GLOBAL MARKETS ANALYSIS
Monetary and Capital Markets

G7 Sovereign Bond Market Functioning and Euro-Area Divergence

WEDNESDAY, OCTOBER 21, 2026

KEY TAKEAWAYS

- **Higher expected interest rates have affected G7 government bond markets unevenly.** Treasury trading has remained resilient, whereas Japanese and euro-area yield-fitting errors have risen since August.
- **Although rate uncertainty has eased from recent peaks, bond market liquidity readings remain divergent across indicators.** The G7 composite measure of illiquidity has moved little since August, but masks contrasting signals across EGB indicators and persistently low JGB market liquidity.
- **While OAT bond buying has helped stabilize EGB trading, demand remains selective.** Quoted bid-ask spreads remain below those associated with earlier sovereign-stress episodes. Demand for safety has favored Treasuries and Bunds, while long-term investors, such as pension funds, have yet to return as broad buyers of French sovereign bonds.

RATE EXPECTATIONS OUTPACE THE MACRO BACKDROP AS UNCERTAINTY EASES

Interest-rate expectations have risen faster than the economic backdrop would suggest. Data through end-September show only a modest acceleration in G7 inflation and a subdued activity rebound. Staff estimates suggest that one-year interest rates expected to prevail one year from now exceed levels implied by those macroeconomic readings (Figure 1). While this gap may reflect pressures on market functioning (examined below) it does not by itself identify illiquidity. It is noted that through October, market contacts have continued to emphasize higher expected policy rates and higher longer-term real rates.

The recent retreat in implied volatility has helped daily yield ranges stabilize. Daily readings have eased from September's peaks, though they remain above late-August levels (Figure 2).

Concerns about the growth effects of further policy tightening have rekindled demand for government bonds. Expectations of restrictive near-term policy persisted, but investors began anticipating that tighter financial conditions may weaken growth and eventually lead to lower policy rates. The decline in one-to-five-year forward minima–defined as the lowest overnight forward interest rate implied by G4 swap curves one to five years ahead–alongside ten-year G4 sovereign yields is consistent with that channel (Figure 3). Tobias et al (2026) reports that by mid-October, investors' concerns about debt-financed AI investment were leading to reduced equity and corporate-credit exposures and increased buying of Treasuries.

THE G7 COMPOSITE LIQUIDITY MEASURE MASKS DIFFERENCES ACROSS BOND MARKETS

The G7 composite remains close to its August reading. Japan's composite has continued to diverge from the other markets (Figure 6), while EGB indicators give a mixed picture (Figure 5). Bloomberg's Treasury yield-fitting error remains contained, while corresponding JGB and EGB errors have increased since August (Figure 4). Market commentary links these discrepancies in part to less arbitrage activity among leveraged investors.

Treasury trading has absorbed the selloff without a broad deterioration in market functioning. September quarter-end repo funding passed without broad disruption, supported by continued funding supply from institutional cash pools, including money market funds. Treasury expanded its buybacks of older bonds in August, with purchases concentrated around the twenty-year sector, where prices improved relative to neighboring maturities. Broader liquidity measures have yet to show a clear response to the expansion (Figures 5 and 7). Assessing electronic order

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books, Carter et al (2026) concluded that recorded transaction costs, adjusted for daily yield ranges, have stayed within historical norms over the past few months. Broader turnover data also show continued trading activity.

Japanese bond pricing remains uneven despite continued demand for long maturities. JGB yield-fitting errors remain elevated after easing in September (Figure 4). Yamashita and Levingston (2026) report continued switching of domestic life insurers from older into more recently issued bonds. That shift leaves older issuances more unevenly priced even as the aggregate demand for long-dated bonds continues to hold up, prompting Japan's liquidity composite to further separate from the other markets.

The Bank of England's sales pause has reduced near-term gilt supply. On September 17, the Bank Executive paused Asset Purchase Facility auctions pending new sales arrangements, with details due by April 2027 and no restart date set (Bank of England 2026). Maturing gilts continue to run off. Trading has continued even as thirty-year yields crossed 6 percent; lower implied volatility and narrower range-based readings fit that resilience (Figures 4, 5, and 7). Ahead of the budget update on October 28, market contacts focus on the composition of borrowing. Greater use of bills and shorter-dated gilts could reduce the amount of duration supply that private hands need to absorb, even if financing needs rise. Banks reportedly hold substantial asset swapped gilt positions, an unwinding of which could move swap spreads without a comparable deterioration in outright trading (Figure 7).

