

The Developed Market Inflation Vigilante

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Rising sovereign bond yields have dominated financial headlines across developed markets (DMs) in recent months. How can we make sense of this apparent global realignment toward a “higher-for-longer” interest-rate posture?

- “Soaring bond yields, gaping deficits and towering debts: what could go wrong?”
- “Battered bond market braces for a new era of interest rates”
- “US 30-Year Treasury Yield Rises to Highest Level Since 2002”
- “France is becoming the ‘poster child’ of sovereign debt problems as government borrowing costs hit near 2008 highs”
- “Australia Bond Yields Jump to Highest Since 2011 on Oil Concerns”

No doubt some of the increase reflects the market’s concern about a lack of fiscal discipline, or the so-called “bond vigilantes” explanation. At Syzygy, however, we prefer to test such narratives against the actual data to see if they truly reflect the underlying economics. That’s where our **Asset Allocation Interactive (AAI)** tool comes in.

First, to place the recent yield spikes in their appropriate historical context, we examine the 10-year tenor across 21 developed and emerging markets (EMs) using our **Government Nominal Yield dashboard**. **Exhibit 1** shows that current intermediate-term borrowing costs are at or below their long-run median in most countries. Rather than an outlier, the recent upswing in sovereign bond yields looks more like a return toward historical norms.



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Key Points

- Sovereign bond yields, though on the upswing, are not especially high. Rather, they are moving back toward their historical norms.
- Inflation is the main economic driver of the steepening yield curve. Across a 21-country sample, the correlation between inflation and the 10Y-3M yield curve slope is 65%, its highest level since 2022.
- The effect is more pronounced in developed markets (DMs), where inflation has proven comparatively sticky. DM yield curves have steepened more than their emerging market (EM) peers.

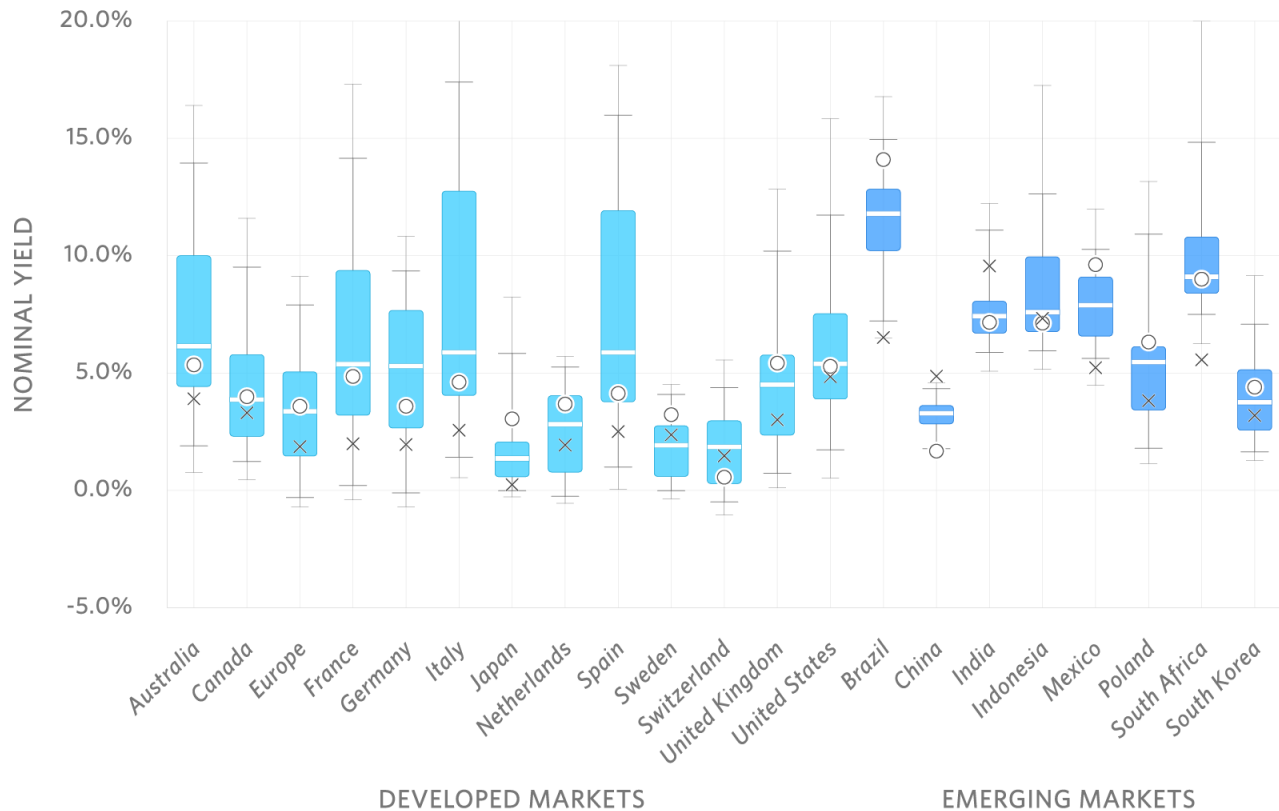
Exhibit 1. AAI Government Nominal Yield (10Y) Dashboard



