



Market Commentary

Tax man cryin'. Rayner smilin'

With the supply-demand mismatch for long-term government bonds, are taxpayers overpaying?

Key points:

- Barring any major surprises, the Fed is widely expected to lower rates by 25bp this month, with a similar move to follow in Q4, but a deeper cut in September remains possible.
- Any suspension of IEEPA tariffs could shock markets, potentially steepening US yield curves and weakening the dollar.
- The Supreme Court may protect Fed independence but its ruling could also reshape the Fed's mandate, potentially limiting its role to monetary policy and reducing regulatory oversight.
- In Japan, we believe that long-end steepening has reached extreme levels, which are not fundamentally justified, leading to concern that systemic over-supply is costing taxpayers.
- With Sino-US relations fragile, the Xi-Putin-Modi alliance may escalate US sanctions, leading to a potential flashpoint triggering risk-off trades, though timing remains uncertain.
- Rising non-oil commodity prices are boosting EM credit performance, with investor enthusiasm for EM assets increasing despite lingering geopolitical concerns.

5 September 2025 (London) – Treasury yields continued to move lower during the past week, supported by signs of ongoing softness in labour market data.

Barring any major surprises in today's Nonfarm Payrolls release, the Fed is widely expected to lower rates by 25bp this month, with a similar move to follow in Q4. However, should data point to an outright contraction in job numbers and a rise in the unemployment rate, then it remains possible that a larger policy move will be merited at the September FOMC.

Meanwhile, next week's CPI release is also important. If inflation remains relatively benign, then the voices in the White House, calling for even more assertive action on rates, are likely to grow ever louder. However, a firming in inflation could exacerbate fears that policy easing into 2026, under a Trump appointed Fed Chair, could endanger medium-term price stability.

At the end of last week, the US Appeals Court ruled against the legality of Trump's imposition of tariffs under IEEPA provisions. This case is now headed to the Supreme Court of the United States (SCOTUS) and an interim opinion could be delivered by SCOTUS within the next 2-3 weeks, with a fast-track final ruling ahead of the end of the year.

Speaking with US attorneys close to this body, the legal view suggests that the Supreme Court will find with the Appeals Court in this case. An interim ruling could potentially suspend IEEPA tariff revenue collection beyond this point, and if this is the case, our sense is that this could come as a shock to the market.

Ultimately, Trump will use other provisions such as 232 tariffs to ensure that revenues collected end up largely the same. However, this could be a somewhat messy process, and it could throw renewed doubts on overreach of Presidential Authority and renew concerns with respect to US policy credibility.

If so, this could be a catalyst for additional yield curve steepening in the US, and a catalyst for renewed weakness in the dollar in our view.

With respect to the removal of Lisa Cook, the legal view suggests that it will be ultimately unlikely that SCOTUS will agree that there is cause for her removal.

Yet, this case may be a few months away from a hearing. Before then there may be many more details released, casting doubts on Cook's integrity, or refuting these claims. In that context, her fate may yet be decided in the court of public opinion.

Moreover, if Cook's case does go to the Supreme Court, there is a chance this opens the door to a split ruling, which could ultimately reshape the mandate of the Federal Reserve.

That is to say that SCOTUS could afford special protection to the Fed from Presidential interference, with respect to interest rate policy, but choose not to grant such protection with respect to other elements of the Fed mandate such as banking supervision etc.

This could open the door to carving off many of the activities that the Fed oversees today into a separate body and leaving a much smaller and more streamlined institution focussed just on its mandate of setting monetary policy.

It could be argued, by some, that going down such a path could end up weakening regulation and supervision and make the US and global economy more exposed to systemic risks in the future.

However, for the time being, markets could be reassured if such an outcome is seen to ringfence interference on interest rate policy.

The steepening theme across global bond curves persisted at the start of this week, with investor enthusiasm for long-dated maturities continuing to diminish.

Largely speaking, demand for long-dated bonds has historically come from pension funds seeking to match the tenor of their assets to long-dated liabilities. However, as defined benefit schemes have closed and those remaining are already duration matched, this means there is structurally less demand for long-dated debt.

In addition, investors in defined contribution schemes seem much less interested in an LDI-based approach.

Yet as demand has dropped, so it may appear that issuing agencies have been slow to adapt their issuance schedules and have continued to issue more long-dated bonds than the market wants or needs. This negative technical has weighed on long-dated yields and is part of the explanation why curves have continued to trend steeper.

Eurozone yields moved in line with other global markets during the past week, with 30-year Bund yields posting a 14-year high at 3.4%. Yet this is notwithstanding fiscal data, which suggests only a modest increase in German spending to this point.

Dutch pension changes have removed one of the largest buyers from the long end of the market. Yet it is striking to observe that the 2/30 curve in Germany is steeper than that in US Treasuries. This is despite the absence of fears with respect to ECB independence and worries about medium-term inflation risks.

Elsewhere in Europe, we await next week's French Confidence vote. It seems certain that Bayrou will depart as Prime Minister and the key question now appears to be whether Macron will be able to install a new appointee from the left, whom the Socialists will support, and the centre-right are also prepared to accept.

The alternative to this outcome will be new elections, which the far-right National Rally (RN) are set to perform well in. Indeed, the RN are strongly motivated to push for elections, as victory may enable a pathway to a law change that enables barred le Pen running in the 2027 Presidential race.

By contrast, the parties on the centre right face heavy losses at the expense of the RN. Therefore, they are motivated to avoid new elections – even if this means they back a more socialist government, which places the burden of fiscal adjustment more on higher taxes for more wealthy citizens.

There is some complex game theory in assessing these political outcomes.

