



Lethame Capital Management

Technology : Research : Investing

Paid to Wait: The Real Hurdle Has Risen

The Standard Narrative in the Financial Press is that Bond Investors Fear Inflation — We Argue that the Bond Market Is Saying Something Else

October 2026

Executive Summary

The global bond sell-off has pushed the 30-year US Treasury yield to its highest level since 2002 and the 30-year gilt to a 28-year high. The *Financial Times* repeatedly offers a similar explanation: for example on 8th October it blamed “*fears over inflation and high public debt*”¹ and the next day, when reporting Pimco’s warning that US yields could reach a 26-year high, suggested this was due to “*fears over high oil prices, inflation and America’s towering public debt*”.² The market’s own pricing tells a different story. A nominal bond yield is the sum of two prices — a real yield and compensation for expected inflation — and since January 2026 almost the entire rise has come through the first:³

$$\Delta \text{ 10-year nominal yield } +0.78\% = \Delta \text{ real yield } +0.73\% + \Delta \text{ breakeven inflation } +0.05\%$$

Investors are not demanding more protection against inflation. They are demanding a higher real return for lending safe capital. The 10-year TIPS real yield of 2.87% is the highest since the October 2008 liquidity dislocation, and the five-year, five-year forward real yield — the real rate for the five years beginning in 2031 — is around 3.1%, its highest since at least 2003. The turning point was 2022: the year the Federal Reserve began its fastest hiking cycle since the early 1980’s combined with shrinking its balance sheet through “*Quantitative Tightening*”.

At the same time, US equities are priced at valuations exceeded only once in 145 years. The Shiller cyclically-adjusted price-earnings ratio (CAPE)^{4,5} stands at 41. Inverting it gives the real earnings yield an investor can expect from normalised earnings — and that yield is now below the real yield on a riskless, inflation-protected government bond:

$$1 / \text{CAPE} \approx 2.4\% < \text{ 10-year TIPS real yield } \approx 2.9\%$$

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The last time that was true was November 2000. Since 1900, every month that began with the equity earnings yield below the real bond yield delivered a subsequent ten-year real equity return below today's TIPS yield. This is not a forecast of when equities will fall, nor a claim that they must. It is an observation about the price of risk:

The hurdle a risky investment must clear is the highest since before the GFC — the equity offer against it is the thinnest since the dot-com peak

1. What Is the Real Interest Rate?

Irving Fisher's distinction⁶ is the appropriate starting point: the nominal interest rate equals the real rate plus expected inflation. The real rate is the price of time — what a lender demands, measured in goods rather than money, for giving up consumption today in exchange for consumption tomorrow.

$$i = r + E[\pi]$$

Fisher's identity tells us how to measure the real rate, but not what determines it. Modern asset-pricing theory, building on Lucas,⁷ derives it from the consumption choices of investors. In equilibrium the marginal investor must be indifferent between consuming one more unit today and lending it at the risk-free rate. Assuming power utility and log-normally distributed consumption growth, as Hansen and Singleton⁸ did, this condition yields a closed-form expression for the (continuously compounded) real risk-free rate:⁹

$$r \approx \rho + \gamma\mu - \frac{1}{2}\gamma^2\sigma^2$$

Each term has an intuitive meaning. ρ is pure impatience: people prefer to consume now and must be paid to wait. $\gamma\mu$ is a wealth effect: if consumption is expected to grow (μ , the mean growth rate of log consumption), we will be richer tomorrow, so an extra dollar tomorrow is worth less to us than a dollar today, and lenders demand compensation for shifting consumption from a poorer present to a richer future — γ measures how strongly people dislike uneven consumption. The final term is precautionary: uncertainty about future consumption (σ , the standard deviation of log consumption growth) makes people want a buffer, raising the demand for safe assets and lowering the rate.

The real risk-free rate is therefore not a risk premium. It is the price of time, set by impatience, expected growth and the demand for safety. Central bankers work with a related concept — the natural or neutral rate, r^* , the real policy rate consistent with full employment and stable inflation — which descends from Wicksell¹⁰ and has been estimated most influentially by Laubach and Williams.^{11,12}

2. The Risk-Free Rate Puzzle and the Price of Safety

Plugging plausible numbers into the equation exposes a well-known problem. With $\rho = 1\%$, $\gamma = 2$, $\mu = 2\%$ and $\sigma = 2\%$, the model implies a real risk-free rate of around 5%. Historically, the real return on US Treasury bills has been closer to 1%. Worse, the high risk aversion required to explain the equity premium — Mehra and Prescott's equity premium puzzle¹³ — implies an even higher risk-free rate.

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Weil¹⁴ named this the *risk-free rate puzzle*: investors hold safe assets at far lower returns than impatience and growth alone would justify.

The most useful resolution for our purposes is that safe assets pay a non-monetary return. Krishnamurthy and Vissing-Jorgensen¹⁵ show that US Treasuries carry a convenience yield: investors accept a lower cash yield because Treasuries are money-like, liquid and universally accepted as collateral. Del Negro, Giannone, Giannoni and Tambalotti¹⁶ find that a rising convenience yield accounts for much of the decline in real rates since the late 1990s. The implication is important:

The safe real rate is low when safety is scarce — and rises when safety becomes abundant

Investors have not always demanded a positive real return on safe assets. Between 2012 and 2021 they repeatedly accepted negative real yields for the privilege of holding them.

