



Fighting may stop, but the economic fallout is just getting started

Middle East tensions ease, markets respond

Key points:

- **Geopolitical de-escalation:** The Middle East ceasefire has held, helping bond yields to decline and U.S. equities to recover above pre-conflict levels.
- **Oil supply disruption:** The Strait of Hormuz closure has started impacting global supply chains, with immediate delivery Brent prices hovering around \$140 per barrel.
- **Inflation outlook elevated:** Euro headline CPI is projected to hit 3% and U.S. CPI could reach 4%, driven by higher energy, food and airline costs.
- **Central bank dilemma:** We expect the ECB to deliver two rate hikes in 2026, whilst the Fed under Kevin Warsh is unlikely to cut rates until inflation retreats.
- **Macro outlook challenging:** Growth forecasts have been revised down, with the Eurozone now expected to grow at only 0.5% and recession risks rising if conflict re-escalates.

London, 17 Apr 2026: With the ceasefire in the Middle East holding, global bond yields traded lower over the past week, with an ongoing recovery in risk appetite helping to push US stocks back above levels seen prior to the launch of Operation Epic Fury. Prospects for additional talks, after those last week failed to yield a material breakthrough, have helped to buoy optimism that a deal is within reach, even though the Strait of Hormuz remains largely closed to traffic for the time being.

Indeed, with the US blockade of Iranian ports coming into effect, it appears that the US is hoping that Beijing will be able to pressure Tehran into conceding ground in upcoming negotiations, though it remains far from clear what concessions Iran is prepared to make, amidst a climate of mutual distrust. This said, with the US having demonstrated no willingness to escalate conflict by putting boots on the ground, it seems realistic to hope that we will avoid a return to the situation facing the region just a couple of weeks ago.

Yet it is still quite possible that transit via the Strait of Hormuz remains impaired for some extended period of time. From an economic perspective, this closure is already starting to have significant consequences, which are being felt across the global economy.

In this context, our latest thinking is that even in a scenario where there is a compromise deal relatively soon, we don't see oil going much below \$80 in the coming six months, as we reflect on the damage to infrastructure and the length of time it will take for supply chains to normalize. We would also note that whilst benchmark oil futures are trading back below \$100 per barrel, prices for Brent on immediate delivery are hovering around \$140, as shortages start to be felt.

From this standpoint, it is worth remembering that tankers may take 4 weeks to travel from the Gulf to their final destination, and therefore it is only just now that consumer markets are starting to feel the start of shortages, which are likely to become much more acute, over the course of the coming weeks.

In the case of the U.S., low taxation on gasoline means that the percentage change in pump prices is more significant than elsewhere. However, with respect to natural gas, it is noteworthy that U.S. Midland gas prices have not risen, whereas prices in Europe have increased substantially in the wake of LNG disruption from the Gulf.

With respect to CPI, we would highlight prospective food inflation, with disrupted fertilizer deliveries impacting crop yields this year and elevated transportation costs also being fed into higher consumer prices. We are also witnessing a large jump in airline prices with fares marked dramatically higher in the past month in the wake of a doubling in jet fuel prices.

In this way, inflation dynamics are subtly different between Europe and the U.S., but in both cases we foresee a level around 1% higher than we think we would have seen were it not for this negative supply shock. This means we project Euro headline CPI to hit 3%, with 4% possible in the U.S., though core prices are expected to be around 0.5% below this level.

Meanwhile, we think economic growth is likely to be adversely impacted by slightly more than 0.5%. This will still see the U.S. economy growing at a healthy pace above 2%, but in the Eurozone, our baseline for growth is now only around 0.5%. In an adverse scenario, were the conflict to escalate again in the days ahead, then this will make a move into recession a probable outcome, rather than a possibility.

In this respect, the energy price shock of 2026 is a classic stagflationary supply shock. This differs with what occurred in 2022, when rising energy prices occurred at a time when demand was strong in the bounce back from Covid, and when policy conditions were stimulative and some way behind the curve, with interest rates having been at 0% and fiscal policy adding to demand.

