# WEEKLY STRATEGY Perspectives

BMO Private Wealth

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## The Great ~~Moderation~~ Normalization

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*"If you would know the value of money, go and try to borrow some."*
– Benjamin Franklin

**The Through Line:** Mounting sovereign deficits and debt among developed economies has investors (and citizens) on edge. Unfortunately, policymakers – the only ones who can durably resolve the overspending issue – are not naturally incentivized to fix the problem. Adding to bond holders' angst are bond yields that keep pushing higher, amplifying the cost to carry the obligations and making balanced government budgets as elusive as a donkey-elephant potluck. This week, we outline the key issues and their potential to impact (or not) asset markets and future macroeconomic prospects.

### A debtor like no other

The issue of sovereign deficits (annual overspending) and debt (cumulative total of deficits) has gnawed at the fringes of investors' minds for decades. Each nefarious round-number milestone – e.g., $40 trillion in aggregate IOUs that the U.S. achieved last week – seems to generate a new round of doomsaying from pundits. Yet, the equation often ignores the reality that global economies are always on the move. While the U.S. government's debt has increased, other indicators of the economy's wellbeing have also increased: GDP, household net worth, aggregate capital stock, for example. **Looking at a simple number without context provides little actionable information.**

We understand the concern, though. Leverage of any sort can limit an entity's options when things go awry. A natural aversion to debt ("neither a borrower nor a lender be") is ingrained in many of us from childhood. In most domestic economies, market forces will eventually demand a resolution when situations turn inside out. Several cases in point: the farm crisis of the 1970s that reshaped the savings and loan industry and reconfigured U.S. farm ownership; the leveraged buyout reckoning of the late 1980s that prompted a multi-decade reformation of corporate balance sheets; or the consumer de-levering that happened in the wake of the Global Financial Crisis (GFC) of 2008/2009. Investors are looking over their shoulders, trying to figure out what happens if a "sovereign debtmageddon" occurs.

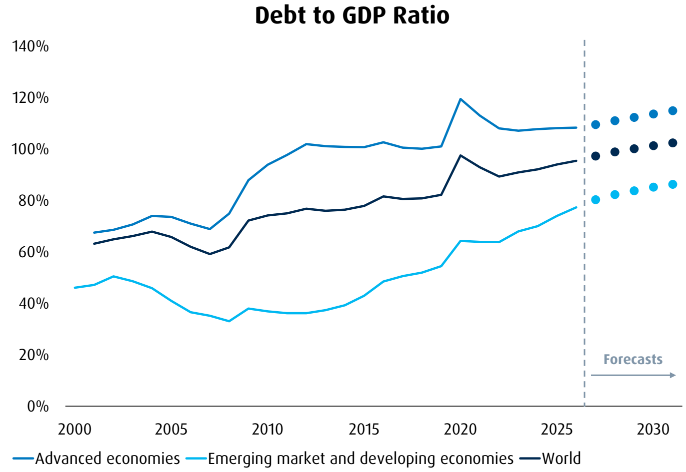
**However, governments are unlike other borrowers in several key respects.** First, the only ones who can technically hold them to account for perceived profligacy are those who purchase government IOUs. Bond buyers (often termed vigilantes when they are playing the role of providing such direct feedback) can force policymakers to rethink their fiscal plans by either demanding more compensation (via higher interest rates) to hold the debt or avoiding the purchase entirely in favor of other investments. Second, administrations have the unique ability to increase taxes or "simply" print more money in order to pay bond holders; the implied "full faith and credit" backing of this power affords an aura of backstop that consumer or commercial borrowers often lack. This lever is seldom pulled, however, as the knock on consequences tend to lead to higher inflation and/or other adverse consequences for policymakers.

### Background: sizing up the issue

According to the Securities Industry and Financial Markets (SIFMA) 2026 Capital Markets Fact Book, total global fixed income debt was approximately $161 trillion in 2025, up nearly 11% from the prior year. Issuance was up 6% to a $30 trillion run rate.[i] The U.S. is the largest, deepest and arguably most liquid portion, making up $61 trillion (38%) of the total.[ii] These numbers include both sovereign and corporate debt.

