Global Macro Research

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Why bond term premia will continue moving higher

Rising term premia, rather than shifting expectations for central bank policy, have been the main driver of recent bond market sell-offs. We think larger fiscal deficits, elevated policy uncertainty, higher inflation volatility, more frequently positive bond/equity correlations, and fewer lower bound episodes, will continue to put upward pressure on term premia.

Key Takeaways

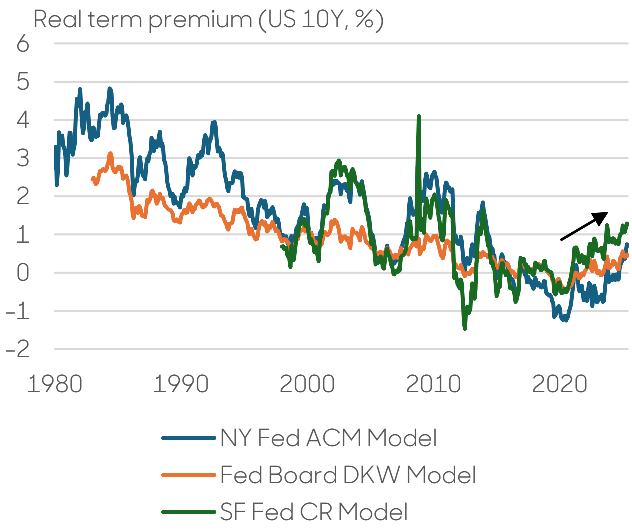
- The bond term premium is on the rise, from a low of -1.5% on 10-year US Treasuries post financial crisis, to 0.85% now. But various structural trends in the economy could see it move considerably higher still.
- High government debts and deficits mean the supply of government bonds is elevated, which, all else equal, should be absorbed by lower bond prices. This is especially true as large price-insensitive buyers are no longer structural sources of demand, as central banks are now selling bonds and many pension funds are fully funded.
- As the economy becomes more prone to negative supply shocks, inflation is likely to be higher on average and more volatile, the interest rates path less certain, and the bond-equity correlation more frequently positive, which should push up term premia.
- The politicisation of technocratic institutions by the US administration could also push up on term premia. For example, Trump's firing of the head of the Bureau of Labour Statistics may increase uncertainty about the quality of economics data, while his chance to reshape the Fed after Adriana Kugler's resignation may lead to greater concerns about fiscal dominance.
- Overall, we think that the term premium could return to its long-run average of around 1.5% in the next couple of years. And we wouldn't be surprised to see spikes in term premia to much higher levels around fiscal and geopolitical risk events.

Bond term premia have been increasing and will continue to do so

The term premium is the element of government bond yields that reflects the additional compensation investors demand for holding government bonds above and beyond their expectations for short-term policy rates.

This additional compensation reflects the risk investors take buying longer-maturity bonds (such as duration, inflation, or credit risk), as opposed to holding a series of shorter-maturity bonds or investing at the policy rate itself.

Figure 1: Term premia fell to historic lows below zero after the GFC, but have been increasing recently

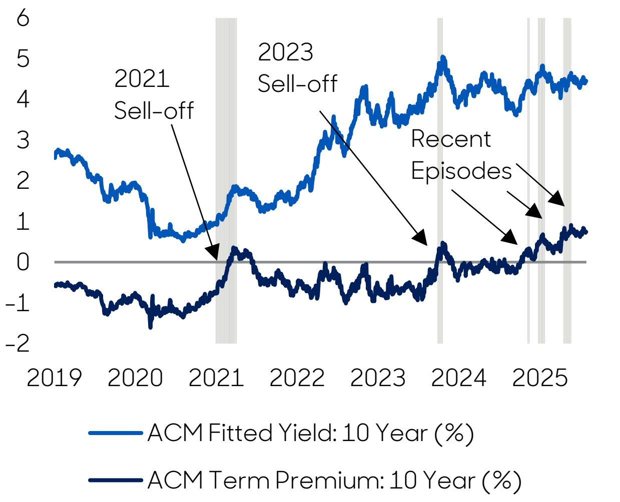


Source: Aberdeen, Haver, August 2025

The term premium is inherently unobservable. But model-based estimates show a distinct decline from the early 1980s onwards, amid lower inflation and reduced interest rate uncertainty (see Figure 1). The Adrian, Crump and Moench (ACM) measure of the 10-year US government bond term premium declined from highs above 4% in the 1980s, to as low as -1.5% following the Global Financial Crisis (GFC).

