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Morning Briefing

On Global Bond Yields & A Japanese Canary

Check out the accompanying [chart collection](#).

Executive Summary: Global debt markets are in disarray, with Bond Vigilantes driving up yields in various nations—including two that lost their leaders this week, France and Japan. William discusses global investors' uncertainties regarding both countries as well as how President Trump's actions have roiled financial markets the world over. ... Also, Joe has great news: The S&P 500's forward earnings have hit record highs for 16 straight weeks now. And participation is broad, with most sectors' forward earnings—and stock price indexes—around their record highs. Plus, Joe reckons that Q3 earnings should grow y/y for all the sectors but one.

Global Yields I: Bad Week for Leaders from Japan to France. It's been a rough few days for prime ministers of the Group of Seven economies. On Sunday, Japan's Shigeru Ishiba fell on his political sword—a punishment for his party's disappointing performance in recent elections. A day later, France's Prime Minister François Bayrou resigned after losing a confidence vote. And their respective governments share something else in common: Both are incurring the wrath of the Bond Vigilantes.

Days before Ishiba quit, 20-year Japanese government bond (JGB) yields rose to the [highest since 1999](#) as investors feared a wave of budget-busting tax cuts. Yet losing Ishiba, the most fiscally conservative Japanese leader in decades, has activist bond traders in a whirl ([Fig. 1](#)).

Conditions in French debt circles are far worse ([Fig. 2](#)). The collapse of France's latest government could collapse confidence in French financial assets. Bayrou was shown the door because of the high borrowing costs of a [44 billion euro](#) (\$51 billion) savings plan.

Let's explore why global bonds markets are in such disarray:

(1) *Busy time for IMF.* Global investors wondering whether France might need to hit up the

International Monetary Fund (IMF) for financial assistance. Even French Finance Minister [Eric Lombard](#) wouldn't rule that out: "I cannot assure you that the risk of IMF intervention [does not exist](#)," he told French radio late last month.

The UK is fending off its own IMF bailout chatter just three years after then-Prime Minister Liz Truss nearly crashed London's financial system ([Fig. 3](#)). German bunds, meanwhile, recently rose to the highest levels since Europe's debt crisis in the early 2010s. Some even think German yields could [soon top Italy's](#) ([Fig. 4](#)).

(2) *Europe's latest stumble*. It's rarely a good thing when European markets begin obsessing over the so-called "[10 spread](#)," or the gap between Italian benchmark yields and their German equivalents ([Fig. 5](#)). The barometer was often discussed during the 2011 Eurozone debt in sporting-rivalry terms.

In a recent [Bloomberg op-ed](#), market veteran Marcus Ashworth argued that "the Mediterranean nation has had a series of mishaps during the euro's quarter-century of existence, but currently it's on an upswing. That's reflected in the tightest differential for 15 years." But "rather than applaud the market's re-rating of Italian debt, European policymakers should lament the deterioration in Germany's standing."

(3) *Trump's market roiling*. US Treasuries, meanwhile, have kept global investors on their feet this year as President Donald Trump's tariffs—and fears of runaway inflation—caused a "mini panic" that shook US financial markets. That episode in April and May saw US 30-year Treasury bond yields breach the [5.00% level](#), one the Bond Vigilantes recently tested again.

Subsequent months brought subsequent confidence shaking events, leaving global markets braced for additional Treasury yield spikes: Moody's Investors Service downgraded the US debt, the Republicans passed their budget mega deal, and Trump has mounted an all-out assault on the Federal Reserve's independence. Treasury Secretary Scott Bessent hasn't helped by floating fringe ideas like repurchasing US Treasuries with [crypto tokens](#) to reduce Washington's debt.

