

Key points

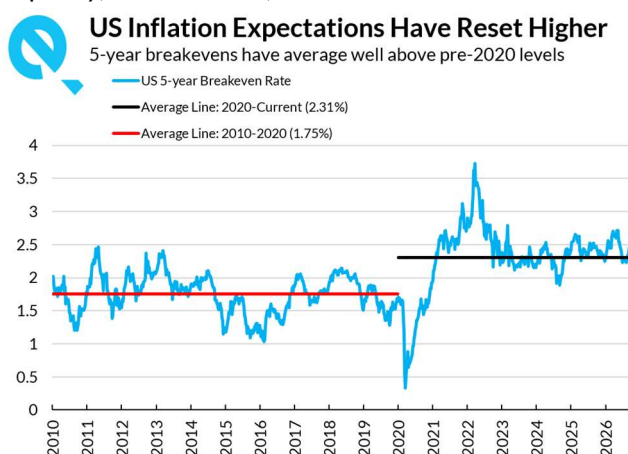
- US Treasury yields rose quickly after 2020 and remained high. Most of the move is a neutral rate pulled up by heavy investment demand, and a market that has stopped pricing a repeat of the zero-rate decade. That is an anomaly unwinding.
- Inflation expectations have also shifted higher, although the larger effect runs through inflation uncertainty, which lifts the term premium. Bonds no longer hedge equities as they did before 2021, and an asset that no longer protects a portfolio must pay more to be held.
- Nothing has broken because transmission slowed rather than stopped. The curve signal was distorted by a cycle in which the front end rose to fight inflation. We see the next 12 months as a period to watch, not a recession call.
- The equity risk sits in earnings, not the multiple. Forward valuations look reasonable only because the expected earnings path is steep, and that path leans on the AI investment cycle. With the buildout now debt-funded, higher yields feed straight into costs, and we would expect an earnings downgrade to be the trigger.
- For the ZAR, the question is whether US yields fall alongside US equities. If the Fed has room to ease, the dollar softens, the carry improves, and the currency can recover quickly. If inflation keeps policy constrained, the weakness may persist. Oil may decide which.

BASELINE VIEW: South Africa enters this cycle with a materially lower risk premium than in previous episodes. The Reserve Bank has a stricter inflation target and defended it by hiking into an oil shock; the fiscal path is stabilising, ratings momentum has improved, and foreigners keep buying local bonds. Over the next six to nine months, we expect any ZAR weakness triggered by a potential US equity correction to be smaller and shorter-lived than the historical beta implies, and we expect a quick recovery if the Federal Reserve can ease in response. That view is contingent on oil. Should equities fall while yields rise, the dollar firms and policy stays constrained, the traditional playbook applies in full, and the ZAR will underperform its emerging market peers.

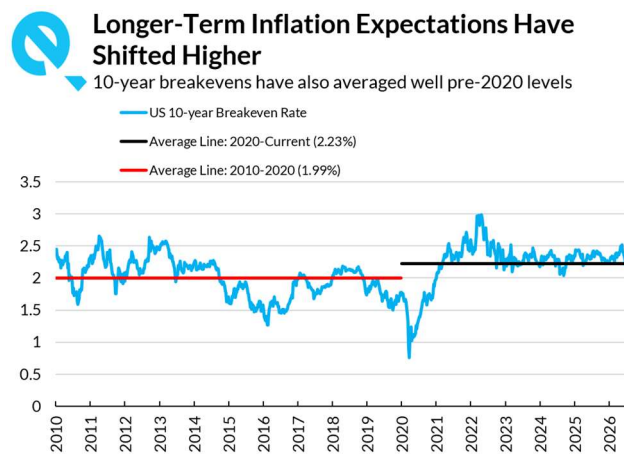
Inflation expectations have shifted

Any attempt to explain why US Treasury yields have remained higher than past cycles has to begin with inflation expectations, and the market's own pricing leaves little doubt that something has changed. Comparing breakeven inflation rates through the decade to 2020 with the period since, the accompanying charts show an upward shift at both the five- and 10-year rates. The University of Michigan's survey of household expectations tells the same story.

