



Wild OATs Spread Autumn Discontent

Brazilian election surprise

Key points:

- **US Treasuries:** the Treasury curve continued its recent bear steepening trend over the past week, with long-end yields reaching new 25-year highs.
- **US term premium:** elevated corporate and government bond supply looks set to persist and we believe that this can be a factor which continues to demand an elevated term premium be built into longer-dated securities.
- **Europe bond market pressure:** signs of stress have also continued to build, with pressure on French government bonds as markets lose confidence in policymakers' attempts to address sovereign debt sustainability.
- **Brazil's Bolsonaro rally:** elections during the past week served as a reminder of how politics and policy can drive financial markets, with domestic assets rallying strongly after a victory for right-wing candidate Flavio Bolsonaro in the first round of voting.
- **Middle East escalation risk:** questions continue to swirl on whether President Trump will pursue renewed escalation in the Middle East after the mid-terms in November.

London, 9 October 2026: The U.S. Treasury curve continued its recent bear steepening trend over the past week, with long-end yields reaching new 25-year highs. At the current point in time, it might appear that there is simply too much new duration being issued for the market to be able to absorb, and thus supply and demand need to be brought much more into balance, in order for yields to stabilise.

In this respect, higher borrowing costs may act to constrain corporate spending plans looking forward, and anecdotally speaking, we have recently heard from a couple of U.S. banks that debt issuance plans are now being pared in response to higher yields. Yet with AI enthusiasm continuing to drive stock indices higher, many of the issuers responsible for the recent growth in debt are not particularly price sensitive.

Moreover, with fears of a Democrat 'blue wave' building for 2028, there is a sense of urgency to get as much AI infrastructure built as possible before a more substantive change in the regulatory environment.

Consequently, elevated corporate and government bond supply looks set to persist and we believe that this can be a factor which continues to demand an elevated term premium be built into longer-dated securities.

This suggests to us that there is scope for the curve to steepen further and whereas we maintain a constructive view on short-dated U.S. rates on the belief that the FOMC will deliver fewer hikes than are priced over the course of the coming year, we remain more cautious further out the yield curve.

With respect to economic fundamentals, last week's jobs report was relatively soft and weak consumer confidence data also highlights the two-speed 'K-shaped' economic trajectory. Anything related to AI is certainly running very hot, but elsewhere, interest rate-sensitive sectors show some signs of cooling.

In credit markets, it has also been interesting to see CCC-rated issuer spreads under pressure in recent weeks, seemingly highlighting the risks of crowding out weaker borrowers in a rising rate environment.

A similar trend has also been witnessed in B-rated names, though unlike CCCs, where spreads are at their widest for the past four years, CLO-related demand for B-rated credit has meant that spreads in that universe remain close to their 2026 average.

Nevertheless, the narrative that the rise in bond yields is starting to weigh on risk assets is one which appears to be gaining traction and in this respect, a further rise in government bond yields could prove to be self-correcting if this triggers a more material tightening in U.S. financial conditions.

Meanwhile, in Europe, signs of stress have also continued to build, with pressure on French government bonds as markets lose confidence in policymakers' attempts to address sovereign debt sustainability.

Despite comments from Le Pen's National Rally that they would seek to deliver fiscal consolidation when in office, it remains difficult to reconcile this objective with policy plans to cut the retirement age and continue adding to social welfare spending.

Ultimately, with austerity deeply unpopular with French voters, it is currently hard for political leaders to talk too tough on fiscal policy ahead of the election for fear of it being costly at the polls.

Comments from the ECB that France remains very far from meriting, or receiving, any support have also unnerved sentiment and with hedge funds deleveraging carry positions which they had maintained in France, spreads have reached levels in excess of three times the average level which has prevailed over the past 12-year period.

Looking ahead, we believe that France will confirm its 2026 Budget with a 5.4% deficit and should national protests start to abate somewhat as the weather cools, a lack of additional bad news could possibly afford some respite to the recent price action. However, any reprieve may not be especially long lasting should overseas holders continue to head towards the exit.

Only a paltry 12% of OATs are held by domestic households and although this infers scope for French savers, as well as French banks, to increase their holdings in order to take advantage of higher yields, there remains a worry that relatively risk-averse holders of French debt may be spooked by recent weakness in the market and thus seek to reduce holdings into a falling market, so triggering further sales.

Such price action is reminiscent of what we last saw in the euro sovereign crisis. Although we remain very far from such a crisis today, there remains scope for concerns to mount if French society remains stubbornly resistant to change.

