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Too Many Bonds, Too Few Loyal Buyers

KEY TAKEAWAYS

- The long end will stay under pressure: Rising supply meets increasingly price-sensitive buyers, requiring higher term premia and keeping long-end yields volatile.
- Stay short in USD and EUR: Long bonds poorly compensate for rising term-premium risk. Short maturities deliver most of the yield for a fraction of the duration, and we favour 3–4 years.
- Moderate CHF duration is a measured exception: Low inflation, limited issuance and strong domestic demand keep CHF term premia contained. With near-zero short-end carry, we favour moderate duration.
- Credit is a carry story: Spreads are near two-decade tights, and rising AI-related supply limits room for further compression. We favour subordinated debt from top-tier issuers with near-term calls.

RATES & STRUCTURAL PRESSURES

Developed-market government bonds have remained under pressure into the autumn, with the sell-off extending across the entire yield curve. The short end took its cue from central banks, which have moved into an increasingly synchronised tightening cycle as an energy-price shock pushed inflation projections higher and forced policymakers to act. With the ECB and the BoJ already firmly in hiking mode, the Fed followed suit in mid-September with its first rate rise since 2023, bearing out the tightening risk we flagged in our September Strategy Update. The decision was unanimous and the communication clearly hawkish. The dot plot (individual FOMC participants' rate projections) points to at least one more hike this year, while markets are pricing further increases well into 2027, as they are for the ECB, the BoE and the BoJ. As the tightening cycle gains momentum, front-end yields across developed markets have moved higher, pushing 2-year yields to or near multi-year highs.

The long end of developed-market curves remained under pressure from a widening term premium, the compensation investors demand for holding long-dated bonds rather than rolling

over short-dated ones. In September, the 10-year Treasury yield broke through 5% for the first time since 2007 (5.15% at the time of writing); the 10-year Bund yield rose to its highest level since 2011 (3.59%); the 10-year JGB yield climbed above 3% for the first time since 1996 (3.07%); and the 10-year Gilt yield hit a post-2008 high (5.34%). We expect the long end to remain volatile, with a persistent upward bias in yields. Uncertainty over inflation, monetary and fiscal policy argues for a higher term premium, but the bigger driver, in our view, is a structural shift in supply and demand across bond markets, as governments and corporates compete for capital:

On the supply side, two forces are flooding bond markets with new issuance: persistently wide government deficits and the AI investment boom. Drawing on OECD and investment-bank estimates, we expect the stock of OECD government bonds to grow by 6–7% in 2026 at constant exchange rates, well above the pre-pandemic pace of around 4%. Rising yields compound the problem: higher interest costs widen deficits, larger deficits mean more issuance, and more issuance pushes yields even higher. Short-term funding, which governments have increasingly relied on to avoid locking in higher term premia, accelerates this vicious cycle, as higher rates feed through to interest costs more quickly. In the US, for example, nearly a quarter of marketable debt is now in T-bills. Corporate bonds add a second wave of supply. New issuance is concentrated in USD investment grade, where net supply is on track for around USD 1 trillion this year, 35–40% above 2025, with AI-related issuers accounting for about a quarter. Much of this paper is long-dated, stacking corporate duration on top of sovereign duration. Globally, we expect the corporate bond stock to grow by 4–6% this year, and with AI capex still ramping up, 2027 is unlikely to bring relief.

On the demand side, government bond demand is shifting from price-insensitive to price-sensitive buyers. In the US, the euro area and Japan, central banks' share of domestic government bonds fell from a peak of 30% in 2021 to 20% in 2025, while price-sensitive investors, such as asset managers, now hold more than half of the outstanding stock (OECD Global Debt Report 2026). In US Treasuries, the world's benchmark rates market, the retreat of price-insensitive demand extends beyond the Fed: foreign official investors held around 40% of Treasuries during the financial crisis, but only 13% by July 2026 (TIC). Hedge funds have increasingly filled the gap. A Federal Reserve study estimates that Cayman Islands-domiciled hedge funds absorbed up to 37% of net note and bond issuance in 2022–24, nearly as much as all other foreign investors combined. Unlike central banks, hedge funds buy only when the trade pays: their demand depends on the cash-futures basis and cheap repo funding. They also hedge away the duration risk, passing it to futures buyers such as asset managers, who demand to be paid for holding it. And because the trade is highly leveraged, it can unwind abruptly under stress, as in the “Dash for Cash” in March 2020. Two developments could further weaken foreign demand. First, if confidence in US institutions continues to erode, foreign central banks could step up the diversification of their reserves into gold and other reserve currencies. Second, Japan, the largest foreign holder of Treasuries in the official statistics, now has a credible domestic alternative: with the 10-year JGB yielding above 3%, FX-hedged Treasuries yield considerably less for Japanese investors, raising the prospect of large-scale repatriation by life insurers and other private investors. Japanese holdings have already fallen by some USD 135 billion since February, though part of this likely reflects yen-support intervention.

