GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

G7 Sovereign Bond Market Functioning and Auction Dynamics

WEDNESDAY, AUGUST 26, 2026

KEY TAKEAWAYS

- **Long-term government bond yields have risen in recent weeks.** G7 term spreads have widened in 2026, primarily driven by an increase in real rates, rather than breakeven inflation rates.
- **However, bond market liquidity has not deteriorated uniformly.** Government bond liquidity and market functioning indicators have improved for most jurisdictions, and bond auctions this year drew decent demand.
- **Liquidity has broadly held up even as volatility has risen, but conditions can deteriorate quickly.** The United States saw a sharp, short-lived jump in yield-fitting error as recently as 2024, so this bears continued monitoring.

POLICY REPRICING, CURVE STEEPENING, AND THE DRIVERS OF THE LONG-END MOVE

Long-term government bond yields have risen in recent weeks. Market contacts highlight investors' growing apprehension towards high debt levels and persistent fiscal deficits, uncertainty about monetary policy and future inflation, and potentially large future government and corporate debt supply needed to finance artificial intelligence and defense spending. This note documents the trajectory of G7 bond-market liquidity and volatility amid this rise in yields, and finds, so far, adequate liquidity and rising price sensitivity rather than outright dysfunction.

Investors expect higher monetary policy rates. Implied policy rates 12 months ahead have risen across G4 and Asia-Pacific economies (Figure 1). This repricing predates the recent change in Fed leadership, and is broad-based, led by Japan and Korea.

G7 term spreads have widened. The market-cap-weighted G7 10-year-2-year slope has continued to steepen, as has every G7 country's own curve (Figure 2).

Widening spreads have been driven mainly by rising real rates, which encompasses both real expected short-term rates and real term premiums. The decomposition of change in nominal yields into real-yield and breakeven-inflation components, by country and tenor, reflects the role of the former as the predominant driver (Figure 3), with broker-dealers attributing large parts of that move to rising term premium. Estimates suggest the broader rise in 10-year yields since this year's low at roughly 75 basis points, with breakeven inflation rates little changed.

DEBT MANAGEMENT, MARKET PLUMBING, AND THE POLICY BACKDROP

U.S. Treasury funding has stayed calm this year, aided by structural plumbing improvements. At a recent market outreach in New York, contacts pointed to the standing liquidity backstop and the absence of a debt-ceiling cash rebuild as key supports. Sponsored and centrally cleared repo now intermediates most Treasury-repo activity, a netting benefit that contacts said has helped keep repo markets orderly even as issuance has risen. That same netting benefit, most prevalent in the United States, is also why fixed-income repo has stayed calm relative to other financing spreads, including for leveraged equity positions. A pending reform to the liquidity-coverage ratio, which would let banks count standing liquidity-facility access toward requirements, matters more; a bank-capital-relief reform has so far had only a marginal effect on Treasury holdings.

Treasury is not expected to add coupon size before mid-2027 at the earliest. Issuance instead leans toward bills, helped by a growing money-market-fund buyer base and new stablecoin-reserve rules, though recent bill auctions have shown softer demand at the margin. Contacts do not expect existing maturity sectors, such as the 20-year, to be retired; more frequent intermediate-tenor reopenings look more likely than a new floating-rate instrument.

This Special Feature was prepared by Johannes S. Kramer, Sheheryar Malik, Yiran Li and Aki Yokoyama (MCM).

AI- and defense-related debt issuance can potentially add a duration-specific squeeze on top of the rise in supply. Much of the prospective corporate issuance tied to AI infrastructure and defense spending are longer term debt that competes with governments for the same 10-to-30-year segment of the curve. Since that additional debt still needs to be absorbed by the same price-sensitive investor base as Treasuries, the associated balance-sheet cost is likely to surface in swap spreads and hedging costs than in bid-ask spreads or headline yield levels. That is consistent with a widening of swap spreads in the United States and United Kingdom (Figure 4).

The Fed's July 29 decision compounded the long-end selloff. The FOMC held rates on a 9–3 vote, an unusually hawkish split, with three dissents favoring a hike, and offered little forward guidance. The curve twist-steepened, and the long end sold off to its highest level since 2007, a move contacts attributed in part to a same-day spike in Middle East oil-supply risk.

G7 bond-market functioning remains broadly orderly, though still reliant on private hands to absorb rising issuance. In the U.S., liquidity metrics and funding plumbing still look resilient: reserve conditions, sponsored repo, and buybacks appear to be containing Treasury-market stress. In Europe, contacts point to softer orderbook depth and concentrated short positioning in EGBs, raising the risk of nonlinear moves around central-bank events. Japan is seen as the market with the clearest structural vulnerability: both BoJ and life-insurer demand are retreating from super-long JGBs, and the curve is biased toward steepening.

