

Investment Strategy Insights

What bond yields are telling us

- In our previous research note, *Rising bond yields don't always deliver pain*, we showed that solid growth and a rising neutral rate in the US were key reasons driving the rise in bond yields. The US term premium has risen in shorter-maturity bonds (up to five years), consistent with greater uncertainty around inflation, interest rates and the economic outlook. At longer maturities, it is harder to disentangle the influence of policy expectations, bond supply and concerns over the fiscal outlook.
- The increase in the nominal 10-year yield has mostly been due to the rise in the real component. This reflects a higher neutral rate of interest and more persistent inflation. The breakeven rate of inflation is around 2.3%, leaving no room for more inflation to push it higher.
- Japan is also putting upward pressure on global bond yields as it saves less and spends more. Economic reform and a willingness to use fiscal policy to raise growth have lifted Japanese Government Bond (JGB) yields. However, the term premium on the 10-year JGB has risen by around 84 bps since the Takaichi government was elected, reflecting concerns about its fiscal plans.

Making sense of the price

In our previous note, *Rising bond yields don't always deliver pain*, we explained why bond yields are rising. Countries with large current account surpluses continue to build savings and invest in countries with large current account deficits, but the target of that investment has changed markedly. For example, since the Covid pandemic, global investors in surplus countries have been funding the US current account deficit less through securities such as US Treasuries and Reserve assets and more in risk assets.

In this research note, we analyse the level of the yield. There is useful information in the yield that indicates what the market thinks about issues such as inflation expectations, longer-term policy rates, real yields and the risk of holding government debt to maturity.

Inflation expectations

A bond yield can be broken down into two components when analysing inflation over the duration of the bond:

Bond yield = real yield + expected inflation.

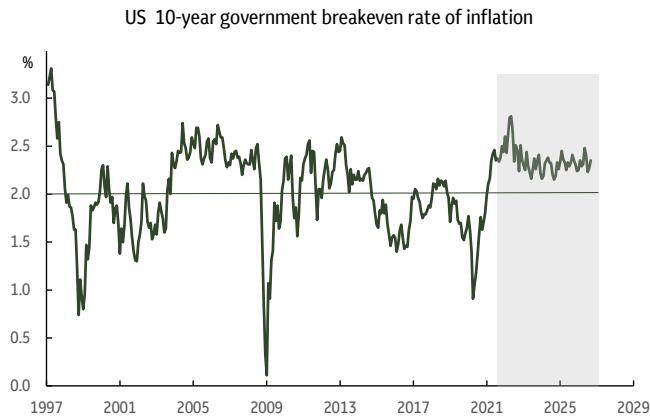
The real yield (TIPS) is traded in financial markets, so the difference between it and the nominal yield is expected inflation over the duration of the bond. Over a 10-year duration, for example, it represents inflation expectations over the next 10 years.

Monetary policy is adjusted to gradually bring demand more in line with the supply-side capacity of the economy so that inflation is consistent with a central bank's inflation target. However, targeting inflation is just one part of a dual mandate that attempts to maximise employment while meeting the inflation objective.

It is much easier for businesses and households to understand adjustments in monetary policy when the central bank has a clear inflation target and communicates its rationale for adjusting policy settings. In turn, this makes the central bank's work easier because the community's inflation expectations are anchored with the target in mind.

In the US, the Fed targets 2% Personal Consumption Expenditures (PCE) inflation and since the pandemic inflation has never slowed to the Fed's target. The breakeven rate of inflation is traded on Consumer Price Index expectations, which are on average a few percentage points above the PCE. So even though PCE inflation has been above the Fed's 2% target, expectations are broadly in line. However, the risk is that expectations begin rising if inflation is above target for an extended period. Inflation could then become self-fulfilling and entrenched above the Fed's target. This month's decision by the Fed to raise rates was, in part, designed to ensure this doesn't happen.

Inflation expectations are above the Fed's target



Source: LSEG, MWM Research, September 2026.

