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Middle East shifts don’t derail the case for bonds

Investment strategy insights

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- Middle East tensions and oil price swings have led to falling bond yields and more moderate central bank rate expectations in recent trading.
- While major central banks remain cautious, we believe near-term rate hikes are less likely.
- Investors should therefore consider locking in high-quality bond yields and diversifying across income-generating assets for resilience.

Investors and central bankers remain highly sensitive to the fast-moving developments in the Middle East—and the consequences for oil prices, inflation, and bonds.

Brent crude oil prices fell nearly 11% last week on renewed oil flows through the Strait of Hormuz. This led to declines in major government bond yields and pricing for central bank rate hikes this year. Yet the weekend saw tit-for-tat strikes between US and Iranian-linked forces, leading to increased maritime security threats and the US Joint Maritime Information Center raising the threat level to “substantial.” So far on 29 June, the US and Iran have agreed to a tentative de-escalation in attacks, with Brent crude oil trading at around USD 72.50 per barrel at the time of writing. Markets and rate-setters will be hoping that if these levels hold, the risk of both an immediate inflation shock and aggressive central bank rate hikes will wane.

Policy expectations in the Eurozone: On the move

The European Central Bank (ECB) has responded to a brighter inflation outlook with a measured approach. Speeches from ECB President Christine Lagarde and Chief Economist Philip Lane last week underscored a commitment to fighting inflation, even as growth slows.

The energy shock from the Middle East conflict pushed headline inflation to 3.2%, with underlying pressures in services and forward-looking indicators suggesting further risks. However, unlike the 2022-23 surge, longer-term inflation expectations remain anchored, and wage-driven second-round effects are limited at this stage. Beyond the June inflation data, we believe investors will closely monitor the trajectory of inflation as a key driver of bond market performance.

We judge that falling energy prices have weakened the case for an immediate ECB hike. Oil futures are now roughly 15% below ECB assumptions for 2026, and gas prices are also lower. This shift has led us to move our expectation for the next ECB hike from July to September, with bond market pricing assigning around a 65% probability to a September move. While the ECB is likely to pause after one final increase, uncertainty remains. Policymakers will likely follow a meeting-by-meeting approach, so investors must be nimble. More favorable inflation or weaker growth in particular could stay the ECB’s hand on another hike.

What about the US outlook?

We believe activity was solid for the first half of 2026, with growth tracking around 2.5-3% in the second quarter thanks to healthy consumer spending, loose financial conditions, and fiscal tailwinds. Business investment has been strong, driven by AI-related capital expenditure and tax incentives. However, higher energy prices are beginning to weigh on real incomes and consumption. As fiscal support fades and energy headwinds persist, growth is expected to moderate toward trend (of roughly 2%) in the second half of the year.

US inflation tracked higher in May, mainly due to energy effects. We believe the Federal Reserve will remain in a prolonged wait-and-see mode, with sticky core inflation and stable labor markets supporting this stance. While we still expect the next move to be a cut, our assessment is this will happen only in 2027, as policymakers wait for sustained disinflation. Risks are balanced: Supply bottlenecks could delay easing, while persistent inflation or strong demand could keep policy restrictive for longer.

What does this mean for bond investors?

Investors can still find opportunities to lock in attractive yields, especially in high quality, short- and medium-maturity bonds. CIO believes markets are overestimating further tightening from major central banks and expects yields to fall over the next 12 months. We believe short- to medium-maturity quality bonds offer an appealing risk-return profile, with starting yields a good proxy for longer-term expected returns. Fiscal and inflation risks are greater in longer-duration debt, making quality bonds a resilient choice.

Look beyond bonds too

For a holistic and well-diversified income strategy, we also like select exposure to growth-sensitive and higher-yielding segments such as emerging markets (EM), high yield, and subordinated debt. EM bonds benefit from resilient global GDP growth and commodity strength, with high real rates and supportive central banks underpinning a positive outlook. Diversified exposure to subordinated debt, including corporate hybrid bonds, may offer defensive access to higher yields amid uncertainty.

Bonds are not the only income asset class. Equity income strategies, yield-generating structured investment strategies, and multi-asset income approaches can further broaden income sources. Investors should be mindful of the unique risks associated with options and structured investments, but these strategies can support income objectives across asset classes.

Despite geopolitical uncertainty and shifting central bank expectations, now remains a compelling time to lock in elevated high quality bond yields, in our view. Diversifying across income-generating assets can help build resilient portfolios, manage risks, and capture opportunities as the macro environment evolves.

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Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.
Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities
Note: For equities, we have a five-tier rating system with two additional preferences
Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.
Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.
When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

Appendix

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