The Price of Capital

For much of the post-financial-crisis era, some investors worried that the world had too much capital and too few productive uses for it. Interest rates hovered near historic lows across developed markets, governments borrowed cheaply, and companies could finance ambitious projects at modest cost. An investment challenge of that era was determining how to invest in a world with easy access to capital.

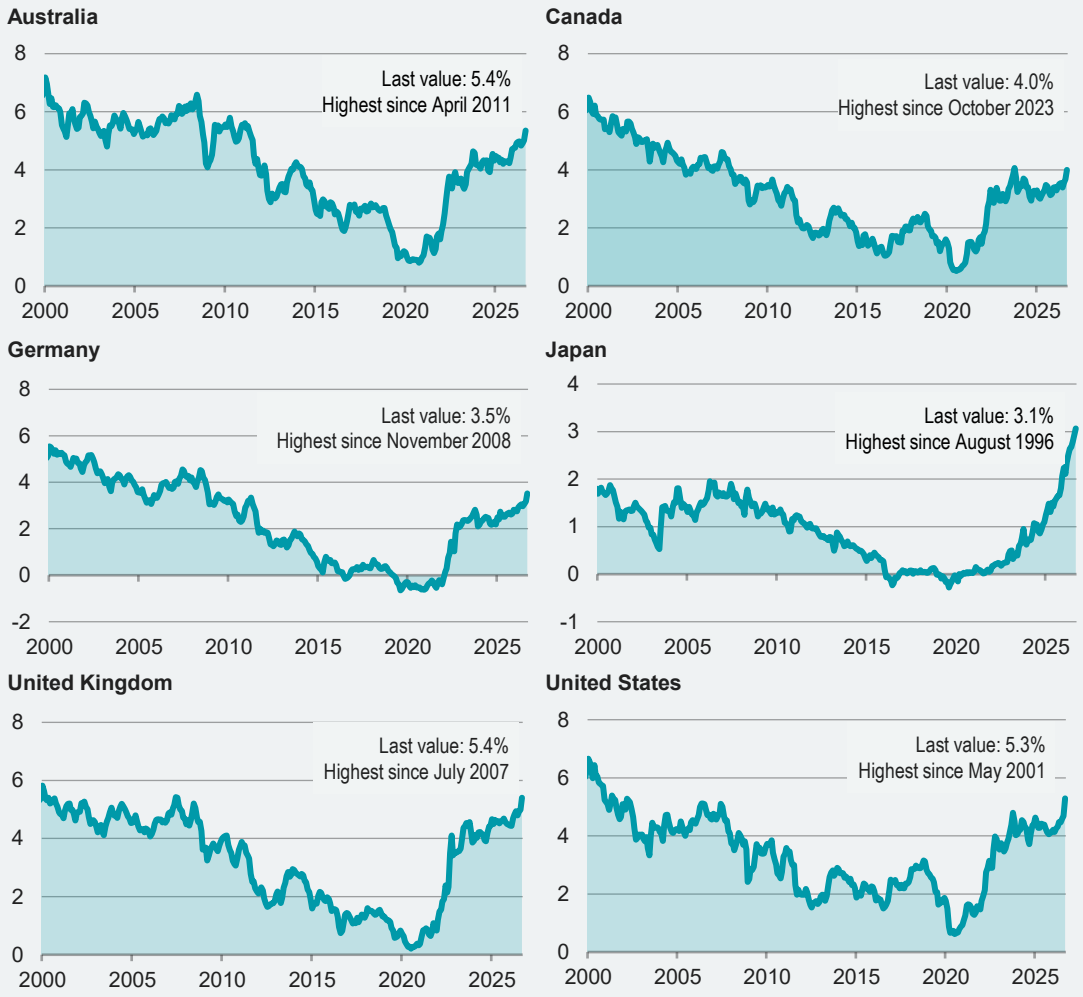
Today, the environment looks different. Government bond yields have risen sharply in recent years and moved higher again over the past month, with several countries approaching or exceeding post-pandemic highs, as shown in **Figure 1**. Inflation and central bank policy have clearly contributed to this move, but they may not be the only factors influencing yields.

At its core, an interest rate is the price of capital, balancing the willingness of investors to supply capital with the demand for investment and financing. Viewed through this lens, the recent rise in yields may represent more than a shift in inflation or monetary policy. It may reflect stronger demand for capital, less willingness to supply that capital, or some combination of the two.

