



French society needs to embrace change, or its politicians won't...

OATs have left a bitter taste this week

Key points:

- **French bond crisis intensifies:** OAT spreads have reached levels last seen during the 2012 EU sovereign crisis, reflecting deep market concerns about fiscal responsibility ahead of the French Presidential election in 2027
- **UK Budget risks echo France:** the Prime Minister Burnham's government faces similar bond market pressures as it ponders Budget decisions, with the potential for early elections next year as Reform struggles and the Conservatives work to rebuild trust
- **Central bank hiking cycle moderates:** the Fed and ECB have signalled further rate hikes later in the quarter, but market expectations for back-to-back increases have diminished as inflation fears ease
- **AI debt supply pressures yields:** over USD500 billion of AI-related debt is being raised this year with an average maturity of 13.5 years, contributing to steeper yield curves as the duration of supply exceeds market absorption capacity
- **Macro outlook remains volatile:** near-term bearish sentiment in fixed income looks overdone, and we see material upside in short- and intermediate-dated securities. Active management is well placed to capture the volatility and regime shifts ahead.

London, 2 October 2026: Global bond curves steepened over the past week, and the volatility we are seeing in fixed income yields is finally gaining attention in financial markets more broadly. Credit spreads are moving materially wider and even equity markets are feeling softer and more vulnerable.

Notwithstanding this, over the past several days, market fears for back-to-back central bank rate hikes have appeared to mitigate somewhat. Williams from the Federal Reserve along with Lagarde at the ECB both steered market participants towards expecting further rate hikes on both sides of the Atlantic, but with these moves unlikely until much later in the quarter.

Eurozone inflation prints in September have been elevated, as we would have expected, following last month's move up in energy prices. However, moderating gas price futures, as well as reports that Middle East oil exports may have reached 97% of pre-war levels, have helped to quell inflation fears on a forward-looking basis. In the US, core PCE inflation declined to 3.0% from a previously reported 3.3%, following annual data revisions.

In this respect, we would highlight the relatively modest degree by which inflation is overshooting the Fed's 2% target, when compared to inflation rates exceeding 8% in the energy shock during 2022. In this respect, although inflation remains elevated, there really seems little for policymakers to get panicked about.

We believe that the FOMC will hike rates in December and again in Q1 next year. However, by next spring, US headline inflation should drop from the mid to high 3's, down to the high 2's. Consequently, we see little reason for the Fed to need to keep hiking beyond this point, absent further shocks or data surprises.

In this case, we extrapolate fewer rate hikes than have been discounted by futures markets. In this respect, we believe that recent position squaring has led to some overshooting in short-dated yields.

We would note that the Fed has no specific desire or mandate to restrain growth and nor should it. If AI investments boost productivity and raise GDP, then all that should matter to the central bank is that inflation remains anchored to its target objective.

Furthermore, we would note that although the AI-related economy may appear red hot, away from tech, much of the rest of the economy is significantly less robust.

The US labour market appears broadly stable, as we await the latest US jobs report due later today. That said, the backdrop of modest nominal levels of additional jobs being added suggests consumer demand growing at a modest pace. Furthermore, with real incomes being squeezed, weak consumer confidence suggests some scope for more forward-looking caution on the part of the consumer.

Returning to the bond market, although our confidence with respect to central banks under-delivering on rate hikes supports the outlook for short-dated yields, we remain more cautious of longer-dated maturities.

An abundance of long-dated fixed income is a factor which is weighing on term premia, and is set to continue to do so. In this context, over USD500 billion of AI-related debt is due to be raised this year and this supply is projected to have an average maturity of 13.5 years.

Simplistically speaking, it strikes us that the supply of duration is now exceeding the market's capacity to absorb it, and this speaks to us of steeper yield curves. Indeed, if higher long-term rates contribute to a tightening of financial conditions, this may also be a factor that leads central banks to deliver less, not more, monetary restraint via interest rate policy.

In addition to corporate bond supply, elevated fiscal deficits also continue to weigh on global bond yields. The need to invest in physical security, energy security and food supply security after three major supply shocks in the past six years, all speaks to a need for more government spending. Ageing societies are also putting pressure on social welfare spending and globally speaking, there are very few countries where the notion of fiscal restraint is remotely popular.

Over the past several weeks, bond market concerns with respect to budgetary responsibility have focussed on France and pressure on OATs has continued to build. With French voters still in denial with respect to the need for change, so it is very difficult for any political party in France to embrace this, with the pivotal 2027 Presidential elections coming into view.

