Bonds and the Fed's New "72D Chess" Playbook

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August 7, 2026

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Ed D'Agostino: Situational Awareness is an AI-focused hedge fund that nearly blew up in the span of a week when AI stocks were dropping, all due to leverage. They borrowed too much money — and that's something Americans know a lot about, as our federal government continues to spend more than it takes in. So what do higher interest rates mean for our government, for Japan, and for most of the Western world? Was Situational Awareness just the first domino to fall? Let's get into it with my friend Jared Dillian, who's just out with a new book called The Awesome Portfolio.

Ed D'Agostino: All right, I'm here with my friend Jared Dillian. JD, it's always good to see you. Thanks for being here.

Jared Dillian: Yeah, of course. Happy to be here.

Ed D'Agostino: I want to chat with you about global bond yields — the most exciting topic in the world. Actually, it might get to be the most exciting topic in the world soon, if yields keep going up.

Jared Dillian: Well, as you know, I like bonds here.

Ed D'Agostino: Yeah, you're the last man standing, I'd say. But when everyone else was a bond bull, you weren't. So talk through that. Why are you into it now?

Jared Dillian: It's funny, because people like to buy the dip in stocks, but they don't like to buy the dip in bonds. Yields are pretty good here. We got out to 530 on bonds; they're at about 518 right now. You've actually had a pretty decent rally. Tens are a little below 470. That doesn't sound bad to me — almost 5% for 10 years sounds pretty good.

Bond traders used to talk about this thing called the rule of sevens. The rule of sevens says that any time you get to a big round number in yields, there's usually demand. So you get to 5% in bonds, and people say, "Look, 5% looks pretty good, I'll get involved here." Bonds don't usually crash. I can't think of an instance — maybe 2022 — but even in 2022, you rarely have an instance where yields shoot up. It's usually the opposite: bonds crash up and yields shoot down. If bonds are selling off, it's usually a slow grind that happens over time.

The bond market generally doesn't crash, because any time you get out to a new level in yield, you get value buyers. You say, "Okay, I like them at 510. I like them at 520. I like them at 530." And you're starting to see a bit of a rally in the last couple of days. I think the inflation story is way overblown — way overblown. CPI beat the estimates by 0.7 the last time. PPI was a big beat. PCE was a big beat. And you're seeing confirmation now in the last couple of days: oil is down nine bucks in the last two trading sessions. So if we get to the next FOMC in September and oil is trading at 65 and the war is pretty much over, do you think Warsh is going to hike rates? No, of course not. I don't think he'd hike rates if oil was at 200. I just don't think he's going to hike rates.

Ed D'Agostino: Can you talk about the game Warsh is playing? There's a lot of dispersion of opinion on Warsh. Some say he's losing the confidence of the market —

Jared Dillian: That's very linear thinking. Linear thinking is based on the old model of the Fed, which was that the Fed should hike rates to stop inflation — and they didn't hike rates, so they lost the bond market, and the Fed is losing credibility. It's totally the wrong way to look at it.

Warsh knew the curve would steepen when he didn't hike rates. He knew that was going to happen. And he has profound philosophical differences with Powell, with Yellen, with Bernanke. He thinks the Fed should have a much smaller role in the economy, in all respects. He's talking about getting rid of FOMC meetings, for starters. He thinks the markets should be conducting monetary policy. So with the Fed absent from that last rate decision — deciding not to hike — he knew the curve would steepen. He knew the long end of the curve would tighten. The market did the tightening for him at the long end. You saw mortgage rates go from six and a half to almost seven very quickly. That's an immediate tightening on the economy. If he had actually hiked rates and the curve flattened and mortgage rates came down, that would have been more accommodative. So Warsh is way ahead of everybody else here. That's the way I look at it.

Ed D'Agostino: Is that action hitting the wrong parts of the economy? I don't think there are too many people right now saying the housing market is overheated.

Jared Dillian: I use the housing market as an example, but if you look at 10-year rates, that's a proxy for not just residential real estate, but commercial real estate and the financing of any capital project a company has. It's more than just residential real estate.

Ed D'Agostino: Sure.

Jared Dillian: There's an immediate tightening effect, and Warsh knew that was going to happen. Now, I did not foresee that. You and I had a conversation — our weekly call — and you asked me what the Fed was going to do. I said it was either going to be a massive steepening or a massive flattening. I said it was going to be a curve trade. But what I did not anticipate was that Warsh was going to do it on purpose.

The other thing: I saw an interesting thing on Twitter from a guy who calls himself Ed Bradford — it's a pseudonym; his handle is Full Carry. He's the one Treasury guy on Twitter. It was a screenshot of something, and he blacked out the name of the Fed official, but it was from a Fed official. Basically, what this person was saying was that they were going to let the long end do the tightening so they could bring down short-term rates — which is the ultimate goal, and which also gets Trump off his back. So if he steepens the yield curve and actually lowers Fed funds, he accomplishes a whole bunch of things at once.

The old model — "if you see the threat of inflation, you hike rates" — people have been questioning for years. The efficacy of Fed policy, and how, counterintuitively, hiking rates is actually inflationary and lowering them is deflationary. People have been making that argument for a long time, and I actually think it's kind of true.