The most significant concern, though, is how Trump's efforts to influence Fed decision-making may backfire. White House flirtations with firing Fed Chair Jerome Powell and removing Governor [Lisa Cook](#) could slam the central bank's credibility. So might lawmakers' rushing Trump loyalist Stephen Miran onto the Federal Reserve Board in time for the FOMC's September 16-17 policy meeting. Miran is expected to be the third dissenting vote

should Powell argue against a rate cut amid hotter-than-expected [inflation](#). More likely is that the majority will vote for a rate cut on September 17. Indeed, there might even be no one dissenting to a rate cut.

(4) *Central banks in harm's way*. An ill-timed Fed rate cut might provoke the Bond Vigilantes to send long-term US rates higher, making Fed rate cuts a wash, as they did in late 2024. Or worse, it might shake up global markets still harboring some [PTSD](#) from the 2008 global financial crisis and the European crash that began in Greece in 2010.

Greece, of course, was at the center of Europe's debt reckoning back then. And the shadow of that episode found its way to Japan earlier this year, compliments of Ishiba.

Global Yields II: Japan as Canary in Coalmine. On May 19, Ishiba committed what's known as a "[Kinsley gaffe](#)." This is when a politician tells some obvious truth they're not supposed to say. Ishiba did so while trying to dissuade lawmakers from cutting taxes, fearing that tax cuts might unnerve credit rating companies. To dramatize the point, Ishiba said "our country's fiscal situation is undoubtedly extremely poor, [worse than Greece's](#)."

Japan's current credit crisis could be a canary in the proverbial coalmine. In a wildly uncertain world this past decade, Japan has often stood out as an oasis of calm. With Bank of Japan's (BOJ) key interest rate locked at zero and political stability to spare, yen assets have become global finance's quiet place. All that is changing as Ishiba's exits the scene after less than 12 months in office.

Here's more:

(1) *JGBs in turmoil*. News of Ishiba's exit boosted Japan's benchmark [Nikkei 225 Stock Average](#) by more than 1% as of Tuesday's close as investors bet on stimulus to come ([Fig. 6](#)). But it's stress-testing the JGB market, reminding global investors how fleeting financial oases can be. Long-maturity JGBs dropped as traders braced for looser fiscal policy.

Though not a pure fiscal hawk by global standards, Ishiba avoided the massive stimulus packages his last several predecessors rolled out early and often. These budget-busting maneuvers help explain why Japan has the biggest debt burden in the developed world—estimates for which run [from 235% to 260% of GDP](#) ([Fig. 7](#)).

(2) *Tax-cut fever*. Ishiba is resigning because of how dismally his Liberal Democratic Party (LDP) performed in the July 20 national election. It emerged without a majority in either

house of parliament, forcing the LDP to join forces with opposition parties to maintain power. These coalition partners all favor tax cuts.

Japan's leader is leaving the scene just as Trump's tariffs kick in and both US and Chinese growth slows. That likely means open season for tax cuts and public spending to battle the headwinds and the [return of the Bond Vigilantes](#).

Activist traders have waded into Japanese waters this year. In mid-May, weak demand for a routine sale of \$6.9 billion of 20-year JGBs made global headlines. The bonds, maturing in 2045, drew the least demand since 2012. The "tail," or gap between the average and lowest-accepted prices, was the [worst since 1987](#). That paved the way for a series of disappointing 40-year auctions since then.

Fast forward to August 19, when another 20-year bond sale flopped. The market's post-auction drop [drove yields to 2.655%](#), their highest since 1999. That ignited more volatility than seen in years and more than a little soul searching at BOJ headquarters.

(3) *BOJ at a crossroads*. That was the year Japan became the first G7 nation to slash rates to zero. Twenty-six years later, the furthest the BOJ has pushed rates above zero is the [current 0.5%](#) ([Fig. 8](#)). Yet just as in 2006 and 2007, the risk now is that the BOJ might soon pivot back to rate cuts as economic growth flatlines.

