The Global Debt Overhang: a worst-case scenario even optimists can't dismiss

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- **This note outlines our worst-case scenario, not our base case: a world where sovereign debt dynamics across the US, Japan, and Europe converge into a single macro shock – rising yields, shrinking buyer bases, and fiscal slippage that markets and asset allocators cannot afford to ignore.**
- **The US sits at the epicenter: fiscal deterioration accelerates just as term premia rise, foreign buyers retreat, and the Treasury leans more heavily on leveraged intermediaries – a fragile configuration that magnifies volatility when confidence wavers.**
- **Japan's balance sheet trap and Europe's quiet fiscal drift amplify global risks: if rate normalization collides with high debt, weak currencies, and political constraints, transmission into FX, credit, and equity markets becomes nonlinear – the kind of environment where optimism becomes a liability.**

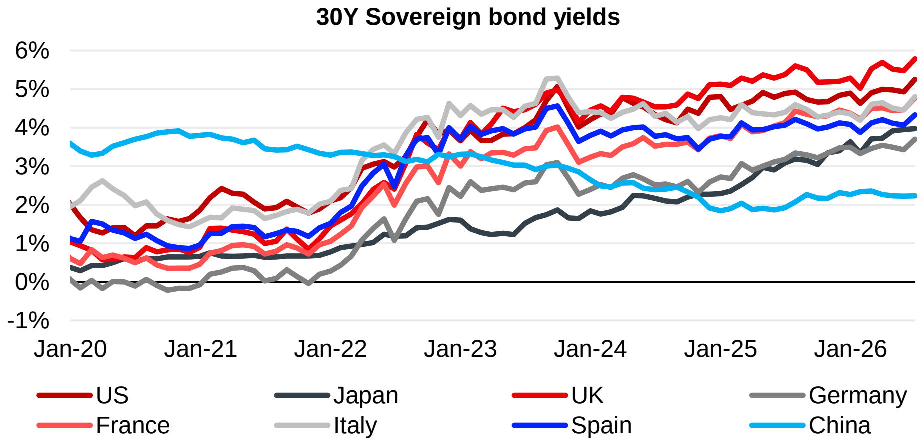
Global sovereign debt markets are entering a new and more fragile phase. Across the US, Japan, and Europe, long term yields are rising despite weakening growth, elevated geopolitical risk, and a global investor base increasingly unwilling to absorb duration at current fiscal trajectories (exhibit 01). The world's largest issuers are simultaneously running large, persistent deficits, facing higher refinancing costs, and showing limited political appetite for consolidation. The probability of a fiscal dominance regime – where fiscal constraints begin to influence monetary policy – is rising. The result is a slow-moving but broad-based debt overhang that can reshape market pricing across rates, FX, credit, and equities.

In the US….

Upward pressure on US treasury yields comes from two structural forces.

The US Treasury market, the anchor of global duration, is showing unmistakable signs of strain. The 30-year yield has surged to 5.25%, its highest level since 2007, while the 10-year is drifting toward the psychologically important 5% threshold. This rise is occurring despite the Treasury's shift toward bill issuance, which normally suppresses long-term yields by reducing supply at the long end. Two structural forces are undermining demand: persistent fiscal deficits exceeding 6% of GDP indefinitely, and growing concerns about inflation discipline, amplified by political pressure on the Federal Reserve. The US debt to GDP ratio is projected to reach 107% by 2029, its highest level since the end of World War II, before rising further for the foreseeable future. Foreign central banks are reducing their Treasury holdings – the dollar's share of global reserves has fallen from 72% in 2001 to 56% today – forcing the US to rely more heavily on leveraged hedge funds and money market funds to finance its USD2trn annual borrowing need. This is a classic early stage fiscal dominance setup: rising yields, rising deficits, and a shrinking natural buyer base.

