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Bond Markets and Fiscal Credibility

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Anyone who has bought a home knows the warning signs: flickering lights, rattling windows, small cracks in the wall. Those problems may not mean the house is collapsing tomorrow. But if the foundation is weakening, every storm becomes more dangerous—and more expensive.

Bond markets work the same way. Treasury yields often move in response to the news of the day: inflation reports, Federal Reserve decisions, recession fears, or geopolitical shocks. But beneath those short-term swings is something more important: confidence in America's fiscal foundation.

As we've explained in previous analyses, US debt levels do not mechanically determine Treasury yields in the short run. Markets can absorb high debt for long periods when investors trust the country's economic strength and political system. But when fiscal health or credibility weakens, markets become more sensitive to new shocks and investors may have different expectations of risk to holding US debt, often increasing interest rates.

This memo explains how fiscal policy affects bond markets—not usually through day-to-day volatility, but through the gradual erosion or reinforcement of confidence in US creditworthiness.

What Moves the Bond Market?

Bond yields are the clearest signal investors watch in the Treasury market. A yield is the return investors demand to hold government debt. When investors are eager to own Treasuries, yields tend to fall. When investors are less interested in Treasuries due to some risk, better financial opportunities, or a supply glut, yields tend to rise. Since 2020, there's been far more debt for investors to absorb, contributing to higher yields. [1]

In the short run, the biggest swings in Treasury yields are usually driven by macroeconomic and monetary developments. Inflation reports, Federal Reserve decisions, recession fears, financial crises, and geopolitical shocks can all move markets quickly because they change expectations about economic growth, inflation, and interest rates. When investors rush into Treasuries during periods of uncertainty, yields fall in what is often called a "flight to safety."

Since the early 1990s, swings in the bond market have also followed monetary policy action and anticipated moves by the Federal Reserve (Fed). [2] Some of the largest bond market moves in recent decades followed:

- Federal Reserve policy actions, including quantitative easing and unexpected rate hikes;

- Major inflation surprises that shifted expectations for future interest rates;
- Financial crises and global shocks that triggered “flight-to-safety” behavior, with investors rushing into Treasury securities.

For example, Treasury yields fell sharply after the Federal Reserve expanded quantitative easing in 2009, rose after unexpectedly strong inflation reports in 2022, and moved dramatically during the market turmoil at the onset of the COVID-19 pandemic. [3]

These episodes help explain an important point: bond markets are often reacting to immediate economic conditions and expectations about Federal Reserve policy. Fiscal policy operates differently. Rather than driving most day-to-day market volatility, fiscal credibility shapes the broader foundation of investor confidence beneath those reactions.

When Fiscal Policy Has Moved Bond Markets

Fiscal policy is far from irrelevant, though. Fiscal policy does affect bond markets—but usually in a different way than inflation reports, Federal Reserve decisions, or financial crises.

Short-term market swings are often driven by immediate economic news. Fiscal policy matters more when it changes investor expectations about economic growth, inflation, the future supply of Treasury debt, or confidence in the US government’s ability to manage its finances responsibly. These responses often unfold over weeks and months rather than days.

Fiscal actions tend to move bond yields through three channels:

- **Growth expectations:** Large fiscal stimulus can raise expectations for economic growth, pushing yields higher.
- **Inflation expectations:** Policies viewed as overheating the economy can increase inflation expectations and raise yields.
- **Debt supply and issuance effects:** Higher projected deficits can require increased Treasury issuance, which may put upward pressure on yields if investor demand does not keep pace.

Several major fiscal episodes illustrate these dynamics.

The American Rescue Plan Act in 2021 contributed to rising Treasury yields as investors anticipated stronger economic growth and higher inflation during the post-pandemic

recovery. [4] Earlier stimulus measures, including parts of the 2009 recovery effort, also affected yields through expectations about future economic activity. [5]

At other times, fiscal policy has moved markets because of concerns about governance and fiscal credibility rather than stimulus itself. Debt ceiling confrontations and credit-rating downgrades have periodically shaken investor confidence in US policymaking, even as longer-term Treasury securities continued to benefit from flight-to-safety demand during broader periods of market stress. The 2011 debt ceiling crisis demonstrated this tension clearly. Even as political brinkmanship raised concerns about US fiscal governance and led to a downgrade of the federal government's credit rating, longer-term Treasury yields fell as investors sought safe assets amid fears of broader financial instability. [6]