Of course, the future path of yields remains uncertain. What is less uncertain is that a higher cost of capital raises the returns investors require from both fixed income and equities.

Figure 1 | Global Sovereign Bond Yields Are Near Multi-Decade Highs

10-Year Yields (%, January 2000–September 2026)



Sources: FactSet and Organisation for Economic Co-operation and Development.
Notes: Data reflect OECD's monthly average 10-year constant maturity government bond yields. Last data point of each series reflect FactSet month-end data.

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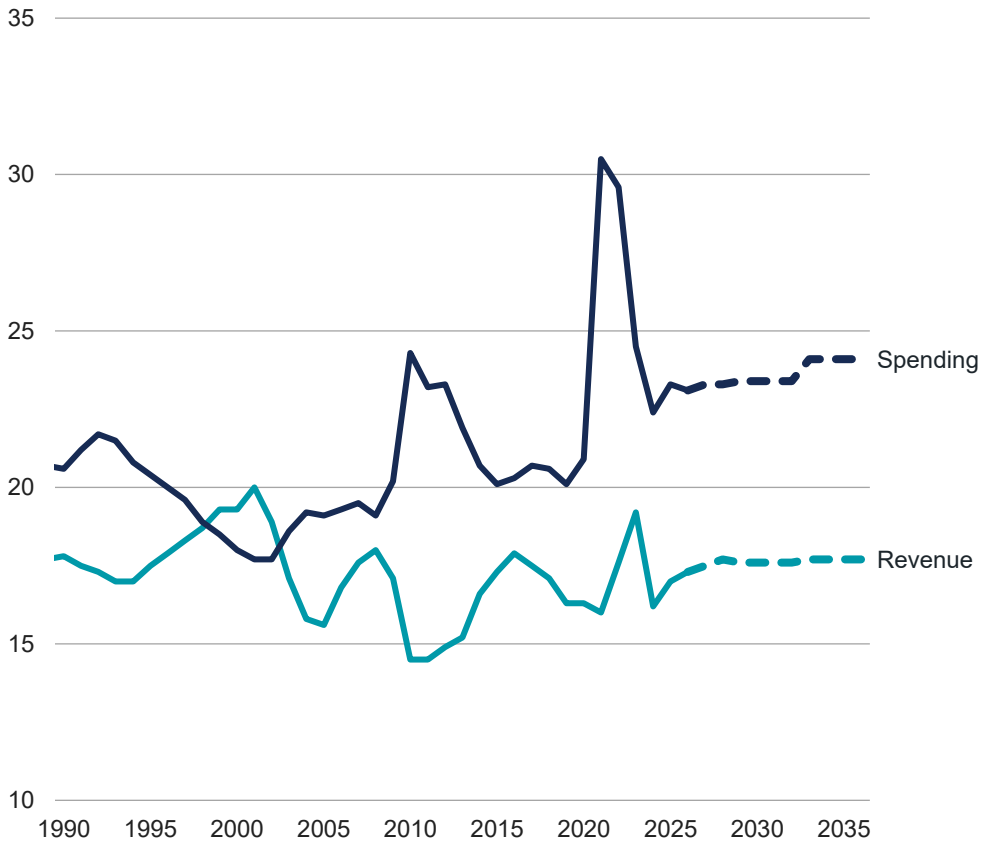
The Competition for Capital

Inflation remains an important part of the discussion surrounding higher yields. One reason inflation does not fully explain the rise in yields is that bond yields reflect both expected inflation and the return investors receive above inflation, known as the real yield. Across many developed markets, much of the recent increase in yields has come from higher real yields rather than higher inflation expectations. While higher energy prices linked to the war in Iran have raised near-term inflation concerns, longer-term inflation expectations have remained relatively stable, suggesting investors continue to view central banks as capable of preventing the energy shock from becoming persistent inflation.

Higher real yields have coincided with elevated government demand for capital. Fiscal deficits remain elevated across much of the developed world, adding to debt burdens that have accumulated over many years. As shown in **Figure 2**, U.S. federal spending exceeds tax revenue by roughly 6% of gross domestic product (GDP) and is projected to remain so for the foreseeable future. Meanwhile, debt issued during years of exceptionally low interest rates is increasingly refinanced at higher borrowing costs, pushing annual interest expense to nearly 4% of GDP. The combination of persistent deficits and rising interest costs has increased governments' need for capital across much of the developed world.