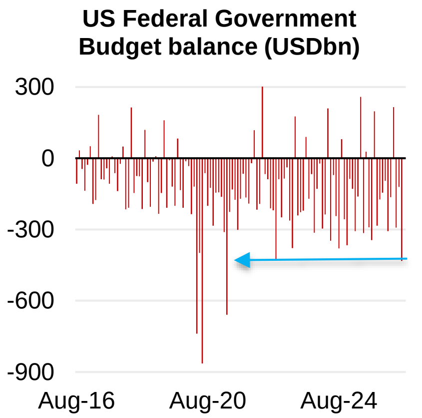
Exhibit 01: Sovereign bond yields have been rising consistently over the past couple of years, but China has been an exception



Sources: LSEG Workspace, and ADCB Asset Management

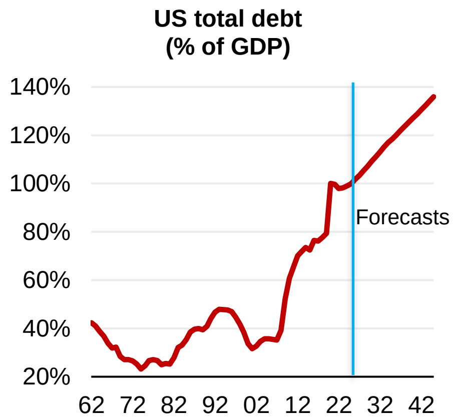
The deterioration in the US fiscal position has accelerated sharply in recent months. After improving through late 2025 – driven by reduced education spending and tariff-related revenue – the fiscal trajectory reversed in mid-2026. The Treasury reported a USD432bn deficit in July, the largest monthly shortfall since March 2021 (exhibit 02). This pushed the fiscal year deficit to USD1.8trn, up 10% from the prior year. The reversal began in June, when the year-to-date deficit flipped from running 9% below the prior year to 2% above it. Several forces are driving this deterioration. Defense spending has accelerated steadily, rising 3% in May, 5% in June, and now 6% year to date. Entitlement spending tends to increase toward the end of the fiscal year as cost of living adjustments take effect and more people receive Social Security and Medicare benefits. Tariff refunds have also reduced revenue significantly, with USD33bn refunded in July and USD115bn refunded year-to-date. Corporate tax receipts have weakened, and refunds have increased due to provisions in the One Big Beautiful Bill Act. The Congressional Budget Office now projects a USD2.1trn deficit for FY2026 – USD200bn higher than its February estimate. Beyond 2027, structural pressures intensify: an aging population, declining labor force participation (now at 1970s lows), and rising geopolitical driven defense spending. US fiscal slippage and therefore the debt deluge is no longer cyclical; it is structural (exhibit 03).

Exhibit 02: Budget deficits in the US have not improved materially despite the tariff receipts



Sources: US Bureau of Economic Analysis, LSEG Workspace, and ADCB Asset Management

Exhibit 03: Congressional budget office expects the US debt to rise for the next couple of decades



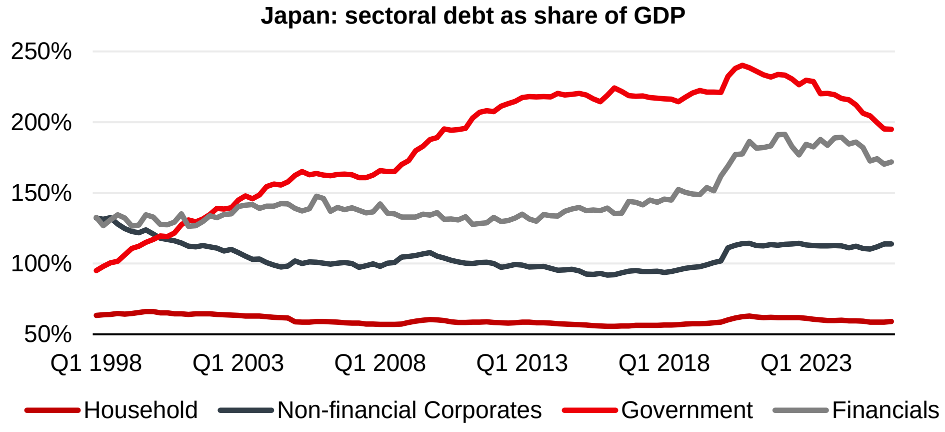
Sources: US Congressional Budget Office, LSEG Workspace, and ADCB Asset Management

….in Japan….

Japan's public sector balance sheet is uniquely exposed to rising rates.