Ed D'Agostino: So what do you think this means for Treasury? We're such a debt-laden nation, and it's only getting worse. How are we going to fund that? Are we just going to keep issuing three-month notes?

Jared Dillian: Bessent's goal when he took over as Treasury Secretary was to term out the debt. He was trying to get yields lower so he could term out the debt, and he never did it. So basically, we're in the same position we were in when Yellen was Treasury Secretary.

Ed D'Agostino: Which he criticized — he criticized Yellen pretty aggressively about that.

Jared Dillian: And we're still in the same position. But having said that, what Warsh did actually improves our fiscal condition. If he had hiked Fed funds and twos went to 4.5% — and I'd say two-thirds of our debt is in bills and twos — we would have had more interest expense. It's funny: people look at bonds going to 530 and say, "Well, we're screwed, we're bankrupt now." Actually, we don't owe that much in 30s — it's pretty small. We don't owe that much in tens either. I think the average maturity of our debt is around five and a half or six years. So that's another goal Warsh accomplished: by not hiking rates, he didn't raise our interest expense.

Ed D'Agostino: So there's a little 3D chess happening here in your mind.

Jared Dillian: 72D chess. It was very smart. Very smart.

Ed D'Agostino: Do you have any thoughts on what's happening in Japan right now? Japan is a large holder of US Treasuries. The yen is weak, there's been intervention on the part of the US Treasury to support the yen and prop up its value. Any thoughts — are they trying to keep the Japanese from having to dump a bunch of Treasuries?

Jared Dillian: From a trading standpoint, the intervention has been both from Japan and from the US. I think this is the first time the US has intervened in the yen in a really long time — I don't remember the exact date, but decades ago. And it's gotten the yen 5% or 6% higher, I think, at this point. There are a lot of people waiting for an opportunity to short it. Ultimately, Japan could appreciate the yen by just raising rates. But they can't, because they have 240% debt to GDP. So they're stuck.

I don't want to play this game of being short the yen while Bessent is in charge, because the BOJ spent 32 billion to intervene. I don't know what the number was on the US side, but there's a lot more behind it. If they really wanted to — and I'm not saying this is going to happen — they could continue to intervene and take dollar/yen to 155, 150. They really could. And I don't want to be involved in that. I just can't handicap it.

Ed D'Agostino: There's an argument out there that Bessent is trying to mitigate the negative impacts of the yen carry trade unwinding. Do you think there's any validity to that?

Jared Dillian: No, I don't think so. I could be wrong, but I don't think so. Look, the yen is objectively very cheap. We have stupid American tourists going over there to buy Pokémon cards. They're having dinners for four for $30. It's very cheap there. Bessent also has a history of making money on his currency intervention — he made money in Argentina, bought the peso, sold the peso, made a couple billion dollars. He's buying the yen at extremely cheap levels. He's a trader.

Ed D'Agostino: With a great pedigree, right? Was he with Druckenmiller at one point?

Jared Dillian: Soros.

Ed D'Agostino: Soros. Yeah. I'm trying to orient this conversation around leverage, because a lot of what's happening seems to be debt-driven. Another example would be the Situational Awareness Fund that got the huge margin call recently. That, I think, was basically the stock market getting spooked — tech stocks selling off, AI stocks selling off — because they thought Warsh was going to raise rates. So it was a short-term event, but this fund was so leveraged that they got a margin call they couldn't handle.

Jared Dillian: In any bear market or crisis, there's always a player that's super, super leveraged that gets blown up first. And everybody then says, "Phew, it's over. That was it." In 2008 it was Bear Stearns. Bear Stearns blew up, JP Morgan took them over at $10 a share, and everyone said, "Financial crisis over, everything's fine." And then the stock market rallied 17% for the next three months, and then we got to the main event, which was Lehman.

So I think this was the starting gun for a tech bear market. It's hard to see that right now, because before I walked in here the S&P was up 2%. It was up 1.5% yesterday. It was up the day before. It's been a rocket ship for the last four days. But I really do think that was the starting gun on the tech bear market.

One of the things I've been thinking about: OpenAI is going to go public. When that S-1 comes out, it is going to scare the hell out of people. When people take a look at the guts, the innards, of what the AI business looks like — how it's just an intractable, cash-burning machine — I really think people are going to freak out.

Ed D'Agostino: I don't disagree.

Jared Dillian: Yeah.

Ed D'Agostino: I'll be the first to say AI is not going anywhere, but I don't get a warm, fuzzy feeling from Sam Altman. Do you? Would you want him dating your sister?

Jared Dillian: I don't know the whole background on Sam Altman. I don't know why Elon Musk hates him. I get that he had a non-profit and turned it into a for-profit and all that stuff, but a lot of people think this guy is a sleazeball, and I haven't really dug into why. I don't understand it.

Ed D'Agostino: Well, you have better things to do. You like bonds, you don't like tech stocks. Do you like gold?

Jared Dillian: Gold is forming a nice little base — acting well yesterday and today. Just from a short-term trading perspective, I think we need one more push down to 4,000 to scare people one last time. But maybe that never happens. The chart is starting to look much better. Interestingly, platinum is up 7% today — the first signs of life in platinum in a really long time.

