

GLOBAL MACRO VIEWS

Fiscal reckoning: When do bond markets blink?

The era of fiscal complacency may be nearing its end. From Washington to Tokyo, bond markets are showing growing sensitivity to rising sovereign debt levels. The attempted passage of a multi-trillion-dollar U.S. budget deal pushed long-dated Treasury yields to multi-year highs. Japan's weak 20-year government bond auction in May revealed how fragile even historically stable markets have become. In Europe, U.K. gilts remain under scrutiny as fiscal space narrows and Germany has drastically changed its "debt brake" to allow more defense spending.

Debt risk is back—and markets know it

Rising debt burdens are no longer theoretical. They are driving volatility, pushing up capital costs and crowding out public investment. As debt servicing costs climb, markets are actively repricing long-term fiscal risk. The consequences: steeper yield curves, a more vulnerable U.S. dollar and heightened sensitivity to policy missteps.

In the U.S., the proposed "Big Beautiful Bill" could add trillions to the national debt. Even a scaled-back version would front-load spending and push the budget deficit from around 6% of GDP currently to above 7% by 2028 — high by historical standards for a non-recessionary period.

The bigger concern is what follows. Budget forecasts rely on the expiration of tax cuts to improve the deficit trajectory beyond 2028. But if those cuts are extended, as seems likely, the shortfall could rise above 8% — much higher than the Congressional Budget Office's projected annual average of around 6% of GDP over the next decade.

Bond investors are responding accordingly. The U.S. 10-year term premium — a measure of the extra yield investors demand to hold longer-term debt — has moved decisively back into positive territory, reflecting growing uncertainty over the long-term path of fiscal policy.



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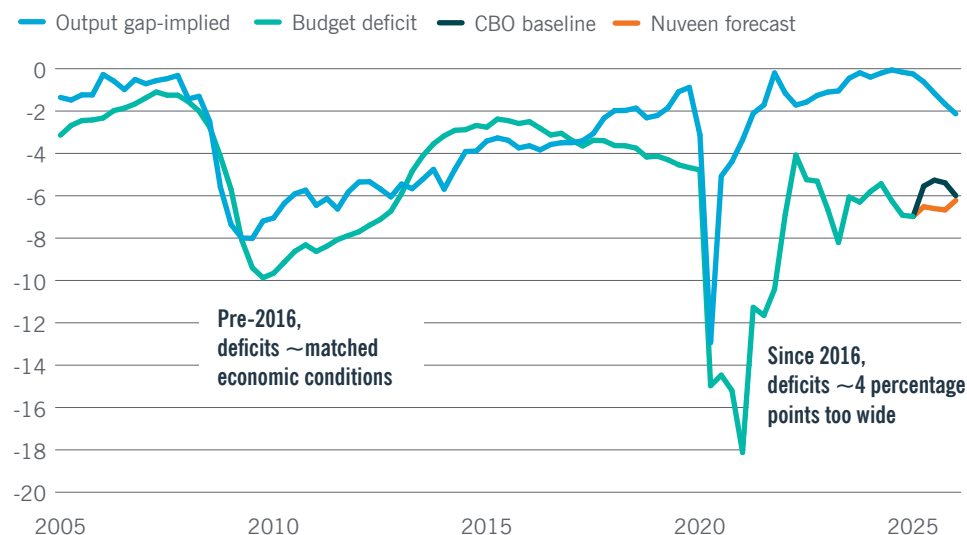
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Investors can shift between sovereigns with ease, making fiscal credibility a critical differentiator.

Fiscal divergence drives term premiums and currency shifts

As investors digest rising U.S. fiscal risks, they are also weighing how these dynamics compare globally. In today's interconnected bond markets, term premiums are not uniform — investors can shift between sovereigns with ease, making fiscal credibility a critical differentiator.

