The Sterling Capital VAULT

Return of the Term Premium

Long-term bond yields reflect the weighted path of the fed funds rate as determined by the Federal Reserve (Fed) plus a term premium. What is term premium and why is it important?

Definition

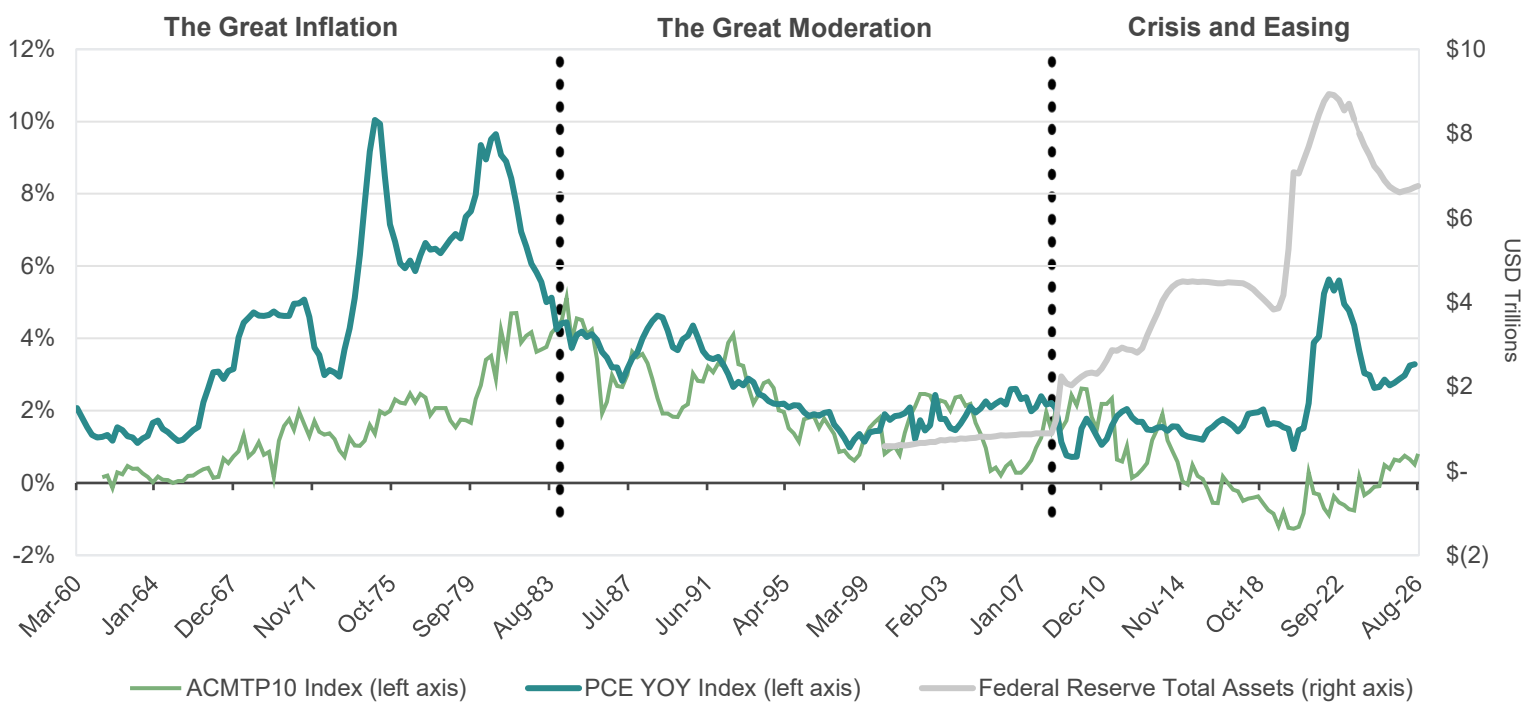
Put simply, term premium is the additional return investors demand for holding a longer-term bond instead of buying and reinvesting a series of short-term bonds over the same time period. This additional expected return compensates investors for interest rate risk, inflation uncertainty, and market liquidity preferences, among other factors, and is an important determinant of the shape of the yield curve.

