

CIO OUTLOOK

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Resilience Under Pressure: Who Absorbs the Higher Real Rate?

The US economy has stayed resilient, but that resilience is concentrated: AI-related investment and households insulated by fixed-rate debt and asset gains continue to sustain demand, while leveraged borrowers and rate-sensitive sectors absorb the rise in real rates. With cost pressures broadening beyond energy, we view the Fed's September hike as the start of a tightening cycle rather than a one-off adjustment, with no predetermined endpoint. Geopolitics, diverging central bank paths and political risk in the US and Europe add to an already complex backdrop.

Key Takeaways

- **Resilience is uneven:** AI capex and insulated consumers keep demand firm while leveraged borrowers absorb higher real rates.
- **No set Fed endpoint:** September's hike likely starts a broader cycle, and December is not a natural stop.
- **Three drivers of real yields:** Fed restraint, a higher r^* and rising term premia each call for different curve and cross-asset positioning.
- **Positioning stays tactical:** We ran smaller curve exposures in Q3 and will keep leaning into trades or stepping aside as pricing shifts.

The US economy remained more resilient than we had expected in spring, which we discussed in [our last Outlook in July](#), supported by strong household spending and AI-related investments. We argued then that a September hike was a possibility, but that one meeting under the new Fed Chair was not enough to establish a durable regime.

Q3 moved that discussion forward. The Fed delivered its first increase, energy disruption remained a constraint rather than a resolved episode, and real funding costs for the economy rose further. The question entering Q4 is how much adjustment is required, how long it persists, and which parts of the economy can absorb it.

While most economists expect continued resilience of economic activity in the US, we note that the rise in real rates has created cracks in markets that are worth watching, particularly widening distressed credit spreads and growing pressure on leveraged borrowers. These may be early indications of where higher marginal funding costs are beginning to bind.

The economic resilience is uneven as activities sustaining aggregate demand are not those most exposed to the marginal increase in funding costs. Their strength can allow policy to firm while the burden of higher interest rates becomes increasingly concentrated elsewhere. As long as technology-related investment and less rate-sensitive consumers sustain aggregate demand, monetary policy may remain tighter than more leveraged households, businesses and financial structures can comfortably absorb.

How much tension the economy must endure depends not only on the capital hunger of the AI buildout but also on the geopolitical landscape. The wars in the Middle East and Ukraine, as well as the midterm elections in the US, add to what has become a highly complex backdrop for macro trading.

From Energy Shock to Persistent Cost Pressure

In our [Q3 Outlook](#), we made the distinction between oil in transit and accessible physical buffers which remains relevant to our investment framework. A pause in hostilities (even with significantly increased oil flow through Hormuz) is not the same as a durable restoration of energy supply. It also does not necessarily resolve shortages of refined products or insurance costs of trade. We continue to separate the immediate price response to headlines from the duration of the underlying disruption.

During a recent visit to the Middle East, I heard a recurring concern among the investors I met: the US may underestimate Iran's resilience and determination, and a military escalation, especially involving ground troops, could prove costly without delivering a durable resolution. The correlation between oil and global rates remained high until recently and, based on my conversations, the market's optimism that Iran will soon be forced to give in to the US's demands is not shared in the impacted region. An escalation would be another hit for the local economies and, especially for the GCC economies, threaten the push to diversify away from carbon energy into tourism, finance and commerce. In turn, this could delay the region's substantial investment commitments to the US, as resources would be shifted to support the local economy and national defense. The region is a major investor in public and private US growth companies of all stages.

Inflation is, however, no longer solely an energy impulse. Our Macroeconomics team points to rising non-fuel import costs and renewed price pressure in business surveys alongside resilient consumer demand, which permits more of the cost increases to reach final prices. The risk is therefore not simply that another energy shock temporarily raises headline inflation, but that repeated supply and cost shocks encounter enough demand for firms to pass them through rather than absorb them in margins. Repeated cost shocks become harder to dismiss when spending remains firm.