Currency: USD
Expected Returns Model: Valuation Dependent
Real/Nominal: Real Terms
Time Horizon: Expected 10Y

Interest Rates - Government Nominal Yield (10Y)

× Expected in 10Y
○ Current



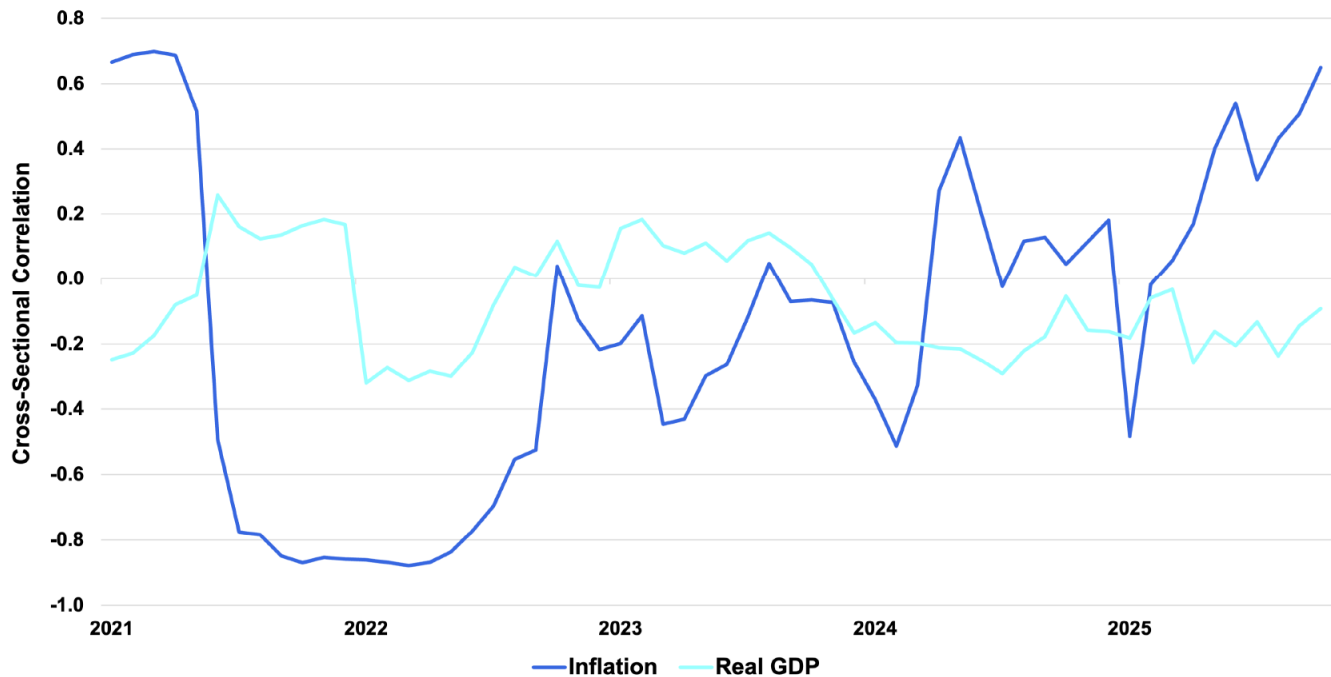
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Of course, the policy rates set by each country's central bank influence intermediate-term rates. To isolate the economic drivers of this environment beyond monetary policy – which have been particularly active since 2022 – we need to strip out the short-term rate. On AAI, we model this simply with the **Government Slope** dashboard, which shows the 10-year minus three-month (10Y-3M) yield curve slope across our 21-country sample.

