RBC BlueBay
Asset Management

Marketing communication

Not flinching when others wince

Bond bloodletting

Key points:

- **US yields jump:** we believe that the latest move in the U.S. yield curve represents an overshoot of fair value, when assessed from a medium-term perspective.

- **US rates pricing:** the market now discounts a further 100bp of Fed rate hikes over the coming year, with cash rates projected above 5% for the coming decade – a path that only looks logical if inflation stays permanently elevated above the Fed's 2% target, which inflation swaps do not corroborate.

- **European energy security:** vulnerability with respect to energy security continues to be laid bare. However, Europe's gas consumption is down ~20% from 2022 thanks to renewables, making the 60% gas storage level less alarming than it may appear.

- **ECB outlook:** if gas prices top out around current levels, we feel more confident that inflation should peak at 4.0% in January and then decline in the months thereafter. This means that two further ECB rate hikes ,in Q4 and Q1, are to be expected, but we doubt there will be any need for additional monetary policy tightening beyond next spring.

- **Eurozone spreads:** regional spreads have been under pressure with French OATs selling off aggressively as concerns with respect to the country's fiscal position continue to build, threatening a downgrade in the sovereign rating.

London, 25 September 2026: Global yields jumped during the past week, with U.S. Treasury yields on Wednesday witnessing the largest one day up move since April 2025. Although this price action coincided with a robust PMI report suggesting healthy economic activity, such data barely explains a 20bp move in yields.

Often it can be tempting to fit a narrative to explain price action, but in this case, it seems that market technicals were dominating more fundamental factors, as a capitulation of long held bullish positions triggered a dislocation in price action.

Subsequently, this move has left the U.S. rates market discounting a further 100bp of rate hikes from the FOMC in the coming year, with cash rates projected to remain at levels above 5% for the coming decade thereafter. Such a sustained, elevated path for interest rates would only appear logical if inflation remains permanently elevated at levels well above the Fed's 2% inflation target, yet this is not what is discounted in inflation swaps.

Alternatively, a higher rate regime could be explained by much higher productivity growth raising R*. However, it is not at all clear at this point whether the AI boom we are witnessing will put all businesses in all sectors in a strong position to withstand permanently higher levels of real interest rates. There are likely to be many sectors and debt issuers in the U.S. economy which struggle to survive in a world where real yields remain at 3%.

Indeed, such an elevated level of real rate in the U.S. has only tended to last for periods of 12 months, or less, in the 35 years since the end of the 1980's. In this respect, pricing may be reaching extreme levels.

Consequently, we believe that the latest move in the U.S. yield curve represents an overshoot of fair value, when assessed from a medium-term perspective. This leaves us retaining the more constructive view on the outlook for duration, which we shared last week, in the wake of a return to Fed orthodoxy when the FOMC raised rates.

It strikes us that many fixed income managers have been caught long and wrong in duration all year, having widely expected central banks to be on an easing path at the start of 2026. Anecdotally, the past month has witnessed a degree of bloodletting with individuals exiting a number of hedge funds and asset managers in the wake of challenged performance. This has led to long positions being liquidated and although it is always hard to know whether such a trend has now run its course, it is still possible to infer that market technical positioning is much more supportive for yields on a forward-looking basis, than has been the case just a few weeks ago.

Within the U.S., rising diesel prices continue to see building political attention. However, suggestions that the White House was mulling a ban on diesel exports seemed to be quickly quashed. Although such a policy may appear to have some level of popular appeal, in reality there is as much risk that such a move actually raises domestic prices, rather than reduces them. Such a policy action could trigger overseas retaliation elsewhere and moreover, time lags mean that there would be little near-term benefit to consumers anyway.

In Europe, yield moves followed developments in the U.S. Given that the continent depends on the U.S. for 50% of its refined diesel, an interruption to supply could represent an additional economic shock both to growth and inflation. Even in the absence of this, Europe's vulnerability with respect to energy security continues to be laid bare.

However, in discussion with European policymakers this week, it was noted that a push towards renewables has meant that EU gas consumption is down approximately 20% from 2022 levels. Consequently, although gas storage levels at 60% of peak capacity appears optically low, this number is less relevant than in the past. Additionally, Europe seems to have learnt not to compete with itself when sourcing gas supplies, thus driving prices higher than is needed, to out-bid countries in other regions.

Subsequently there is growing confidence that gas prices top out around 80 on TTF futures, unless there is additional disruption to global supply, noting that Europe is also making up its gas shortfall from U.S. based shipments. Should gas prices top out around current levels, we feel more confident that inflation should peak at 4.0% in January and then decline in the months thereafter. This means that two further ECB rate hikes in Q4 and Q1 are to be expected, but we doubt there will be any need for additional monetary tightening on either side of the Atlantic, beyond next spring. This also speaks to a constructive view with respect to government bond yields in the region.

