
Rising Yields, Falling Rates: Investigating the ‘Reverse Conundrum’ in U.S. Treasuries

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1. Introduction

This paper examines the key drivers of bond market dynamics in the current economic environment, with a focus on the relationship between inflation, real yields, foreign investment trends, and gold. Given the persistently high interest rates, shifting inflation expectations, and global capital flows, understanding the factors influencing bond yields is critical for assessing market risks and opportunities.

The analysis is structured into three key sections:

1. Inflation and Real Yields – Exploring how inflation trends and Federal Reserve policy decisions have shaped bond yields, with particular attention to the recent stickiness in inflation and its implications for real interest rates.
2. Foreign Investment in U.S. Treasuries – Investigating the role of foreign demand for U.S. government debt, including how geopolitical risks, currency dynamics, and central bank reserve strategies influence Treasury yields.
3. Gold as an Alternative Investment – Assessing the relationship between gold prices and bond yields, particularly in periods of heightened economic uncertainty, as investors weigh inflation hedging against real return prospects.

By analysing these factors, this paper aims to provide a comprehensive view of why bond yields have diverged from historical expectations and what this means for investors, policymakers, and global financial stability. At the end of the paper, we provide our own insight into the potential ramifications of the indicators assessed and how their continued trajectory may shape financial markets in the coming months.

The Conventional Expectation: Fed Rate Cuts and Bond Yields

Under normal market conditions, when the Federal Reserve lowers the Federal Funds Rate (EFFR), bond yields, especially long-term yields like those on the 10-year Treasury, are expected to decline. This expectation is based on fundamental principles in financial markets. The EFFR serves as the benchmark for short-term interest rates in the economy. When the Fed lowers it, borrowing costs decrease, making higher-yielding bonds more attractive. As a result, investors looking to secure these higher yields increase their purchases of Treasuries, which in turn raises bond prices and lowers yields due to heightened demand.

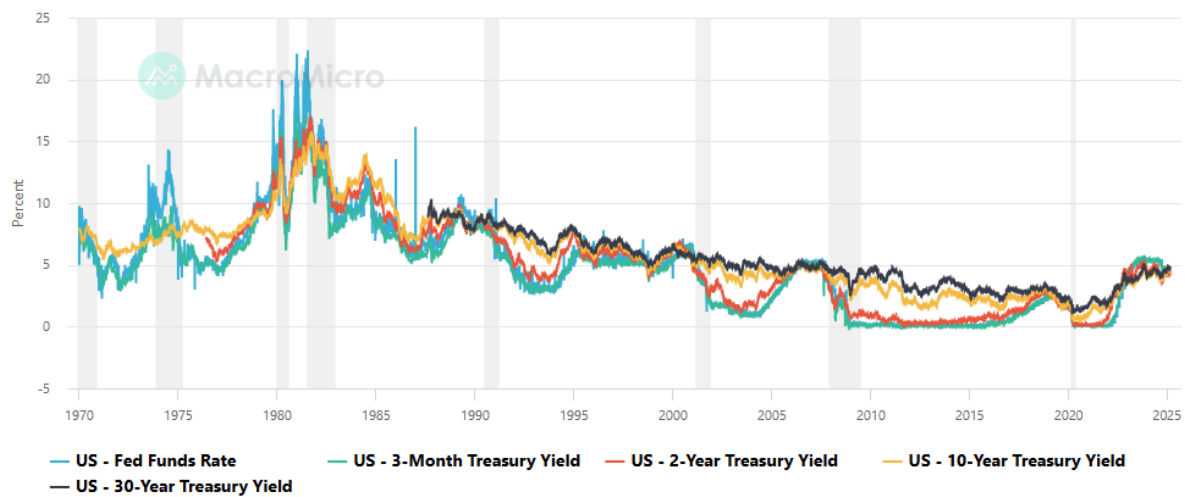


Figure 1.1: U.S. Treasury Yields + EFFR

Additionally, rate cuts often signal the likelihood of further reductions in the future. Investors anticipating this trend will move to lock in current yields, further driving down bond yields. Historically, Treasuries and the EFFR have fluctuated in tandem, reflecting this relationship (see Figure 1.1). Lower rates also tend to stimulate the economy by making credit cheaper; however, they may also signal weakening economic conditions. If the market expects slower growth and lower inflation, investors shift towards safer assets such as Treasuries, increasing their demand and consequently driving bond yields lower. This relationship has been evident in past rate-cutting cycles, such as those in 2008 and 2020, where bond yields declined following Fed rate cuts. Yet, in the current environment, this expected correlation has broken down, giving rise to what is now referred to as the Reverse Conundrum.

The Greenspan Conundrum: A Historical Parallel

The Greenspan Conundrum describes the unusual behaviour of long-term Treasury yields in the mid-2000s. Despite the Federal Reserve aggressively raising the EFFR, long-term yields remained low and even declined further at times. In 2005, then-Fed Chair Alan Greenspan described this divergence as a “conundrum” because it contradicted traditional monetary policy expectations. Typically, when the Fed raises short-term rates, long-term yields are expected to rise as tighter financial conditions lead investors to expect slower economic growth. This usually results in a flattened or inverted yield curve, signalling a potential economic slowdown or recession. However, from 2004 to 2006, the Fed raised the EFFR from 1% to 5.25%, yet long-term bond yields failed to rise accordingly.

Economists and researchers have suggested multiple explanations for this anomaly. One major factor was foreign demand for U.S. Treasuries, as countries with large trade surpluses, such as China and Japan, were purchasing vast amounts of Treasuries to manage their reserves and stabilise their currencies. This strong demand for safe assets helped suppress long-term yields. Another explanation was low inflation expectations, which led investors to believe that higher bond yields were unnecessary to compensate for future price increases. Additionally, the rise of structured financial products, such as mortgage-backed securities (MBS), increased demand for long-term bonds, further keeping yields low. This prolonged suppression of long-term rates encouraged excessive risk-taking, ultimately fuelling the housing bubble that culminated in the Global Financial Crisis (GFC).

The Reverse Conundrum: A Modern-Day Opposite Effect

Today, we are witnessing a similar but opposite phenomenon, hence the term Reverse Conundrum. Much like in the mid-2000s, the Federal Reserve has adjusted interest rates, yet the long end of the yield curve has moved in the opposite direction of expectations. On September 19, 2024, the Fed initiated the first of three rate cuts, totalling a 100-basis point reduction in the EFFR. However, instead of declining, the 10-year Treasury yield rose by 110 basis points over the same period (see Figure 1.2).

This suggests that fundamental shifts in global capital flows and investor behaviour—such as declining foreign demand for U.S. Treasuries, increased gold purchases, and concerns over U.S. fiscal sustainability—are overriding the conventional relationship between Fed policy and bond yields. Understanding these dynamics is crucial in assessing how monetary policy will interact with global financial markets in the years ahead.

