Market View

Do rising bond yields change central bank thinking?

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At a glance

- The Fed, ECB and BoJ all held interest rates this week, as government borrowing costs reached multi-decade highs.
- Rising bond yields raise borrowing costs across the global economy but matter more where they reflect fiscal concerns than economic strength.
- This is unlikely to change near-term rate decisions but may lead to wider divisions within central bank committees.

The US Federal Reserve (Fed), the European Central Bank (ECB) and the Bank of Japan (BoJ) all announced that they were holding interest rates steady this week, despite a backdrop of rising yields. However, both the Fed and the ECB left the door open to further increases. Over the past two months, 10-year government bond yields in both the US and France have risen above 5%, reaching levels neither have seen since 2002.[1]

Rising bond yields matter to central banks because they tighten financial conditions – the overall cost and availability of borrowing for households, companies and governments. When long-term borrowing costs rise, mortgages, business loans and government debt all become more expensive, which slows the economy without any change in interest rates. The question is whether central banks see this as a welcome constraint on demand, or as a problem that requires a response.

This week, we look at why higher yields appear to be less of a concern for the Fed than for the ECB, what ECB President Christine Lagarde signalled about France, and how Japan, a significant owner of French government bonds, fits into the picture.

The Fed holds as US growth outpaces borrowing costs

On Wednesday, the Fed held its main interest rate at 3.75–4.00%, following a unanimous 0.25% increase in September, although two of the 12 voting members dissented in favour of a further increase. Chair Kevin Warsh acknowledged that financial conditions had tightened but said he was "unwilling and unable to call them tight".[2]

The minutes of the Fed's September meeting showed officials largely attributing the rise in yields to expectations of higher interest rates, continued investment in artificial intelligence and solid economic growth, rather than to concerns about government borrowing.[3] In the US, nominal growth – the growth in the size of the economy before adjusting for inflation – was 5.9% over the past year, ahead of a 10-year yield of around 5%. When incomes grow faster than the cost of borrowing, higher yields are easier for households, companies and the government to absorb. For this reason, the Fed's debate remains focused on inflation rather

than on the bond market.

French borrowing costs reach a 24-year high

The picture in Europe is different. The yield on France's 10-year government bond peaked at 5.08% last week, while the additional yield investors demand to hold French rather than German government bonds widened to around 1.7%, before easing to around 1.55% this week.

Much of the cause is domestic and reflects growing concerns about its public finances and political uncertainty. France's budget deficit has exceeded its target of 5% of gross domestic product (GDP) for four consecutive years and is now expected to reach 5.4% this year, while government debt has risen to around 119% of GDP.[4] Lawmakers remain divided over next year's budget, which includes €43 billion of spending cuts and revenue measures that the government lacks a majority to pass. The cuts are challenging to implement as trade unions have called for nationwide action on 5 November following weeks of widespread protests.

France is also unusually reliant on overseas investors, who hold around 60% of its government debt, compared with roughly 30% in the US and UK.[5] This leaves French bonds more vulnerable to shifts in foreign investor demand.

Lagarde revealed more than the ECB

On Thursday, the ECB held its deposit rate at 2.5%, as expected, even though eurozone inflation reached 3.8% in September as energy prices rose. In its statement, the ECB noted that financing conditions had tightened since its last meeting, which is likely to weigh on inflation and growth. It is estimated that the rise in German bond yields since September has had roughly the same effect on growth and inflation as a 0.25% rate increase, and closer to 0.5% for France.[6]

For investors, the key question was therefore around how Lagarde would characterise the rise in French yields. The ECB has a bond-buying tool, created in 2022 and is yet to be used, that allows it to support a country whose borrowing costs rise in ways it judges unjustified by economic fundamentals, provided that the country follows EU fiscal rules. Ahead of Thursday’s ECB meeting, Lagarde said the "primary and first solution lies at home in France". This suggests the ECB may be reluctant to intervene directly unless market conditions deteriorate significantly.

At her press conference, Lagarde took a more neutral tone, stating that the ECB has tools to address disruptions to the way its policy decisions feed through to borrowing costs across the eurozone.[7] However, Lagarde also announced her intention to step down as ECB President in February 2027, eight months early, giving Macron the opportunity to elect her successor.

Japan faces its own test with higher yields

On Friday morning, the BoJ held its main interest rate at 1.25%, the highest level in 31 years. One of the nine board members voted for an increase to 1.5%, and the bank said for the first time that underlying inflation has reached its 2% target, validating expectations that it will raise rates in December.[8] Japan's 10-year yield has risen above 3% for the first time since 1996, reaching around 3.1% in early October, partly reflecting Prime Minister Sanae Takaichi's spending plans.[9] Yet Japan's budget deficit is much smaller than France's, and only around 14% of its government bonds are held overseas, leaving the market far less exposed to foreign selling. BoJ Governor Kazuo Ueda has argued that raising interest rates at an appropriate pace would itself help to avoid spikes in bond yields.

Developments in Japan matter for European bond markets too as Japanese investors hold around 5% of French government bonds, but with Japanese yields now more attractive, some have begun to sell.[10]

What this means for portfolios

Rising government bond yields tighten financial conditions wherever they occur, but the significance depends on what is driving them. In the US, they largely reflect a strong economy, while in France and, to a lesser extent, Japan, they reflect concerns about public finances that are harder for central banks to ignore.

On balance, we believe this is unlikely to prompt the ECB or the BoJ to change course on interest rates in the near term. However, it may lead to wider disagreement within their committees, as some members weigh the tightening already delivered by bond markets against inflation that remains above target. A disorderly rise in French yields that spreads to Italy and other eurozone countries would be the development most likely to change that.

For investors, this argues for being selective about which government bond markets you hold, and when. Where yields are rising alongside economic growth, they offer an attractive source of income. Where they are rising because of fiscal strain, volatility is likely to persist, which makes disciplined position sizing and a focus on time horizon more important.

Sources

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2 Federal Reserve

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7 Bloomberg

8 Bloomberg

9 Reuters

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