Rates: Global bond markets at a tipping point

ING THINK · Padhraic Garvey, CFA · 2026-09-03 · English original

If the music stopped now, the absolute level of long-end yields for many issuers looks reasonably fair. The problem is the music is still blaring. A lot is going on, and most of the pressure continues to point upwards for long rates. That does not have to be a drama, but then again, it could become one should it get pushed too far

It can take a lot to awaken long-end yields, but when they get prompted into action, they can be quite flighty. We've seen various episodes of this in recent years for idiosyncratic reasons. Think UK gilts and French OATS and respective political post-pandemic wobbles, or the perception of joint liability attached to Italian BTPs and concern there pre-pandemic. The past number of months have been different, as we've seen a synchronised rot attach to long ends, in particular across many (or most) developed markets.

Japan: From zero to hero on the 30yr yield

One of the standouts here is the Japanese 30yr yield, which has touched 4.2%. That's four times the policy rate (currently 1%). There is clearly a tension between these two. The genesis of that is the evolution of a normalised inflation dynamic. The Bank of Japan (BoJ) has undershot versus this, so the long end has had to overreact. And that BoJ tension is also reflected in severe weakness attached to the Japanese yen. So much so that it prompted joint intervention between the US and Japan, in an effort to calm instability. But the root cause here is a slow BoJ. If that does not change, the pressure will remain.

US: The cross-over point that 5% on the 10yr suggests

We've opined on the link between this and US Treasuries here. Essentially, if the yen required aggressive enough offsetting selling of US dollars, it risks a sell US Treasuries narrative. And that's the last thing the US Treasury wants to see right now. Especially as Treasury Secretary Scott Bessent has made it known through a doubling of long-end buybacks that there is a degree of discomfort when Treasury yields hit elevated levels. The root problem here is the size of the fiscal deficit, and until that is properly addressed, the pressure attached to Treasury yields is set to remain. The US 10yr yield is now at 4.8%, with progress toward 5% quite probable ahead.

A key area to watch is 5% on the US 10yr yield. Breaks above that would likely be resisted by the US Treasury. If the 10yr yield does break above, remember that 5% is not particularly high. We hit that level back in 2023, and the long-run fair neutral value for the 10yr yield is in the area of 4.5% (see here). At '5%', we're above that. But we arguably should be, given where inflation (3.5%) and the fiscal deficit (6% of GDP) are printing.

A few things are going on here. First, we should not forget that the pandemic shocked developed markets into inflation generation, resulting in a logical tendency for interest rates to return toward normal (from being abnormally low). Second, the pandemic generated a material build in developed market government debt, and took already rocky debt dynamics to a more troubling place. The US is a clear case in point here.

Eurozone: Caught between cross-winds

Meanwhile, the US fiscal pressure, together with a changing political dynamic, has injected an increased defence need for European governments, in turn adding to fiscal spending requirements in the future. And various energy shocks have added to European inflation pressure. That, together with a far more troubling contemporaneous inflation dynamic, is forcing eurozone yields to the upside.

On the front end, the European Central Bank has hiked and is set to do more. On the back end, there is a relative value re-pricing required so that eurozone long-end rates sit appropriately versus alternatives. For example, in March this year, the 30yr Japanese yield moved above the 30yr German yield, and that spread has since widened to the 40bp area. That's a simultaneous relative value pressure.

Throw in the 30yr UK gilt yield at just short of 6% and there is a self-fulfilling path of least resistance higher that we need to remain concerned with.

AI: The productivity boom

The issue right now is that there is no material countervailing force to resist these moves. Also, they are being driven predominantly by higher real rates. Higher real rates are tougher to reverse, until or unless we get to a level where demand for elevated yields begins to kick in.

Fed Chair Kevin Warsh at the opening of the G20 finance meeting spoke of an upcoming discussion on what he described as a secular growth phase ahead. This is no doubt in reference to the productivity revolution that could come from the astonishing AI spend currently ongoing, which in itself is making a material contribution to macro-wide spending. That correlates with higher real yields, as does duration-heavy issuance pressure in this space.

Given this, it's tough to see the pressure for higher long-end yields magically dissipate. And even when it does for a period, the Iran war and energy price pressure provide an additional excuse to keep them elevated. This is especially a live problem for Europe to deal with, and for Asia, and indeed beyond. Given this weight of confluences, Treasury Secretary Bessent may well have his work cut out to ease the pressure through increased Treasury long-end buybacks (these start on 9 September). The risk is we may have to endure an overshoot before things structurally calm, as the current upside pressure on real rates remains intense.

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