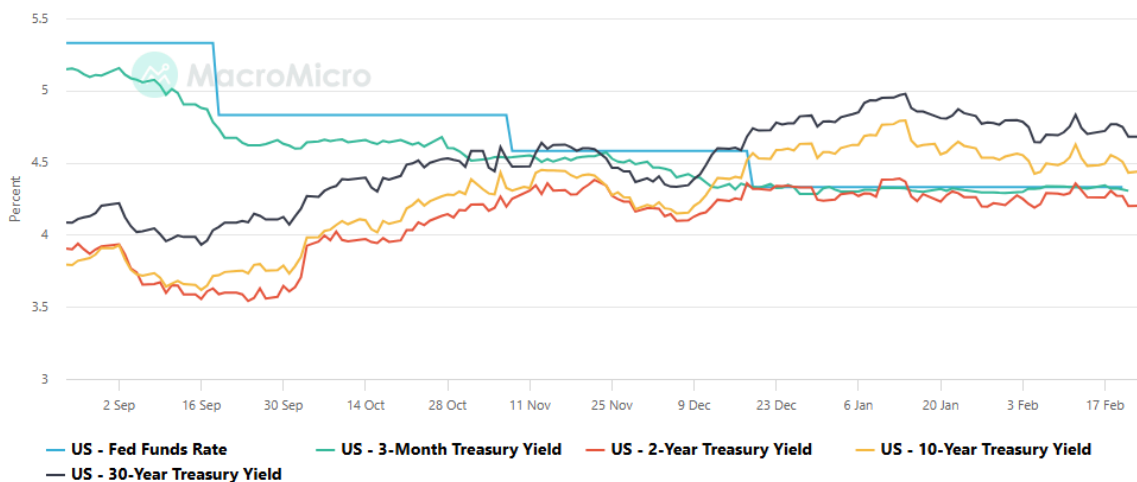


Figure 1.2: Divergence between FFR & Yields

2. Inflation & Real Interest Rate Effect on Nominal Bond Yields

One of the key factors influencing bond yields is inflation. When inflation rises, investors demand higher yields to compensate for the erosion of their purchasing power. However, the degree to which inflation is currently driving bond yields remains uncertain.

Breakeven Inflation Rate (BEI) and Its Role in Bond Yields

A key metric for assessing inflation expectations in bond markets is the breakeven inflation rate (BEI). BEI is calculated as the difference between the yield on a nominal Treasury bond and an inflation-protected bond (TIPS).

The importance of BEI lies in its reflection of the market's expected average inflation rate over the bond's maturity. If BEI rises, it suggests that markets anticipate higher inflation, pushing nominal yields up. Conversely, if BEI remains stable while nominal yields increase, it indicates that something other than inflation expectations, such as rising real yields, is driving bond yields higher.

Currently, the 10-year BEI is stable at around 2.40%, suggesting that inflation expectations have remained anchored. Despite recent inflation volatility, bond markets do not appear to be pricing in a significant increase in future inflation. Instead, the recent rise in Treasury yields has been driven primarily by higher real yields.

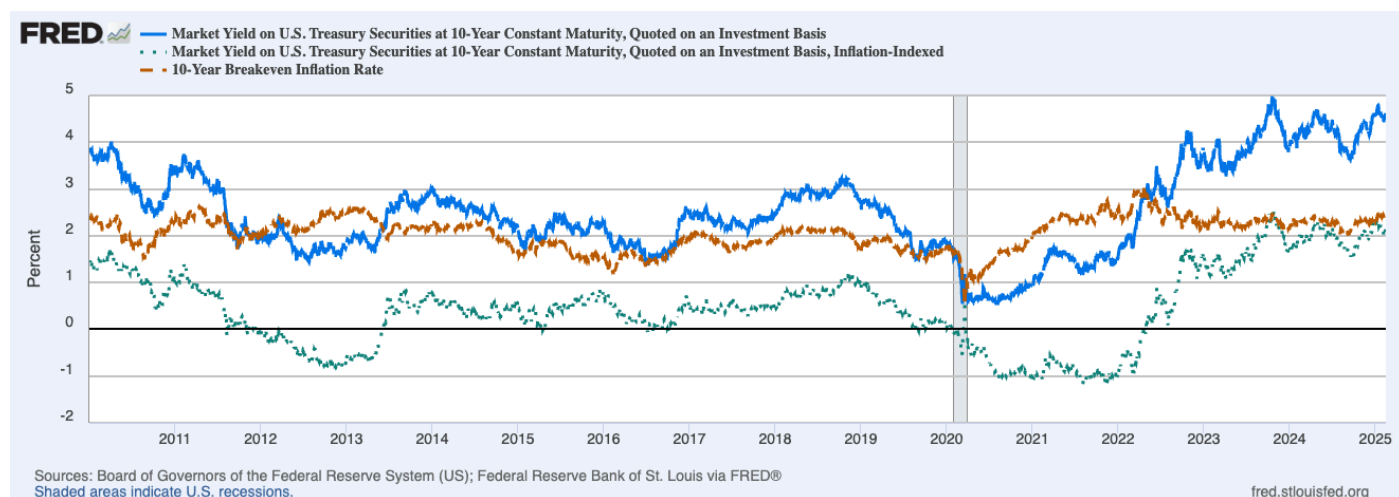


Figure 2.1: Nominal & TIPS 10-Year Yield & BEI

Rising Real Yields as the Primary Driver of Bond Yields

Since nominal yields consist of real yields plus BEI, and BEI has remained relatively unchanged, the increase in nominal yields must be coming from higher real yields. Real yields represent the inflation-adjusted return that investors earn on bonds. Unlike nominal yields, real yields strip out inflation expectations, reflecting the true cost of borrowing and the real return on investment. A key way to measure real yields is through the yield on TIPS, where the real yield moves inversely with demand for TIPS.

The sustained increase in real yields reflects a combination of Federal Reserve policy tightening, stronger economic growth expectations, and shifting investor preferences.

Federal Reserve Policy & Its Impact on Real Yields

One of the key drivers of higher real yields is Federal Reserve policy. The Fed's commitment to keeping interest rates elevated and reducing liquidity has directly impacted long-term borrowing costs, contributing to the rise in real yields. While the Fed primarily controls short-term interest rates, its policies also influence long-term Treasury yields through rate decisions, quantitative tightening (QT), and market expectations of future policy.

Over the past three years, the Fed has aggressively raised interest rates in response to the economic effects of the Covid-19 pandemic and persistent inflation pressures. These rate hikes tightened financial conditions, increasing borrowing costs and pushing real yields higher as investors demanded greater returns. At the same time, QT which began in June of 2022, has increased the supply of Treasuries in the market, further contributing to rising real yields by reducing overall liquidity.