This follows an extended period of inflation above the Federal Reserve's 2% target. Supply shocks once treated as isolated have become recurring, first with Russia's invasion of Ukraine and now with the conflict between the United States and Iran. With no end in sight to these wars, investors must price more frequent energy shocks. Tariffs, reshoring, and broader supply-chain fragmentation have removed a disinflationary impulse that flattered inflation data for most of 30 years. All the while, fiscal deficits are running at levels once reserved for recessions despite strong growth, and the artificial intelligence buildout is itself inflationary in the near term by raising competition for electricity, construction capacity, skilled labour, and semiconductors.



Source: Bloomberg, ETM Analytics

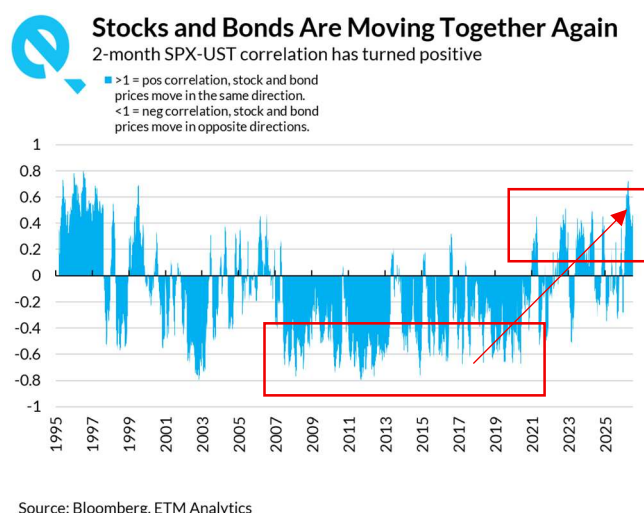


Source: Bloomberg, ETM Analytics

Measured against the full move in vanilla yields over the same period, only part can be explained by higher inflation expectations. Inflation still matters, but through a different channel. Both 5-year and 10-year breakevens have reset above their pre-2020 averages, suggesting markets now assume a structurally higher inflation backdrop than prevailed in the 2010s. Even so, expectations remain relatively well anchored, with 5-year compensation only modestly above the 10-year, implying the current energy shock is expected to fade rather than become permanently embedded. This points to a market pricing in somewhat higher inflation, with a temporary war premium layered on top. However, the Fed's 2%

target itself still appears credible. A more important route, in our view, runs through inflation uncertainty. Inflation can drive high yields even if expected inflation moves little, if inflation uncertainty is what changed. Higher uncertainty about the inflation path raises the term premium demanded on bonds. The clearest observable evidence for this comes from the relationship between bonds and equities.

For most of the period between the late 1990s and 2020, the dominant risk facing markets was an economic demand shortfall. When growth disappointed, equities fell, inflation fell with them, central banks cut rates, and bonds rallied. Bonds therefore hedged equities, and investors accepted a lower yield in exchange for portfolio stability. In an inflation-driven world, the mechanism reverses: a supply shock raises prices and damages growth at the same time, so bonds and equities fall together, which can hurt a portfolio significantly. As the adjacent chart shows, that is largely what has happened since 2021, and a bond that no longer protects a portfolio has to compensate its holder with yield instead.



The larger story is a neutral rate that has moved higher

Astute readers might wonder: if inflation uncertainty explains part of the move, what accounts for the rest? The short answer is that structural shifts, such as rising debt levels and an ageing population, necessitate a higher neutral policy rate, and we would argue this remains the single most important explanation for where yields have settled.

The neutral rate, commonly written as “r-star” or r^* , is the rate at which policy neither stimulates nor restrains activity and the economy grows at potential without inflationary or deflationary pressure. Below it, policy is loose, and borrowing and spending are encouraged. Above it, policy is tight and disinflationary pressure builds. Central banks cannot observe it, so they use estimates as the anchor for judging their settings. It is not a fixed number, but rather the product of long-term forces governing the supply of and demand for capital.

