Daily: Bond opportunities remain despite volatility

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Podcast:Signal over Noise: Positioning for the physical AI era, on Apple and Spotify. (6 mins)Video: The AI Show | NVIDIA's guidance and our upgrade of China hardware (4 mins)Video: Deep Dive | Position in gold and broad commodities (5 mins)

A sell-off in global bonds drove yields to new highs at the start of the week as renewed fighting in the Middle East pushed oil prices higher and weighed on investor sentiment. US President Donald Trump threatened further strikes against Iran after the Islamic Republic launched missiles at two US air bases in Jordan. Over the weekend, Washington said it had struck Iranian launchers that were deploying mines into the Strait of Hormuz.

The 10-year US Treasury yield rose to nearly 4.78%, the highest level since January 2025, while the 30-year yield stood at 5.27% at the time of writing. Long-dated German and French bond yields both reached their highest levels in 15 years, while the 10-year Japanese government bond yield briefly hit 3% for the first time in 30 years. Brent crude oil, meanwhile, has climbed above USD 92/bbl.

With no clear path to reopening the Strait after six months of war, inflation worries remain elevated. Uncertainty over the Federal Reserve’s policy outlook, fiscal concerns, and rising AI-related debt issuance have all kept bonds under pressure.

Yield volatility is likely to persist in the near term, and we have highlighted the structural factors that could keep long-dated bond yields elevated (read "Interest rates strategy: The long bond summer break(out)"). We now expect the 30-year and 10-year Treasury yields to end the year at 5% and 4.5%, respectively.

But we also believe yields on shorter-dated government bonds should decline in the coming months, and we maintain our preference for short- to intermediate-tenor quality bonds.

Energy flows through the Strait should recover over time. The situation in the Middle East remains fluid, with both Washington and Tehran signaling that they are prepared to respond to further attacks. But while oil prices are still elevated relative to pre-conflict levels, they should stay well below those associated with a meaningful shock to global growth, as efforts to reopen the Strait of Hormuz continue. Our base case remains that traffic through the waterway should recover gradually over time amid economic pressures on the US, Iran, and the Gulf countries.

Inflation should moderate further. A gradual resumption of oil supplies should reinforce the disinflationary trend evident in recent US data. In fact, while July’s overall core personal consumption expenditures (PCE) price index did not point to a significant slowing in inflation, the contribution from oil- and tariff-sensitive categories to the share of PCE components with elevated inflation has fallen by half over the past four months. We note that upcoming methodological revisions to the calculation of prices for digital goods and financial services could lower PCE inflation by 0.2 percentage points. Shelter inflation has also been running at a rate similar to or lower than its pre-pandemic pace, while slower wage growth should further support stable or lower inflation in wage-sensitive services.

The Fed has room to keep interest rates steady. We believe incoming data should allow the Fed to remain on hold for the remainder of this year. Although Fed officials have recently made hawkish comments about inflation risks, policymakers have also emphasized the US central bank's data-dependent approach. We expect market pricing for Fed rate hikes to recede as confidence in continued disinflation increases, allowing short-dated bond yields to decline.

So, we continue to see an attractive risk-return profile in the short- to intermediate-maturity segment of high-quality government and corporate bonds. Yields are likely to decline over the coming months, while their currently elevated levels provide a cushion against volatility and serve as an important driver of returns.

Source: https://www.ubs.com/global/en/wealthmanagement/insights/chief-investment-office/house-view/daily/2026/latest-01092026.html