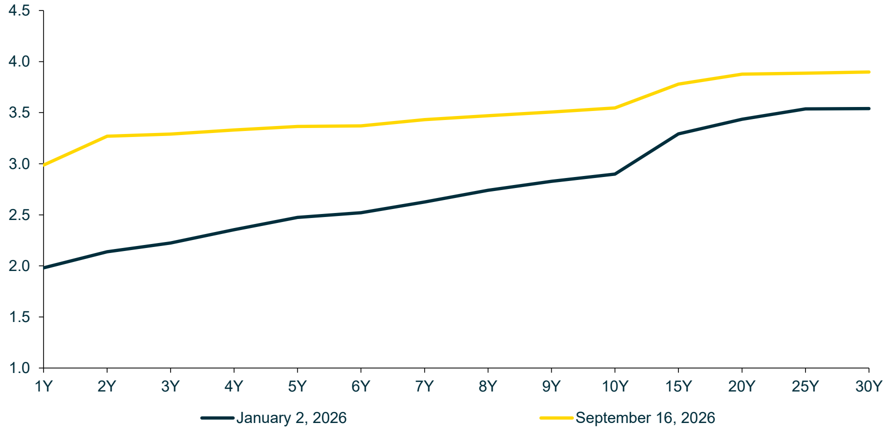
How far will yields go up?

Yields on European government bonds are climbing to their highest levels in years. Rising inflation in the wake of the conflict in the Persian Gulf and higher key interest rates are major factors driving this trend. However, concerns about high debt levels in many countries are also increasingly weighing on the bond market. We analyze just how precarious the fiscal situation is in major economies.

Dr. Vincent Stamer [AC]

Yields on government bonds have risen worldwide this year. The yield on 10-year German government bonds rose by nearly one percentage point since the beginning of this year and recently broke through the 3.5% mark. For shorter maturities, the increase was even greater (Chart 1). All of this not only strains government finances but also affects bond and loan interest rates for German companies. We analyze the reasons for the rise in yields and provide an outlook.

Chart 1 - Government bond yields rise along the curve
Yields of German government bonds with increasing maturity, in %



Source: Bloomberg, Commerzbank-Research

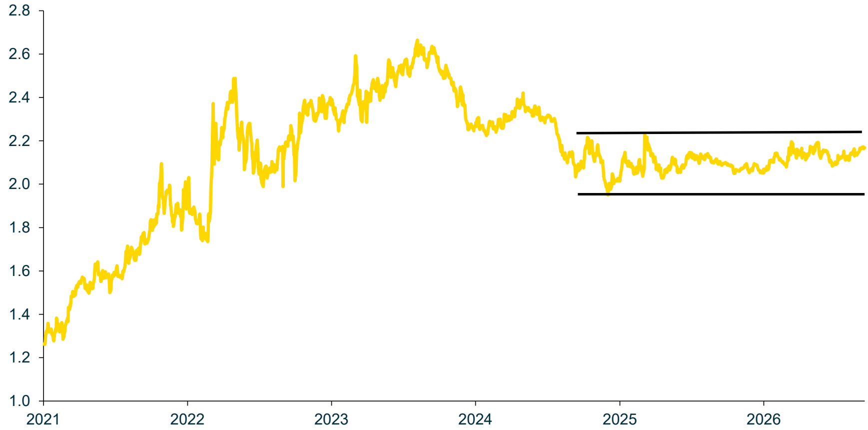
Energy prices are driving inflation expectations, ...

One of the most important drivers of yields is inflation. The conflict in the Persian Gulf has recently pushed inflation in the euro area up to 3.2%, and it is expected to rise further. This is because attacks on a key pipeline in Saudi Arabia and other incidents have sent the price of Brent crude soaring to just under $110.

The current rise in inflation has also caused investors' inflation expectations for the future to rise, which is why they are demanding – and successfully securing – higher bond yields as compensation. However, this primarily affects bonds with shorter and medium-term maturities. Long-term inflation expectations for the next five to ten years, as derived from market data, have remained largely stable (Chart 2).

