

Flash

Outlook update on policy rates and bond yields

Key Messages

1. Due to resilient economic growth, sustained high energy prices and high-interest rate volatility, we are adding one 25bp hike to our US Fed and ECB forecasts. We now see a BoE hike in November (previously December).
2. The recent surge in government bond yields has been driven by real yields via AI-related investment capital and upward revisions in the natural rate of interest, suggesting a "higher for longer" environment. Accordingly, we have raised our 12-month yield targets by 25bp for the US, Germany, and the UK. The new targets are 4.75%, 3% and 4.65%.
3. Given the renewed attractiveness of UK yields, we upgrade UK government bonds to Positive.

Pressure continues to build

The current economic environment is characterised by significant inflation uncertainty and interest rate volatility, driven by robust economic data, growth tailwinds from AI, and rising energy prices. This landscape has pushed central banks towards a more hawkish stance. Consequently, we are revising our outlook to include an additional 25bp rate hike for both the Fed and the ECB. We do, however, anticipate fewer hikes than currently priced in by the markets.

Federal Reserve Bank

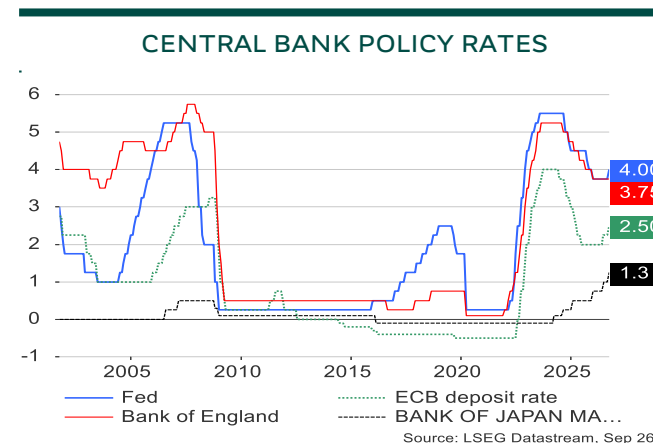
During the September meeting, Kevin Warsh acknowledged that policy was too loose, and inflation remained too high. This was probably intended to signal to the markets that the concerns driving the rise in long-term Treasury yields had been noted. As oil prices and bond yields have continued to climb in recent days, we have decided to add one rate hike to our forecast. We now expect the FOMC to raise rates in December and January, thereby unwinding the 2025 "insurance cuts" and returning the real policy stance to a roughly neutral level. In our base-case scenario, the FOMC would hike just enough to maintain a stable unemployment rate before pausing. We believe the markets' expectation of nearly four additional hikes over the next year is exaggerated.

European Central Bank

The underlying tone of the ECB's September communication reinforces our view that the tightening cycle is not yet over. We now forecast an additional hike in December, followed by an extended hold in mildly restrictive territory throughout 2027. While the economy continues to be resilient, both headline CPI and core CPI inflation remain above target (at 3.2% and 2.4% respectively). Although there are no clear signs of the second-round effects suggested by ECB wage data, continued pressure on oil and gas prices, partially due to refinery issues, indicates a shift toward the ECB's adverse scenario. Market expectations mirror those for the US and appear even more aggressive.

Central Banks	Previous 12-month target	New 12-month target	Market 12-month expectations*
Fed	4.25	4.50	4.80
ECB	2.50	2.75	3.37
BoE	3.75	3.75	4.78
Bank of Japan	1.75	1.75	3.05

* Source: Bloomberg



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We do not anticipate any material relief in energy prices before the November meeting. The Bank of England's September meeting reinforced our conviction that the MPC will deliver a single 25bp "insurance" hike to 4.00% on 5 November. The Monetary Policy Committee revised its projections upward for GDP growth (Q3 2026 to 0.4% from 0.1%) and inflation (Q1 2027 to slightly above 4%). Furthermore, it toned down the pessimistic language regarding the UK economy and labour market that characterised previous decisions.