Figure 1: U.S. budget deficit wider than warranted by fundamentals



Data source: Bloomberg, Congressional Budget Office

Over the past few years, countries with the largest increases in government debt burdens have experienced the sharpest rises in term premiums. This reflects growing concern about long-term fiscal sustainability rather than near-term growth or inflation expectations (see figures 2 and 3). This growing fiscal risk premium shapes not only bond yields but also currency dynamics — with investors increasingly sensitive to how fiscal policy influences reserve asset demand and exchange rates.

Global examples: U.K. gilts and Japan's fragile calm

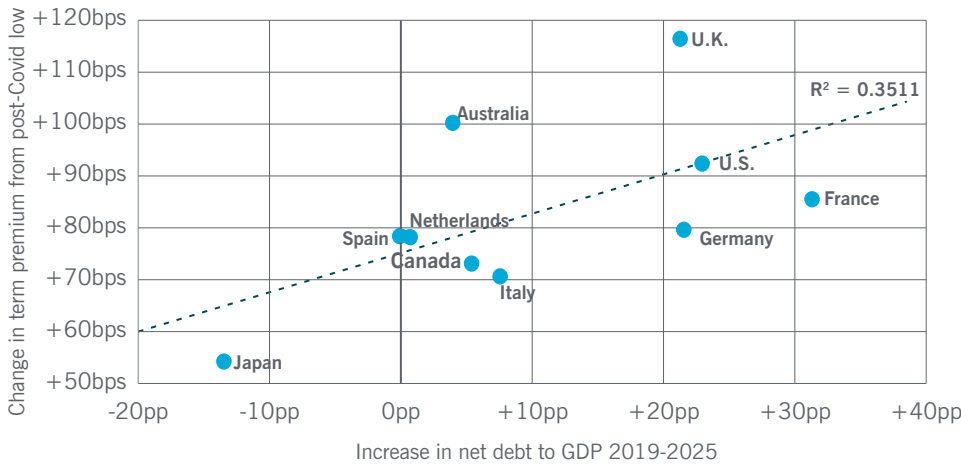
The impact of these fiscal dynamics is evident across major developed markets — from the U.K. to Japan — where local factors amplify global pressures and, in turn, feed back into global currency and capital flows.

In the U.K., the gilts market is caught between global repricing pressures and domestic fiscal uncertainties. Highly correlated with U.S. Treasuries and German bunds, gilts are vulnerable to shifts in global sentiment. But local challenges — including reduced fiscal space and cautious signals from the Bank of England amid persistent wage pressures — heighten the risk of curve steepening and sustained volatility. In our view, a further deterioration in economic data owing to employer contribution increases could overshadow such fiscal fears, driving gilt yields lower by end-2025.

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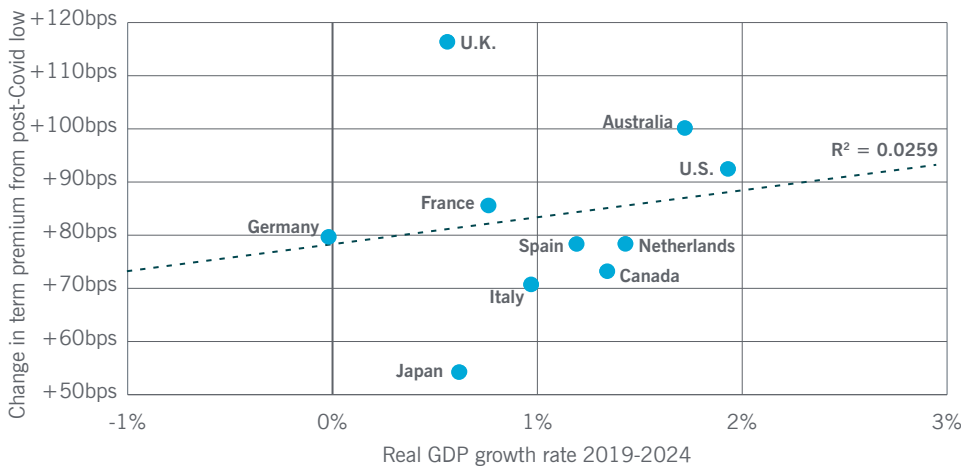
Fiscal policy and debt sustainability are front and center, shaping both fixed income and currency markets.

