Fixed Income Review & Outlook

3Q 2026: Rising Rates Reshape the Bond Market

Madison INVESTMENTS

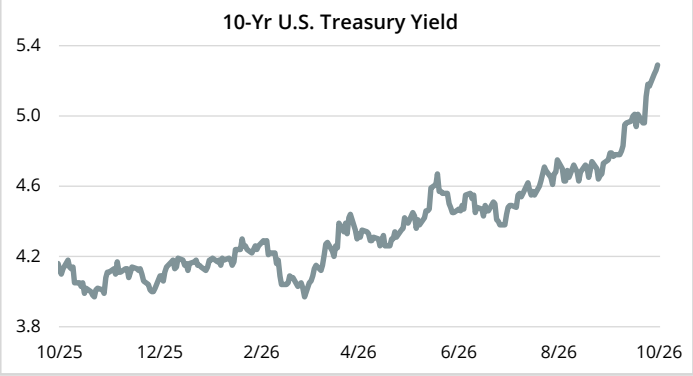
- Yields climbed as economic and geopolitical forces converged to drive renewed market uncertainty.
- The Fed raised rates as inflation persisted, while Treasury efforts failed to reverse rising long-term yields.
- Credit remains resilient, but tight spreads and AI-related risks make selectivity increasingly important.
- Elevated yields offer attractive income, diversification, and a cushion against further rate moves.

Going Up, Up, Up

Yields traced a volatile upward path in the third quarter as economic and geopolitical forces converged to revive market uncertainty. Tariffs continued to work their way through the economy, with additional tariff threats being made to key trading partners in the quarter. The conflict in the Middle East kept energy prices elevated, with diesel prices becoming an increasing concern. The massive AI infrastructure buildout has added to inflation concerns despite helping overall growth, and fiscal policy continues to increase the supply of Treasuries at a time when investors are demanding more compensation to hold longer-term debt.

Despite these developments, the economy continues to grow. The labor market has slowed, but not enough to suggest a material deterioration in economic activity. And, importantly for the Federal Reserve (Fed), inflation has not yet hit wages.

This leaves investors in an unfamiliar environment. Higher yields create a better starting point for bonds, but yields are higher for legitimate reasons, with potentially further to go.

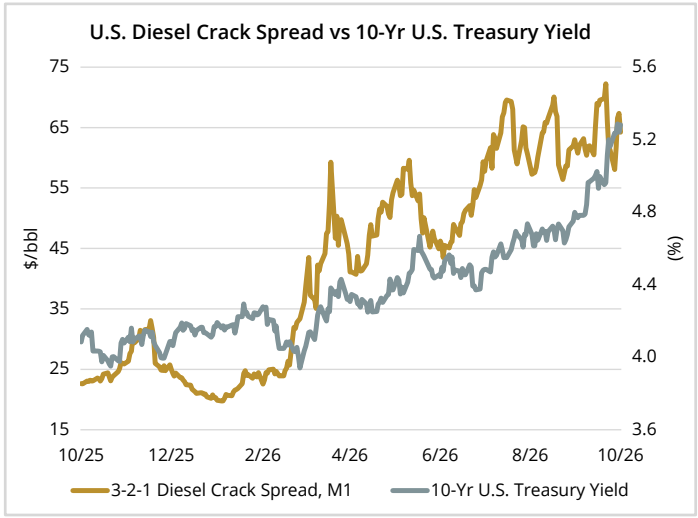


Energy prices, tariffs, and fiscal deficits are all pressuring the long end of the yield curve, while persistent above-target inflation has left the Fed little choice but to intervene with rate hikes.

The good news is that higher starting yields are doing exactly what we would expect them to do. Despite the move higher in rates, bond returns have held up much better than they did during the 2022 selloff, as income is providing a meaningful cushion against interest rate volatility.

