Ostrum Asset Management — Assets for Life

Long-term rates: the end of the old world

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Synthesis

The recent rise in long-term interest rates may no longer be a simple adjustment. The conflict in Iran, oil prices hovering around $90, and persistent US inflation have acted as triggers. But behind these immediate factors lies a deeper transformation: the world that allowed for persistently low rates is disappearing.

The first change: inflation could become structurally higher and more volatile. Since the 1980s, globalization, offshoring, and international value chains had allowed developed economies to import disinflation. Geopolitical fragmentation is gradually reversing this dynamic: reshoring, tensions over raw materials and strategic components, rising energy costs, and a shrinking workforce due to aging are creating more pressure on costs and wages.

The second change: US monetary policy is becoming less predictable. Warsh wants to reduce the Fed's communication and challenge forward guidance. The goal is to make markets more dependent on their own analysis of the economy. But less information also means a wider range of expectations and potentially more volatility in interest rates.

Third disruption: the explosion in public financing needs. US debt has just surpassed $40 trillion, and the IMF expects global public debt to exceed 100% of GDP by 2029. Aging populations, healthcare, defense, AI, decarbonization, and industrial policy are all requiring substantial spending. The supply of public debt will therefore remain structurally abundant.

Added to this is growing competition between public and private capital needs. AI, electricity infrastructure, and the climate transition require massive investments. If European savings increasingly finance its own technological catch-up, and if China recycles fewer of its surpluses to the United States, US debt could face less automatic external demand. The result would be further pressure on real interest rates and bond yields.

Finally, the change is political and institutional. The world of globalization was based on the idea of a convergence of rules and institutions. This convergence is fading in favor of national strategies, competing industrial policies, and power dynamics. This heterogeneity increases uncertainty and demands a higher premium for long-term capital investment.

This may be the real regime change: long-term interest rates are now rising because the global system is becoming less predictable, less cooperative, and more capital-intensive. Globalization had fostered convergence and lower interest rates; fragmentation could produce the exact opposite.

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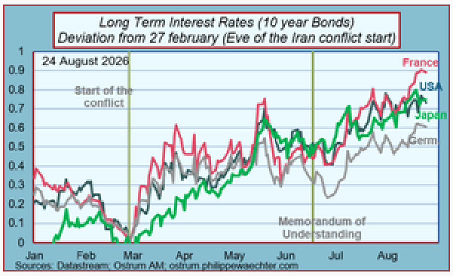
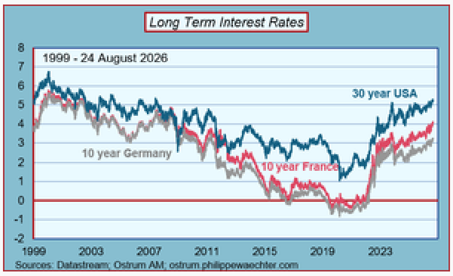


Is the bond market undergoing a readjustment or is it entering a period of regime change? This is the question that arises in light of the observed drift in long-term interest rates. The upward movement began with the US-led conflict in Iran, against a backdrop of inflationary shock fueled by rising oil prices.
But hostilities continue, the price of a barrel of oil is stuck at $90, and when a shock persists, it can transform into a regime change. To understand this, it's necessary to distinguish between immediate issues and those that structure the bond market.



Last week, the financial press echoed the upward trend, with 10- and 30-year interest rates reaching levels not seen since 2005 or 2006, depending on the maturity and the country. These short-term movements were fueled by the usual factors influencing interest rate fluctuations, such as persistent inflation in the US. They may have been amplified by announcements like the US public debt crossing the $40 trillion threshold during the week of August 16.

The announcement of the Treasury's purchase of the long part of the US debt also temporarily moved the markets, but without excess, as the operation was not large-scale and not at all associated with a change in fiscal strategy.

In France, the rise in interest rates, far exceeding what has been observed in neighboring countries, stems from discussions on the sustainability of public debt and government proposals for the 2027 budget, the validity of which will be limited by the presidential election next May. The economic discussions surrounding this presidential election are primarily fueled by the ECB's neutralization of public debt.

On this point, the discussion is somewhat absurd because, in order to neutralize French debt within the ECB, the debt would first have to be held by the Bank of France, which is not the case. The Bank of France is merely the custodian in an operation initiated by the ECB.

