

The New Role of Geopolitical Risk in Bond Investing

INSIGHTS

Interest rate volatility is reshaping bond markets. We examine why geopolitical risks have become increasingly linked to bond market volatility since 2025, and discuss the implications for the term premium, fixed income positioning and investment opportunities.



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Highlights

- Geopolitical risk has become a more important driver of bond-market volatility. In the last two years, the relationship between the two has strengthened materially.
- The novelty is not the quantity or size of geopolitical shocks; it is their quality. Recent shocks differ from traditional ones because they have originated in the U.S. and have been inflationary for the U.S.
- While traditional geopolitical shocks tended to compress the term premium and yields on U.S. Treasuries, recent shocks have pushed both higher, resulting in a novel and magnified effect on bond yields. We believe this explains why long-term bond yields remain relatively elevated even as markets anticipate lower policy rates and reduced rate volatility.
- We describe the current environment as one of **“Predictable Volatility.”** Geopolitical tensions may generate repeated market swings, but the most likely endgame remains gradual de-escalation rather than permanent escalation.
- For investors, volatility is increasingly an opportunity as well as a risk. Headline-driven sell-offs and rallies can create attractive trading opportunities, particularly in a broadly range-bound rates environment. **Rather than simply being a threat, geopolitical risk has become increasingly tradable.**

Theoretical Underpinnings

First, let’s start by understanding and defining the **term premium**. Assuming a near-zero risk of the U.S. government defaulting on its debt, the yield of a 10-year U.S. Treasury (UST, henceforth) should be determined by the central bank policy rate expected to prevail over the next 10 years (the “compound short rate”), plus a “term premium” compensating investors for taking interest rate risks (i.e., the risk of holding a bond for 10 years instead of investing in an overnight loan reinvested every day for 10 years).

In the last 20 years, the term premium (TP, henceforth) has ranged from -1.2% to 3%, a range comparable with that covered by the 10-year UST yield itself (0.5% to 5.1%). The TP is thus a major driver of long-term yields. Because it is unobservable, it is often seen as a residual and thus unexplainable. There are, however, key drivers with identifiable influence on it, and these allow investors to identify different bond yield regimes and exploit them in trading strategies.

To see this, one should decompose the TP as follows:

$$\begin{aligned}
 \text{TP} &= \text{Price of Interest Risk} \times \text{Expected Interest Risk} \\
 &= \text{Price of Insuring Against One Unit of Interest Rate Volatility} \\
 &\quad \times \text{Expected Volatility of Policy Rates}
 \end{aligned}$$

The TP can increase because:

1. Investors increase the compensation they require for one unit of interest rate risk because they attach less value to such insurance. This happens, for example, when U.S. growth accelerates and makes a recession less likely. Investors then become less interested in buying the insurance against recessions bonds provide; or
2. Expectations of higher volatility in central bank policy rates emerge, for example because inflation accelerates to unprecedented levels, as it did in 2021–2022, and reduces investors' conviction on future inflation and interest rate paths

This distinction is important because it explains the changing relationship between interest risk and long-end UST yields.

To see this, consider the MOVE (Merrill Lynch Option Volatility Estimate) index, often referred to as the “VIX for bonds.” The MOVE index measures the implied volatility of options on USTs. It proxies expected interest rate movements and is therefore a good proxy for the second component of the TP. When the TP's first component (the price of risk) does not change dramatically, expected volatility of future rates drives the TP, and the TP and MOVE are closely correlated. In such periods, an increase in expected volatility of future policy rates (i.e., interest rate risk) pushes up long-end bond yields.

The Lehman Brothers bankruptcy was a good example of such a period: a financial crisis originating in the U.S. pushed up policy rate uncertainty. As a result, both the MOVE index and the TP jumped.

Figure 1: Move and Term Premium



Sources: Federal Reserve Bank of San Francisco; Bank of America/Merrill Lynch. As of June 2026.

There are, however, periods when the two components of the TP diverge, and so interest rate risk and the TP also diverge. The pandemic was one such example: while the MOVE index jumped, the TP dropped. Why? Because markets predicted a sharp recession, and in recessions USTs tend to outperform other assets, so the price of interest risk dropped as investors were happy to pay for the diversification benefits offered by USTs. Expected rate volatility jumped, but the price of risk fell. Similar dynamics were at play in the 2021-2022 inflation boom.