However, term premia have been increasing in recent years. The ACM measure is now around 0.85%, with notable bond sell-offs in 2023, 2024, and most recently during mid-2025 primarily reflecting a rise in the term premium, rather than an increase in policy interest rate expectations (see Figure 2).

Figure 2: Rising term premia have played a big role in recent bond sell-offs



Source: Aberdeen, Haver, August 2025

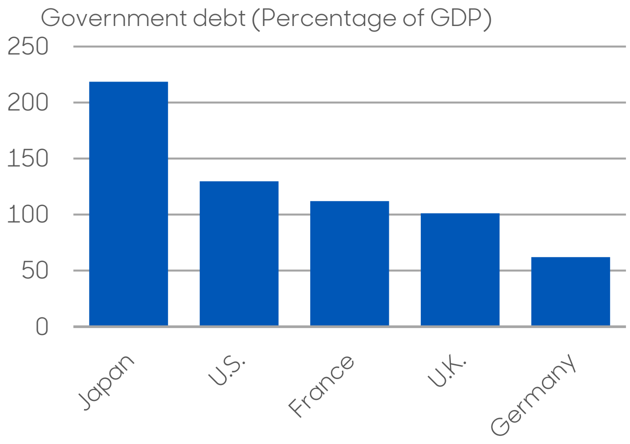
We think several structural forces will take term premia higher still in coming years.

Large deficits mean elevated bond issuance

The US has government debt well over 100% of GDP and a fiscal deficit above 6%. Moreover, debt and deficits are large across many advanced economies (see Figure 3).

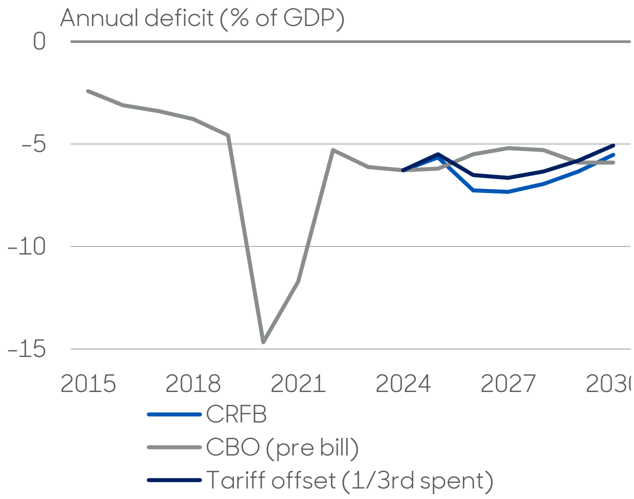
The recently signed US fiscal package – the One Big Beautiful Bill Act (OBBBA) – will increase the deficit further still, perhaps to around 7% of GDP (see Figure 4).

Figure 3: Public sector debt is very high across advanced economies



Source: Aberdeen, Haver, August 2025

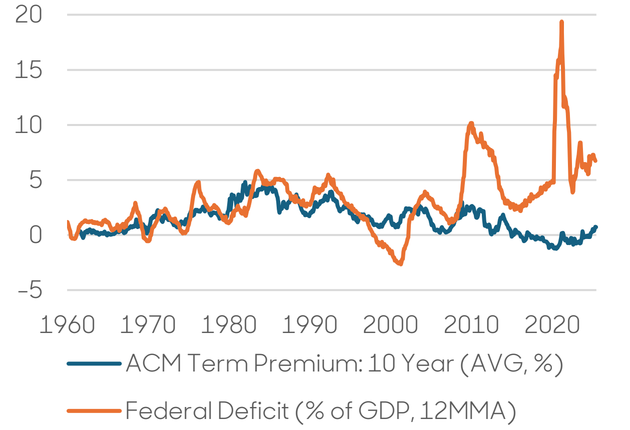
Figure 4: The US fiscal deficit is likely to increase because of the One Big Beautiful Bill Act



Source: Aberdeen, Haver, August 2025

Even though the relationship between the US fiscal deficit and term premia has weakened since the GFC, all else equal, bigger deficits result in higher term premia (see Figure 5). That's because, outside of a liquidity trap, there is a downward-sloping demand curve for Treasuries, meaning more Treasury supply can only be absorbed by lower prices via higher term premia.

Figure 5: Bigger fiscal deficits mean higher term premia, although this relationship has weakened



Source: Aberdeen, Haver, Capital Economics, August 2025

And while there is still extremely little likelihood that this elevated issuance will cause a US credit default, Moody's May 2025 downgrade to the US credit rating to Aa1 underlines that this risk may have increased at the margin.

