...Bond yields uncover the inconvenient truth about borrowing

#bonds #us #europe #uk #ustreasury #fiscalpolicy #macro #swapspread #yieldcurve

By Illiana Jain
Economist, Westpac

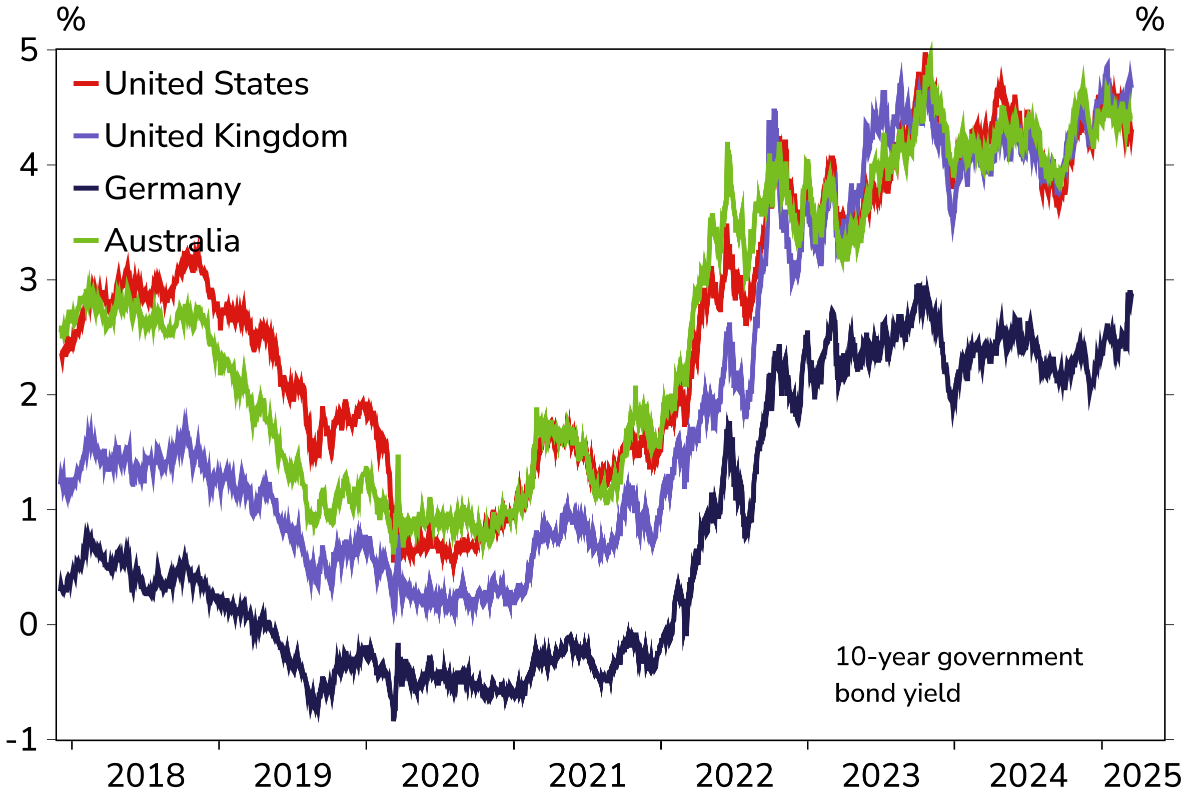
10:05 March 18 2025

Government bond yields are starting to find their footing higher. Supporting this sustained move higher is investors' appetite for high yields and the unwind of quantitative easing. The result will be higher borrowing costs for governments.

Across developed markets, bond yields have risen dramatically in recent years and are currently settling well above levels prevailing before the pandemic. Beyond economic factors such as inflation risks and the shift in the global balance of saving and investment, debt dynamics are also providing support for yields. Two main debtrelated factors argue for a higher term structure. First, wide government deficits at risk of further expansion have significant boosted actual and expected new bond issuance. Second, quantitative tightening by central banks has reduced their holdings and led to broader questions about the appetite for government paper in the years to come.

These debt-related factors translate into a lower ‘convenience yield’, the yield investors are willing to forgo to hold safe and highly liquid assets like government bonds. In a recent speech, European Central Bank Committee member Isabel Schnabel outlined evidence that this convenience yield is beginning to decline. This in turn has contributed to the increase in yields on government bonds.