USTs' insurance value in bad states of the world, QE programs affecting UST scarcity, collateral use for repo transactions and regulatory purposes, and geopolitics all affect the price of risk. When these factors are in the driving seat, long-end bond yields and interest rate risk stop moving together, creating confusing dynamics.

As **Figure 1** shows, we have been in one such period for three years. Expected rate volatility fell, but the price of risk jumped. This is because all of the factors listed in the previous paragraph pushed the price of risk up. First, in June 2022, the Fed shifted from quantitative easing to tightening (thus reducing UST scarcity). Then, in 2023, the U.S. economy accelerated notably, dispelling market worries that Fed hiking would hurt growth (and thus reducing the diversifying value of bonds). This kept the TP and yields high even as the sharp drop in inflation pushed expected rate volatility down dramatically.

What really stood out, however, was the novel role that geopolitics and geoeconomics played in this period. Expectations of pro-growth policies after Trump's re-election, the tariffs announced on Liberation Day and the attacks on Iran provided a series of geopolitical and geoeconomic shocks that propelled the price of risk to new highs.

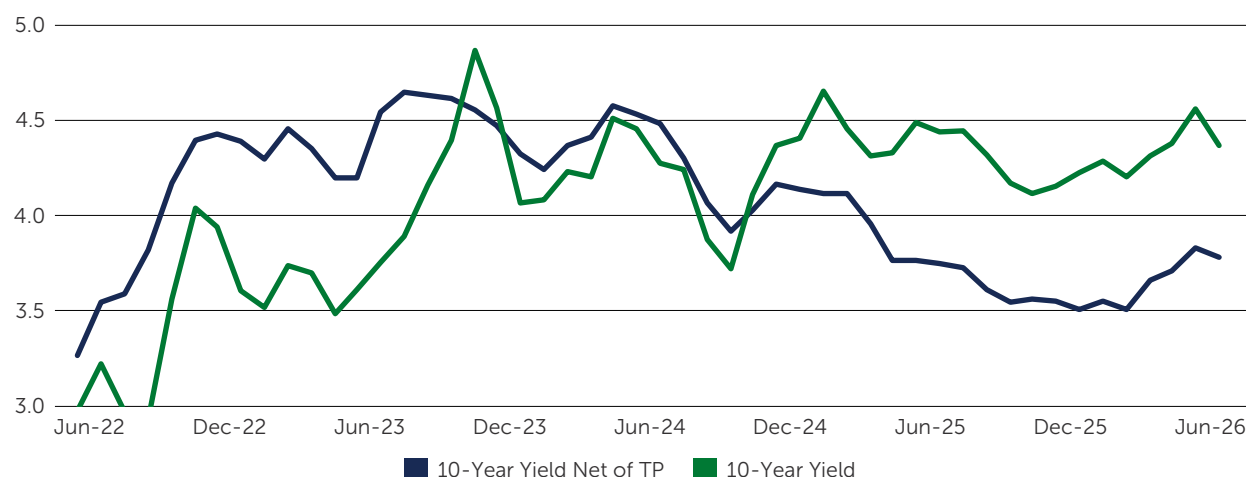
Crucially, these shocks were radically different from old, "standard" geopolitical shocks because:

1. They increased uncertainty around U.S. inflation and, therefore, future Fed rates; and
2. They originated in the U.S.

This contrasted with standard geopolitical shocks, which originated outside the U.S. and did not affect U.S. inflation or policy rate volatility expectations. As a result, these new geopolitical shocks had completely different effects on UST yields. While standard shocks would have increased the insurance value of USTs and would not have affected interest rate risk—thereby pushing the TP and UST yields down—the new shocks decreased the insurance value of USTs and increased interest rate risk. As a result, the TP jumped.