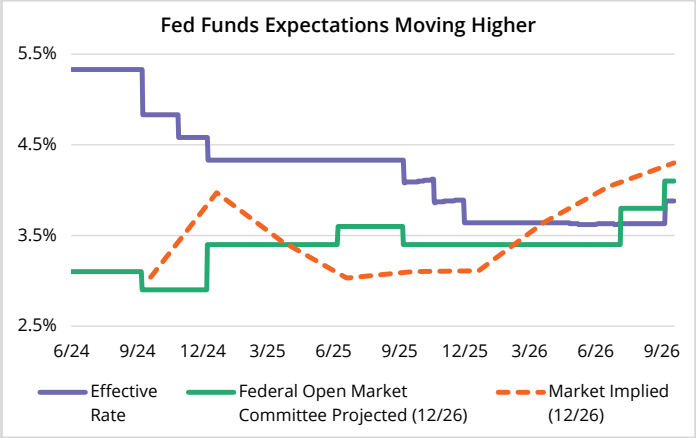
The Cumulative Impact on Rates

Energy is the most important piece of the inflation story. The ongoing conflict in Iran has driven energy costs uncomfortably high, with no resolution in sight. Not only are crude oil and gasoline prices higher, but diesel prices have also spiked, which arguably has a greater impact on the broader economy, since these costs will appear in transportation, manufacturing, agriculture, and other downstream activities. Sustained inflation here will be much harder to contain.



3-2-1 diesel crack spread: measures the gross margin of turning crude oil into refined products ($/bbl, lhs). U.S. 10-Yr Treasury Yield (%, rhs).

Which leads us to interest rate policy. Even though the Fed's policy rate will have little impact on oil and diesel prices, Chair Kevin Warsh and his hawkish rhetoric have essentially backed the Fed into a corner, where the only plausible move to tame inflation and maintain credibility is to raise rates. And that's just what they did in September, raising the Fed Funds rate by 25 basis points and hinting that more hikes could come.



The Market Implied Rate is derived from the CME 3-Month SOFR Dec 2026 futures contract. This is a proxy that reflects market expectations for the Fed Funds Rate.

Market pricing currently points to three additional rate hikes by the end of 2027. If Chair Warsh wanted the bond market to assist in creating restrictive conditions, that's exactly what he got.

The Treasury has also taken steps to address pressure at the long end of the curve. In August, it announced plans to double the pace of Treasury buybacks from $4 billion to $8 billion. The market did not go along with this attempt, and long-term rates continued moving higher.

By the end of the third quarter, the 10-year Treasury reached 5.29%, and the 30-year Treasury yielded 5.64%, both multi-decade highs. Mortgage rates across the U.S. are back above 7%. Heading into the mid-term elections, affordability concerns will be top of mind for voters and heavily propagated in political ads. For the incumbent party, a policy pivot ahead of November would not be out of the question.

Approaching Risk with Caution

Despite inflation and turmoil in the rates market, credit spreads continue to convey strength in the corporate sector. Opportunities remain in a tight-spread credit market, but this environment requires more selectivity. The flood of hyperscaler issuance has met sufficient demand, but investors may not be compensated adequately given questions about the sustainability of AI-driven growth. A spread-widening, even back to historic averages, would impact prices and potentially amplify the effects of rising rates.

We're paying close attention to the cash flows and financial health of hyperscalers, as well as companies and issuers indirectly exposed to the AI investment cycle. We're also watching how much new supply is coming to the market and how easily investors are absorbing it.

Within the credit market, we're finding better relative value in Financials, particularly banks. But even here, selectivity matters, as some financial institutions have greater exposure to the AI investment cycle, while others face risks associated with private credit. As with any corporate sector, Financials are not one homogeneous trade.

Outlook

Between the war in Iran, tariff policies, fiscal discipline, and the AI boom, something will need to give for the upward trend in interest rates to reverse. Under normal circumstances, the cumulative effect of these factors would signal a slowdown and, according to the traditional playbook, lower rates. However, these are anything but normal times, and even if economic growth slows, the long end of the curve could remain under pressure from energy prices, inflation, and fiscal concerns.

For investors, the rate volatility and upward movement have provided an attractive entry point for bonds. Starting yields are meaningfully higher than in recent years, giving investors not only income but also the diversification they couldn't get in a zero-rate environment, plus a cushion if rates continue moving higher.