MARKET FUNCTIONING AND LIQUIDITY METRICS

Liquidity deterioration has not been uniform across the G7 looking across a range of indicators. Six liquidity indicators, comprised of yield-fitting error, quoted bid-ask spread, Corwin-Schultz breadth, implied yield volatility, repo spread, and swap spread, are computed by country and combined into one composite gauge (Figures 4 and 5). Year-to-date, JGBs stand out as the laggard whereas EGB liquidity metrics have improved most. U.S. Treasuries and Gilts read more mixed across these indicators, with evidence of deterioration concentrated in swap spreads.[1]

Evolution of an aggregate liquidity index is underpinned by differing paths across market. The market-cap-weighted G7 average has stayed close to its own history even as individual members have not (Figure 5): Japan's index has climbed steadily since 2024 to its highest level in the sample, Canada swung from its weakest reading of the period in 2024 to among its best by 2026, and the United Kingdom saw an early, sharp deterioration in 2022 that has since fully reversed. For now, the lack of a uniform trend across liquidity conditions among advanced economy sovereign issuers can be seen as a source of resilience: even Japan's steady decline has not, on its own, pulled the G7 average down. That said, this offset holds only as long as liquidity strains stay country-specific: A shock hitting every market at once would not be diversified away.

Volatility is moving with liquidity, not against it, a reminder that conditions can turn quickly. Yield-fitting error and implied volatility by country (Figure 6) show volatility easing in the United States, Euro area, and United Kingdom since the Fed's leadership transition; Japan is the exception, where both measures have kept climbing, with the fitting error now above its 2022–23 peak. The United States panel underscores the point: its yield-fitting error jumped by more than a point within weeks in 2024, well before this year's repricing began.

Investor views are best characterized as "adequate market liquidity, but higher price sensitivity." Liquidity premia do not appear to be the dominant driver across G7 markets, though reduced demand from structural buyers and broker-dealer balance-sheet constraints are raising the compensation required to warehouse duration, especially at the long end. Dealers frame long-end pricing as increasingly sensitive to auction concession, debt-management guidance, the Fed balance-sheet path, and cross-market spillovers from JGBs.

[1] The heatmap and composite liquidity index combine six indicators, including yield-fitting error, quoted bid-ask spread, Corwin-Schultz (2012) range-based breadth, implied yield volatility, repo-OIS spread, and swap spread, each computed using market-capitalization-weighted 2-, 5-, 10-, and 30-year tenor buckets and percentile-ranked against that country's own 2022–2026 history (higher percentile = worse). Repo spread is the one indicator not blended across the euro-area countries, since the euro-area repo series is already a Haver euro-area aggregate rather than a national composite. The euro area reading is itself a market-cap blend of Germany, France, and Italy; the G7 average blends the five reporting units, the United States, Japan, the United Kingdom, Canada, and the Euro area, using currency-adjusted government market-cap weights.

AUCTION REACTIONS

U.S. and Japanese auctions cleared without stress. The most recent U.S. 10-year (August 12) and 30-year (August 13) auctions drew bid-to-cover ratios of 2.53x and 2.39x, with same-day yield reactions inside ±5 basis points and tails near zero. Japan's 30-year bid-to-cover, at 3.86x, was the strongest reading of any G7 auction in the sample.

Germany's 10-year Bund auction was the outlier. The July 29 sale covered at just 1.14x, versus 2.3x–3.1x elsewhere in the G4/G7, with a same-day yield reaction of nearly 6 basis points, the largest of any 10-year auction in the round. Read against the euro area's improving bid-ask spreads elsewhere (Figure 4), this looks more like an auction-specific soft patch than a broader functioning problem, though it bears watching at the next Bund sale.

Auction data for the United Kingdom, France, and Italy may be too stale to treat as fully current. Because these sovereigns issue at that tenor intermittently, the most recent auctions for particular lines may predate much of this year's repricing, limiting their usefulness as a real-time read on long-end auction functioning.

