

Investors are unfazed by bond yields, but higher rates will hit equity valuations



ROGER MONTGOMERY
ANALYSIS

Have you noticed interest rates on long bonds are rising with apparent impunity? Bond rates fall; stocks go up. Bond rates rise; stocks still go up – maybe by a bit less, but they still go up. Nothing, it seems, can stymie the stockmarket’s advance. This dynamic calls for a closer look under the bonnet.

In the past, cyclical economic factors were the primary driver of bond rates, which ultimately self-corrected as central banks fought inflation or moribund economic growth at the short end of the yield curve.

But that was when nations co-operated, when free global trade provided stability, when supply chains weren’t targets in military conflict, and before national security and strategic autonomy dictated economic policy.

Today, central banks operate in an altered regime. They can’t print energy, unblock trade routes or subsidise domestic manufacturing plants. And when fiscal deficits expand persistently, as they are under Donald Trump in the US and Anthony Albanese here at home, inflation remains structurally stubborn.

Consequently, central bankers aren’t the primary drivers of the economic cycle – they’ve become downstream price-takers forced to maintain higher benchmark interest rates just to keep inflation expectations checked.

It’s easy to see why bond yields have climbed so aggressively across global markets. Geopolitical conflicts in the Middle East and eastern Europe continue to disrupt critical supply networks, putting persistent upward pressure on crude oil and refined petroleum prices.

Meanwhile, rising rates in Japan are forcing international hedge funds to unwind their once-lucrative carry trades. To repay their cheap-yen loans, they’re dumping higher-yielding government debt across the US and Europe, driving bond prices there down and yields up.

In the US, higher bond yields at least partly reflect solid economic growth. The most recent Purchas-



ing Managers Index soared to its highest level in five years, and manufacturing climbed to multi-year highs, revealing corporate America is running hotter than anticipated.

Compounding the economically and structurally driven yield rises is a surge in corporate bond supply from AI hyperscalers to fund AI infrastructure; at the same time, the widening US budget deficit requires financing through debt issuance.

So is this 1920, when US 10-year Treasury yields initially poked above their long-term historical average, peaked shortly thereafter and then entered a structural, multi-decade decline as the impact of the Depression and then World War II took hold?

Or is this 1967, when yields broke above that same long-term average and just kept going,

eventually climbing into double digits amid fiscal profligacy and commodity shocks, which embedded inflation into the 1970s?

It’s tempting to assume one of those precedents sets the stage today. What if the real answer is neither does? What if yields create a third path and simply occupy a higher range – with rates elevated by supply shocks, deglobalisation trends and the structural shifts unique to today?

Then there’s the idea that today’s algorithmic trading, instantaneous information flow and hyper-reactive policy shifts could trigger a major bond bear market that plays out in fast-forward, peaking and reversing over months rather than decades.

Meanwhile, equity investors seem to be blissfully unfazed by rising bond yields. Maybe that’s because history shows rising

yields don’t automatically sink stock prices. It’s the underlying driver of those yields that determines whether stocks sink or soar.

For now, it’s economic strength and earnings growth driving acceptance of higher bond yields. But remember interest rates act on asset prices like gravity on Earth: when benchmark bond rates are low, the gravitational pull on equity valuations is negligible. But when Treasury yields sit near 5 per cent or higher, that gravitational pull intensifies.

Another reason for the apparent calm is investors are betting AI will deliver unprecedented “escape-velocity” earnings growth. Relying, however, on AI earnings growth to defeat interest rate gravity is a fundamentally risky proposition, because AI earnings growth is by no means guaranteed.

First, corporate capex on hardware can’t outpace real-world revenue forever.

If enterprise software tools fail to deliver tangible productivity gains for customers, or if open-source or cheaper Chinese models do the job well enough and undercut the frontier models, technology giants will eventually be forced to scale back their infrastructure spending. This is the AI armageddon scenario I have alluded to in previous columns. If one blinks, the entire hype-machine grinds to a halt.

Second, hardware and memory manufacturer profit margins sit near historical highs today. But margins tend to be mean-reverting, which means they’re vulnerable, particularly to competition and cyclical slowdowns.

Third, the rollout of AI will confront strained electrical grids,

utility shortages and construction delays.

Finally, if massive AI investment keeps the broader economy booming, that will fuel consumer demand and keep inflation elevated, adding further pressure on central banks to keep benchmark interest rates higher for longer.

But the law of large numbers means earnings growth has to slow, and that means so do share price gains. Unless artificial intelligence translates into rapid, cash-generative productivity gains across the entire business landscape, higher interest rates will eventually reassert their gravitational pull, drawing equity valuations back to Earth.

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