3. Four Decades of Decline

The secular decline in real interest rates is one of the most studied facts in modern macroeconomics. Rachel and Smith¹⁷ attribute roughly four percentage points of the decline in the global neutral rate since the 1980s to slower growth, ageing populations and higher desired saving. Bernanke's "*global saving glut*"¹⁸ and Summers's "*secular stagnation*"¹⁹ are usually told as a loanable-funds story, in which too much saving chases too little investment. We do not share that framing. Banks create deposits when they lend and governments create net financial assets when they run deficits, so there is no fixed pool of saving to be competed over.^{20,21} The more useful reading is stock-flow consistent: every financial asset is someone else's liability, and the yield on government debt depends on who must hold the outstanding stock, and on what terms.²² Seen this way, the "*glut*" was a glut of price-insensitive demand for safe duration, not a surplus of savings. Readers of our earlier notes on China and the dollar system^{23,24,25} will recognise the mechanism: Pettis²⁶ argues that persistent surpluses reflect the domestic distribution of income in surplus economies, whose excess savings must be absorbed abroad, much of it in US Treasuries. In *The Savings Glut in Reverse* we argued that the 2026 sell-off reflects this process unwinding: as China's reserve managers and the Bank of Japan step back as captive, price-insensitive buyers of government duration, price-sensitive private capital must be induced to take their place — and the inducement is paid in real yield, not inflation compensation.²⁷

The longest records show that the decline is not merely a recent phenomenon. Jordà, Knoll, Kuvshinov, Schularick and Taylor²⁸ find that across 16 advanced economies since 1870, safe assets have returned around 1% a year in real terms while risky assets have returned around 7%. Schmelzing²⁹ extends the record back to the fourteenth century and finds a "*suprasecular*" decline in global real rates of roughly one to two basis points a year. For US equities specifically, Siegel³⁰ documents a real return of between 6.5% and 7% a year since 1802 — a stability so striking that Smithers and Wright³¹ dubbed it "*Siegel's constant*". Shiller's data give 6.5% a year from 1881 to 2023.³² But the constant is an average earned from an average starting valuation — a CAPE of around 17 — not a return available at any price, a distinction to which Section 13 returns.

Crucially, Caballero, Farhi and Gourinchas³³ show that while the safe real rate fell, the measured return on productive capital in the United States did not. The gap between the two — the risk premium — widened. That observation frames this note. The safe rate has now risen sharply, but equity valuations imply the risk premium has compressed rather than adjusted.

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4. Quantitative Easing: A Thumb on the Scale

Secular forces explain the trend in real rates; central-bank balance sheets explain part of their level. Between 2009 and 2022 the Federal Reserve, the Bank of England and other central banks bought government bonds on an unprecedented scale, removing duration from private portfolios and becoming the largest price-insensitive buyer in the market. As we have noted before, the effect after the Global Financial Crisis was that real rates were crushed and owners of risk-free assets were starved of yield.²⁵ Event studies of the first programmes estimate that US purchases lowered the 10-year term premium by between 30 and 100 basis points³⁴ and that UK purchases depressed gilt yields by about 100 basis points.³⁵ Federal Reserve staff estimate that the Fed's accumulated holdings were holding the 10-year term premium down by about 100 basis points at the end of 2016.³⁶ Importantly for this note, the effect operated on real yields: Abrahams, Adrian, Crump, Moench and Yu find that large-scale asset purchases lowered Treasury yields primarily by reducing real term premia.³⁷

Quantitative easing did not just lower the price of money — it lowered the real price of safe capital

The reverse is not symmetric. Du, Forbes and Luzzetti find that quantitative tightening has raised government bond yields, but by far less than quantitative easing lowered them, with domestic non-bank investors largely absorbing the bonds central banks have shed.³⁸ The Bank of England — running the most aggressive QT programme among major central banks, a point we examined in an earlier note on UK gilt yields³⁹ — estimates its sales have added 15–25 basis points to 10-year gilt yields.⁴⁰ And the Federal Reserve ended the run-off of its balance sheet on 1 December 2025,⁴¹ reinvesting maturing mortgage-backed securities into Treasury bills — a duration-shortening adjustment to the plumbing rather than renewed stimulus, as we argued at the time.⁴² The 2026 rise in US real yields therefore cannot be a QT flow effect.

The better reading is that a real hurdle of close to 3% is not abnormally high. The 10-year TIPS yield averaged 2.1% from 2003 to 2007 and 0.3% from 2009 to 2021. Today's real yield is what a safe real rate looks like when a central bank is no longer the marginal buyer. What remains abnormal is the equity market: the US CAPE averaged 26 between 2003 and 2007, against 41 today. Equities are still priced as if the QE-era discount rate applied.