Looking at just sovereign debt, the International Monetary Fund's Global Debt Database highlights the growing size of these obligations relative to GDP for countries around the world (chart).[iii] Total debt had been relatively flat by this measure until the broad fiscal stimulus many countries initially offered in the GFC and subsequently during the 2020 pandemic. **Advanced economy debt now stands over 100% of GDP; the U.S. is 125% while Canada (including provincial debt) is 111%.[iv]**

**Debt to GDP Ratio**




Source: International Monetary Fund (2026)

Policymakers have a vested interest in providing fiscal stimulus during unprecedented events. Austerity measures applied during periods of slow or negative growth (aimed at balancing budgets) are unpopular with voters and rarely allow politicians to keep their jobs. **Unfortunately, policy tweaks that facilitate consumption and other economic activity (supplemental aid, tax breaks) are difficult to remove once enacted since citizens quickly layer them into their base expectation level.**

## The current sovereign debt dilemma

Even if you've never owned one, your life is impacted by bonds. That's because what happens in the debt market doesn't stay in the debt market. It reverberates throughout the global economy and directly influences rates on your car loan, your mortgage and your BNPL (Buy Now Pay Later) programs.

Bond yields, particularly in longer-dated instruments, have been pushing (not necessarily vaulting) higher based on concerns about a number of factors: the Middle East war (and its potential long-term impact on the price of oil and petroleum products); inflation that remains stuck above the Fed's stated target; and, more importantly, growth that's stronger than expected.

Higher rates are problematic for government finances because they make it costlier to fund ongoing deficits; spending that is already outpacing revenue becomes even more troublesome when the cost to finance adds incrementally to the total IOU. In the U.S., for example, debt servicing is now the third-largest item in the federal budget (debt services outlays represent 14.5%). Europe and Japan face similar challenges; in the U.K., debt servicing is expected to represent more than 8% of total public spending.[v]

Recent/proposed moves in the U.S. and Canada may well exacerbate the issue (at least in the short run) since tax cuts and spending increases add to the "credit-card maxxing" vibe.

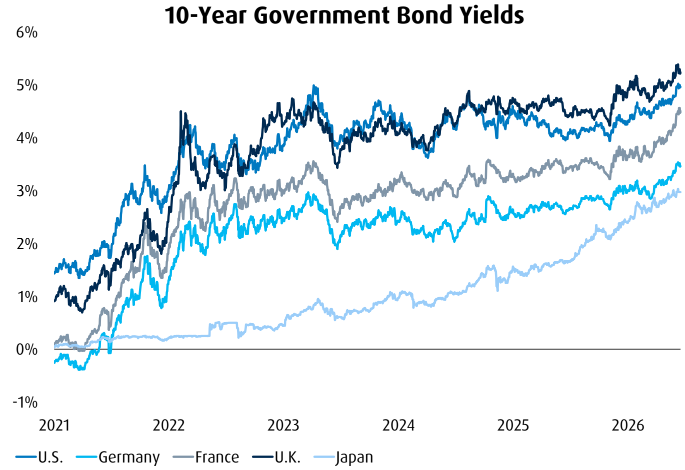
Sovereign debt markets are also facing increased competition. Record Investment Grade (IG) and High Yield (HY) bond issuance this year is giving investors choice – particularly from hyperscalers looking to fund new data centers, research and development, and acquisition activities. All else being equal, additional supply nudges rates higher because sellers must compete for investors' affection.

## The market's reaction function is changing

Fixed income markets (and traders) have a hard-earned reputation for being the steady, sober ones in the crowd. Operating from the creditor's vantage point, their analysis entails consideration around adequate compensation for potential inflationary pressures and getting their initial investment returned (return OF capital versus the return ON capital that stock jockeys obsess over). Both of those perspectives have been challenged this year after interest rates – particularly intermediate (10-year) and longer dated maturities (20 and 30-year notes/bonds) – moved higher.