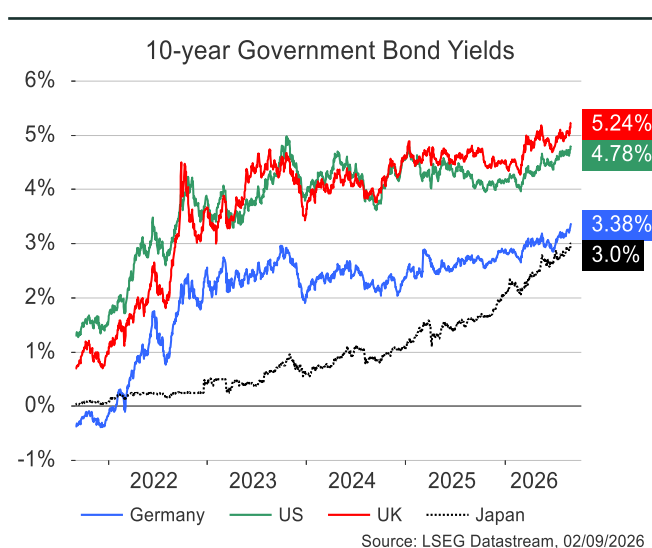
Regarding the BoJ, we maintain our view that it will raise its policy rate at a quarterly pace over the forecast horizon, with expected hikes to 1.5% in December 2026 and 1.75% in March 2027. However, should inflation risks escalate due to Middle East tensions, AI-driven demand, or FX shifts, we see further upside potential. We forecast a terminal rate of 2.5% in 2028.

Higher bond yield targets

US yields have sold off aggressively across the curve since mid-summer, with the 10-year yield rising by nearly 80bp. This trend has accelerated particularly over the last few weeks. The resilience of growth was further confirmed by a stronger-than-expected preliminary September Composite PMI index. Meanwhile, oil and gas prices have risen again, accompanied by reports that the US administration is considering a 90-day diesel export ban. The primary driver of US yields remains the real yield, likely reflecting expectations of increased capital demand in the coming years. A higher term premium, growing deficits and debt have likely also contributed. Breakeven inflation remains stable, hovering at around 2.25%.

The term premium has retraced from its late-August peak. While we maintain that US yields are overshooting their fair value, we have increased our 12-month target from 4.50% to 4.75%. Given the Fed's hiking cycle and no imminent cuts expected, investors should remain cautious and patient. A further market push towards 5.50% would offer a more attractive entry point. Indeed, we have some doubts about the latest revisions of the natural rate of interest linked to AI. In the eurozone, the 10-year German government bond yield has also risen significantly, with a move which is similar in magnitude to that of the US since early July. This trend is driven by the same fundamental factors as in the US, namely debt and deficit dynamics. Consequently, we are raising our 12-month target from 2.75% to 3%, though we see limited further upside from current levels. We remain Positive on core eurozone government bonds. A similar pattern has emerged in the UK, where we are raising our 12-month target from 4.4% to 4.65%. Although current levels are above our long-term fair value estimates, we are increasingly confident that the government will take the necessary steps to stabilise debt dynamics. Accordingly, we upgrade UK Gilts to Positive.

BOND YIELDS



Our Investment Recommendations

Asset class	Zone	Our opinion	
Government bonds	Germany and core eurozone	+	We are Positive on core Eurozone govies. Yields rose again well above our targets, and the expected return remains attractive. We favour maturities of 7-10 years.
	Non-core Peripheral countries	=	Neutral on non-core peripheral debt (Portugal, Italy, Spain, Greece).
	United Kingdom	+	Positive on UK government bonds.
	United States	=	We are Neutral and prefer 2-5 years maturities. Neutral on TIPS.
Corporate bonds Investment Grade (IG)	Eurozone	+	- Positive on the eurozone. We are Neutral on US and UK corporate bonds. - We prefer maturities up to 7 years in the eurozone and up to 5 years in the US. - Neutral on convertible bonds.
	UK/United States	=	
Corporate bonds High Yield (HY)	Eurozone and United States	=	- Neutral on corporate HY bonds. - Neutral on fallen angels and rising stars.
Emerging bonds	In hard currency	=	Neutral on EM hard currency bonds (sovereign and corporate).
	In local currency	=	Neutral on EM local currency government bonds to Neutral.

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