President Donald Trump has suggested some outstanding Treasury debt may be illegitimate, while members of the administration have contemplated the forced redenomination of foreign holdings of Treasuries into century bonds at significantly lower interest rates, or the imposition of user fees on foreign holders.

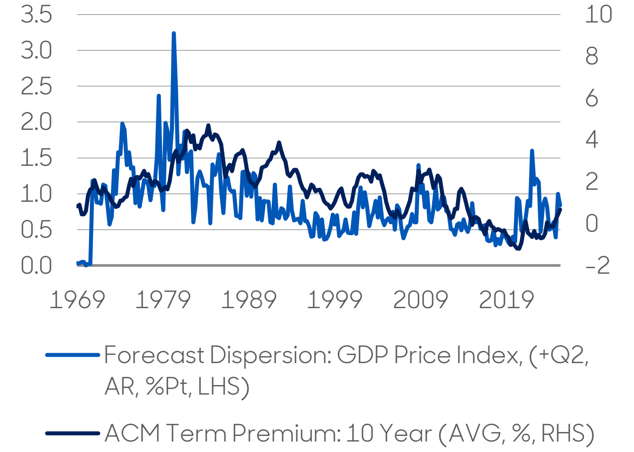
These comments should *probably* be dismissed as bluster. But even raising the prospects of these reductions in the US' willingness to honour its debt obligations increases the need for term premia to compensate for the risk.

Policy uncertainty is elevated

At a fundamental level, the term premium exists to compensate investors for uncertainty. So higher uncertainty puts upward pressure on term premia. For example, increased dispersion around consensus growth or inflation forecasts is associated with higher bond term premia (see Figure 6).

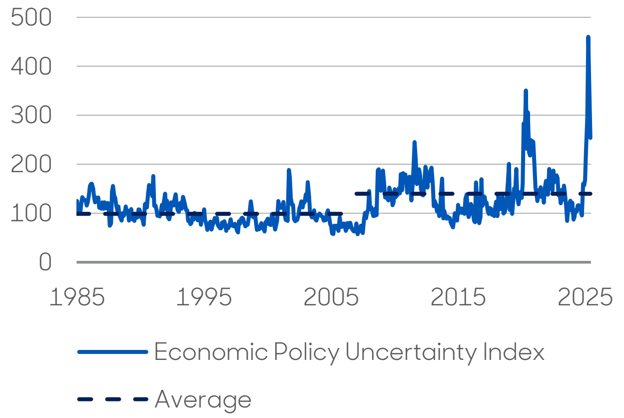
News-based measures of uncertainty took a structural step higher post-GFC, and uncertainty will likely continue to rise for the foreseeable future (see Figure 7).

Figure 6: Increased economic uncertainty, as measured by forecast dispersion, can mean higher term premia



Source: Aberdeen, Haver, August 2025

Figure 7: Economic policy uncertainty has been structurally elevated, and may move higher still



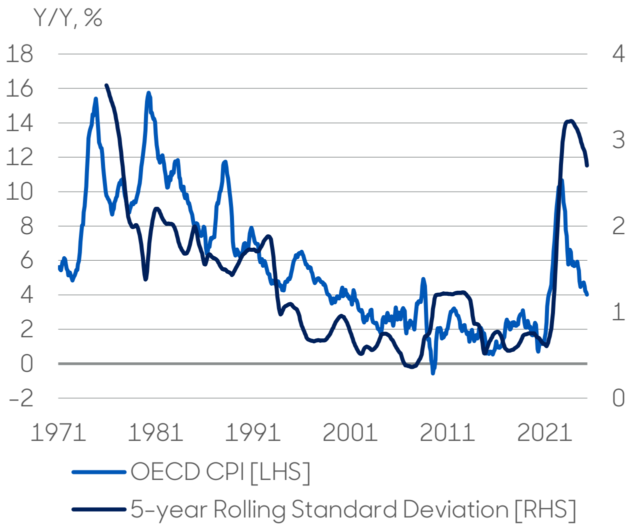
Source: Aberdeen, Haver, August 2025

After all, US policy is particularly volatile, and, at a global level multi-polarity and competing powers contribute to a less predictable and more uncertain environment compared to that of the post-Cold War period.

Inflation is likely to be more volatile

Not only is uncertainty in general higher, but we think that the uncertainty and volatility of inflation specifically is likely to be higher (see Figure 8).

