

When fiscal risk returns: Lessons from France

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EXECUTIVE SUMMARY

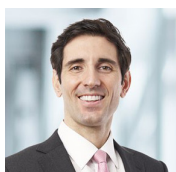
- **French bond markets are flashing renewed fiscal concerns.** Investors are demanding higher yields to hold French government debt amid large budget deficits, political uncertainty, and slowing economic growth.
- **This is not another European debt crisis, at least not yet.** European banks are significantly better capitalized than in 2011, and the ECB has tools in place to help contain market stress and limit contagion to other countries.
- **Fiscal sustainability could become a major market theme in 2027.** Upcoming elections in France and the U.S. may force investors to focus more closely on government debt levels and the political willingness to address fiscal imbalances.
- **Several developments will determine whether risks escalate.** Key areas to watch include broader bond market contagion, Japanese investment flows, global energy prices, tightening monetary policy, and the durability of corporate earnings growth.
- **The economic backdrop remains supportive, but risks are rising.** Strong earnings and resilient household balance sheets continue to support markets, but if bond yields rise because of fiscal risk rather than economic growth, volatility could spread more broadly across financial markets.



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The uptrend in global bond yields has just taken a new turn, with emerging signs of stress in French government bonds. In this note, we discuss what's behind these moves, lay out a roadmap for what investors should be watching over the next few months, and explain why fiscal stability may become a key market theme once again.

What is happening in France?



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The yield on the 10-year OAT French note¹ has risen by ~90 basis points (bps) since the end of July, causing its yield spread to the benchmark German 10-year Bund to widen by 70 bps over the same period (Figure 1). And while bond yields have increased materially across both developed and emerging markets over the past two months, concerns surrounding the situation in France stand out because of what's driving the move: not robust economic growth and booming capital expenditures, but deepening anxiety about the country's fiscal sustainability, as evidenced by the rise in the OAT 10-year term premium.²

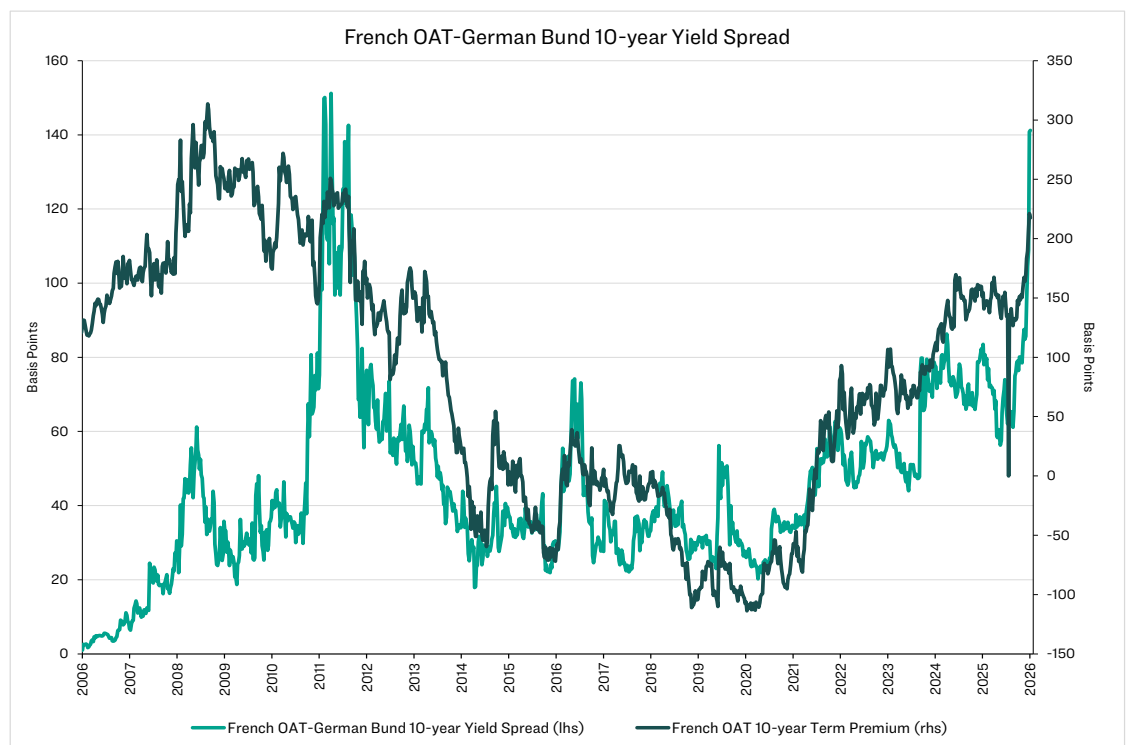
France's budget deficit has remained elevated at around 5% of GDP, or wider, since the European Commission allowed a departure from fiscal rules to support household and business spending following the COVID-19 pandemic. But the lack of fiscal discipline is not unique to France, as governments in the U.S., the United Kingdom (UK), Japan, and several other European Union (EU) countries have similarly struggled to stabilize their national debt. So, why is France being singled out by investors, and why now?

