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Interest rates at the intersection of inflation, public finances, and artificial intelligence

11 September 2026, 10:21 UTC, written by Michael Bolliger

Long-term interest rates are being driven by structural forces, including inflation dynamics, high and rising government debt, and a changing buyer base for government bonds. Over time, advances in artificial intelligence are also likely to play a greater role in the sustainability of public finances. The comparison between East and West is revealing here too: China pays low yields despite high debt because of its large pool of savings, while many other countries must offer higher interest rates to attract enough capital. Governments may increasingly seek to encourage investors to allocate more to domestic government bonds. For investors, the message is clear: Used selectively, high-quality bonds can play an important role as a source of portfolio income. But where risk tolerance and liquidity planning allow, we see more attractive opportunities in equities and alternative investments.

A few days ago, we revised higher our forecasts for US policy rates, while recognizing that uncertainty is and will remain high. But the more important question is this: Will the pivot in interest rates be temporary, or are we entering a lasting new regime? This matters because the monetary policy path helps determine how to build an optimal portfolio, from bond allocations and equity valuations to the appropriate mix of real estate and gold.

Several factors suggest that interest rates could remain elevated in many economies. First, inflation dynamics have changed. The contrast between the US and China is instructive. In the US, core inflation has been above the Federal Reserve's target for years. In China, the GDP deflator has been negative for years, while consumer prices have risen only modestly. China currently pays around 1.7% on 10-year government bonds, compared with about 4.8% in the US. If US inflation moves back toward target, interest rates are likely to follow. We consider this a realistic scenario, although uncertainty around the forecast remains high.

Second, the fiscal position of many governments is deteriorating. China's debt stands at around 75% of GDP. Including the liabilities of local government financing vehicles, institutions such as the International Monetary Fund estimate the true debt burden at roughly 135% of GDP. In the US, federal debt held by the public is around 124% of GDP; France is at about 116%, and Japan at roughly 206%, according to IMF estimates. The prospect of lower deficits is limited, partly because political majorities are often too fragile for difficult decisions on social security, pensions, or health care.

This brings us to the third driver: Who buys these bonds? Particularly in the US, Treasury yields also depend on an international investor base that includes central banks, sovereign wealth funds, insurers, and asset managers. That buyer base is changing. Japanese investors are reducing their holdings of US Treasuries, the US dollar's share of global foreign-exchange reserves is falling, and alternative investments, including infrastructure, are gaining importance. As a result, yields must rise to attract new buyers. China, by contrast, finances itself mainly from domestic savings surpluses. More than 40% of GDP is saved, and capital controls keep much of that money in the country. With few attractive alternatives, a large share flows into government bonds—even at low yields. The interest rate gap between the US and China is striking. Applied to more than USD 40 trillion of debt, it would reduce annual US interest payments by over USD 1 trillion—roughly equivalent to the country's defense budget. It is therefore entirely possible that both the US and Europe will increasingly introduce incentives to encourage domestic investors to invest more frequently in local bonds. This is already happening, for example through reduced capital requirements for US banks holding government bonds. Over the medium term, this could help push interest rates lower.

A fourth factor is artificial intelligence. In the short term, the rapid buildout of AI infrastructure has probably fueled inflation. Heavy investment in data centers, energy, and infrastructure is colliding with limited capacity, pushing up prices in areas such as energy, natural resources, and semiconductors. Companies in these sectors—and investors in them—stand to benefit. Over the medium term, AI could lift productivity and potential growth, making high debt ratios more manageable. It may also be deflationary in some areas through automation, efficiency gains, and lower marginal costs for services.

What does all this mean for investors? Structural forces are likely to continue shaping interest rates. For long-term investors, there is a case for using high-quality bonds selectively as a source of portfolio income. Where risk tolerance and liquidity management allow, however, we see better return opportunities in equities—for example, across the AI value chain and in infrastructure. Unlike bonds, these investments are more likely to benefit from higher inflation and deficits, partly because some of this spending flows to companies as revenue and profit. For issuers, by contrast, it is recorded as spending or debt that must later be repaid or refinanced.

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