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Navigating the volatility in global bond markets

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Allison Nathan: Bond yields around the world have been exceptionally volatile in recent weeks. So, what's behind the sharp moves in global bonds? And what could they mean for the economy and for investors? I'm Allison Nathan and this is Goldman Sachs Exchanges.

Today, I'm joined by Jonny Fine, Global Head of Investment Grade in Goldman Sachs Global Banking & Markets and by George Cole, Head of European Rates Strategy for Goldman Sachs Research. Jonny is here in our New York studio and George is joining us from our London office. George, Jonny, good to talk to you.

Jonny Fine: Nice to be back.

George Cole: Thanks, Allison.

Allison Nathan: So, George, let's start with you. Global bonds have been markedly, and I would say, unexpectedly no investors that I know of was expecting this level of volatility heading into the new year. So, help us understand what's driven the recent moves.

George Cole: Yeah, thanks Allison. So, if we go back over a kind of multi month period since, say, around about the September period have been very substantial in global bond markets. US yields moving about 100 basis points higher at the 10-year point on the curve. Similar move in the UK. Maybe about half that in European yields. And all of that is really, I think, due to a revision of expectations on growth, on inflation, and on the monetary policy path that is expected particularly from the Fed.

Now, part of that is because the US data set has been better. You've seen improvement in things like the labor market where there was some source of concern if we go back to the September period. We've also seen the Fed

revise its view of inflation. It did that at the December meeting, leading to a revision of expectations of just how much the Fed could be cutting interest rates.

And of course, after the US election we had a fairly substantial pricing of US growth stronger across US macro assets. And so, all of that has pushed up bond yields across the curve. And I think what is really important to note and really important when we think about the interaction across global bond markets, is it's not just been a change in the policy path for yields, and particularly in the US, it's also been an increase in bond risk premia.

And the way that we would think about that is we know that deficits are large. There is a lot of supply of sovereign bonds coming to market. That is much easier to digest if inflation is low, you know, growth is slowing, and central banks are cutting when you see expectations going in the other direction. Actually, what we are seeing is the market demand additional risk premia in the curve. So, we see this simultaneous increase in rate expectations. But also bond risk premia in the major bond markets.

Allison Nathan: And so, Jonny, is that what you're

seeing, just this sense that there's a digestion problem brewing in the bond market?

Jonny Fine: I think it's a combination of things. And I think those things are all rooted in fundamentals, at least in the near-term, uncertainty, and fear. And the fundamentals in the near-term are what's the data telling us? So, obviously, it's very unusual. We began a cutting cycle in September and 10-year yields are almost 100 basis points higher than they were then when the Fed started. That wasn't on anyone's bingo card coming into 2025, or certainly the back end of last year.

But the fundamentals, as George mentioned, have been good. Growth dynamics have been good. The labor market has been strong and robust. And economic data has been leaning towards more inflationary as opposed to disinflationary. And that has changed the narrative around the path of short-term rates for the Fed. So, coming into the payrolls report at the back end of last week, markets priced in just over one cut for the remainder of 2025. A little bit more than that now. But it was really just kind of one cut, there or thereabouts.

And as David Mericle, and other people in the research group frequently remind me, the expected path of rates is really a probability weighted average. And when you kind of think about where we'd gotten to, if you have one cut that's priced in by the end of the year, that could be if you have, like a two-person survey, it could be one person saying, "I think there's going to be two cuts," and one person saying, "I think there are going to be no cuts." And therefore, the probability weighted average is one.

If you looked at all the data and volatility as to where things stood, there is actually a 35 percent probability that over the course of the next 12 months the short-term rates will be higher, i.e., the Fed would be hiking. That seemed a little unusual. Didn't really seem to square with the data. But there was, obviously, a lot of fear and uncertainty that was in that.

There's a lot of uncertainty, I think as well, with respect to government policy. The reality is, is that under the next administration, we know what the direction of travel is for things that impact rate markets, fiscal policy, trade policy, immigration policy, government efficiency as well. We know what the direction of travel is. We don't know how far away

the destination is. And we don't know how fast the car is driving towards that destination either. And that won't be clear for several weeks and months.

So, that uncertainty has embedded itself in a much higher term premium than we're used to seeing in treasury yields. In fact, I think we're at the highest level of term premium for over 10 years. Or certainly since 2015 in 10-year treasuries at around about 60 basis points.