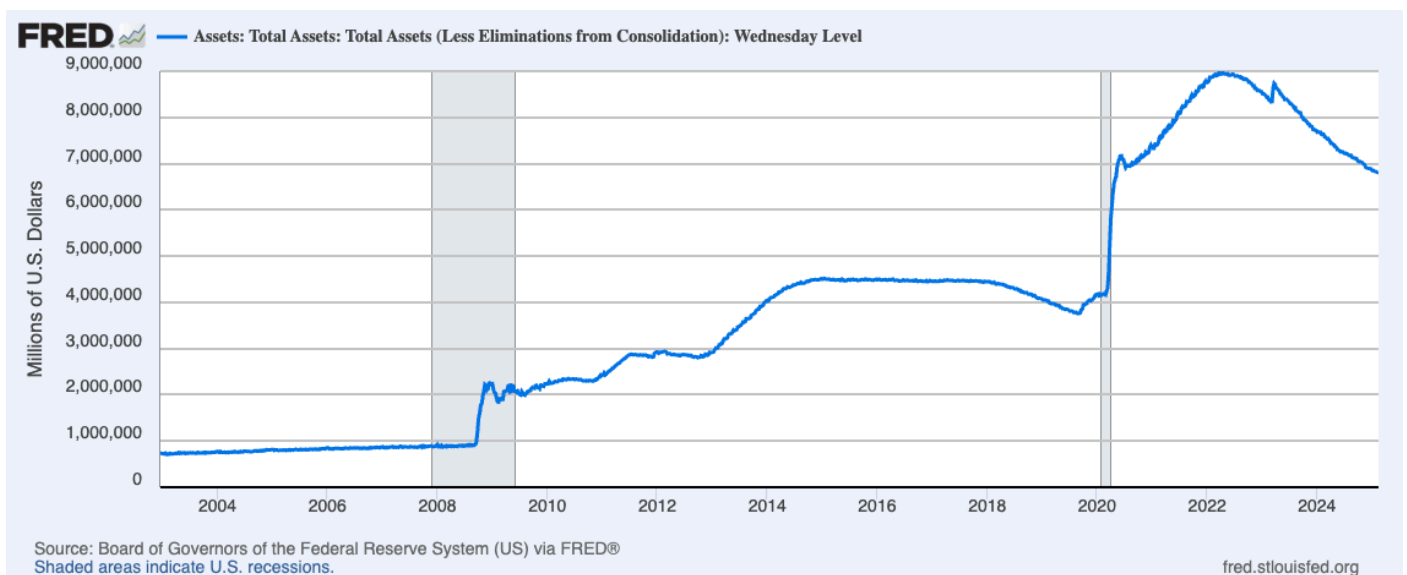


Figure 2.2: Federal Reserve Balance Sheet

However, In September 2024, the Fed began a cutting cycle, reducing the Federal Funds Rate by 50 basis points. Traditionally, Fed rate cuts lead to lower long-term bond yields, such as the 10-year Treasury yield, as easier monetary conditions increase demand for bonds. However, in the current market, this expected relationship has broken down. Despite rate cuts, 10-year yields have remained elevated as illustrated in Figure 2.3, suggesting that factors beyond monetary easing, such as economic resilience and shifting investor expectations, are causing real yields to rise.

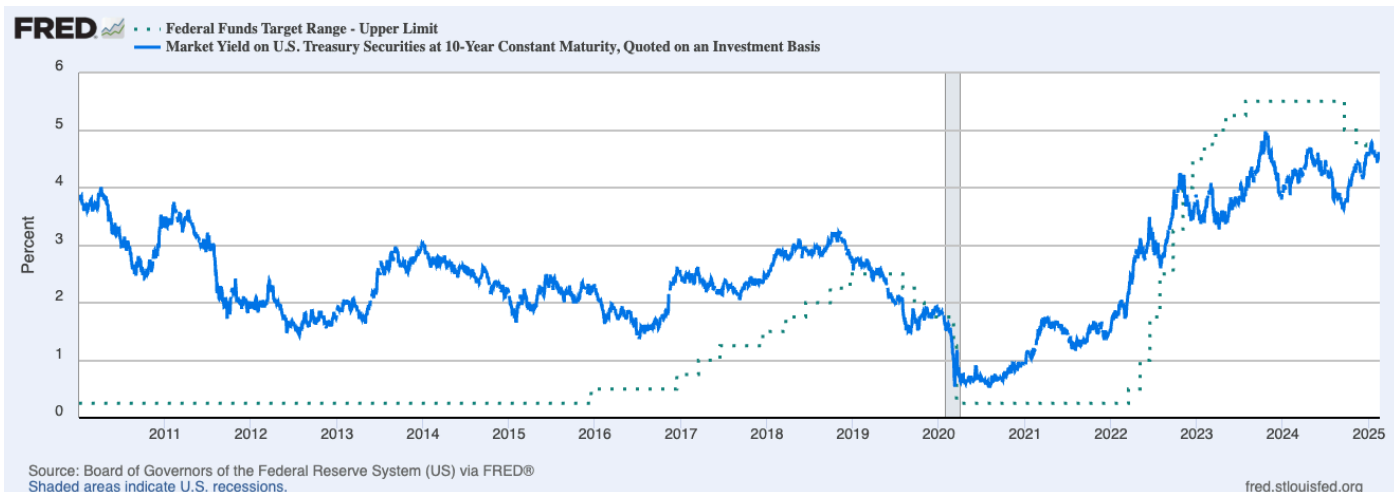


Figure 2.3: 10 Year Treasury Yield vs Federal Funds Rate Projections

This shift in expectations is illustrated in Figure 2.4, which compares market projections for the Federal Funds Rate in March 2024 vs. June 2024. Initially, markets anticipated multiple rate cuts in 2025, assuming that inflation would decline rapidly, and economic growth would slow. However, by June 2024, as inflation remained above target and economic data exceeded expectations, projections for rate cuts were significantly reduced. This shift in sentiment reinforced the idea that the economy was more resilient than previously thought, reducing the need for aggressive rate cuts. As a result, investors demanded higher real returns, further pushing up real yields despite the Fed’s easing cycle.

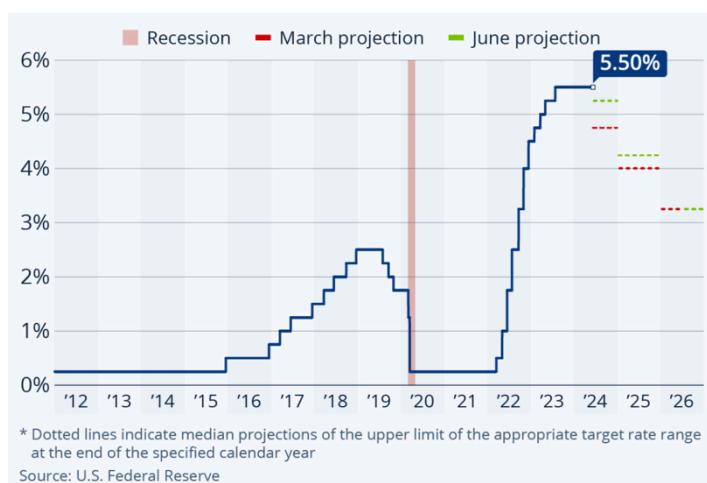


Figure 2.4: FFR Market Projection March Vs June 2024

Economic Growth Expectations & Their Impact on Real Yields

In addition to Federal Reserve policy, stronger-than-expected economic growth has also contributed to the rise in real yields. As economic growth remains resilient, investors have revised their expectations for long-term interest rates, reducing demand for bonds and pushing real yields higher.

For the year of 2024, the Blue-Chip Economic Indicators Survey reported that professional forecasters anticipated 1.3% real GDP growth for 2024. In contrast, according to the Bureau of Economic Analysis (BEA), the U.S. economy expanded by 2.8% over the course of 2024.

How Stronger GDP Growth Affected Market Expectations

Stronger-than-expected GDP growth fundamentally altered market expectations for monetary policy. With forecasters expecting only 1.3% growth, markets had priced in aggressive Fed rate cuts to accommodate a softer

economy. However, as actual GDP growth reached 2.8%, investors reassessed their outlook, leading to reduced expectations for rapid monetary easing. With the Fed having less justification to lower rates in a strong economic environment, demand for long-term Treasuries, including TIPS, declined. This shift in sentiment kept real yields elevated, as investors anticipated higher real borrowing costs for an extended period.

