

SARI Commentary: We are all oil traders now

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Renewed conflict in the Gulf pushed oil above US\$100 a barrel and drove a sharp rise in global bond yields. Although near-term volatility may persist, higher yields are creating increasingly attractive opportunities for long-term fixed income investors.

Market Review

Developed-market bond yields surged in September, reaching levels not seen in decades. Oil traded above US\$100 a barrel as hostilities resumed in the Persian Gulf, spread to the Red Sea and were compounded by Ukraine's targeting of Russian refineries. Shorter-duration bonds underperformed as markets priced the likely response of central banks to another energy supply shock.

US yields rose the most after the US Federal Reserve (Fed) tightened policy amid persistent inflation and solid economic growth. The Fed indicated that the policy stance may not yet be restrictive enough to return inflation to its 2% target. By month-end, markets had responded to this guidance by pricing a federal funds rate of close to 4.75% by July 2027, compared with the current target range of 3.75–4.00%.

The European Central Bank (ECB) raised its deposit rate by 25 basis points to 2.5%, its second increase in 2026. While the Fed appears to be responding to persistent inflation, the ECB is tightening pre-emptively to guard against the indirect and second-round effects of higher energy prices. The longer energy prices remain elevated, the greater the risk that they feed into broader inflation. Market pricing shifted towards further tightening, even as the ECB acknowledged that risks to growth remain tilted to the downside because higher energy costs weigh on real incomes, spending and investment, and may tighten credit conditions.

As outlined in our August commentary, "Lock it in Eddie", the Reserve Bank of Australia (RBA) raised the cash rate by 25 basis points to 4.6% at the end of September. The conditions for further tightening signalled at the August meeting were subsequently met as inflation surprised to the upside and remained well above the RBA's 2–3% target range. The decision was unanimous, although Governor Bullock's press conference adopted a relatively dovish tone. August inflation, released the following day, was marginally below market expectations but remained elevated. Markets continued to price a further increase in December, with some probability of another move by June 2027.

The Bank of Japan (BOJ) continued its gradual path towards monetary policy normalisation, raising its policy rate by 25 basis points to 1.25%. This was the sixth increase since the tightening cycle began in March 2024 at –0.10%. Even after the increase, financial conditions remain accommodative, with underlying inflation at the BOJ's 2% target. Officials framed the September move as a shift in the policy regime, citing upside inflation risks from the Middle East conflict, AI-related demand and the weaker yen's effect on import costs. Markets expect around three further increases, taking the policy rate to approximately 2% over the next year, with the risk of a faster pace or larger moves. The gradual withdrawal of accommodation has not prevented strong gains in Japanese risk assets: Japanese equities have led developed markets over the past year, while Tokyo house prices have risen by about 5% a year over the past five years.

Market Outlook

The path of the Gulf conflict remains highly uncertain, while bond yields continue to move closely with oil prices. This leaves bond investors weighing two broad scenarios.

Scenario 1: de-escalation. A resolution similar to June's memorandum of understanding would return oil below US\$80 a barrel and support bond prices, as central banks may not need to deliver all the rate increases currently priced by markets. In this scenario, current bond yields appear particularly attractive at shorter maturities, which are closely linked to policy rates.

Scenario 2: further escalation. Additional damage to pipelines, refineries or shipping could push oil well above US\$150 a barrel, particularly after six months of supply disruption have depleted inventories and strategic reserves. Central banks could then be forced to raise policy rates beyond current market pricing, pushing bond yields higher and generating near-term mark-to-market losses.

However, as the ECB noted in September, the combination of higher oil prices and higher interest rates materially tightens financial conditions and increases downside risks to growth and employment. Under the escalation scenario, weaker consumption and business activity would ultimately increase the likelihood that central banks reverse part of their tightening. Long-term bond investors should therefore look through short-term price volatility and consider adding duration selectively when energy-driven volatility pushes yields higher.

Three factors support this approach. First, markets already price substantial further tightening across the US, Europe and the UK through mid-2027, providing scope for bond gains if the conflict de-escalates. Second, oil flows from the Gulf have proved more resilient than expected. J.P. Morgan estimated that total regional oil exports had recovered to 89% of pre-war levels by the end of September; crude exports were at 98%, although refined-product exports remained materially weaker. This recovery could limit further upward pressure on oil prices. Third, investment-grade corporate yields are at multi-decade highs. For example, BBB+ rated US bank bonds with around four years to maturity yield approximately 6% when hedged to Australian dollars, providing a meaningful income buffer against a further rise in yields.

In our view, elevated starting yields provide a meaningful income cushion and improve the medium-term risk–return profile of investment grade bonds. We therefore expect to add duration selectively during periods of energy-driven yield volatility, while maintaining disciplined credit selection.

Portfolio changes

Heightened volatility across rates and credit created opportunities to increase the portfolio's prospective return. During the month, we extended duration as yields rose and added selectively to credit to capture higher all-in yields.

Rates. We added 0.5 years of duration during the month, taking total portfolio duration to 1.7 years at month-end. The largest increase was in Australia, where we added 0.25 years and shifted exposure towards shorter maturities as the yield curve flattened and short-dated bonds underperformed longer-dated bonds. As outlined in the August commentary, we expected three-year Australian Government bond yields to approach 5% as the anticipated RBA increase became fully priced. We began the month with a negative duration position in maturities below five years and added 0.5 years of duration in this segment as yields approached 5%. We also added 0.2 years of US two-year duration as oil prices rose earlier in the month. In the UK and Europe, we increased exposure to short-dated bonds as markets moved to price around four rate increases by both the ECB and the Bank of England. At month-end,

duration exposure was 0.3 years in each of the UK, Europe and the US, and 0.75 years in Australia, with a yield-curve steepening bias across each market.

Credit. We allocated 7.5% to a new short-duration US investment-grade strategy, funded primarily by reductions in Australian and European credit. We had not held a dedicated US investment-grade strategy for some time because spreads had been near historical lows. Heavy issuance from US technology companies subsequently pushed spreads wider and created more attractive opportunities. The strategy's all-in yield is above 6% when hedged to Australian dollars. Combined with low duration and diversification away from Australian credit, where we are more cautious on the growth outlook, this provides attractive return potential.

We also allocated 3.5% to global high yield towards month-end as spreads widened. All-in yields were close to 9% when hedged to Australian dollars, with duration of around three years, providing a substantial income buffer against further spread widening. This allocation was funded by reducing holdings of Australian bank subordinated debt.

Foreign currency. We maintained total net foreign-currency exposure at close to 4%. Following the BOJ's rate increase, we raised Japanese yen exposure to 1% and reduced euro exposure to 2%. We maintained short positions of 0.5% in both the British pound and Swiss franc, reduced aggregate emerging-market currency exposure to 1%, and increased US dollar exposure marginally.

Portfolio positioning. The portfolio yield ended the month at approximately 6.5%, its highest level in several years and around 2 percentage points above the RBA cash rate of 4.6%. We increased both duration and credit risk as government bond yields rose and credit spreads widened. In our view, current yields provide improved compensation for capital risk and near-term volatility, particularly in maturities below five years

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