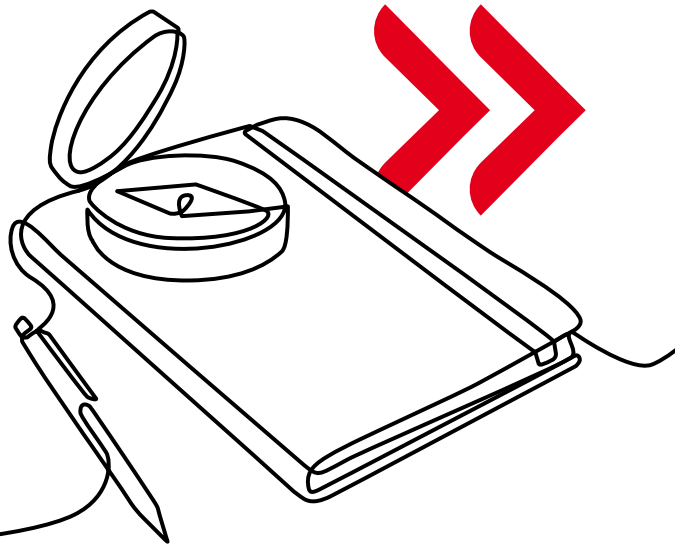
The Investment Institute
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Letter from the Editor
Guns, butter and bond yields



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10 October 2026

Letter from the Editor is our weekend read, which looks at the big picture, one question at a time.

There are good reasons to believe that the global bond sell-off is overdone. Nevertheless, the recent rise in yields provides the opportunity to take a look at Europe's longer-term fiscal challenges. Rearmament and de-risking is unfolding at a time when ageing populations, affordability concerns and technological disruption are placing growing demands on the state. Hence, funding strategic autonomy through sizeable cuts to welfare spending is unlikely and risks undermining the social contract on which political stability rests. As a result, Europe will need to rethink a fiscal and monetary architecture that was not built for an era of great power politics and ever-growing fiscal commitments.

Hello from the Investment Institute

The global bond sell-off continues, albeit with varying intensity. In our latest *Quarterly Updates*, we argue that fundamentals do not justify current yield levels. Despite the war in Iran and renewed energy concerns, inflation expectations in both the US and Europe remain well anchored. Most of the rise in yields, particularly in the US, reflects an increase in real rates that would be consistent only with a meaningful acceleration in economic growth. Even when allowing for the transformative potential of AI, such outcome does not appear realistic.

A more plausible explanation would be that markets are overreacting to an increasingly hawkish Fed. And in Europe, where there is no fiscal sustainability issue, investors are forgetting that radical parties typically moderate once in government. In addition, there are the many tools both the Fed and the ECB can deploy in order to calm markets – but so far this has not happened.

However, given the current rise in yields, we take a look at Europe's long-term fiscal challenges. Europe is relearning the language of power, deterrence and defence at a time when ageing populations, affordability pressures and technological disruption are pushing social demands ever higher. Public finances are increasingly caught between these competing imperatives: boosting strategic autonomy and preserving the welfare state.

The protests in Madrid and Paris, while triggered by different factors, are reminders of the social pressures already building beneath the surface.

So the question for today is: **Can Europe rearm and derisk without undermining its social contract?**

This involves a broader version of the "guns and butter" dilemma. Today's guns are not related only to traditional military spending but to all the factors that reduce geopolitical vulnerabilities, including defence, security, energy, technology and critical supply chains, with the ultimate goal of achieving strategic autonomy.

If European governments choose the orthodox path of cutting social spending (the butter) to fund strategic autonomy policies (the gun), financial markets might see only partial relief. The greatest cost would come in terms of social discontent and political instability, which could be quite unsettling for investors. However, the most realistic scenario is that European nations will try to have both, guns and butter, which would lead to a larger state, higher public debt and rising interest rates. At least this is what history tells us. In turn, fiscal dominance and financial repression may become the new normal to maintain social cohesion and political stability.