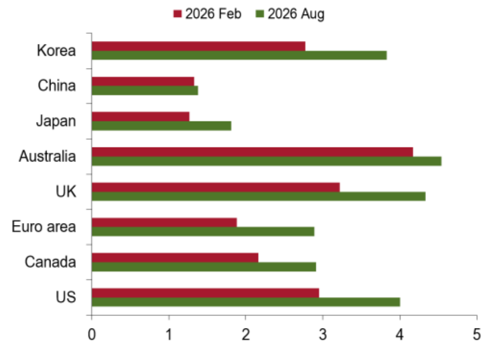
Auction demand has generally remained resilient despite the recent rise in yields. Relative to their own history, bid-to-cover ratios remain within or above typical ranges in most G7 markets, suggesting that higher sovereign issuance and term-premium repricing have not led to a broad-based deterioration in auction demand (Figure 7). Broker-dealer commentary similarly argues that supply continues to find buyers across major sovereign markets, although absorption is becoming more price-sensitive and increasingly concentrated in valuation-sensitive investors rather than official-sector demand. The main exceptions are Japan, and, to a lesser extent, Germany, where recent auctions have shown weaker demand relative to historical norms. However, auction participation alone provides only a partial read on market functioning. Figure 8 therefore examines how sharply yields react when new supply is absorbed, showing that auction-day price reactions have diverged more noticeably across markets in 2026 in reflection of increasingly uneven absorption of government bond supply across G7 sovereign markets.

FIGURES

A broader repricing than the Fed alone can explain.

1. Rate-Cut Expectations Have Faded Across Nearly Every Market Shown

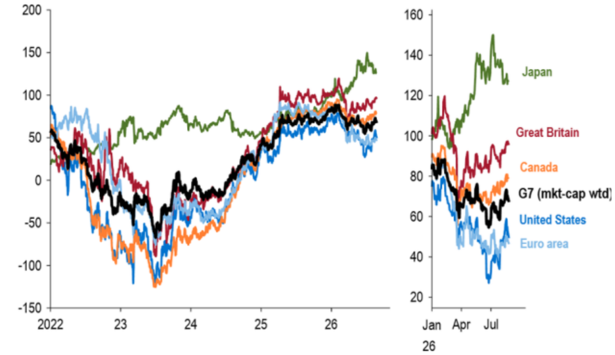
(Percent; 12-month-ahead implied policy rate)



The long end has kept cheapening on trend.

2. G7 Term Spreads Have Risen Further in Recent Weeks

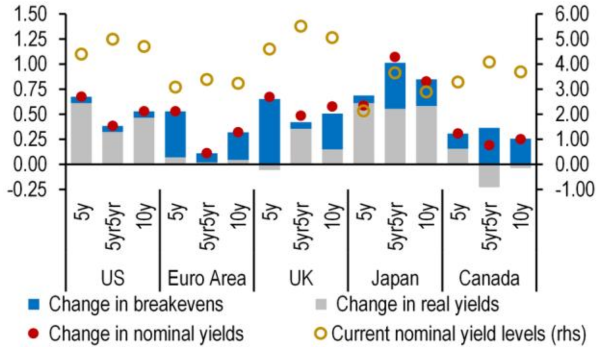
(Market-cap-weighted G7 average and by country, basis points)



Real rates rising with breakevens little changed

3. Real Yields Contributed Substantially to Higher Bond Yields

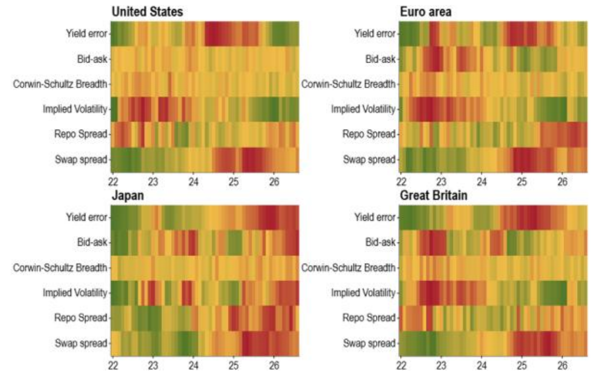
(Percentage points; year-to-date change in break-even, real yields, and nominal yields, by country and tenor)



Notable G7 markets moving in opposite directions.

4. Euro Area Metrics Improved Most, while Japan Faces a Trend of Declining Liquidity

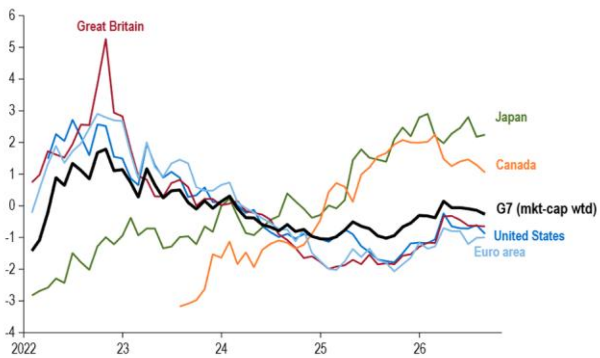
(Percentile rank against own 2022–26 history; red = worse, green = better)



One market is driving the tail risk across G7 markets.

