

HIGHER FOR LONGER (PART II)

On the Shorter End

Heading into 2026, market participants expected the Federal Reserve to keep the fed funds rate steady then cut modestly in the second half of the year. The Fed has a dual mandate: price stability (keep inflation low and predictable near its 2.0% long term target) and maximum employment (the highest level of employment that does not spike inflation). The U.S. has seen a tight labor market with low unemployment, but inflation has consistently remained above target. The Fed's preferred inflation measure, the personal consumption expenditures (PCE) price index, had a headline annual reading of 3.4% (including all items consumers buy) and a core annual reading of 3.0% (excluding food and energy) for August. The former reflects recent spikes in energy prices while the latter reflects structural inflation of the last several years. This is what drove the Fed to raise its benchmark rate by 25 bps in September with expectations for at least one more hike by year end.

While higher short term rates immediately make variable rate debt, like credit cards and lines of credit, more expensive, they also generally tighten credit across the yield curve. This is a headwind for consumers, putting the housing market in a deeper freeze, and for businesses, making corporate financing more expensive. RMC first used this commentary title in early 2024, then referring to shifting expectations for rate cuts that didn't happen as soon as expected. Today, higher for longer applies not just to the short end of the yield curve, but inflation and long term yields as well. There are key reasons to expect interest rates to remain elevated, and there are portfolio management implications to be considered.

On the Longer End

The 10-year Treasury yield sits at ~5.2% as of this writing, near its highest level in 24 years. This yield is typically considered the most important figure in global finance. It is the closest measure of a risk-free, long term investment and is the basis for most financial transactions. Persistent inflation, rising sovereign debt levels, and AI financing demands are forces that may keep it higher.

- **Taxation through Inflation** – Americans have seen significant taxation through inflation, with the U.S. dollar losing 23% of its purchasing power since 2020ⁱ. Most recently, the war with Iran has caused the price of WTI crude to increase more than 40%, however, the prices for diesel, jet fuel, and shipping are up considerably more. This impact goes beyond energy and shipping costs and will be reflected in the prices of many goods and services. Less recently, Congress passed a cumulative ~\$7 trillion of stimulus from 2020 to 2022, or ~27% of GDP (which ironically included the Inflation Reduction Act)ⁱⁱ. This historic amount of stimulus alongside emergency spending is still reverberating in the economy and is reflected in inflated asset prices across the stock market, housing, and consumer goods. As long as inflation remains elevated, the Fed will keep its benchmark rate higher and inflation expectations will drive investors to demand greater real rate protection, pushing both short and long term yields higher.
- **Lack of Fiscal Discipline** – In his most recent memo, famed investor Howard Marks wrote about rising yields and mounting U.S. debt. He aptly noted, *"Today's deficit is in the vicinity of 6% of GDP, an extraordinarily high level for an economy enjoying prosperity with unemployment of only 4%. Net interest outlays are projected at more than \$1 trillion this year, more than the defense budget, and they will rise rapidly if the debt continues to grow faster than GDP."* He further explained, *"Large deficits can be inflationary, especially when the economy is operating near capacity, since the government adds more to liquidity through its spending than it withdraws through taxes."* These are straightforward but not novel musings, as other prominent financial

market voices have communicated these concerns to Congress, which disregards the issue without accountability. If debt continues to grow faster than GDP, investors will demand higher interest rates on U.S. debt, driving interest expense and the deficit higher in a negative spiralⁱⁱⁱ.

- **Frontier Funding Needs** – As RMC wrote about last quarter, the staggering amount of capital needed for the AI investment cycle is only comparable to the construction of railroad infrastructure. The increasing demand for debt will put upward pressure on interest rates as the “cost” of money will increase. Similarly, the demand for any input related to this infrastructure buildout, such as construction materials, specialized labor, semiconductors, and electricity, will push prices higher.

On Portfolio Construction

Bonds were not competitive with equities over the last two decades, and for that reason, investors may want to reconsider portfolio construction for a higher interest rate environment. In some cases, investors relied on a higher equity allocation as dividend-paying stocks offered greater income production than bonds. While keeping risk tolerance and investment objectives in mind, it may be timely to consider a greater allocation to fixed income. Notably, the S&P 500 earnings yield and the 10-year Treasury yield have converged, with the latter moving higher and entirely removing the yield gap, or equity risk premium (“ERP”). The ERP is the additional return an investor expects for holding a risky asset, like stocks, as compared to a risk-free asset like a Treasury bond. Valuation frameworks that consider forward earnings show a greater ERP; however, this is based on increasingly concentrated earnings projections^{iv}. For example, a diversified bond ladder that emphasizes higher coupon bonds will “lock in” these higher yields until each bond’s maturity. Bonds have historically stabilized portfolio returns when stocks are in a downturn, providing protection of principal and predictable cash flow to support distribution needs, like a required minimum distribution for an IRA or a spending policy for a foundation. Conversely, bonds pay a fixed nominal amount, while companies can increase dividend payments and stocks have historically been a superior hedge to inflation.

In addition to the aforementioned factors, a resilient economy, strong corporate earnings, and continued growth expectations have also pushed rates higher. The AI investment cycle has driven this growth, however, which has advanced the S&P 500 higher by ~14% in 2026. Market breadth is extremely narrow, as nearly 50% of S&P 500 companies are now in a bear market, or down at least 20% from their 52-week highs^v. While this may present single-stock opportunities, the broader market remains very unbalanced, with the ten largest companies now comprising 41% of the S&P 500 (notably, AMD and Micron, both semiconductor companies, surpassed JPMorgan and Berkshire Hathaway in market cap, replacing them on the top ten list). Higher yields have yet to materially lower share prices of these companies or impact their earnings expectations, but the equity market remains vulnerable to disruption to the AI trade, like regulation, innovation, or an even higher interest rate environment. As always, RMC is available to discuss, as a shift in asset allocation is not intended to “time” a potential downturn in equities or a top in yields. Rather, asset allocations should first be anchored in one’s risk tolerance and investment objectives, and then positioned to take advantage of current market conditions.

ⁱ U.S. Bureau of Labor Statistics (BLS)

ⁱⁱ Tax Policy Center, Urban Institute & Brookings Institution

ⁱⁱⁱ Memos from Howard Marks “Shall We Repeat the Laws of Economics – Part III”

^{iv} Northern Trust Asset Management

^v Morningstar, Dow Jones & Company

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