The COVID-19 crisis in 2020 highlighted how several market forces can unfold simultaneously. At the start of the crisis, investors rushed into Treasuries, pushing yields lower in a classic flight-to-safety response. But that quickly evolved into a liquidity crisis that pushed yields higher and required Fed intervention. Even after trillions of dollars in deficit-financed fiscal support through the CARES Act, Treasury yields still declined because investors prioritized safety during this global shock. [7]

Conclusion

Bond markets do not respond mechanically to rising debt levels, and Treasury yields are often driven in the short run by inflation data, Federal Reserve decisions, recession fears, and global shocks. That reality can make it tempting to dismiss concerns about the nation's long-term fiscal trajectory.

But fiscal credibility still matters because it shapes how investors interpret all of those other risks. When markets believe the United States can manage its obligations responsibly, Treasury securities remain a trusted safe asset even during periods of economic stress. When confidence in that foundation weakens, markets become more vulnerable and volatile, and future crises become harder to contain.

ENDNOTES

1. Ip, Greg. “The Dangerous Brew That’s Rattling Bond Markets.” *The Wall Street Journal*, 21 May 2026, https://www.wsj.com/economy/central-banking/the-dangerous-brew-thats-rattling-bond-markets-b46def14?mod=author_content_page_1_pos_2. Accessed 26 May 2026.

2. US Department of the Treasury. “Daily Treasury Par Yield Curve Rates.” US Department of the Treasury, 2026, https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2026. Accessed 26 May 2026.

   An unexpected Federal Reserve tightening cycle in early 1994 helped drive a 39-basis-point rise in the 10-year yield on April 4, 1994, while strong economic growth and renewed tightening expectations contributed to another 34-basis-point one-day rise in March 1996.

   Board of Governors of the Federal Reserve System. “1994 Historical Materials.” *Federal Reserve*, https://www.federalreserve.gov/monetarypolicy/fomchistorical1994.htm. Accessed 26 May 2026. And; Borio, Claudio, and Robert McCauley. *The Anatomy of the Bond Market Turbulence of 1994*. Bank for International Settlements, Dec. 1995, http://www.bis.org/publ/work32.pdf. Accessed 26 May 2026. And; Kliesen, Kevin L. “Risk Management in Monetary Policymaking: The 1994–95 FOMC Tightening Episode.” *Federal Reserve Bank of St. Louis Review*, 24 Apr. 2025, https://www.stlouisfed.org/publications/review/2025/apr/risk-management-monetary-policy-1994-95-fomc-tightening-episode. Accessed 26 May 2026.

3. US Department of the Treasury. “Daily Treasury Par Yield Curve Rates.” US Department of the Treasury, 2026, https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2026. Accessed 26 May 2026.

   In one of the biggest single-day bond market reactions in recent history, the 10-year yield fell 51 basis points on March 18, 2009, after the Federal Reserve announced it would purchase $300 billion in long-term Treasuries as part of its Quantitative Easing (QE1) expansion during the recovery from the Global Financial Crisis.

   See Board of Governors of the Federal Reserve System. “Federal Reserve Announces It Will Purchase up to $300 Billion of Longer-Term Treasury Securities over the Next Six Months.” *Federal Reserve*, 18 March 2009, https://www.federalreserve.gov/newsevents/pressreleases/monetary20090318a.htm. Accessed 26 May 2026.

   The 10-year yield rose 28 basis points after a hot Consumer Price Index report in June 2022, then fell 30 basis points after a later CPI report came in below expectations in November 2022.

   See “Treasury Yields Rise After CPI Data.” *The Wall Street Journal*, 13 June 2022, https://www.wsj.com/livecoverage/stock-market-news-inflation-consumer-price-index-june-2022/card/treasury-yields-rise-after-cpi-data-hHd1TVLGRG6eYtH2Z0ba. Accessed 26 May 2026. And; “U.S. Treasury Yields Fall Sharply After CPI Data.” *Yahoo Finance*, Reuters, 10 November 2022, https://finance.yahoo.com/news/treasuries-u-treasury-yields-fall-151718893.html. Accessed 26 May 2026.

   Yields fell early in the response to the COVID-19 outbreak, rose 29 basis points shortly after the pandemic was declared in mid-March 2020 amid severe liquidity stress in the Treasury market, and then fell sharply again in late March after Federal Reserve interventions stabilized market functioning and recession fears intensified.