Term premium is not directly observable or measurable, but it can be estimated with statistical methods that decompose yields into discrete factors. We favor the Adrian, Crump, and Moench (ACM) 10-year Treasury Term Premium model (ACMTP10)[1] as it was created by researchers at the New York Fed and benefits from its more simplistic, straightforward approach relative to other techniques. Of note, measures of term premium can vary significantly by hundreds of basis points, so viewing various estimates of term premium together can be worthwhile.

Historical Review

Term premium has demonstrated a relatively slow rate of change over time as investors gradually distinguish between one-time events and structural shifts. In the 1960s-1970s, as it became apparent that inflation was entrenched, investors demanded additional compensation to hold long-term bonds. As a result, term premium rose in fits and starts from effectively zero to >4% over a 20-year period.

Term Premium in Various Regimes



PCE: personal consumption expenditures. YOY: year over year. Chart data is as of 08.13.2026. Chart source: Bloomberg L.P. Regime classification added by Sterling Capital for illustrative purposes. [1]According to the Federal Reserve, New York Fed economists Tobias Adrian, Richard K. Crump, and Emanuel Moench developed a dynamic no-arbitrage linear term structure model to describe the joint evolution of Treasury yields and term premia across time and maturities, described in detail in Adrian, Crump, and Moench (2013). In these models, bond yields are driven by a small number of 'pricing factors' – which are linear combinations of yields, such as principal components – and which evolve over time according to a vector autoregressive (VAR) process. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees these methods will be successful. This information must be read in conjunction with the definitions and disclosures on the last page.

In the 1980s and 1990s, inflationary pressures eased as globalization and information/communication technology transformed the economy. Real growth surged and culminated in a fiscal surplus for the U.S. government in 2001 as they benefitted from strong demographic trends and productivity gains. Against this backdrop, general uncertainty fell, and term premium followed suit.

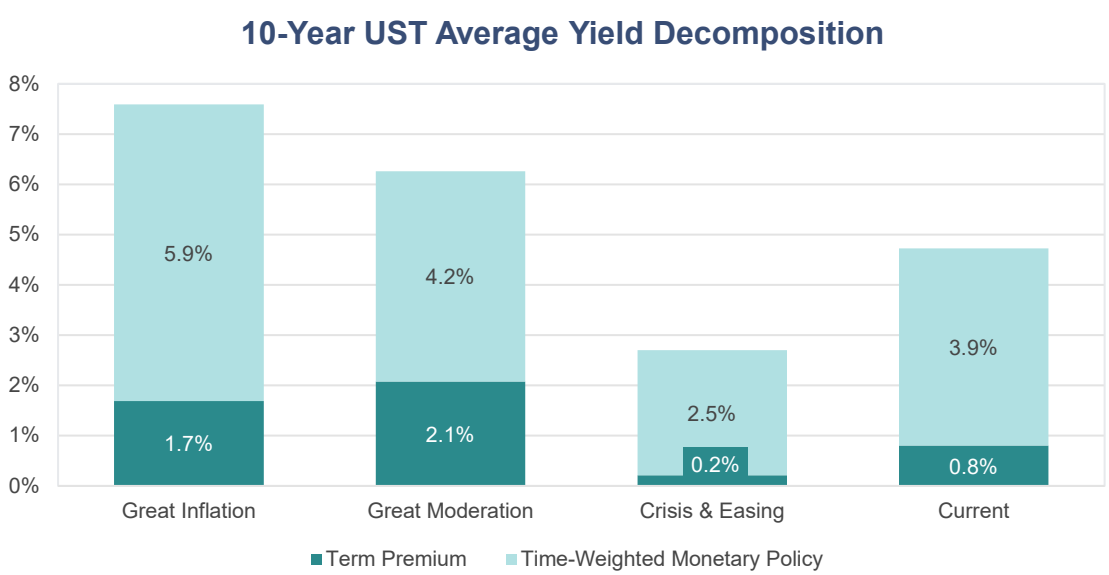
Following the Great Financial Crisis (GFC) in 2008 and the pandemic in 2020, the Fed notably expanded its balance sheet to support the financial system via quantitative easing (QE). During this time, term premium further retreated, even going deeply negative, as the Fed moved from being a marginal participant in the Treasury market to owning over $4T in U.S. Treasury bills, notes, and bonds today. The Fed's actions simultaneously skewed the supply/demand dynamics of the market and lowered the perceived risk of holding longer-term bonds, reducing the term premium demanded by the market.

