

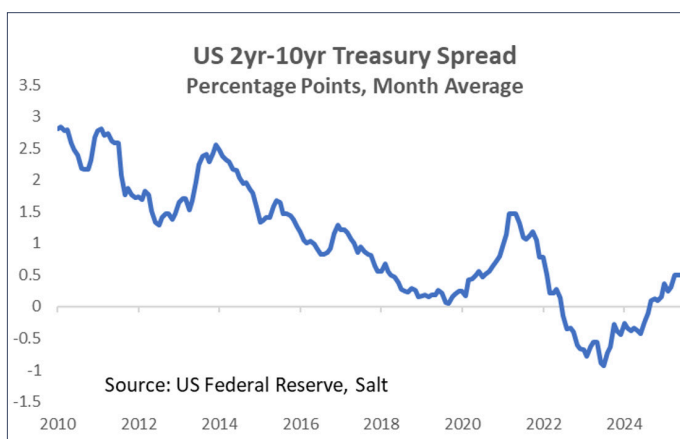
# SALT INSIGHT

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## Global Yield Curve Steepening: Market Discipline in Action

Yield curves across the developed world are steepening, with long-term rates rising relative to the front end. This is not merely cyclical noise: it reflects a structural repricing of risk in global capital markets.

Several forces are at play. As we have argued previously, neutral policy rates have shifted higher. Fiscal deficits in key advanced economies are proving both large and persistent, leading to heavy sovereign issuance at a time when central banks are scaling back their purchases. Investors must absorb the marginal supply and are demanding greater compensation for doing so. At the same time, inflation risk premia remain elevated, and the structural backdrop of ageing populations and shifting global savings patterns is eroding the conditions that once kept long-term yields suppressed.



What is striking is that the most recent steepening has occurred as monetary policy has been easing. Several central banks have cut policy rates aggressively, yet bond markets have responded by pushing long yields higher. In effect, investors are rejecting the idea that policy can be eased materially without consequences for inflation and fiscal sustainability.

### Fiscal Risks Around the World

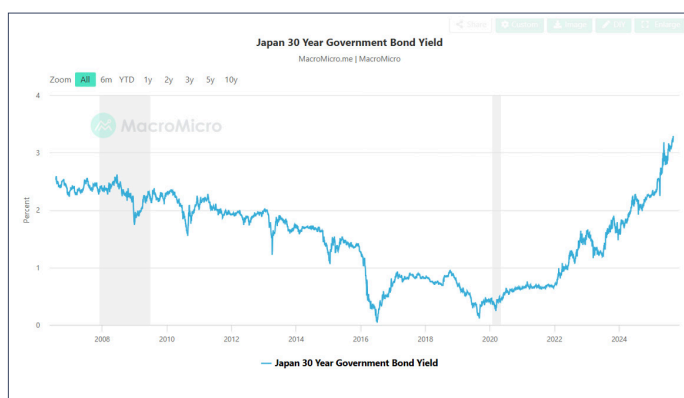
**United States:** The U.S. fiscal deficit has become entrenched at around 6–7% of GDP despite full employment and strong growth. Debt-to-GDP is on track to exceed 120% within the decade, with interest costs already rivalling defence spending. The political gridlock around deficit reduction has amplified investor concerns. U.S. Treasuries remain the global benchmark, but the “risk-free” asset is being repriced to reflect fiscal slippage.

**United Kingdom:** The U.K. faces the dual challenge of weak growth potential and high financing needs. Public debt has climbed above 100% of GDP, while a sluggish productivity outlook and post-Brexit trade frictions constrain revenues. The gilt market remains sensitive to credibility lapses, as shown by Liz Truss’s short tenure as UK Prime Minister in 2022, and investors remain wary of any fiscal slippage. As I write, 30-year gilts are trading at 5.69%, their highest level since 1998.

**Europe:** Fiscal risks vary, but the structural challenge is common: slow growth and an incomplete fiscal union.

France and Italy in particular face high debt ratios and fragile political coalitions, raising doubts about their ability to adhere to Stability and Growth Pact rules. The ECB's ability to stabilise spreads is constrained by its own balance sheet normalisation. Rising term premia in Bunds increasingly reflect systemic fiscal concerns across the bloc.

**Japan:** Japan remains the outlier, with debt-to-GDP above 250% — the highest in the developed world. Until recently, ultra-low inflation and the Bank of Japan's yield curve control regime allowed this to persist without consequence. That equilibrium is shifting. A normalisation of inflation expectations, with core inflation stabilising near 2%, has forced the BoJ to allow yields to drift higher. In Japan's case, steepening reflects both fiscal arithmetic and the long-awaited repricing of inflation risk.