Furthermore, the agreement of France's other partners within the European System of Central Banks would be necessary in France's specific case. Their adherence to such a procedure is questionable. Implicitly, to create the impression of regaining some room for maneuver, the cancellation of a portion of the public debt seems like a good idea.
However, past experiences do not support the resulting monetary and financial stability.

Since France cannot cancel its debt, the only option would be to withdraw from the Eurozone monetary system. This is unacceptable.

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These factors fuel short-term fluctuations, but what interests us is the structural dynamic, the one that drives the trend. There are four major factors.

A higher inflation rate is expected in the future.

The inflation rate, which was kept under control during the long period before the pandemic, will be more difficult to maintain around central bank targets. Economic fragmentation, disregard for regulations, increased bilateral relations, rising energy prices, and the disruption of international value chains will create friction, leading to higher and likely more volatile inflation over the long term. This is the structural change we should expect.

Since the mid-1980s, developed countries have been importing disinflation. The offshoring of production made this possible. One consequence was downward pressure on wages, as the risk was offshoring and job losses. However, since inflation was very low, this was a viable situation, especially since large-scale, mass wage negotiations had been replaced by individualized wages. Purchasing power, however, grew slowly. This is also one of the reasons for the higher levels of household debt in most developed countries.

This system has changed with the fragmentation of the world. Global value chains are no longer necessarily the ultimate goal. Relocation is necessary, but with wage constraints that will be all the more pronounced as the share of the working population shrinks in many European and Asian countries. Yet, income within economies, including that going to retirees, is generated by the working population. If incentives are not strong enough, production gains will be lower. Consequently, costs will rise.

Furthermore, input prices will rise. Large contractors prioritize these costs, leaving only a small portion for other players who need semiconductors, memory chips, or rare earth elements. Decarbonization, which will need to be faster than current rates, will put upward pressure on these prices and generate higher costs.

Finally, energy prices will remain high. Oil demand will remain robust for some time, but opportunities for further exploration and production are more limited than in the past. Therefore, the price of a barrel of oil is not going to collapse. We are also seeing a shift in demand towards electricity. This is a positive factor because electricity is an energy source that can be decarbonized through renewables and nuclear power. This shift is evident in the development of data centers, which is driving up electricity prices. Electricity is the key element in decarbonization.

On another front, households' ability to take on additional debt will be more limited. This will create more intense pressure on nominal prices and wage negotiations.

The factors that had allowed for low and controlled inflation rates have evaporated, and the risk today is that the behavior of economic actors, institutions, and different countries or regions will no longer be driven by a common dynamic. This will result in a higher trend inflation rate than that which prevailed before the pandemic. These rates will be significantly higher than the current targets of central banks for an extended period.

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The Fed's monetary policy is losing its bearings.

The Fed's policy is not very clear. Warsh wants to change the rules, particularly those put in place after the Great Recession of 2008. He wants minimal communication from the Fed so that investors can effectively analyze the real economy without the potentially distorting lens of the central bank. He also wants to reduce the number of FOMC meetings, shorten press releases, and eliminate the forward guidance system that the Fed implemented after the Great Recession to limit excessive volatility during specific periods.

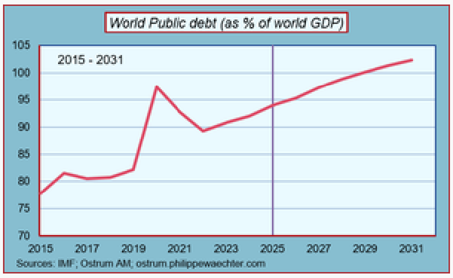
The ambiguity of this new strategy is that despite everything, investors will have to make interest rate forecasts but they will do so with less information, at the risk of increasing interest rate volatility since the range of possibilities will be wider.

Before February 4, 1994, the Fed did not communicate. Investors had to perceive the change in the central bank's attitude toward the money market to deduce the nature of the new monetary policy. It was rather rudimentary, but the markets were far less developed than they are today.

It would be inefficient to revert to such a system in a data-driven and information-based economy. Investors know what they have lost but are unaware of the new rules that will guide the US central bank.
Warsh's speech in Jackson Hole next weekend could be beneficial.

The temptation and necessity of public debt

Everywhere, the temptation is to increase public debt, and even Germany is playing this game. The figures are spectacular. The most striking is the $40 trillion figure in the US during the week of August 16, 2026, but everywhere else, public needs are considerable. The IMF expects public debt to exceed 100% of global GDP in 2029 and then continue to rise.