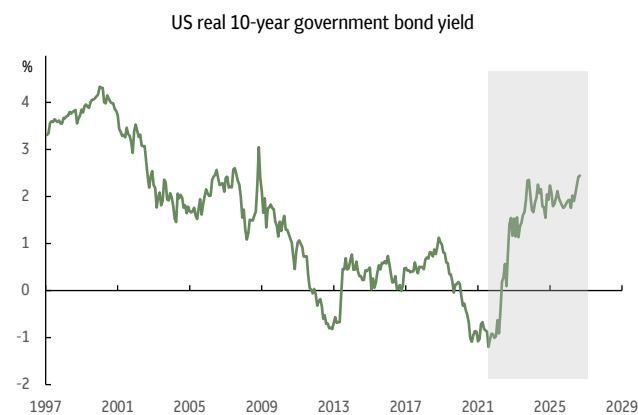
It's also worth noting that even though this measure of expectations is above the Fed's 2% target - it hasn't changed much since 2025. This means that the nominal yield has risen mainly because the real yield has risen.

Real yields rise when the demand for capital outstrips supply or when central banks are raising rates faster than inflation.

Global central banks had been reluctant to raise rates until the global oil shock occurred, so a large part of the recent rise in the real yield is due to strong demand for capital to fund the areas we identified in our earlier note such as AI, defence, aged care, and green energy. In other words, the risk-free rate is rising to balance the supply and demand for capital. In the process, interest rate sensitive sectors such as housing and consumer spending are being crowded out to make way for business investment and government spending.

The other piece of information in a higher real yield is that the economy can cope with a higher real rate of interest. That is, the real neutral rate, which is the rate at which monetary policy is neither too tight nor too loose, has risen.

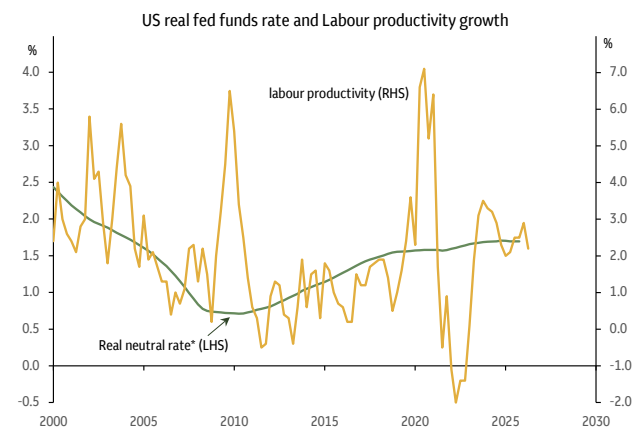
The real yield has risen a lot



Source: MWM Research, September 2026. The shaded area highlights the recent increase in the real 10-year yield.

There is also a reasonably close longer-term relationship between labour productivity growth and the real neutral rate in the US. When productivity growth is accelerating, the real neutral rate tends to rise and vice versa. This relationship makes sense because stronger productivity means creating more output from the same input.

The neutral rate is rising steadily



Source: New York Fed. The real neutral rate is the two-sided estimate of the Laubach-Williams model. MWM Research, September 2026.

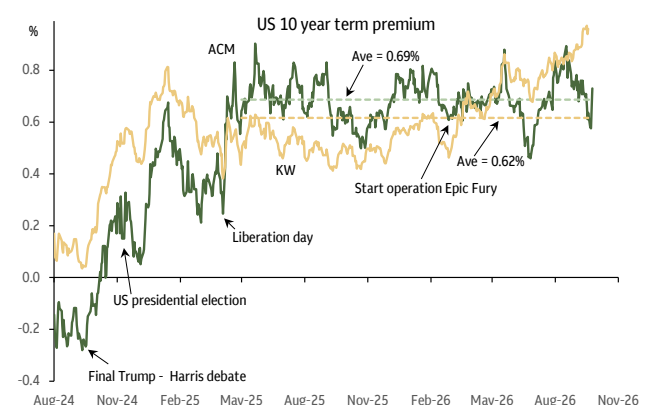
The term premium and duration risk.