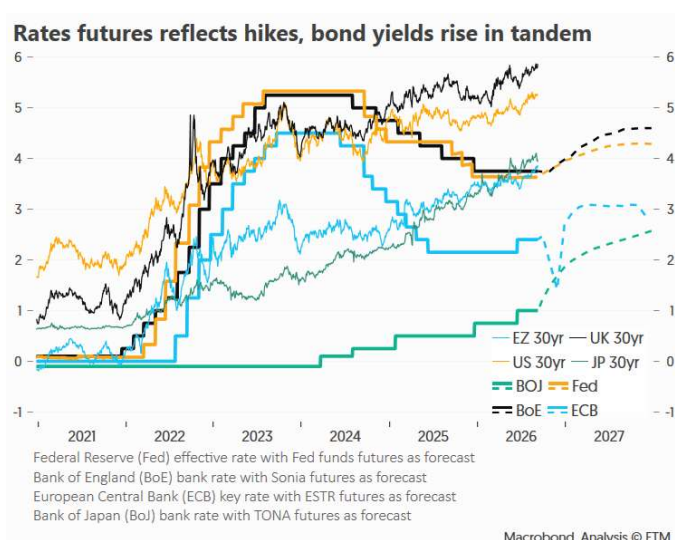
Those forces have been pulling in one direction for some time. The world is shifting from the excess savings and secular stagnation of the post-crisis decade (2008) towards higher investment and lower saving. Industry has become more capital-intensive, governments are running structural deficits that absorb savings, while demographic change is shrinking the pool of savers relative to spenders across the developed world. Moreover, higher defence spending and the reshoring of supply chains (both consequences of a more fragmented geopolitical order) are absorbing real capital that would previously have gone elsewhere. Each raises the competition for capital. The artificial intelligence buildout is the clearest current example, directing hundreds of billions of dollars a year into data centres, power generation and semiconductor capacity. Whatever one concludes about whether the returns will ultimately justify that spending, its effect is to draw capital away from alternative uses.

A 10-year yield is, at its simplest, the market's expectation of the average policy rate over the coming decade, plus compensation for holding that expectation for 10 years. Through the 2010s, the market expected policy to remain close to zero for years, and that was rational at the time. Rates were at their lower bound, central banks were buying bonds to suppress long yields, and the economy showed little sign of generating enough inflation to justify anything else. The result was a decade in which the market priced policy well below any plausible estimate of neutral, indefinitely.

That is no longer the case. The market now prices policy much closer to neutral, so the rise in the 10-year yield is largely the market ceasing to price a repeat of the 2010s. Yields have stopped reflecting an emergency that ended some time ago. The extraordinarily low yields of the past decade were the anomaly, and we are watching it unwind.

The term premium has normalised rather than blown out

A bond yield is also made up of a term premium, which is the additional compensation an investor requires when lending for longer periods of time. It exists because a great deal can happen over 10 years, and the holder must account for uncertainty about whether inflation, policy, or the fiscal position turn out very differently from what was originally anticipated. Like the neutral rate, the term premium is theoretical; it cannot be observed directly and has to be estimated.



Fed models show that the term premium fell sharply negative in the quantitative easing years. In such an environment, investors would have paid a premium for more risk. That happened because a large, price-insensitive buyer (the Fed) actively bought to enhance market liquidity, making bonds prized for the protection they offered against equity drawdowns. Today the term premium sits near its long-run average, a normalisation from a suppressed level rather than crisis-level risk compensation.

There is, however, an important distinction between horizons that should not be lost. Measured over the past decade, the term premium explains only a modest share of the rise in yields, and the neutral rate does most of the work. Measured over the past year alone, the term premium explains much more of the move. This follows as the war and associated oil shock have raised inflation uncertainty, questions about the reaction function of a Federal Reserve under new leadership have added policy uncertainty, and, as we discuss next, both the supply of Treasury paper and the composition of its buyers have been shifting. The market may ultimately be trading in a different regime, with the globally crucial oil market experiencing tremendous pressure over the last 12 months.

Supply is rising

The financial media's dominant argument is that the United States is issuing more debt than the world is willing to absorb. Gross federal debt has passed \$40 trillion, deficits are projected to exceed 5% of GDP every year for the next three decades, and interest costs have reached a multi-decade-high share of federal revenue. The Treasury Borrowing Advisory Committee noted in August that on current auction sizes, primary dealers see a funding shortfall of roughly \$1.5 trillion across the 2027 and 2028 fiscal years, with coupon increases likely to be warranted from 2027. Treasury has managed this so far by leaning heavily on short-dated bills rather than lifting long-dated issuance, which has kept pressure off the long end, but only defers the problem.