## Market Discipline Returns

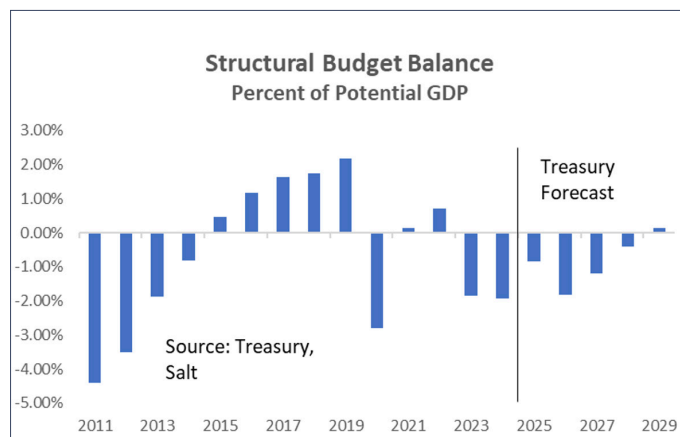
In all cases, yield curve steepening is a form of market discipline. Investors are effectively telling governments that deficits matter, and long-term funding costs will no longer be artificially suppressed. The combination of heavy issuance, higher neutral rates, and diminished central bank support is restoring risk pricing to sovereign bond markets.

The consequences are clear. Higher long-term yields feed through to higher mortgage rates, corporate financing costs, and the discount rates applied to future growth. Central banks lose some control over financial conditions, as the long end increasingly reflects fiscal realities rather than monetary intentions.

## The New Zealand Position

New Zealand's fiscal position is stronger than most other developed economies because our debt levels remain modest by international standards, our average debt maturity profile is prudent, and our institutional frameworks underpin credibility. Net core Crown debt is projected at around 43% of GDP in 2025, with a commitment to get it back under 40% of GDP, compared with ratios exceeding 100% in the U.K. and France, 120% in the US, and more than 250% in Japan.

While New Zealand is running a structural deficit, the scale of the imbalance is far smaller than in peers, and successive governments have generally demonstrated a willingness to stabilise debt over the cycle. Importantly, our fiscal rules — including the focus on net debt and operating balance — and a relatively transparent budget process provide investors with confidence in medium-term sustainability. This combination affords New Zealand a fiscal "credibility premium," helping keep borrowing costs lower than they might otherwise be in a world of rising global yields.



That relative strength provides resilience, but not immunity. NZ government bond yields are priced in an open, globally integrated market where US Treasuries anchor valuations. Rising US term premia inevitably spill over into higher New Zealand yields. With our bond market relatively shallow, offshore-driven volatility is often amplified. The result is that households, firms, and government all face higher borrowing costs regardless of our domestic fundamentals.

## Implications for Investors and Policy

For investors, the global steepening of curves alters both Strategic and Dynamic Asset allocation. In SAA frameworks, long-dated sovereign debt is once again yielding at levels that restore its role as a core portfolio anchor. However, that real yield improvement must be judged against greater bond price volatility, which is proving persistent since 2022's severe bond bear market. For DAA, the challenge is to navigate heightened volatility, distinguishing between "good" steepening driven by growth and "bad" steepening driven by fiscal stress.

For policymakers, the imperative is twofold: maintain credibility and address structural deficits. There are no easy options in reducing structural deficits. Governments can impose expenditure restraint, look for new revenue by either broadening the tax base or adjusting the rates of existing taxes. The most politically palatable but hardest to achieve option is to institute growth-oriented reforms that improve productivity. Cutting spending or raising revenue are politically difficult, but without them, markets will continue to impose discipline through higher long-term rates.

I always assume people are joking when they say we should just inflate the debt problem away. In case they're not, it's important to note this is the worst thing a government can do. History shows that deliberately tolerating higher inflation to erode the real value of liabilities only undermines fiscal credibility, drives up borrowing costs, and shifts the burden onto households through higher living costs. Markets quickly price in the strategy by demanding higher long-term yields, offsetting any short-term erosion of debt ratios. Instead of easing the problem, it compounds it, turning inflation into a fiscal as well as a monetary failure.

## **In Summary**

The steepening of global yield curves is a reminder that markets remain the ultimate arbiter of fiscal credibility. The US, UK, Europe, and Japan all face specific fiscal risks that are feeding into higher term premia and tighter financial conditions. For Japan, the adjustment is compounded by the long-delayed normalisation of inflation expectations.

For New Zealand, the imperative is to safeguard credibility. For us here in New Zealand, we cannot afford to add a local risk premium to the global re-pricing already underway. Fiscal consolidation and clear monetary discipline are essential to preserve the premium we currently enjoy. Resilience is not immunity. Indeed, in a world where capital markets are re-pricing risk, the cost of complacency would be high.

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