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Market View
Rising yields and growing debt piles: the new reality for bond investors

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Date 30 May 2025

Reading time 4 minutes

At a glance

- Developed market government bond yields rise sharply
- Japanese and US government debt see long-maturity bond yields rise to decade highs
- Current yield levels offer investors a solid income stream

Since the late 1980s, many investors have relied on the 60/40 portfolio – a mix of 60% in equities and 40% in bonds, with the majority in government debt – as a core strategy. The philosophy behind it is straightforward: equities deliver superior returns over the long term as they benefit directly from growing economies and businesses, while bonds provide an income and protect portfolios should growth shocks occur, offering solid returns while dampening volatility.

For many years, this thesis proved true. From the peak in 2007 to market lows in early 2009, US Treasuries gained 15% while the S&P 500 fell over 55%. However, this investment approach has come under pressure over the past few years. Bond yields – the return an investor earns on a bond – have been at record lows following the pandemic, supported by central bank purchases, also known as quantitative easing. Generationally high inflation prompted central banks to bring interest rates to the highest levels in two decades. This led to a sharp rise in bond yields and declining bond prices – yields move inversely to bond prices – resulting in substantial drawdowns in securities that were once considered to be risk-free.

At present, 10-year US government bond yields are around 4.5%, and therefore look compelling to investors seeking an income. However, recent developments in bond markets have raised questions about whether the 60/40 portfolio construction can be relied upon amid structural market changes.

Supply and demand dynamics impacting bond markets

Over the last few years, central banks have not only stopped purchasing new government bonds but have been reducing their balance sheets. This means the amount of tradable government debt is increasing as an indiscriminate buyer – i.e., central banks – steps away.

Meanwhile, pension funds have been adapting to regulation that requires them to match their liabilities over the past few decades with bonds and other assets. They have been large buyers of government debt and given higher bond yields, they have moved towards better balanced schemes, resulting in less incremental demand for bonds compared to the past decade. (Pension funds tend to purchase bonds with longer maturities, as they make payments to retirees decades into the future.)

At a time when demand for government bonds is weakening, supply of government bonds is increasing. This is a result of a large fiscal deficits over the past decade, with President Trump's so-called "big, beautiful bill" – which has been approved by the House of Representatives but is still being debated in the Senate – projected to put the US on a path of even larger debt and deficits.[1] This fiscal trajectory prompted ratings agency Moody's to downgrade US sovereign debt to Aa1, bringing it in line with Fitch and S&P as the rating agencies signal concern over US debt. Furthermore, the historically fiscally conservative Germany has opted to increase expenditure on defence to support Ukraine and bolster European defences given US rhetoric of removing military support for Europe. This will result in a potential increase of German bunds up to 1 trillion euros.

High interest rates result in higher interest costs for governments. As a result, governments are likely to issue more debt to finance their own increasing interest bill. The combination of all these factors have seen investors demand higher interest rates for holding longer maturity debt.

Yields march higher

On 22 May, US 30-year bond yields moved to over 5%, a level not seen since October 2023, and a level we haven't closed at since 2007.[2] Japan has experienced similar rapid increases. Japan's 30-year government bond yields moved up to 3.18% on 22 May, the highest ever since that maturity was first issued in 1999,[3] although has since fallen back less than a week later. This trend of medium- and long-dated yields rising has been going on since late last year, when the Federal Reserve (Fed) began cutting interest rates. This is a palpable concern, as rising interest expenditure when central bank cut rates impede central banks' ability to stimulate the economy.

Japan's finance ministry sent a questionnaire to market participants on 26 May asking for their views on issuance.[4] This in turn led to speculation Japan's finance ministry is about to cut long-dated issuance, following in the footsteps of the US and UK, which have both reduced issuance of longer-dated maturities.

Conclusion

The drive for austerity and balanced budgets seen during the global financial crisis has faded away in favour of more active fiscal policies given defence needs, rising medical costs and pressure on government budgets. This has spurred concerns about the issuance of government debt and ultimately, who will be the buyer of this debt.

In the aftermath of Trump's so-called Liberation Day, bonds demonstrated their role as a diversifier during the short and sharp global growth shocks. Although the 60/40 model faces headwinds, the income the bond component provides is the most attractive in decades. While the path remains uncertain and the prospects for capital returns are unclear, investors can still rely on the income.

[1] BBC: https://www.bbc.com/news/articles/c0eqpz23l9jo

[2] Deutsche Bank

[3] Deutsche Bank

[4] Bloomberg

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Jeremy is our Deputy Chief Investment Officer. He sits on the Investment Committee and chairs the Fixed Income Committee. His coverage encompasses both rate and credit products and works closely with the funds team.