Lower convenience yield aids bond yields



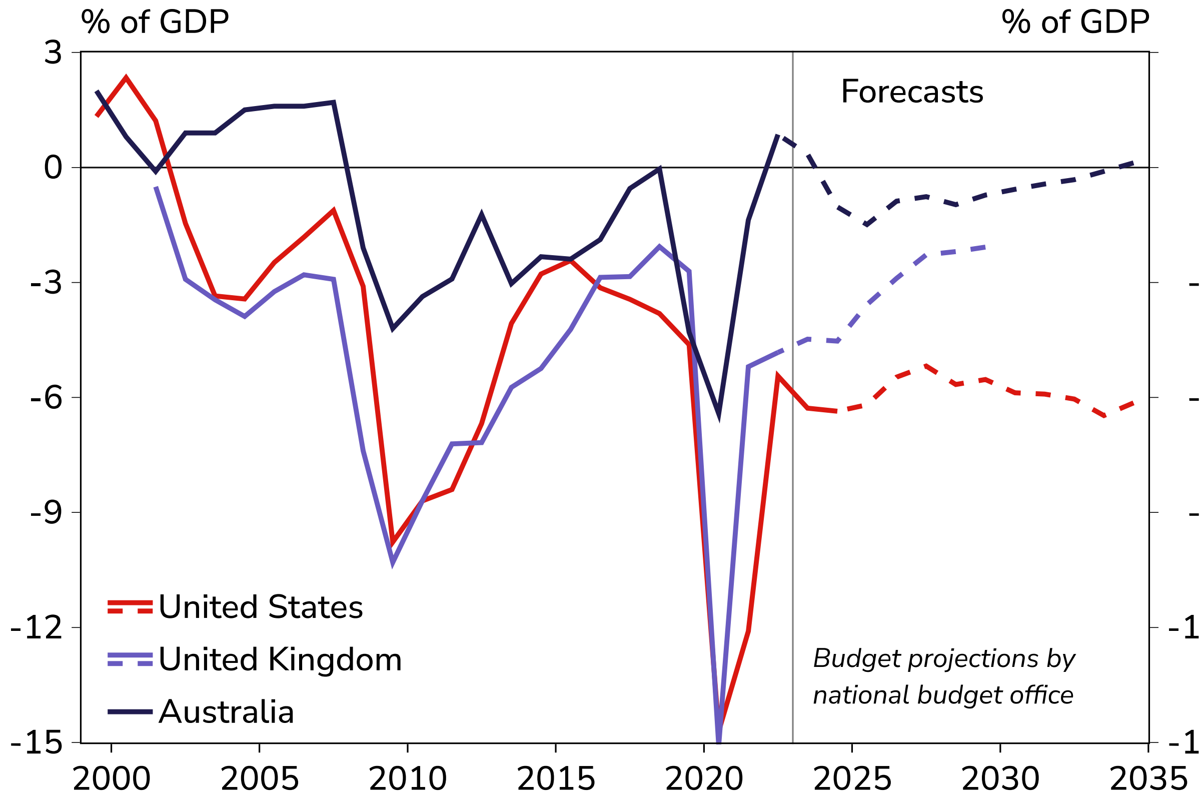
Source: U.S. Treasury, Macrobond, Macrobond, Westpac Economics

The decline in the convenience yield has occurred as government issuance has grown since the onset of the pandemic. Estimates by the Federal Reserve suggests in the US the convenience yield is around 70bps down from around 125bps prior to the pandemic. The research also shows a steady downtrend in the yield since GFC, interrupted briefly by COVID.

Looking ahead, budget deficits are anticipated to persist across developed markets adding materially to the stock of government debt. The US Congressional Budget Office anticipates the US deficit will hold around 6% of GDP, while, in the UK, the budget position is only expected to improve slowly from around 5% to 2.5% of GDP by 2029, assuming a favourable outlook for growth. In Europe, increased defence spending alone looks set to drive larger deficits. For example, the German parliament is set to vote on a constitutional amendment that allows for a significant lift in defence-related borrowing. Even in Australia, where the Federal budget has been closer to balance, the

Parliamentary Budget Office expects small deficits to be the norm out to 2033. All this points to a historic supply of developed-market government bonds coming to market.

