

On Yields and Debts

October 1, 2026

THE 10-YEAR TREASURY YIELD IS ABOVE 5.00%

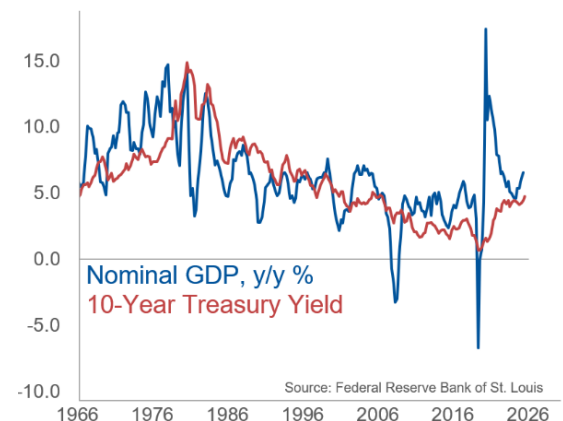
U.S. Treasury yields have risen sharply amid higher oil prices and stronger economic growth prospects, with the 10-year note now at multi-decade highs (near 5.25% at time of writing). Baird Strategas has written previously about 5.00% as an important psychological and financial threshold for the 10-year yield. Three of the firm's partners—Jason Trennert, Tom Tzitzouris, and Don Rismiller—discuss the wide-ranging implications of rising yields—including for economic growth, the fixed-income market, and the cost of servicing the national debt.

Economic growth and the path of Treasury yields. *From Jason Trennert, Chief Investment Strategist and Chairman.*

When forecasting the 10-year Treasury yield, historically the idea has been that the yield should be roughly equivalent to nominal GDP (the total value of everything the U.S. economy produces, in today's prices). This makes sense in theory: if the government wishes to sell bonds, it needs to provide a yield of at least what an investor could earn in the economy. This is no hard and fast rule, but as you can see in the chart, the two metrics moved fairly closely for several decades. Going back to 1962, nominal GDP exceeded 10-year Treasury yields by an average of just 71 basis points (0.71 percentage points).

In more recent decades, the chart also shows nominal GDP and the 10-year yield moving more independently from one another in the post-2008 [quantitative easing era](#). Here we see yields remaining near historic lows (under the influence of monetary policy) as GDP rose and fell. Now we're in a new era, in which the Fed is de-emphasizing the use of its balance sheet for easing or tightening policy. This return to the historical correlation is important, because nominal GDP was north of 6% in the second quarter and is tracking to be in the same ballpark for Q3. This suggests to us that the path of least resistance for Treasury yields is higher.

Nominal GDP vs. 10-Year Treasury yields



Observations for fixed income investors to consider. *From Tom Tzitzouris, Head of Fixed Income Research.*

- 1.) **This yield rise has mirrored the 2023 spike.** The current selloff in Treasuries (price and yield move in opposite directions) mirrors the selloff we saw in the fall of 2023—and while it's not our firm's base case, history suggests that [10-year yields could be headed for 5.50% or beyond](#). These yields also continue to track the moves seen during the 1973 oil embargo (another time when oil prices were high), and we know that yields have tended to rise following the start of Fed rate hike cycles. The move in yields coincides with improvements in economic data, but we're now starting to see credit weaken as well (more below). The outright level of rates isn't out of bounds with where nominal GDP is tracking (as Jason noted above). However, rapid rate changes can destabilize markets. Companies can stomach yields above 5.0% provided they're accompanied by growth and a stable overall yield environment, but if the selloff and volatility persist, it could destabilize markets.
- 2.) **Markets are assigning higher risk outside the U.S.** Recent yield increases reflect the idea that the 10-year yield should be in the range of nominal growth. However, markets seem to be assigning higher risk to nations that have the largest gaps between government bond yields and nominal growth, such as France, Italy, Australia, and the UK. The spread between U.S. rates and nominal growth is tame compared with much of the rest of the world. With strong U.S. economic growth likely to continue in Q3, the rise in yields look to us more like a reflection of what GDP tracking measures have already been telling us rather than a sign of fiscal deterioration.

