25 SEPTEMBER 2026

focus

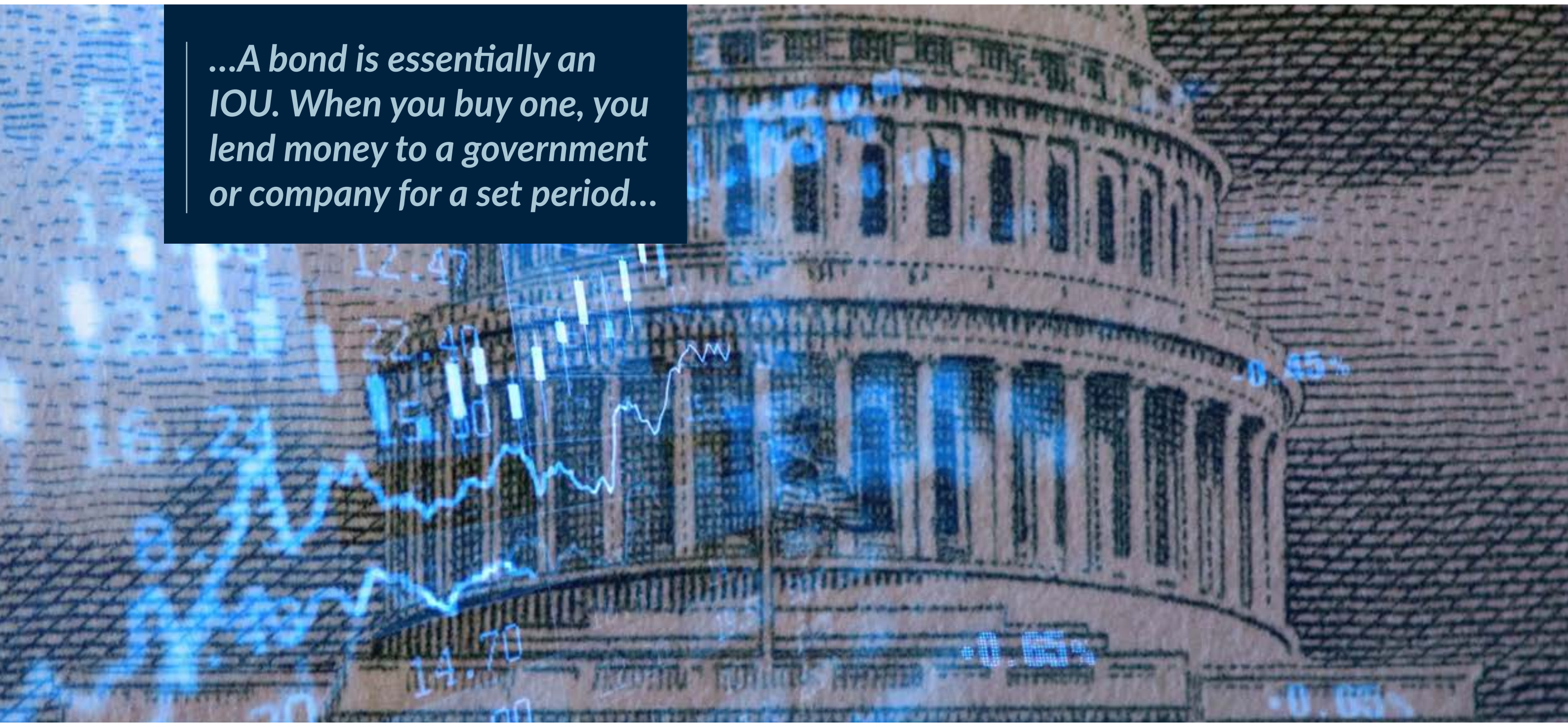
Why Bonds **Matter**

Bonds have traditionally been the quieter cousin of equities. They play an important role in portfolios by helping to protect capital and generate income, but they rarely attract the same attention as shares. **That has changed in recent months. Government bond yields have risen sharply, putting pressure on share markets, property and borrowers.**

90 YEARS

FORSYTH BARR
INVESTMENT ADVICE

> *…A bond is essentially an IOU. When you buy one, you lend money to a government or company for a set period…*

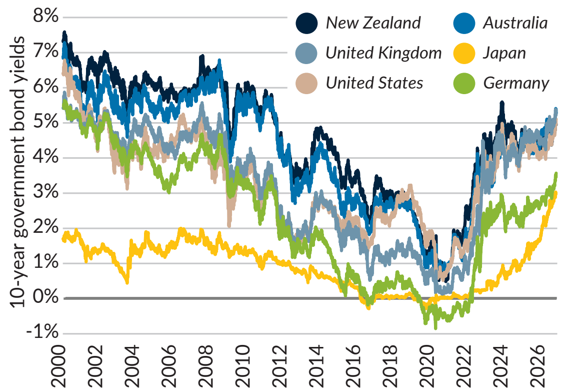


A bond yield is the annual return an investor can expect at its current market price. Bond prices generally move in the opposite direction to market interest rates. When interest rates rise, existing bonds paying lower rates become less attractive, so their prices fall. When rates fall, the reverse happens.

