CARLYLE

GLOBAL RESEARCH

The Carlyle Compass

April 15, 2025

---

*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team. Received this email as a forward? Subscribe here.*

Do Treasury Bonds Hedge Equity Market Risk?

At the start of the year, we asked: What is the purpose of tariffs? That the President likes them was never in dispute. But what is the endgame? What are they supposed to achieve?

On April 2, an answer arrived. Tariffs were to be used to close bilateral trade deficits. So, if American consumers purchased low-cost apparel from Bangladesh or vanilla beans from Madagascar and income levels in those economies prevented them buying much back from the U.S., then import taxes would have to rise by 37% and 47%, respectively, to suppress Americans' excessive consumption of these products.

This seemed unorthodox. Exports finance imports, but not necessarily from the same trading partner. U.S. businesses license enough intellectual property rights to the European Union ($49 billion in 2023) to pay for all of the spices, onesies, outerwear, and basketwork from Bangladesh and Madagascar that U.S. consumers could ever want. And since these bilateral deficits result from differences in living standards and natural resource endowments, they're not easily fixed through negotiated adjustments in tax and trade policies.

The stock market didn't care for the new tariff schedule, but it was the volatility in bonds that gave policymakers pause. The spike in yields was blamed on "technical factors," namely forced selling by leveraged investors who'd wagered that spreads between Treasury yields and equivalent duration SOFR swap rates would narrow. But few doubted that the unwelcome widening of spreads (technically "tightening" in market jargon) resulted from the tariff shock.

Higher bond yields pose a problem in themselves, but the bigger concern is "portfolio theoretic." Treasury bonds were thought to "hedge" equity market risk, predictably increasing in value when stocks sold off. This feature makes them a far more attractive addition to investors' portfolios than they'd seem on a standalone basis. Beyond the technical unwind in the bond-swap basis, three additional factors seem at play:

1. **Overvalued dollar.** The dollar entered the year at its strongest levels, on a real-effective basis, since the mid-1980s' Plaza Accord. The combination of high U.S. base rates, stronger relative growth, and years of equity market outperformance served as a magnet for global capital flows. Some depreciation was already in the cards; recent events may have simply accelerated the timetable for adjustment, as foreign investors reassess the relative allure of dollar assets generally.

2. **Sanctions risk.** Since Russia's invasion of Ukraine, gold has captured a disproportionate share of "safe haven" flows, potentially because sanctions risk has changed foreign central banks and reserve managers' view of the Treasury market (Figure 1).

Figure 1: Decoupling Between Gold & TIPS Yields

GOLD VS TIPS BEFORE & AFTER "FREEZING" RUSSIAN RESERVES

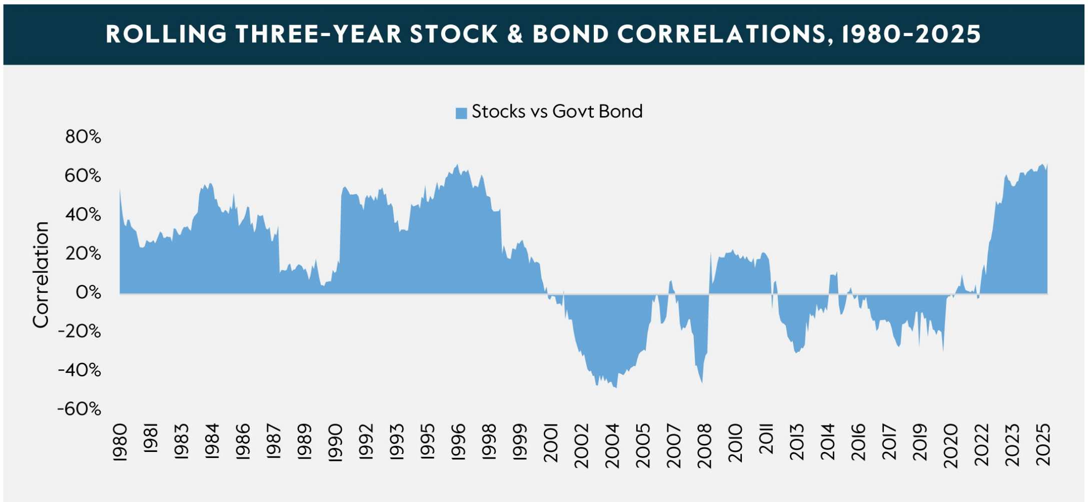
Source: Carlyle Analysis; Bloomberg, Federal Reserve, April 2025. There is no guarantee any trends will continue.