5. The Hurdle Has Risen — and It Is Real

The simplest way to test the inflation narrative is to decompose the 10-year Treasury yield into its two components. Using September 2026 monthly averages:

10-year nominal (4.99%) ≈ TIPS real yield (2.64%) + breakeven inflation (2.35%)

If investors feared inflation, the breakeven would be rising. It is not. At 2.33% on 9 October the 10-year breakeven sits in the middle of its range since 2003 (median 2.2%), even though PCE inflation is running near 3.7%.⁴³ The rise in nominal yields has come almost entirely through the real component (Figure 1).

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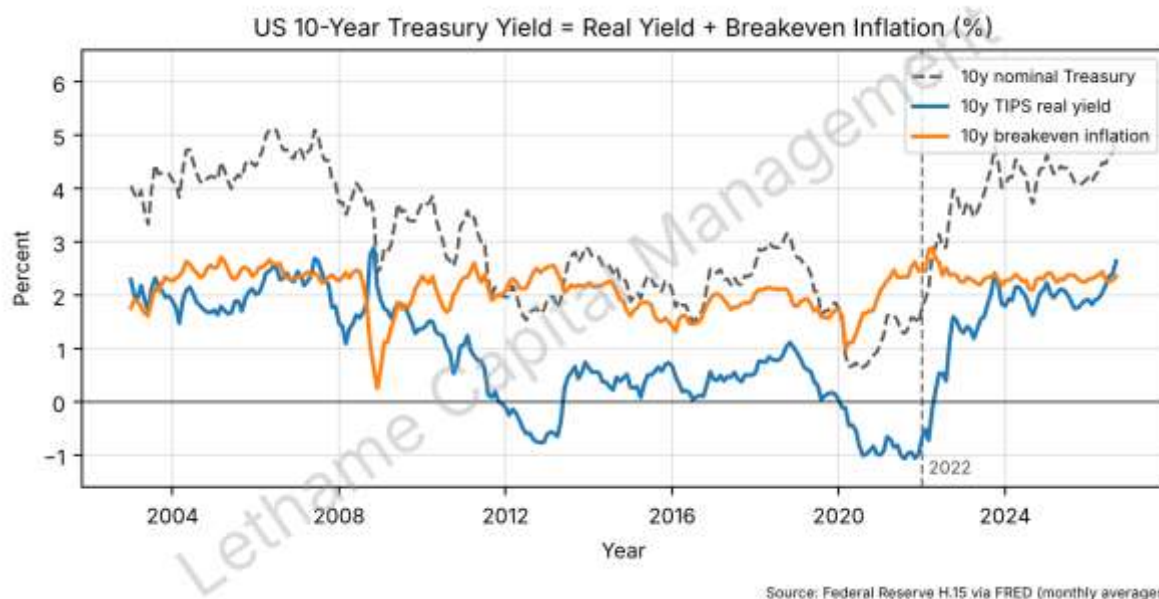


Figure 1: US 10-Year Treasury Yield = Real Yield + Breakeven Inflation (%)

Source: Federal Reserve H.15 via FRED, monthly averages.³

The 10-year TIPS yield of 2.87% on 8 October is the highest since October 2008. Then, real yields spiked only because forced selling during the Lehman crisis crushed TIPS prices, and breakevens briefly fell towards zero. Today's real yield is not a liquidity event. The 17 September reopening of the 10-year TIPS cleared at 2.653%, the highest for that maturity at auction since October 2008.⁴³

6. Stripping Out the Federal Reserve: The 5y5y Forward

A 10-year yield partly reflects the expected path of policy rates, and the Federal Reserve raised rates in September. To separate the long-run price of safe capital from near-term monetary policy, we use the five-year, five-year forward real yield implied by the 5- and 10-year TIPS yields. Investing for ten years at the 10-year rate must deliver the same real return as investing for five years at the 5-year rate and then for a further five at the forward rate f :

$$(1 + 2.87\%)^{10} = (1 + 2.62\%)^5 \times (1 + f)^5 \Rightarrow f = 3.12\%$$

Intuitively, the 10-year rate is approximately the average of the two five-year periods, so $f \approx 2 \times 10\text{-year} - 5\text{-year}$: if the average is 2.87% and the first half is 2.62%, the second half must be about 3.12%.

This is the highest since at least 2003, when the five-year TIPS series begins. The matching 5y5y breakeven, 2.32%, is almost exactly its 2003–2026 median of 2.29%. The market expects inflation to be controlled over the long run; what it demands is a higher real return over the long run (Figure 2).