Meanwhile Eurozone spreads have been under pressure with French OATs selling off aggressively as concerns with respect to the country's fiscal position continue to build, threatening a downgrade in the sovereign rating. OAT spreads above 110 are now at their highest levels since 2012, though it is noteworthy that many EU policymakers seem very happy, for now, that the market does its work and pushes spreads wider.

There has been widespread irritation within the EU at the French reluctance to improve its fiscal position, and there is some hope that a wider spread may force policy makers to take more steps to put France on a more sustainable path. However, fiscal consolidation remains unpopular with a French electorate which has become accustomed to being able to live beyond its means, and so it may be unlikely to expect much improvement this side of the 2027 Presidential election.

This said, being short France is now a consensually owned position. Passage of a budget over the coming month could well see a retracement in spreads and we would favour a neutral stance here, looking to re-establish a short position at more favourable levels.

Elsewhere, other sovereign spreads have been dragged wider with France and appear attractively priced relative to high grade corporate credit. At a time when Germany's own credit trajectory is also on a weakening path as the economy struggles, so other countries have been performing better on a relative basis meaning that material weakness in spreads does not appear fundamentally justified.

UK yields also continued to move higher. Up to now, the Bank of England (BoE) has wanted to take a more sanguine view on inflation, but CPI may hit 5% in Q1, as January utility bills jump and other costs are passed through to consumers. With almost 50% of wages indexed to CPI (allowing for minimum wage and public sector wages) this means that UK inflation will remain elevated through the first half of 2027, with indexed gains kicking in at the beginning of April.

Although the UK economic outlook appears soft, we think BoE Governor Bailey will be obliged to hike at least 2 or 3 times in the next 6 months, though this may still infer fewer than the 5 rate hikes discounted in the futures curve.

On this basis, we feel there is a basis to be positioned long in short-dated UK rates, but we remain more bearish further out the curve, leading to a curve steepening position. Everything we hear on the forthcoming Budget sounds like more spending. A reduced fiscal headroom of £15bn is also likely to be announced, but in the absence of credible underlying assumptions and with a refusal to take steps to tackle runaway welfare spending, so we think that gilt investors may not respond that positively.

Japanese markets were closed on holiday for most of the past week, but also caught up to U.S. moves, sending yields higher. Meanwhile, a stronger dollar has seen the greenback strengthen against most currencies over the past week, with the DXY index back close to the year's highs.

We continue to feel that many of the factors observed in 2026, including a positive in terms of trade shift, AI dominance and secular U.S. growth outperformance, should all have led to a materially stronger dollar over the past months on a fundamental analysis. In this respect, the fact that dollar gains have been more limited, speaks more to medium-term asset allocation shifts away from the U.S.$ and U.S. assets.

On this basis we remain wary in expressing a directional view on U.S.$ for the time being and hold modest currency risk. We have favoured the Brazilian real versus the Canadian dollar in the Western hemisphere. Meanwhile, in Europe we remain constructive on the Hungarian forint and Icelandic krona, versus shorts in the British pound and Swiss franc.

Elsewhere, in emerging markets, some nervousness with respect to higher U.S. rates and a stronger dollar have weighed on sentiment. Ukraine has underperformed as peace hopes continue to fade, though in Brazil, tighter polls in the run-up to next month's Presidential elections, in conjunction with lower domestic inflation, have benefitted local bonds.

We still see value in owning high yield carry in a number of pockets in EM and on a secular basis, still see an increase in asset allocation flows towards EM debt and equity strategies. Elsewhere in credit, spreads continue to be muted and aside from the periodic 6-month rolls of CDS and itraxx CDS indices, there remains little to report with spreads grinding mostly sideways in direction.

Looking ahead

In recent times, it feels like bond yields have been performing about as well as the football team, Tottenham Hotspur, who currently lie bottom of the English Premier League, notwithstanding building hopes for a better season earlier this summer.

However, in fixed income markets unlike football, thankfully, there will tend to be more of a medium-term trend towards price reversion. When bond yields rally strongly, then basic math infers that returns on a forward-looking basis will be suppressed.

Similarly, higher yields may be painful in the short term, but such a move ensures forward-looking returns at a more elevated level. Consequently, with global bond yields at their highest level for more than 20 years, we see merit in owning duration.

The pain trade in 2026 has been towards higher yields but this is now changing as positions are closed and former bulls flip their positioning to jump on a trend to higher yields, when this move is already well extended. The past six months have been painful. But as we would reflect, in the bomber flyover at the Trump-Xi meeting at Washington airport this week, in moments of pain, some will wince and others won't flinch. We know which camp we would rather place ourselves in…..

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About RBC BlueBay Asset Management

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