It has also been buying back longer-dated paper, and recently it announced it would triple the size of its long-end liquidity-support buyback operations. The US Treasury is clearly not comfortable with the long end. Nor is Treasury the only borrower competing for long-dated money. The long end is absorbing government and corporate supply at the same time. Corporate issuance has been running at record levels this year, with AI-related borrowers accounting for a large share, which means the long end is absorbing government and corporate supply at the same time. Auctions have nonetheless cleared comfortably thus far, but the market could grow fragile given distended issuance.

Why nothing has broken

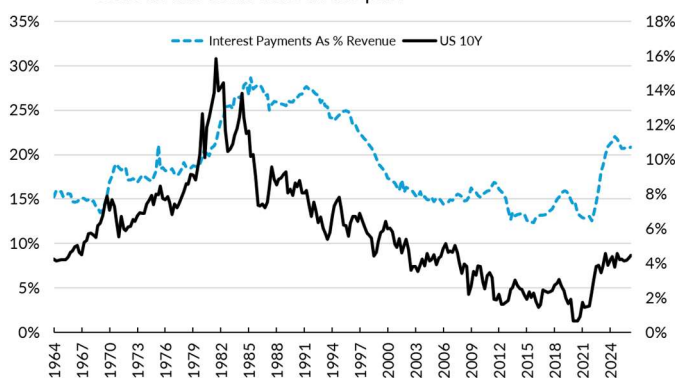
Now that we've established why yields are where they are, the more pressing question for investors is why nothing appears to have broken. Historically, a rise in yields of this speed and magnitude has been followed by financial accidents, and leading recession indicators have been flashing red for some time without much happening. What follows is an attempt to explain why markets and the broader economy have proven so resilient.

- Nominal economic growth in the United States has continued to run above the government's borrowing cost. If that relationship holds, debt can be dealt with more easily in the future. The Congressional Budget Office's projections place the crossover, where the average rate on government debt exceeds nominal growth, around 2031. Interest payments as a ratio of federal revenue have reached a multi-decade high. This implies a worrying constraint on fiscal flexibility. It appears, however, that improving growth potential through automation can help remedy this going forward.
- Rates transmission has also been slow. Households and companies locked in borrowing at low rates for longer periods when rates were at their lowest, insulating them far longer than in previous cycles. Private balance sheets have also been repairing while government leverage grew, so economy-wide indebtedness tells a milder story than the sovereign figure alone. With such a large stock of government debt outstanding, higher rates now transfer meaningful interest income to the private sector, which materially blunts the contractionary effect. Transmission has therefore slowed, although the wall of refinancing ahead is the mechanism through which it eventually arrives.



US Interest Payments vs. 10Y Yield

Markets do not seem to be pricing in fiscal risks at the same scale as has been done in the past

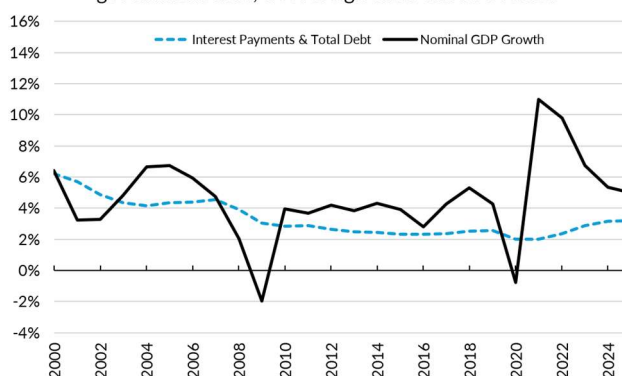


Source: Federal Reserve Of St. Louis, ETM Analytics



Nominal GDP Growth vs. Debt Interest

As long as GDP growth outpaces interest payments on government debt, a sovereign crisis can be avoided



Source: Federal Reserve Of St. Louis, ETM Analytics

- The indicators themselves have been degraded by policy interventions, and the yield curve deserves particular attention because it is the most watched. When short rates exceed long rates, the market expects policy to be cut sharply, which ordinarily implies an expected slowdown. On that basis, an inverted curve has preceded every US recession for more than half a century. Yet the inversion beginning in 2022 was among the longest on record, and no recession followed. This was likely because the front end rose as the Fed fought an inflation shock, rather than the long end falling as the market priced a growth collapse. Years of quantitative easing had also suppressed the term premium, which mechanically flattens the curve and makes inversion easier for reasons unrelated to growth.