Figure 2 | U.S. Federal Budget Gap Is Expected to Persist

Federal revenue and spending as a percentage of GDP (1990–2035)



Sources: U.S. Office of Management and Budget (OMB) and Congressional Budget Office (CBO).
Notes: Federal revenue and spending are shown as a percentage of U.S. GDP. Historical data through 2025 are from the Office of Management and Budget. Projections for 2026-2035 are from the Congressional Budget Office. Dashed lines indicate projected values.

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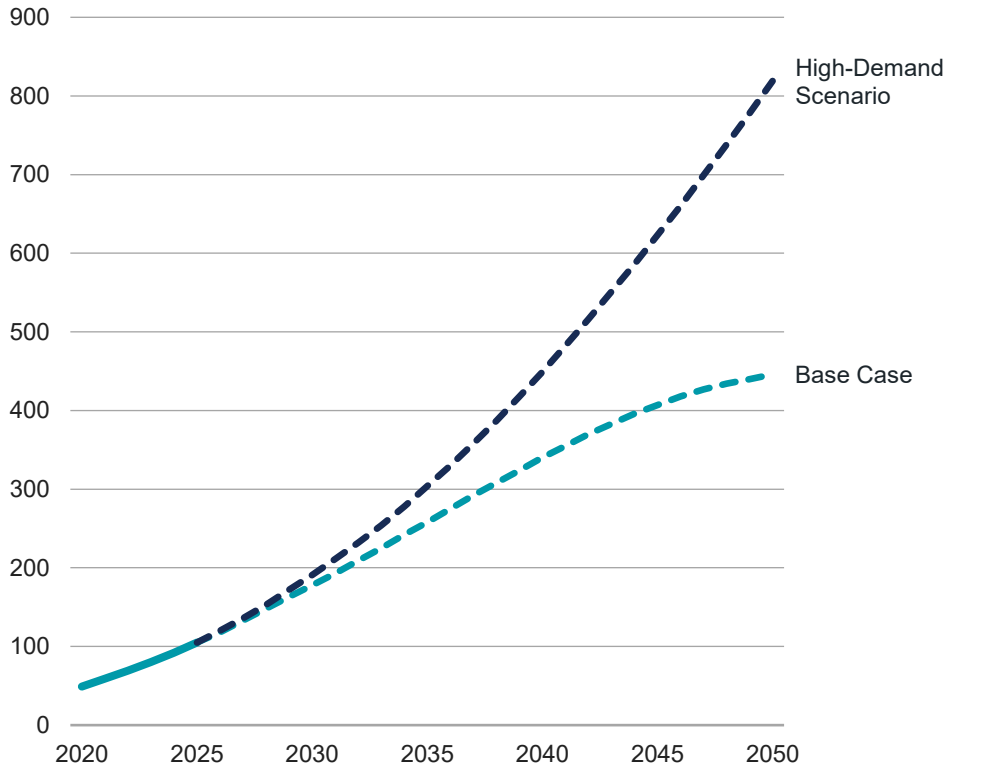
Yields may also be reacting partly to expectations of private-sector demand. Artificial intelligence (AI) has triggered one of the largest technology investment cycles in decades, with its promise to improve productivity. Capital expenditures among five major hyperscalers — Alphabet, Amazon, Meta, Microsoft, and Oracle — have risen dramatically and are projected to continue increasing in the coming years. Aggregate capital expenditures have grown from less than $100 billion in 2020 to nearly $700 billion in 2026. Importantly, these figures do not fully capture the scale of the buildout.

A significant increase in AI adoption would require additional investment across large parts of the economy. **Figure 3** illustrates one example, showing that data center electricity consumption is projected to more than double over the next decade under the U.S. government's base-case forecast. Meeting that demand would involve investment in power generation, transmission networks, substations, cooling systems, and other physical infrastructure. These projections illustrate how hyperscaler spending could contribute to a broader demand for capital.

Individually, none of these developments fully explains the rise in yields. Collectively, they illustrate how governments, businesses, and infrastructure projects may make larger claims on global savings at the same time. Because interest rates help balance the supply of savings with the demand for financing, these developments provide a useful framework for understanding the higher cost of capital.

Figure 3 | Data-Center Growth Is Increasing Demand for Power Infrastructure

U.S. commercial data-center server electricity consumption (billion kilowatt-hours, 2020–2050)



Source: U.S. Energy Information Administration.
Notes: Historical and projected U.S. commercial data-center server electricity consumption is shown in billion kilowatt-hours. The dashed lines are projections and represent the reference case and high electricity demand cases. Data are from the Annual Energy Outlook 2026, released in April.

