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RSW's Q3 2026
Fixed Income Newsletter

The Rising Sun Gets Hotter

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A Note on Timing

For 21 years, we have published our quarterly commentary at quarter-end. This time, we're breaking with tradition.

We're publishing this commentary early because we believe an opportunity is beginning to emerge, and we thought it was important to share our thinking while these developments are unfolding.

There are a lot of moving parts, and they're all connected. So, let's get into it.

When we wrote our 2026 Outlook ("From 1990s Powerhouse to Today's Warning Signal"), we suggested that Japan could offer an early glimpse of what was developing in global fixed-income markets. At the time, it may have seemed unusual to look to Japan for clues about U.S. Treasury yields. Even more unusual was the idea that those same developments could eventually provide insight into where municipal yields were headed.

That warning light is now flashing red, not yellow.

Japan's 10-year government bond yield exceeded 3%, the first time since 1996. It was up a full percentage point from the beginning of the year, a 50% increase.

This is a country that spent decades training investors to believe Japanese interest rates would remain close to zero forever.

For years, the Bank of Japan (BOJ) was one of the largest buyers of its own government bonds. That helped suppress yields and, in the process, reduced the amount of price discovery taking place in the market. Japan has slowly been taking the training wheels off by gradually reducing its bond purchases since 2024.

In other words, the central bank is allowing long-term interest rates to be formed more freely by the market. As a result, what we are now witnessing is what happens when the central bank is no longer the sole determinant of the price of Japanese government debt.

The result? Not just higher yields. Much higher yields.

At the same time, the Bank of Japan's policy rate already stands at 1%, up from zero percent in March 2024. Markets are also assigning a high probability to another 25-basis-point increase.

The important point isn't simply that Japan is raising rates. It's also what has been happening to the value of its currency, the yen. Higher yields helped stabilize the yen, which began to strengthen against the dollar.

The significance of this yield surge goes well beyond Japan and brings us back to RSW's forecast. For decades, Japan provided the world's cheapest source of funding, allowing investors to borrow yen at extremely low rates and invest the proceeds in higher-yielding assets around the world, including U.S. Treasuries.

This was the famous **yen carry trade**: borrow cheaply in Japan, invest somewhere else, collect the spread, and repeat.

As Japanese yields rise, however, the math is not "mathing." The yen-funded carry trade is now beginning to feel less like a free lunch and more like the bill has finally arrived.

Leverage Works Both Ways

If the Yen Strengthens

With Japanese bond yields now substantially higher, Japanese investors have more reason to keep their money at home rather than invest it overseas. We are already seeing evidence of this shift, with purchases of foreign bonds declining as domestic yields rise.

At the same time, a potentially stronger yen driven by higher yields makes the carry trade even less attractive. Investors borrowing yen must consider not only the performance of the asset they purchased but also the increasing cost of repaying the yen used to finance it. That is beginning to put pressure on a trade that has been an important source of global liquidity.

If that trade continues to unwind, the consequences won't necessarily be polite. Yen-funded capital has found its way into bonds, equities, credit, emerging markets, private assets and virtually anything offering a better return than Japanese government debt. As those positions unwind, the selling pressure can spread across asset classes.

If the Yen Weakens

When the yen weakens significantly, Japanese authorities may intervene to limit inflationary pressure by selling dollars and buying yen. That supports the currency, but it also raises an important question: where do the dollars come from?

Japan holds an enormous pool of dollar-denominated reserves, much of it invested in U.S. Treasury securities. We have already seen how those reserves can be used to support the yen. During its April intervention, Japanese authorities sold roughly $40 billion of foreign-exchange reserves to buy yen. Since April, Japan's holdings of U.S. Treasury securities have declined by more than $100 billion, with total holdings still topping $1 trillion, according to the St. Louis Federal Reserve.

That matters because Japan is not simply a potential seller of Treasuries, it has already been reducing its holdings. And if pressure on the yen intensifies, additional intervention could put further pressure on those holdings at a time when the United States is already issuing debt at an extraordinary pace.

Keeping the Yen in Its Lane

The important distinction is between Japan buying Treasuries and Japan simply not being forced to sell more of them. Given the size of Japan's Treasury holdings, that distinction matters.

This leaves Washington with an interesting balancing act. Policymakers have an incentive to see a more stable yen because it reduces the risk of additional Treasury selling from Japan. At the same time, a yen that strengthens too quickly could accelerate the unwinding of the carry trade and create a very different kind of global market shock.

The objective, therefore, isn't simply a stronger yen. It's a more stable yen.

If all that wasn't enough, there's another unusual paradox worth considering…

The Long and Short of It

While Federal Reserve Chairman Kevin Warsh continues to talk tough on inflation and is hiking short-term rates, Treasury Secretary Scott Bessent has become increasingly active in trying to keep longer-term Treasury yields from moving higher. And how is the Treasury supporting those purchases of longer-maturity debt?

You guessed it: Treasury bills.

That creates an interesting contradiction. Bessent has an obvious interest in keeping longer-term borrowing costs under control. The 10-year Treasury is a critical benchmark for mortgage rates and the broader economy. But if Warsh remains focused on inflation and short-term rates need to move higher, the Treasury could simultaneously be trying to keep long-term yields in check while the Fed is making short-term borrowing more expensive.

In other words, Washington may be pulling in two different directions.

There is another constraint that cannot be ignored: the size of the federal debt. A strong dollar can be managed. High interest rates can be managed. Even ever-growing debt can be managed. One is manageable. Two can be uncomfortable. All three at once is a different story.