Figure 8: The volatility of inflation is likely to be higher amid more supply-side shocks



Source: abrdn, Haver, August 2025

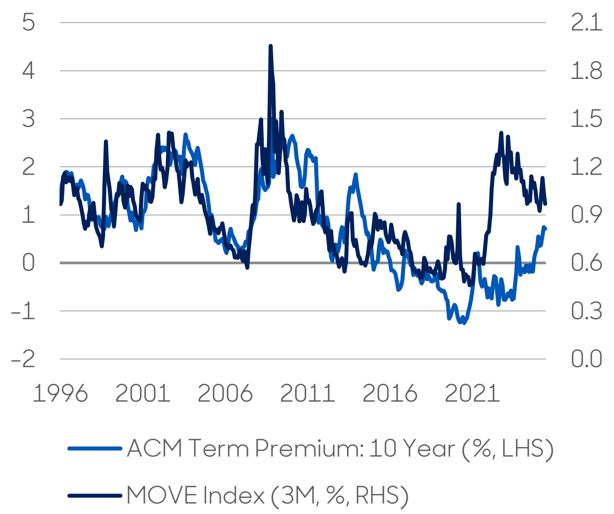
This is because the global economy is more likely to be hit by negative supply-side shocks, including the geopolitical environment becoming more challenging, aspects of globalisation reversing, and climate change.

Negative supply shocks push down on growth and up on inflation. So, if these become more frequent in the future, inflation is likely to be more volatile and higher on average.

Moreover, supply-side shocks are difficult for central banks to navigate as policymakers must prioritise either bringing inflation back to target or output stabilisation. They therefore make it harder for investors to predict how monetary policy will respond, with this increased uncertainty pushing up on term premia (see Figure 9).

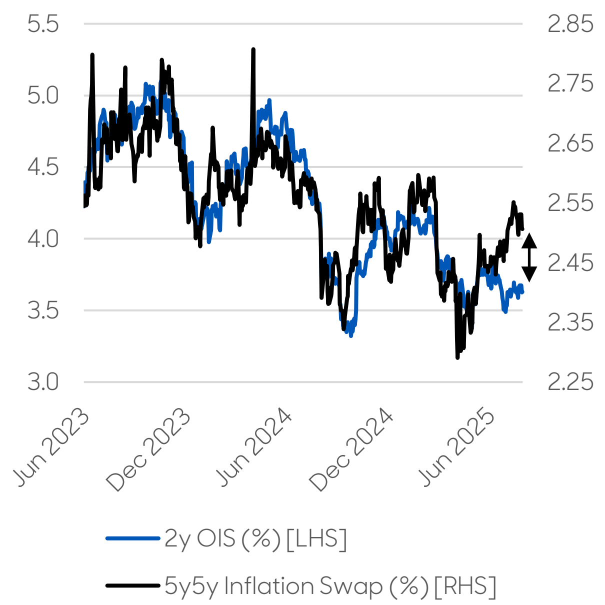
Finally, the greater political pressure the Fed is currently under may increase concerns about its ability to stabilise inflation over the long run (see Figure 10).

Figure 9: Higher bond market volatility has been associated with higher term premia, although this correlation has broken down more recently



Source: Aberdeen, Haver, August 2025

Figure 10: Long term market inflation expectations have risen by more than policy rate expectations as political pressure on the Fed has increased



Source: Bloomberg, Haver, August 2025

Positive bond/equity correlation means reduced diversification benefits from government bonds

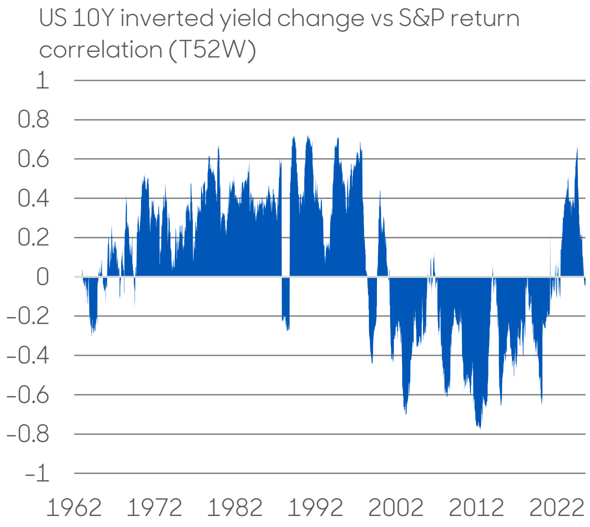
A world of more supply shocks is likely to lead to a shift in the bond/equity correlation in a way that has implications for term premia.

Demand shocks push growth and inflation in the same direction and so tend to push bond and equity prices in different directions.

