

Investment OUTLOOK

February 2026



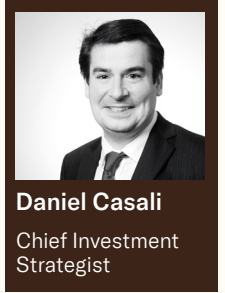
*A monthly round-up
of GLOBAL MARKETS
and trends*

*In this issue:
Policymakers face a
Hobson's Choice.*

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Policymakers face **a HOBSON'S CHOICE**



Summary

Policymakers face a Hobson's choice: either loosen policy to support growth and risk inflation or tighten and risk recession. Accommodative fiscal and monetary policy supports the equity rally but raises bond market vulnerabilities. Elevated public debt constrains policy flexibility, making portfolio diversification, such as owning gold, essential to hedge against risks in the bond market and geopolitical tensions.

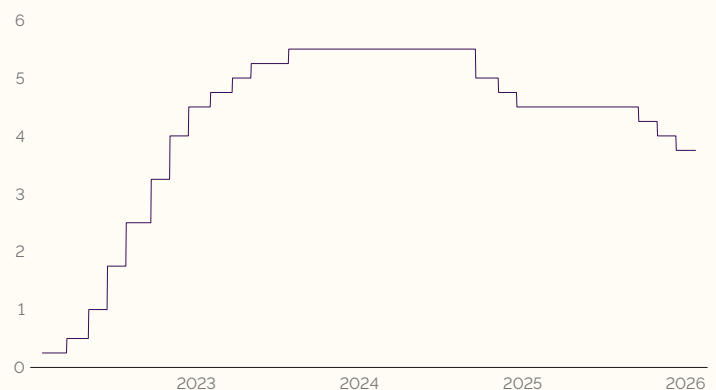
Bring on the policy easing

In 17th-century Cambridge, English stable owner Thomas Hobson offered customers what seemed like a choice of horses but in fact was no choice at all: take the horse nearest the door or none. Hobson enforced this rule to keep his horses healthy and evenly used, and although customers believed they had options, it was really a take it or leave it. The term "Hobson's choice" now describes any situation where only one real option exists.

Today, governments and central banks face a similar dilemma. They can loosen policy to boost growth, risking a resurgence of inflation, or tighten policy to restrain inflation, risking a recession. Neither path is attractive, yet one will need to be taken.

Right now, it is clear which path is being taken in the United States as policy moves toward further loosening. On the monetary side the Federal Reserve (Fed) has already cut interest rates by 1.75% points since their peak and is expected to cut further in 2026.¹

US Fed Funds target rate



Source: LSEG Datastream / Evelyn Partners as at 23 January 2026

At the same time, fiscal policy is adding fuel to the fire through wide budget deficits. The US government's One Big Beautiful Bill Act (OBBBA) that kicks in this year is front-loading stimulus to the economy. The US are not alone here - Germany's budget deficit is set to widen in 2026, and Japan's new administration is ramping up spending.

The powerful combination of monetary and fiscal easing has supported equities, and reinforced the perception that governments will spend their way out of every political predicament - a pattern established during the global financial crisis and amplified throughout the pandemic.



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Risks from the bond market

Nevertheless, for policymakers, this remains a Hobson's choice. Elevated US government debt makes policy loosening almost unavoidable. Federal debt now exceeds 125% of GDP. This creates financing challenges for the US government and risks instability in the bond market.¹

To preserve debt sustainability, and avoid a disorderly spike in yields, policymakers have strong incentives to target lower interest rates even if that means tolerating higher inflation risks. A case in point is the fact that the Fed ended quantitative tightening at the start of December 2025 and has shifted to expanding its balance sheet through a short-term asset purchase program of \$40 billion per month.¹ For the bond market, this matters because when the Fed buys government debt, even short-dated bills, it adds liquidity and can help steady borrowing costs.

Although running policy too loose could lead to higher government bond yields as investors may demand a premium to compensate for inflationary risk. This could lead to heightened volatility in equity markets, as was seen during 2022 when central banks abruptly raised interest rates after pandemic-era stimulus.

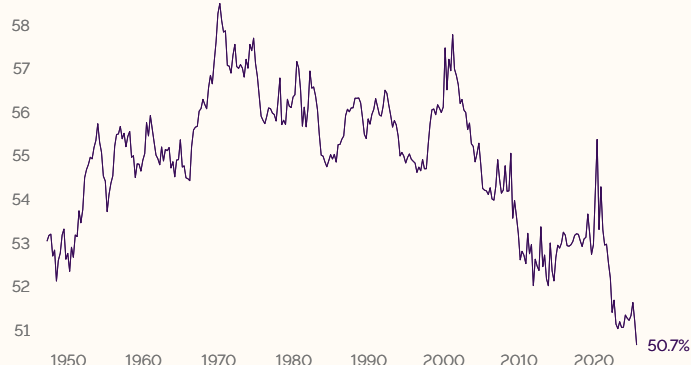
Current equity valuations assume a stable bond market backdrop, so any tightening could weigh heavily on rate-sensitive sectors such as technology, which trades on a high valuation. Against this backdrop, we see three key factors that could trigger bond market volatility for investors to monitor closely in 2026.