In a complex economy, the role of the State has never been more important. In the USA, fiscal stimulus is permanent and the deficit is the largest since the post-war period in calm times (it was higher than it is now during the pandemic and during the Great Recession of 2008, two unusual events).

In general, the equation is complex to solve because society is shifting towards aging and the associated retirement and health costs, shifting towards more military spending as the world fragments and the alliances of the past are no longer what they used to be.

The state must also intervene in a world marked by the two technological revolutions of AI and decarbonization. We must act quickly and mobilize resources to address these radical changes, in which every country and every region hopes not to fall behind. In Europe, the needs of both are considerable.

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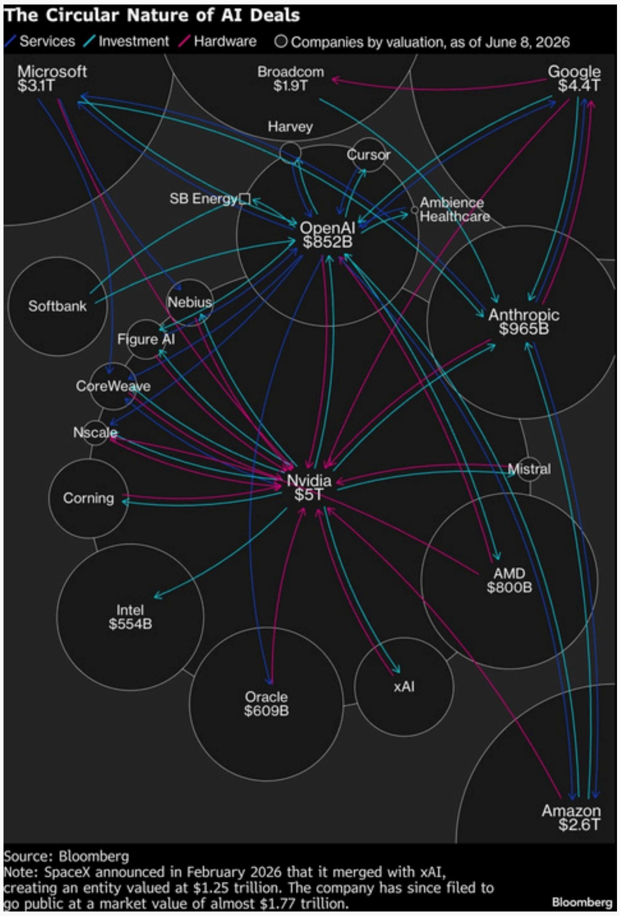
Resource allocation – a complex equation

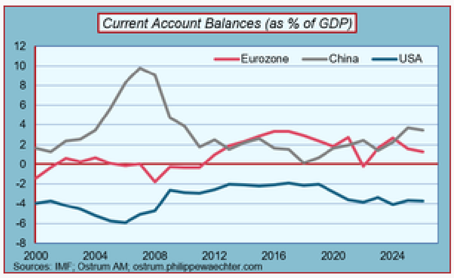
Funding pressures will intensify as the private sector is also heavily involved. Its needs are considerable to capitalize on the momentum of AI and stay on course towards decarbonization. The graph illustrates the dynamics of AI needs according to a recent Bloomberg analysis. It also reflects the risk within this sector, highlighting a degree of inbreeding.

This should drive up real interest rates due to a greater need for investment, creating an imbalance between savings and investment. If everyone wants to invest—whether they are AI companies, renewable energy producers, or governments for their own reasons—then available savings will be used more heavily. This will push the real interest rate, the rate that equalizes investment and savings, upwards.

An illustration of this phenomenon and the fragmentation of the global economy can be found in international imbalances. These have been the subject of recent official reports, which raise questions about the global economy's capacity to cope within this new fragmented framework.



European and Chinese surpluses generate strong global savings which enable the financing of the American deficit.
This could change if the European savings surplus is used to finance technological catch-up, decarbonization and military spending through the mechanisms of the Savings and Investment Union (formerly known as the Capital Markets Union).
Furthermore, it is difficult to imagine China using its savings to finance the US.
There will be a squeeze on US debt and pressure on bond yields. This raises the question of the risk associated with US assets. Will US government bonds remain the risk-free assets that investors need?



The use of different rules, and choices that are less cooperative, have an impact on the level of interest rates.

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The political dimension and the autocratic temptation

The political context has changed radically.
During the long period of globalization, the underlying idea was that democracy would be the ultimate goal of the market economy. By developing trade, political democracy would eventually prevail in a large majority of countries. Implicitly, there was the idea of playing by consistent rules almost everywhere.