That is why bonds and equities have been negatively correlated for much of the last forty years (see Figure 11).

And this negative correlation is the foundation for standard diversification arguments for bond/equity portfolios.

Figure 11: More frequently positive bond/equity correlation reduces the diversification benefits of bonds



Source: Aberdeen, Haver, August 2025

However, because supply-side shocks push growth and inflation in different directions, they tend to push bond and equity prices in the *same* direction.

A positive correlation between bonds and equities undermines the standard portfolio diversification argument for government bonds. Therefore, investors may require higher term premia to hold them in a portfolio.

There are fewer natural buyers at the long end

One of the reasons term premia were so suppressed during the post GFC period is that the Fed and other major central banks were providing a large price insensitive source of demand for longer-maturity bonds via their quantitative easing (QE) programmes.

How QE pushes down interest rates in contested, but it almost certainly depends on the state of the economy and the communication accompanying the asset purchases. So, it does not follow that all the term premia suppression that occurred via QE necessarily has to reverse in a one-for-one manner as central banks run down their asset holdings via quantitative tightening (QT).

Nonetheless, all else equal, the loss of a major source of bond demand presumably has to put some upward pressure on term premia, especially as it leaves the market more dependent on private sector buyers who are more sensitive to shifts in macro conditions and risk sentiment.

Meanwhile, one of the main sources of relative price-insensitive private sector demand for long bonds is also drying up as pension funds are increasingly fully funded. This dynamic is particularly pronounced in the UK, where liability-driven investment (LDI) schemes were once a huge source of demand for long-dated gilts but no longer need additional duration risk to hedge their exposure, and in Japan.

There may be fewer zero lower bound episodes

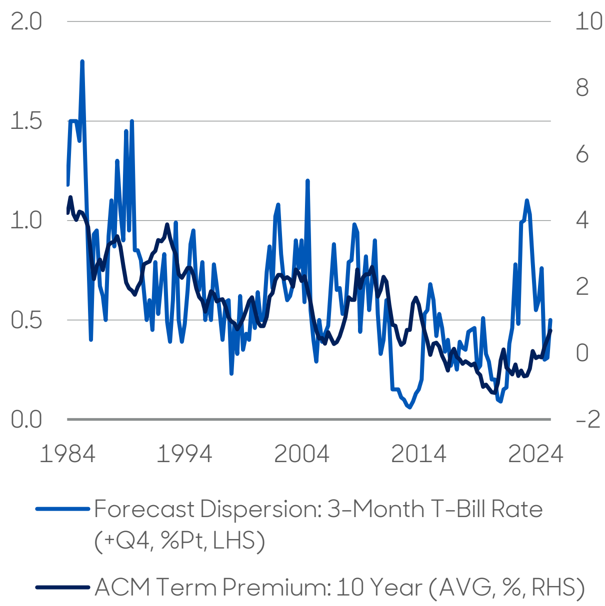
Another implication of higher average inflation, more supply-side shocks, and a policy mix that increases nominal GDP growth, is that economies may be less prone to getting stuck at the effective lower bound of interest rates in the future.

This matters because less frequent lower bound episodes ought to lead to higher term premia.

Periods during which the economy is sitting at the lower bound tend to be prolonged precisely because they are defined by monetary policy not being able to become sufficiently accommodative to reflate the economy.

In such an environment, the outlook for policy interest rates is clear: rates stay stuck at very low levels for a prolonged period. That is to say, the uncertainty about the path of interest rates is much lower, and this lower uncertainty means less term premia (see Figure 12).

Figure 12: Lower interest rate uncertainty (such as during lower bound episodes) means less term premia



Source: Aberdeen, Haver, August 2025

Moreover, because government bonds perform especially well in real terms during lower bound episodes, investors are willing to pay up for this in the form of lower term premia.

But as the risk of future lower bound episodes declines, the insurance provided by government bonds becomes less attractive, and investors require higher term premia.

So how much higher could term premia go?

Bond term premia have already increased meaningfully, as these structural changes start to play out.

However, we suspect that this repricing of term premia has further to run. Pressures on government fiscal positions are only likely to increase. And geopolitical uncertainty may mount further in the years ahead, as the US-China great power rivalry deepens.

Since the ACM measure of US 10-year Treasury term premia began in 1962, the average level of premia has been 1.5% (albeit with a significant downward trend until recently), relative to the current level of just under 1%. We think this is a reasonable level that term premia could reach in the next couple of years. And we wouldn't be surprised to see spikes in term premia around fiscal and geopolitical risk events.

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