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# The Carlyle Compass



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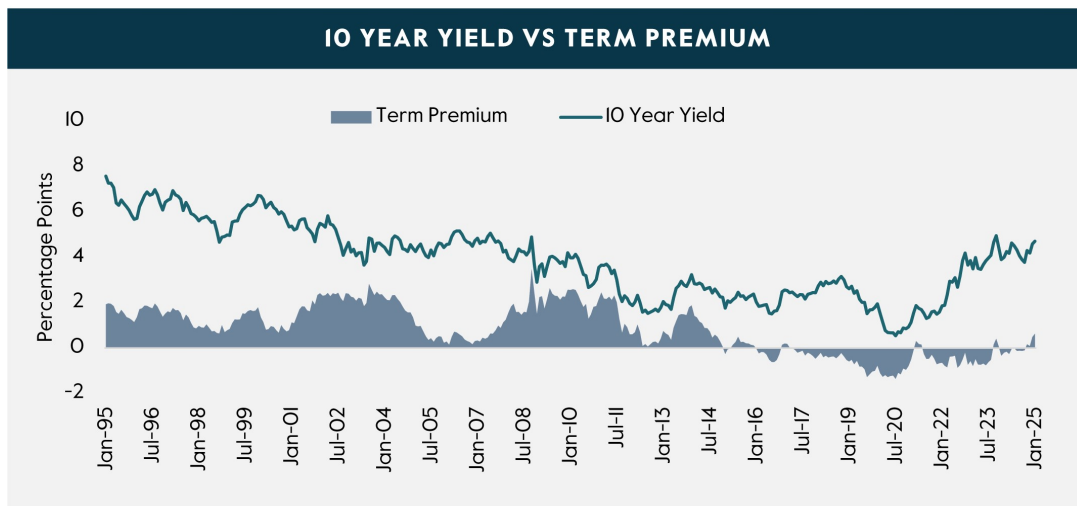
Bond yields aren't supposed to rise when short-term rates decline. Yet, the backup in Treasury yields since the Fed's first cut in September is now progressing at an ["alarming"](#) rate, prompting a frantic search for answers.

Investigators seem to have found the culprit: the "term premium," or compensation that holders of longer-term Treasury obligations earn for bearing interest rate risk. According to the [Adrian, Crump, and Moench \(ACM\) model](#) updated daily by the Federal Reserve Bank of New York, the term premium has risen by 90 basis points since the Fed first cut interest rates. The implication is that bondholders have grown worried that a surge of Treasury issuance will cause yields to rise, depressing the market value of their holdings,

or that inflation will remain above target, inflating away the real value of their principal.

When looking at the past 30 years of data (Figure 1), the curiosity is not today's term premium—which looks quite modest historically—but that this premium vanished for most of the past 15 years. From the start of 2016 through the time of the Fed's first cut last year, the term premium was negative nearly 90% of the time.

**Figure 1: Sharp Rise in Term Premium from Negative Levels**



Source: Carlyle Analysis; Federal Reserve Bank of New York, January 2025. There is no guarantee any trends will continue.

Prior to the Global Financial Crisis (GFC), owners of 10-year Treasury notes received about 180 basis points more, per year, than they could expect to earn on T-bills over the same holding period. Maybe this seems like a lot. But back then, people still worried about the possibility that rates could go up. Just a one standard deviation increase in yields between 1988 and 2008 would be enough to shave 10% off the market value of a 10-year bond portfolio. If you could earn 4.25% in money markets, why invest in fixed-rate bonds unless they offer adequate compensation for that volatility?

In the subsequent years, as inflation remained subdued and central banks pinned overnight rates at zero and used their balance sheets to exert downward pressure on longer-dated yields, the risk of higher rates receded from our collective consciousness. Investors came to regard duration as an important [source of potential upside](#), as the prices of longer-dated bonds rose substantially as yields dropped towards ([and, in many cases, below](#)) zero. As the risk of capital losses turned into fear of missing out, the term premium fell into negative territory.

Now, we seem to have returned to a world where cash offers a positive real return and bonds present downside risk. No surprise the term premium has returned to positive territory. But that’s hardly what stands out when comparing the current situation to pre-GFC averages.

**Table 1: Term Premium Remains 65% Below Pre-GFC Average**

	10 Year Treasury Yield	Expected Average Short-Term Interest Rate	Term Premium
January 2025	4.71	4.08	0.63
Pre-GFC Average ('88-'08)	6.05	4.25	1.8
Difference (in Basis Points)	-134	-18	-117
%Deviation from Pre-GFC Average	-22%	-4%	-65%

Source: Carlyle Analysis; Federal Reserve Bank of New York, January 2025. There is no guarantee any trends will continue.

Table 1 breaks down the yield on the 10-year Treasury into the expected annualized return on T-bills over the next 10 years and the term premium, as reported by the NY Fed.

The 10-year yield currently sits 134 basis points below its average in the 20 years that preceded the GFC. But that’s almost entirely explained by a **sharp decline** in the term premium, which remains 117 basis points, or 65%, below its average during that 20-year period. The NY Fed model—calibrated on [yield curve data](#)—implies that T-bills will earn about 4.1%, on average, over the next decade, only 18 basis points, or 4%, below their average in the pre-GFC period. If investors were as concerned about interest rate and inflation risk today as they were back then, 10-year yields would be above 5.5%.

These are just the results of a model; perhaps money market yields will be substantially lower than it implies. But for today’s term premium to be “high” historically, investors would have to expect money markets to return less than 2.85%, annually, over the next ten years.

Sub-3% cash yields had been the market’s assumption. But is that still the case today, after two years of nearly 3% real GDP growth and 3% core CPI inflation in the face of interest rates thought to be “[restrictive](#)”? If so, this may be a rates

market that finds it's operating with a lot more risk and far less premium than commonly supposed.

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