What matters more is what happens next. Historically, recessions begin as the inverted curve snaps back to a positive slope. In several past downturns, the curve had already returned to a positive slope before the recession began, with the lag typically around six to 12 months. The curve has now re-steepened, so that period has begun. However, we would not put too much weight on the signal alone. The Federal Reserve Bank of New York's recession probability models are currently close to their long-run averages and well below the levels seen before previous recessions. Labour market data has also improved rather than weakened. This has been an unusual cycle, which may have reduced the yield-curve signal's reliability. We therefore see the next 12 months as a period to watch closely, not a clear recession call.

What it would take for high yields to trouble equities

For South African investors, the transmission that matters most runs through equity markets, since it is a wobble in US stocks rather than a move in Treasury yields as such that reliably reaches the ZAR. History suggests yield levels matter far less than the reasons behind them. Equity markets have risen comfortably alongside rising yields, provided those yields rose because the market was upgrading its expectations for economic growth. They have struggled when yields rose for other reasons, such as fiscal anxiety or an inflation scare, because the discount rate then rises without any offsetting improvement in cash flows being discounted. A yield that is high because the neutral rate rose alongside a genuine investment boom is different from one that is high because investors demand a risk premium to hold government paper. Speed also deserves a mention, since markets have generally coped well with high yields and rather badly with rapidly rising ones, a fast move affording earnings no time to catch up while forcing mechanical de-risking across leveraged strategies.

Whether the US stock market is considered expensive depends entirely on which earnings you use. On trailing earnings, the index is richly valued by almost any historical standard. On forward earnings, which is to say price relative to what companies are expected to earn over the next 12 months, the multiple has fallen through this year and now sits below its five-year average, because estimates have been revised upward faster than prices have risen. Analysts have been more optimistic than usual, and companies have been beating expectations at an unusually high rate. In the language of the trade, the market has been growing into its valuation.

An important qualification around any valuation discussion is that we may well be living through a once-in-a-lifetime structural shift. If artificial intelligence delivers even a fraction of the productivity gains its proponents claim, the appropriate multiple is not the one that prevailed in the 1990s or the 2010s. Nobody can say with confidence what future the technology will ultimately lead to, and much anticipated growth is already priced in. The risk of under-delivery, however, could rival the dot-com bust.

The vulnerability, then, is not that the multiple appears reasonable because of a very steep expected earnings path. That path depends heavily on the artificial intelligence investment cycle continuing to deliver. Revisions have been running in the market's favour, supporting valuations for now. Should they turn, the forward multiple would rise mechanically even if the index did not move, and we would expect the turn itself to be the catalyst for a correction.

Higher yields reach equity valuations through three channels. The first is the discount rate. As yields rise, future cash flows are worth less today, and the effect is largest for companies whose profits lie furthest in the future, which fits the high-growth technology names that dominate the US market. Apple is a good example, with its forward earnings yield materially below the 10-year Treasury yield and modest projected growth. Nvidia is the counter-example. Its valuation is high, but very rapid expected earnings growth pushes the forward multiple sharply lower and lifts its forward earnings yield above the Treasury yield. That gives it greater protection from the discount-rate shock, but only for as long as those earnings forecasts are delivered.

The second channel is the reallocation channel, which is the observation that bonds have become a competitor for capital in a way they were not for well over a decade. With the yield curve upward sloping again, an investor is paid to wait, and government bond yields now sit above the earnings yield on the S&P 500. In theory, that should pull capital from equities into fixed income. In practice, the configuration has persisted without triggering the rotation, so allocators do not move on relative value alone.