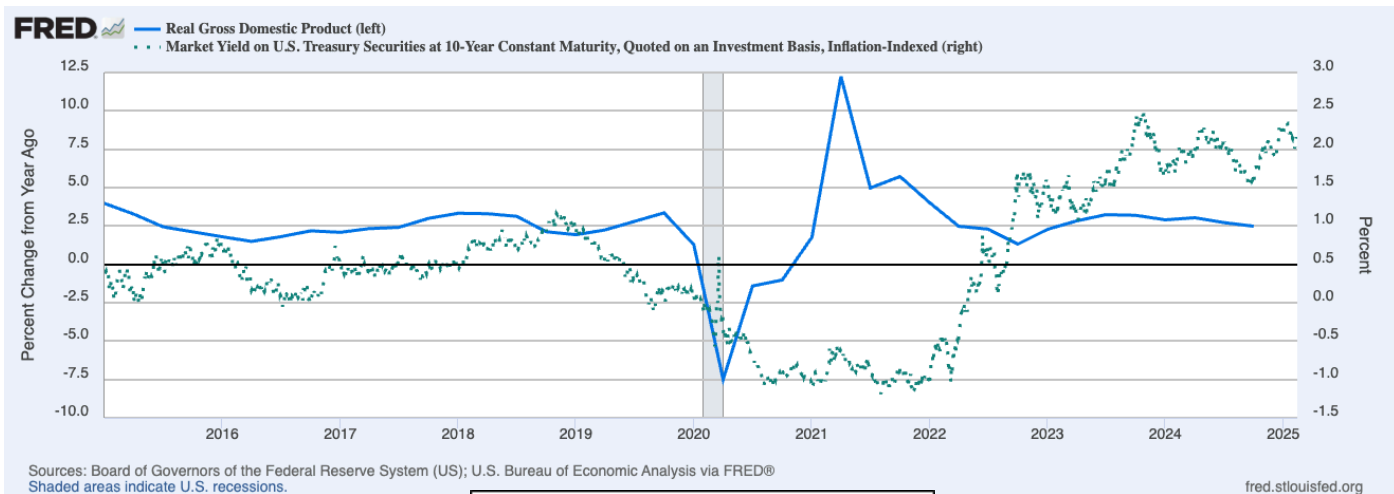


Figure 2.5: Real GDP & U.S. 10 Year TIPS

Labour Market Strength (Unemployment & Wage Growth)

Further, the labour market remains historically strong, with the unemployment rate holding steady at around 3.7% in 2024 and wage growth averaging 4-5% YoY. Continued labour demand and rising wages have bolstered household incomes, sustaining consumer spending. This resilience in employment reduces the need for aggressive Fed rate cuts, as strong wage growth supports economic expansion while keeping demand for credit stable.



Figure 2.6: Unemployment & Wage Growth

Consumer Spending & Retail Sales

Similar trends are identified in consumer spending where despite higher borrowing costs, consumer spending remains resilient, with retail sales continuing to grow through 2024. As shown in Figure 2.7, total consumer spending steadily increased from April 2024 to January 2025, reflecting strong labour markets and wage growth supporting household demand. The upward trend in spending indicates that consumers have not significantly pulled back despite elevated interest rates, reinforcing expectations of sustained economic momentum.

However, the slight dip in early 2025 suggests a potential moderation in spending, possibly reflecting the delayed impact of higher borrowing costs or shifting consumer sentiment. Nonetheless, the overall trend remains strong, supporting the argument that the U.S. economy does not currently require aggressive monetary easing. This aligns with higher real yields, as sustained consumer demand reduces the urgency for the Federal Reserve to cut interest rates in the near term.

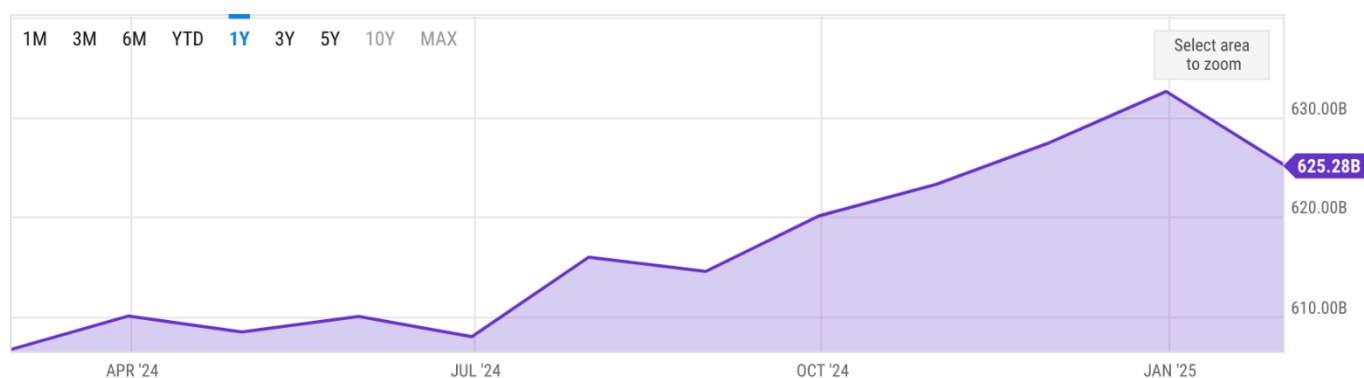


Figure 2.7: US Personal Consumption Expenditures

The U.S. Dollar's Role in Treasury Yield Movements.

The strength of the U.S. dollar plays a crucial role in bond markets, influencing capital flows, inflation dynamics, and overall financial conditions. As U.S. real yields rise, demand for dollar-denominated assets increases, reinforcing the dollar's appreciation. This dynamic affects treasury yields in several ways, primarily through interest rate differentials, inflationary pressures and liquidity conditions.

The positively correlated dynamic between the U.S. dollar and treasury yields is primarily driven by interest rate differentials and capital flows. As U.S. real yields increase relative to other major economies, investors seeking higher inflation-adjusted returns move capital into U.S. assets, strengthening the dollar. This is evident in Figure 2.8, which shows a strong correlation between the U.S. dollar index and 10-year treasury yields.

