

(Bloomberg) -- Hello and welcome to the newsletter, a grab bag of daily content from the Odd Lots universe. Sometimes it's us, Joe Weisenthal and Tracy Alloway, bringing you our thoughts on the most recent developments in markets, finance and the economy. And sometimes it's contributions from our network of expert guests and sources. Whatever it is, we promise it will always be interesting.

If you like chatting with us, check out the Odd Lots Discord, where you can hang out and talk with us and with other listeners 24/7.

Here's what Tracy's thinking about...

The big story in markets right now is an almighty selloff in government bonds, particularly those issued by countries like the US, UK and Europe.

Much of the selloff has been attributed to a pickup in inflation expectations as the Iran War and its associated oil shock continue to roll on. But there's a strong argument to be made that what we're seeing right now is something more secular, less 'transitory' and more about a substantial repricing of real rates. If that's the case then it suggests that higher real rates may be here to stay for some time.

There are two megatrends that matter here.

The first is the AI buildout and the massive amount of capital that is being dedicated to it. The scale of capital being deployed into data centers, chips and related infrastructure is enormous and still accelerating. Not only is a huge chunk of the investment-grade corporate bond market tied to the AI buildout, it's even starting to become a big component of the junk-rated market too.

Importantly, this isn't just a tech sector story — it is a broad capital demand story, sucking up financing from across the credit spectrum and competing directly with sovereign borrowers for funds.

The second has to do with what I'll call

the chokepoint economy, or the idea that governments all over the world have become more attuned to economically-important shortages and the need to build up domestic capacity and resilience. The policy response is visible everywhere and includes stockpiling, reshoring, subsidizing production, retooling supply chains and so on.

All of these policy responses are also capital intensive and represent a sustained shift towards higher baseline investment — often funded through bigger deficits. That's also upward pressure on real rates.

The ECB's Isabel Schnabel summed up the idea in a recent Reuters interview. "Even if the war ended today, a lot of damage has already been done to energy infrastructure and global supply

chains,” she said. “So, even then, I believe that a monetary policy reaction would be needed.” They key thing here is that the supply-side damage outlives the immediate shock.

Crucially, both these megatrends end up reinforcing each other. The AI buildout puts pressure on existing energy systems and supply chains, intensifying some of the chokepoints governments are trying to resolve. At the same time, efforts to build up domestic capacity end up further increasing capital demand.

And even a relatively benign economic outcome can end up being consistent with higher yields. “AI may present an ongoing positive supply shock that supports future growth and productivity, pushing real rates higher while limiting forward inflation risk,” says Barclays Cross-Asset Research Team.

This is also the view of John Briggs over at Natixis, who’s been writing about a new and more elevated real yield regime in the US. He argues that higher productivity should increase demand for capital “because future returns on investment are expected to be higher.”

The big takeaway from all of this is that even if we were to get a peace deal today, yields may not fall very far in response. Infrastructure and petroleum stockpiles will need to be rebuilt. And barring a huge shift in the behavior of investors, AI will continue to Hoover up hundreds of billions of dollars in funding.

Of course, it’s early days. As the Barclays team also notes, “we will not know what the true drivers of the current [bond market] price action are until we have the luxury of hindsight.” But at this point, I think there’s ample reason to consider the current bond selloff as more the market repricing the cost of building in the future, rather than the market repricing immediate inflation risk.

What Joe is thinking about today I like our podcast episodes that deal with industrialization. I think those conversations are interesting. They might even be important (if, for example, the US is serious about rebuilding domestic manufacturing that is competitive with China).

Still, many of the industrialization conversations leave me a little bit unsatisfied. Because when people talk about what works and what doesn’t work, they usually point to a handful of examples in East Asia (Korea, Taiwan, Japan, and of course China) and the strategies these countries used to rapidly climb the value chain.

Again, these are interesting conversations, but it would be nice to have more examples that aren’t just from East Asia. Otherwise the advice sounds to me like “if you want to industrialize, you should be Korea, Taiwan, Japan, or China” which isn’t very useful advice to most countries.

Over the weekend, we released an episode of the podcast with Norman Foster, renowned architect and founder of Foster + Partners who among other things, designed the new JPMorgan HQ in Manhattan as well as Bloomberg’s gorgeous London offices. He’s probably one of last of the so-called starchitects, or one of the few architects who has ever been close to being a household name (at least in a relatively small number of households).

I went into the interview expecting to talk about the changing nature of design work; perhaps the

influence of social media on visual aesthetics or the future of the profession in the world of AI. We did talk about all of that to some extent.

What I wasn't expecting was how much political economy we got into, and why the West often struggles to build big, while the world gawps at the huge engineering projects that we regularly see out of China.

One interesting point he made is that when you look at the heyday of British engineering and design, much of it took place in the immediate wake of WWII, after the Allies had secured victory, while rationing was still being imposed on the British consumer. As he noted, people had coupon books that limited their purchasing capabilities, and thus to some extent, a household's purchasing power was severed from its income.

This reminded me of a very commonly discussed aspect of Chinese industrial success, which people refer to as financial repression. While there's a lot of talk about boosting household consumption (particularly out of Beijing) in recent years, the reality is that China is known for its modest welfare state (which encourages a high savings rate), the country's lack of unions, and that households tend to get poor returns on their savings and investments.

So in theory the net effect is that household consumption is kept in check. Meanwhile money flows into capital investment, and the industrial economy isn't competing so much with the consumer economy for real resources.

This isn't my area expertise, so you'll have to forgive my pidgin understanding of economy history. But when I think about these things, it seems obvious that societies living above subsistence is still an incredible recent development in human history. And that when you look at countries that have achieved a relatively high level of productivity and wealth, these types of constraints on household purchasing looks fairly common.

Perhaps when we talk about (re)industrialization, we can actually say more than just "be East Asia." We can also talk about difficult choices that countries have to make with respect to household purchasing power. That's of course politically difficult, but at least marginally more useful.

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