

Navigating a higher-for-longer world

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Higher sovereign bond yields have increased the income available to investors, but the additional yield further out the curve may not fully compensate for the risks of extending duration.

Persistent US inflation, resilient activity, and fiscal headwinds have led markets to price a higher path for policy rates. While rising prices, higher borrowing costs, and geopolitical uncertainty continue to create challenges, economic growth has remained surprisingly resilient. Together, sticky inflation and resilient economic growth point to the potential for further upward pressure on rates.

Given this, our view is that rates could continue their recent upward momentum in the near term. We therefore remain cautious on broad macro positioning, maintaining a neutral stance on duration and the yield curve while remaining underweight credit.

Resilience amid rising risks

In September, the Federal Reserve (the Fed) unanimously raised rates by 25 basis points (bp) to 3.75%–4.00%, its first hike since 2023.¹ The updated projections reinforced the shift with the median policy-rate forecast increasing to 4.1% for 2026 and 2027, up from 3.8% and 3.6% respectively, in June.² At the same time, the Fed raised its growth and inflation forecasts and lowered its unemployment projection, a combination that has pushed Treasury yields higher.

As we enter the final quarter of 2026, a key macro theme is rising tail risks, reflected in a broader range of potential economic outcomes. Sticky inflation, geopolitical tensions, energy market pressures, and an increasingly narrow set of market and economic drivers are all contributing to heightened uncertainty.

In an already complex environment, the outlook remains clouded. Both the economy and markets are becoming increasingly concentrated in the AI theme, accentuating tail risks should any cracks appear in that theme. We see no signs of cracks at this stage, but this is an area we are monitoring.

Still cautious on duration

With US markets pricing at least a further three 25 bp rate increases by mid-2027 and the 10-year/10-year forward rate at its highest level since the early 2000s, the case for adding duration may appear compelling. However, we remain cautious for the following reasons:

- Most of the rise in nominal yields is driven by real yields. Of the 100 bp rise in the US 10-year yield, the inflation breakeven is only around 10 bp wider from the start of the year. If inflation expectations were to become more embedded and breakevens widen, this could push nominal yields still higher.
- Rates may be closer to “normal”. Interest rates may appear elevated relative to the exceptionally low-rate environment of the past 15 years. However, viewed against the pre-GFC backdrop of 2% to 4% inflation, robust economic growth, and limited central bank intervention in bond markets, current yield levels appear far less extraordinary.
- Yield curves may not be as attractive as they appear. If we are entering a market regime more akin to the 2000s, it is notable that yield curves do not appear especially steep. A regression of the 2-year/10-

year Treasury spread against the 6-month Treasury bill rate suggests the curve is currently around 25 bp flatter than fair value relative to the 2000-2008 period.³ Should a higher term premium become embedded in markets, yields could face further upward pressure.⁴

- Investors have struggled to time the duration trade. The rise in long-term yields has undoubtedly improved the income available from sovereign bond markets. However, attractive yields alone do not eliminate the risks associated with longer-duration bonds. For instance, allocations to long-duration strategies failed to outperform with any consistency following the peak in central bank rates as curve steepening during the 2024-2025 easing cycle eroded returns from longer-dated bonds.

The key question for investors is not whether long-term yields appear attractive in absolute terms, but whether the additional yield available further out the curve adequately compensates for the additional duration risk (Figure 1).

Catalysts for lower yields

For the market to sustain a durable rally either oil needs to fall sharply, or it needs to become clear that higher oil prices are not meaningfully impacting the broader economy. A ceasefire with Iran could push oil prices lower but given recent history, the market is likely to remain sceptical that any deal will hold.

Given the strength of the US domestic economy, supported by the AI CAPEX build-out and high levels of government spending, it will take time before it is clear the degree to which higher energy prices will feed through into broader inflation.

What this means for investors

The rise in government bond yields is one of the most significant fixed income developments in recent years. Yet despite more attractive yields, we do not believe the case for extending duration has become materially more compelling. Elevated volatility, modest term premia, and a wider distribution of potential economic outcomes continue to argue for caution.

We believe rates could continue to move higher in the near term. As a result, we remain neutral on duration and yield-curve positioning and underweight credit. Rather than taking broad macro bets, we favor areas where investors are being compensated for taking specific risks, including housing-related exposure, non-agency residential mortgage credit, diversified asset-backed securities, and hard-asset-backed opportunities such as railcars, equipment finance, and small-business lending.

¹Bloomberg Finance L.P., as of September 16, 2026.

²Bloomberg Finance L.P., as of September 16, 2026.

³Based on a regression of weekly data from January 07, 2000 to December 26, 2008. $R^2 = 91.42\%$.

⁴Fiscal deficits and debt issuance remain important medium-term risks. While stronger productivity and nominal growth could eventually improve debt dynamics, continued fiscal borrowing and AI-related investment are adding upward pressure to rates today. The timing gap between current financing needs and future productivity gains remains a key risk to monitor.

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