The third is the corporate debt cost channel. The artificial intelligence buildout was initially financed with cash from the largest technology companies, which made it largely insensitive to interest rates. However, that has since changed, with capital expenditure increasingly funded with debt. Higher yields now feed into buildout costs, just as depreciation on earlier vintages of equipment begins to hit reported earnings. That is how a move in rates becomes an earnings downgrade, undermining the valuation argument set out above.

The ZAR's response depends on which driver breaks first

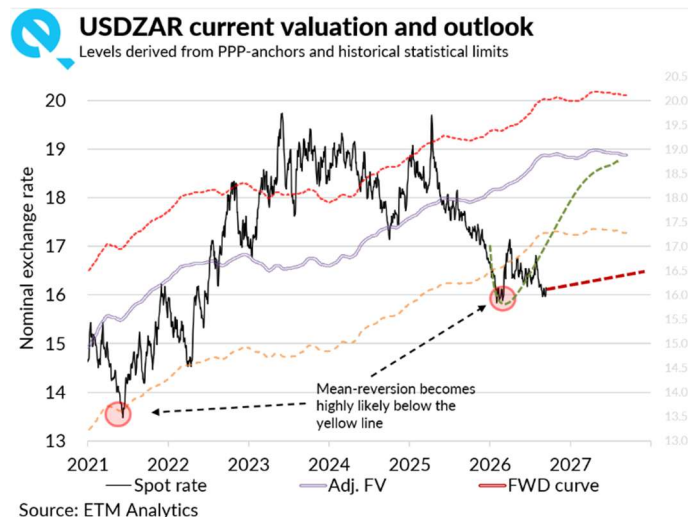
All of which brings us to the ZAR's prospects. The usual expectation is that high US yields and a wobble in US equities should trigger ZAR depreciation. The ZAR has shown remarkable resilience recently, and that strength should not be ignored. It has traded to its strongest levels in more than three years, and volatility measures show little sign of investor anxiety, even as US yields climbed toward their highest levels in over two decades.

Three factors explain this performance. The first is a domestic re-rating. The move to a lower inflation target has compressed the inflation risk premium embedded in ZAR pricing, while improved ratings momentum following the first upgrade in roughly two decades has also supported foreign investment. The second is the terms of trade, driven by the structural global central bank gold bid. The third is that emerging markets, as an asset class, have become the relative bright spot rather than the developed world. The developed world carries sticky inflation and wide fiscal deficits, while many emerging markets offer orthodox policy settings and the commodity tailwind.

Of course, none of this makes the ZAR immune. Rather, it means the response to a would-be US equity correction depends on what US yields and the dollar do at the same time. If long yields rise, the dollar firms and risk appetite falls together; the ZAR likely weakens. If equities fall but yields fall with them as the market prices in prospective monetary easing, there is an initial hit, but a softer dollar and lower yields improve the carry, and the ZAR can recover quickly. If the shock is specific to the United States and weakens the dollar, as the tariffs did in April 2025, the ZAR may barely move. The ZAR's direction therefore depends less on whether US equities fall than on whether US yields fall with them.

That, in turn, depends on the Fed, and the sequencing matters because it determines not merely the depth of any ZAR weakness but its duration. Any correction is likely to unfold in two phases: the shock itself and then the policy response. If inflation has moderated by the time the correction arrives, the Fed has room to cut. Lower US rates and the accompanying dollar weakness would likely support high-yielding emerging market currencies such as the ZAR. Conversely, if inflation is still running above target when equities fall, the Fed is constrained. It cannot ease with conventional policy into an inflation problem without risking its credibility. In that scenario, the initial ZAR weakness may persist. Oil therefore matters more than its share of the trade account suggests, since oil determines whether the Fed has room to move.

Notably, South Africa meets all of this in much better shape than it has been for years. The inflation target is stricter, and the Reserve Bank has indicated that it will defend it. The fiscal path has stabilised, with debt projected to peak in the coming years. The first ratings upgrade in about two decades has come through with more possible, the greylisting is behind us, load shedding no longer dictates the working day, and foreigners have been buying local bonds in size. The JSE is at multi-year highs, and the currency has been calm through a turbulent year. A correction would find South Africa with less risk premium to lose, a more credible central bank, and better terms of trade than in any comparable episode of the past decade.



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