Looking at polls today, victory for Le Pen and National Rally appears the base case, particularly should the second-round runoff feature the hard left socialist, Mélenchon. With 10-year spreads reaching highs last seen in the 2012 EU sovereign crisis, when the break-up of the single currency still seemed like a very real possibility, there is a sense of crisis building in the bond market. The volatility in French government markets is also spilling over into other peripheral spreads.

Yesterday we witnessed the first double digit widening in Italian BTP spreads in some time. In the short term, the sell-off in OATs may have gone too far and some retracement is possible. However, pressure on the French spread is unlikely to abate, and we remain inclined to sell on rallies versus Italian BTPs and other Euro sovereigns, where spreads have also pushed wider in the wake of French moves.

It is also noteworthy in France that the low level of domestic participation in the OAT market speaks to a structural weakness in the buyer base. Paris would be well advised to look to policies designed to encourage a greater share of domestic investment to be channelled towards its bond market. Indeed, this theme of a re-domestication of portfolio allocation could be an increasingly important theme more broadly in global markets in the years ahead.

What is happening in France should also serve as a warning in the UK, as the Burnham government ponders its Budget decisions. Arguably, the Prime Minister used his speech at the Labour Party conference to outline

priorities following the next election and it could yet be possible that the UK could go to the polls as early as next year, with the Reform Party in some disarray and with the Conservatives still struggling to rehabilitate trust in their party.

Indeed, a shift back towards domestic assets is already starting to get underway in Japan and here we continue to think that this will help support long-dated bond yields. In contrast to other bond markets, the Japanese yield curve is already very steep and as interest rate policy normalises, so we expect this to flatten out.

Elsewhere, there has been a growing sense that higher bond yields are starting to weigh on risk assets. US equity remains supported by robust earnings momentum, yet relentlessly higher long-dated yields represent a challenge for other long duration assets.

In this respect many asset allocators we meet with appear inclined to raise fixed income allocations at the expense of stocks. Yields stand at multi-decade highs and these asset allocation shifts are also supported by the notion that the forward-looking outlook in equity markets appears more uncertain, at a time when a majority of stocks in the S&P Index now exhibit a negative correlation to the index itself, on the back of ongoing concentration with respect to market leadership.

In FX markets, the dollar has pushed firmer on the back of a more bullish appraisal of US growth prospects. However, we still think that longer-term diversification away from US assets is a theme that will ultimately limit broad-based dollar strength.

In light of this, we have flattened out a short position in the Canadian dollar versus the greenback, following recent dollar gains. We express a modest underweight in the dollar versus higher yielding currencies in emerging markets, where carry continues to appear attractive in the context of countries maintaining high real levels of interest rates.

We see value in a number of sovereign spreads and look for recent moves to retrace, noting that an ongoing deterioration in German credit quality also infers further convergence relative to southern Europe, which should help spreads in due course.

Looking ahead

Today's US jobs report will be closely watched, and at a time when Treasury market volatility has been elevated, any material surprise could provoke a short-term market reaction. That said, it is inflation data that is more important than growth data at the moment. In this regard, it will be the next CPI report that may have a more important significance for yields, as we progress into the final quarter of the year.

US midterm elections are also drawing closer and with Trump's popularity continuing to slide, polls indicate the Democrats ahead in all the Senate swing states, which have been considered to be 'in play'. A majority for the Dems in both chambers of Congress appears highly likely and it is even possible to imagine as many as 54-55 Senate seats for the Democrats in the upper chamber.

This could yet renew hopes that a successful impeachment of Trump could come into view, were the President to overreach his own authority in the remainder of his term. Should these political considerations constrain Trump's ability to a much bigger escalation in the Middle East, or some other controversial policy action, then this may be no bad thing. Yet we also know Trump is unlikely to disappear quietly into the background as it is just not in his DNA.

Either way, there is plenty of scope for volatility and upheaval in the months ahead and this speaks to the opportunity to deliver returns through active management, where these trends can be identified ahead of the crowd.

It has been a rough year for bond yields on a year-to-date basis, but we are also reminded that the same was true for the first nine months of 2023, only for yields to rally by 110bps in the final quarter of the year.

We continue to think that short-term sentiment in fixed income markets has become too bearish and if we are correct, there may be material gains to be made in short and intermediate-dated fixed income securities.

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