However, this is not what is happening. Autocracies now dominate. According to indicators published by the V-Dem Institute, there are now more autocratic countries (92) than democratic ones (87). The population of autocratic countries, according to this institute, represents 74% of the world's population. The graph shows the political dynamics based on a smaller number of countries. Recently, there has been a strong movement towards democratic dynamics, particularly after the fall of the Berlin Wall in November 1989. Since then, the situation has gradually reversed, giving a considerable share to autocratic countries. These are defined as being governed by one person or a small number of people with mechanisms that neutralize checks and balances. They are governed by discretionary rules that are largely unchallenged.

More autocratic countries mean that each will want to dictate and operate according to its own rules, both within its borders and in its relations with the rest of the world. Given the heterogeneity of choices made by the United States, Russia, China, India, and Turkey, both economically and politically, we should expect global inconsistencies that will create uncertainty. This will be reflected in the interest rates of the various countries.

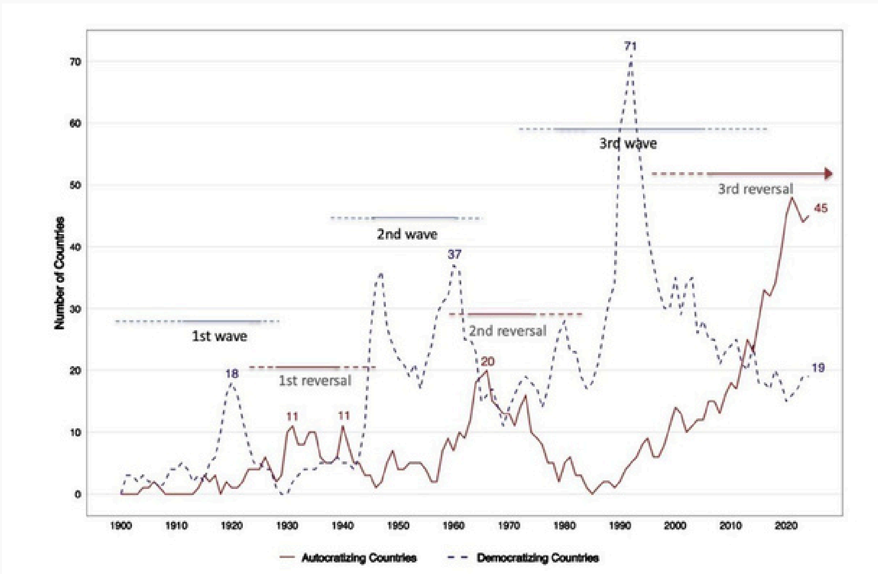

Figure 4. Three waves of democratization and autocratization.

Note: Data for the graph comes from V-Dem dataset and the ERT dataset versions 15.[32] The identification of start and end of waves by author inductively reading from the numbers in the graph.

Source: Lindberg, S.I. 2026. "Fifty Years of the Third Wave(s): From Democratization to Autocratization." Democratization, Online First (open access).

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Conclusion

For a long time, the convergence of institutions and operating rules mitigated the disparities that could exist between regions and countries. Objectives were consistent, resulting in relatively low interest rates. Certainly, there were crises, but the responses to them were never contradictory among the major countries.

This is the context that has been changing since the end of the pandemic and the intensification of technological, economic and political competition. There are several dimensions.

Industrial, economic, and political choices are becoming more localized. China, the United States, and Europe no longer share a common dynamic, as each country or region must define its own path, either because it reflects a political choice or as a reaction to a decision. One example is the Inflation Reduction Act implemented by Joe Biden in August 2022, extended by Trump's tariff policy since April 2025. The objective is to relocate production to the United States at the expense of traditional partners.

The second question after the pandemic concerns the risk-free status of US government bonds. Recent research (*) shows that since the pandemic and the ensuing imbalances, doubt has taken root in the minds of investors. Shocks no longer trigger a rush on US Treasury bonds; China and Japan are reducing their exposure to these assets, and the premium of government bonds over AAA-rated private assets has disappeared. This relative fragility of the US market reflects a new risk hierarchy in the minds of investors.

The consequence is a much greater heterogeneity in trajectories and expectations, which may diverge, reflecting rules and institutions that are no longer necessarily similar or consistent. This will result in persistently higher long-term interest rates. Current levels may then appear as the lower end of future trajectories.

(*) See Hanno Lustig https://thetwocents.substack.com/p/what-are-us-treasury-markets-telling

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