Energy-intensive activities may experience demand destruction in Q4. This could also hit lower-income households and economies that are more exposed to imported energy. By itself, this may not push the US

into a recession. Developments in the Gulf and attacks on the energy infrastructure in Russia/Ukraine will determine the outlook for physical supply and refined-product availability in Q4.

The Fed: Uncertain Endpoint

On September 16 the Fed increased the target range for the Fed funds rate to 3.75%-4.00%. The 25bps increase was described as removing “a dose of accommodation”, an indication that the Fed did not regard financial conditions as meaningfully restrictive. We believe that the Committee is reassessing the required restraint, not just correcting a past decision by reversing previous cuts.

The Fed’s September projections also changed the balance of risks. No participant assessed growth or employment risks as skewed to the downside, while 17 of 18 saw upside risk in headline inflation. Our economists continue to expect further hikes, conditional on economic data holding up, and view September as the start of a broader tightening cycle rather than a one-off adjustment. December, therefore, should not be treated as a natural endpoint simply because three hikes would reverse last year’s three insurance cuts. Equally, a higher endpoint should not be inferred from historical precedent alone. Policy will depend on whether underlying inflation slows, demand broadens or weakens, and financial conditions tighten or ease. Importantly, weakness in the most rate-sensitive parts of the economy may not be sufficient to stop the tightening cycle if aggregate demand remains supported elsewhere.

The Fed Chair’s recent communication changes have improved the market’s ability to understand his thinking. Less forward guidance does not necessarily mean persistently higher realized interest rate volatility. Uncertainty about the policy path is different from uncertainty about the objective. A credible commitment to price stability can coexist with a less explicit path of future decisions. The coming quarters will show what the actual impact on market volatility from less forward guidance will be. The working-group reviews that the Chair initiated could be a potential source of further institutional change. The distinction between ordinary repricing and genuine market dysfunction is equally important when we think about the Fed’s new reaction function. A less interventionist Fed must distinguish between losses that are the necessary consequence of price discovery and market dysfunction that threatens the transmission of monetary policy.

Concentrated Resilience and Uneven Adjustment

In the third quarter, the S&P 500 gained approximately 2% on a price basis while real rates measured by 10-year TIPS yields increased by about 69bps. Strong earnings for the market in general and an expected rise in cash flows for long-duration growth stocks allowed equities to shake off the headwind from rates. This resilience does not mean that higher real rates are economically benign. Rather, it suggests that the sectors currently driving earnings and investment have so far been able to absorb the increase in discount rates better than more leveraged and interest-rate-sensitive parts of the economy.

Tech companies with substantial internal cash generation and high margins are generally less sensitive to modest increases in short-term interest rates. Households protected by existing fixed-rate debt, higher income from their investment portfolios and appreciation on their equity holdings can remain largely insulated from higher interest rates and maintain spending growth. Households without stock market

investments or savings, particularly those looking to finance purchases such as homes or cars, are more vulnerable to higher interest rates. Sectors facing tighter margins and refinancing needs are also exposed, but weakness in these areas may not weigh on overall growth enough to alter the Fed's course. Monetary policy is set for the aggregate economy, even though exposure to interest rates is always uneven. Strength among less rate-sensitive households and sectors can keep aggregate demand firm enough to require higher rates, even as those rates place increasing strain on more exposed parts of the economy. This creates the risk that monetary restraint has to become increasingly severe for the marginal borrower before it becomes sufficiently restrictive for the aggregate economy.

Even the AI capex cycle is not immune to credit market saturation and stress. As the buildout becomes more dependent on external capital, higher real rates raise the hurdle rate that future productivity gains must clear. Credit downgrades or tighter financing conditions could be one catalyst that turns the narrative, and a different regulatory environment following the midterm elections could be another.