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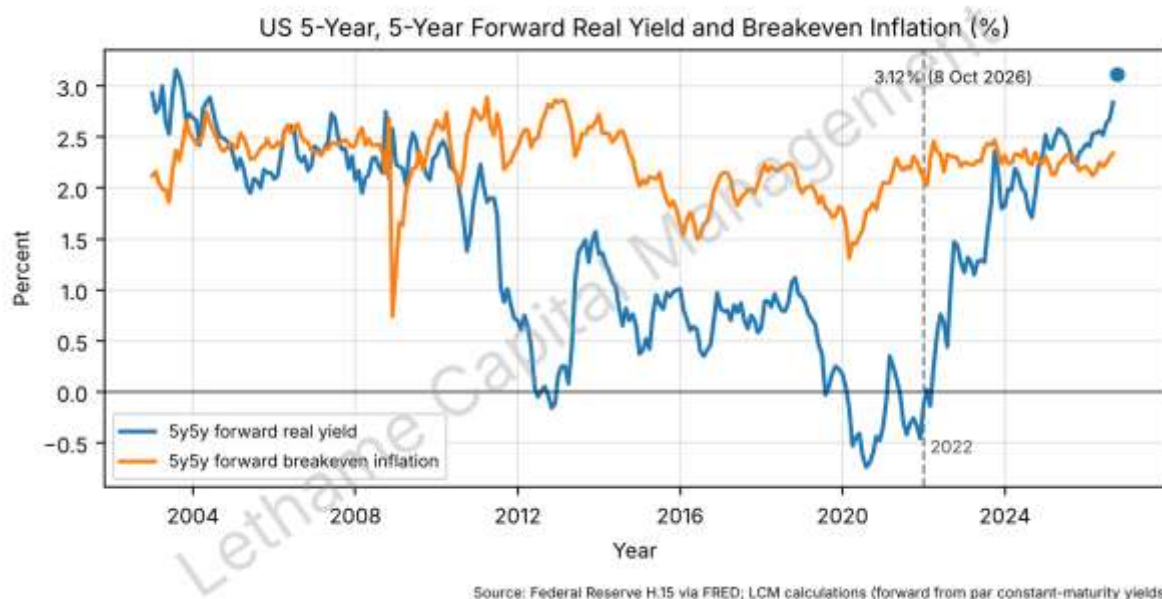


Figure 2: US 5-Year, 5-Year Forward Real Yield and Breakeven Inflation (%)

Source: Federal Reserve H.15 via FRED; LCM calculations.³

7. Cross-Checking the Result

Market breakevens are imperfect. They embed an inflation risk premium and are distorted by the lower liquidity of TIPS relative to nominal Treasuries. Two model-based measures help. The Cleveland Fed model of Haubrich, Pennacchi and Ritchken,⁴⁴ which draws on inflation swaps and survey data, separates the real rate from expected inflation. The Kim–Wright model⁴⁵ estimates the term premium — the compensation for holding long-dated duration over and above the expected path of short rates. The Adrian–Crump–Moench⁴⁶ and D’Amico–Kim–Wei⁴⁷ models provide alternative decompositions.

Table 1: Decomposition of the 2026 Move in US 10-Year Yields (%)

Measure (10-year)	Jan 2026	Sep 2026	Change	Last higher
TIPS real yield	1.91	2.64	+0.73	Nov 2008
Cleveland Fed real rate	1.67	2.24	+0.58	Jul 2007
Cleveland Fed expected inflation	2.33	2.57	+0.24	Jun 2007
Kim–Wright term premium	0.57	1.08*	+0.51	Pre-GFC average ≈ 1.0

Monthly averages. *Kim–Wright at 2 October 2026; January figure as reported by TwentyFour.⁴⁸ Sources: FRED; Federal Reserve Bank of Cleveland; Federal Reserve Board.

One qualification should be stated plainly. The Cleveland Fed model attributes roughly a quarter of the 2026 rise to higher inflation expectations — now at their highest since mid-2007 — which TIPS breakevens may understate because TIPS have cheapened relative to nominal Treasuries. The inflation story is therefore not zero. But it is the minority of the move. On every measure, the real rate is at its highest since 2007–08, and the term premium has returned to its pre-GFC average of about 1%.⁴⁸

8. Why the Price of Safe Capital Is Rising

Mapping the data back onto the theory suggests four mechanisms, none of which requires higher inflation expectations:

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- **Safety is becoming less scarce.** Every fiscal deficit adds government liabilities that the private sector must hold, as reserves or as bonds.²¹ Large deficits — now augmented by war-related borrowing⁴³ — together with the cumulative shrinkage of central-bank balance sheets since 2022 and weaker official and Japanese institutional demand (Section 9), increase the stock of Treasuries the private sector must hold. Although the Federal Reserve has stopped shrinking its balance sheet, it is no longer the marginal buyer it was during the QE era (Section 4). Holder data make the point directly: price-insensitive investors held an estimated 76% of outstanding US Treasury bonds nineteen years ago against around 43% today, and during the Fed's 2022–2025 balance-sheet reduction a 17 percentage-point rise in the price-sensitive share accompanied a 1.1 percentage-point rise in the term premium.²⁷ In the language of Section 2, the convenience yield is eroding and the safe rate rises towards the return on capital.
- **Bonds have lost their hedging value.** Since 2022 the correlation between US equity and bond returns has been closer to positive than negative. A bond that falls when equities fall offers no insurance and warrants a positive term premium, not the negative one investors accepted in the 2010s.
- **Fiscal and policy uncertainty.** Uncertainty about the future supply and real value of government debt raises the real term premium rather than inflation compensation. Market participants are saying as much: Citigroup's global head of short-term rate trading attributes the sell-off to the scarcity of "*credible budgetary policies*" globally, and Mizuho notes that pension funds remain reluctant to buy long-dated bonds despite higher yields.¹ Both describe investors demanding more compensation to hold government duration — a real-rate story, not an inflation-expectations story.
- **A higher return on real capital.** Investment in artificial intelligence, the energy transition and defence has raised the expected return on productive capital. This does not work by draining a fixed pool of savings: bank lending and fiscal deficits create the financial assets that fund investment.^{20,21} It works through relative returns: a safe asset must offer enough real yield to be held alongside higher-returning risky capital. Faster expected growth also raises the γ term in the equation of Section 1. We treat this as a supporting rather than a necessary explanation; the balance-sheet mechanism above does not depend on it.²⁷

We regard these as complementary rather than competing explanations. All four point to a structurally higher real hurdle rather than a cyclical inflation scare.