Long-end UST yields did not rise further because the policy rate expected to prevail in the next 10 years (i.e., the “compound short rate” defined at the beginning of this document) fell dramatically. The chart below shows this neatly: the 10-year yield net of the TP (i.e., the compound short rate) has dropped meaningfully since September 2024, yet the 10-year UST yield has remained range-bound. In other words, inflation risk gave way to geopolitical risk as the main source of pressure on long-end UST yields.

Figure 2: 10 UST Yield with and Without TP (%)



Sources: Federal Reserve Bank of San Francisco; Barings. As of June 2026.

We believe that this new form of geopolitical risk (originating from the U.S. and being inflationary for the U.S.) will persist in the coming months and years, and that this new, strong positive correlation between such risk, term premia and long-end UST yields will have to be managed by investors.

Investment Implications

With this framework in mind, it is worth considering the investment implications if these dynamics persist.

If the rise in term premia were primarily driven by structural changes in the U.S. economy (e.g., persistently higher expected inflation volatility), it could be interpreted as a warning signal for long-duration bond investors. What makes the current episode different, however, is that the increase in term premia has been closely linked to geopolitical tensions that have originated, for the most part, from the confrontation between the United States and Iran.

The path from the outbreak of a conflict to an eventual ceasefire is rarely straightforward. It involves multiple stakeholders, competing incentives and complex strategic interactions. In our view, a game-theoretic framework provides a useful lens through which to understand these dynamics and assess their likely evolution.

In a Chicken Game setting, the ultimate destination is managed de-escalation. However, players operate under incomplete information and must first test each other's resolve and tolerance for risk. Immediate concessions often carry significant domestic audience costs—a concept formalised by Fearon (1994)¹—while prolonged escalation generates rising economic and political costs over time.

As these costs accumulate, incentives gradually shift toward partial and incremental de-escalation rather than a comprehensive or abrupt resolution. As a result, supply constraints and risk premia may persist for some time, even as tail risks gradually recede.

For both sides, avoiding a mutually destructive outcome is essential. Yet the path toward a final settlement is far from straightforward. For the United States, a premature concession may entail political costs, while for Iran it may raise concerns about regime stability. Consequently, progress toward the ultimate objective is likely to be gradual, characterized by negotiation, signaling and incremental confidence-building measures rather than a swift agreement.

The conceptual framework is illustrated in **Figure 3**.

Figure 3: Chicken Game Dynamics and Managed De-Escalation

Escalate: Sustained military/economic pressure, brinkmanship De-escalate: Step back, reduce tensions		
	Iran: Escalate	Iran: De-escalate
U.S.: Escalate	Worst Outcome for Both • Energy supply shock, higher inflation • Financial-market volatility • U.S.: Rising domestic political costs (approval, election risk) • Iran: Economic stress, regime-stability risk	Best U.S. Outcome • Preserves deterrence and “strength” signaling • Short-term political credibility • Iran: Loss of leverage, domestic audience cost
U.S.: De-escalate	Best Iran Outcome • Maintains defiance narrative • Strategic leverage preserved • U.S.: Audience cost, loss of strong-leadership signal	Realistic Equilibrium* • Gradual, managed de-escalation • Deterrence preserved on both sides • Markets: Lower tail risk, but lingering supply constraints and risk premia (esp. energy)

*Equilibrium reached through sequential signaling and cost accumulation, not instant cooperation.
Source: Own illustration based on game theory concepts discussed in Schelling (1960), The Strategy of Conflict, and Fearon (1994), Domestic Political Audiences and the Escalation of International Disputes.

Chicken Game dynamics often involve repeated efforts to influence an opponent's behavior through signaling, commitment and brinkmanship—concepts extensively analyzed in Thomas Schelling's The Strategy of Conflict (1960).² Public statements, military signaling and the articulation of “red lines” all serve to demonstrate resolve and encourage the other side to move first toward de-escalation without triggering an actual collision.

1. Source: Fearon, J. Domestic Political Audiences and the Escalation of International Disputes. As of 1994.
2. Source: Schelling, T. The Strategy of Conflict.