Chart 2 - The long-term inflation expectations are moving sideways

Long-term inflation expectations in the euro area for the next 5 to 10 years, calculated from forward inflation swaps; in %



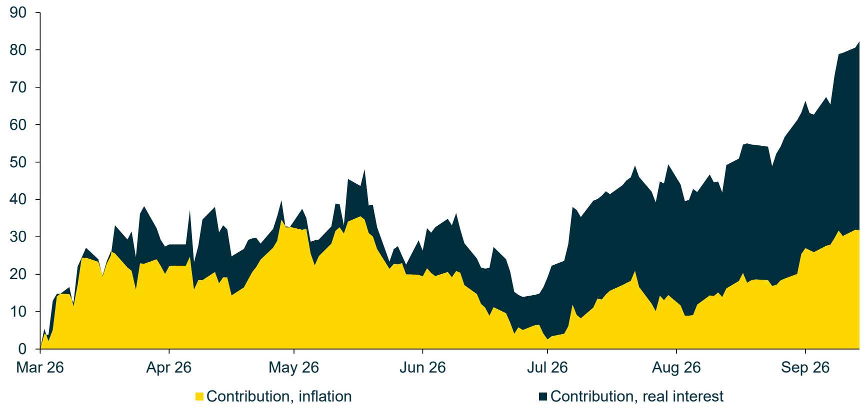
Source: Bloomberg, Commerzbank Research

... with bond yields being driven primarily by real yields, ...

In fact, Chart 3 shows that, since the outbreak of the Iran War in late February, only a little more than one-third of the rise in yields on 10-year German government bonds has been caused by an increase in market-based inflation expectations for the next ten years. In contrast, nearly two-thirds of the rise in yields can be attributed to the so-called real interest rate, which is driven by all other, non-inflationary (real) factors.

Chart 3 - The real interest drives nominal rates

Contributions to the nominal yields of 10-year Bunds, in basis points



Source: Bloomberg, Commerzbank Research

... which are driven primarily by government debt

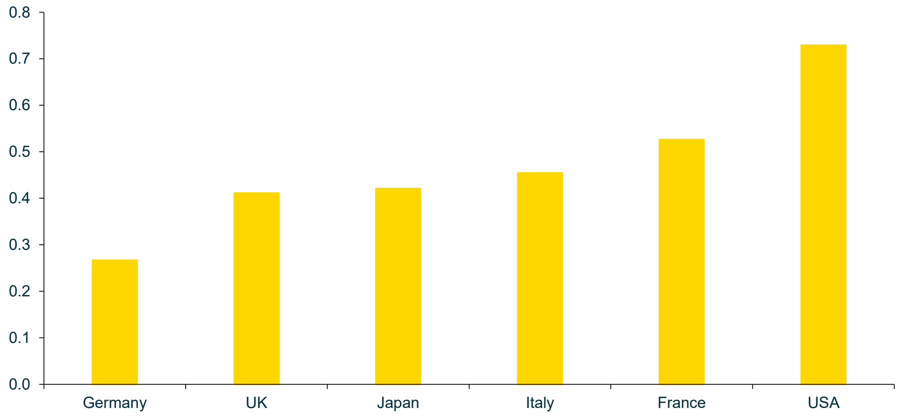
The following factors are most commonly cited as causes of the rise in real yields:

- **“Spillover” effects:** This is particularly true for European bonds: a rise in U.S. Treasury yields also drives up European bond yields because, from the perspective of many investors, they serve as substitutes for domestic government bonds.
- **Uncertainty effects:** An investment in a 10-year bond carries the risk that inflation or market interest rates will rise more sharply than expected over the course of those ten years. If this risk increases, investors demand a higher yield as compensation.
- **Supply and demand:** The supply and demand for capital change – due to increased capital needs among tech companies or economic growth for example. However, additional bond issuances by governments or the sale of bonds by the ECB can also increase supply and, consequently, yields.
- **The sustainability of government finances:** Ultimately, every bond carries a risk of default. If this risk increases – for example, due to excessive budget deficits – bond yields rise.
- **Key interest rates:** If a central bank raises its key interest rates, the real yield rises assuming inflation remains constant. This is because banks and investors have more attractive alternatives when key interest rates are higher. This effect is more pronounced for shorter maturities.