9. The Japanese Life Insurer Goes Home

Central banks were not the only price-insensitive buyers of long-dated government debt. For much of the past two decades the other was the Japanese life insurer. As Michael Green sets out in a recent essay, these institutions carry an average liability cost of roughly 2% — the return their old promises require — and during the decade of yield-curve control the 10-year Japanese government bond (JGB) yielded roughly zero.⁴⁹ The money went abroad, into Treasuries, bunds, gilts and Australian bonds, until Japan became the largest foreign holder of US Treasuries, at roughly \$1.1 trillion. It was bought to match long-dated yen liabilities, not to maximise return: a liability-driven, largely price-insensitive bid of exactly the kind Section 2 describes.

A Japanese insurer buying Treasuries removes the currency risk with a rolling hedge whose cost is, in effect, the gap between US and Japanese short-term rates. What it earns is therefore not the headline US yield but something close to Japanese cash plus the slope of the US curve. Figure 3 compares that

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hedged return with the yield on a 10-year JGB. From 2016 to 2021 the hedged Treasury generally offered more. In mid-2022, as the Federal Reserve began raising rates and shrinking its balance sheet, the hedging cost soared, the relationship flipped — and it has not flipped back since. On our estimate the yen-hedged 10-year Treasury yielded around 2 percentage points less than a JGB through much of 2023 and 2024, and still yields around a percentage point less today.

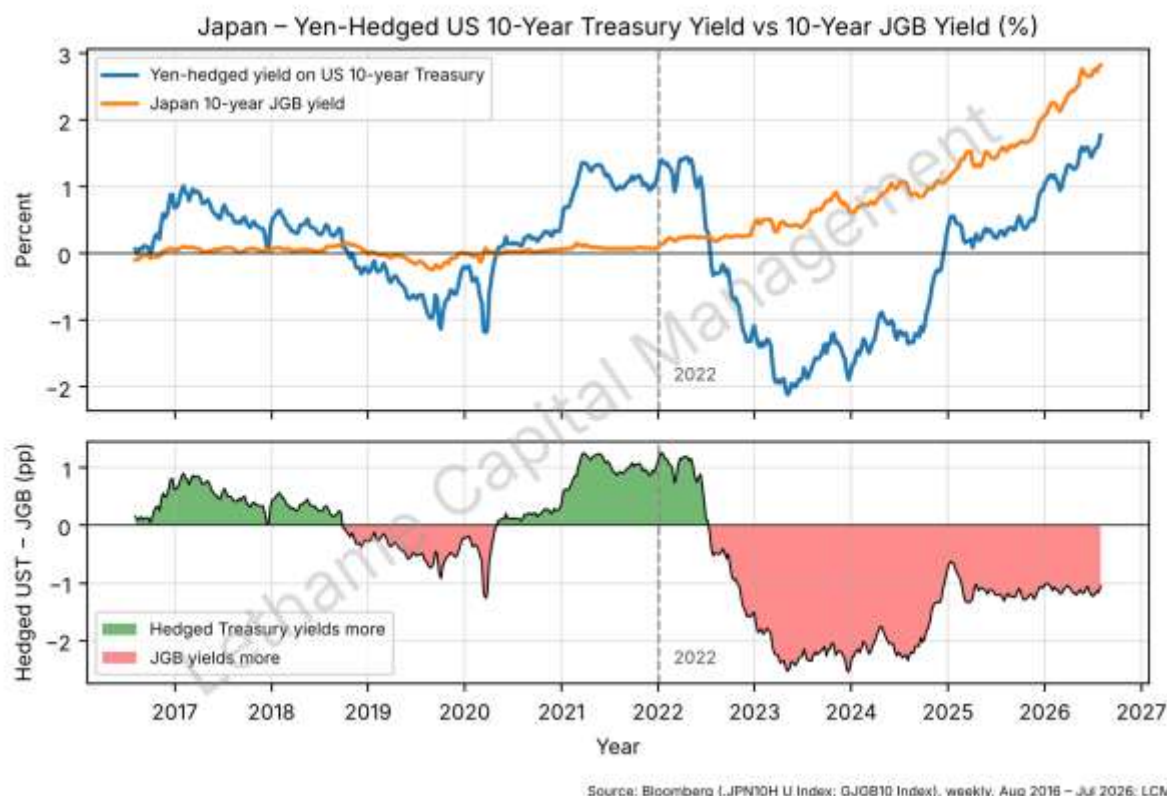


Figure 3: Japan – Yen-Hedged US 10-Year Treasury Yield vs 10-Year JGB Yield (%), 2016–2026

Source: FRED (OECD; Federal Reserve H.15); LCM estimate, monthly.³ Hedge cost approximated by the 3-month US–Japan interbank rate differential.