Sentiment towards France is being undermined by the concomitance of three dynamics:

- Widespread protests against the government's proposed austerity measures have erupted in many major cities across France. This is unnerving investors and raising the stakes for a political class that so far has been unable to coalesce around a credible plan to reduce the budget deficit.
- These protests are also presenting an early window into the crucial presidential election³ scheduled for April 2027. As of this writing, prediction odds currently assign a cumulative 55% chance that a fringe candidate will ascend to the Élysée Palace. Polymarket currently assigns a 43% chance that far-right candidate Marine Le Pen will win, with a more modest 12% chance assigned to far-left candidate Jean-Luc Mélenchon. Both candidates have been highly critical of the current relationship with the EU, and Mélenchon even raised the option of a debt write-off—a measure unlikely to advance through parliament, but nonetheless emblematic of the unconventional policy approaches these candidates could bring to the table.
- While the French economy is well diversified, with world-class startups in the fields of artificial intelligence (AI), life sciences, and energy, it now faces a dire fiscal situation alongside a stagflationary economic environment. Real Gross Domestic Product (GDP) grew modestly at 1% year-over-year (YoY) as of June 2026, while inflation recently rose to 3% YoY and productivity growth has annualized a mere 0.5% since 2021. In investors' eyes, this reduces the prospects of a scenario in which accelerating productivity and economic growth alleviate fiscal pressures—a scenario that has so far contributed to keeping fiscal concerns in check in the U.S., for example.

FIGURE 1

French yields are reflecting widening risk premia.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

What are the key factors to monitor going forward?

- **Risk of contagion.** We hear a recurring question: Is this a repeat of 2011, when the parabolic rise in yields across peripheral European countries— Portugal, Italy, Ireland, Greece and Spain— threatened the future of the EU? We don't see evidence of this for now.

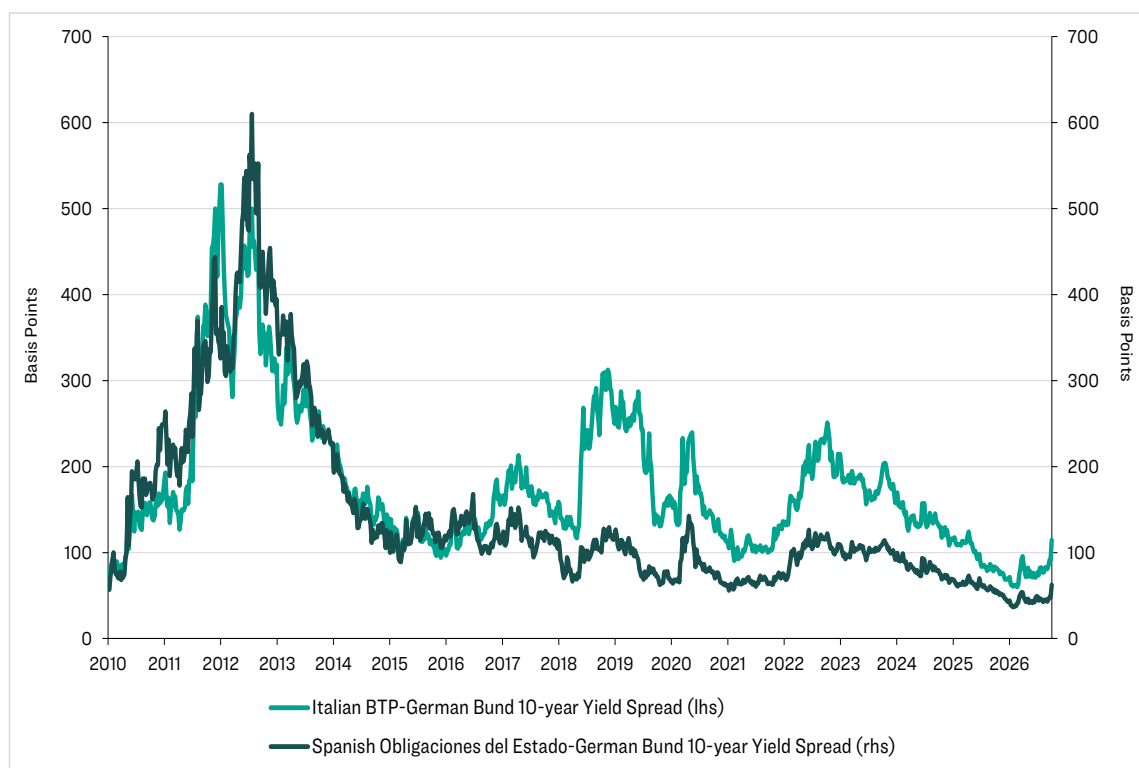
One reason is that the risk of contagion through the banking system is much more limited than it was back then. The average Common Equity Tier 1 ratio⁴ for European banks has increased from 13% to 16% over the past decade, compared to just 6% in 2011.

