Vigilante justice?

Financial markets react quickly to policy changes

By Jim Reber

While it will possibly take months and even the rest of the year to see the full shakeout, April 2025 was a laboratory for market efficiency. Some might contend there was an element of ruthlessness in the activity. Starting even before the Trump administration's trade policy tariffs went into effect on April 2, the "Bond Vigilantes," a nebulous gang of institutional debt investors, started shooting up the place.

Barely a week after so-called "Liberation Day," the U.S. bond market—particularly the longer tenors—had administered its brand of frontier justice. The 10-year note, which has an outsized effect on the economy due to its correlation to mortgage rates, rose nearly 50 basis points (0.5%). At the same time, and tellingly for the mood of consumers and the broader global economy, all the major stock indices retreated. It's not often that debt and equity markets move in tandem; more often than not, they travel in opposite directions.

Couldn't help noticing

The term "bond vigilante" was coined by legendary economist Ed Yardeni in the 1980's, when long-term yields were soaring far into double-digit territory. It connoted investors who were uber-hawkish on inflation, and were ready and willing to sell their holdings and drive prices down/yields up until they were satisfied that they were being adequately compensated for their price risk. There have been several periods in the 21st century when the vigilantes were barely visible, especially following the Great Recession and during the COVID-19 pandemic.

The term came back into vogueish use in 2022 as prices of goods began spiking year-over-year in the 8% range, and the Federal Reserve was hiking short-term rates every chance it got. We still haven't seen inflation back in the 2% box the Fed has set as its objective. By some measures, inflation is picking up steam, so the vigilantes have remained on notice. The very real consequences of protracted trade wars, the worst of which could include price hikes accompanied by weaking labor markets, have gotten the attention of the inflation hawks, to say the least.

Duration divergence

Another interesting development following April 2 is the steepening of the yield curve to levels not seen since 2022. To be sure, a 50-basis point slope between "2's and 10's" does not qualify as steep. However, while the Fed has very carefully chosen its comments and is making no promises about further rate cuts (or rate hikes, for that matter), investors have begun to factor in an additional cut or two in the 2025 numbers. So why the steepening?

Our “friends,” the vigilantes, are protecting themselves against more inflation deterioration. They are investors, by and large, at the long end of the curve, which is only marginally influenced by the Fed’s monetary policy, as long as that does not include open market operations. The Fed has recently confirmed it will continue to wind down its balance sheet, albeit at a slower pace than in 2024. At the short end of the curve, yields didn’t run up as much in the April 2 aftermath, since the Fed has reiterated its “data-dependent” posture. This steepening, in essence, was building in the increased possibility of both a slowing economy and doubt about maintaining stable prices.

Law…and order?

The fiscal “discipline” by both bond and stock investors caused the administration to walk back some of the harshest rhetoric regarding tariffs. After yields rose every day between April 4 and 12, they actually retreated the remainder of the month. The two-year note’s yield fell about 26 basis points for April, while the 10-year note fell about three basis points. It’s a fair to say part of the return to relative calm was the administration softening its commentary on the removal or firing of Fed Chairman Jay Powell. The major stock market indices, all of which were down by double-digit percentages mid-month, ended up basically unchanged between +1% and -3%.

The takeaway? Whether you consider yourself a bond vigilante or merely an observer, it’s clear that they’re back—and watching. The gang also has shown it still has enough collective clout to move bond market yields, and influence monetary, fiscal, and trade policies. Those who choose to tangle with this notorious bunch had better pack a lunch—it could be a long slog.

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