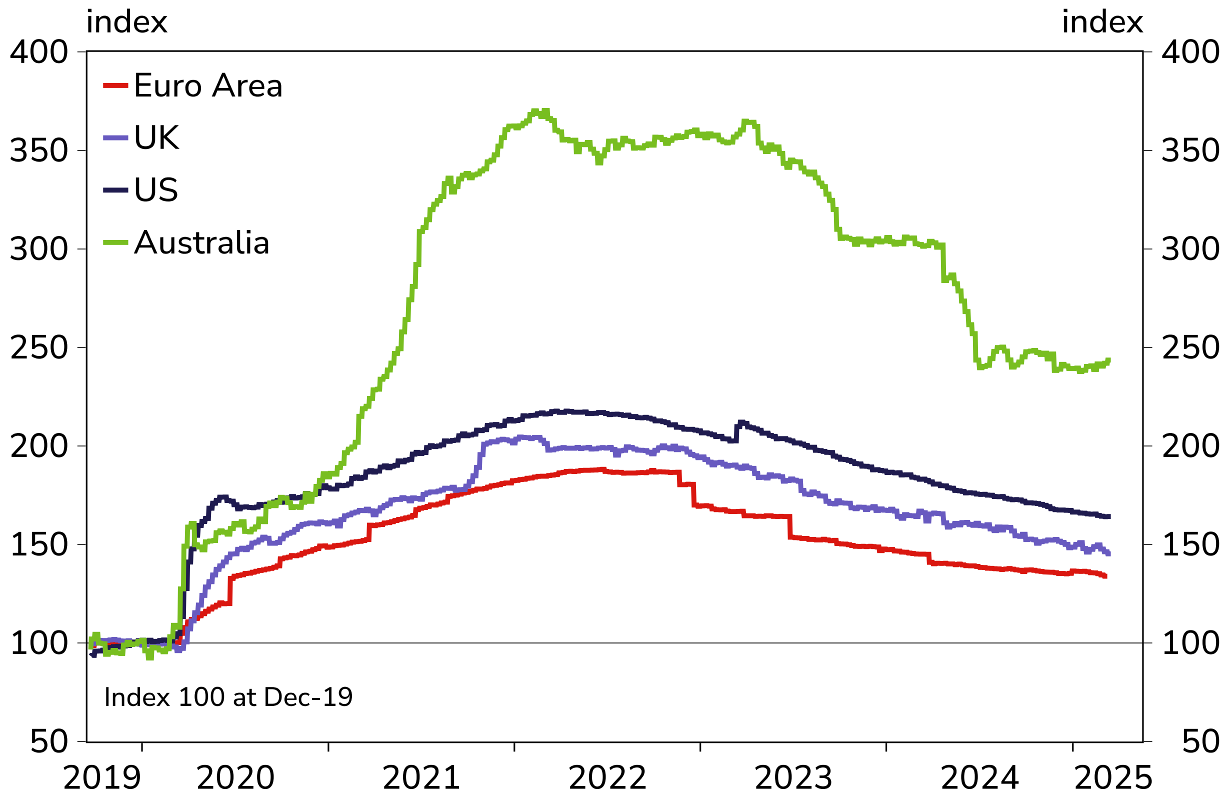
Gov'ts anticipate deficits will persist



Source: CBO, OBR, APH, Macrobond, Westpac Economics

With ample supply, investors are no longer willing to accept a lower yield for the privilege of holding what was once seen as a scarce resource. Evidence of sated demand can also be seen in swap/bond spreads turning negative in numerous countries. Recent developments in Germany are a prime example, with reports of plans to increase defence spending substantially jolting government yields higher while swap yields held firm. Widening swap/bond spreads turned materially negative for the first time in December 2024.