FRENCH BUYING RETURNS, BUT THE BUYER BASE REMAINS NARROW

France's recovery in trading activity has not yet brought back an equally broad set of buyers. Mid-October commentary reports rising euro-area trading volumes, improved French market depth, and domestic purchases. However, foreign demand remains selective and short positions substantial. Covering those positions can raise turnover without creating durable demand to absorb large sales. French yield-fitting errors remain elevated, while the French range-based trading-cost proxy shows intermittent spikes rather than a sustained increase (Figure 8). An October 18 report showed that Dutch pension funds' OAT holdings had fallen by $6.6 billion (€5.8 billion) in the second quarter, while Bund holdings had risen (Davidsson, Salim, and Thomas 2026, drawing on EIOPA pension statistics). October 13 reporting on ABP, the Dutch civil-service pension fund, described similar selectivity: Treasury-sale proceeds were reinvested in Dutch, German, and Spanish bonds, with France excluded from the new allocations (BNR 2026).

Selective foreign buying raises uncertainty around who will absorb future French bond supply. Banks have reduced the OAT share of their sovereign portfolios. While accounting classifications cushion much of the immediate effect of falling bond prices on earnings, French bank credit default swap (CDS) spreads widened alongside sovereign CDS spreads, albeit less than in 2011–12. Markets therefore continue to price some sovereign–bank risk; the accounting cushion does not ensure renewed bank purchases of government debt. For now, the GDP-weighted French, Italian, and Spanish spread over Germany remains below the roughly 150–180 basis-point region associated with broader and less predictable quoted costs in the earlier sovereign-stress sample (Figure 9). Further spread widening could increase risk of trading-cost spikes.

An enduring flight-to-quality shift toward German bonds can leave dealers holding more risk elsewhere in the euro area. French bonds already offer a larger yield premium over swaps than German bonds (Figure 8). Historically, a larger German funding advantage over swaps has coincided with wider French, Italian, and Spanish spreads over Germany (Figure 10). A more heterogeneous investor base and short covering can stabilize prices without restoring broad buying. Dealers absorbing client bond sales must then finance the inventory and manage its interest-rate risk. If they retain net duration, paying fixed in swaps hedges the risk of rising yields. Such hedging can push swap rates higher while safe-haven buying lowers Bund yields, increasing Germany's funding advantage over swaps.

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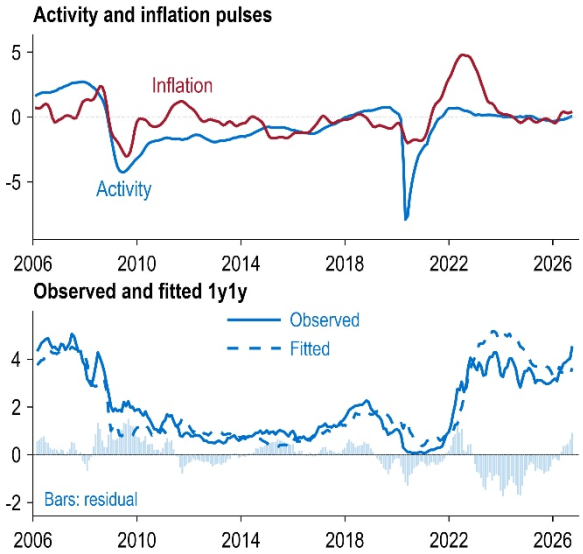
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FIGURES

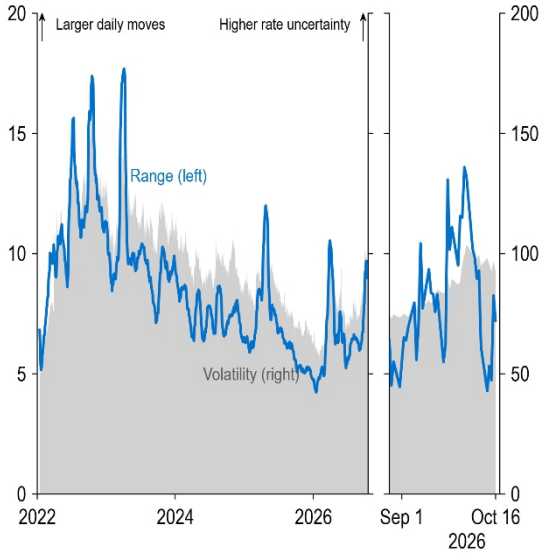
By end-September, G7 near-term forwards exceeded levels implied by the macroeconomic backdrop.