Last week (WSP: Debunking the Myths of Spooky Season) we noted that volatility has been higher in the bond market than in the stock market since the start of the Middle East War – a highly unusual occurrence, especially during periods of heightened macro tensions. **Markets appear to be transitioning away from viewing bonds as providing much needed ballast in traditional portfolio construction. Bonds are now also seen as potential active generators of income and returns for investors who are demanding higher compensation for taking a variety of risks.** Case in point: the debt-to-yield feedback loop is increasingly non-linear. At higher debt-to-GDP ratios, incremental increases in debt prompt disproportionately larger moves in spreads and yields.

**10-Year Government Bond Yields**




Source: Bloomberg L.P. (2026), as of 9/22/2026

Higher yields, especially term premiums (the extra yield demanded for holding bonds that have longer maturities), theoretically bring more capital discipline than they did in the go-go free money days when rates were barely above zero. Commercial and consumer markets are making adjustments and fixing balance sheets. For better or worse, governments are seldom held to that same level of discipline – they can run deficits for decades as long as someone keeps buying.

## The changing face of bond buyers

The composition of buyers is shifting: we see a tad fewer vigilante bond buyers (steady long-term holders acting as adult in the room) and a tad more twitchy-fingered buyers (hedge funds and other short-termers who adhere less firmly to the buy-and-hold philosophy). The traditional buyer base has changed over the last decade with decreased dealer participation (thanks to rules passed in the wake of the GFC) and declining pension fund participation as the funds themselves distribute and shrink in size. Central banks are trimming holdings and/or placing the next trade into other asset classes such as gold. Sovereign wealth funds and pension funds also seem to be gradually reducing purchases and diversifying risks. On the flip side, price-sensitive buyers (hedge funds, leverage investors, stable coin issuers) are making an increasing share of purchases.

**That combo platter of issues (increased supply, weaker demand and a less stable buyer base) introduces more volatility that could push long-term rates higher, at least over the short term.** We've already witnessed how sensitive bonds are to changes in energy prices and activity (or lack thereof) in the Strait of Hormuz.

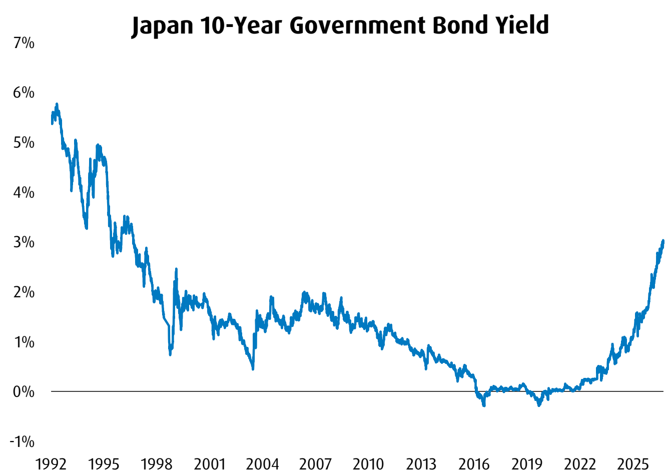
## Who are the adults in the room?

Are sovereign bonds still considered the steadier alternative? Investors are nervous about the rise in yields in many countries such as UK and U.S. 10-year yields crossing 5% for the first time in almost 20 years and Japan's 10-year above 3% for the first time since 1996.

Rating agencies are on the lookout for rising risk – and the possibility of outlook/rating downgrades is greater. Last June, Fitch changed its outlook on the global sovereign debt sector from neutral to deteriorating. It also noted the fiscal deterioration in Europe, which led to France and Poland in particular being downgraded. S&P did reaffirm the U.S. rating (AA+) for the moment. But against the backdrop of a growing deficit and an aggressive fiscal policy, investors may be concerned that a rating agency could downgrade the U.S. rating, a move we last saw in 2011. Canada`s AAA rating, one of only 11 countries rated the highest by S&P, could also be at risk should the current trade uncertainty and fiscal policy path persist.

Investors are watching closely when newly elected policymakers introduce plans that could negatively impact the trajectories of government deficits. For example, in 2022, new British Prime Minister Liz Truss announced plans for large debt-funded tax cuts and substantially expanded fiscal stimulus. Bond markets – and the pound – rioted, forcing her to step down after barely six weeks in office.