Japan, the world's most indebted sovereign, is confronting a different but equally consequential set of challenges. With a sovereign debt to GDP ratio of c200%, Japan's fiscal position is colliding with the post-YCC (yield curve control) reality. Long dated Japanese government bond yields have risen to multi-decade highs, while the yen remains near a 40-year low despite repeated foreign exchange intervention. Japan's public sector balance sheet is uniquely exposed to rising rates. Consolidated liabilities across the central government, local governments, the Bank of Japan, public pension funds, and public financial institutions total 255% of GDP. Bank reserves, which reprice overnight, stand at 75.5% of GDP, while another 17% of GDP in Treasury bills rolls over within months. A 100 bp increase in rates lifts annual interest expense by close to 1% of GDP almost immediately. On the asset side, the public sector holds 56% of GDP in largely unhedged foreign securities and another 50% of GDP in equities. Higher rates would strengthen the yen and mark down both asset classes, converting the depreciation tailwind of recent years into losses. Japan, therefore, is trapped between two difficult choices: raising rates to support the yen, which would increase debt service costs and trigger losses on foreign assets; or keeping rates low, which would weaken the yen further, fuel imported inflation and risk a disorderly unwind of the yen carry trade. This is the world's largest sovereign carry trade – and can destabilize at short notice.

Exhibit 04: Japan's debt levels remain elevated with the prospect of rising further



Sources: Institute of International Finance, and ADCB Asset Management

….and in Europe….

Europe's sovereign debt dynamics are less acute but no less important. France and the UK are running deficits near 5% of GDP, with long-term yields rising toward decade highs. Political constraints limit the scope for fiscal consolidation, and both economies face rising refinancing costs as the ECB and BoE shrink their balance sheets. Europe's sovereign risk is broad, persistent, and increasingly priced. While not yet at crisis levels, the region's fiscal slippage adds to the global backdrop of rising term premia and declining investor tolerance for duration. More importantly, Europe faces elevated interest rates also at a time when potential growth is weak (exhibit 05).

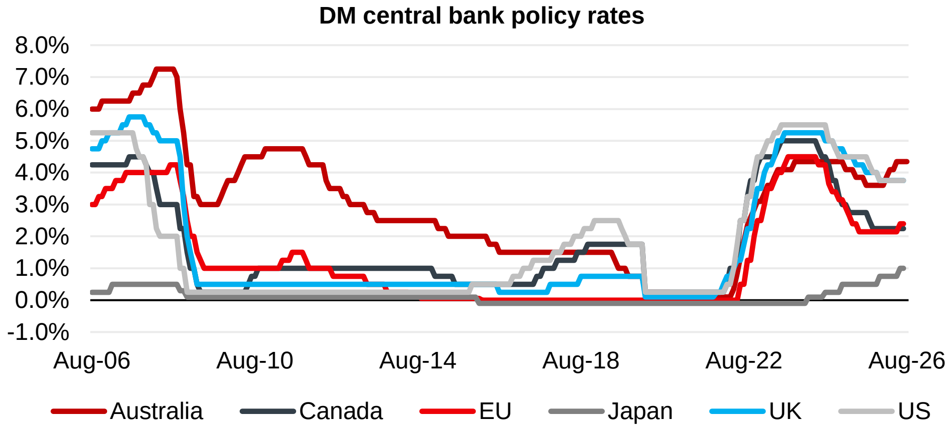
Political constraints limit the scope for fiscal consolidation in Europe.

….fiscal policy has turned more reactive rather than strategic….

Across major economies, policy actions are increasingly reactive rather than strategic. Foreign exchange intervention – such as Japan's recent yen support using Euros – is being used to avoid upward pressure on US Treasury yields that would accompany additional dollar sales. Governments are shifting issuance toward the short-end to manage funding costs, even as this increases rollover risk. Central banks are diversifying their reserve holdings away from US Treasuries, reducing demand for long duration sovereigns. Political pressure on monetary policy is rising, raising inflation risk premia and undermining central bank credibility. The recent US intervention to support JPY at the same time avoiding selling of US treasuries is not proactive fiscal strategy; it is damage control.

Central banks are diversifying their reserve holdings.

Exhibit 05: Policy rates remain elevated and in some cases are rising



Sources: LSEG Workspace, and ADCB Asset Management

….while structural shifts are making worst-case scenario plausible….

A number of structural shifts currently underway are making the worst-case scenario plausible.

Although the scenarios outlined in this note are explicitly not our base-case, several structural shifts across global debt markets make it sufficiently plausible to merit close attention. The sovereign debt cycle is no longer defined solely by fiscal arithmetic or interest rate dynamics. Instead, it is shaped by deeper changes in market structure, investor composition, leverage, and the transmission channels linking sovereigns, banks, and non-bank financial institutions (NBFIs). These shifts collectively increase the probability that sovereign stress could propagate more quickly and more broadly than in past cycles.

