



Escalation after mid-terms?

The calm before the storm

Key points:

- **Fed on hold but hikes ahead:** the Fed has held rates at 3.88%, with markets expecting cumulative hikes through Q1 next year as U.S. inflation remains above target for nearly six years.
- **Geopolitical risk:** the risk of a material Middle East escalation has risen, with US-Iran peace negotiations at a standstill and the imminent removal of pre-mid-term electoral constraints expected to open the door to further hostilities.
- **Eurozone inflation heats up:** Eurozone CPI has risen to 3.8%, with TTF gas futures topping €100. This suggests that inflation could test 4.5%, potentially forcing the ECB to hike in December and Q1.
- **Brazil shock:** Brazilian assets have suffered a sharp repricing following Lula's surprise election victory, with the currency falling 10% and local rates rising over 250bps, although markets are seen as overshooting.
- **A challenging road ahead:** the global macro backdrop has deteriorated, with energy-driven inflation pressures, stalled geopolitical negotiations, and tighter monetary policy across major central banks presenting a challenging outlook for risk assets.

London, 30 October 2026: US Treasury yields were little changed in response to the Federal Reserve's decision to hold interest rates at 3.88% this week. A hold had been widely expected, though Warsh did little to dispel the notion that the Fed won't be hiking in December, and then again in Q1 next year.

At this point, a cumulative three hikes will then have unwound the easing Chair Powell delivered in 2025. This may mark a point where Fed policy returns to neutral. However, with US inflation now having exceeded target for close to six years, it's unlikely that the Fed will be able to take a more relaxed stance, until inflation is on a declining trajectory, and with the pace of price increases much closer to its 2% target, than is the case today.

Meanwhile, the drumbeat of war seems to be growing louder in the Middle East. Attempts to negotiate a peace settlement between the US and Iran have largely ground to a standstill, with neither side looking like it will compromise its own entrenched position.

In Washington, logic has dictated that President Trump would not want to take action to cause a further spike in energy prices, ahead of the mid-term elections. But with these soon out the way, this will remove this perceived constraint on new escalation.

There is a sense in the administration that Iran cannot be permitted to prevail in the current conflict. With hawks citing Iranian intent to accelerate its nuclear programme, there is an understanding that action needs to be taken sooner rather than later.

That said, there remains a very strong aversion to deploying US boots on the ground. Knowing this, the IRGC remains inclined to believe that any bombing campaign against them is likely to deliver limited results.

Logic dictates that Iran should dig in and not surrender. Moreover, Iran retains the ability to inflict material damage on its regional neighbours in such a scenario, and it hopes that this will act as a deterrent on US action.

Yet, with emotions ruling over logic, there is nonetheless the sense that escalation is becoming inevitable, regardless of this. In this respect, a material escalation on both sides would deliver a further upside to energy prices, compounding the inflationary shock already being felt across the global economy. On this basis, we think that this is an opportune moment to close long duration positions in developed rates markets.

In Europe, the latest ECB meeting was relatively dovish in tone, as Lagarde announced her well-flagged resignation from her role as Chair, setting up the race for her successor. Yet elsewhere, TTF gas futures have topped €100 in the past week, partly driven by supply fears in a tight market.

Speaking to commodity analysts, it appears that higher oil prices are sustaining demand for gas, from Asian buyers. With Europeans still needing to build stocks, there is a sense that further upside may be likely during the coming month. This move suggests that Eurozone inflation is now likely to test 4.5%, noting that CPI already stands at 3.8%. Consequently, it remains very likely that the ECB will need to hike in December and again in Q1, consistent with ensuring pricing stability.

Meanwhile, at least a moderation in French stress has offered some welcome relief over the past few days. As we had flagged last week, it looked like French OATs had become over-sold, at spread levels wide of Albania.

With Moody's retaining a Aa3 credit rating for France last Friday, so there has been some near-term respite in selling pressure. However, the structural issues in France remain unresolved and having added French risk at the widens, we are now inclined to reduce.

The UK Budget was largely a non-event, with Chancellor Healey at pains not to do anything that would upset financial markets. In many respects, it may be possible to view the Budget through the lens of a Prime Minister eager to call an election in the New Year.

Labour has been building a lead in the polls in recent weeks and with Burnham also thinking that a pro-EU campaign will also help win him votes, excitement among Party strategists is starting to build.

Reform has had a poor 2026 and with public trust in the Conservative Party only rebuilding slowly under Kemi Badenoch, so Burnham may well be tempted to go to the polls in Q1, before the worst of the inflation shock and subsequent interest rate shock start to kick in.