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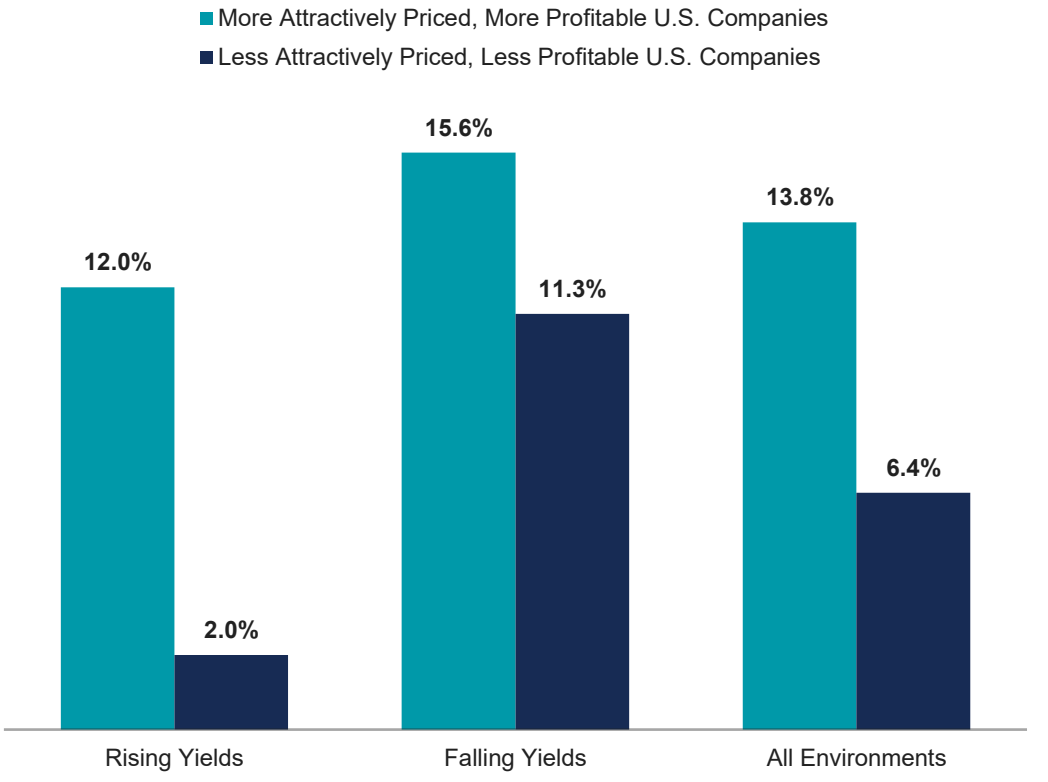
When Capital Matters More

A higher price of capital is not necessarily negative for equity markets. While yields are higher than they were for much of the post-financial-crisis period, many remain below their long-term historical averages, including the benchmark U.S. 10-year Treasury note. Investors have navigated both higher- and lower-rate environments over time, and equity markets have generated substantial long-term growth in both. Historical evidence can nevertheless provide some context for thinking about today's environment.

One perspective on how different types of companies have performed across interest-rate environments is shown in **Figure 4**. It divides the full historical sample into periods of either rising yields or falling yields and compares the returns of more attractively priced, more profitable U.S. companies with those of less attractively priced, less profitable companies. The more profitable, attractively priced group outperformed in both environments, as would be expected, and the return difference was larger when yields rose. These results suggest that disciplined attention to profitability and valuation has been rewarded in both rising- and falling-yield environments.

Figure 4 | Returns to Profitability and Valuation Have Persisted Across Yield Environments

Annualized returns during rising and falling 10-year U.S. Treasury yield environments (July 1963–July 2025)



Sources: Kenneth R. French Data Library, Federal Reserve Bank of St. Louis (FRED), and Avantis Investors calculations.
Notes: Monthly U.S. equity returns are from the Fama-French 5×5 portfolios sorted on book-to-market equity and operating profitability. More Attractively Priced, More Profitable Companies and Less Attractively Priced, Less Profitable Companies are market-cap-weighted composites from the most and least favorable regions of the 5×5 matrix, respectively. The analysis uses the full monthly history available from the Fama-French data library. Yield environments are based on monthly changes in the 10-year U.S. Treasury yield. Returns are annualized. **Past performance is no guarantee of future results.**

The Price of Capital

Fixed-income investors face a different set of considerations. Most bond indexes are weighted by debt outstanding, meaning issuers receive greater benchmark weight as they borrow more. As shown in **Figure 5**, that mechanic has materially changed the composition of the U.S. bond market. In fact, U.S. Treasury securities increased from less than one-quarter of the public investment-grade market in much of the 2000s to nearly one-half today.