Armed with this data, we examine the cross-sectional correlation between the 10Y-3M slope and the current inflation rate in each economy as shown on AAI's **Global Inflation** page. Here, something stands out: the correlation between the two series is 65%, which

places it in the 97th percentile historically. That is the highest level since the initial inflationary surge peaked in 2022. **Exhibit 2** shows the trajectory of this series from late 2021, when global inflation first started to rise amid the COVID-19 pandemic.

**Exhibit 2. Cross-Sectional Correlation:
10Y–3M Slope and Inflation/Real GDP Growth**

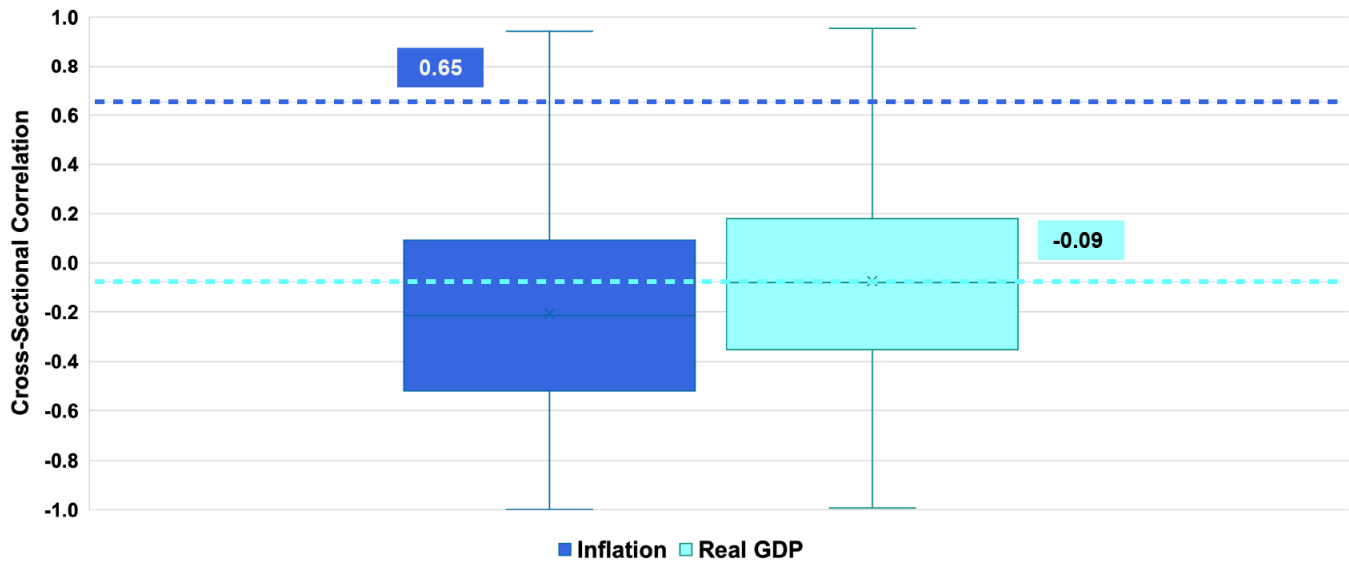


Source: Syzygy Asset Management, based on data from Bloomberg.

Across countries, the relationship is clear: the higher the inflation rate, the steeper the yield curve tends to be. Since 1970, this series of correlations has averaged -21%; **Exhibit 3** shows the recent stretch is quite abnormal.

Using AAI, we also examine other possible explanations for the higher slope, such as robust GDP growth. The connection is negligible, which indicates that inflation, rather than current or expected growth, is more closely associated with the unusually steep yield curves we see throughout the world today. So, while the bond vigilantes may indeed be trying to impose fiscal discipline, inflation seems to be what's really shaping yield curves.