Once the home market can cover yen promises without currency risk, hedge-roll risk or a foreign-bond committee, a Treasury must offer substantially more — not slightly more — to justify its place in the portfolio. Green notes that by mid-2026 a yen-hedged 10-year Treasury offered 55–80 basis points over Japanese cash, while a 10-year JGB offered 2.9% and a 30-year JGB 4%; roughly half of Japan’s ten largest life insurers have said they are reducing foreign bond holdings.⁴⁹ As he puts it, this is “*less a story about Treasuries becoming unattractive than about Japanese bonds becoming good enough*”.

Two features make this withdrawal easy to underestimate. First, the insurer does not need to sell a single bond for its departure to matter; it need only stop replacing the bonds that mature and stop bidding for new issues. A purchase that does not happen never appears in the holdings data — it appears in auction demand and in price. Second, prices are set at the margin. Gabaix and Koijen’s inelastic markets hypothesis shows that when the marginal holder is price-insensitive, relatively small changes in flows can move prices disproportionately.⁵⁰ The loss of a dependable, liability-driven bidder therefore raises the real yield required to clear the same issuance, without any change in inflation expectations — the same balance-sheet mechanism we described in *The Savings Glut in Reverse*.²⁷

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10. 2022: The Year the Captive Buyers Left

Figure 3 dates the turn precisely, and it is not an isolated date. 2022 is when every one of the forces described in this note changed direction at once:

- **Japanese life insurers:** in mid-2022 the 10-year JGB began to out-yield the yen-hedged 10-year Treasury, and it has done so ever since (Figure 3).
- **The Federal Reserve:** having been the largest price-insensitive buyer of Treasuries since 2009, the Fed began raising rates in March 2022 and shrinking its balance sheet in June 2022 (Section 4).
- **The price of safe capital:** the 10-year TIPS yield, negative since 2020, turned positive in May 2022 on a monthly-average basis and has stayed positive since (Figure 1).
- **The hedging value of bonds:** the correlation between US equity and bond returns turned from negative to positive, removing the insurance value that had justified a negative term premium (Section 8).

2022 marks the end of the captive-buyer regime — the year the price-insensitive buyers of government duration began, together, to step back

Taken together, these explain why the real hurdle has risen without any change in long-run inflation expectations. Between 2022 and 2025 the price-sensitive share of Treasury holdings rose by around 17 percentage points as the term premium rose by about 1.1 percentage points.²⁷ The 2026 leg of the sell-off is the same regime continuing: the buyers who accepted a low real return because the asset solved a balance-sheet problem are being replaced by buyers who have no such problem to solve, and who charge accordingly.

11. The Offer: Shiller's CAPE

The cyclically-adjusted price-earnings ratio, developed by Campbell and Shiller⁴ and popularised in *Irrational Exuberance*,⁵ divides the index price by the ten-year average of inflation-adjusted earnings. Averaging over a decade smooths out the business cycle, so CAPE measures what an investor pays for a normal year of earnings.

At 41, the US CAPE is more than double its long-run average of 17.8 and has been exceeded only at the 1999–2000 peak (Figure 4). The S&P 500 closed at a record high on 6 October, in the same week that long-dated Treasury yields reached their highest levels since 2002.¹ The Coolabah Capital Investments (CCI) charts and presentation that inspired this note reach the same conclusion relative to bonds: the forward earnings yield less the real government bond yield is 2.8%, against an average of 4.6% since the late 1980s — the thinnest margin since around 2002.⁵¹

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Figure 4: US Equities – Shiller Cyclically-Adjusted P/E (CAPE), 1881–2026

Source: Robert Shiller online data;³² LCM extension from October 2023 (see Data and Methodology).

12. The Hurdle Versus the Offer

Inverting CAPE gives a cyclically-adjusted earnings yield. Intuitively, if an investor bought the whole market and received its normalised real earnings each year with no growth, $1/\text{CAPE}$ would be the real return earned. Subtracting the real bond yield gives the *excess CAPE yield* proposed by Shiller, Black and Jivraj⁵² — the additional real return equities offer over a riskless real bond:

$$\text{ECY} = 1/\text{CAPE} - \text{real 10-year yield} = 2.44\% - 2.64\% \approx -0.2\% \quad (-0.4\% \text{ at the 8 October TIPS yield})$$

Over the twentieth century the equity offer sat comfortably above the real bond yield: the post-1900 average excess CAPE yield is 5.2%. It turned negative only around 1929–30, 1936–37 and 1999–2000. None of these proved a good moment to own equities (Figure 5).

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Figure 5: US Equities – Cyclically-Adjusted Earnings Yield vs 10-Year Real Bond Yield (%)

Source: Shiller;³² FRED;³ LCM calculations.

13. What History Says About Starting Valuations

Figure 6 plots the starting CAPE in every month from 1881 to 2013 against the real total return over the following ten years, with dividends reinvested. Any single observation is noisy; the slope is not. Fitting the relationship gives an expected ten-year real return of approximately -0.3% a year at a CAPE of 41 (0.0% using post-1950 data alone). A regression on the excess CAPE yield gives 1.8% on post-1950 data. Every specification lands below the 2.87% available on TIPS.