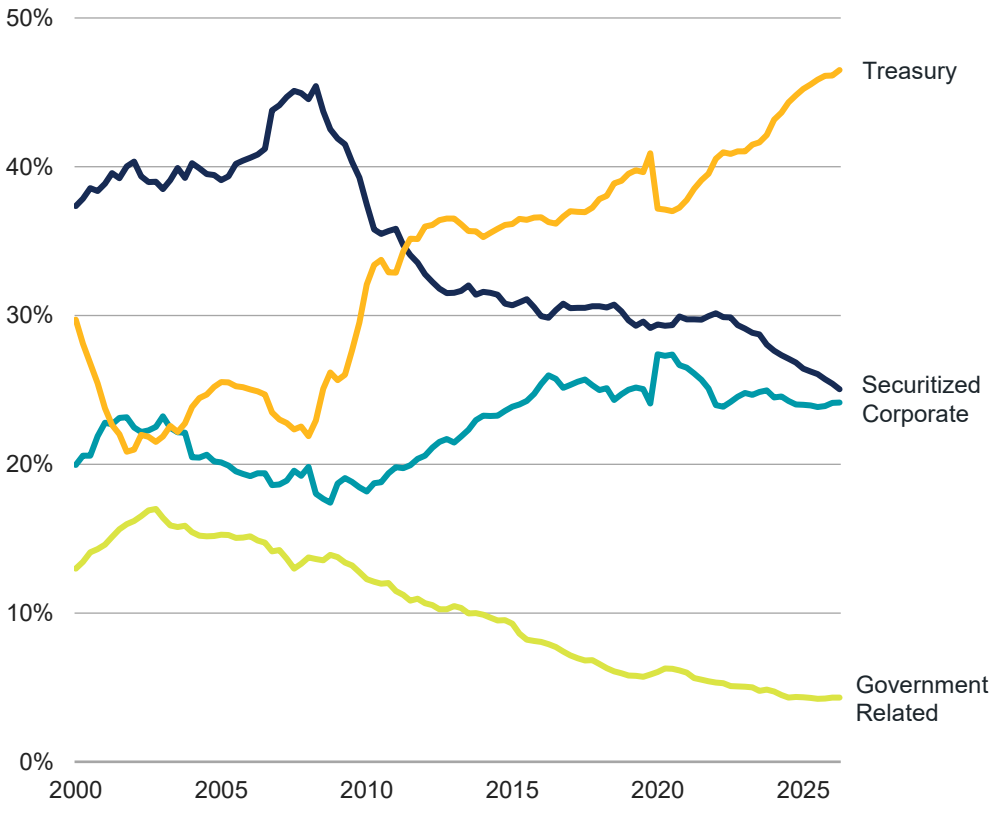
Treasury securities can provide liquidity, diversification, and protection. But their growing weight highlights an important distinction between equity and bond benchmarks. Equity indexes generally allocate more capital to companies that become more valuable. Bond indexes generally allocate more capital to issuers that create more debt. Benchmark composition, therefore, reflects where borrowing has occurred, not necessarily where investors receive the most attractive combination of yield, maturity, credit quality, and price.

A Disciplined Investment Process

Markets involve uncertainty. The challenge is not identifying every winner in advance. It is allocating capital in a way that balances expected returns and risks across a wide range of possible outcomes. A higher cost of capital may influence the opportunity set available to investors, but it does not change the importance of diversification, valuation, and a disciplined investment process. Those principles remain relevant across market environments.

Figure 5 | Government Borrowing Has Reshaped the Bond Market

Sector weights in the Bloomberg U.S. Aggregate Bond Index (2000–2026)



Source: Bloomberg.
Notes: Sector weights are based on market value. The four sub-indexes shown sum to the Bloomberg U.S. Aggregate Bond Index. Government Related includes agency and supranational issuers. Securitized includes mortgage-backed, asset-backed, and commercial mortgage-backed securities.