This poses quite the balancing act for BOJ Governor Kazuo Ueda. Since taking the reins in [April 2023](#), Ueda has been battling the highest inflation since the early 1980s. Even now, headline inflation is rising at a [3.1% y/y rate](#). With GDP expected to increase [0.7% y/y](#) this year at best, Japan is arguably the major economy most vulnerable to stagflation as 2026 approaches.

(4) *Political meddling*. During his [343 days](#) in office, [Ishiba](#) has been as laidback a leader on BOJ policy as Japan has seen in decades. Since the 1990s, a revolving door of leaders, one after another, leaned on the BOJ to lower rates. This pressure explains why Japan is still in the quantitative easing mode.

Now that deflation is gone and consumer prices remain hot, Team Ueda is keen to continue tightening. That might have a few political empires striking back hard. Particularly as Tokyo worries about slowing growth and debt servicing costs that are literally exploding in real time.

(5) *No reformers in sight.* Japan's 32.4 trillion yen (\$220 billion) of [debt financing needs](#) is bigger than [Qatar's annual GDP](#). Rising bond yields could easily push these numbers toward Greece's GDP levels.

Part of the worry is that neither frontrunner vying to replace Ishiba—LDP party members [Shinjiro Koizumi](#) and [Sanae Takaichi](#)—is an economic reformer. Koizumi, 44, is Ishiba's agriculture minister and scion of a political dynasty. He would represent a marked generational shift for a seniority-obsessed political system. Former Economic Security Minister Takaichi, 64, would become Japan's first female leader.

(6) *Stimulus time—again.* Eurasia Group's David Boling argues that Takaichi, a staunch supporter of the loose monetary and fiscal policy championed 2012-2020 Prime Minister [Shinzo Abe](#). Koizumi's lack of experience suggests he will stick with the macro policies championed by Abe and his father, the 2001-2006 prime minister, [Junichiro Koizumi](#).

This likely means doubling down on the weak yen policies of the last 25 years. And cutting consumption tax rates and other tax rates to boost household spending. Yet with the Bond Vigilantes ready to pounce from New York to Paris to Tokyo, the months ahead could be decidedly rocky.

US Strategy I: Lengthy Record-High Earnings Streak Underway Again. Through the week ended September 4, the S&P 500's forward earnings rose to a record high for a 16th straight week. That's its longest winning streak since rising to successive record highs for twice that long, or 38 weeks, through the September 13, 2024 week ([Fig. 9](#)). Between these two streaks was a brief eight-week time-out from record highs during Trump's Tariff Turmoil in April. (As a reminder, "forward" earnings are the time-weighted average of analysts' consensus estimates for the current year and next one.)

During that broken record streak, forward earnings fell just 0.9% from its April 3 record high to its subsequent low three weeks later (during the April 24 week). Since that low, the S&P 500's forward earnings has risen 5.9% to its latest record high of \$292.92 per share and is on pace to meet our year-end forward earnings forecast of \$300 per share.

Most of the S&P 500 sectors have recovered fully, or nearly so, to record-high forward earnings and index prices, as Joe shows below:

(1) *Many sectors' forward earnings near record highs.* During the August 28 week (the latest available), very few sectors were in the forward earnings doghouse ([Fig. 10](#)). Tariffs have

not been the roadblock to higher earnings that analysts and investors initially had expected.

Nine of the 11 sectors are less than 2.3% from their recent record-high forward earnings and are sure to remain close through the Q3 reporting season. The highly cyclical Energy and Materials sectors still face a longer trudge back. Their forward earnings remain deeply depressed, down 39.5% and 23.6% from their respective record highs during mid-2022.

(2) Most sectors' stock price indexes also near record highs. The stock market's rebound since April 8 has followed along with the forward earnings and pulled all the sector price indexes higher. None are in a bear market any longer. Eight of the 11 sectors are less than 6% from hitting a new record high, and three are now in corrections instead of bear markets ([Fig. 11](#)).