But higher yields above and beyond Treasuries don't automatically mean better opportunities. This is an environment where all risks can dictate performance—duration, credit, inflation, liquidity. Selectivity matters, given the forces affecting rates and the uncertainty that resides within the new AI-heavy economy. There are no bad bonds, just bad bond prices.

Bond Concepts: What Really Moves the 10-Year Treasury Yield?

Investors pay close attention to the 10-year Treasury yield because it is a foundational "risk-free" reference point by which just about every asset in the world is valued. Traditionally, the 10-year yield is a reflection of economic growth expectations and inflation, but more recently other factors have become more influential.

- **The path of Fed policy** – As the Fed steers the short-term policy rate to head off inflation or stimulate growth, the market-driven 10-year yield will often be an indication of the Fed's level of success.
- **Energy prices** – Higher energy prices, including refined products such as diesel, can feed inflation throughout the economy. Significant spikes in energy prices can elevate inflation expectations and will often lift bond yields.
- **Fiscal deficits** – The Congressional Budget Office projects that debt held by the public will reach 120% of GDP by 2036, up from around 100% today. If this trajectory continues without congressional intervention, Treasury supply will continue to increase and could raise questions about the market's willingness to absorb that supply.
- **Foreign demand** – Foreign investors hold approximately 30% of publicly held U.S. debt. Changes in foreign demand would affect the supply and demand balance and, in turn, the yield investors would require to own longer-term Treasuries.

It is tempting to explain a move in the 10-year Treasury with a single factor. The reality is much more complicated. For investors, understanding why yields are moving can be just as important as the direction they are moving, as it will have implications across a portfolio. A rate increase driven by stronger growth expectations differs significantly from one driven by higher inflation or a higher term premium. Each can have different implications for the bonds, stocks, and other risk assets in a portfolio.

To learn more about the drivers of interest rates, read Rising Term Premiums or listen to our recent podcast episode, What's Really Driving the 10-Year Treasury.

"Madison" and/or "Madison Investments" is the unifying tradename of Madison Investment Holdings, Inc., Madison Asset Management, LLC ("MAM"), and Madison Investment Advisors, LLC ("MIA"). MAM and MIA are registered as investment advisers with the U.S. Securities and Exchange Commission. Madison Funds are distributed by MFD Distributor, LLC. MFD Distributor, LLC is registered with the U.S. Securities and Exchange Commission as a broker-dealer and is a member firm of the Financial Industry Regulatory Authority. The home office for each firm listed above is 550 Science Drive, Madison, WI 53711. Madison's toll-free number is 800-767-0300.

Any performance data shown represents past performance. Past performance is no guarantee of future results.

Non-deposit investment products are not federally insured, involve investment risk, may lose value and are not obligations of, or guaranteed by, any financial institution. Investment returns and principal value will fluctuate.

This report is for informational purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any security and is not investment advice.

Upon request, Madison may furnish to the client or institution a list of all security recommendations made within the past year.

In addition to the ongoing market risk applicable to portfolio securities, bonds are subject to interest rate risk, credit risk and inflation risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Credit risk is the possibility that the issuer of a security will be unable to make interest payments and repay the principal on its debt. Bonds may also be subject to call risk, which allows the issuer to retain the right to redeem the debt, fully or partially, before the scheduled maturity date. Proceeds from sales prior to maturity may be more or less than originally invested due to changes in market conditions or changes in the credit quality of the issuer.

Diversification does not assure a profit or protect against loss in a declining market.

Basis point: one-hundredth of a percent.

Bond Spread: the difference between yields on differing debt instruments of varying maturities, credit ratings, and risk, calculated by deducting the yield of one instrument from another.

Federal funds rate: the target interest rate range set by the Federal Open Market Committee (FOMC) for banks to lend or borrow excess reserves overnight. It influences monetary and financial conditions, short-term interest rates, and the stock market.

Yield Curve: A graph showing the various yields of similar types of securities that vary in their maturity dates. A flat yield curve is one in which short-term bonds have yields similar to longer bonds.