The Bank of England is expected to hike interest rates next week. Although we think that the BoE will retain a dovish bias, relative to other central banks, it seems certain that this will be the first in a number of interest rate increases, which are delivered over the months ahead. Ofgem energy bills are seen increasing by 38.6% by next April and in this light, it is hard not to think that UK CPI won't be above 5%.

In this respect, the relentless rise in gas price futures in the past week, are extremely unwelcome. The UK economy has actually performed better than we and many would have expected, since the start of this year. However, pain in the housing market is only building and there is a sense that there may be more bad news to digest ahead of us, than there is behind us. Moreover, it is hard to see inflation managing to begin to reverse its gains before the middle of the summer

The Bank of Japan kept rates unchanged at its policy meeting today, though retained its hiking bias, with markets widely projecting a hike to 1.5% in December. This should be delivered by Ueda, but thereafter progress may become stickier.

As the bank starts to approach its neutral rate, this could see it turning more cautious, rather than more assertive. A hike to 1.75% should nonetheless be delivered in June, but after that, the make-up of the Board is likely to turn more dovish, with two political appointees set to be announced by Prime Minister Takaichi.

Inflation in Japan is likely to rise less than elsewhere, due to falling rice prices, which weigh heavily in CPI and help offset the move up in energy prices. This may help reassure the bond market.

Yields may also take support thanks to building evidence of rising domestic demand for domestic fixed income, as recently evidenced in recent strong data for retail JGB participation.

However, Japanese markets will remain very sensitive to overseas developments, and so conviction with respect to a long duration stance is also diminished.

Events in emerging markets were dominated by last weekend's Brazilian elections and the surprise victory for Lula, at the expense of the market preferred candidate, Flavio Bolsonaro.

This election marked the first occasion when the winner in the first round of voting has subsequently failed to secure the Presidency, and this may speak to how effectively Lula and his party operatives were at rallying their base and deploying social media to their own advantage.

Brazilian assets have suffered a brutal re-pricing, with the currency declining 10%, before bouncing, and local rates rising by over 250bps. Clearly investors have been caught the wrong way around and stop loss pain is playing a material part in these moves.

That said, we think that Brazilian asset prices have been overshooting – particularly when we compare current levels to those which prevailed during the summer, at which time, Lula had been widely expected to win.

We would note that Lula represents continuity, rather than change, in Brazil, and from that perspective, there seems little reason why financial markets should not trade back to levels seen earlier this year.

Moreover, we are inclined to expect Lula will pick a fiscal conservative, such as Alckmin, as Finance Minister, and should this be confirmed, then there could be even more scope for a retracement rally.

In FX, the dollar has continued to edge stronger over the past week, though it continues to be striking how low volatility in FX remains, relative to moves in other asset classes. In credit, some stabilisation in AI has seen spreads narrowing, on the hope that recent hedge fund deleveraging has represented something of a market clearing event. European credit has also been helped by a calming of French fears, though has materially lagged the US in the recent rally.

More broadly speaking, we think that investor sentiment in AI-related credit may remain fragile. With no real sign of a slowdown in AI-related debt and equity issuance, this does speak to the market technical remaining challenged, knowing that investors will need to sell assets in order to make room for all of the pending supply that is coming their way.

That said, away from AI, a repricing of spreads means that there is more value in IG credit than has been the case for a number of months.

Looking ahead

Next week's focus will fall on the US mid-term elections and what then comes afterwards. We expect a bruising night for the Republican Party, with the Democrats set to take clear control in both chambers of Congress.

Speaking with activists, it seems clear that there will be a push to impeach Trump and although the Democrats will be well short of the numbers required, there is a building sense that some disillusioned Republicans may seek to shore up their own popularity by throwing their commander-in-chief under the bus.

This notion would have been unthinkable just a few weeks ago and it speaks to how low the President's approval ratings have sunk, that this is even a topic of conversation.

Yet, with Trump's approval rating now so low, he may stop trying to play to the crowd. He knows that the war in the Middle East is largely unpopular with voters, but there is a risk that the President feels an ideological duty to prevail over the great evil, which he perceives the Iranian regime to represent.

With few who are close to the President prepared to question his wisdom or interrogate his plans for action, this could set the scene for a possible policy error. Although it is hard to attach clear probabilities to military escalation, it certainly strikes us that a window for action in the coming month could well represent a 30%

risk, and therefore it is something investors may be compelled to factor into their thinking and positioning in global markets.

There is much more value in yields and spreads than was the case earlier this year, and we think that it would be inappropriate to express a view which is too bearish at this juncture. However, there have been a number of turning points in 2026.

In this respect, knowing when to have more risk and when to have less has been important in being able to add to positions during moments when we have seen market dislocations, and hopefully this is something we can be well prepared for in the weeks ahead, should this occur.

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