1. Macro Pulses and Forward Rates
(Monthly; percent and percentage points)



Since September's peaks, lower implied volatility has helped daily yield ranges stabilize.

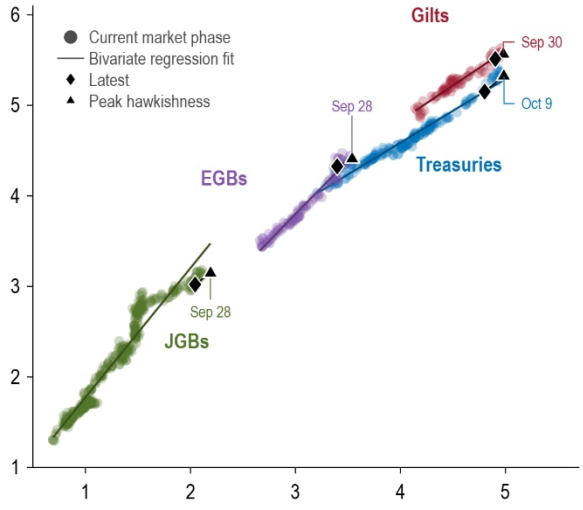
2. Daily Yield Range and Rate Uncertainty
(Basis points; left: yield range, right: implied volatility)



Sources: Bloomberg Finance L.P.; Haver Analytics; IMF, World Economic Outlook database; LSEG; and IMF staff calculations.
Note: Reflecting GDP-weighted composite across G7 advanced economies. Left: monthly activity/inflation pulses and observed/fitted 1y1y rates; bars show observed minus fitted. Right: Yield range (blue, left; 21-trading-day average in full history) and implied volatility (grey, right).

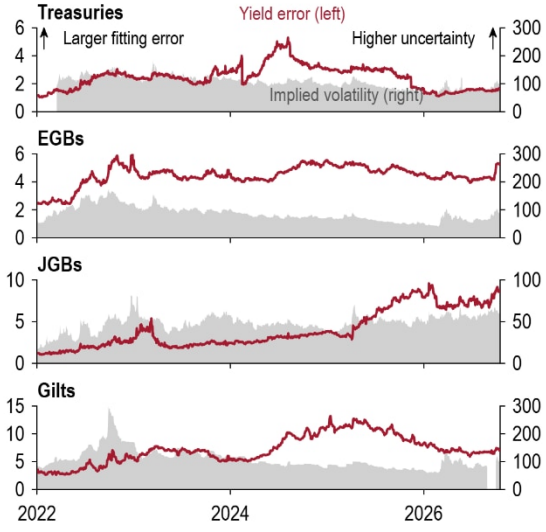
Lower expected policy rates have helped ease ten-year yields.

3. Forward Minima and Ten-Year Yields
(Percent; x: trough instantaneous forward, years 1–5; y: ten-year sovereign yield)



Japan's bond pricing remains uneven despite lower rate uncertainty.