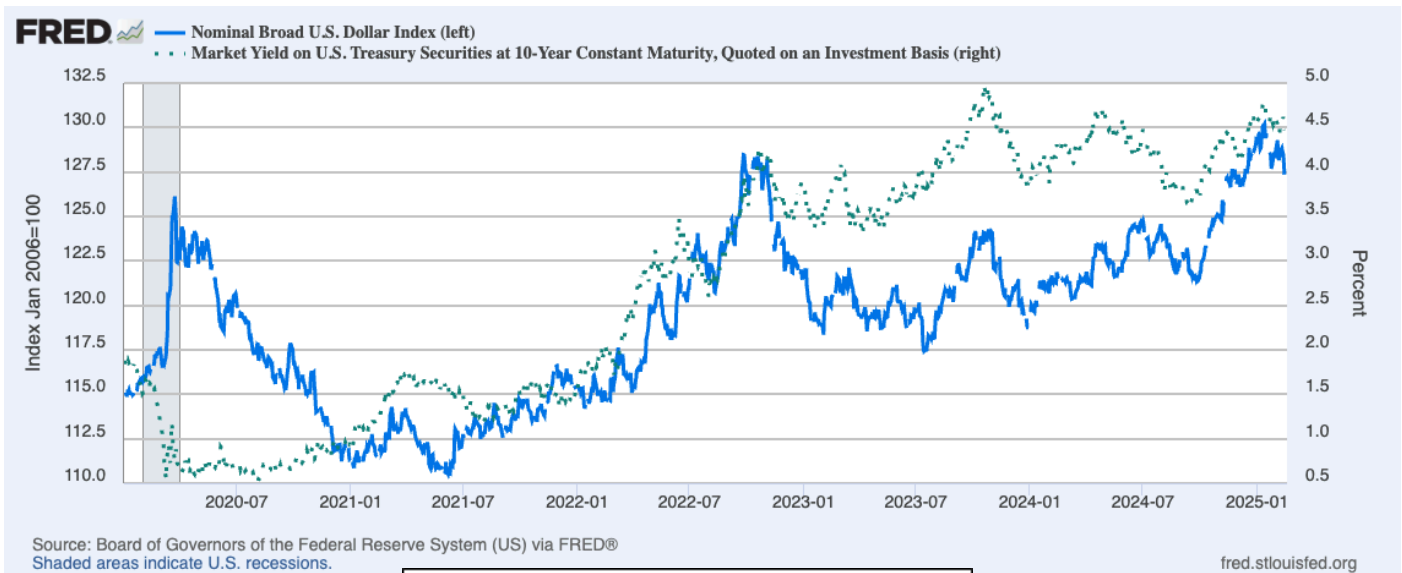


Figure 2.8: U.S. Dollar & U.S. 10-Year Correlation

Beyond its impact on capital flows, the strength of the U.S. dollar also tightens financial conditions, which can have broad implications for inflation and Federal Reserve policy. A stronger dollar reduces imported inflation, as globally traded commodities such as oil, metals, and agricultural goods are priced in U.S. dollars. This helps moderate price pressures but also raises borrowing costs for global firms and emerging markets, reinforcing restrictive conditions.

The U.S. dollar acts as both a driver and a reflection of Treasury yield movements. Higher real yields attract capital into dollar-denominated private assets, reinforcing dollar strength and tightening financial conditions. This dynamic supports higher real yields in the short term, as markets price in fewer expected Fed rate cuts. However, if prolonged, dollar appreciation could eventually weigh on growth and inflation, leading to shifts in Treasury yields as expectations adjust for future monetary policy changes.

The Inflation Outlook

After a period of steady disinflation, recent inflation readings suggest renewed upward pressure, challenging expectations of a smooth return to the Fed's 2% target. As shown in Figure 2.9, core inflation followed a clear downward trend throughout mid-2024, declining from 3.8% in March to a low of 3.2% by late 2024. However, since early 2025, inflation has stabilised and is showing signs of persistence at 3.3%, raising concerns that inflationary risks may not be fully contained. Additionally, CPI inflation increased to 3% YoY in January 2025, while core PCE remained elevated at 2.8%, reinforcing the uncertainty surrounding inflation's trajectory.

This inflationary resurgence could alter market expectations for Federal Reserve policy, delaying anticipated rate cuts and keeping real yields higher for longer. Markets had been pricing in multiple rate cuts for 2025, assuming inflation would continue to decline. However, if price pressures remain persistent, investors may adjust their positioning, leading to increased volatility in bond markets and a potential repricing of breakeven inflation rates to reflect a higher long-term inflation risk.

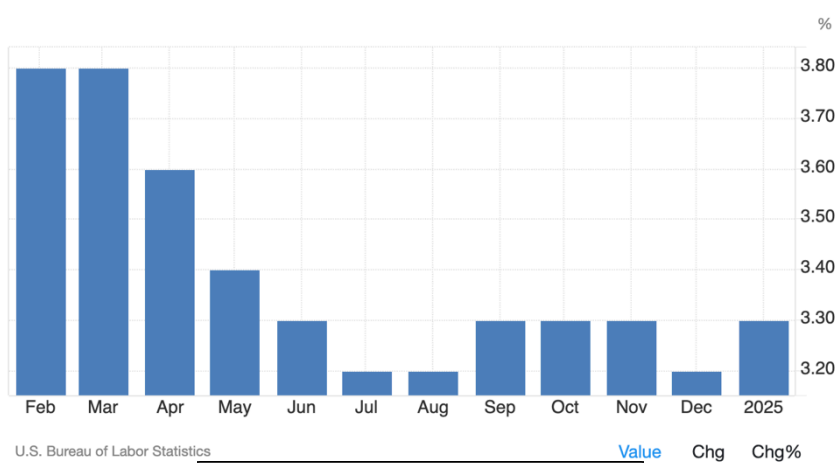


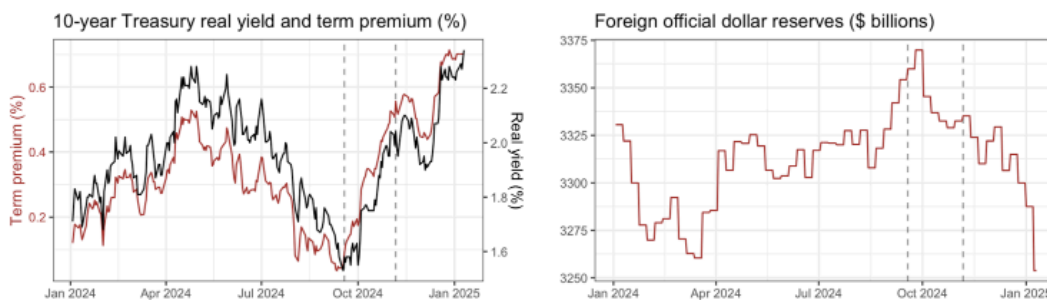
Figure 2.9: U.S. Core Inflation Rate YoY

Looking ahead, the market’s perception of inflation risks will be a key driver of Treasury yields. Should inflation prove stickier than expected, real yields could rise further as the Fed maintains restrictive policy for an extended period. However, if inflation pressures ease, markets may regain confidence in a gradual path toward rate cuts, allowing real yields to decline and financial conditions to loosen accordingly.

3. Foreign Investment Funding Demand

Foreign investment in U.S. Treasuries plays a crucial role in stabilising bond yields, as foreign countries purchase U.S. debt for various reasons, primarily to manage foreign exchange reserves and stabilise their currencies. Consistent, large-scale purchases of U.S. bonds increase demand, which pushes bond prices up and yields down, thereby reducing borrowing costs for the U.S. government and businesses. During times of financial crises or economic uncertainty (e.g., the Global Financial Crisis, the COVID-19 pandemic), Treasuries are viewed as a safe-haven asset, leading to increased foreign demand and further stabilising yields. Additionally, foreign countries use U.S. Treasuries as a tool for currency and trade policy. China, for example, has historically used U.S. Treasuries to suppress the yuan’s appreciation and maintain its export competitiveness. Japan, with its high savings rate and low domestic bond yields, has traditionally invested heavily in U.S. bonds to earn better returns.

