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More Hawkish Federal Reserve Keeps Upward Pressure on Bond Yields

US Treasuries delivered weak returns in August as a sharp late-month sell-off overwhelmed earlier gains. Yields initially declined on the back of softer economic data, including weaker-than-expected employment indicators and a modest easing in CPI inflation, reinforcing expectations that policy rates had likely peaked. However, sentiment reversed abruptly in the final days of the month, with yields rising across the curve as investors reassessed the outlook for monetary policy following a hawkish Jackson Hole speech from Federal Reserve Chair Kevin Warsh. In his first appearance at the symposium as Chair, Warsh argued that while the labour market remains consistent with full employment, inflation is still running above the Fed's 2% target and there is insufficient evidence that underlying price pressures are easing at the required pace. He reaffirmed the Fed's commitment to restoring price stability, warned that further policy tightening could be necessary if progress on inflation stalls, and notably declined to provide forward guidance on future rate decisions. While Warsh also highlighted the transformative potential of artificial intelligence to boost productivity and long-term growth, markets focused on his higher-for-longer policy stance, driving yields higher despite the softer macroeconomic backdrop.

UK Gilts delivered modestly positive returns in August, although performance remained below the level of coupon income as higher yields weighed on capital returns. Markets were increasingly focused on the UK's inflation outlook, with headline CPI accelerating from 2.6% to 2.9% and core inflation remaining stubbornly elevated at 2.6%, highlighting the persistence of underlying price pressures. A key risk for the months ahead is the sharp rise in global LNG prices, to which the UK remains particularly exposed given its reliance on imported gas. Sustained increases in energy costs could feed through to both household bills and broader inflation, potentially reversing recent progress on disinflation. Against this, the domestic growth outlook remains subdued, which is likely to limit the Bank of England's willingness to tighten policy in the near term. As a result, we expect no change in the Bank Rate at the September MPC meeting. However, should inflation continue to rise, particularly as a result of higher energy prices, the Bank may face renewed pressure to resume tightening during the fourth quarter despite the weak economic backdrop.

European sovereign bond markets have increasingly differentiated between Italy and France as their fiscal positions have moved in opposite directions. Italy's debt-to-GDP ratio has declined from 154% in 2020 to 139%, supported by a primary budget surplus and a substantial reduction in the fiscal deficit under Prime Minister Giorgia Meloni's government. This improvement in fiscal metrics has been accompanied by greater market confidence in Italy's policy framework and debt sustainability. By contrast, France's debt burden has continued to rise, while its budget deficit remains above 5% of GDP, drawing greater attention to the country's fiscal outlook. Political fragmentation, repeated budget stand-offs and the approaching presidential election may complicate efforts to deliver meaningful fiscal consolidation, particularly given resistance to spending restraint and welfare reforms. We expect the ECB to hike the target rate from 2.25% to 2.5% at the upcoming meeting on 10th September.

Japanese Government Bonds continue to present an attractive opportunity (for longer-dated issues) despite the prospect of further policy normalisation by the Bank of Japan. The Japanese yen remains materially undervalued on most long-term measures, providing a potential source of additional return for unhedged international investors should the currency strengthen from current levels. At the same time, the JGB yield curve remains exceptionally steep by historical standards, offering meaningful compensation for extending duration. Long-dated Japanese government bonds now provide some of the highest nominal yields available in Japan for more than a decade, creating an attractive entry point for investors seeking high-quality sovereign exposure. While inflation has become more entrenched and wage growth has improved, much of the expected policy tightening appears already reflected in market pricing. We expect the Bank of Japan to deliver a further rate hike at its meeting on 18 September, continuing its gradual transition away from ultra-accommodative monetary policy. However, the combination of an undervalued currency, elevated long-end yields and a steep yield curve provides a compelling foundation for long-term returns. In our view, these factors more than compensate for the risk of modest additional policy tightening and support a constructive outlook for long-dated JGBs.

Chinese government bonds delivered a largely stable performance during July, with yields remaining broadly unchanged as subdued inflation pressures were offset by a still-challenging economic backdrop. While economic growth indicators continued to provide a mixed picture, bond markets appeared to take comfort from expectations that policymakers would maintain targeted fiscal and monetary support measures while refraining from large-scale stimulus. Inflation remained muted, reinforcing the view that monetary policy is likely to remain accommodative for an extended period. In currency markets, the renminbi strengthened modestly against the US dollar, with USD/CNY declining from 6.75 to 6.71 during the month. The move was driven primarily by broad-based US dollar weakness and a modest improvement in sentiment towards Chinese financial assets, reflecting expectations that policy support and gradual economic stabilisation will help underpin market confidence.

Emerging market debt delivered a relatively strong performance during August, with the JPMorgan EMBI Global Index returning +0.9%. Credit spreads also continued to tighten, with the JPMorgan EMBI Global spread narrowing from 227 basis points to 217 basis points, reflecting resilient investor demand for emerging market credit and a stable fundamental backdrop. The combination of spread compression and carry more than offset the impact of modest moves in underlying US Treasury yields, resulting in positive total returns across the asset class. While valuations remain relatively full by historical standards, the tightening in spreads suggests that markets remain comfortable with the macroeconomic and credit outlook for emerging market sovereign issuers. Carry continues to provide an important source of return, particularly in an environment where many emerging market economies have already made substantial progress in bringing inflation under control and maintaining fiscal discipline.

The following chart shows the yield on 5-year UK Gilts and UK Natural Gas Futures:

5-Year UK Gilts and UK Natural Gas Futures

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

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