1) Stronger-than-expected US economic growth

Given the scale of fiscal and monetary easing, combined with wealth gains from rising equities, resilient US demand growth seems likely. This should translate into a firmer labour market, even after the crackdown in net immigration and redundancies in the Federal sector under the direction of the Department of Government Efficiency.

US labour also remains comparatively affordable, with the share of labour compensation to GDP at a record low of 50.7%, down from a last peak of 57.8% in 2001, the year China joined the World Trade Organization.¹

US employee compensation to GDP, %



Source: LSEG Datastream / Evelyn Partners as at 23 January 2026

For investors, a stronger labour market could lessen the urgency for additional interest rate cuts and could push US long-dated Treasury yields higher on inflation concerns. However, as a counterbalance to the inflation risk, there is sufficient crude oil supply flowing around the global economy. The recent removal of Nicolás Maduro from his Caracas palace by US forces - reshaping the political dynamics of a country with the world's largest proven oil reserves - supports this situation. A post-Maduro Venezuela under US control of petroleum fields could unlock significant investment and boost crude exports, adding supply to global markets. This could push oil prices lower over time, easing inflation concerns.



2) *A shift to a more left-leaning UK government*

From a portfolio perspective, the UK gilt market matters. The UK faces upcoming local elections in England, Wales and Scotland, where the Labour party is expected to perform poorly. Given Prime Minister Keir Starmer's weak approval ratings, the risk of a leadership challenge is elevated. A leftward shift, which is possible given the Labour party's rules, could increase gilt yields, particularly longer-dated bonds.

Compounding the risk, the Office for Budget Responsibility warns that Defined Benefit (DB) pension schemes are largely closed to new members and are being actively wound down. This reduces demand for long-dated gilts and drives up yields. DB pension schemes demand is projected to fall from roughly 30% of GDP to around 11% by 2050, potentially adding about 0.8% to long-dated gilt yields and £22 billion to debt-servicing costs.

As a result, the UK Debt Management Office may need to issue more short-dated debt and therefore rely more on price-sensitive investors, increasing volatility and fiscal risk as public debt climbs.

3) *Japan's debt concerns*

Given Japan's status as home to one of the largest sovereign bond markets, shifts in Japanese fiscal and monetary policy, or investor behaviour can transmit rapidly to global bond markets through capital flows, yield differentials, and currency dynamics.

Moreover, after decades of low inflation and near-zero interest rates, recent wage increases and consumer price rises have pushed the Bank of Japan toward rate hikes, lifting the 10-year Japanese Government Bond (JGB) yield to 2.3%, the highest level since 1997.¹

Japanese 10-year government bond yield, %



Source: LSEG Datastream/Evelyn Partners as at 23/01/2026

Since October, new Japanese Prime Minister Sanae Takaichi has reinforced this shift. Her expansionary fiscal agenda is set to intensify following her decision to call a snap general election for 8 February, aimed at securing a stronger mandate to advance her economic programme. However, this introduces three key risks for global bond markets — and potentially for equities:

Fiscal credibility risk: Takaichi's central campaign pledge is to lower the 8% consumption tax on food to zero, but the policy currently lacks a clear funding plan, drawing uncomfortable parallels with former UK Prime Minister Liz Truss's unfunded tax-cut agenda in 2022.

Political execution risk: Despite Takaichi's personal popularity, it remains uncertain whether her party can secure a firm lower-house majority, raising the risk of policy inconsistency or legislative gridlock at a particularly delicate economic juncture.

Global spillover risk via capital flows: Rising JGB yields are eroding the appeal of the yen carry trade, in which investors borrow in yen — historically at low interest rates — to purchase higher-yielding assets abroad, such as foreign bonds. As domestic borrowing costs rise, these carry trade positions may be unwound, prompting selling in overseas bond markets. This repatriation of capital could push global yields higher, tighten financial conditions, and amplify cross-asset volatility well beyond Japan.

Balancing easy policy with risks

In short, policymakers face a Hobson choice. They could tighten policy, but that could lead to a recession and raise their debt burden in the economy over time.

However, more palatable is to keep policy loose, even if that raises the risk of inflation. For investors, this is a more appealing outcome as it would mean that underlying economic growth would support company earnings.

Right now, near-term inflation risk appears contained, allowing equities to extend gains, supported by incremental policy easing and improving earnings. Even so, investors should keep diversifiers topped up in their portfolios. These include financial assets, such as gold, which benefits from solid official and private demand, as well as being a hedge against geopolitical issues, such as Trump's threat for the US to take control of Greenland by force if necessary.

Speak to us

Source

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Warnings

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Past performance is not a guide to future performance.

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