Foreign Reserve Reductions and Rising Yields

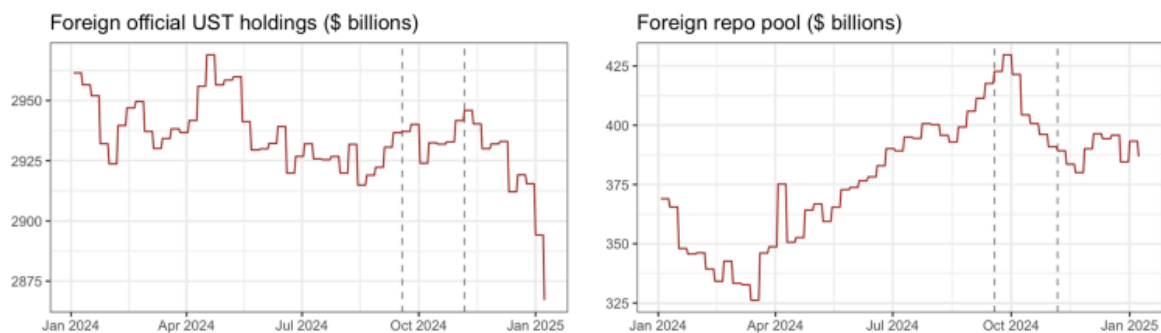


Notes: The left panel plots the daily real 10-year US Treasury yield (TIPS) and the Kim and Wright (2005) 10-year US Treasury term premium estimate. The right panel plots the weekly average of foreign official dollar reserves custodied at the Federal Reserve. The first vertical dashed line is 18 September 2024 (Sep FOMC). The second vertical dashed line is 6 November 2024 (US elections)
Source: FRED, Fed H.4.1, and authors’ calculations.

Figure 3.1: 10 Year Treasury Yield & Foreign Official Dollar Reserves

Currently, there is strong evidence suggesting that the decline in foreign official dollar reserves, which includes both foreign official Treasury holdings and the foreign repo pool, has closely coincided with the start of Federal Reserve rate cuts in September 2024. At the same time, long-term Treasury yields have been rising, indicating a potential link between reduced foreign demand and the upward pressure on yields.

As seen in Figures 3.1 and 3.2, the dotted lines represent both the first rate cut (September 18, 2024) and the U.S. Presidential Election (November 6, 2024). These markers indicate a potential shift in foreign policy, with countries selling off their Treasury and repo reserves custodied at the Fed, thereby reducing the total amount of foreign official dollar reserves. This trend is particularly evident in Japan and China, historically two of the largest holders of U.S. Treasuries and key sources of demand.



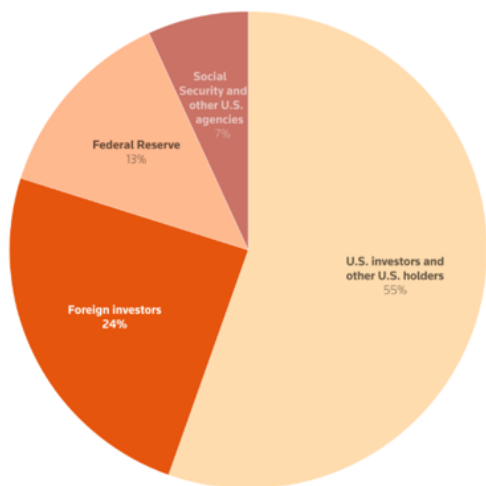
Notes: The left panel plots the weekly average of foreign official US Treasury holdings. The right panel plots the weekly average of foreign official deposits in reverse repos custodied at the Fed. The first vertical dashed line is 18 September 2024 (Sep FOMC). The second vertical dashed line is 6 November 2024 (US elections).

Figure 3.2: Foreign UST Holdings & Foreign Repo Pool

As of November 2024, approximately 24% of the total \$36 trillion U.S. public debt is held by foreign investors. Japan and China together account for over 5%, with Japan holding \$1.1 trillion and China \$770 billion (see Figures 3.3 and 3.4). Given that these two nations collectively hold nearly 6% of total U.S. public debt, a significant reduction in their Treasury purchases—or outright selling—could have substantial effects on Treasury prices and yields.

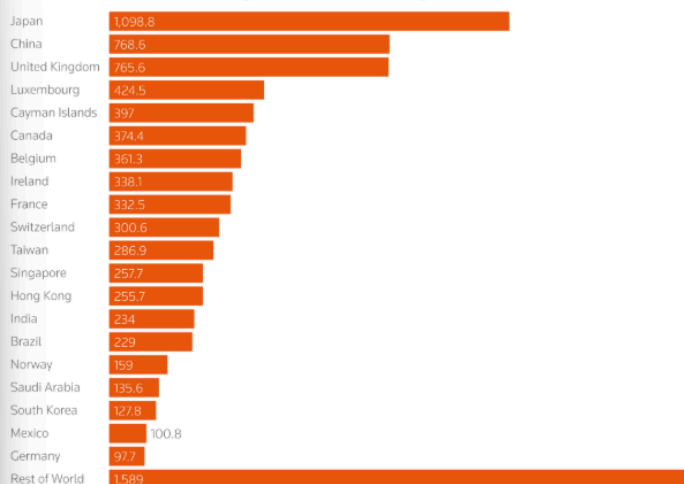
Who owns U.S. debt?

About a quarter of the United States' roughly \$36 trillion public debt is held abroad



Foreign owners of U.S. debt

Japan and China are the top foreign holders of U.S. sovereign debt



Note: As of November 2024.

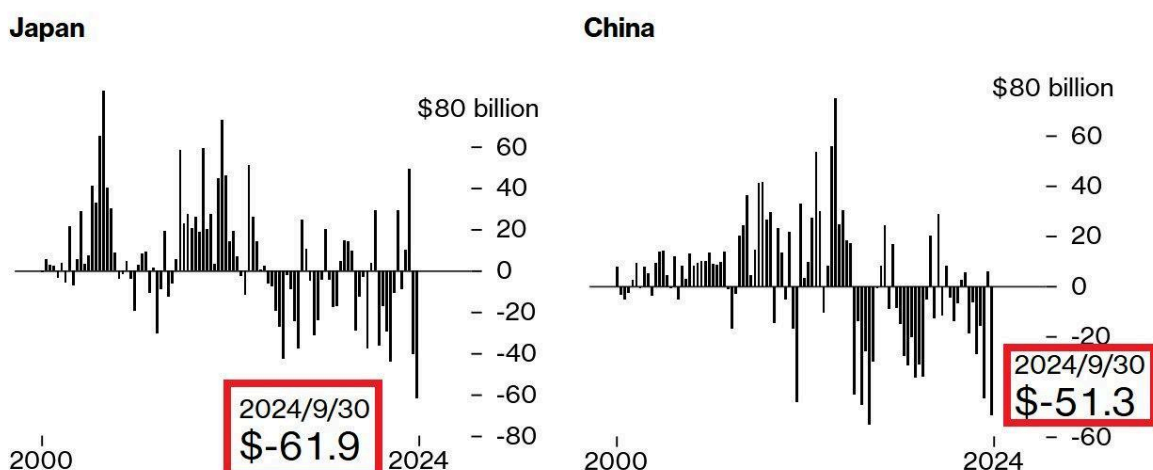
Figure 3.3: U.S. Debt Holdings

Major Foreign Selling Trends in 2024

This trend is already underway. In Q3 2024, Japan recorded its largest-ever sale of U.S. Treasuries, offloading \$61.9 billion (following a \$40 billion reduction in Q2). China also sold off its second-largest amount on record, marking six out of the last seven quarters as net selling periods. As a result, China’s U.S. Treasury holdings have fallen below \$800 billion for the first time since the Global Financial Crisis in 2009.