The nominal bond yield also has embedded information about longer-term policy rate expectations and the compensation investors demand to hold the security for its duration.

Bond yield = average short rate expectations + term premium.

The New York Fed publishes daily estimates of the term premium for 1 year to 10 years duration using two different models of the term premium, with the ACM model averaging 69bps since mid-2025 and the KW model averaging 62bp over the same period. The ACM model estimates have trended sideways over this period, while the KW estimates were below ACM until March 2026 before rising to 94bps.

The 10-year term premium has trended sideways



Source: New York Fed models of longer-term short-rate expectations. Adrian, Crump, Moench (April 2013), "Pricing the Term Structure of Interest Rates". Kim and Wright

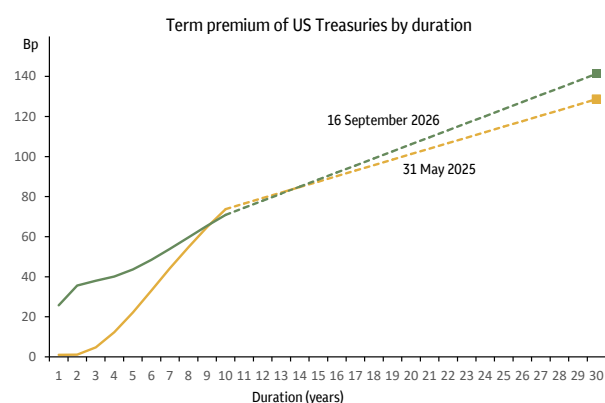
(2005), "An Arbitrage-Free Three-Factor Term Structure Model and the Recent Behaviour of Long-Term Yields and Distant-Horizon Forward Rates", MWM Research, September 2026.

Academic research highlights the uncertainty inherent in estimating term premia. Different models can produce different estimates of the level of term premium, although their movements over time are often broadly consistent over the longer term.¹

The term premium naturally increases with duration and slopes upwards from left to right. Investors ask for more compensation for holding bonds for longer periods. Importantly, the term premium on bonds with 8–10-year duration has been little changed over the past 18 months. This implies that over the longer-term inflation will remain relatively low and consistent with the Fed's target and that the US government will service the debt that it has issued, at least over the next 10 years.

Nonetheless, investors in bonds with a duration of less than 8 years have required compensation for the risk that policy rates will be higher in response to stubborn inflation, with the risk more acute over the next 2-3 years.

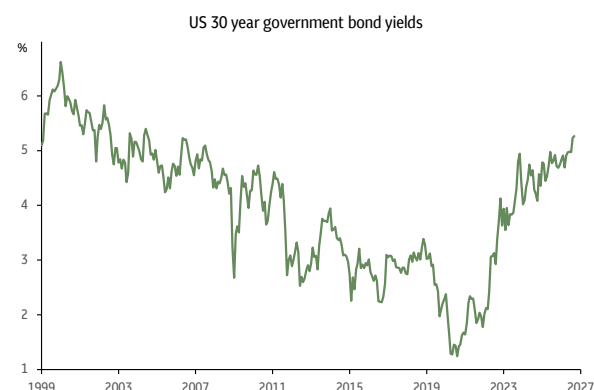
The term premium of short duration bonds has increased



Source: New York Fed model of longer-term short-rate expectations. Adrian, Crump, Moench (April 2013), "Pricing the Term Structure of Interest Rates", Bloomberg, MWM Research, September 2026. The dotted line is a linear approximation between the 10-year and 30-year US government bond.

But longer duration bonds are important, particularly in the US where mortgage rates are fixed for 30 years. The US 30-year Treasury yield has risen by around 400 bps since the pandemic, with large increases also seen at the same duration in other sovereign bond markets such as Japan, France and Italy.

US 30-year yields have risen sharply as well



Source: LSEG, MWM Research, September 2026.