Another reason is that the European Central Bank (ECB) has developed a broad toolkit intended to tackle and disincentivize rampant market speculation. The Transmission Protection Instrument⁵ is specifically designed to prevent market moves that are not justified by economic fundamentals. While the current situation may not qualify for the mechanism to be activated, its availability is likely already playing a role in preventing contagion across other European markets.

The 10-year yield spreads between Italian, Portuguese, Greek, and Spanish bonds and the German Bund have remained relatively stable compared to France, and remain significantly lower than levels observed in 2022, let alone 2011. We will continue to watch this space to gauge the risk that the French risk premium is beginning to impact broader risk sentiment.

FIGURE 2

Peripheral yield spreads remain far from stressed levels.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

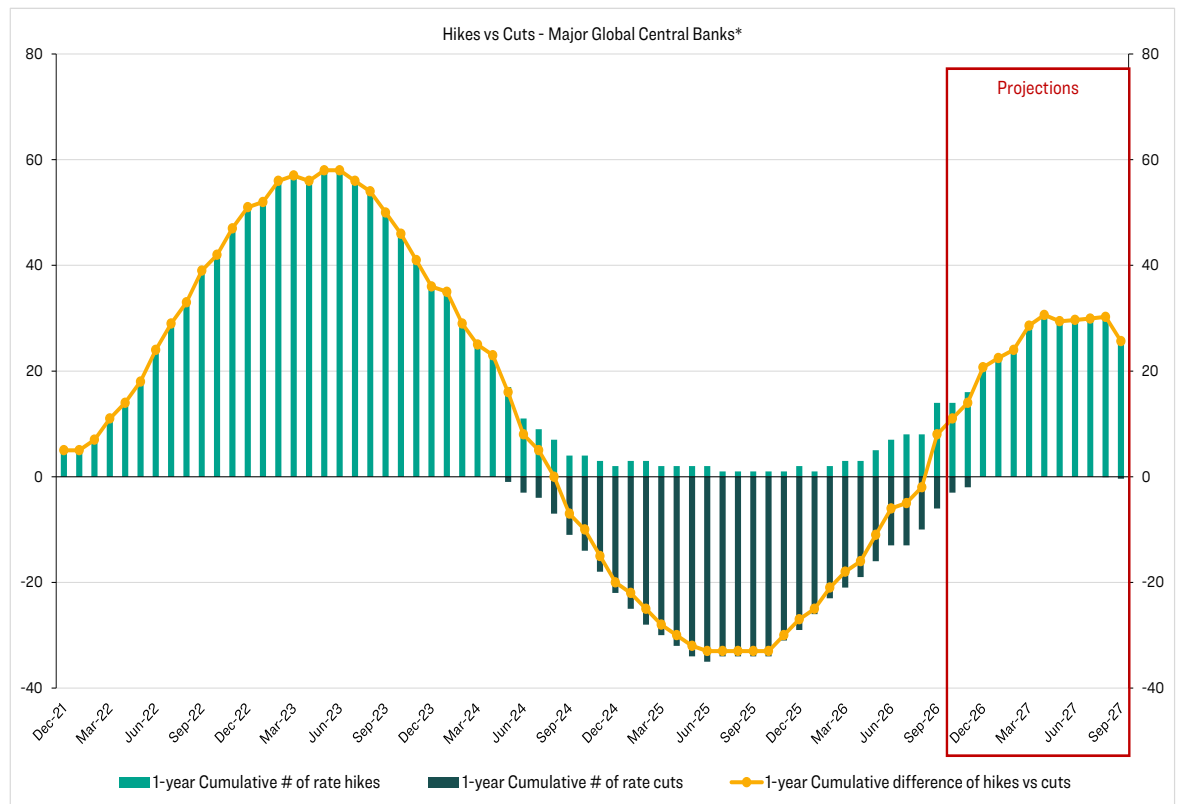
- **Political willingness and ability to deal with growing fiscal imbalances.** The U.S. midterms in November and the French elections next spring are likely to refocus investors on this issue. Simply relying on expectations that economic growth is