During World War II, when the government needed to keep interest rates from rising too far, it used yield-curve control because it could not afford to finance massive amounts of debt at market rates. To accomplish this, the Federal Reserve helped the Treasury keep rates under control by capping yields at various points along the yield curve, from 3/8% on Treasury bills to 2½% on longer-term bonds. Whenever rates threatened to move above those levels, the Fed stepped in and bought Treasury securities to keep them from rising further.

I think we could see some version of that response again. Call it yield-curve control or something else. The name doesn't matter. The math does.

The government is already paying more to service a very large debt load, and a substantial amount of that debt will have to be refinanced at today's higher rates. So, when I hear people talking about another 2022-style hiking cycle, I keep asking the same question: How high can rates really go when Washington itself can't afford them?

In my view, lower rates eventually become less about stimulating the economy and more about keeping the government's debt burden from becoming unmanageable. Something has to give. I think it is far more likely to be rates and the dollar than Washington's appetite for deficit spending.

The 5% Question

Against the backdrop we've outlined, the U.S. 10-year Treasury yield has now reached 5%, the threshold we identified as a potential destination in our 2026 Outlook. At the time, we expected the 10-year to first retest its 2025 peak of 4.79% before ultimately moving toward 5%. It got there.

The question now is what happens next.

Before answering that question, it is important to understand how we approach a move like this. We don't try to identify the exact basis-point peak in yields. Trying to pick the precise level where yields top out is a fool's errand. Instead, we focus on identifying a zone where the risk and reward begin to change and the market could reverse course. At 5%, we are at one of those decision points.

That doesn't mean 5% is the top, although it could prove to be. What it does mean is that we are entering an area where the opportunity becomes much more interesting.

Today, the forces pushing U.S. yields higher are still firmly in place. Rising Japanese yields, growing federal deficits, increased corporate borrowing, and the enormous capital spending tied to artificial intelligence are all competing for investor capital. At the same time, volatility in the dollar-yen relationship, rising energy prices and increasing Treasury issuance are adding to the pressure on the bond market. With all these forces working at the same time, it’s not surprising that the bond market continues to misbehave.

Assuming these conditions persist, our best guess is that the 10-year could reach the **5.25% to 5.40%** range. I’m not saying it will. I’m saying that, given the forces working against the bond market, it’s plausible.

A move above 5% does not necessarily mean those elevated yields are here to stay. We believe 5% is either the peak or the point where a final blow-off move in rates takes place before this upward shift runs its course.

For more than a decade, investors became accustomed to extraordinarily low rates, massive central-bank purchases, and virtually unlimited liquidity. That "zero-bound" world is gone. Perhaps permanently.

Our base case is that elevated rates eventually begin to attract stronger demand as economic growth slows, inflation moderates, and global investors once again seek the liquidity and safety of U.S. government bonds. As we have learned from past episodes of surging rates, it is the higher rates that eventually end the party.

In other words, the path may once again be:

Higher first. Lower later.

The key, as always, is not simply having an opinion on the interest rate markets. It's being prepared when your target zone is reached. After more than four decades of managing interest-rate risk, I've learned that the best opportunities rarely arrive with a sign saying, "This is the bottom."

Usually, they arrive looking like a problem, and occasionally, they arrive looking like Japan.

Municipal Bond Commentary

When Treasury yields move higher, municipal yields feel the pressure too. Beyond the pressure from rising Treasury rates, the tax-exempt market is facing two forces pulling in opposite directions. Supply is enormous. Demand is enormous.

Right now, supply is winning. That has been putting additional upward pressure on municipal yields and creating a more challenging environment for investors, particularly those who have already experienced losses as rates have moved higher. At the same time, the sheer volume of new issuance has improved valuations in the tax-exempt market. More bonds coming to market gives investors more choices, but it also means issuers have to offer more attractive yields to get those bonds absorbed.

For example, 10-year tax-exempt ratios (the yield on 10-year AAA municipal bonds relative to the yield on 10-year U.S. Treasury notes) have moved into what we consider a more attractive range. Over the past five years, the average ratio has been about 68%. Today, that ratio is approximately 74%, putting it firmly into what we consider the "buy zone." Simply put, as the ratio increases, investors are paying less for the tax-exempt benefit.

The shape of the yield curve adds another important piece to the picture.

For example, a 10-year AAA rated municipal bond offers 52 basis points of additional yield than a bond maturing in 5 years. In Treasuries, extending from 5 years to 10 years adds only 15 basis points of yield.

The difference is even more striking at 15 years. Moving from 5 years to 15 years adds 105 basis points of additional yield in the municipal market, compared with just 32 basis points in Treasuries.

In other words, investors are being paid much more to extend maturities in the municipal market than in Treasuries.

Those higher yields create an opportunity to put more meaningful levels of tax-exempt income into portfolios. As our disciplined process dictates, we recently added duration (a measure of interest rate sensitivity) to our client portfolios. RSW has maintained a relatively low level of interest rate risk this year, which gives us the flexibility to take advantage of the higher yields now available.

The decision to extend maturity and/or duration is based on what we can earn going forward, not on what has already happened. Higher tax-exempt yields and longer maturities put portfolios in a better position to earn meaningful tax-advantaged income over the coming years, while also creating greater potential to offset unrealized losses should yields decline over the coming quarters.

For clients, we understand why some may be anxious. Rising yields mean falling bond prices, and the broader portfolio has already experienced a drawdown as rates have moved higher. Nobody enjoys watching bond prices fall, even when the underlying income opportunity is improving.

Our approach is to add duration selectively and methodically as the compensation for taking on additional interest rate risk becomes more attractive. We are not trying to predict exactly where rates will peak. We are focused on taking advantage of the income available today while positioning portfolios for the years ahead.

For municipal investors, that could mean selectively locking in tax-exempt income at levels that would have seemed almost unimaginable during the zero-rate era.

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