   See Bank for International Settlements. “The Treasury Market in Spring 2020 and the Response of the Federal Reserve.” *BIS Working Papers*, no. 966, 2021, https://www.bis.org/publ/work966.htm. Accessed 26 May 2026.

Other global events also produced substantial increases in yields, including a 28-basis-point rise after Iraq invaded Kuwait in August 1990 amid fears of a major oil shock and broader economic disruption.

See Newman, Rick. "Lessons from the Last War That Rocked Global Markets." *Yahoo Finance*, Reuters, 24 February 2022, https://finance.yahoo.com/news/lessons-from-iraq-kuwait-invasion-225924707.html. Accessed 26 May 2026.

4. US Department of the Treasury. "Daily Treasury Par Yield Curve Rates." US Department of the Treasury, 2026, https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2026. Accessed 26 May 2026.

The American Rescue Plan enacted on March 11, 2021, at the beginning of President Biden's administration, contributed to higher yields with the expectation of higher economic growth and inflation. The 10-year yield increased just one basis point the day of the bill's signing, but it subsequently increased 17 basis points over the next five trading days.

See Hoogland, Meilina, Annelie Petersen, and Gavin Goy. "The Market-Implied Effects of the Biden Stimulus and the Fed's New Policy Framework." *CEPR VoxEU*, 15 Mar. 2021, https://cepr.org/voxeu/columns/market-implied-effects-biden-stimulus-and-feds-new-policy-framework. Accessed 26 May 2026.

5. US Department of the Treasury. "Daily Treasury Par Yield Curve Rates." US Department of the Treasury, 2026, https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2026. Accessed 26 May 2026.

The signing of the 2009 American Recovery and Reinvestment Act, enacted on Feb. 17, 2009, shortly after President Obama took office amid the fallout from the Global Financial Crisis, coincided with a 25-basis-point drop in the 10-year yield. The yield then increased by 16 basis points over the following five trading days, suggesting that the severe recession and safe-haven pricing that dominated enactment day partially reversed as markets began pricing in the legislation's potential stimulus effects.

See Board of Governors of the Federal Reserve System. “Annual Report 2009, Monetary Policy Report of February 2010.” *Federal Reserve*, https://www.federalreserve.gov/boarddocs/rptcongress/annual09/sec1/c1.htm. Accessed 26 May 2026.

6. US Department of the Treasury. “Daily Treasury Par Yield Curve Rates.” US Department of the Treasury, 2026, https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2026. Accessed 26 May 2026.

   Conceptually, the risk of default during the 2011 debt ceiling crisis should have pushed Treasury yields higher during the lead-up to the Budget Control Act in summer 2011 and near-default by the federal government, yet a flight-to-safety mechanism dominated. There was a 20-basis-point decrease in the 10-year yield in the 30 days leading to the signing of the Budget Control Act, followed by an 11-basis-point decrease the day of enactment as the bill cut spending. When S&P subsequently downgraded its US credit rating, the 10-year yield fell by another 18 basis points the following day.

   Markets were pricing two different risks simultaneously: a technical default/political dysfunction risk, and a much larger global growth and financial panic risk. The latter risk dominated the 10-year bond market.

   The debt ceiling crisis primarily affected very short-term Treasury bills, especially securities maturing near the projected “X-date.” Intermediate and long Treasuries like the 10-year rallied strongly because the alternatives were worse, even though US political dysfunction was dangerous and US fiscal credibility was being questioned. Investors largely viewed the risk as political brinkmanship and possible technical default, not insolvency.

   See Akabas, Shai. “Debt Limit Analysis.” *Bipartisan Policy Center*, 27 June 2011, https://bipartisanpolicy.org/report/debt-limit-analysis/. Accessed 26 May 2026. And; Phillips, Matt. “For Treasurys, Rally Runs On.” *The Wall Street Journal*, 30 Dec. 2011, https://www.wsj.com/articles/SB10001424052970204720204577130601067034044. Accessed 26 May 2026. And; Janus Henderson Investors. “Analyzing the Impact: Historical Perspectives on U.S. Treasury Downgrades.” *Janus Henderson Investors*, 2025, https://www.janushenderson.com/en-us/investor/article/analyzing-the-impact-historical-perspectives-on-us-treasury-downgrades/. Accessed 26 May 2026.