4. Yield Errors and Implied Volatility
(Basis points; burgundy: yield error, left; grey: implied volatility, right)

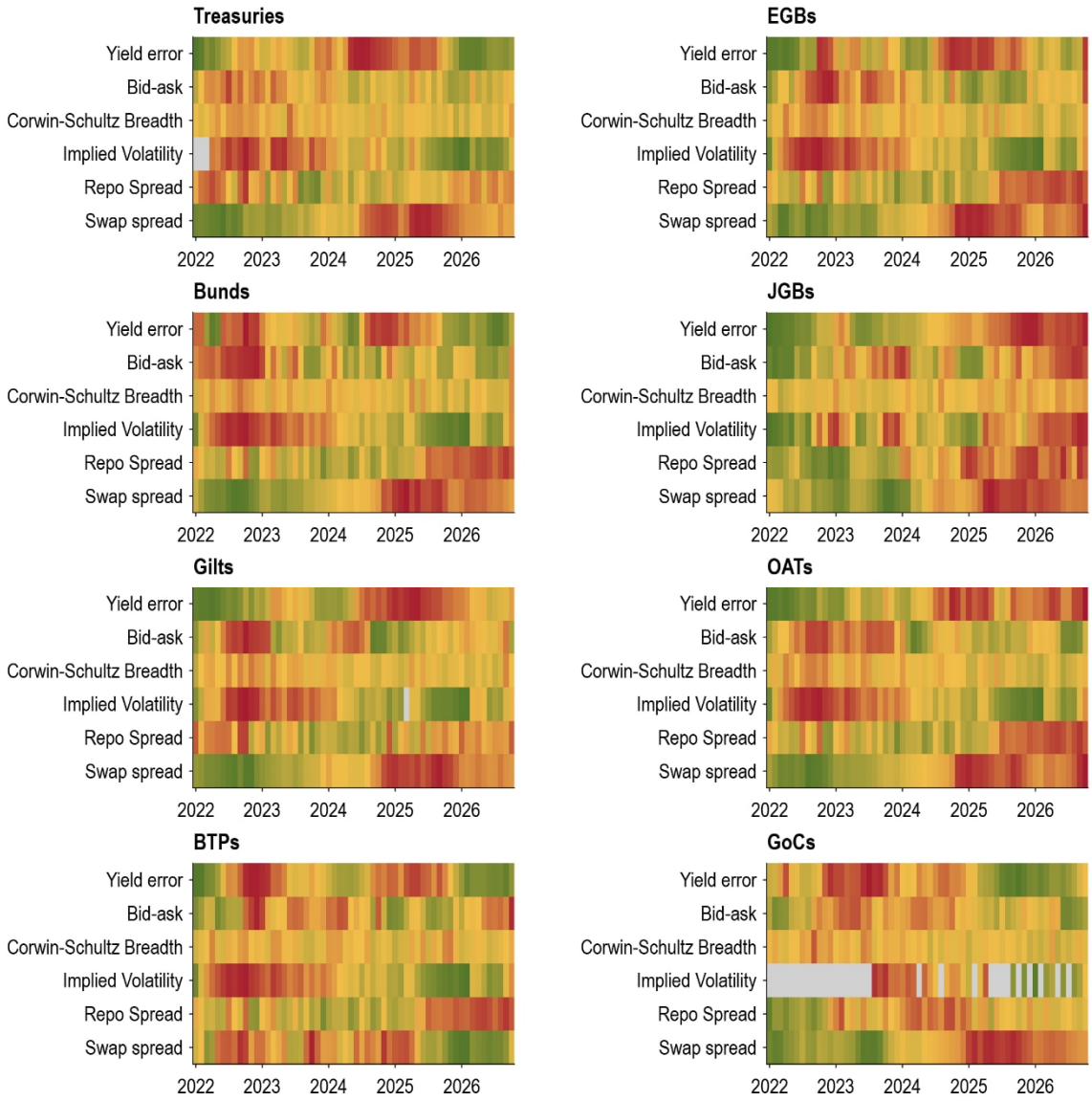


Sources: Bloomberg Finance L.P.; LSEG; and IMF staff calculations.Note: Figure 3: Fisher–Nychka–Zervos (FNZ) smoothing splines fit instantaneous swap forwards, with smoothing selected by daily generalized cross-validation (Fisher, Nychka, and Zervos 1995). The forward minima correspond to the minimum instantaneous forward rate over years 1–5 in each market. The current phase runs from its latest dated ten-year-yield trough through October 16. Episode dating adapts Bry and Boschan (1971) for each individual market, as used for equity-bear episodes in the April 2026 GFSR (Figure 1.19, panel 3). EGBs market-value-weight Germany, France, and Italy. Colored lines show bivariate regression fits; triangles mark the highest daily forward trough; diamonds mark October 16. Black lines connect the marked observations. Figure 4: one-month swaption-implied yield volatility.

Bond market conditions have diverged across countries.