The most recent example of this vigilance occurred in Japan where incoming Prime Minister Sanae Takaichi brought a stimulus package as well as plans to increase defense spending for the first time since WWII. **However, it's important to remember that the large move in Japan's rates was off a near-zero level where they'd been stuck for more than a generation (30+years).** The Japanese example also has several unique attributes that complicate its use as a point of comparison for other countries: first, its debt-to-GDP ratio is already over 250%. And second, the bulk of government debt is owned by Japanese-based investors – unlike most other sovereign bonds, which are owned by institutional and retail holders from around the world.




Source: Bloomberg L.P. (2026), as of 9/22/2026

## Central bank policy

The entire post-COVID period has been challenging for central bankers. The massive supply chain disruptions plus Russia's invasion of Ukraine (and the resultant disruption to energy prices) rapidly pushed inflation from zero to high single digits, initiating a period of global hikes. Inflation was on a reasonable trajectory in most locales by 2023/2024 only to be interrupted by a series of policy and positioning changes introduced in President Donald Trump's second term. Efforts to get inflation down to target have been stymied by tariff/trade policy, a hot Middle East war and (more recently) new supply chain chokepoints in fast-forwarding the infrastructure necessary to support the buildout in AI and advanced technology. Several central banks, including the European Central Bank (ECB), the U.S. Federal Reserve and the Bank of Japan, have all increased rates in recent weeks. And more may be deemed necessary in coming months depending upon how the pressure of increased energy and infrastructure build costs are disbursed into the system.

## Implications for investors

**The sovereign debt saga is no longer just a fixed income story. It has become a cross-asset risk that could shape returns over the next several years.** Markets are becoming increasingly focused on fiscal sustainability and not just inflation risk or central bank policy. Investors are rightly questioning whether governments can continue to expand deficits. This wariness, plus several other factors, is pushing rates higher. **The current trajectory suggests that the cost of capital may remain structurally higher than it has been in recent history – though more in line with longer-term and pre-GFC averages.** In other words a normalization after a period of extended moderation.

**Unlike previous periods of high interest rates, there are limited concerns (so far) over the potential for sovereign defaults since the economic fundamentals and presence of the secular AI and infrastructure buildout remain supportive of activity.** However, the combination of further monetary policy tightening, greater political instability (rise of far right and far left candidates with different approaches and an increasingly divided electorate) and the deglobalization trend could lead to higher market volatility in the near term, starting with the interest rates market.

Higher yields plus fluid policy and trade relationships leave the door open for policy mishaps – e.g., will a specific central bank hold too long or hike more than necessary, impacting a country's growth potential? Further reduction in monetary accommodation could lead to reduced investments and growth if there is a miss.

**In the short run, sovereign bonds may be more volatile than investors have been trained to expect – although the volatility is more indicative of structural rather than fundamental issues. From a diversification standpoint, current rates offer investors alternative investment choices they did not have when bond yields were substantially lower. A combination of government, corporate and alternative fixed-income investments can offer interesting diversification in an uncertain environment.** Term risk remains important, which suggests a moderate duration featuring a concentration in a short- and mid-term sector is favored.

## Next week in North America

A datapalooza week will deliver reads on employment, housing, trade, manufacturing and services. What a nice way to fill the time until earnings season kicks off the following week.

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| **Monday 9/28:** | **U.S.** none scheduled \| **Canada** none scheduled |
| **Tuesday 9/29:** | **U.S.** Case-Shiller home price indexes, Conference Board Consumer confidence, JOLTs, \| **Canada** GDP |
| **Wednesday 9/30:** | **U.S.** ADP National employment reports, GDP, Goods trade balances, Wholesale and Retail inventories, PCE \| **Canada** none scheduled |
| **Thursday 10/1:** | **U.S.** Weekly jobless claims, US Manufacturing PMI, ISM-Manufacturing, Construction spending \| **Canada** S&P Global Manufacturing PMI |
| **Friday 10/2:** | **U.S.** Non-farm payrolls reports \| **Canada** none scheduled |

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[i] Capital Markets Fact Book - SIFMA
[ii] ibid
[iii] World Economic Outlook (April 2026) - General government gross debt
[iv] ibid
[v] US Debt Is 2× China's — Country Debt Comparison: GDP Ratio, Per Capita & Total [2026]