5. Japan's Liquidity Gauge Has Deteriorated Since 2024; the G7 Average Has Stayed Range-Bound

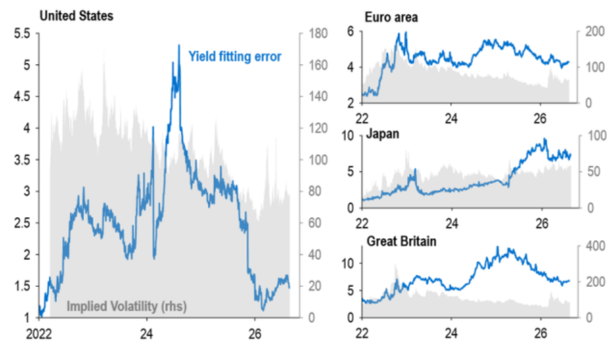
(First principal component of six liquidity indicators, by country and G7 market-cap-weighted average)



One curve keeps getting harder to fit.

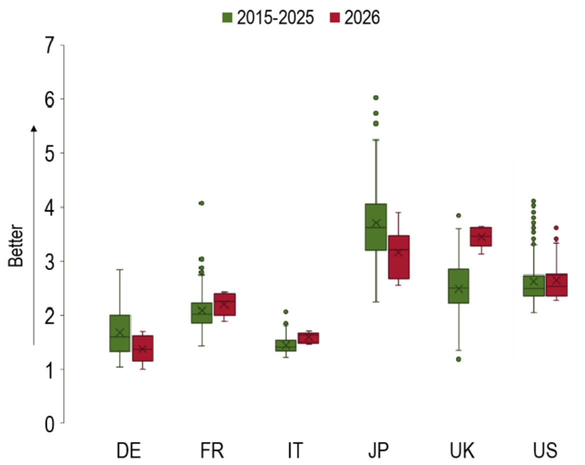
6. Volatility Has Calmed in the U.S., Euro Area, and U.K. with Japan being the Exception

(Basis points, by country)



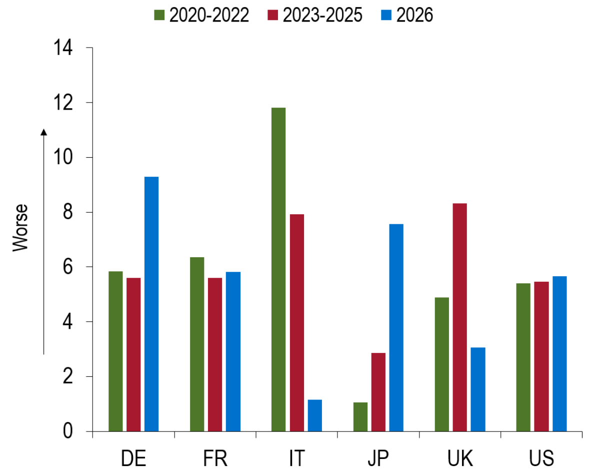
Auction takedown generally robust across G7 issuers.

7. 10-year Bid-to-Cover Ratios Against Each Market's Own Auction History
(Bid-to-cover ratio)



Supply is being absorbed unevenly.

8. Auction-Day Tail Reactions Have Diverged Across Markets in 2026
(90th-percentile basis-point change in 10-year yields on 10-year auction days, by period)



Sources: Bloomberg L.P.; Haver Analytics; LSEG; national debt management offices; and IMF staff calculations.
Note: Figure 1 shows 12-month ahead policy rate expectations based on overnight forwards, adjusted for the basis between overnight interest rate swaps and policy rates.Figure 2-6 reflect IMF staff calculations from the market-functioning pipeline described in footnote 1, covering 2022–August 2026 (partial). Figure 2 captures term spreads between the 10-year and 2-year tenors with the inset isolating year-to-date 2026 moves. Euro area metrics reflect a market-cap-weighted blend of Germany, France, and Italy; bp = basis points; pp = percentage points. Figure 5 captures the aggregate liquidity indicator per country as the principal component across the six liquidity metrics with the G7 composite reflecting a market capitalization weighted aggregate. Figure 6 captures market-cap weighted implied volatility across the 2-year, 5-year, 7-year, 10-year and 30-year tenors 3-months hence. Figure 7 shows the bid-to-cover ratios for 10-year government bond auctions. Figure 8 shows the 90th percentiles of daily 10-year bond yield changes on 10-year bond auction days within the indicated periods.