- The first reason this worst-case scenario is plausible is the emergence of a new sovereign-bank-NBFI nexus. The classical sovereign-bank “doom loop” of the Eurozone crisis has evolved into a triangular feedback system in which NBFIs – hedge funds, money market funds, leveraged intermediaries, and even stablecoin issuers – now play a central role. Banks’ direct sovereign exposures have become less important in explaining the co-movement between bank and sovereign risk. Instead, banks’ exposures to NBFIs have become the dominant transmission channel. Because many NBFIs engage in leveraged sovereign bond strategies funded through short-term repo borrowing, even modest shocks to sovereign yields can trigger margin calls, forced deleveraging, and fire sales. These dynamics feed back into sovereign markets, amplify volatility, and transmit stress to banks through counterparty exposures. This triangular nexus makes sovereign risk episodes more nonlinear and more prone to sudden liquidity shocks than in the past.

- Second, the investor base for sovereign debt has shifted toward more pro-cyclical, rate-sensitive buyers. Traditional holders – banks and insurers – have been partially replaced by money market funds, hedge funds, leveraged funds, and digital asset issuers. These investors are more sensitive to funding conditions, collateral valuations, and market momentum. Their behaviour can change abruptly when volatility rises or when yields move sharply. Governments have become increasingly reliant on these segments to absorb large volumes of issuance. This broadens the investor base but also introduces new channels for liquidity shocks. A sudden withdrawal of demand from these segments could disrupt core sovereign markets and, via banks' exposures to NBFIs, feed back into the banking system. This structural shift increases the plausibility of disorderly market moves in a stress scenario.
- Third, sovereign financing practices themselves have become more complex and more exposed to pro-cyclical dynamics. The recent use of total return swaps (TRS) by several frontier sovereigns illustrates how collateralised financing can introduce margin-call risk and opacity. When sovereign credit weakens, the value of pledged collateral falls, triggering margin calls precisely when liquidity is most constrained. TRS also complicate restructuring dynamics, potentially incentivizing sovereigns to prepay secured claims and exclude them from burden-sharing – as seen in Ecuador's 2020 repo prepayment. While TRS usage remains limited, the broader trend toward secured sovereign borrowing increases the system's sensitivity to collateral valuations and market volatility. In a worst-case scenario, these structures could amplify stress.
- Fourth, global debt has entered a structural supercycle driven by healthcare, energy, AI, and defense ("HEAD"). As per the IIF, global debt now exceeds USD350trn – 305% of GDP – and sovereigns account for a rising share of this total. Unlike previous waves of debt accumulation driven by crisis response or ultra-low rates, today's debt expansion is rooted in long-term strategic spending priorities. Governments are simultaneously facing rising healthcare costs, aging populations, energy security needs, and large scale investment in AI and digital infrastructure. These pressures are structural, not cyclical, and they are unfolding in a higher rate environment. This combination increases the likelihood that sovereign borrowing needs will remain elevated even as debt service costs rise. In such an environment, fiscal slippage becomes easier to trigger and harder to reverse.
- Fifth, leverage is rising across non-sovereign segments in ways that could interact with sovereign stress. AI-related corporates have sharply increased borrowing to fund data center and semiconductor investment, with investor appetite showing early signs of softening. Margin debt in the US is at record highs, and leveraged funds have proliferated. Private markets face refinancing pressure after a decade of ultra-

low rates. These pockets of leverage create potential accelerants: if sovereign yields rise sharply, funding conditions tighten, and leveraged positions unwind, the resulting deleveraging could spill into credit markets, equities, and FX. In a worst-case scenario, sovereign stress would not remain isolated – it would interact with corporate leverage, NBFI fragility, and liquidity-sensitive investor bases.

- Finally, the monetary-fiscal nexus has tightened. Higher rates feed directly into debt service costs at a time when deficits are structurally large. Expansionary fiscal policy can undermine disinflation efforts, while central bank credibility becomes more important, and more fragile. Markets are increasingly sensitive to fiscal signals, policy communication, and the perceived willingness of governments to consolidate. In this environment, small policy missteps can have outsized market consequences.

Taken together, these developments make the worst-case scenario outlined in this note plausible enough to warrant serious consideration, even though it is not our base-case. The sovereign debt cycle has become more complex, more interconnected, and more exposed to pro-cyclical behaviour across banks, NBFIs, corporates, and leveraged investors. The system is not on the brink of crisis – but it is more vulnerable to one than at any point in the past decade.