Ed D'Agostino: One of the things — and I'm guilty of this, I try to keep it in mind — on podcasts like this, where we're discussing investments, we don't really talk about time horizon, or how you think about markets. So somebody who doesn't know you as well as I do might say, "Wait a minute, Jared is saying it's not necessarily the time to buy gold, because of the chart or the technicals." And yet, if I read something else you write, you say you should always have an allocation to gold — a 20% allocation. Can you talk about how investors should reconcile that? A lot of casual investors go to YouTube, of all places, to get their financial information, and it's really easy to confuse yourself.

Jared Dillian: Yeah, it's just a matter of time horizons. For 99% of people, who are not active traders, you should just have 20% of your portfolio in gold all the time. And I've told you before, I have 40% in mine. So the drawdown from 5,600 to 4,000 has been super painful. But my time horizon is basically infinity — or 5 to 10 years. A really long time.

What I was just talking about was short-term trading. If you're a futures trader or a day trader, the entry points are really important, because if you buy it at 4080 and it trades down to 3980, that's going to be painful. But if your time horizon is 10 years, you don't really care whether it's 3980 or 4080. Just buy it. It doesn't matter.

Ed D’Agostino: You wrote a book about this sort of thing — about how to think about portfolio construction, especially if you're not a market participant. Tell me a little bit about the new book. When's it coming out?

Jared Dillian: The Awesome Portfolio is being published by Harriman House. It's being released September 8th, so just about a month from now. Look, I don't really care if I make money off this book — that's a secondary concern. I want lots of people to read it and implement this strategy, because this is the smartest way to save for retirement, and the way people do it right now is bad. Very bad.

Ed D’Agostino: Without giving away all the secrets you wrote in the book, tell me how this is different from the conventional way people are counseled to save for retirement now. I'm not going to name names of companies.

Jared Dillian: I'll answer your question with a story. You know I write for Reason magazine. I don't remember the article I did recently — it had something to do with the stock market — and I mentioned index funds. My editor wrote back to me. She said, “Well, people should invest in something safe, like index funds.” And I was like, “D'oh.” I hear this all the time — index funds are conservative, they're safe, the S&P 500 is safe. Ed, did you know the S&P 500 is safe?

Ed D’Agostino: It's perfectly safe. Sure. I love concentration.

Jared Dillian: I get this all the time. The S&P 500 has gone down 50% or more four times in the last 100 years. If you're saving for retirement — if you're 22 and you're going to retire at 62 or 72 — in that 40- or 50-year period, you're almost guaranteed to have one of these big bear markets. Maybe two, maybe more, plus 20% corrections and 10% corrections. And over the course of your investing career, you're going to feel all kinds of emotions as you go through these drawdowns.

The S&P 500 in the financial crisis went down 57%. So if you had a million dollars saved up, you now have $430,000. Ninety percent of people are just going to vomit — they're going to tap out and stop compounding. The 10% who hang on are going to be miserable until they get back up to the high-water mark. They're going to be very sad. So this is a way to save for retirement with very minimal volatility — hardly anything in the way of drawdowns — and the trade-off is basically 2%, maybe 1%, on your returns. If you can live with making 1 or 2% less to eliminate that volatility and stress — and you never have to look at your investments, you can just go do your thing — you're totally happy.

Ed D’Agostino: I can't tell you how many people I know who are in their 60s and well into their 70s who are essentially all stocks plus their house.

Jared Dillian: Yeah. And the great thing about The Awesome Portfolio is that you don't have to do any of this brain damage of changing your asset allocation over time. The conventional wisdom is that you start out with a lot of stocks, and then you get old and start moving into bonds — which people aren't doing, but that's what they should be doing. But you'd move into bonds over time, and that requires some thinking. This portfolio is suitable for people at any stage of life. All you have to do is rebalance it once a year. That's it.

Ed D'Agostino: So, The Awesome Portfolio, from Harriman House — can you order it now?

Jared Dillian: Yes, you can pre-order it, and you'll get it on September 8th. I highly recommend you pre-order it — it would help me out a lot, so please do that. It's not a long book; it's about 200 pages, a very quick read. I'm going to absolutely blow your mind. I actually get into the math, which is a little bit of a risk, because some people don't like math. It's funny — in No Worries, which is over here (I have my copy of No Worries), which came out in 2024, I have a chapter on The Awesome Portfolio that's just a brief overview. A lot of the reviews I got on Amazon were people saying, "Well, he never went into the math behind it." And I'm like, "Okay, well, here we go — now we're going to get into the math." I'm going to prove it to you. I'm going to prove that the Sharpe ratio on this is through the moon. It is the optimal portfolio.

Ed D'Agostino: And you can learn more about it at your website, jareddillianmoney.com.

Jared Dillian: Yep.

Ed D'Agostino: Good luck with your book. I'm excited to see it come out.

Jared Dillian: Thanks. We're going to do this again next week, right? We're going to talk about the book again.

Ed D'Agostino: We're going to do a podcast every day until September 8th to talk about the book, yes.