It is difficult to disentangle all these factors through data analysis. However, there are indications that spillover effects from the U.S. play a significant role for Europe, and that uncertainty about future inflation plays at least a partial role [1]. Key interest rates – or rather, expectations regarding future key interest rates – also drive up yields; however, according to our calculations, this effect is not a major factor compared to the rise in yields on 10-year bonds.

High budget deficits and speculation about the sustainability of government debt appear to be important factors behind the rise in real yields. This is supported by the fact that, by comparison to European peers, real yields have risen the most in France (Chart 4). The political deadlock in Paris has caused the budget deficit to rise to just over 5% of GDP – more than in the other major euro area countries. With regard to the future development of bond yields, government debt is therefore the key factor.

Chart 4 - The United States and France face the highest real yield increase
Increase of the real yield between January 1 and September 15 2026, in percentage points



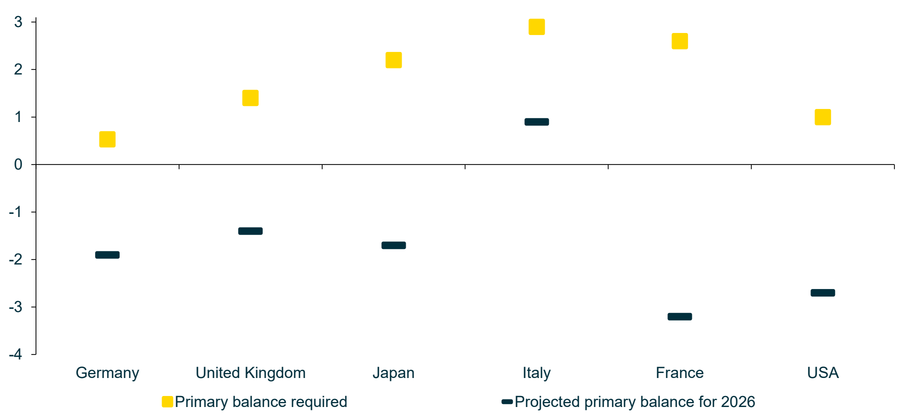
Source: Bloomberg, Commerzbank Research

The burden on government budgets is increasing

An important measure of the sustainability of government debt is the stabilization of the debt-to-GDP ratio. We therefore calculate what primary balance (the budget balance minus interest payments) would be needed to stabilize the current public debt-to-GDP ratio. The largest gaps between the required deficit-to-GDP ratio and the ratio expected for 2026 are found in France, Japan, and the United States (Chart 5).

However, there are also other measures of the strain on government budgets. For example, interest payments in Italy and the U.S. will rise to over 4% of GDP over the next five years. Both factors underscore why real yields on government bonds from Japan, Italy, France, and the U.S. have risen so sharply since the beginning of the year.

Chart 5 - The financial situation in many countries is becoming increasingly dire
Primary balance in % of GDP; required for stabilization of debt-to-GDP ratio and estimates for 2026



Source: Bloomberg, Commerzbank Research

Yields are likely to continue rising in the long term

Speculation about the sustainability of public finances will not subside without sweeping reforms in the affected countries. In that case, the supply of government bonds would also continue to rise. However, many countries lack the political majorities needed to reverse course.

If the conflict in the Persian Gulf subsides and inflation falls again, bond yields could drop temporarily. But rising government debt relative to GDP points to further increases in yields over the long term. By the end of next year, 10-year German government bond yields are likely to have risen above their current levels again.

[1] The "Drivers" model from Bloomberg Economics suggests that spillover effects from the U.S. account for more than half of the nominal rise in German bonds. However, trends such as inflation, expectations for key interest rates, and uncertainty often occur simultaneously in the U.S. and Europe. The calculated spillover effect could therefore overlap with other effects. Analyses from the BIS quarterly publication show that, for European bonds, uncertainty about future inflation plays a measurable but secondary role. (Back)

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