Why investors are getting worried about global bond markets

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Key points

• Government bond yields have climbed sharply across the US, Australia, Japan and Europe.

• CommBank says much of the shift reflects expectations that interest rates will average higher over the long term.

• Rising government debt and questions about policy credibility are adding to investor concerns.

A sharp sell-off in government bonds is pushing borrowing costs to levels not seen for decades across some of the world's biggest economies.

In the US, 10-year Treasury yields this week reached a near three-year high of around 4.8%, while Japan's equivalent yield moved above 3% for the first time in 30 years.

A bond yield is essentially the return investors demand for lending money to a government or company.

Australia's 10-year government bond yield rose above 5.19%, its highest in more than 15 years. UK and German borrowing costs have also reached multi-year highs as investors confront higher energy prices, inflation risks and rising government debt.

CommBank Head of Market Strategy and Rates Research Adam Donaldson says the moves point to something bigger than the normal day-to-day swings in financial markets.

“What you're seeing is a change, a structural change that's occurred over a number of years, but a 30-year period where yields and interest rates were falling is now being reversed,” Donaldson said on the CommBank View Economics and Markets podcast.

Why are bond yields rising?

The immediate pressures differ between countries, but Donaldson says one of the most important changes is happening underneath the surface.

Bond yields can rise when investors become worried that inflation will remain high. But Donaldson says longer-term inflation expectations embedded in US and Australian bond markets have not moved dramatically.

Instead, much of the increase has come through higher “real yields”, the return investors demand after taking expected inflation into account.

That suggests markets are reassessing how high central bank interest rates may need to average over the longer term.

“The cash rate part has been the dominant part of the story this year,” Donaldson said.

The shift is important because long-term government bond yields help set the price of money elsewhere in the economy.

“They're a benchmark for all other fixed rates in the economy,” Donaldson said.

They also influence how investors value other assets, including shares and property, while higher government borrowing costs ultimately flow through to taxpayers.

A global race for capital

One reason rates may need to remain higher is that the world needs much more money to fund investment.

Artificial intelligence and data centres require vast spending on computing infrastructure and energy. Governments are increasing defence spending, while the transition to lower-emissions energy will require further large-scale investment.

“There's a global boom underway in various investments,” Donaldson said.

“Those things are expensive. They require savings to fund them. And it's that balance that is shifting, that is putting rates up.”

Donaldson's argument is that the global balance between the amount of money available to invest and the amount governments and businesses want to borrow has changed.

“I don't think it's necessarily over,” he said.

Government debt is back in focus

At the same time, investors are paying closer attention to how much governments need to borrow and whether they have credible plans for their finances.

Donaldson said the market was uncomfortable with a US budget deficit equivalent to around 6% to 7% of GDP, particularly when there was little evidence it would be reduced substantially in the near term.

But he does not believe the US is heading towards an imminent debt crisis.

“We probably look at this as more of a slow burn,” Donaldson said.

Rather than a single breaking point, markets can put governments under pressure by demanding higher returns to keep lending to them.

Donaldson pointed to the UK bond market turmoil during Liz Truss's brief period as prime minister as an example of how rapidly those pressures can emerge and force policymakers to respond.

“We expect there might be periods where you have kind of flare-ups,” he said.

Japan is another market receiving increasing attention. Its 10-year government bond yield has now climbed above 3%, marking a major reversal for an economy that spent decades with extraordinarily low interest rates.

What are bonds, how do they work, and why does the bond market matter?

Bonds and bond markets are an important part of the economy, but most people don’t know a lot about them. Here’s a guide to what they do and how they work.

Investors are demanding more compensation

Those concerns can show up through what's known as the “term premium”.

Put simply, this is the additional return investors demand for locking their money into a long-term bond rather than repeatedly lending for shorter periods.

Donaldson said the term premium in the US bond market had increased by about two percentage points over the past five years, moving from negative territory to decisively positive.

That means investors increasingly want to be paid for the uncertainty involved in lending money for 10 or 30 years.

Confidence in central banks is part of that calculation.

Donaldson said markets would be watching whether the US Federal Reserve follows through if incoming economic data shows further rate rises are needed to contain inflation.

If investors began to lose faith in the Fed's willingness to act, Donaldson said longer-term US yields could potentially rise another 0.3 to 0.5 percentage points relatively quickly.

“That's where the risk factor is at the pointy end,” he said.

The world has changed

The broader shift goes beyond any one central bank or government.

Donaldson points to several forces that helped push global interest rates lower for decades but are now moving in the opposite direction.

The expansion of global trade brought more workers and cheaper goods into the world economy. A strong US dollar helped contain imported inflation in America. Global savings were plentiful, while investment demand was relatively subdued.

Today, trade is more fragmented, geopolitical tensions are driving defence spending, governments are borrowing heavily and businesses are competing for capital to fund an investment boom.

“When you think about all of those things at the moment, they're basically in reverse,” Donaldson said.

“That 30-year period, we've got the other side of that coin. And that's a big deal.”

Where does Australia fit?

Australia cannot escape a global rise in bond yields, but Donaldson says it has some advantages.

He points to Australia's fiscal position, the RBA's willingness to respond to inflation and strong domestic savings through the superannuation system.

There is also growing international demand for Australian-dollar assets, a trend CommBank calls “Aussie dollarisation”.

Australian-dollar capital market issuance has reached a record high for the year to date, Donaldson said, with overseas demand extending beyond federal government bonds to debt issued by state governments, banks and businesses.

“Relative is the word,” Donaldson said of Australia's outlook.

Australia remains exposed to the forces pushing global yields higher, but its policy settings and investor demand could allow Australian bonds to perform better than some overseas markets.

What does it mean beyond bond markets?

Higher government bond yields do not stay confined to trading screens.

They can lift fixed mortgage rates, raise financing costs for businesses and increase governments' interest bills. They can also put pressure on share and property valuations because investors have a higher-returning alternative against which to compare those assets.

For Donaldson, one of the biggest messages from today's market is what bonds are signalling about the future cost of money.

He said markets currently imply that Australia's cash rate will average around 3.8% over the long term. A couple of years ago, that figure was well below 3%.

“There'd been a huge adjustment,” Donaldson said.

“People need to get their mind around, OK, well, that's what it means for the cash rate in Australia. So mortgage rates, other floating lending rates, those type of things.”

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