bound to accelerate via faster productivity gains might be insufficient, especially against the backdrop of rising interest rates at least partially offsetting this positive dynamic. Bond investors are likely to begin expecting more material progress on cutting spending or raising more revenue—outcomes that would be politically challenging and therefore difficult to build consensus around. In a worst-case scenario, episodes similar to the UK’s 2022 “Truss moment,” where a sharp rise in yields forced the government to reverse unfunded tax cuts proposed by then-Prime Minister Liz Truss, could become more common as the ultimate mechanism through which markets try to enforce fiscal discipline. This is a key risk, in our view.

- Monetary policy conditions are once again tightening.** As of September, the cumulative effect of monetary policy conducted by central banks across advanced economies is tightening for the first time since mid-2024 (Figure 3). Judging by market-implied expectations, this tightening is set to accelerate throughout the first half of next year. This removes a key support for global yields and increases the chance that fiscal dynamics may become the predominant driver of bond yields.

FIGURE 3

Rate hikes are once again outpacing rate cuts.



Source: Bloomberg, TIAA Wealth Chief Investment Office. Central banks part of the calculation are: Fed, ECB, BOE, BOJ, BOC, RBA, RBNZ, Riksbank, Norges Bank.

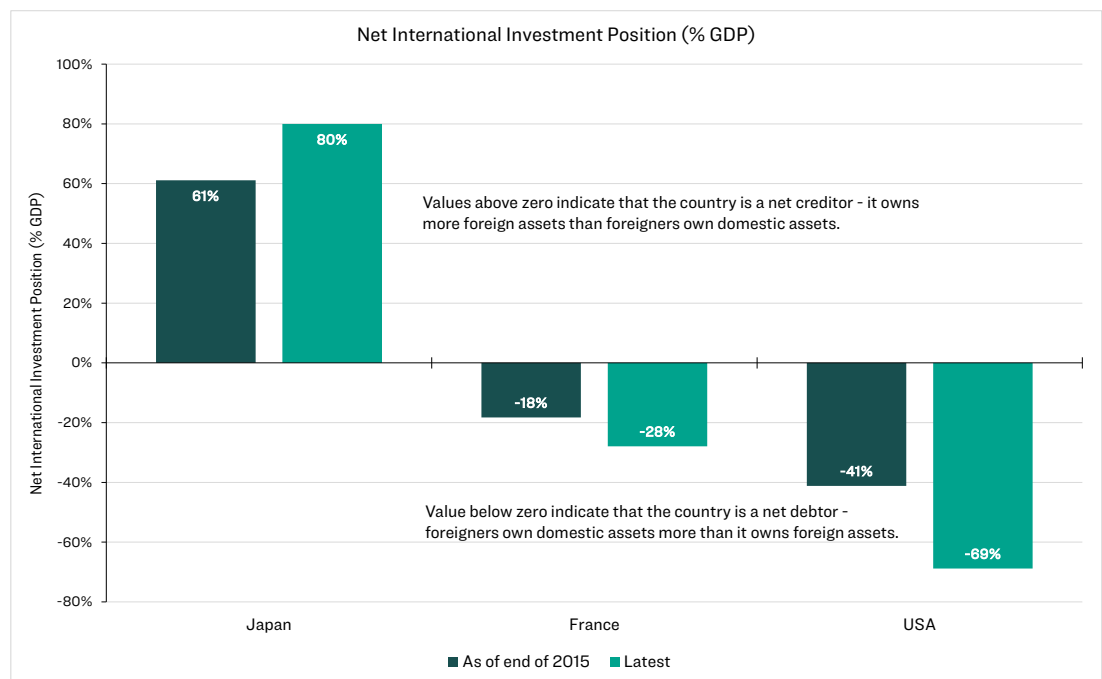
- Rising global bond yields could trigger significant shifts in global investment flows.** Japan is of particular interest from this standpoint. As Figure 4 shows, Japan is a significant global creditor. Japanese investors have spent much of the past few decades chasing higher investment returns abroad amid stagnant economic growth and near-zero interest rates at home. Higher-return markets like the U.S. and Europe became key destinations for Japanese capital. But the economic incentive for Japanese investors to retain outsized international