3. **Enormous funding needs.** Through the first six months of the FY2025 fiscal year, the U.S. fiscal deficit was $1.3 trillion, up 22% from the same period in FY2024. Prior concern about a "debt overhang" led the Treasury to shorten the average weighted maturity of its net issuance. Roughly 21% of the outstanding stock of Treasury is funded in money markets, a T-bill share about 50% above its historic average of 14%. If the debt were funded according to the historic mix of instruments, the yields on 10-year notes and 30-year bonds would almost certainly be higher than they are today.

This isn't just a question of whether Treasury yields are headed higher. If Treasury yields *do not decline* when stocks sell off, investors may discover they've been paying for a "hedge" that no longer works.

It's not as unusual to see the market value of bonds and stocks fall in tandem as it may seem. That was the normal state of affairs in the 1980s and 1990s when central banks had to be as concerned with inflation as with risk to growth (Figure 2). During that time, investors priced bonds to deliver a return premium to cash that averaged 100 to 150bps per year (*The Carlyle Compass*, January 14). That premium turned negative in the post-GFC era when investors came to expect that the Fed would launch QE to drive bond yields lower whenever the stock market tanked.

Figure 2: Bonds Have Not Always Hedged Stock Market Risk



Source: Carlyle Analysis; Bloomberg, April 2025. There is no guarantee any trends will continue.

If Treasury bonds are no longer a "negative beta" asset that reliably offsets stock market losses, then they don't currently yield enough for the discretionary buyer to hold them in lieu of floating-rate AAA assets.

JASON THOMAS

Head of Global Research & Investment Strategy

This material is provided for educational purposes only. Nothing herein constitutes investment advice or recommendations and should not be relied upon as a basis for making an investment decision. It does not constitute a personal recommendation or take into account the particular investment objectives, financial situations, or needs of individual investors.

Economic and market views and forecasts reflect our judgment as of the date of this presentation and are subject to change without notice. In particular, forecasts are estimated, based on assumptions, and may change materially as economic and market conditions change. Carlyle has no obligation to provide updates or changes to these forecasts. Certain information contained herein has been obtained from sources prepared by other parties, which in certain cases have not been updated through the date hereof. While such information is believed to be reliable for the purpose used herein, Carlyle and its affiliates assume no responsibility for the accuracy, completeness or fairness of such information.

Past events and trends do not imply, predict or guarantee, and are not necessarily indicative of, future events or results. This material should not be construed as an offer to sell or the solicitation of an offer to buy any security, and we are not soliciting any action based on this material. If any such offer is made, it will only be by means of an offering memorandum or prospectus, which would contain material information including certain risks of investing including, but not limited to, loss of all or a significant portion of the investment due to leveraging, short-selling, or other speculative practices, lack of liquidity and volatility of returns.

Recipients should bear in mind that past performance does not predict future returns and there can be no assurance that an investment in a Carlyle fund will achieve comparable results. The views expressed in this commentary are the personal views of certain Carlyle personnel and do not necessarily reflect the views of Carlyle. Investment concepts mentioned in this commentary may be unsuitable for investors depending on their specific investment objectives and financial position; each recipient is encouraged to discuss such concepts with its own legal, accounting and tax advisors to determine suitability. Tax considerations, margin requirements, commissions and other transaction costs may significantly affect the economic consequences of any transaction.

In connection with our business, Carlyle may collect and process your personal data. For further information regarding how we use this data, please see our online privacy notice at https://www.carlyle.com/privacy-notice.