CAIM CROWN AGENTS INVESTMENT MANAGEMENT

Capital Markets Monthly
FIXED INCOME

August 2026

CHARLES THOMSON
Head of Portfolio Management

charles.thomson@caiml.com

The Iranian conflict continues to be the main driver of bond yields

US Treasuries weakened over July, with yields rising across the curve as investors priced in firmer inflation risks and a more hawkish Federal Reserve. Longer-dated yields underperformed, resulting in a steeper yield curve, reflecting concerns that higher oil prices following the resumption of military action in Iran could feed through to inflation expectations. The front end also remained under sustained pressure, with the 2-year Treasury yield rising for a fifth consecutive month, increasing by around 92 basis points since the end of February (from 3.37% to 4.29%), underscoring the market's reassessment of the likely path for US monetary policy. Against this backdrop, markets increased expectations for further policy tightening, extending the sell-off in government bonds. Following the July 29 FOMC meeting, Chair Kevin Warsh maintained a hawkish tone, stressing that the Federal Reserve's inflation target remains 2% and has not shifted higher. He emphasised that policy would remain data dependent and that the FOMC stands ready to raise rates if inflation proves persistent. The message reinforced the Committee's commitment to restoring inflation to target.

UK Gilts also came under pressure during July, with the yield curve steepening as 30-year gilt yields rose by around 30 basis points over the month. At its 30 July meeting, the Bank of England's Monetary Policy Committee maintained a cautious stance, although the voting split shifted to 6–3, with Catherine Mann joining the hawks in favour of tighter policy, highlighting continued concern over underlying inflationary pressures. While UK CPI inflation eased from 2.8% to 2.6%, this improvement is likely to prove temporary, with a renewed acceleration later this year appearing all but inevitable as energy base effects reverse. Markets nevertheless interpreted the Bank's communication as marginally less hawkish, leading to a substantial decline in the implied probability of a September rate hike. Politically, the appointment of Burnham as Prime Minister was broadly well received by markets, with the decision to appoint Healey, rather than Ed Miliband, as Chancellor viewed as supportive of fiscal credibility and therefore relatively constructive for the gilt market going forward.

European government bonds also weakened during July, with German Bund yields moving higher across the curve. The 2-year Bund yield rose by around 30 basis points, reflecting a marked reassessment of the ECB policy outlook, with markets now assigning a very high probability to a further rate increase at the Governing Council's 10 September meeting. Although the latest euro area headline inflation reading surprised modestly to the downside, the improvement is likely to prove transitory, with energy base effects expected to push inflation higher later this year. Political risk remained an important differentiator within the region, with the 5-year French government bond spread over Germany holding at an elevated 50 basis points—wider than both Italy and Greece—highlighting persistent investor concerns over France's fiscal outlook. Meanwhile, peripheral spreads were generally well contained, reflecting continued confidence that the ECB's policy framework remains effective in limiting broader fragmentation risks across the euro area.

Japanese government bonds continued to weaken during July as investors priced in further monetary policy normalisation by the Bank of Japan. The 5-year JGB yield briefly reached 2.05% on 24 July, its highest level since the 1990s, underscoring the scale of the repricing in the Japanese rates market. We increasingly expect the BoJ to deliver a further 25 basis point rate increase before year-end, supported by persistent inflation and stronger wage growth. The Japanese yen was also highly volatile in July, strengthening to around JPY 157 per US dollar at month-end from a low near JPY 164. The move fuelled market speculation that Japanese authorities may have intervened in the foreign exchange market, following reports of official rate checks—often viewed as a precursor to intervention—and comments from US Treasury Secretary Scott Bessent that the yen appeared very undervalued. While higher domestic yields are improving the relative attractiveness of JGBs for Japanese investors, we remain cautious on the asset class given the prospect of further policy tightening and continued upward pressure on longer-dated yields.

Chinese government bond yields were broadly unchanged during July as markets balanced subdued inflation against a still-challenging economic backdrop. While growth indicators remained mixed, stable government bond yields reflected expectations that the authorities would continue to provide targeted policy support while avoiding large-scale monetary easing.

In foreign exchange markets, the renminbi strengthened modestly over the month, with the USD/CNY exchange rate falling from 6.79 to 6.75, supported primarily by a softer US dollar and improving sentiment towards Chinese financial markets.

Emerging market debt weakened during July, with the JPMorgan EMBI Global Index returning -1.5%, reflecting the broader sell-off in global government bond markets. Credit spreads also moved modestly wider, with the JPMorgan EMBI Global spread increasing from 217 basis points to 227 basis points. Despite this widening, spreads remain broadly unchanged on a year-to-date basis, suggesting that the weakness in July was driven primarily by higher underlying US Treasury yields rather than a material deterioration in emerging market credit fundamentals. While valuations remain relatively full by historical standards, carry continues to provide an important source of return for investors.

The following chart shows the yield on 5-year Japanese Government bonds and the JPY exchange rate.

5-Year Japanese Government bonds and the JPY exchange rate

Source: Bloomberg Finance L.P., 31 July 2026.

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CAIM | CROWN AGENTS INVESTMENT MANAGEMENT

3 More London Riverside, London, SE1 2AQ, United Kingdom

+44 (0)20 7489 7223

www.caiml.co.uk | CAIMinsights@caiml.com