CBs are shrinking their balance sheets



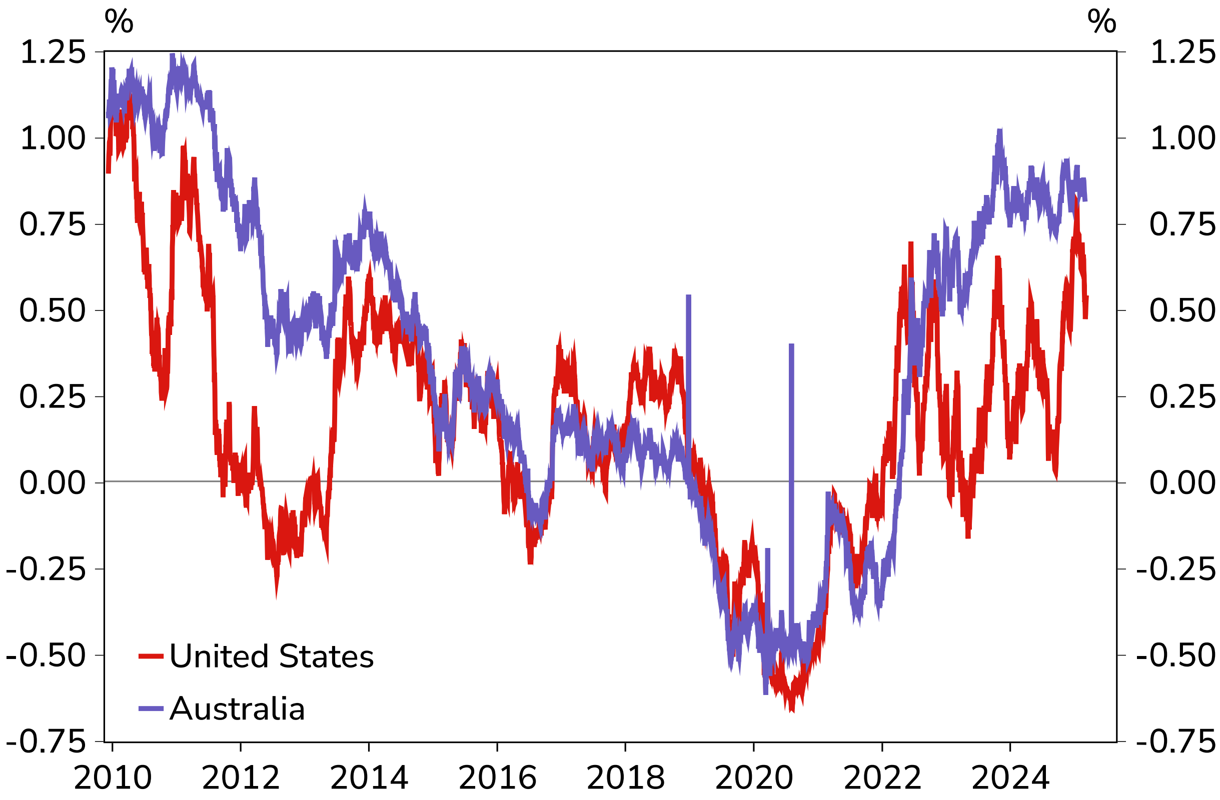
Source: BOJ, BoE, Fed, SNB, PBoC, Riksbanken, RBA, StatCan, RBNZ, ECB, Macrobond, Westpac Economics

In Australia, swap spreads were negative during 2020, when an unprecedented amount of fiscal support was given during COVID, and again in November 2024, as US President Donald Trump was re-elected and markets anticipated slower growth and greater US government spending, dragging up bond yields globally. These negative spreads have widened since midDecember. All told, larger negative swap/bond spreads speak to greater uncertainty in the minds of investors around future government finances and consequently to a higher required return for holding government bonds.

It is not only supply that has shifted but also demand. Central bank assets have come down substantially since their peak in 2022; monetary authorities have been reducing the scale of their balance sheets as they unwind earlier quantitative easing programs. Assuming another crisis does not materialise, central bank holdings of government securities will be smaller than prior to and during the pandemic. This development also supports a higher term structure across the curves of major markets.

As this transition continues, central banks are also likely to reduce the duration of their assets, removing the downward pressure put on term premia by quantitative easing (QE). Estimates from the Australian Office of Financial Management show that since the RBA decided to end its QE programme in February 2022, term premia has started to drift up from -20bps to +85bps in January 2025. Term premia had been steadily declining since 2010, while current estimates are close to where it was in March 2023. Similarly, term premia have trended higher since the FOMC decided to start normalising its balance sheet in June 2022. Note however, the scale and pace of the increase in term premia will also depend on where along the curve governments issue. The further out this skews, the wider the term premia will travel.

QT to see term premia drift up



Source: Fed, AOFM, Macrobond, Westpac Economics

The primary implication of these developments is that, for a given monetary policy stance, the yields at which governments borrow will be higher, placing upward pressure on borrowing costs and current and future deficits. Given the increase in interest costs a higher term structure brings, governments will need to become more considered about how they spend.

For nations like Australia, a strong labour market, robust population growth and resilient export receipts offer flexibility to manage the budget, particularly with a broadly balanced starting point and tax brackets that are fixed in dollar terms. Countries such as the US and UK, in contrast, face considerable challenges, though admittedly are likely to see greater 'safe-haven' demand, dampening the drift higher in yields. Unlike the US with its CPI-indexed tax brackets, the UK can also achieve budget repair through bracket creep.

The risk to watch out for in the US and UK in particular is if/ when a shock arises. Given the current size of deficit and debt levels, the ability of these nations to balance providing support for the economy and ongoing debt servicing will become materially more complex and difficult. Whether other nations' circumstances follow or not, risks priced into core developed-world yields are likely to permeate across global debt markets, impacting markets as far away as Australia and New Zealand.