exposures is gradually being eroded. Japanese bond yields have risen significantly over the past two years and are now yielding more than U.S. and European bonds after accounting for the cost of hedging currency exposures.⁶

In addition, domestic fundamental dynamics have steadily improved, with faster economic and wage growth, stronger credit growth, and crucial governance reforms. As a result, Japanese investors could become more sensitive to changes in global fundamentals that further undermine the appeal of international assets relative to domestic ones. For example, a change in the risk perception associated with government bonds previously deemed “risk-free,” such as French OATs, could alter investment behavior. This is particularly relevant given that foreign investors hold 61% of France’s long-term debt securities, according to Banque de France. A reversal of the cross-border investment flows that have benefited global markets for much of the past decade could spark and exacerbate episodes of volatility.

FIGURE 4

Japan is a large creditor to many major global economies.



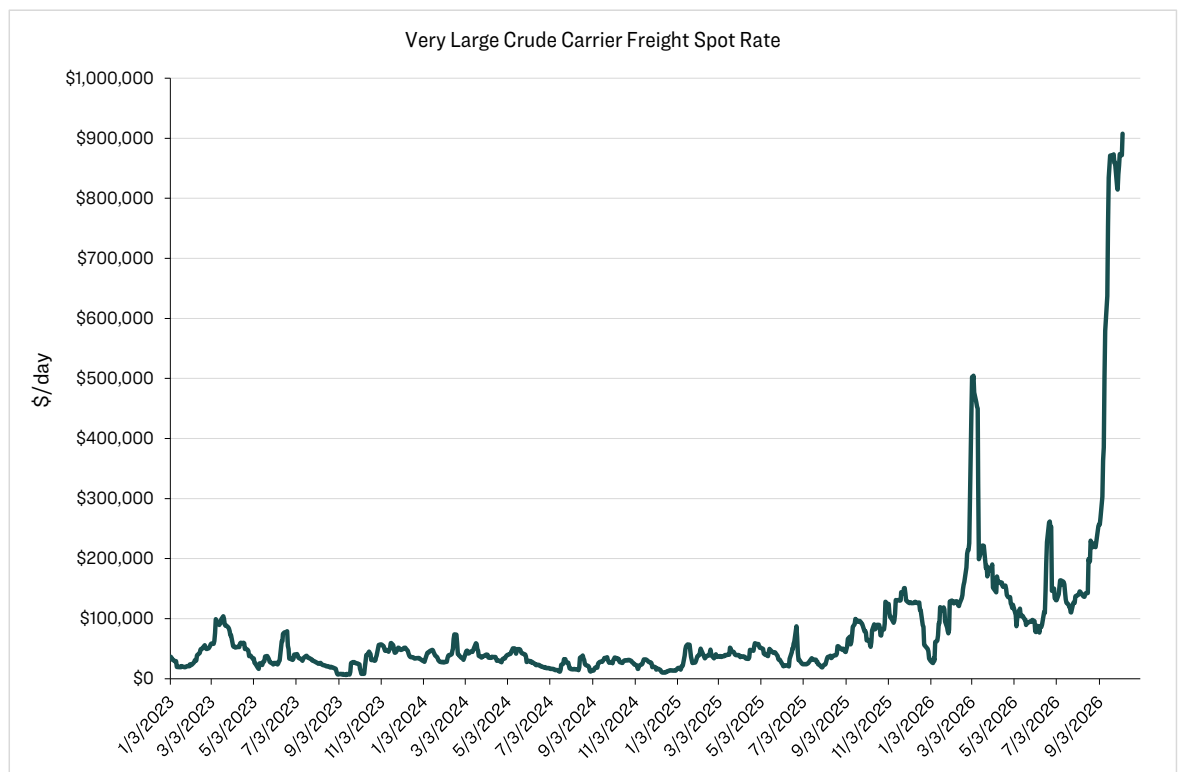
Source: IMF, TIAA Wealth Chief Investment Office