7. US Department of the Treasury. “Daily Treasury Par Yield Curve Rates.” US Department of the Treasury, 2026, https://home.treasury.gov/resource-center/data-chart-center/interest-rates/TextView?type=daily_treasury_yield_curve&field_tdr_date_value=2026. Accessed 26 May 2026.

Yields collapsed initially in late February 2020-early March 2020 due to recession fears in a classic flight-to-safety move. The 10-year yield reached a low of 0.54% on March 9, 2020, before sharply increasing.

The March 2020 rise in the 10-year yield was less about inflation fears from stimulus and more about a severe liquidity crisis in the Treasury market itself. Markets entered a global dollar liquidity crisis when investors sold Treasuries to raise cash and Treasury market liquidity deteriorated.

Yields fell again after the Fed intervened aggressively and investors fully recognized the scale of the economic collapse and recession risk. By late March the Federal Reserve restored confidence in liquidity by launching enormous quantitative easing, buying Treasuries, stabilizing market functioning, and backstopping credit markets.

In the case of the CARES Act enacted on March 27, 2020, during the COVID-19 lockdowns, the 10-year yield decreased by 11 basis points the day of the legislation’s signing and another 10 basis points over the next five trading days. Despite trillions of dollars in deficit-financed stimulus provided through the bill, the drop was consistent with risk-off investor behavior—along with confidence that Treasury markets could support the additional debt.

By the times the CARES Act was signed, the Fed calmed earlier fears about Treasury liquidity and reinforced confidence that the Treasury could absorb additional borrowing.

See Aldasoro, Iñaki, Torsten Ehlers, Bryan Hardy, and Egemen Eren. “The Global Dash for Cash in March 2020.” *Liberty Street Economics*, Federal Reserve Bank of New York, 28 July 2022, https://libertystreeteconomics.newyorkfed.org/2022/07/the-global-dash-for-cash-in-march-2020. Accessed 26 May 2026. And; Schrimpf, Andreas, Hyun Song Shin, and Vladyslav Sushko. “The Treasury Market in Spring 2020 and the Response of the Federal Reserve.” *BIS Working Papers*, no. 966, Bank for International Settlements, 2021, https://www.bis.org/publ/work966.htm. Accessed 26 May 2026. And; Liang, Nellie, and Pat Parkinson. “Enhancing

Liquidity of the U.S. Treasury Market Under Stress." *Brookings Institution*, 16 Dec. 2020, https://www.brookings.edu/articles/enhancing-liquidity-of-the-u-s-treasury-market-under-stress/. Accessed 26 May 2026. And; Financial Stability Board. "Holistic Review of the March Market Turmoil." *Financial Stability Board*, 17 Nov. 2020, https://www.fsb.org/2020/11/holistic-review-of-the-march-market-turmoil/. Accessed 26 May 2026. And; Wigglesworth, Robin, and Colby Smith. "How the Treasury Market Got Hooked on Hedge Fund Leverage." *Financial Times*, 15 Mar. 2021, https://www.ft.com/content/0bf5bcc2-6ff1-4309-afbf-f470250a4721?syn-25a6b1a6=1. Accessed 26 May 2026. And; Barth, Daniel, Michele Gambera, and Phillip Monin. "Market Liquidity in Treasury Futures Markets during March 2020." *Federal Reserve Board Finance and Economics Discussion Series*, Board of Governors of the Federal Reserve System, 2023, https://www.federalreserve.gov/econres/feds/market-liquidity-in-treasury-futures-market-during-march-2020.htm. Accessed 26 May 2026. And; Liang, Nellie, and Pat Parkinson. "Treasury Market Resilience: Ever More Important." *Brookings Institution*, 17 Mar. 2021, https://www.brookings.edu/articles/treasury-market-resilience-ever-more-important/. Accessed 26 May 2026. And; Liang, Nellie. "Treasury Market Resilience." *Brookings Institution*, Apr. 2025, https://www.brookings.edu/wp-content/uploads/2025/04/Treasury-market-resilience-testimony-Liang.pdf. Accessed 26 May 2026. And; Office of Financial Research. "OFR Models One Theory on the Cause of March 2020's Treasury Market Fragility." *Office of Financial Research*, 3 Apr. 2023, https://www.financialresearch.gov/the-ofr-blog/2023/04/03/ofr-models-one-theory-on-the-cause-of-march-2020s-treasury-market-fragility/. Accessed 26 May 2026.