The yield of the 30-year government bond is around 20 bps higher than the 10-year yield. However, the data shows that the term premium on the longer duration bond is around 19 bps above its average since mid-2025 compared to the 10-year term premium (4 bps). In other words, over the next 30 years, there has been a recent increase in risk for holding the longer-duration bond to maturity, but it is within recent ranges since the Liberation Day tariff announcements. The current level is also around the level last seen in 2011 when the US fiscal position was in better shape.

The 30-year term premium is above the average since mid-2025



Source: New York Fed model of longer-term short-rate expectations. Adrian, Crump, Moench (April 2013), "Pricing the Term Structure of Interest Rates", Bloomberg, MWM Research, September 2026.

Duration risk is also rising in Japan

The BoJ raised its policy rate to 1.25% this month, which is the highest level in 30 years. This milestone is significant for several reasons:

- *Japan has traditionally been a big global saver.* Japan, along with China and Germany are the world's three largest

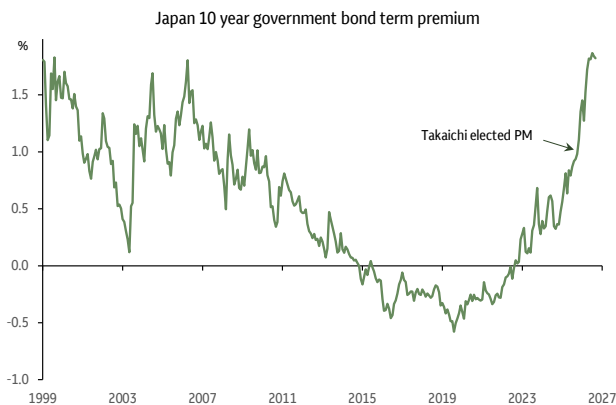
¹ Cohen B.H, Hördahl P, Xia, D (September 2013), Bank of International Settlements, "Term premia: models and some stylised facts".

global savers. But since 2021 domestic economic reform and rising government spending has meant that it no longer runs persistent current account surpluses that are invested in other countries. This has helped push up global government bond yields.

- *Japan's government is spending.* The Takaichi government's "proactive fiscal policy" has led to a budget request for FY27 of 143.1 trillion yen (\$US918 billion). The government spending is to be mainly funded by around 40 trillion yen (\$US360 billion) in new bond issuance.
- *Japanese debt is already large, with net debt 170% of GDP.* This doesn't leave much room for raising government spending or cutting government taxes. One of the government's key promises is to cut the food consumption tax over 2 years from 8% to 1% starting April 2027 at a cost of about 10 trillion yen.

Prospects for stronger growth, an end to 30 years of weak inflation and deflation, and fiscal expansion plans against a backdrop of already high debt have all combined to lift the term premium on Japanese government debt. The term premium has risen by 84 bps since the Takaichi government was elected. This represents not only fiscal risks but also the inflationary risk where aggregate demand and aggregate supply are more closely balanced.

The JGB term premium has risen rapidly

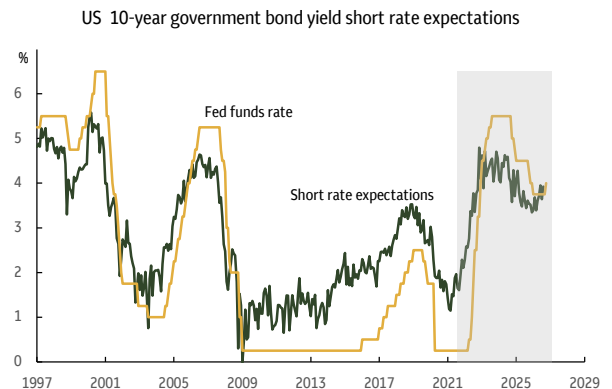


Source: LSEG, MWM Research, September 2026.

Short-term rate expectations

The component of the yield that represents the average short rate or policy expectations over the term of the bond is anchored by monetary policy interest rate settings. It's estimated to be around the current policy rate but typically undershoots peaks in the policy rates and overshoots troughs. During the zero-policy rate era when the Fed was implementing quantitative easing, it was around 100 bps.