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- 3.) **Fears don't seem to be concentrated in Tech.** Last year, the market flipped to viewing software as riskier than semiconductors due to advances in AI and the insatiable demand for hardware. But while credit spreads (how much a corporate bond is yielding above Treasuries) have inched higher, these signs of fear don't appear to be concentrated in the Tech sector, where spreads have increased only modestly. This indicates that the market isn't focused on AI spending fears. It also shows that Tech hasn't been impacted as much by the Federal Reserve's recent rate hike. In short, if you're a Tech firm and you can borrow at 6% for a *much* higher estimated return on a data center investment, a small rise in rates doesn't slow your roll. But if you're manufacturing firm expecting only a 7% estimated return, you're going to think twice about financing your project.

Addressing national debt fears. *From Don Rissmiller, Chief Economist.*

Government debt fears aren't new. They were sizable around 2010, resulting in the [Bowles-Simpson commission](#). This report did not affect much change to the long-term budget, however. After 2008, quantitative easing and zero interest rate policy created "financial repression" in a low-inflation decade. Debt continued to expand with little consequence. Today, debt is even higher relative to income, and inflation is stickier. Unless interest rates are held artificially low, the ratio of debt/income should move sideways long-term as a definition of fiscal sustainability (otherwise, interest costs would eventually consume the entire budget).

Option 1: Ignore the budget constraint. When debt is below income, there may be room to increase borrowing with little immediate consequence. This was basically the U.S. decision of the last decade. But now with a debt/GDP ratio of around 1.0, there's reason to believe the budget constraint should become more binding.

Option 2: Respect the budget constraint. Barring a default, operating on debt to bring our debt-to-GDP ratio under control (using increased taxes or reduced spending) presents disinflation/deflation risk, like we saw with austerity efforts in Europe in the 2010s. Working on GDP is trickier. Immigration policies and trade have been the preferred 21st century solutions, but both have become politically thorny. [That leaves a sustained productivity uptick and/or inflation.](#) And inflation is tricky, as the Fed is charged with preventing inflation...unless the U.S. pursues "fiscal dominance" (the idea that continually growing government deficits produce increases in inflation that "dominate" central bank intentions to keep inflation low). That would itself be a dangerous scenario.

Debt vs. Growth. With debt and GDP about 1:1, we don't want the built-in growth of debt (the interest rate) to exceed the growth in the economy (potential GDP). So far, so good. But these numbers can vary over time – and this assumes we can control primary deficits (government spending). Financial repression has been a government story in the past decade, but the Fed seems too agitated about inflation for such a strategy currently.

Counterpoint: Japan. A counterpoint is Japan, where debt/GDP continued to skyrocket, but Japan is a unique case. First, Japan was less worried about inflation given a 20-year experience with declining population and deflation. Second, Japan's debt is mostly owned locally. If Japanese investors are willing to accept very low returns on government bonds, the system can work; the tradeoff is that they may be giving up higher returns elsewhere. We would view this opportunity cost as a wealth tax that the population is (or at least has been) willing to pay. Japan's example shows that a government can proceed for a long time if it can find a wealth tax that a wealthy population is willing to pay – and inflation remains low. This does not seem to be a great model for the U.S., however.

Bottom line, best hope. My view is that we can basically choose whatever size government we want, but we should get better at paying for it in real time. This payment is necessary first to stabilize the primary deficit (government spending, excluding interest). Then we need the economic growth rate to exceed interest rates to deal with the existing debt. With inflation concerns climbing (and so, without 0% rate "repression" policy available for use), U.S. debt/GDP, especially north of 100%, is likely to matter now. This is a new paradigm. Productivity growth is likely the best hope going forward.

Federal Debt Held by the Public as Percent of GDP



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