CAPITAL ECONOMICS

GLOBAL MARKETS UPDATE

New forecasts for developed market government bonds

- **In line with our upwardly revised forecasts for the 10-year US Treasury yield, we've raised our projections for 10-year government bond yields in most other developed market economies. But we still expect those yields to fall, in general, by the end of next year, and in some cases by quite a lot.**
- **We recently revised up our forecast for the 10-year US Treasury yield, for a couple of reasons.** For one, we've raised our estimate of where the fed funds rate will be in the medium term. What's more, we think the rise in term premia – which seems to have been behind much of the sell-off in long-dated Treasuries lately – is unlikely to reverse. (See our recent *Update* for all the detail on this forecast change.)
- **Similar factors, in our view, apply elsewhere as well.** We've pushed up our medium-term policy rate forecasts in a few economies, including the euro area and Japan,. And while we don't have timely estimates of government bond term premia for most economies, it wouldn't be surprising if they'd increased alongside those in the US as well.
- What's more, the smaller falls in Treasury yields we now expect would probably put less downward pressure on yields outside the US.
- **As a result, we've revised up our forecasts for 10-year yields in most economies, and now expect them to settle significantly (50-100bp) higher than we'd previously projected. There are two overarching points to note about the new forecasts.**
- **First, we still expect yields to fall by the end of next year.** Although we've nudged up our forecasts for central bank policy rates in a few places in recent months, those forecasts are still generally lower than those implied, for example, by OIS rates. (See Chart 1.) We suspect investors may be underestimating how quickly many major central banks will turn dovish as inflation reaches their targets.
- **Second, we think there will be significant variation in how far yields fall across different economies.** While we think inflation is on the way down across the board, in our view some central banks will have to keep rates elevated longer than others to ensure price pressures ease sufficiently.
- **In the euro-zone, in particular, we don't think yields will fall far.** We suspect the ECB is unlikely to be in a position to cut rates until late next year. And when it does, we expect it to follow something close to the path already discounted in markets for a while. (See Chart 2.) We still think the central bank will *eventually* cut a bit further than investors expect; that, coupled with lower Treasury yields, might still place some downward pressure on euro-zone yields. But we don't think they'll fall by much, especially compared with the decline we expect in the 10-year US Treasury yield.
- **That said, within the euro-zone, we think yields in the "peripheral" economies will decrease a little more, over time, than those of "core" economies.** In the near term, the yield spreads of peripheral bonds over core ones will probably be held in check by the prospect of ECB intervention, even if the economic picture deteriorates a bit. And we think that as the economy starts to find a firmer footing in late 2024, spreads could narrow a little. But we don't think they'll fall far, with worries about fiscal sustainability – especially in Italy – likely to remain in the backs of investors' minds.
- We've also revised up our forecasts for the 10-year gilt yield, consistent with a view that policy rates there will have to remain higher for longer than we'd previously thought to bring inflation down in the UK economy. But we still think investors are underestimating how far the Bank of England will cut once it *does* get started; that, in our view, will mean the 10-year gilt yield falls quite sharply. (See our forthcoming *UK Markets Outlook* on our dedicated *UK Markets* Service for more detail.)
- **By contrast, we think yields in Australia, New Zealand, and Canada will fall by roughly as much as those in the US.** Although these economies have held up better than expected, partly due to high inward immigration, the signs still point, in our view, to significant slowdowns in all three. That, we think, will sap

Thomas Mathews, Senior Markets Economist, thomas.mathews@capitaleconomics.com

inflationary pressures and ultimately allow central banks to cut by much more than seems to be discounted in financial markets.

- **Finally, we suspect the Bank of Japan will be less of an outlier than it has been in the past. But we still don't expect the 10-year yield there to move all that much.** We expect it to join the global hiking cycle – if belatedly – early next year. And Yield Curve Control no longer seems to be a binding constraint, meaning the 10-year yield is more free to move with those elsewhere. But ultimately we think rate hikes there will be small – indeed, somewhat less than investors expect (see Chart 3) – and that volatility in JGB yields is unlikely to pick up much. As such, we expect the 10-year JGB yield to fall, but only by a little.
- **Chart 4 shows changes in 10-year government bond yields implied by our new forecasts.** The full detail will be available shortly on our data platform.

Chart 1: OIS-Implied Policy Rates At End-2025 Less CE Forecasts (bp)

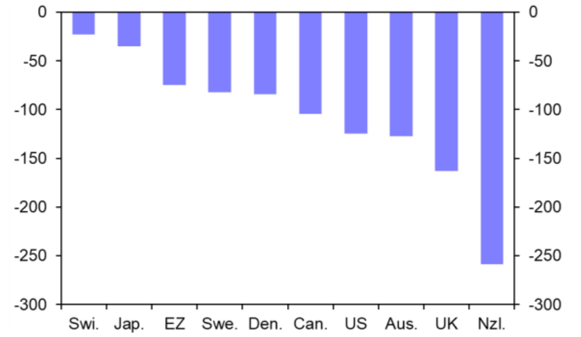


Chart 2: ECB Deposit Rate (%)

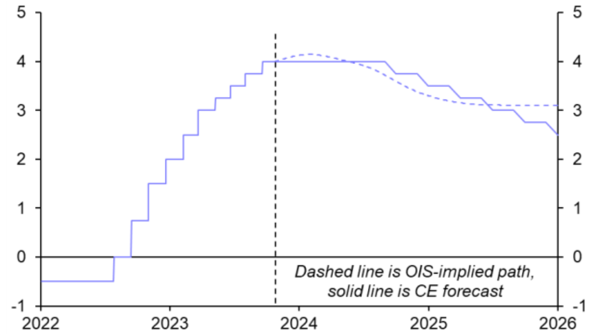


Chart 3: Bank Of Japan Deposit Rate (%)

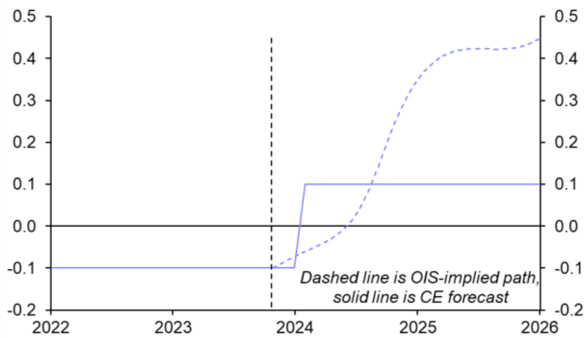
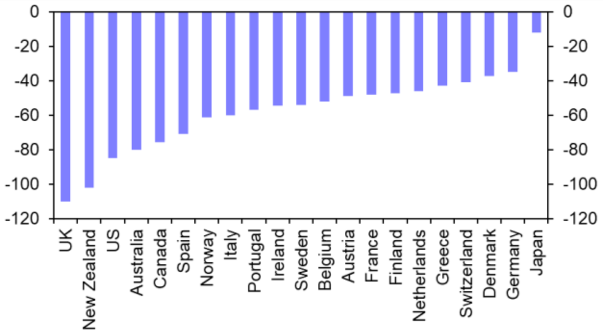


Chart 4: Changes In 10-Year Yields To End-2025 Implied By CE Forecasts (bp)



Sources: Refinitiv, Capital Economics

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