Here's how far the sectors remain below their record-high index prices, as of Monday's close: S&P 500 (-0.1%), Communication Services (-0.3), Information Technology (-1.8), Financials (-1.8), Industrials (-2.7), Consumer Discretionary (-3.1), Consumer Staples (-3.8), Materials (-5.4), Utilities (-5.9), Energy (-11.8), Health Care (-12.5), and Real Estate (-19.2).

US Strategy II: Double-Digit Q3 Earnings Hopes Remain. Last week's data show that analysts still expect the S&P 500 to record proforma earnings growth of 8.4% y/y in Q3 ([Fig. 12](#)). That didn't change much since the week before.

The analysts collectively forecast that five of the 11 sectors will grow Q3 earnings faster y/y than the broad S&P 500 index: Information Technology, Real Estate, Industrials, Materials, and Financials. Five of the remaining six sectors are expected to post declining y/y EPS at a relatively low single-digit percentage rate.

When Q3's typical positive surprise "hook" in the data series arrives after actual earnings are incorporated, we think 10 of the 11 sectors could post positive y/y earnings growth. That would be the broadest growth among the sectors since all 11 rose y/y during Q2- and Q3-2021.

Here's how the sectors' y/y Q3 earnings growth forecasts rank: Information Technology (21.6%), Real Estate (18.7), Industrials (16.7), Materials (15.3), and Financials (10.3), S&P 500 (8.4), Communication Services (5.7), Health Care (-0.1), Consumer Discretionary (-1.3), Consumer Staples (-2.1), Utilities (-2.6), and Energy (-6.2).

Calendars

US: Wed: Headline & Core PPI 0.3% & 0.3%; Atlanta Fed GDPNow 3.0%; Wholesale Inventories 0.2%; MBA Mortgage Applications. **Thurs:** Headline CPI 0.3%*m/m*, 2.9%*y/y*; Initial Claims 234k; Federal Budget Balance -\$305.7b; Fed's Balance Sheet; IEA Monthly Report. (Source: FX Street)

Global: Wed: Italy Industrial Production 0.3%; Japan PPI -0.1%*m/m*, 2.7%*y/y*; Japan BSI Large Manufacturing Conditions -3.3. **Thurs:** ECB Interest Rate Decision 2.15%; Eurozone Deposit Facility Rate 2.00%; Lagarde. (Source: FX Street)

US Economic Indicators

NFIB Small Business Optimism Index ([link](#)): The Small Business Optimism Index (SBOI) continued to increase in August, climbing 0.5 points to 100.8—the fourth successive month above its historical average of 98.0, and up from its recent bottom of 95.8 posted during April. Meanwhile, the Uncertainty Index fell 4 points to 93, though remains elevated, posting its 11th highest reading in over 50 years—reflecting an uncertainty about financing expectations and planned capital expenditures. During August, four of the 10 components of the SBOI increased, four decreased, while two were unchanged. Contributing positively to August's SBOI were sales expectations (+6ppts to 12%), earnings trends (+3 to -19), current inventory (+3 to 0), and plans to increase employment (+1 to 15), while components contributing negatively were expect economy to improve (-2 to 34), now is a good time to expand (-2 to 14), plans to make capital outlays (-1 to 21), and current job openings (-1 to 32). Meanwhile, plans to increase inventories and expected credit conditions were unchanged in August. Quality of labor (21%) was once again the single most important problem for small business owners in August, with taxes (17), inflation (11), poor sales (10), government regulations (9), and insurance costs (9) rounding out the top six. The bottom four ranged from 3% to 8%. The net percentage of owners raising selling prices slipped for the second month to 21% in August from 24% in July after climbing from 25% in April and May to 29% in June. It was at 32% in February—which was the highest percentage since May 2023—while a net 26% of owners plan price hikes in the next three months, down from 32% in June. Turning to compensation, a net 29% reported raising compensation in August, up from 27% in July, while a net 20% plan to raise compensation in the next three months, up from 17% in July; it peaked at 28% last November.

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