**Exhibit 3. Distribution of Cross-Sectional Correlation:
10Y–3M Slope and Inflation/Real GDP Growth**

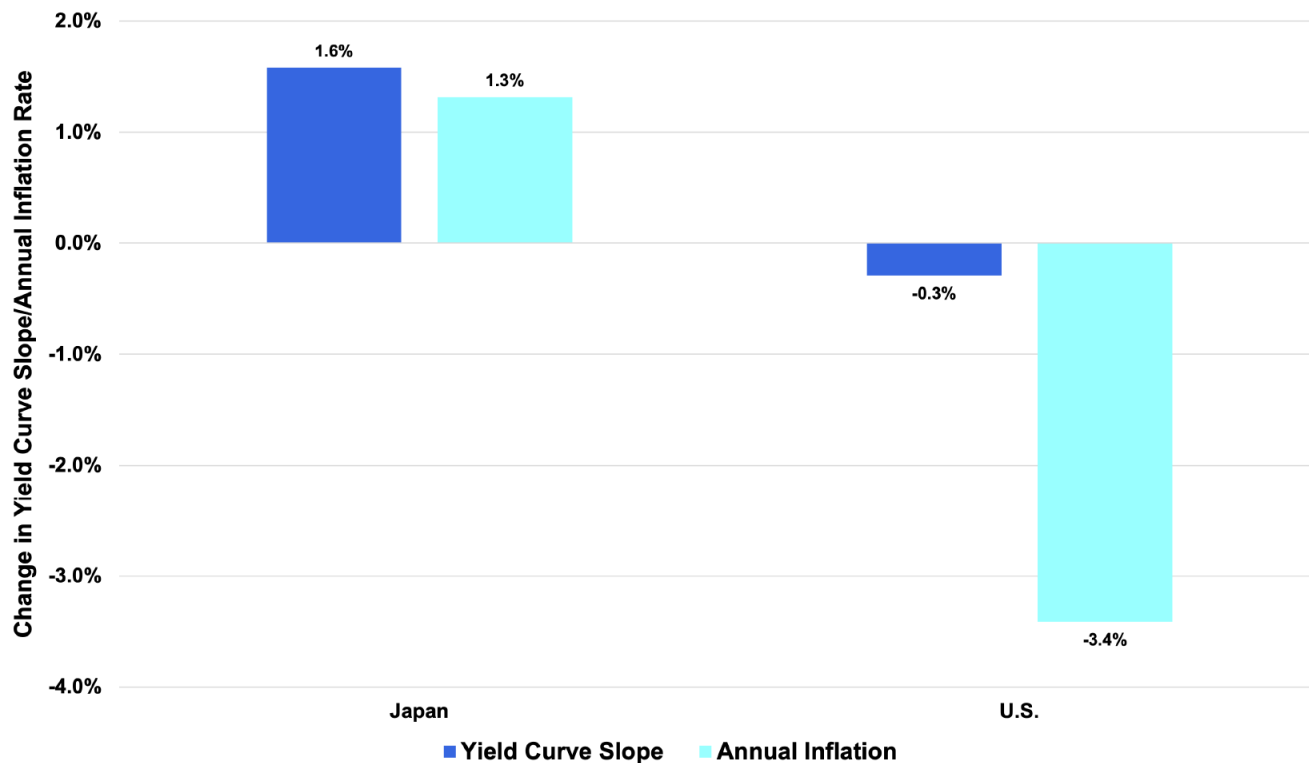


Note: The dashed lines and text boxes highlight the current cross-sectional correlation relative to the long histories of the distributions, which go back to 1970.
Source: Syzygy Asset Management, based on data from Bloomberg.

Categorizing the 21 countries into DMs and EMs presents another interesting takeaway: rising DM inflation is a relatively recent phenomenon. The average DM inflation rate is only about two percentage points lower than its average EM counterpart, which places it in the 17th percentile historically. In 2022, however, average EM inflation was five to six percentage points higher than average DM inflation. Since 2022, evidently, DM inflation has been comparatively stickier.

Higher inflation has more recently led to higher 10Y–3M slopes, as **Exhibit 2** shows. Indeed, the average DM yield curve has steepened by 2.2 percentage points in the last couple years, compared to only 1.6 percentage points for its average EM peer. Japan provides perhaps the most salient example: Since December 2021, its yield curve slope has increased more than that of any country in the sample except Malaysia. At the same time, only Turkey, Indonesia, and Australia have eclipsed Japan in its annual inflation rate change. **Exhibit 4**, which shows Japan’s yield curve slope and inflation next to those of the United States, reveals the inflation vigilante at work.

Exhibit 4. The Japanese vs. U.S. Yield Curve Slope and Inflation Change (since December 2021)



Source: Syzygy Asset Management, based on data from Bloomberg.

Rising sovereign bond yields have important implications for expected returns across many asset classes. We encourage readers to explore AAI to see how the changing rate environment is influencing our current forecasts. Our analysis shows that resurgent inflation is driving these higher yield curves across the globe, but especially in developed markets.

While the bond vigilantes may be getting the headlines, the inflation vigilante is what we see in the data.

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