5. Liquidity Indicators Continue to Diverge Across Markets

(Monthly averages of daily own-history percentile ranks; 2022–October 16, 2026)

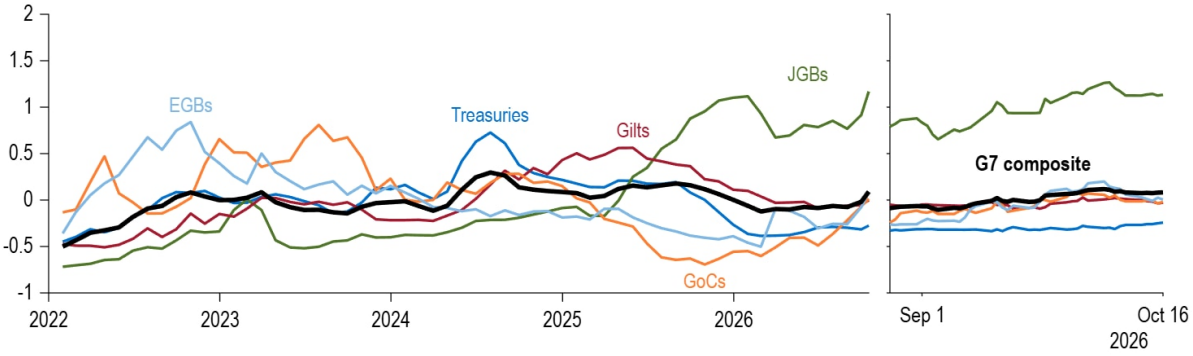


Source: Bloomberg Finance L.P.; LSEG; Haver Analytics; and IMF staff calculations.
Note: Green/red mark favorable/unfavorable own-history readings; grey denotes missing or insufficient data. *Yield error* is Bloomberg's relative-value curve-fitting-error index. *Bid-ask* is bid yield less ask yield in basis points. Nonpositive tenor widths are excluded before maturity-bucket averaging; outstanding-amount weights are renormalized over available buckets. *Corwin-Schultz Breadth* adapts daily high/low yields; *Implied Volatility* uses one-month ATM swaptions. *Repo Spread* averages overnight repo less OIS, one-week less overnight repo, and one-month less one-week repo. *Swap spread* is government yield less matched swap rate for percentile ranking. Benchmark-tenor measures use relative outstanding amounts; legacy EGB volatility equally weights tenors. Bunds, OATs, and BTPs share regional volatility/repo rows. October is partial. Treasuries = United States; EGBs = euro-area blend of Germany, France, and Italy; Bunds = Germany; JGBs = Japan; Gilts = United Kingdom; OATs = France; GoCs = Canada; BTPs = Italy.

The G7 composite masks Japan's persistent divergence.

