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WHAT OUTLOOK FOR MARKETS IN THE FACE OF RISING SOVEREIGN YIELDS?

Nicolas Bickel,
Group Head of Investment Private Banking & CIO

The second-quarter earnings season is drawing to a close and has clearly been very strong. The 30% year-on-year increase in S&P 500 earnings in the United States and the 23% rise in earnings for the Euro Stoxx 600 in Europe have, for the time being, pushed into the background the renewed hostilities around the Strait of Hormuz, persistent inflation, rising sovereign yields and uncertainty ahead of the US midterm elections.

Investors have indeed been reassured by the resilience of the global economy and companies' ability to sustain a high pace of earnings growth, enabling equity markets to continue rising since the end of July.

Equity markets rebounded following the correction in the artificial intelligence (AI) theme in July
August was particularly interesting for equity markets, marked by a rebound in the technology sector following reassuring results regarding companies' ability to monetise their massive investments in AI, as illustrated by the excellent figures reported by Microsoft and Nvidia.

In this context, the MSCI World gained 2.5%, while technology-heavy emerging markets outperformed, rising 3.2% in August. The European market, which is less exposed to technology and was affected by the ECB's more hawkish stance in response to persistent inflation, posted only a slight gain over the period, with the Euro Stoxx 600 up 0.3%.

Broader participation in index performance
While the largest capitalisations still account for a significant share of this performance, with the three largest companies contributing 50% of the S&P 500's monthly increase, gains have spread across a wide range of stocks and sectors. Indeed, the average S&P 500 constituent rose by 5.9%, 3% more than the index in August.

Semiconductors' outperformance came to an end in June and, since then, certain sectors have managed to stand out. In the United States, the healthcare sector has gained more than 15% over the past two months, with financials and energy completing the podium. In Europe, financials have led the way, posting an 18% gain since the end of May, while most sectors have delivered positive returns.

That said, amid continued oil price increases and rising expectations of interest-rate hikes, equity markets are showing signs of nervousness during a period that is not statistically the most favourable for equities. Indeed, September is historically the only negative month, with the S&P 500 and Euro Stoxx 600 indices posting average returns of -1.15% and -1.30% respectively over the past 25 years.

A number of factors are behind the rise in sovereign yields
The most significant development in financial markets since the end of June has undoubtedly been the continued rise in sovereign bond yields. US 10-year yields reached 4.80%, a level not seen since November 2023, while 30-year yields exceeded 5.30%.

The US Treasury did attempt an "Operation Twist", issuing short-term debt to buy back long-term debt in an effort to limit the rise in yields. Small in scale and most likely ineffective over the long term, this operation does not appear to have gained credibility among investors, despite the potential use of the US Treasury's current account. Without effective coordination with the Federal Reserve (Fed), we believe this action has little chance of having a lasting impact on long-term yields. Only a change in fundamentals—inflation, growth and, above all, a reduction in public deficits—could trigger a cycle of lower long-term rates.

Following last Friday's employment report, which showed US job creation well above expectations, as well as inflation figures that have so far failed to confirm any genuine deceleration, markets are now pricing in a Fed rate hike by year-end, with the probability of a September increase estimated at 60%.

It is worth noting that, in recent weeks, long-term rates have risen almost as much as short-term rates. Under normal circumstances, expectations of Fed rate hikes should mainly affect short-term rates. They should even lead to a decline in long-term rates through a fall in the inflation premium caused by higher policy rates, which are primarily used to combat inflation. However, the deterioration in public finances has become such that investors are increasingly uncomfortable with duration, pushing real yields to levels not seen in 15 years. Real yields are now more than twice the S&P 500 dividend yield.

In addition, foreign buyers can currently find attractive yields in their domestic currency. Following 30 years of low interest rates in Japan for instance, 10-year yields now trade above 3%, reducing the appeal of investing in US Treasuries. Competition from high-quality corporates, which have issued almost as much debt as the US Treasury in 2026, is also weighing on sovereign yields.

Adding to this are the intentions of powerful institutional investors to sell a substantial portion of their government debt holdings—such as Norway's sovereign wealth fund, to the tune of USD 100 billion—as well as new initial public offerings, which are directing some liquidity towards their transactions. We find ourselves in a situation where governments are competing in capital markets to finance their ever-increasing debt. Moreover, weak demand for US Treasury bonds from long-term investors is causing a form of liquidity drain.

This situation is by no means unique to the United States. European yields are also affected, notably French sovereign debt, which briefly yielded more than Bulgarian debt. It is trading at a spread of 89 basis points over German debt, levels not seen since 2024. German debt is also under pressure as Berlin sees its deficits increase and potentially temporarily exceed the Maastricht criteria. Europe's largest economy is facing 10-year yields above 3% while growth remains below 1%, and Germany's reputation for political stability is now being undermined by the record unpopularity of its Chancellor, Friedrich Merz, whose approval rating stands at only 13%—an unprecedented level for a German head of government.

Rising yields have so far had only a limited impact on equity markets

At this stage, rising yields are not directly affecting equity valuations. Historically, increases of this magnitude have tended to slow investment and economic activity, while also driving down valuations, particularly in the technology sector. However, the financial position of these giants remains very strong, with substantial cash flows making them less sensitive to interest rate movements and, above all, record earnings growth that more than offsets lower valuations. The impact is mainly reflected in wider credit spreads, by around 20 to 30 basis points on high-quality bonds from hyperscalers in recent weeks.

Nevertheless, higher rates are tightening financial conditions for all participants in the economy. In a period of economic boom, this may simply help prevent overheating. A mild economic slowdown and, above all, tighter monetary policies, could eventually affect equity markets. Although recession is no longer at the forefront of investors' concerns, excessive central bank tightening to control inflation could weaken growth and bring this risk back into focus. There are also unpredictable factors, such as a sharp escalation of tensions in the Middle East or a surge in agricultural commodity prices following the El Niño climate phenomenon, but these remain difficult to quantify at this stage.

Corporate strength should enable equity markets to weather this crisis

For now, investors continue to ride the wave of excellent corporate results, including in Europe, where all sectors—with the exception of consumer-related sectors—have revised their earnings forecasts upwards.

Despite the indirect risk associated with high interest rates, particularly regarding the cost of capital and investment profitability, it is important to remember that markets have managed to cope with every challenge encountered in recent years. Whether it was the software sell-off, the semiconductor rally, sharp sector or factor rotations, or political and geopolitical developments, markets have consistently overcome these events and have continued—rightly so—to believe in companies' extraordinary ability to adapt in an increasingly uncertain environment. From the pandemic to the war in Ukraine, from trade wars to the private credit crisis, from the surge in inflation to that in public deficits, and from fears of recession to fears of deflation, the past six years have been a succession of crises of varying severity.

Yet they have not prevented companies from delivering first-rate performance, nor equity markets from trading at levels two to three times higher than their 2020 lows—admittedly supported by an investment cycle of unprecedented scale, particularly in the technology sector.

Our conviction remains that equities should stay the main contributor to the performance of diversified portfolios over the medium term, as long as the economy succeeds in maintaining a sufficiently strong pace of growth and inflation gradually returns towards the 2% target without requiring major action by central banks.