Present Day

Today, we believe positive term premium has returned in a meaningful way.

Looking back to the beginning of 2024, ACM-estimated 10-year term premium has risen from negative territory to +80 basis points (bps), an increase of 114 bps. More than 25 bps of this cumulative total has materialized in the weeks following Fed Chair Kevin Warsh's first press conference on June 17. With this context, how much higher can term premium rise?

We believe that term premium is unlikely to reach prior highs. While long-term rates remain predominantly market-driven, the influence of policy actions on rates is structurally increasing. The Fed is now a large and permanent holder of U.S. Treasury instruments and is currently expanding the size of its balance sheet via reserve management purchases (RMP). Meanwhile, the Treasury Department has increased its T-Bill issuance to above-average levels, thereby reducing the amount of longer-dated duration the market must absorb. These actions suppress term premium. Furthermore, the Trump Administration is focused on lowering the 10-year yield, putting a higher term premium that we feel is at direct odds with their policy aims.



UST: United States Treasury. Chart data is as of 08.17.2026. Chart sources: Federal Reserve Economic Data (FRED); Sterling Capital Management Analytics. The views expressed represent the opinions of Sterling Capital Management. Any type of investing involves risk and there are no guarantees these methods will be successful. This information must be read in conjunction with the definitions and disclosures on the last page.

On the other hand, we believe Chair Warsh's actions to date may have contributed to more monetary policy uncertainty and thus a higher term premium, both directly and indirectly; directly, via reducing the degree of Fed communication known as forward guidance, and indirectly, via potentially making the Fed's reaction function less clear and predictable. In general, we feel that Chair Warsh appears to seek a reforming role at the Fed, including questioning the appropriate measure by which the Fed should manage inflation, arguing for a smaller Fed balance sheet, and creating various task forces to review the Fed's operations. With inflation around 3% (as measured by core PCE on a year-over-year basis) and a stated commitment to price stability and the 2% target, how the Fed ultimately chooses to balance the tradeoffs across these various issues could bear significant weight on term premium. Further, we feel the general lack of will on either side of the aisle in Washington to address U.S. fiscal health and reign in budget deficits may add additional uncertainty to the investment landscape.

Important Information & Disclosures

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A Note on Indices: The volatility of an index varies greatly. All indices are unmanaged, and investments cannot be made directly in an index.

The **core Personal Consumption Expenditure (core PCE) Index** is a measure of prices that people living in the U.S., or those buying on their behalf, pay for goods and services.

Technical Terms: the technical terms below are sourced from Corporate Finance Institute and the Bureau of Economic Analysis (BEA).

The **fed funds rate** refers to the interest rate that depository institutions (such as banks and credit unions) charge other depository institutions for overnight lending of capital from their reserve balances on an uncollateralized basis.

The Great Financial Crisis (GFC) of 2008-2009 refers to the massive financial crisis the world faced from 2008 to 2009. The financial crisis took its toll on individuals and institutions around the globe, with millions of Americans being deeply impacted. Financial institutions started to sink, many were absorbed by larger entities, and the U.S. Government was forced to offer bailouts to keep many institutions afloat.

Quantitative easing (QE) is a monetary policy of printing money that is implemented by the Central Bank to energize the economy. The Central Bank creates money to buy government securities from the market in order to lower interest rates and increase the money supply.

Quantitative tightening (QT), also known as balance sheet normalization, is a type of monetary policy followed by central banks. It simply means that a central bank reduces the pace of reinvestment of proceeds from maturing government bonds.