Japan and China Both Sell Treasuries in 3Q

Quarterly net purchase of Treasuries



Sources: Department of the Treasury, Bloomberg

Figure 3.4: Quarterly Net Purchase of Treasuries

Reasons for the Foreign Pullback

The reduction in U.S. Treasury holdings by foreign countries has multiple explanations (but not limited to):

- **Geopolitical Tensions:** China has been gradually reducing its reliance on the U.S. financial system, particularly amid rising tensions over Taiwan, the South China Sea, and trade disputes. The potential for increased tariffs and a renewed trade war under a Trump administration is fuelling this shift. As of February 20, 2025, Trump has proposed a worldwide tariff of 17.5%, further incentivising China to move away from U.S. dollar-based trade.
- **De-Dollarisation and BRICS Expansion:** The creation of BRICS+ (Brazil, Russia, India, China, South Africa, and new members like Saudi Arabia, Iran, and the UAE) signals an ongoing move away from U.S. dollar reliance. Many of these countries are reducing their dependence on the U.S. financial system, particularly after the U.S. froze Russian dollar reserves following the Ukraine conflict. BRICS nations are also actively discussing the potential formation of a new global reserve currency, possibly backed by gold, oil, or other commodities. If BRICS nations continue settling trade in alternative currencies (e.g., the yuan, yen, or gold-backed assets), it would further diminish demand for U.S. Treasuries, impacting global markets beyond just the bond sector.
- **Japan's Domestic Yield Increases:** As the largest foreign holder of U.S. debt, Japan's selling of Treasuries could be particularly disruptive. Japan's 10-year bond yield has risen to 1.44%, more than doubling in the past year, reducing the incentive to invest in lower-yielding U.S. bonds. The Yen Carry Trade Debacle of August 2024 showcased how rapidly rising Japanese yields can disrupt global financial markets, suggesting further reductions in Japan's U.S. bond holdings could have broad-reaching implications.

Potential Future Risks and Market Confidence

Another growing factor that could further erode foreign investment in U.S. Treasuries is concern over fraud and mismanagement within U.S. financial institutions. Reports indicate that the Department of Government Efficiency (D.O.G.E.) is uncovering fraudulent activity across several government branches, including the Federal Reserve and the U.S. Treasury. This not only damages confidence in U.S. financial markets but may further discourage foreign investors from increasing their Treasury holdings.

Confidence in any asset, especially one considered risk-free, like U.S. Treasuries, depends on the market's belief in its stability and reliability. If investors doubt the security and credibility of the U.S. financial system, they may demand higher yields to compensate for the added risk, further driving up Treasury rates.

This trend is only exacerbated by the increasing national debt, which now stands at \$36.5 trillion, with interest payments alone surpassing 1 trillion, exceeding the entire U.S. defence budget. Even with the global status of being the global reserve currency, there is growing scepticism about how long the U.S. can sustain its borrowing without consequences. Rising interest costs put increasing pressure on government finances, and if confidence in the government's ability to manage its debt deteriorates, demand for U.S. treasuries could reduce significantly.

However, recent efforts by D.O.G.E, with reports indicating savings of nearly 150 billion in under two months suggests a push towards fiscal responsibility. If these reforms continue, they could help restore investor confidence and strengthen the U.S. as a more attractive investment for foreign entities.

China, Japan, and other BRICS nations are actively reducing their exposure to U.S. Treasuries, shifting towards alternative reserve assets, trade settlement systems, and gold. As foreign investors pull back, the U.S. must offer higher yields to attract domestic and alternative foreign buyers, further contributing to the unexpected rise in long-term yields despite ongoing rate cuts. This dynamic continues to reinforce the reverse conundrum, where the Federal Reserve's monetary policy is failing to lower long-term bond yields due to fundamental shifts in global capital flows and investor behaviour.

4. Gold and Its Bearish Effect on Treasury Yields

Gold's use in trade dates back as far as 4500 BCE, with evidence emerging from the Varna Necropolis in present-day Bulgaria. The first known gold coins were minted in Lydia, an ancient kingdom in modern-day Turkey, around 600 BCE. These coins facilitated trade and commerce, and subsequently, almost all civilisations, including the Greeks, Romans, and others, have used gold as a primary trading currency to establish stable economies. Notably, silver has almost always accompanied gold in trade, given gold's historically high value and limited accessibility.

Gold as a Modern Safe-Haven Asset

Today, gold remains one of the most reliable stores of wealth, proving itself as a safe-haven asset that protects investors from inflation, economic crises, and currency devaluation. It has become a major competitor to US Treasuries, as central banks worldwide continue to increase their gold holdings each year.

Furthermore, under Basel III, a set of international banking regulations developed by the Basel Committee on Banking Supervision in response to the Global Financial Crisis (GFC), physical gold held by banks is now classified as a Tier 1 asset. This designation means that gold is recognised as a high-quality liquid asset (HQLA), allowing banks to count it toward their core capital reserves. The only other Tier 1 assets under Basel III are a bank's common equity and additional capital instruments (such as perpetual bonds and preferred shares).

Although US Treasuries are also classified as Level 1 HQLA (alongside foreign AAA government bonds and central bank reserves), they are not classified as Tier 1 assets like gold. This distinction enhances gold's credibility as a financial reserve asset for banks. While most of Europe is already compliant with Basel III, the US has delayed implementation. However, US regulatory agencies, including the Federal Reserve, have proposed adopting the final Basel III components by July 1, 2025. This transition could have significant implications, as increased demand from banks accumulating gold would not only drive up gold prices but also reduce demand for other safe-haven assets, particularly US Treasuries.

Reported official gold holdings and gold as a percentage of total foreign exchange reserves*

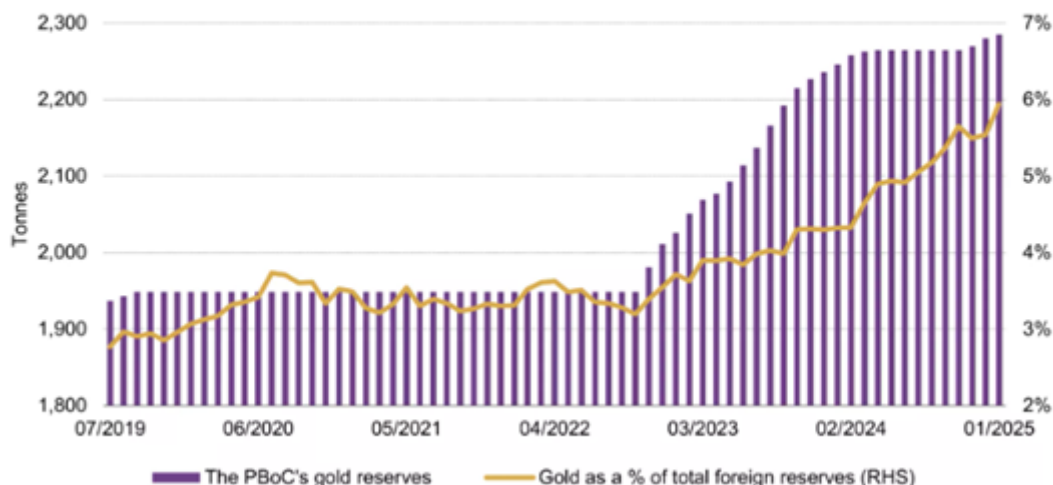


Figure 4.1: Official Gold Holdings as % of foreign exchange reserves

The Shift Away from US Treasuries

Since the COVID-19 pandemic, central banks have accelerated their gold purchases. The rapid expansion of fiat currency supply, followed by rising inflation, economic instability, and geopolitical tensions, has made gold an increasingly attractive alternative to US dollar-denominated assets. In particular, Eastern economies and BRICS nations have made strong moves to de-dollarise their reserves and establish gold-backed trade mechanisms. China has notably ramped up its gold purchases, reporting dramatic increases in gold reserves over the past three years (see Figure 4.1). However, historical trends suggest China may be underreporting its actual gold holdings. Between 2009 and 2015, China officially reported no gold purchases, only to later reveal a 600-ton increase in its reserves. Analysts believe this strategy artificially suppresses gold prices by concealing true demand. Similarly, India, traditionally a major gold purchaser due to cultural and religious factors, has reported its highest gold import levels in a decade as of February 2025 (see Figure 4.2).

