Carsten: Weathering the shocks

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The most striking thing about this summer isn't the string of unprecedented shocks – it's that the global economy has barely flinched. But a new risk has emerged in recent days, and this one comes with a transmission channel attached: the bond market sell-off. Higher rates could be kryptonite for an economy that has so far looked suspiciously bulletproof

Several heatwaves and a long drought. A trade war between the US and Canada. Iranian-American negotiations that ran hot, then cold. A Strait of Hormuz that reopened, then closed again. And oil prices doing what oil prices do when all of the above happens at once.

The striking thing about this summer isn't this list. It's that the global economy barely flinched. Most leading indicators still point to continued, if subdued, growth for the rest of the year. Numbness, or a real disconnect between geopolitics and macroeconomics? Perhaps a bit of both. Supply chains have got better at routing around trouble, and headlines still move considerably faster than order books. But we should stop congratulating the patient before the tests come back. Because a new risk has emerged in recent days, and this one comes with a transmission channel attached: the bond market sell-off. Higher rates could be kryptonite for an economy that has so far looked suspiciously bulletproof.

The trigger, in my view, is not the admittedly worrying fiscal position of many developed economies. Weak public finances are not new, and there was no shortfall or newly discovered black hole to set anything off. What changed is the scenario markets are pricing: a Middle East conflict that has become an almost-forever war, oil prices high for longer, inflation pushed up, and central banks forced to hike harder.

The feedback loop is the dangerous part. Yields didn't rise because of sovereign woes – but rising yields draw attention back to sovereign weakness, and the story can quickly become self-fulfilling. Higher interest payments crowd out more useful spending, which makes the fiscal picture worse, which justifies the yields. Back in 2020, the US paid some 3% of GDP on interest; now it is closing in on 5% of GDP. France is moving from a good 1% of GDP to 3% of GDP, and even fiscally-sound Germany moves from 0.5% GDP to 1.5% GDP.

But don't be too alarmed. I think markets have got ahead of themselves. It's hard to imagine major central banks raising interest rates enough to push their economies into recession in response to what remains a textbook exogenous supply shock. As long as there are few knock-on effects from energy into the rest of the economy, why would they? This is what makes the idea of insurance rate hikes so appealing – central bankers dislike the phrase, but hiking modestly to stop energy prices doing wider damage still looks like the right instinct. Going harder would risk more than a slowdown. It would push governments into deeper trouble, and while central bankers are no champions of debt-fuelled growth, they are even more wary of triggering a sovereign debt crisis.

For too long, we treated shocks like heatwaves and droughts as weather events: temporary and seasonal. We should have recognised them for what they are: symptoms of a changing climate that is here to stay.

Financial markets are now grappling with a similar question: should higher policy rates and rising government debt be viewed as something cyclical or structural? In my view, higher policy rates, and central banks' efforts to contain energy-driven inflation, will ultimately prove cyclical. They are the weather. High government debt, by contrast, looks much more like the climate: a structural feature that could shape economies and markets for years to come. The important difference is that, unlike climate change, high government debt is not an inevitability. It remains a matter of policy choice.

Our key calls

• Energy: We have revised our oil and gas forecasts higher with little sign of a breakthrough between the US and Iran. European natural gas remains vulnerable into winter.

• Bond markets: It’s tough to see the pressure for higher long-end yields magically dissipate. We have an end-year forecast for the US 10-year of 4.90% and the risk is that we have to endure an overshoot before things structurally calm.

• United States: A hawkish speech by Fed Chair Kevin Warsh makes a September rate hike look probable. But we think that tepid job creation and cooling inflation mean this needn’t turn into a series of hikes.

• Eurozone: The stage is set for another rate hike this month but for now we think this will be the last.

• China: Given the soft start to the second half and signs that policy support will remain relatively modest, we’re trimming our 2026 GDP forecast slightly – to 4.6% YoY from 4.7%.

• UK: Contrary to market pricing, we think the combination of a fragile jobs market and cooling core inflation should help unlock Bank of England rate cuts in 2027.

• Japan: We expect a Bank of Japan rate hike in September and two follow up moves in January and April 2027.

• Central and Eastern Europe: Poland remains resilient despite energy and fiscal risks; Czech growth is firm and inflation contained, but the Czech National Bank remains vigilant; Hungary’s recovery may revive assets, while Romania still faces stagflation and political uncertainty.

• FX: In light of a more hawkish Fed outlook, we now expect the dollar to stay stronger for longer. We are dropping our year-end 2026 EUR/USD forecast to 1.16 from 1.18 and raising the USD/JPY profile to 160 from 158.

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