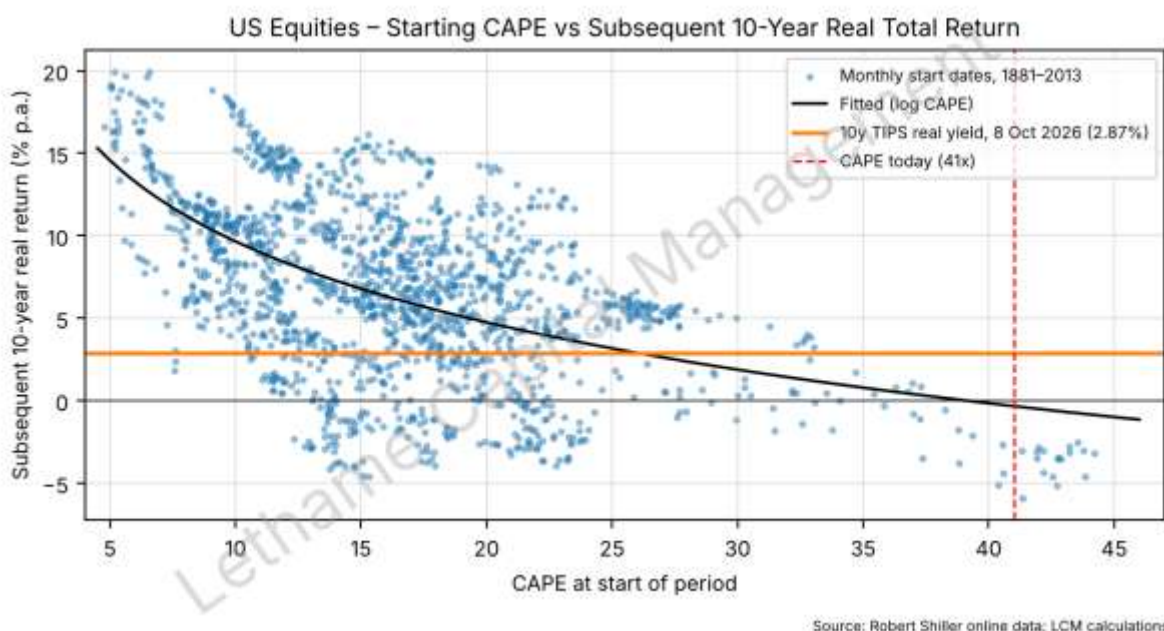


Figure 6: US Equities – Starting CAPE vs Subsequent 10-Year Real Total Return

Source: Robert Shiller online data;³² LCM calculations.

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Table 2: Subsequent 10-Year Real Total Return by Starting Valuation, 1881–2013

Starting condition	Months	Mean	Worst	Best	% above 2.87%
CAPE below 15	690	8.8%	−4.2%	20.0%	86%
CAPE 25 to 30	83	4.4%	−1.2%	6.6%	80%
CAPE above 30	57	−1.0%	−5.9%	4.5%	12%
Negative excess CAPE yield (post-1900)	38	−1.7%	−4.6%	1.9%	0%
All months	1,593	6.7%	−5.9%	20.0%	77%

% p.a., real. Overlapping ten-year windows, so months are not independent observations.

Two observations stand out. Of the 57 months that began with a CAPE above 30, only 12% delivered a real return above today's TIPS yield. And of the 38 post-1900 months that began with a negative excess CAPE yield, none did:

Since 1900, no month starting with a negative excess CAPE yield has delivered a ten-year real equity return above 2.87%

14. Building-Block Scenarios

A simpler cross-check requires no regression. The real return on equities is approximately the dividend yield, plus real growth in earnings, plus the annualised change in valuation:

Real return $\approx$ dividend yield + real earnings growth + Δ valuation

We assume a dividend yield of 1.2% and real growth in normalised earnings of 2.0% a year — between the 1.8% achieved since 1881 and the 2.4% achieved since 1950 — and vary only where CAPE ends in 2036 (Table 3).

Table 3: Illustrative 10-Year Real Equity Returns vs TIPS (% p.a.)

CAPE in 2036	Valuation drag	Real return	vs TIPS 2.87%	Comment
41x (unchanged)	0.0	3.2	+0.3	Perfection
35x	−1.6	1.6	−1.3	Mild de-rating
30x	−3.1	0.0	−2.8	2000s-style
25x	−4.8	−1.8	−4.7	Post-GFC average
17.8x (long-run average)	−8.0	−5.1	−7.9	Full reversion

Return = $(1 + 3.2\%) \times (\text{CAPE in 2036} / 41)^{(1/10)} - 1$. Illustrative, not a forecast.

Even if valuations never fall, equities are expected to beat TIPS by only about 0.3% a year — and investors bear full equity risk to earn it. Since 1900, 71% of ten-year windows contained a real drawdown of 30% or more, and 38% contained one of 50% or more. Any de-rating at all makes the expected excess return firmly negative.

