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Debts, deficits and disruptors: Revisiting the opportunity in government bonds

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6 min read • 5 Feb 26

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Focus over the past decade has been heavily concentrated on credit markets, however, we believe there is an often overlooked opportunity in the government bond market that may warrant further attention. As much as 2022 bruised investors, with the big correction seen in government bond markets as interest rates rose rapidly, we believe now may be a good time to revisit the asset class in both developed and emerging markets, particularly as credit markets become less exciting.

One of the major concerns worrying investors is the size of government deficits and government credit risk. However, we believe government risk can be a better option than corporate risk given the levers governments are able to pull that corporates cannot: the ability to tax and cut spending, meaning government bonds can readjust their offering when necessary. While there may be some very valuable companies in the world with significant cash on the balance sheet, the government could simply draw on these companies via tax; for example, we have seen the implementation of windfall taxes in recent years.

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Furthermore, we have experienced a paradigm shift in favour of government bonds. During the period following the global financial crisis, government bonds offered little in the way of yield, and returns in corporate bonds were driven by the spread component. Now, that has dramatically changed. Marketing communication of the return driven by rates, whilst spreads remain very tight. As value-based investors, who view spreads as too expensive currently, we can see the value in government bonds which are carrying attractive starting yields; possibly a good time for investors to re-engage in this space, in our opinion.

The term premium opportunity

There is currently the potential for substantial term premium to be captured in the market. The term premium is a way of measuring duration risk; essentially the extra yield paid to hold longer-term debt compared to shorter-term debt. The last time the term premium was this elevated was in 2011/12 when it was driven by an extremely low cash rate. Today, however, the term premium is higher even as rates sit at more moderate levels. This indicates that, whilst there are concerns about fiscal sustainability in developed market governments, these are largely priced into markets and investors have been rewarded for investing for longer in government bonds.

In these assets, the return you might expect to generate over a holding period of two to four years is very dependent on the starting yield and term premium at the beginning of the investment period. With term premiums at current levels and reasonably attractive starting yields, we believe an investor might expect to generate decent returns over the subsequent holding period. In the UK, the starting yield and term premium are as high as they have been at any point over the last 30 years, creating a potentially attractive entry point in our opinion.

Adding value with active management

In current markets, we see potential opportunities for active managers to add value. An active manager can move allocations dynamically between assets, pivoting to different sectors when they become attractively priced, and taking profits before moving to areas that appear cheap as the term premium moves around. For example, we see that in US, UK and German bonds most of the term premium is captured by 10 to 15 years, with Marketing communication increase thereafter. So, by buying 10- to 15-year bonds, we are able to capture a lot of the term premium on offer without having the duration risk of a 30-year bond.

Another tool used by active bond investors is roll-down; the return generated as a bond moves down the yield curve over time. On an upward-sloping curve, longer-dated bonds offer higher yields because they embed more term premium. For example, a 10-year bond will usually yield more than a seven-year bond. After three years, that 10-year bond effectively becomes a seven-year bond. If market conditions are unchanged, its yield will 'roll down' to the lower yield associated with seven-year maturity. This decline in yield results in a higher bond price. As a result, the investor earns not only the coupon income but also a capital gain from the roll-down effect.

Taking a global lens

Active managers can benefit from taking a global perspective.

For many years, the Japanese government bond market has received limited attention from investors, however, recent developments have drawn attention to this area once more, with a steepening in the yield curve meaning 30-year government bond yields are now broadly in line with those seen in Europe. But is it worth investor attention?

While new prime minister Sanae Takaichi is politically popular, there is a concern for bond markets that her administration could see a continuation of fiscal stimulus and lower interest rates. Aiming to re-anchor inflation expectations away from zero over the long-term would give them more flexibility going forward and more room to hike interest rates and cut them again during a downturn. However, the country faces structural challenges. Japan has one of the highest government debt levels in terms of percent of GDP, not to mention that its central bank also owns over half of the government bond stock. This means that to consider hiking interest rates, even marginally, v Marketing communication to their debt servicing costs. This creates a difficult choice between prioritising lower rates and fiscal spending with the trade-off resulting in a weaker currency and potential inflation going forwards. We are however, seeing longer-term premiums in Japanese bonds. There is speculation that if we continue to see high yields in Japan, this could cause a repatriation flow back from Japanese investors, however we don't anticipate this to happen as quickly as some think; as long as Japanese yields remain less compelling than those available in markets such as the US.

Japan is experiencing a negative feedback loop whereby markets are concerned about the fiscal position of Japan, resulting in higher yields, but this is not feeding through to a stronger currency due to fiscal weakness. It is of course hard to ignore the steepness of the curve, but this doesn't necessarily mean the curve won't continue to steepen. It's an interesting space to look at, but potentially indicative of risks.

By contrast, there is a substantial pick up to go into other higher quality sovereigns. For example, Norway has been yielding similar levels to the US at the front-end of the curve. This highlights an interesting contrast between the government market and credit. In credit, there is a high degree of correlation between sectors, not accounting for idiosyncratic risks. However, government markets have diverging factors such as the actions of central banks. As a result, developed market countries, from Japan to Norway, can decouple. This creates opportunities for an active manager to add value.

Over the last few years the volatility between emerging markets (EM) and developed markets (DM) has compressed. EMs have become better quality, more sophisticated issuers with deeper and more liquid bond markets, while DMs' fundamentals have deteriorated, especially from a fiscal perspective. This fiscal differentiation has propelled EM, particularly EM local markets, which has been further bolstered by a weaker dollar narrative and falling yields – reflecting their robust response to inflation in 2021-22 whereby they acted quickly and to a great degree of success, creating room for the cutting cycle we saw throughout most of 2025.

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Furthermore, EMs can provide a natural diversification benefit, where a lot of economies are driven domestically and no longer as dependent on the US or broader sentiment. For example, we have recently seen India being punished through increasing tariffs, but has a very domestically driven economy which provides a good degree of insulation. Demonstrating this, India's rating was upgraded last year, despite the 50% tariff imposed upon them. Meanwhile, we often see that countries within EM are driven by idiosyncratic stories; whether that be policy moderation, political drivers, restructuring stories amongst improving fundamentals, or stemming from commodities, such as gold in South Africa or copper in Chile. There is much for investors to consider in this space.

Revisiting opportunities in government bonds

With elevated term premiums and attractive starting yields, we believe there may be a significant opportunity to earn strong returns within government bonds. By harnessing the tools available to an active manager, such as duration management and roll-downs, as well as diversification across geographies, there is a compelling case to revisit government bonds, in our view.

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