Exhibit 06: Moves in bond yield curves can have profound cross-asset implications

Mean monthly performance of asset classes – by yield curve regime (%) *

	Bear Flattening	Bear Steepening	Bull Flattening	Bull Steepening
Global Equities	**0.6%**	**1.0%**	**0.7%**	**-0.9%**
DM Equities	0.6%	0.9%	0.7%	-0.8%
EM Equities	0.7%	1.4%	0.5%	-1.9%
Global Aggregate Bonds	**-0.6%**	**-0.7%**	**1.3%**	**1.6%**
Global Treasuries	-0.8%	-1.1%	1.4%	1.8%
Global IG Credit	-0.5%	-0.5%	1.4%	1.2%
EM External Bonds	0.2%	0.2%	1.8%	-0.1%
EM Local Bonds	-0.6%	-0.1%	1.1%	1.2%
Global HY Credit	0.4%	0.8%	1.1%	-0.2%
Commodity Aggregate	**0.3%**	**0.8%**	**0.0%**	**0.6%**
Industrial Metals	0.7%	1.7%	-0.1%	-0.6%
Energy Commodity	0.6%	1.1%	-0.2%	0.9%
Agriculture	0.0%	0.7%	-0.1%	0.8%
Precious Metals	-0.5%	0.1%	1.0%	1.4%
WTI Crude Oil	1.7%	2.5%	-0.6%	1.0%
Gold	-0.2%	-0.2%	1.4%	1.7%
Dollar Index spot	**0.5%**	**0.3%**	**0.0%**	**-1.0%**
EUR-USD	-0.5%	-0.2%	0.0%	1.2%
GBP-USD	-0.3%	0.3%	-0.2%	0.6%
USD-JPY	0.9%	1.6%	-0.5%	-1.3%
EM FX	0.1%	0.4%	0.4%	0.3%

*Source: MSCI, Bloomberg, GSCI, LSEG Workspace, and ADCB Asset Management. | Notes: *Using monthly data since August 1993.*

…. with potential implications for markets and asset allocation.

It pays to think how these macro dynamics linked to the debt overhang will impact market outcomes and asset allocation.

The transmission channels through which the debt overhang affects markets are broad and increasingly visible. In rates markets, higher term premia are steepening curves and keeping the MOVE index structurally elevated. Duration-heavy portfolios face renewed drawdown risk, and political events – from fiscal packages to debates over central bank independence – are exerting greater influence on yield volatility. In foreign exchange markets, the dollar remains strong as foreign fiscal risk rises, while the yen remains vulnerable despite intervention. The euro and pound are carrying widening fiscal risk premia. In credit markets, sovereign stress is raising bank funding costs and tightening lending conditions. Corporate spreads are widening asymmetrically, with high yield issuers more sensitive to refinancing risk. Private credit markets face elevated refinancing pressure as base rates remain high. In equities, higher discount rates can pressure long-duration sectors such as technology and growth, while financials are exposed to the sovereign-bank loop. Defensive sectors can outperform in fiscal risk regimes. In alternatives, real assets benefit from inflation hedging but suffer from higher real yields, infrastructure faces rising financing costs, and gold is gaining from fiscal dominance hedging.

These dynamics carry clear implications for asset allocation even under the worst-case scenarios. In sovereign bonds, long duration exposure to the US, Japan, the UK, and France should be reduced, with a preference for short-dated bills and floating rate notes. Selective emerging market duration may offer opportunities where fiscal anchors are stronger. In credit, investment grade issuers with strong cash flow durability are preferred, while high yield issuers with large refinancing needs in 2027–2029 should be avoided. Private credit exposure should focus on senior secured structures. In equities, portfolios should tilt toward low-duration, cash flow rich sectors such as energy, industrials, and financials. High duration technology could come under pressure, and companies with pricing power and low leverage should be favoured. In FX, an overweight USD remains appropriate, while the yen should be underweighted until credible fiscal consolidation emerges. Selective underweights in the euro and pound may be warranted. In alternatives, gold offers a hedge against fiscal dominance, real assets with inflation-linked cash flows provide resilience, and highly levered infrastructure should be avoided.

In summary….

….the global debt overhang under the worst-case scenario can become a central market pricing factor. Rising term premia, shrinking natural buyer bases, and politically constrained fiscal frameworks create a world where sovereign risk is macro critical again. The next phase of market volatility will be driven less by inflation and more by fiscal sustainability. Investors must recognize when the sovereign debt cycle turns – and position accordingly.

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