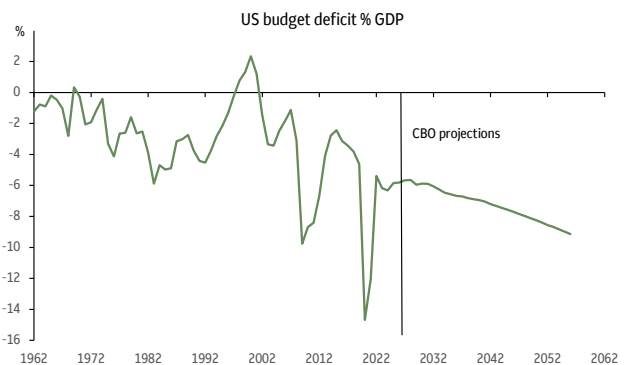
Long-term short rate expectations are rising



Source: LSEG, MWM Research, September 2026

Of course, circumstances may change and the term premium may increase further, reflecting risks that the US Treasury will find it difficult to service its debt. After all, the US fiscal deficit is large and is expected to increase over the longer-term. Its current path is probably not sustainable with net interest payments now around 13% of total expenditure and expected to rise to around 29% over the next 10 years. This also means that the US government has limited room to respond to future downside economic risks.

The US government fiscal position is expected to continue to deteriorate

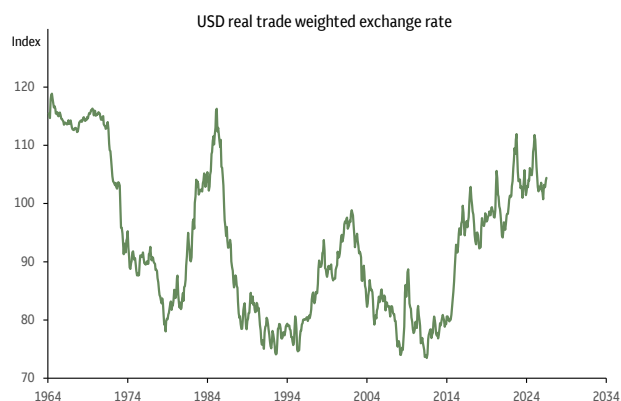


Source: Congressional Budget Office, MWM Research, September 2026

We mentioned in our earlier note that Japan has shown there is also a relatively painless way out of fiscal problems, and it could require a combination of economic and budget reform, along with some inflation and a weaker currency.

In the past, the US dollar has seen long-term cycles that have lasted on average 9.3 years, and the current cycle may be near its peak.

The dollar can adjust lower during fiscal restraint



Source: LSEG, MWM Research, September 2026.

In summary, inflation expectations embedded in the 10-year yield are around the Fed's 2% target, but there is little room for complacency. At the same time, a deteriorating fiscal outlook and growing Treasury supply could contribute to a higher term premium even without a material increase in perceived US sovereign default risk.

Real US yields are rising reflecting a higher neutral rate of interest and so too are longer-term short rate expectations. This is partly due to stronger productivity growth, but also the current inflation backdrop, which has manifested out of stronger structural growth from AI investment, green energy, and government spending. The Fed has the difficult job of trying to squeeze out cyclical sectors of the economy, such as consumer spending and housing, to make room for these areas of structural growth. The end goal is to preserve as much of the job gains made since the pandemic that it can, while at the same time achieving its inflation target.

The economic turnaround in Japan and the Takaichi government's fiscal plan have clearly lifted the term premium. In part, this is due to better economic prospects, but also Japan's large debt burden.

The issues we have identified in this note and the prior note mean upward pressure on bond yields is likely to persist for the time being.

Macquarie WM Investment Strategy Team

This Report was finalised on 1 October 2026.

Recommendation definitions (Macquarie Australia/New Zealand): Outperform – return >10% in excess of benchmark return Neutral – return within 10% of benchmark return Underperform – return >10% below benchmark return.

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