Looking back



If defence expenditure rises, welfare spending does not decline.

A recent paper by economists Johannes Marzian and Christoph Trebesch, covering 114 episodes of military buildups across advanced economies since 1870, challenges the traditional notion of a trade-off between guns and butter. Their central finding is that countries rarely finance rearmament through cuts in social spending. If defence expenditure rises, welfare spending remains, at a minimum, broadly intact, or even rises. The adjustment takes place through a combination of higher borrowing and higher taxation.

This is true not just during major wars, when military efforts require rapid decisions that can be best made by issuing new debt instead of cutting spending after lengthy parliamentary discussions. Also, peacetime military buildups are usually funded through a combination of higher taxes and more debt rather than with social spending cuts. The most striking example in this sense is the Cold War. In those years, Europe maintained a substantial defence budget while expanding its welfare state.

The logic of the guns-and-butter trade-off seems to work only in one direction: when defence becomes less necessary, governments reallocate resources towards welfare. But when security threats increase, welfare spending rarely falls by a corresponding amount.

The decades following the end of the Cold War illustrate this dynamic. With the Soviet threat gone and the American security umbrella taken for granted, European governments enjoyed a sizeable peace dividend. Defence spending steadily declined while social spending expanded further. Only in recent years has this trend begun to reverse. Since 2019, European defence spending has risen above its post-Cold War lows, driven by rising geopolitical tensions and renewed pressure from Washington for NATO members to shoulder a greater share of the collective defence burden.

The European dilemma

Europe is facing the guns-and-butter dilemma once again. Yet the continent appears determined to address it in the same way nations have done in the past: by attempting to preserve both. This is the cynical interpretation of the National Escape Clause (NEC), which was introduced under the EU's reformed Stability and Growth Pact. The NEC provides additional fiscal space for defence or energy spending, allowing governments to temporarily deviate from the fiscal adjustment path required by EU rules, provided that debt sustainability is not jeopardised.

So far, 18 EU member states have requested to activate the clause, including Germany, Spain and Poland. Italy, which is expected to exit the excessive deficit procedure (EDP) in early 2027, will see its deficit-to-GDP ratio drop below 3% to 2.9%; however, as a result of the NEC, it will jump to about 3.5%.

From a public-finance perspective, this is not an ideal solution. But politically it is a pragmatic way to buy time. It allows governments to respond to a deteriorating security environment without immediately forcing difficult decisions on pensions, healthcare or other politically sensitive areas of expenditure.

While the NEC is a pragmatic solution for Europe's security threats, it presents two limitations in terms of design. First, it creates an asymmetry. For countries already below the 3% deficit threshold, such as Germany last year, it provides genuine additional fiscal space. For countries still under an EDP, such as France, it merely relaxes adjustment requirements without fully eliminating fiscal constraints. Italy's decision to activate the clause only once its deficit falls below 3% (next year) illustrates the difference. Delaying what is increasingly becoming existentially vital spending for rigid rules risks undermining the ability of the continent to defend itself in the future.

Second, the NEC will be granted until 2028. This means that the EU de facto treats strategic spending as a temporary exception rather than as a response to a structural shift in Europe's security environment. But the Russian threat is here to stay, while America's strategic retrenchment from Europe has been underway for more than a decade (since Obama's pivot towards Asia in 2012), reflecting a broader shift of US attention towards the Indo-Pacific. Moreover, some analysts believe it might take up to 10-15 years for Europe to achieve strategic autonomy.

A new framework

If spending to achieve strategic autonomy becomes a long-lasting element of European fiscal policy (especially considering increasingly ambitious NATO commitments or the need to diversify more energy sources), while democratic constraints make large-scale cuts elsewhere politically difficult, temporary exemptions and ad hoc flexibility are inadequate solutions. What's needed is a change of mindset about how monetary and fiscal policy interacts in the eurozone.

