income, the "Treasury question" is answered not by the deficit alone, but by a market that has found a firm floor in the face of disappointing economic data.

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