Now, one thing I think that the market is doing with this uncertainty, and this comes to the fear point, is that they're pricing some of these outcomes to worst. They're pricing some of the outcomes from a tariff perspective to worst. They're pricing some of the outcomes from a labor market tightness, deportation, impact on labor input cost, etcetera, etcetera to worst. And they're pricing some of the fiscal imbalances to worst as well. And as a result of that, that created, I think, the backdrop for this significant run up in yields and increase in treasury volatility.

So, that's kind of how I think about it. Fundamentals uncertainty and some real fear leading to what I think has been some inefficiencies in how the market's priced term

yields.

Allison Nathan: Right. And so, term premium, by the way, is just what investors demand for holding the risk of sovereign bonds, right?

Jonny Fine: Further out the curve, yeah, exactly. Above and beyond what might be thought to be the fundamental value of the yield curve at that point in time.

Allison Nathan: But if we take a step back and we think about market expectations, which have driven a lot of this as you have said and George has said, it's been, from my perspective at least, very volatile in the sense that last year at one point the market was pricing seven cuts. Now they're, as you just said, there is a meaningful probability being priced into the market of hikes. Obviously, the data has changed. But even before the election, it just felt that the market was particularly sensitive and particularly volatile. Is that true? Or is that just my impression?

Jonny Fine: No, it's very, very real. And I think a lot of what's rooted in that is that when we got to the peak of the hiking cycle, there was the expectation that it would be a

real bite taken out of economic activity. The transmission mechanisms of higher interest costs for consumers, higher funding costs for corporates, the consequence impact on economic activity. And it didn't really happen to a meaningful degree. And so, the narrative started to shift towards US economy can do pretty well in a higher yield environment even on a sustainable basis.

And then what changed from there was with the activity levels remaining robust and with, as said, kind of the disinflationary indicators starting to slow, and it becoming clearer that we'd get to the Fed's two percent inflation target more slowly, the market started to really ask the question as to how restrictive really is monetary policy?

And so, like no one really knows what this thing is, as we call, R squared, which is the neutral rate of interest above which there should be contractionary pressures on the economy and below which there should be expansionary. But markets started to say maybe that R squared, which people had previously thought around about 3 percent, might actually be nearer 4 percent, which means that we're therefore much nearer the end of the cutting cycle than anyone had thought previously. I think that's probably not

the right interpretation for the market to have. But to me, that's been in part a significant driver of some of this volatility.

And the one aspect that you touched upon in your original question that we haven't really responded to is the technical pressure of the supply of treasuries that might come to market. And I think this will be really interesting under the next administration. One thing that was notable about the funding strategy of treasury, particularly in 2024, was that a lot of the issuance was in the bills market and the very short duration markets overall that were going to money market funds. And therefore, not going to the term markets. Not going to 10 and 30-year treasury notes and bonds. And so, de facto, there wasn't the pressure of the long end of the curve last year.

Some of the incoming members of the administration have been quite vocal about this not being the appropriate financing strategy that they would like to see play out. Wanting to have a longer duration average issuance pattern and strategy. And people have started to kind of think about, well, maybe that means that this mix of bills versus bonds is going to shift under the next

administration. Scott Bessent, the incoming Secretary of Treasury, confirmed, has been outspoken on this point. The incoming CEA chair Stephen Miran has been very vocal about, in effect, the last administration followed what he calls an activist treasury issuance program, which is that de facto using government funding is a tool to impact monetary policy transition into the real economy.

Allison Nathan: Interesting. So, George, you had mentioned that even though in the last week or two we've seen a bit of a bond market panic, as I would describe it, bond yields are actually off their recent peak in part because the data's a little bit kinder. If we think about the US inflation data, in particular. But how vulnerable is the market to more volatility ahead? It seems like this is just data point by data point.

George Cole: I do think that really does speak to the uncertainty that Jonny mentioned earlier. The market has gotten a little more nervous about the inflation trajectory. And so, the incoming data that we got this week in the US, quite a modest downside surprise to inflation, but nonetheless, enough to see yields correct, you know, fairly substantially lower. It was, of course, reinforced. We had a

move in UK CPI where, arguably, you know, maybe the stakes were a little bit higher given inflationary concerns there. That was also a downside surprise that offered some calm to the market.