- The sustainability of the current corporate earnings cycle across developed and emerging markets.** The strength of the current earnings cycle has been critical to buffer the impact of rising global bonds yields on equity prices and on economic growth. While rising interest rates have caused a decline in the multiples investors are willing to pay to buy equities, stronger profit growth has more than offset this dynamic. This differs from 2022, when the fall in equity valuations caused by higher bonds yields overwhelmed an anemic earnings picture, sending equity prices significantly lower. As a result, while households in 2022 were negatively impacted by both higher borrowing costs and shrinking asset values, today the continued rise in household wealth is cushioning the drag from higher rates. The continuation of this trend will determine how deeply and broadly the impact of higher bond yields might propagate across the economy.
- When and how quickly energy prices normalize.** We have seen reports over the past few days that crude oil export flows from the Middle East have recovered to

80%-90% of pre-war levels (although the flow of refined products like diesel and jet fuel is still only ~50% of pre-war levels). This is a positive development, and one that could eventually take some pressure off global bond yields and economies more reliant on Middle East crude oil, like Europe. But while flows have improved, safety of navigation through the Strait of Hormuz has not. Iran continues to target container ships, and the lion's share of shipments transiting through the waterway are reportedly handled by "feeder vessels" operated by the UAE, while private shippers continue to view operational risks as elevated. This is also clear when looking at Very Large Crude Carrier (VLCC) freight prices, which have skyrocketed over the past few weeks (Figure 5). To operate a VLCC from the Arabic peninsula to China, shippers are asking close to ~\$1 million per day, compared to an average of \$32,000 between 2020 and 2025. High freight prices are contributing to elevated prices for refined products, as refiners need to absorb exorbitant shipping costs by charging significant margins. Crack spreads⁷ have not budged and remain close to \$70/barrel. A normalization on this front is necessary for the impact of energy prices on inflation, household affordability and global yields to subside, in our view.

FIGURE 5

Freight shipping costs have skyrocketed.



Source: Bloomberg, TIAA Wealth Chief Investment Office.

Conclusions

The spike in global bond yields has been mostly attributable to rising economic growth and the relentless demand for capital spurred by the AI buildout. We discussed these dynamics in a recent [CIO FocusPoint | Higher for longer still: What's driving rates now?](#) However, the French situation is a reminder that fiscal sustainability is likely to periodically resurface as a key concern for investors, especially around elections and when economic growth slows. We don't see evidence of broad-based contagion for now, and the strength and resilience of the economic and earnings cycle provide crucial support that is cushioning the rise in borrowing costs.

But markets are facing a growing set of questions as we look ahead to the U.S. and French elections. Should bond yields fail to stabilize and should the drivers of higher rates shift from strong growth to rising risk premia, we could see volatility seep into other corners of global markets, including equities. We think the ability of politicians to articulate credible solutions to the current fiscal imbalances could become a key market theme in 2027.

Endnotes:

1. French OATs (Obligations assimilables du Trésor) are Agence France Trésor medium- and long-term government bonds issued by the French state to finance its debt.
2. The extra compensation investors demand for owning long-term bonds rather than continuously rolling over short-term bills.
3. France is a semi-presidential republic in which executive power is shared between a directly elected president, and a prime minister responsible to a bicameral parliament.
4. The Common Equity Tier 1 ratio measures a bank's highest-quality capital (common equity and retained earnings) relative to its risk-weighted assets. It is a core gauge of a bank's ability to absorb losses without becoming insolvent.
5. A tool introduced by the ECB in 2022 to counter "unwarranted, disorderly" market dynamics that impair the transmission of monetary policy across member states. It allows targeted purchases of sovereign bonds issued by countries experiencing fundamentally unjustified spread widening.
6. When investors buy bonds denominated in a foreign currency, they can decide to hedge the currency risk. The hedging cost depends on the interest rate differential between the two countries. Currently, a Japanese investors hedging U.S. dollar exposure would pay a 3% hedging cost over a 12-month period.
7. A crack spread is the difference between the price of crude oil and the price refiners can sell the finished product for – like gasoline, diesel and jet fuel.



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