What Real Rate Repricing Tells Us

Nominal yields and quoted TIPS real yields rose in Q3, while inflation breakevens ended only modestly higher; the sell-off in bonds was predominantly driven by real-yield repricing:

Market measure	30 Jun 2026	30 Sep 2026	Q3 change
US 2-year nominal yield	4.17%	4.89%	+72bps
US 10-year nominal yield	4.47%	5.28%	+81bps
US 10-year TIPS real yield	2.22%	2.91%	+69bps
US 10-year inflation breakeven	2.23%	2.37%	+14bps
US 2s10s curve	29.3bps	39.8bps	+10.5bps
S&P 500 price index	7,499.36	7,651.54	+2.0%

A detailed analysis of the higher borrowing costs matters. The rise in real yields could reflect three different drivers:

- First, investors may expect real policy rates to remain higher for longer. This is the cyclical financial conditions restraint path.
- Second, the equilibrium rate r^* may have risen in anticipation of productivity benefits from AI. AI investments can increase demand for capital before associated productivity benefits are fully realized, while higher expected returns may support further investment. Together, that could lift the equilibrium rate, though the net effect depends on the response of savings, investments and supply. This interpretation is important because higher real yields driven by stronger expected returns on capital have different implications for growth and

risk assets than an equivalent increase driven by tighter monetary restraint or term premium.

- Third, investors may demand higher compensation for holding duration because of fiscal uncertainty, bond supply or changes in the investor base. This rise in term premium can raise long-term funding costs even without a comparable change in the expected policy path.

These explanations interact: a higher r^* can itself change expected policy, and policy uncertainty can affect risk premia. The main investment question for us is whether higher real yields are constraining resilience or partly reflecting the forces sustaining it. The answer may differ across the economy: the same real rate that reflects attractive expected returns on capital for one sector can represent an increasingly binding financing constraint for another.

The modest steepening in Q3 was more consistent with our structural view, but the path to it reinforces the lesson from the first half of the year: policy-sensitive flattening and long-end repricing that steepens the curve can dominate at different stages, and a structural case for higher term premia does not determine the best curve position at every point. Our traders reflected this with much lower and more tactical curvature exposures throughout the quarter.

Rhymes of the Past

When analyzing past Fed cycles it quickly becomes clear that resolving inflation problems requires more than one hike. When we try to identify regimes whose conditions most resemble today's, four hiking periods stand out: 1987, 1988, 1994 and 1999. None of these delivered less than approximately 120bps of tightening, and the two best matches (1988 and 1994) each delivered about 300bps of tightening over roughly one year. In three of the four, core PCE was higher 12 months after the start of the hiking cycle, and within two years of the start, no cycle saw core PCE fall more than about 30bps.

Their market reactions were also instructive. 2-year yields rose in all four hiking cycles 3, 6 and 12 months after initiation of the hikes. The curve was flatter in 3 of 4 cycles after 12m months. Yet, the S&P 500 was higher in 3 of 4 cycles after 12 months. The dollar was mixed. The historical lesson is that a sustained hiking cycle can, but usually does not, derail risk assets. The market outcome depends on the nature of the inflation shock and the pace of tightening.

Common Shocks, Different Resilience

The direction of monetary policy has converged across several major central banks, but the pace of tightening and domestic growth constraints differ. September saw hikes by the Fed, ECB, BOJ and RBA. This is not evidence of coordinated policy, but rather a common energy shock interacting with different domestic conditions and different capacities to absorb higher rates.

Our economists' assessment for the Eurozone sees another increase in December, rather than October, with less confidence than in the previous two steps. Europe's trade-off is particularly sensitive to whether higher energy costs reach wages and final prices or instead weaken consumption and output. The UK and Australia provide different versions of the same problem: higher policy rates pass relatively quickly to households

through variable-rate mortgages, even while inflation risks and demand remain material. Australia has the additional issue of a rapidly weakening housing market. This contrasts with the US, where the prevalence of fixed-rate mortgages has insulated many existing borrowers and slowed the transmission of higher policy rates into household cash flows. The same degree of monetary tightening can therefore produce very different effects on consumption and housing across economies.