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15. The Bull Case, Stated Fairly

Several arguments suggest CAPE overstates how expensive the market is. Each has merit; each also requires something to be true.

Structurally higher margins. Today's index is weighted towards asset-light, high-margin technology businesses that arguably deserve a higher multiple than the industrial index of the twentieth century. This requires those margins to prove durable through a cycle in which the real cost of capital has risen by around four percentage points since 2021.

Accounting changes. Siegel⁵³ argues that changes in accounting standards, particularly the treatment of write-downs, depress reported earnings and bias CAPE upwards. Even a 15% adjustment leaves CAPE near 35 — still in the 2000-era zone. Asness⁵⁴ has shown that CAPE retains its long-horizon predictive power despite such critiques.

An AI productivity boom. Faster earnings growth would close the gap. But the same investment boom raises the return on capital that safe assets must compete with, which is one reason real rates have risen. Faster growth arrives together with a higher hurdle.

CAPE is a poor timing tool. This is true: markets can stay expensive for years, as they did from 1997 to 2000. This note makes a statement about the next decade's expected return, not next quarter's price.

16. Investment Implications

First: the relevant hurdle is the real safe rate, not zero. Between 2012 and 2021 the real return on cash and government bonds was negative, and almost any risky asset cleared the hurdle. Every risky allocation must now be benchmarked against a riskless real return of close to 3%.

Second: TIPS are a competitive asset in their own right. A laddered TIPS allocation locks in roughly 2.6–2.9% real for ten years with no drawdown risk if held to maturity. In a low-expected-return world, that is a meaningful return rather than a defensive placeholder.

Third: passive equity beta is poorly compensated. At a CAPE of 41, the expected real return on US equities is approximately equal to, or below, the TIPS yield. Investors are being asked to bear equity risk for little or no expected reward.

Fourth: favour return sources independent of starting valuation. Systematic trend-following does not depend on the level of the market. Hurst, Ooi and Pedersen⁵⁵ document positive trend returns across more than a century, including during the largest equity drawdowns — a property that matters most when valuations are stretched.

Fifth: be explicit about what would change the view. We would revisit this assessment if the excess CAPE yield rose back above 2% (through lower prices or lower real yields), if the 10-year TIPS yield fell below 1.5%, or if the 5y5y breakeven rose above 2.75% — which would indicate a genuine inflation scare and change the rates thesis.

Conclusion

The financial press continually frames the 2026 bond sell-off as an inflation scare. The market's own pricing says otherwise. Breakeven inflation, at both the 10-year and the 5y5y horizon, sits at its long-

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run median. What has repriced is the real price of safe capital: the 10-year TIPS yield is the highest since 2008, the 5y5y real forward the highest since at least 2003, and the term premium has returned to its pre-GFC norm. The academic literature offers a coherent explanation — safety has become less scarce, bonds no longer hedge equities, and the captive, price-insensitive buyers of government duration are retreating.

Yet US equities are priced as if that repricing had never happened. A CAPE of 41 implies a cyclically-adjusted earnings yield of about 2.4% — below the 2.9% real yield on a riskless, inflation-protected government bond. Caballero, Farhi and Gourinchas showed that the falling safe rate of the past four decades opened a wide risk premium. That premium has now all but disappeared:

For a decade investors were told there was no alternative to equities — in real terms, there now is

History does not tell us when an expensive market will correct, and it may not correct at all. But it is unambiguous about the expected reward for owning one. When the real hurdle is high and the equity offer is thin, the patient investor is, for the first time in a generation, paid to wait.

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Data and Methodology

Rates are monthly averages of Federal Reserve H.15 constant-maturity nominal and TIPS yields from 2003 to September 2026, with daily values at 8 October 2026.³ Five-year, five-year forwards are computed as $[(1 + y_{10})^{10} / (1 + y_5)^5]^{(1/5)} - 1$ from par constant-maturity yields, consistent with the methodology FRED uses for its published 5y5y forward breakeven series; strictly, forwards should be derived from zero-coupon rates, and the difference is a few basis points at most.

CAPE, earnings, dividends and CPI are from Shiller's monthly dataset to September 2023.³² From October 2023 to September 2026, monthly S&P 500 prices are divided by a ten-year average earnings figure interpolated geometrically between Shiller's September 2023 value and the level implied by a CAPE of 41.0 in September 2026, as reported by Coolabah Capital Investments;⁵¹ the interpolation affects only the path, not the end-point.

The yen-hedged 10-year Treasury yield in Figure 3 is estimated as the 10-year Treasury yield less the hedging cost, approximated by the difference between US and Japanese 3-month interbank rates (OECD data via FRED). The hedged yield includes the cross-currency basis: compared with a simple estimate based on the 3-month US–Japan interbank rate differential, the basis has added around 0.45 percentage points a year to the cost of hedging since 2016.

The real bond yield used in the excess CAPE yield is the 10-year TIPS yield from 2003 and, before that, Shiller's long-term interest rate less trailing ten-year CPI inflation, a standard but noisy proxy; at the January 2003 splice the proxy was about 0.7 percentage points below the TIPS yield. Forward ten-year real total returns reinvest dividends monthly; the last complete window begins in September 2013.

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