Such signaling tends to increase market uncertainty and short-term volatility even when the ultimate destination remains de-escalation. Importantly, however, the resulting increase in volatility can itself act as a constraint on further escalation by raising the economic and political costs faced by both sides. **This is what we describe as “Predictable Volatility.” The path is volatile, but the destination remains broadly visible.**

In Chicken Game situations, players rationally postpone adjustment while assessing each other’s resolve. This tendency contributes to elevated market volatility, but **such volatility is often temporary rather than permanent.**

The period before the equilibrium outcome is reached is particularly vulnerable to headline-driven market dislocations. We view these episodes as manifestations of Predictable Volatility: periods in which markets experience repeated bouts of uncertainty while gradually converging toward managed de-escalation.

For investors, this can create opportunities to monetize volatility. Excessive headline-driven market moves may provide bond investors with attractive entry and exit points, supporting a disciplined “buy on dips, sell on rallies” approach within a broadly range-bound market environment.

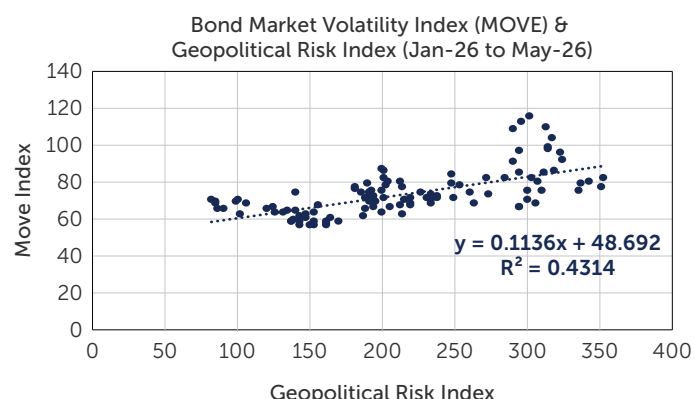
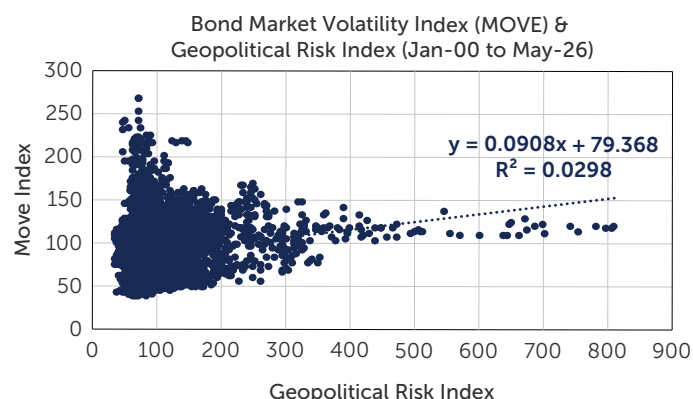
Figure 4 shows the relationship between the Geopolitical Risk index (GPR) and the MOVE index, a widely used measure of bond-market volatility.

Since 2000, the relationship between the two series has been relatively weak, as would be expected when geopolitical risk originated outside the U.S. and had little impact on U.S. interest rate volatility. However, following the U.S. intervention in Venezuela and subsequent geopolitical developments, a notable strengthening in the relationship has emerged since early 2026.

The linkage between GPR and MOVE has become materially stronger, suggesting that markets are translating geopolitical developments into bond-market volatility more strongly than in the past, again consistent with the theory that geopolitical risk originating in the U.S. and affecting U.S. inflation expectations should have a more forceful impact on UST yields. Importantly, this does not necessarily imply that geopolitical risk has become more dangerous. Rather, it suggests that geopolitical developments have become more consistently priced by financial markets and therefore more amenable to investment positioning. In other words, geopolitical risk has become increasingly tradable rather than simply threatening.

As long as the ultimate direction remains one of managed de-escalation, this heightened relationship between geopolitical risk and bond-market volatility may represent not only a source of risk but also a source of investment opportunity. **Higher GPR–MOVE explanatory power makes geopolitics more tradable, not necessarily more dangerous—provided the ultimate destination remains de-escalation.**

Figure 4: Geopolitical Risk has Become More Tradable in 2026



Source: Geopolitical Risk (GPR) Index (Caldara & Iacoviello); MOVE Index (Bank of America Merrill Lynch; own calculations. As of May 31, 2026.

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