6. Aggregate Liquidity Remains Uneven Across Markets

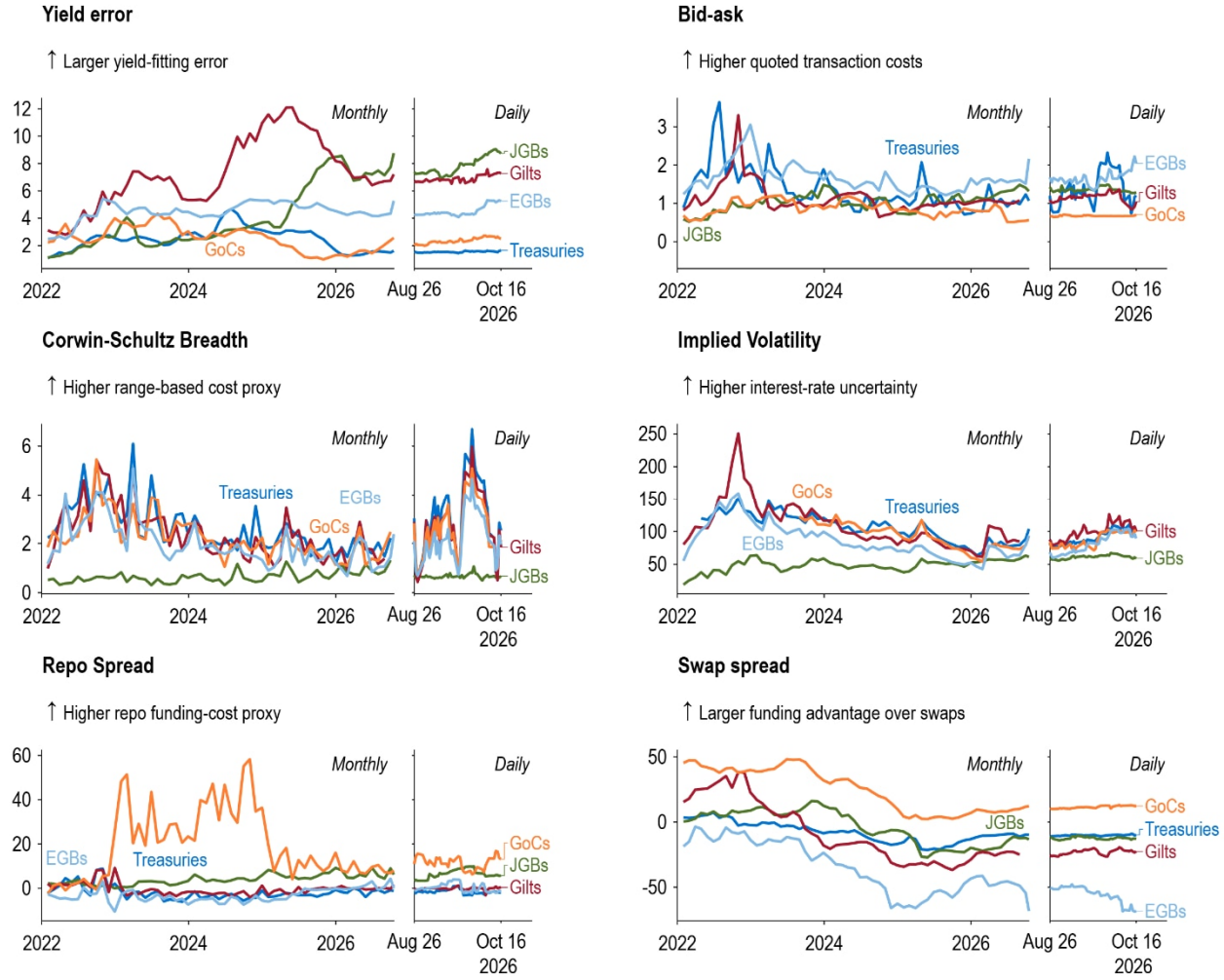
(Monthly history and daily zoom since August 26; loading-constrained composite; black: G7 composite)



Recent moves show no common deterioration across markets.

7. Monthly Conditions and the Daily Update

(Basis points; monthly history on the left, daily developments since August 26 on the right)



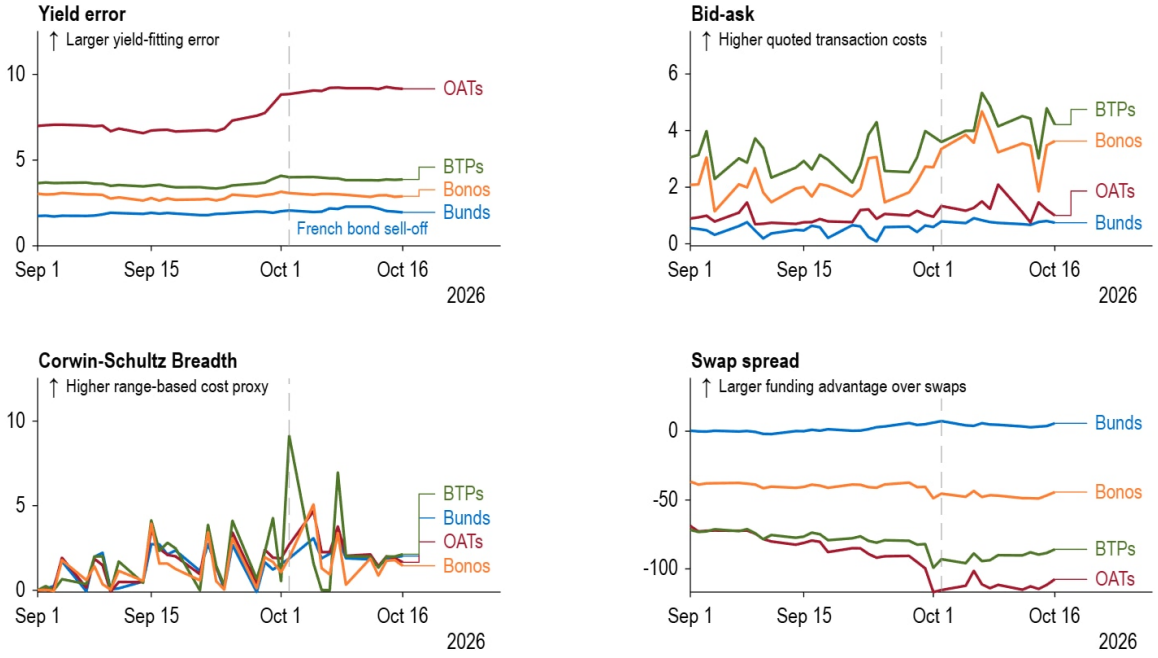
Sources: Bloomberg Finance L.P.; Haver Analytics; LSEG; and IMF staff calculations.