If elections are avoided, then a Budget may be supported which offers some fiscal consolidation, albeit much less than Bayrou had been proposing. In this case, French OAT spreads may rally back below 70bp versus Bunds, though are likely to top 90bp in the absence of such agreement, and a new national vote.

Ultimately, if there are elections and RN does well, then an outcome leading to an RN candidate such as Tanguy as Prime Minister could see spreads widen above 100bp, at least on a short-term basis.

At this level, France may even become cheap and we are inclined to think that he could end up treading in the footsteps of Italy's Georgia Meloni.

Yet, for now, we think that maintaining a short in OATs makes sense and we are likely to see a week of protests in the French streets, whose images can always unsettle international investors. However, we are assessing where it may make sense to close this position in the coming days or weeks ahead.

In Japan, we believe that long-end steepening has reached extreme levels, which are not fundamentally justified. A 10/30 curve of 167bp is unheard of in developed bond market valuations, particularly in a market where nominal yields remain very low.

Consequently, with 30-year yields topping 3.3%, this puts the 15-year yield at 5% on a 15-year forward basis. This rate traded below 1% as recently as 2021 and we now stand at levels in Japan, not seen since the start of the 1990s.

At this point we think that the Japanese Ministry of Finance would be well advised to announce that it will only re-issue long dated bonds should the spread to 10-year JGBs normalise back to 75bp, or less.

Although domestic investors do not own many superlong dated bonds, the concern is that systemic over-supply by the Ministry of Finance is costing taxpayers as the government is paying excessive yields on these maturities.

Elevated 30-year yields also create a negative impression of Japan's vulnerability to fiscal sustainability. It is also attracting the ire of overseas policy makers, with Treasury Secretary Scott Bessent recently remarking on his concerns that price action in long-dated JGBs is having a negative impact on all long-dated global government bond yields.

In the UK, policy prevarication has seen gilts continue their recent underperformance. As previously mentioned, we believe that the Bank of England should stop QT and think that it may now be starting to listen to these calls.

Similarly, we think that the DMO should be much more explicit in suspending long-dated issuance in line with the suggestion for Japan, above.

Furthermore, there are policy initiatives which could be within this government's grasp to turn sentiment around, if they are decisive enough to do so.

For example, one wonders why it would be a bad thing to notify those with ISA investments that 50% of holdings will need to be invested in UK-denominated assets going forward in order to continue to enjoy the tax-exempt benefit these saving vehicles attract.

Such measures would help address the negative market technicals, which threaten to turn into a doom loop of higher yields, feeding projections of an ever-larger fiscal shortfall and thus escalating worries relating to debt sustainability.

This said, we continue to contend that the government also needs to be able to communicate that it understands that just raising taxes alone won't address fiscal concerns. To win back investor trust, Starmer and Reeves need to show they have an ability to address welfare spending.

Indeed, with deputy Prime Minister (and potential rival), Angela Rayner, now wounded by a scandal relating to her underpaying taxes on her 3rd home, politically speaking, this could be a good moment for Starmer to try to re-seize the initiative. It seems like the 'red queen' is under pressure and viral AI TikTok videos of the deputy Prime Minister laying it down 'gangsta style', flashing her wads of cash, won't help her standing with her voter base.

Credit spreads have traded somewhat softer, as heavy seasonal issuance has led to some re-pricing of spreads. New issuance has offered little concession to existing deals and so there have been relatively few opportunities to participate in new deals to this point.

We have also observed that syndicate desks have been adept at building inflated order books by marketing deals at somewhat artificially cheap levels, only to re-price deals ahead of the book close. Consequently, even those deals which have been 10 times over-subscribed based on the initial guidance have ended up trending weaker post allocation, often to a chorus of investor frustration.

That said, it could be argued that the disappearance of new issuance premia suggests a more optimal market and one in which issuers can feel confident that they are managing to achieve the best possible pricing available to them.

In emerging markets, there has been plenty of attention on the recent gathering of Xi, Putin and Modi at the Chinese military parade. Presenting a united front against the US may lead to increased polarization on a geopolitical basis.

From this standpoint, we may expect the US to seek to tighten sanctions on Russia and seek the EU and its allies join in with sanctions and tariffs on India.

Sino-US relations have been benign over the past several months, partly on the back of the US realising its strategic vulnerability with respect to rare earths, should it risk a bigger fall out with China.

However, there is a sense that this marks more of a temporary reprieve than an improvement in relations. From this perspective, a flashpoint between Xi and Trump could be a catalyst for a risk-off trade at some point in the months ahead.

Yet trying to predict when this could occur and what shape this will take remains uncertain and consequently this is not a risk that financial markets can properly price or account for.

Meanwhile, firmer commodity prices (away from oil) are supportive for a number of EM credits and, notwithstanding geopolitical worries, it seems that investor enthusiasm for EM assets in general is on the rise after many years spent in the doldrums.

Looking ahead

Over the past several months, US markets have been cheered on the notion that Trump policy is working. The Big Beautiful Bill managed to pass, tariffs have been implemented without an adverse response and financial markets have managed to perform relatively well as a result.

Whether markets can continue to rally may hinge on this narrative continuing to hold over the months ahead.

Will Trump be able to get the Fed to deliver the rate cuts he wants to see without needing to resort to attacking the Fed to the point where markets lose confidence with respect to political interference?

Will tariff revenues continue to roll in and will the US manage to avoid a flashpoint which materially deteriorates the relationship with China? Will the economic data on jobs and inflation remain benign and will it continue to be possible to project a sunny outlook for growth on the back of fiscal and monetary easing and deregulation benefits in 2026?

These are some of the key questions whose answers will determine the path ahead of us.

That said, it could be naïve to expect the outcomes ahead to be entirely black and white. There have been many surprises during the course of 2025 thus far. It is highly unlikely that we have seen the last of them.

Notes to Editors

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