Figure 2: Rising debt burdens drive term premiums



Note: bps: basis points; pp: percentage points
Source: IMF, Bloomberg.

Figure 3: Growth rates do little to drive term premiums



Source: Bloomberg.

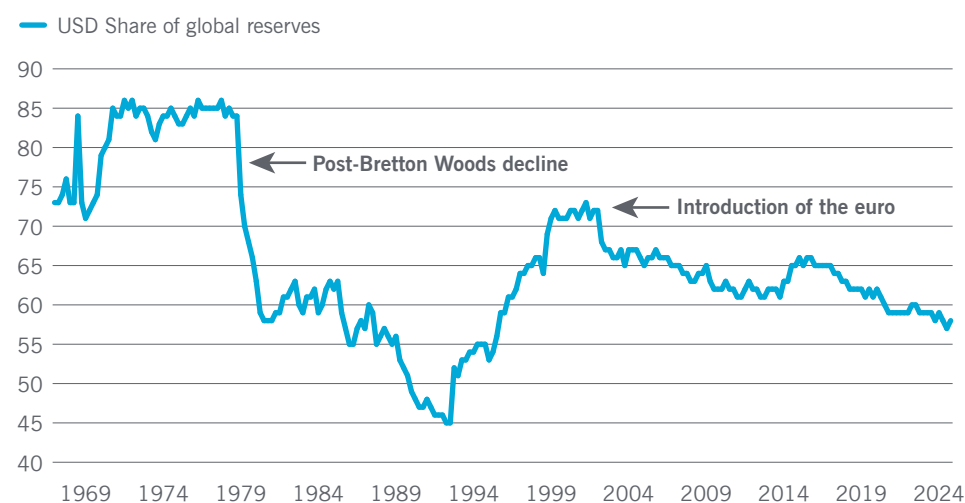
Meanwhile, Japan's bond market, long stabilized by deep domestic demand and central bank interventions, is showing cracks. A weak 20-year auction and speculation over the Bank of Japan's normalization underscore emerging strains. Despite policymakers' reassurances, the combined pressure of global term premium increases and shifting domestic fiscal policy introduces new risks for duration investors. Even so, the rise in Japanese government bond yields has spurred interest from foreign investors and the Ministry of Finance has signaled it will likely trim bond issuance in response to recent market moves despite fiscal direction remaining unclear.

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Dollar outlook: not crisis, but gradual repricing

These fiscal and market dynamics help explain why the U.S. dollar, while remaining the global reserve currency, is experiencing a gradual repricing. Rising U.S. debt and twin deficits have long fueled concerns about the dollar's durability. While a sudden crisis seems unlikely, fiscal pressures are eroding the dollar's valuation premium.

Figure 4: Declining U.S. dollar reserves since 2000



Data source: International Monetary Fund

Foreign demand for Treasuries has remained resilient. Continued buying from Japan, the U.K. and others has offset China reducing exposure. Yet, the search for alternatives is evident. While the dollar's strength is underpinned by deep and liquid markets, future gains will likely be more constrained. A slow, secular weakening — rather than a sharp crisis — appears the more plausible path as investors rebalance toward other reserve assets over time.

Positioning in a world where debt matters again

The age of ultra-low rates and unconstrained fiscal expansion appears to be behind us. In this environment, investors need to be more discerning — with renewed focus on duration risk, sovereign selection, fiscal resilience and currency exposure.

While a return to austerity is not imminent, bond markets are starting to price greater discipline into long-term sovereign yields and reflect evolving currency risks. Quality assets, active management and careful global diversification are essential in navigating this new phase — where ***fiscal policy and debt sustainability are front and center, shaping both fixed income and currency markets.***

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Endnotes

Sources

All market and economic data from Bloomberg, FactSet and Morningstar.

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