A key emerging trend is that gold is increasingly being used for trade settlements, including oil, commodities, and debt payments, bypassing the US dollar-dominated financial system. This shift not only makes global gold flows harder to track but also reduces demand for US Treasuries as a reserve asset.

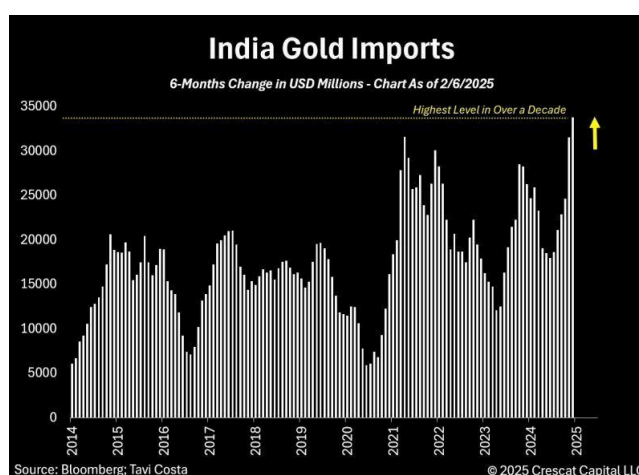


Figure 4.2: India Gold Imports

Gold Demand in the West

While gold accumulation has been most pronounced in the East, a similar trend is emerging in the West. The Comex and London Metals Exchange (LME) have recently been under scrutiny as gold stockpiles surged by over 12.5 million ounces (400 tonnes) in the past three months. This surge caused a major supply shortage at London bullion banks, forcing them to borrow gold from central banks to meet delivery demands.

The exact reason behind this sudden increase in gold demand remains uncertain. Some analysts attribute it to anticipated US tariffs on neighbouring countries, while others believe it reflects a broader decline in confidence in US financial stability. Additionally, with the Trump administration conducting an audit of US gold reserves, speculation has emerged that the US government itself may be secretly stockpiling gold, as very few entities would be capable of such large-scale purchases.

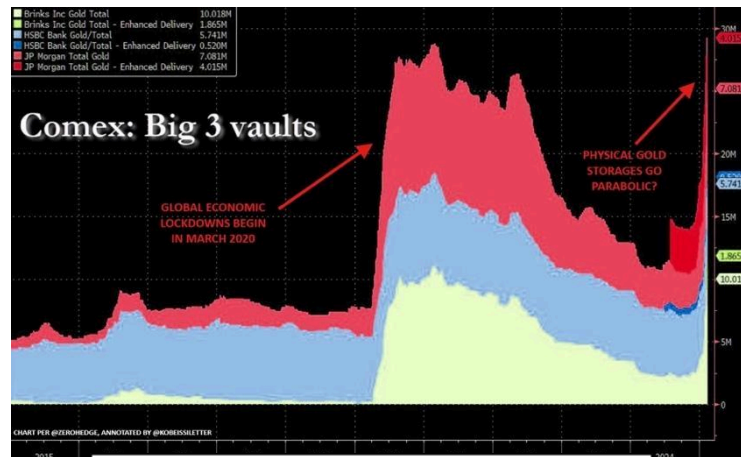


Figure 4.3: Gold inventories in major Comex vaults

The Impact on Bond Yields and the Reverse Conundrum

The rising demand for gold, both as a safe-haven asset and a financial reserve, is directly impacting US Treasury demand, keeping bond yields elevated despite the Federal Reserve’s rate cuts. As central banks, particularly BRICS nations, continue to accumulate gold to reduce their dependence on US Treasuries, they are weakening demand for US debt securities.

The Basel III regulations, which further strengthen gold’s Tier 1, HQLA classification, are expected to accelerate this trend as banks increase their gold holdings. With the US set to implement Basel III by July 1, 2025, this could further diminish Treasury demand, putting additional upward pressure on bond yields.

Additionally, the rise of gold-backed trade agreements and alternative settlement systems is gradually eroding the US dollar’s dominance in global trade, making gold a more attractive store of value. This shift, coupled with the recent disruptions in Western gold markets (Comex, LME) and a surge in physical gold demand, indicates that investors are increasingly favouring gold over US Treasuries.

Despite the Federal Reserve’s efforts to lower interest rates, the declining demand for US Treasuries, driven by rising gold demand and de-dollarisation efforts, is keeping long-term bond yields elevated, reinforcing the reverse conundrum. The ongoing accumulation of gold by central banks, the implementation of Basel III, and the growing use of gold in trade settlements all suggest a fundamental shift in the global financial system. As these trends continue, they could reshape the role of US Treasuries as the world’s primary safe-haven asset in the years ahead.

5. Conclusion

The growing divergence between bond yields and the Federal Funds Rate suggests that the Federal Reserve is losing control over the bond market, as investors increasingly reject the Fed’s narrative on inflation and monetary policy expectations. Despite the Fed’s commitment to a higher-for-longer rate strategy, Treasury yields have remained elevated, reflecting market scepticism about the central bank’s ability to achieve a soft landing while bringing inflation back to target.

This disconnect is driven in part by sticky inflation, which has not declined as smoothly as anticipated. With core inflation remaining above 3%, markets are beginning to price in the possibility that the Fed may have to maintain restrictive policy for longer than previously expected, or worse, that rate hikes have failed to rein in inflation effectively. Investors are demanding higher real yields as compensation for the risk that inflation remains persistent and erodes returns over time.

At the same time, geopolitical risks and shifting global trade dynamics are reshaping capital flows, further complicating the Fed's efforts to control long-term yields. Gold has continued to attract inflows as a safe-haven asset, benefiting from both inflation hedging and geopolitical uncertainty. Meanwhile, increasing U.S. tariffs and trade restrictions raise the potential for de-dollarisation, which could reduce foreign demand for U.S. Treasuries and contribute to sustained upward pressure on yields.

Ultimately, the bond market's defiance of the Fed's rate trajectory signals a broader loss of confidence in the central bank's ability to control inflation, stabilise growth, and manage financial conditions effectively. If this divergence continues, the Fed may find itself forced into more aggressive policy actions, either delaying rate cuts further or even reintroducing rate hikes, to regain credibility. In the meantime, investors will likely remain wary, keeping bond markets volatile as they navigate inflation risks, policy uncertainty, and global economic shifts.

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