But I think what that is telling you is that the inflation data still really does loom large. And so, of course, incoming prints are going to matter a lot. I think that when you think about the Fed's perspective, there remains uncertainty about the inflationary impact of the various policies of the new administration. Tariffs being a good example of that.

Jonny's point is very well taken. The market, I think, so far has concentrated, at least in the US outlook, on the inflationary consequences of tariffs, rather than necessarily the growth impact. I think that that probably is not quite true in the rest of the world where, as we might speak about later, there's been a much less rosy or optimistic repricing of growth, say in Europe or China since over the last couple of months.

But it does mean that that uncertainty, until it resolves, is probably going to keep the volatility around the data prints relatively high.

Now, on the data path we're expecting, there won't be renewed inflation pressures coming out of, say, the labor market or forward inflation expectations, outside of potential tariff-affected categories. We are expecting inflation to continue to moderate in an underlying sense and, ultimately, that provides some more anchoring on medium-term relief for yields. But of course, until we get through some of the early phases of this administration, we learn a little bit more about upcoming policies, we're probably still going to find the data points quite volatile.

Jonny Fine: But George, do you think about tariff inflation differently from, let's call it, normal inflation? Obviously, tariff inflation is one time in nature. And does it demand therefore the same monetary policy response as would, quote/unquote, "normal inflation?" Or is this kind of like really something that market practitioners should be a little less concerned about?

Allison Nathan: Right. And by the way, will the market appreciate that difference?

George Cole: Yeah. I think it's a great question because,

ultimately, we've had a similar debate before if we go all the way back to the 2021/2022 inflation episode, which not in full but at least partially was driven by some temporary supply side distortions that, of course, was infamously leading to the description of transitory. Now, it is right that a one-off change in the price level, in theory you should be able to look through such a change. But what is really key is do you see second round effects where that initial surge in inflation, maybe for a single or temporary supply-side shock or some one-off price change, does that affect behavior in the rest of the economy by raising inflation expectations, raising wage demands that then see that inflation shock propagate through the rest of the economy?

Now, the good news, I think now, is that the fears around those second-round effects are subsiding. And I think that that is true across many economies. And in the US in particular, if you look at things like wage pressures, measures of inflation expectations outside of a particular survey we got on the University of Michigan release, they have generally been quite benign and suggest that the risk of those second-round effects are pretty limited.

Now, of course it will depend on the uncertainty around

tariff policy. One of the aspects that I think is still unclear is do we get a set of tariff announcements and then think that that is it? Or does it increase uncertainty further down the line about more to come? All of those sorts of things probably need to be weighed up. But as it stands, we are relatively optimistic that outside of the categories directly affected by tariffs, we are going to see those second-round effects remain quite low and that monetary policy has probably got to be anchored on that underlying inflation dynamic that we still are probably optimistic about.

Allison Nathan: So, Jonny, George obviously has a pretty benign view of how things go ahead. But when you talk to clients, both on the investor side and on the corporate side, how are corporates dealing with this level of volatility? How concerned are they about the rate outlook as they think about their strategies?

Jonny Fine: On the investing side of the equation in the business that I traffic in day to day, which is corporate debt, investors love these high yields. And by definition, great risk-adjusted returns available for their portfolios. And that's been in part something that's kept credit spreads at what are now very close of the multi decade

tights.

From a corporate issuers' perspective, those who think about their issuance cost on a fixed rate cost of debt basis, they're continuing to grapple with the same issues that have really been present for a couple of years now, albeit having made peace with the fact that we're not going back to a zero-interest rate environment and a 2 percent 30 year any time soon.

And so, the good news is that for the most part earnings are outstripping any impact from this increased interest expense. And growth opportunities are creating investment opportunities for our corporate clients that are hurdling, even with higher inputs for cost of capital. So, that means that there's continuing demand to issue corporate debt. It's been a pretty busy start to the year. We'll kind of really have a better picture of that post corporate earnings and as we get into the bulk of the first quarter. But for many it's business as usual.

Now look, at the same time, I think where we are, especially compared to a year ago when we had elevated yields but a sharply inverted yield curve, we now have a

positively sloped yield curve. So, it is cheaper to issue shorter-dated debt than it is to issue longer-dated debt. I'd expect some corporates to avail themselves of that lower financing cost, especially those who are very responsible in the low yield environment and really termed out their capital structures.