In this regard, where we have formerly worried about some euro sovereigns in the periphery having been 'too big to fail', so there could be a worry that a country such as France could end up proving 'too big to save'.

Meanwhile, in response to a more risk-averse outlook, short-dated Euro yields rallied over the past week as investors price out previously discounted rate hikes. We think that this process may have further to go, and similar to the U.S., we continue to see some value in yields at the front end of the yield curve.

Across the English Channel, politicians in Westminster have been watching developments in France with a degree of concern and in this respect, it may appear that plans for a more ambitious budget of spending increases seem to have been put onto the backburner.

In this respect, it may be interesting to speculate whether Burnham is starting to look towards a General Election in 2028, with Labour performing somewhat better at the polls at a time when other political parties in the U.K. seem to be in various states of disarray.

Elections in Brazil during the past week also served as a reminder of how politics and policy can drive financial markets, with domestic assets rallying strongly after a victory for right-wing candidate Flavio Bolsonaro in the first round of voting. With markets having feared another term under President Lula, these results represented a positive surprise, pushing local yields 150bp lower and the Brazilian real almost 5% stronger in the immediate aftermath.

We have retained a constructive view on Brazilian assets and believe these moves have further to run, on the assumption that Flavio will emerge victorious in the second-round run-off.

We also see this as part of a continued move across Latin America towards more right-wing market-friendly administrations across much of the continent and in this respect, we continue to retain a relatively favourable stance across assets in the region as a whole.

In credit markets, euro spreads underperformed, with French names coming under pressure following weakness in government bonds. Many French corporate names trade inside OATs on a spread basis, but as we have seen elsewhere, domestic corporate bonds won't be immune to developments in government bond markets.

With other sovereign spreads across the Eurozone also widening in the wake of French moves, this has presented a more challenging backdrop for European credit spreads, though up to this point, trading has remained very orderly in nature.

Indeed, dislocations have been far more pronounced in government bonds. For example, last week, the spread on two-year French bonds jumped from 25bp to 85bp in just a couple of days, on an unwind of leveraged hedge fund carry positions.

This serves again as a reminder of the important role which market technicals can play and the risks that can accumulate when leverage is allowed to build over an extended period.

We have retained a flat stance on France, though for now remain minded to sell OATs should we see spreads rally back and on a relative basis we think owning sovereign credit elsewhere in Europe in names such as Italy holds much more merit.

Unlike France, Italy will most likely exit the Excessive Deficit Procedures in the Eurozone and has delivered a primary fiscal surplus. Despite the fact that they have proposed an increase of the deficit for next year using the national escape clause for additional spending for defence expenses and energy security we think that the EU will be open-minded to water down Maastricht criteria somewhat.

In this respect, we see Italy as a candidate worthy of ECB support should any move in Eurozone spreads start to become more systemic, threatening the stability of the single currency.

Looking ahead

We believe that it is much easier to identify value in shorter-dated yields than is the case for longer maturities at present. We also see value in sovereign spreads in those countries which are growing and have a robust balance sheet.

For example, Bulgaria and Croatia are two smaller members of the EU whose economies have been relatively vibrant and where government debt levels are very low compared to other EU peers.

We have learned in the past that sovereign credit ratings tend to lag behind movements in spreads and from that standpoint, there is a clear sense that France should be the lowest-rated country in the single currency right now, as bond markets would attest.

Back across the Atlantic, questions continue to swirl on whether President Trump will pursue renewed escalation in the Middle East after the mid-terms in November. Although this is threatened, we sense that the U.S. administration remains allergic to the idea of putting boots on the ground and given we have witnessed how little can be achieved through a bombing campaign at this point, it is questionable what rational options actually exist, even if escalation is the motivation.

This is a thesis we will look to test in meetings with policymakers in Washington in the coming week, yet for now, a continuation of the status quo in the Middle East appears the most likely scenario to prevail for some time yet to come.

Consequently, we think that in a world where energy prices track sideways, U.S. inflation should peak in the high 3s later this year before dropping to the high 2s by the spring as energy base effects drop out of the data.

Beyond this, we believe further progress to suppress price gains may prove more problematic, but we similarly think that the Fed will be relatively relaxed on inflation once it is back below 3% and trending lower, at a time when interest rates will be some margin above most perceptions of neutral.

Returning back to France, we would once again reflect on the notion that French society cannot expect to keep living beyond its means. There needs to be a moment of collective national learning and realisation on this point, and it is possible that this will only occur after a period of some market-enforced discipline. If only France would wake up and smell the coffee! Quite literally, it is time for the country to go back to school!

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