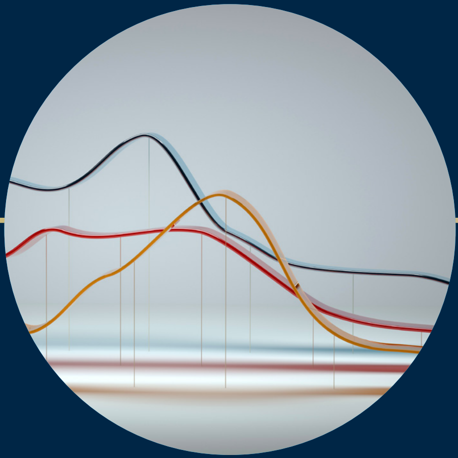
MARKET SIGHTLINES



Numerous Pressures Push Interest Rates Higher

By **Michael O'Keeffe, CFA**
Stifel's Chief Investment Officer

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Long-term interest rates continue higher. The 30-year Treasury yield peaked recently around 5.36%, a level last seen nearly two decades ago, while the 10-year rose to 4.95%. Short-term rates did not rise as much, so the yield curve has steepened. Why? Investors are asking for more compensation to lend to the government for 30 years – an increase in what's called the "term premium." In our article **Fiscal Trajectory: Borrowed Time**, we describe a debt path that is not sustainable and possible scenarios forward. In this Sight|Lines, we discuss the drivers behind rising rates and implications going forward.

THE TAKEAWAY: NUMEROUS FORCES DRIVE RATES, BUT U.S. FISCAL WORRIES MAY BE GROWING

Long-term government yields have risen to levels not seen in nearly 20 years, with government borrowing and our Fiscal Trajectory likely an increasing driver of higher rates. In summary:

- The 30-year Treasury yield has peaked recently at roughly 5.36%, its highest level in nearly two decades, with larger increases at the longer end.
- Such moves are not limited to the U.S. bond market – long-term government yields have risen to multidecade highs across Europe and Japan as well.
- Inflation worries have often driven interest rate volatility, but these recent moves may be driven by investors asking to be paid more for lending over long periods – the term premium.
- U.S. federal debt hit a notable milestone recently by passing $40 trillion, but – importantly – the retirement and health entitlement commitments add roughly $88 trillion more.
- Our **article** highlights the importance of austerity – higher taxes and/or lower spending to reduce the deficit – and healthy economic growth to reset the path, which may reduce the term premium.
- In August, the U.S. Treasury increased its buyback program to improve liquidity and market function, but yields fell only briefly, reinforcing the likely role of the term premium in recent moves.
- Borrowers, like the U.S. government and companies building our artificial intelligence infrastructure, are competing for long-term capital, and when this competition increases, yields can go higher.
- Federal Reserve policy can influence market rates, often more on the shorter end of the yield curve, so we'll be watching the results of next week's Fed meeting carefully.

IN-DEPTH: WHILE NUMEROUS FORCES DRIVE RATES, WORRIES ABOUT U.S. FISCAL TRAJECTORY MAY BE GROWING

Long-term yields on government bonds have risen to levels not seen in nearly 20 years, with the U.S. Fiscal Trajectory likely an increasing driver of these higher rates. Going deeper:

- Longer-term U.S. Treasury yields have risen to levels not seen for a long time:
  - The 30-year yield peaked recently at 5.36%, a level not seen in nearly two decades.
  - The 10-year yield, an important reference rate for borrowers, peaked at 4.95%, last seen in October 2023.
- Such moves are not limited to the U.S. bond market:
  - Long-term German yields have reached levels last seen about 15 years ago.
  - French 30-year yields are the highest since the global financial crisis.
  - Japanese 10-year yields are approaching 3% for the first time since the mid-1990s.
- Inflation expectations have remained somewhat stable recently, signaling inflation worries are not as much of a driver:
  - The 30-year breakeven rate – the market-implied average expected inflation rate – has been stable at about 2.3% recently.
  - Investors' demand for a higher real rate – the rate earned beyond inflation – signals a possibly higher term premium.
- Federal debt has passed $40 trillion, or 125% of gross domestic product (GDP), with no sign of a slowdown in growth:
  - The fiscal 2026 deficit is $1.9 trillion, 5.8% of GDP, and net interest above $1 trillion – roughly 19% of federal revenue.
  - Treasury estimates about $88 trillion in unfunded obligations for Medicare (approximately $60 trillion) and Social Security (approximately $28 trillion).
- Our **article** highlights the importance of austerity and healthy economic growth as a path to a better Fiscal Trajectory:
  - Unfortunately, austerity (higher taxes and/or lower spending) remains politically unappealing to elected officials.
  - The continued strength of the U.S. economy presents one glimmer of hope, especially if AI leads to more growth.
- In August, the Treasury announced it would at least double the levels of planned buybacks of outstanding 10- to 30-year debt to improve liquidity and market function:
  - Long-term yields initially fell modestly, but then quickly reversed and continued higher.
  - Buybacks can improve liquidity, but they will not likely change the fundamentals driving long-term pricing.
- Corporate borrowing, like that tied to the AI buildout, is now competing with our government for bond investors:
  - Bond issuance by the largest U.S. cloud providers has passed $100 billion this year, more than double 2025 levels.
  - More issuance in longer-dated debt means investors may demand higher yields, another possible driver of higher rates.
- Fed policy can influence market rates, often more on the shorter end, and so we'll be watching next week's Fed meeting:
  - Fed funds futures are currently pricing in a 75% chance of a 0.25% Fed funds rate increase, supported by hawkish comments by Chair Kevin Warsh during his Jackson Hole speech.
  - While Chair Warsh is downplaying Fed communications, the Fed's Summary of Economic Projections will be released next week, providing an update on officials' views on inflation and rates.

WHAT WE THINK

Long-term yields have risen recently. With inflation expectations staying relatively stable as nominal yields have climbed, investors appear to want more compensation for time and uncertainty rather than for inflation. We believe the U.S. Fiscal Trajectory is one force behind these moves, a trajectory unlikely to shift any time soon. Inflation, inflation expectations, and Fed policy shifts can also influence rates, especially on the shorter end of the yield curve. So, we will be watching the results of next week's Fed meeting carefully.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
StifelInsights.com

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