The current European fiscal framework was designed for a world in which security threats appeared distant, economic dependencies were not weaponised, and defence was largely treated as a public good provided by the US. Under those conditions, higher deficits could be interpreted as evidence of fiscal indiscipline.

But public spending aimed at preserving continental security and achieving strategic autonomy is qualitatively different from other forms of public spending. Europe may therefore need a more permanent mechanism to distinguish strategic autonomy-related investment from ordinary spending, allowing governments to address common strategic challenges without repeatedly relying on emergency clauses and temporary exemptions.

Without this type of fiscal flexibility, national governments might underinvest in those areas that matter for the future of Europe, as spending cuts elsewhere would be politically difficult to pass. And, in reality, the trade-off between guns and butter may be less stringent than it seems at first glance. If defence spending in particular is channelled towards technological progress, it could lead to productivity gains that could expand, rather than shrink, available resources, reducing the need for painful spending cuts. According to some analysis, on average, a 10% increase in government-financed R&D generates an increase in privately funded R&D of about 5%. Similarly, reducing energy dependencies might boost Europe's competitiveness, particularly in the most energy-intensive sectors.

While more permanent rules might relax some of the democratic constraints, the deeper issue is institutional. Europe may be approaching the limits of an institutional framework that was designed primarily for economic integration rather than strategic competition, where free markets are now being sidelined, while corporate and state power increasingly interact in ways reminiscent of earlier mercantilist periods. In such an environment, rules on state aid may need to be reconsidered, but also the roles played by all major economic institutions, including the central bank.

ECB President Christine Lagarde rightly warned against fiscal dominance and any erosion of central-bank independence. Yet monetary policy should be redesigned to reflect a world of higher defence spending, industrial policy and strategic investment. This does not mean debt monetisation or impairing the credibility of the central bank. Its role as guardian of price stability is not in question. More plausibly, it implies a greater willingness to counter market fragmentation and limit disorderly increases in sovereign borrowing costs in the context of debt levels that would have seemed excessive during the era of the peace dividend. This will undoubtedly be a difficult balancing act.

Finally, the question is not only how much debt will be issued, but who should issue it. If Europe is entering an era of structurally higher borrowing aimed at strengthening continental security and strategic autonomy, the logical response would be the creation of common European bonds jointly guaranteed by member states: let's call them

strategic autonomy bonds. The European Commission's NGEU and SAFE instruments are a good starting point in this respect. In particular, the scope and size of the SAFE instrument, which currently covers defence spending and has a total envelope of EUR 150bn, should be expanded, while its guarantees should be reconsidered.

Otherwise, financing security through separate national balance sheets would likely produce underinvestment, duplication of capabilities and widening financial divergence across the continent. And the creation of an ad-hoc financial instrument for strategic autonomy would also make the ECB's job easier, as this type of spending would be clearly distinct from traditional social spending that is politically more divisive, especially between the north and the south of the continent – thus it would be easier to assess market volatility on the basis of each country's underlying fundamentals, drawing a clear distinction from Europe's long-term strategic priorities.

Joint issuance would also yield broad benefits. It would encourage cross-border strategic projects, reduce the constraints imposed by national fiscal positions and help create a genuine European safe asset. A sustained programme of common European debt issuance could provide the missing financial infrastructure needed for the euro to strengthen its international role, lowering Europe's dependence on the USD while enhancing financial sovereignty.

Investment implications

The current market sell-off is a reminder of how challenging a world flooded with public debt will be. For investors, the key lesson is that Europe's race to boost its strategic autonomy is unlikely to be financed through a simple transfer of resources from welfare to defence. History suggests that the adjustment will occur through higher public borrowing, higher taxation and a larger state.

This points to a structurally higher equilibrium level of interest rates, even if cyclical growth remains modest. These dynamics could be counterbalanced by a more activist ECB to contain monetary policy fragmentation. Without a more cohesive relationship between fiscal and monetary authorities, the risk is underinvestment in the strategic areas of relevance for the future of Europe and widening sovereign spreads among European nations.

Enjoy your weekend!

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