There will be others, I think, that will look at the financing environment and saying, sure, that's the cost of doing business, but maybe I'll average in over the course of a year, as opposed to getting all my financing done in one fell swoop. And they'll average in by either issuing debt a couple times as opposed to once. Or they'll use some interest rate derivatives to help manage that risk.

Allison Nathan: And George, if we think about that relationship between global growth and yields, how are you thinking about that as this point? And at what point would yields begin to weigh on our growth outlook?

George Cole: Well, I think that we spend a lot of time talking about the fundamental justification for higher yields and the improved prospects for the US economy that was being embedded into that yield move. And I think

that’s a really great contrast to make against the rest of the world where it's not as obvious at all. That either there is this support for that higher yield view in the growth data. If we think from Europe to China to the UK, growth data has been anemic. And although you’ve seen maybe a slower than expected decline in inflation, it still looks like inflation is on the downward trajectory in those economies. And yet, what you have seen is that yields have been dragged higher as a result of the US move.

So, I really do think that the story between the US economy and the rest of the world remains quite a divergent one. And we’re in, perhaps not for the first time, a situation where we need to ask the question, is the yield move we’re seeing across global bond markets appropriate for all these economies? Or is it really an issue of having to live with the higher yields that are being generated by the US economy?

And so, we’ve seen rate spreads widen, particularly between the US and Europe. That seems to us to be fundamentally justified. But it may well be the case that we’ll see this yield move start to decouple or look a little bit stretched, and get some of those growth fundamentals in the other economies.

Now, in the US itself, I think that we are, particularly since the December Fed meeting, seeing a slightly less favorable response in risk assets to the move higher in yields. And of course, the response to the US CPI relief was quite telling in that regard.

Now, that probably tells you that at least the question is being asked, is the size of the move in US yields now compatible with very high growth expectations in the US? Our analysis suggests the move has probably not been big enough to be self-correcting just yet. But I think that that is looking a little clearer in some of these other economies where the fundamentals are less strong, that maybe these yield moves, at least from that spillover that we're seeing from the US, are becoming counterproductive.

I do think that the UK has really been one of the best exponents of the spillover effects from higher US yields and a higher duration or term premia in global curves. And the reason I would say that, the UK is a twin deficit economy. It borrows from the rest of the world. It has a fiscal deficit. And as a result, it probably should be a relatively high beta expression of yield moves when global interest rates go up.

Allison Nathan: Last question, maybe more of a speed round. George, where do you then see bond yields moving through 2025?

George Cole: We do think they're moving lower. We're forecasting 4.35 percent on the US 10-year yield, 4 percent in gilt yields, which is a long way below current levels, and 1.9 percent in European yields. Now, of course, that forecast depends on the relative growth in inflation trajectories continuing to show, at first point, divergence. So, we're expecting weaker growth outcomes in the UK and the European economy versus the US. But we're expecting underlying inflation progress across all three. And that really does remain the key.

There are some, maybe, headline inflationary effects that might give volatility to inflation releases over the year, particularly in the UK. But as long as we're seeing that progress in underlying inflation moving lower, as long as we're seeing the evidence that those second round effects that central banks were so worried about are something we shouldn't fear for 2025 and beyond, we do think that this gradual cutting cycle will soothe bond markets and see

rates a little bit lower.

As always though, we're of course watching the data like a hawk. And in particular, some of these inflation releases.

Allison Nathan: And Jonny, do you agree?

Jonny Fine: I mean, you can't ask an economist and a banker a speed round question without getting a two-minute answer. So, I'll do my best. So, I think the following. I think that the markets fear that the neutral rate of interest is higher than anyone thought it was 12 months ago. I think that's overblown. I think the market is underestimating the potential fiscal responsibility, both in terms of income, as well as spending, from the next administration. And I think the market is overestimating the impact on inflation from tariffs that will be implemented under the next administration overall. I think all of those things together make me a bond bull for the year.

Allison Nathan: Great, thank you so much Jonny and George.

Jonny Fine: Thank you for having us.

George Cole: Thanks, Allison.

Allison Nathan: This episode of Goldman Sachs Exchanges was recorded on Friday, January 17th, 2025. I'm your host, Allison Nathan. Thank you for listening.

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