DURATION & SWISS FRANC BONDS

In sum, a rising supply of duration is meeting an increasingly price-sensitive and fickle investor base. Absorbing it will require higher term premia, particularly at the long end, where structural demand has weakened. Long-duration bonds therefore offer an unattractive risk-return profile: in USD and EUR, extending from three to ten years adds only 20–30 basis points of yield for roughly

three times the duration – poor compensation given persistent upward pressure on term premia. Short-dated bonds, by contrast, offer attractive carry with limited duration risk. Following the recent repricing, we see particularly good value in the three- to four-year segment in USD and EUR.

Switzerland remains the exception. Structurally low inflation, limited net issuance under the debt brake and strong domestic demand from pension funds and insurers should keep CHF term premia contained, though not immune to global spillovers. With short-end carry close to zero, the rationale for staying short that applies in USD and EUR largely falls away. Moreover, CHF duration offers an asymmetric payoff: limited downside in a global bond sell-off, and support from safe-haven inflows in a risk-off episode. We therefore favour moderate duration in CHF.

CREDIT MARKETS

Corporate bond spreads widened in Q1 but have since retraced to levels close to their tightest in two decades, supported by resilient fundamentals and all-in yields that continue to attract robust inflows. There are, however, early signs that demand is becoming more selective: spreads of AI-related issuers have widened relative to similarly rated peers in other sectors as supply has accelerated. With AI-related issuance set to rise further and unlikely to peak before 2027–28, we see an asymmetric outlook for credit spreads: limited room for further tightening, but a meaningful risk of a supply-driven repricing. Against this backdrop, we expect carry, rather than spread compression, to drive credit returns over the coming months. We seek to enhance carry selectively through subordinated debt from high-quality issuers with near-term first calls. Their short spread duration means the additional yield provides a substantial cushion against spread widening, and in recent quarters these instruments have been no more volatile than senior bonds of comparable maturity, reflecting a robust bid for these securities.

PORTFOLIO IMPLICATIONS

- **Hybrid Credit:** European bank AT1s remain attractive even though spreads trade close to historic tight. Current valuations understate the sector's post-GFC balance-sheet repair and the broad ratings upgrades that followed. Nearly half of the USD 270bn AT1 market is now rated investment grade, yet these bonds still offer roughly 100bp over similarly rated corporates. The premium is largely technical: AT1s are excluded from the major aggregate bond indices and have no structural buyer base. Supply dynamics are supportive. Most upcoming calls are already pre-funded, and net new issuance should stay limited. If regulators revise the AT1 framework, outstanding instruments would most likely be grandfathered, which would add scarcity value.

Non-financial corporate hybrids carry less structural risk than AT1s and correspondingly yield slightly less. They have no regulatory triggers and no mandatory coupon cancellation. Instead, investors take subordination risk, optional coupon deferral risk and extension risk, meaning the issuer may choose not to call at the first date. Extension risk is mitigated in practice by three factors: the strong market convention of calling at first call, the potential loss of 50% equity credit after that date, and the step-up and reset mechanics.

We seek to limit drawdown risk in a spread correction by confining subordinated exposure to top-tier issuers, primarily G-SIBs on the financial side, and to instruments with near-term first-call dates where the issuer has strong economic incentives to call. Security selection should also take account of secondary-market liquidity, credit quality and extension risk.

- **Inflation-Indexed Government Bonds:** US Treasury Inflation-Protected Securities (TIPS), for instance, offer an attractively priced hedge against upside inflation surprises in the near term. The case rests on two pillars. First, 2-year breakevens look cheap at around 2.4%, below headline CPI inflation of 3.4% and merely in line with core inflation, implying that markets expect the energy shock to fade quickly. Second, 2yr TIPS offer a real yield of around 2.4%, close to its highest since before the financial crisis, so investors are paid to hold the hedge rather than having to give up carry for it. For targeted exposure to short-term upside inflation surprises, we implement this view through low-cost ETFs focused on short-dated US TIPS, providing a cost-efficient way to position for higher-than-expected inflation in the near term.
- **Renminbi Bonds:** Within EM, we maintain a strong preference for renminbi bonds of the highest quality. The IMF's 2026 External Sector Report estimates its real effective exchange rate to be undervalued by roughly 21% (range: 17–25%), and estimates that correct for China's likely understated current account surplus put the gap closer to 30%. The catch is timing: Beijing is slowing the renminbi's appreciation, so the gap will close only gradually. This is a medium-term position, not a tactical trade.

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GENERAL CONTACT · Acumentum AG · Stadthausquai 1 · 8001 Zurich · Switzerland