

The Bond Market View: Pressure building

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Key points

- Sovereign 30-year yields have reached their highest levels since the Global Financial Crisis in many countries
- Markets expect the Federal Funds rate to rise to around 4.25% over the next year
- Global spending on artificial intelligence, net zero, defence and resilience is intensifying competition for capital
- Australian 10-year bond yields have moved above the 15-year highs reached in March
- Australia's fiscal consolidation should limit pressure on longer-term yields and rates

Global bond markets remain under significant pressure as the themes and consequences from the new economic and geopolitical era to emerge since COVID become ever clearer. The focal point in recent times has been 10-30yr sovereign bond yields, where the combined impact of competition for capital, inflation fears and economic policy credibility bite most. Sovereign 30yr yields have touched their highest levels since the disinflationary 2008 Global Financial Crisis (GFC) in many countries (chart 24).

Japan's bond market in the spotlight

Recent pressure has been most acute in Japan, where ultra-low yields (and the flow of savings) have long weighed down on global yields. Markets continue to believe that Bank of Japan (BoJ) monetary tightening is too slow and rates too low to stem declines in the JPY and cool inflation. The falling currency, inflation concern, high government debt, lack of fiscal discipline and the BoJ's withdrawal of quantitative easing (QE) are a powerful upward force on yields that many believe can only be stemmed when the BoJ gets serious about tightening. Focus on whether they do that in mid-September is high.

While Japan is the poster child, such concerns are filtering through to many markets, particularly Britain and France where fiscal discipline and debt levels are front of mind.

US fiscal pressures in focus

But it is the US where questions are becoming loudest due to the USD's role as a reserve currency and US Treasuries' central role as a global benchmark. The US budget deficit (and thus funding requirement) has recently started to widen again in response to tax cuts (and tariff refunds) at a time when the economy is running hot and automatic stabilisers should be lowering the deficit (chart 25).

The increase in the US government's call on funds comes at a time when hyperscalers and others are massively lifting capex and spending on AI. This is compounding the increase in global spending, which is already being supported by the transition to net zero, defence, and broader security and resilience measures. The lift in global spending generates intense competition for capital and pressure on global savings. The result is that estimates of neutral interest rates are rising, pushing up expected average cash rates, as well as the term premium investors require over and above the expected cash rate to

commit capital to long-term bonds.

The inflationary impact of the Iran war and the strength of the US economy have seen markets switch from pricing Fed Fund rate cuts to hikes. Markets now expect the Fed Funds rate to rise to around 4.25% over the next year. But concern the Fed may not actually have the resolve to tighten policy as required, together with the competition for capital, has meant the term premium has not declined as it normally would, keeping the yield curve steeper than would be expected (off the higher cash rate, chart 26).

Fed Chairman Kevin Warsh expressed concern over inflation and the stance of policy at his recent Jackson Hole address, but markets are yet to be convinced the Fed has the resolve to tighten and lower inflation.

Central bank credibility is essential to anchor inflation expectations and bond yields. The market is approaching a crucial point and strongly signalling that the Fed needs to lift rates. Failure to do so could cause yields to spike significantly. But we do anticipate the Fed will shift in this direction and conditions should start to normalise somewhat.

Australian bond yields move higher

After declining sharply after the start of the war and particularly the May Budget, Australian 10yr bond yields have moved in tandem with US yields in recent weeks and moved above the 15-year highs reached in March (chart 27).

The RBA rate hike that we forecast is fully priced in and we shouldn't see much additional pressure on the front end of the curve. Eventual cuts we forecast in 2027 should renew contraction in the Aus-US spread in due course and see it turn negative. The major fiscal consolidation announced in the May Budget has secured the 'AAA/Aaa' credit rating and sets Australia apart from most advanced economies. This should limit pressure on term yields and rates. However, the outlook also remains heavily dependent on the path of global markets, particularly confidence in US policymakers.

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