

New CBA index shows bond market staying calm even as rates rise

Commonwealth Bank · 2026-10-09 · English original

Key points

- CBA has launched the Australian Government Security Volatility Index (AGSVIX), a new gauge of implied uncertainty in the Australian government bond market.
- Despite bond yields rising this year, the index shows market uncertainty has actually fallen – suggesting investors are adjusting their interest rate expectations, rather than reacting to fresh uncertainty.
- CBA's research finds it's the "term premium" – not expectations for the cash rate – that really drives swings in bond market volatility.

Bond yields affect everyone, not just traders. They feed into mortgage rates, government borrowing costs and the broader cost of credit. This year yields have risen largely because upside surprises in inflation data have forced markets to reassess how high, and for how long, the Reserve Bank will need to keep the cash rate.

But yields alone don't tell you how confident or nervous investors are feeling about the future. For that, economists look at "implied volatility" – essentially, how much uncertainty is priced into options markets.

CBA's new index tracks exactly that for Australian government bonds, and is comparable to the well-known US "MOVE" index used for US Treasuries.

An orderly rise, not a nervous one

Bond yields have risen over the past year, but CBA's analysis shows investors haven't become more uncertain alongside that move – a combination that can look unusual at first glance.

To understand why, CBA's economists split what drives bond yields into two parts: the "expectations component" – where markets think the cash rate and inflation are heading – and the "term premium" – the extra compensation investors demand for the risk of locking their money into longer-dated bonds.

Their modelling finds these two forces pull bond market uncertainty in opposite directions: when yields rise because of firmer rate expectations, uncertainty can actually decline, but when yields rise because investors demand more compensation for risk, uncertainty tends to climb.

Hamid Yahyaei, Director of Fixed Income and Interest Rate Strategy at CBA, said this pointed to a calm, orderly shift in interest rate expectations rather than rising concern in markets.

"Our subdued AGSVIX points to an orderly repricing of 'higher for longer' policy rate expectations rather than a loss of credibility for the RBA," Yahyaei said.

In other words: yields can rise because markets expect the Reserve Bank to hold rates higher for longer – not because anyone is suddenly less sure where rates will land.

"If the market becomes increasingly convinced that the RBA will need to deliver additional tightening, the distribution of future rate outcomes may shift higher without becoming materially wider. We need to think about statistically – a higher level of average yields does not have to coincide with 'fatter' tails – that only happens when the term premium rises," Yahyaei said.

What this means looking ahead

CBA's economists expect credible central bank action – tightening policy to keep inflation in check – to, over time, lift the expected path for rates while actually lowering the term premium, because investors need less compensation for inflation uncertainty when they trust a central bank to act on its mandate. That's broadly consistent with what's been happening in Australia, where higher yields have mainly reflected rate expectations rather than a surge in risk premiums.

A word of caution

Even so, CBA's team isn't getting complacent.

"Implied volatility is already very low, which does leave the market vulnerable to a sharp widening in the variance risk premium (VRP) if a term premium shock widens the range of possible yield outcomes," Yahyaei said – a reminder that a sudden shock to the term premium, rather than further shifts in rate expectations, is the bigger risk to watch.

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