Note: Monthly history and daily readings since August 26; October is partial. Figure 6 uses a loading-constrained adaptation of Bernanke, Boivin, and Eliasz (2005); black is the market-value-weighted G7 composite across five non-overlapping reporting groups. Figure 7 shows monthly source averages and daily readings, in basis points, de-noised based on the Hamilton, Ma, and Xi (2026) procedure.

Renewed French buying has not revived a broad buyer base.

8. National Indicators Show What the Euro Area Aggregate Conceals

(Maturity-weighted national indicators; basis points; September 1–October 16)

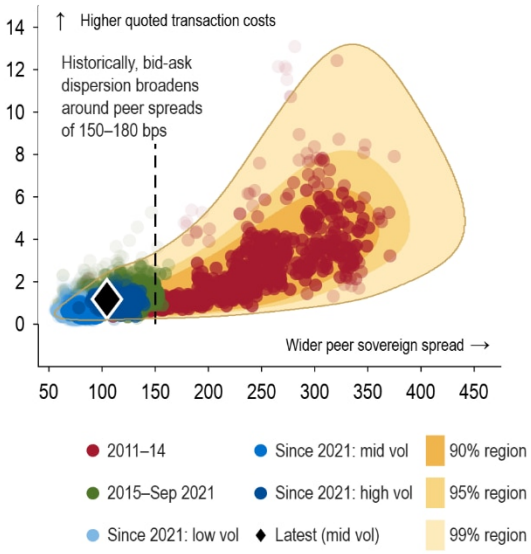


Sources: Bloomberg Finance L.P.; LSEG; and IMF staff calculations.
Note: National swap spreads use the common euro swap curve minus each sovereign yield. Regional repo and swaption series are not copied into national panels. Bunds = Germany; OATs = France; BTPs = Italy; Bonos = Spain.

Trading costs remain below past sovereign-stress levels.

9. Sovereign Spreads and Liquidity Costs

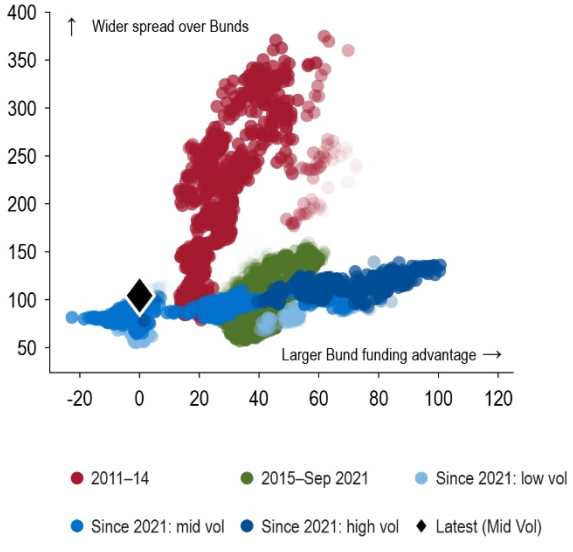
(Basis points; x: peer sovereign spread; y: average bid-ask width)



German bond premiums have coincided with wider sovereign spreads.

10. Bund Swap and France/Italy/Spain Spreads

(Basis points; x: swap less Bund yield; y: GDP-weighted France/Italy/Spain over Germany)



Sources: Bloomberg Finance L.P.; Leister (2023), Commerzbank; IMF, World Economic Outlook database; LSEG; and IMF staff calculations.
Note: Peer spreads GDP-weight France, Italy, and Spain over Germany. Figure 9 averages bid-ask widths across France, Italy, Spain, and Germany. Shaded regions contain 90, 95, and 99 percent of the joint probability from a Frank copula model (Frank 1979) fitted to August 2011–December 2014 observations, capturing the historical relationship between sovereign spreads and quoted trading costs.