Fiscal capacity adds another dimension. Defense, infrastructure and demographic pressures create spending demands across Europe, but the ability to finance them and improve productive capacity differs by country. As a result, similar fiscal impulses can have very different implications for growth, inflation and sovereign risk premia. France deserves attention because modest growth and large deficits coincide with a difficult political environment ahead of the 2027 presidential election. France's electorate is unwilling to pursue painful supply-side reforms and hand over more economic responsibility from the state to the private sector, and therefore flees to populists that offer painless miracles – sometimes as radical as proposing to simply cancel debt, which would certainly push the monetary union into choppy waters.

Specific policy commitments by rising European populist parties matter: how much additional spending is promised, what offsets are politically feasible, and whether reforms increase supply or weaken confidence. For markets, the potential transmission runs through yields, sovereign spreads, bank funding and the euro's exchange rate. This will likely create opportunities to distinguish countries and curve segments.

Japan: Two Yen Tails, Different Balance Sheets

Japan is a potential transmission point for global funding and duration risk. Long-end yields rose in Q3, while the yen appreciated following interventions. But the more relevant signal for the currency is the move in real yields and real yield differentials. Since late 2024, 10-year nominal JGB yields have risen by approximately 2 percentage points, yet elevated inflation has limited the corresponding increase in real yields, while USD/JPY ended Q3 near its late-2024 level. The question for global asset allocation is whether Japanese real yields rise sufficiently relative to foreign alternatives to encourage capital to return home. Hedging costs, cross-currency basis, liabilities and portfolio mandates will also determine whether higher JGB yields translate into reduced foreign-bond demand.

The weakening of the yen until the intervention at the end of July highlighted tail risks associated with the currency. The depreciation tail is primarily a problem of level, persistence and policy response. A weakening yen can raise imported costs and squeeze real incomes. If those pressures make inflation more persistent, the case for BOJ tightening strengthens, transmitting the adjustments into refinancing costs. Intervention may affect timing and financing of that adjustment, but it does not resolve the underlying trade-off between tolerating currency weakness and imported inflation or tightening policy at the cost of greater pressure on the domestic economy.

The appreciation tail operates through a different set of balance sheets. A rapid increase in the yen can impose losses on unhedged yen-funded positions. If losses, higher volatility or higher collateral requests force investors to sell assets and buy yen, the adjustment can become self-reinforcing. Speed matters

because it influences the time available to absorb or hedge losses, but positioning and liquidity determine whether an exchange-rate move becomes a broader liquidation.

In 2024, the yen appreciated roughly 4% between July 31 and August 5. The Nikkei fell almost 20% and the S&P 500 over 6%; Japanese and US 10-year yields declined. In December 2022, a similar move in the yen was accompanied by higher bond yields, broadly unchanged US equities and declining VIX. The same currency move did not produce the same market outcome.

As we think about the impact of currency moves on markets, and the yen in particular given valuation levels and its importance as a funding currency, our task is to identify the shock and the exposed balance sheets, not to assume that every large move is destabilizing or that both appreciation and depreciation tails imply higher bond yields. The reaction function of policymakers adds to the complexity of the task.

Elections and Their Possible Impact on Policy Paths

In the US, we analyze different outcomes of the upcoming midterm elections through the policies they could enable, constrain or delay. Affordability and the distribution of AI's benefits are key anchors for this work. These issues are increasingly connected: the scale of AI-related investment is becoming more visible to voters at the same time that concerns about electricity costs, infrastructure requirements and the distribution of productivity gains are becoming more politically salient. A change in congressional control could alter the administration's legislative room, fiscal bargaining and oversight of AI. It would not automatically produce a particular regulatory outcome or reverse implemented policies, but markets will likely be sensitive to the degree to which the costs and distributional effects of the AI buildout become salient electoral issues.

In Europe, the questions center on fiscal commitments and political capacity to implement them. Markets have reacted violently to unrealistic budget forecasts, and France is particularly exposed. The broader weakening of the political center in core European countries poses an enormous tail risk for markets. The populist movements have no credible answer to Europe's toxic mix of low growth, demographic aging, overburdened and expanding social security nets, and high debt loads in countries like France and Italy.