Bond yields may sound dull, right up until the moment they don't. They provide a benchmark for the return other investments need to offer. Even a relatively small change in bond yields can have a significant effect on the prices of shares and other investments around the world.

The rise has been uncomfortable for existing bondholders because bond prices fall when market yields rise. It has also created an opportunity. New bonds now offer more attractive income, and bond portfolios can reinvest maturing securities at higher rates. Understanding both sides of that adjustment is important.

DEVELOPED-MARKET BOND YIELDS HAVE RISEN SHARPLY SINCE 2021



Source: LSEG, Forsyth Barr analysis

A quick bond refresher

A bond is essentially an IOU. When you buy one, you lend money to a government or company for a set period. In return, the issuer generally pays a fixed rate of interest, known as a coupon. For example, a bond with a face value of $100 might pay $5 a year, with the $100 repaid when the bond matures.

Long-dated bonds are more sensitive to changing interest rates because their fixed payments stretch further into the future. Rising yields can therefore reduce the value of long-term bonds, even when the borrower remains in good financial health.

It's important to remember that, if you hold a bond until it matures, you should continue to receive its coupon payments and have its face value repaid, provided the borrower doesn't default.

What is pushing yields higher?

There is no single explanation, but the forces fall into two broad camps.

The first is immediate. The renewed escalation in the US–Iran conflict has pushed Brent crude oil back to around US$100 a barrel. Higher fuel prices flow through to freight, food, manufacturing, and household energy bills, making it harder for central banks to declare victory over inflation. In response, markets have priced in higher interest rates across most major economies, including New Zealand.

The second set of forces is less dramatic but may prove more persistent. Governments are borrowing heavily to meet the costs of ageing populations and to fund infrastructure, healthcare, and defence.

As governments borrow more, they generally need to offer more attractive yields on bonds to entice buyers. Investors also face greater uncertainty about inflation, public finances, and where interest rates will eventually settle. They demand additional compensation for locking up their money for longer in an uncertain environment. This is known as a 'term premium'.

There is also a more positive factor at work. The US and other major economies have proved more resilient than many expected earlier this year, reducing the need for central banks to lower interest rates.

Heavy corporate borrowing is also adding to the competition for investors' money. Major technology companies are investing enormous sums in data centres, electricity supply, and other AI infrastructure. Even highly profitable firms are increasingly financing this investment with debt rather than cash. When governments and companies are all trying to borrow more, they may need to offer higher interest rates to secure funding. Taken together, these pressures suggest the ultra-low interest rates of the 2010s are unlikely to return anytime soon.

A return to normal

It is tempting to view today's interest rates as unusually high. But history suggests the decade following the Global Financial Crisis (GFC) was the real exception.

From 2009, and again during COVID-19, central banks held policy rates near zero and bought bonds on a large scale. This pushed government bond yields to exceptionally low levels.

Since 1990, the US 10-year Treasury yield has averaged around 4%, compared with less than 3% over the past decade. Today's yield of close to 5% is above that longer-term average, but much closer to it than the sub-2% levels seen during much of the 2010s.

New Zealand's experience is similar. The 10-year government bond yield spent much of the 2000s between 5% and 7%, broadly in line with where it trades today. It fell sharply from 2020 as the Reserve Bank cut the OCR to near zero and began buying bonds.

None of this makes the adjustment easy, particularly for borrowers refinancing debt fixed at pandemic-era lows. Bond markets are likely to remain volatile while inflation, government borrowing and central bank decisions dominate the outlook. However, investors should not assume yields will eventually return to the exceptionally low levels of the 2010s. Today's levels may prove closer to normal in the years ahead.

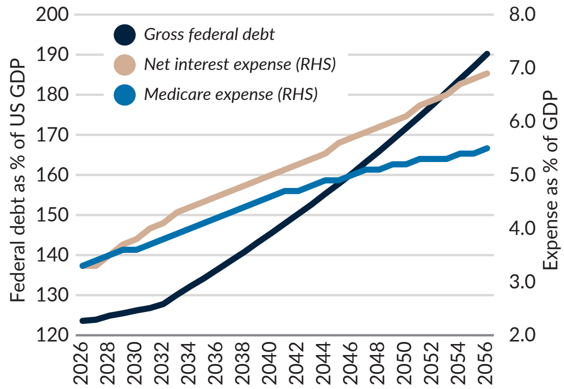
The impact of rising US government debt

The deteriorating state of US government finances is another concern. US federal debt recently surpassed US$40 trillion, while annual interest costs now exceed US$1 trillion, making them the third-largest item in the federal budget.