Q4 Scenarios

As in our Q3 Outlook, we retain the separation of the US growth forecast from the energy and supply backdrop, without treating them as completely independent. In Europe and Asia, the link is certainly stronger and poses in particular a challenge for the ECB. Our baseline is resilient US growth and persistent cost pressure, with room for further monetary tightening but no predetermined terminal rate. The distribution of possible outcomes includes both a constructive supply-led improvement and a broad demand slowdown. We broaden the second axis from Gulf escalation to cost pressure because the inflation risk is no longer solely an energy story: import costs and domestic pass-through now matter alongside physical energy availability.

US demand	Cost pressures persist	Cost pressures ease
Resilient	Working baseline: further tightening remains possible. Higher real financing costs coexist with selective earnings strength; policy paths and sector outcomes diverge.	Constructive adjustment: improved energy supply and broader productivity gains allow disinflation without a major slowdown. The case for additional hikes diminishes.
Weakening	More difficult trade-off: inflation limits the initial policy response. Credit pressure and growth weakness can eventually change front-end pricing, while long-end risk premia remain uncertain.	Broader disinflation: falling demand and lower costs increase scope for monetary relief. Front-end rallies and bull steepening become more plausible, but credit may still deteriorate.

The signposts indicating which scenario we are closest to are real consumption and employment strength; the balance between high-tech and other investment and the financing conditions supporting AI capex; underlying inflation momentum and cost pass-through; and physical energy availability. In markets, we are watching nominal and real yields; market-based inflation measures; curve shape; dispersion in credit spreads; FX moves; bond auctions; and funding markets.

Implications for Tactical Macro

What moved? Where on the curve? And which other markets confirmed the interpretation? Those are practical questions to identify trading opportunities. A rise in expected Fed restraint can favor policy-sensitive rates and flatteners where implied pricing is insufficient. A repricing of duration risk can instead support long-end bond shorts or steepeners. Inflation compensation and commodity curves offer a different set of expressions when the initial cost shock is dominant. A rise in real yields associated with stronger productivity and a higher equilibrium rate may have different cross-asset implications again, particularly if stronger expected earnings allow equities to absorb a higher discount rate.

A correct macro assessment does not ensure an attractive trade if it is already priced. The lesson of 2026 is that positioning analysis has moved to the top of any risk manager's concerns because it can create an implicit negative convexity profile. For each expression, we need a disagreement with market pricing, a catalyst, a tolerable carry and liquidity profile, and an understanding of what evidence would lead to an exit.

Sequencing remains critical – another lesson of this year's macro environment. An inflation shock may first raise front-end rates, only to be reversed later when weaker demand concerns dominate the curve, while fiscal concerns may lift back-end yields. A structural view on the interest rate curve should not become an inflexible position through different phases of market price discovery.

Our Q3 Outlook's emphasis on liquidity and preserving risk capacity remains central to the investment framework. Changing correlations, such as between oil and rates, will remain a challenge. Discretionary macro seeks opportunities in relative pricing and the sequence of adjustment; systematic approaches offer



a complementary macro investment style that has benefited from exploiting more persistent trends in markets.

Conclusion

This year has been exciting and exhausting, and we expect no less of this final stretch of the year. Like athletes, we need to be prepared and trained for the competition of extracting alpha from liquid markets. Decades of experience help us judge when to lean into trades and when to get out of the way, regardless of our long-term views.

One of the defining questions of Q4 will be to distinguish higher rates supported by stronger productivity from higher rates required to suppress demand or compensate investors for risk. We also need to understand who absorbs the burden of higher real rates and whether supply improvement, demand destruction or tighter financial conditions will deliver disinflation first. The answer may differ across sectors, countries and balance sheets, and the sequence of those adjustments will matter as much for markets as the eventual macro outcome. That is where the case for active, flexible macro investing lies.



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