On current projections, gross federal debt could rise from around 124% of GDP today to almost 190% over the next 30 years. Under that scenario, interest costs will soon exceed spending on Medicare. Stabilising the debt trajectory would require reducing the annual deficit by roughly US$840 billion, yet neither major political party has presented a credible plan to achieve this.

A more likely outcome is that US debt continues to rise, interrupted by modest efforts to reduce borrowing and periodic disputes over the debt ceiling.

US DEBT AND INTEREST COSTS ARE PROJECTED TO KEEP RISING



Source: Congressional Budget Office, Forsyth Barr analysis

New Zealand's position is much healthier by comparison. Treasury expects its main measure of government debt, net core Crown debt, to peak at around 46% of GDP in 2027/28 before gradually declining. Even so, New Zealand cannot take overseas demand for its debt for granted in the way the US can. The New Zealand dollar is not a global reserve currency, so maintaining confidence in the country's finances remains important.

How US bond yields affect New Zealand bonds and mortgages

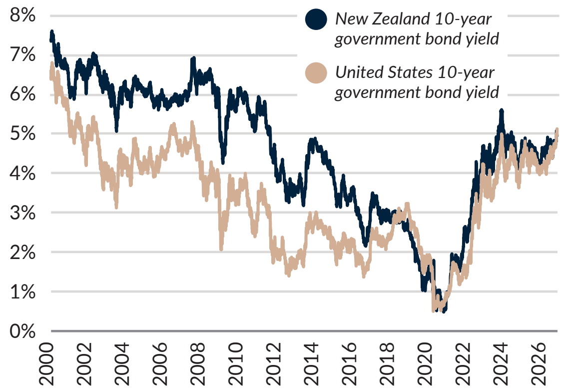
The US 10-year government bond yield briefly reached 5% in mid-September, hitting the highest level since the Global Financial Crisis (GFC). New Zealand's 10-year government bond yield has also moved above 5% recently.

There is nothing magical about a 5% yield. An economy doesn't stop functioning because a number ticks from 4.99% to 5.00%. But round numbers act as a psychological line in the sand, and the speed of the move matters as much as the level.

US government bonds provide a benchmark across global markets. Their yields influence mortgage rates, business loans, company borrowing costs, and the value investors place on shares and property. As a result, a rise in US yields can make borrowing more expensive in New Zealand and elsewhere, even if local central banks do nothing. New Zealand and US 10-year government bond yields have generally moved closely together over the past 20 years, with a correlation of around 80%.

...Bonds can... help protect a portfolio if the economy weakens...

NEW ZEALAND AND US BOND YIELDS GENERALLY MOVE TOGETHER



Source: LSEG, Forsyth Barr analysis

What does this mean for shares?

First, borrowing becomes more expensive. Companies refinancing debt may face larger interest bills, leaving less money for dividends, investment, or expansion. Highly indebted businesses are usually more exposed.

Second, higher yields reduce what investors are willing to pay today for profits expected many years from now. This is particularly important for high-growth companies because a larger share of their value depends on earnings that they are expected to generate well into the future.

Third, bonds become more competitive with shares. When bond yields were near 1% during COVID, investors had a strong incentive to move into shares, property, and other riskier assets in search of returns. With government yields now closer to 5% and corporate bond yields higher again, a relatively secure, highly rated bond competes much more effectively for investors' money.

This does not mean shares will fall whenever yields rise. If yields are climbing because growth is strong, profits can offset the valuation pressure, and right now, company results and profit outlooks across the globe are generally solid. The more concerning scenario is one in which yields rise rapidly solely due to inflation, particularly if higher costs are squeezing household spending and company margins at the same time.

The bottom line for a diversified investor

Rising yields can hurt bond prices in the short term, and 2022 was a reminder that bonds and shares can fall together when inflation is the shared enemy. That episode led some investors to question whether bonds still deserve their place in a portfolio.

The longer-term picture is more encouraging. Lower bond prices allow new investments to lock in higher yields, while bond funds can reinvest their income at more attractive rates. Over time, this additional income provides a larger buffer against any further decline in bond prices. Bonds can also help protect a portfolio if the economy weakens: slower growth would typically lower interest rate expectations, pushing bond yields down and prices up, even as shares struggle.

For diversified investors, higher yields cut both ways. Borrowing costs are no longer exceptionally low. As a result, valuations matter more, and companies and investments reliant on high levels of debt warrant closer scrutiny. Markets may remain unsettled while oil prices, inflation, and central bank decisions dominate the headlines. At the same time, investors are being paid more to hold good-quality bonds, portfolios can generate stronger income, and bond prices have greater potential to rise if economic conditions weaken and yields fall.

If at any time you want to discuss investment options and opportunities, your Forsyth Barr Investment Adviser is available to provide you advice and assistance.

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