This economic backdrop is markedly different from what we were discounting at the start of 2026. Consequently, we would caution against the recent rebound in the prices of risk assets, now that the missiles have stopped flying through the sky. U.S. stocks may have posted new record highs over the past few days, but we would observe that the macro backdrop is going to be more challenging than was the case at the start of the year, and monetary policy conditions on both sides of the Atlantic are set to be more restrictive (or less accommodative) as a result.

With respect to the ECB, we discount two hikes in 2026, in line with what is discounted in futures curves. We struggle to see the Fed hiking under Kevin Warsh this year, but rate cuts are also very unlikely until inflation is on the way back down again.

Assessing the opportunity set in markets, we do not hold a strong directional view with respect to U.S. Treasuries. In Europe, we think adding outright exposure in inflation linked bonds appears interesting, with rates markets having already priced in two hikes in the case of the Eurozone.

Since we see a bigger overshoot in inflation as the principal risk to ECB and short dated German Bunds, buying real yields instead of nominal goes some way to mitigating this risk. With respect to yield curves, we think there will be an opportunity to return to curve steepening trades, as short rate expectations should peak once a peak in inflation can be established, given the prospects for weaker growth to follow in its wake.

Moreover, pressure on fiscal spending may continue to weigh on long dated bonds. However, we think that it may still be premature to return to steepeners at a time when we think inflation surprises will continue to come through on the upside in the data over the next month or two.

We continue to think the Bank of England will be reluctant to hike rates against a weak economic backdrop. However, inflation overshoots more easily in the UK than elsewhere and consequently Governor Bailey may end up with little choice. Once we can see a peak in inflation, then we think there may be an opportunity to renew a more bullish stance on Gilts, but with prospective political volatility around the corner, now does not feel the right time to be invested and Gilts can continue to trade with elevated volatility, given the absence of a solid domestic buyer base.

In Japan, we see the BOJ likely maintaining policy on hold at the end of this month, as Ueda and colleagues determine they want to take more time to assess the economic impact of the war in the Middle East. Inflation

in Japan currently stands at 1.5% and we see this rising towards 2.5%. But as long as a strong indication of a June hike is forthcoming and the threat of FX intervention remains, so it may be possible to ensure that the yen remains below Y160 versus the dollar.

Meanwhile, we continue to look for evidence that Japanese domestic investors will materially increase domestic asset weights in their asset allocation decisions, which they are in the midst of debating at the start of the new fiscal year.

We see increased JGB allocations supporting long dated JGB yields, knowing that Japanese pension funds only need to earn 2% annual returns, and long dated domestic bond rates are already well in excess of this level.

In FX markets, the dollar has been trading with a weaker bias as the conflict has receded. Looking ahead, we think we are moving back towards a weaker dollar regime, and that global trends will see more investment domestically as countries and regions seek to retain savings to fund local objectives.

Meanwhile, the drop in perceptions of the United States has seen many clients seeking to allocate away from the U.S. market, eager to look at opportunities elsewhere. This backdrop can be supportive in Emerging Markets, notably so in those economies which are oil exporting nations such as Brazil, Colombia, or elsewhere in Latin America. Here, local bond and FX weakness since the start of the conflict has not appeared justified and on a relative basis adding longs versus shorts in Asian countries such as India, Thailand or the Philippines, which are all oil importers, appears to hold merit.

In this context, we think there remains substantial complacency in credit and equity markets and it does not feel like markets have fully reflected the changes in the macroeconomic backdrop, even if Trump is able to agree a peace deal in the days ahead.

Looking ahead

It is likely that the focus at some point will shift from the daily analysis surrounding the Strait of Hormuz and back onto the economic data and the building inflation shock, and subsequent growth shock, that events have already baked into the system.

Upside surprises on CPI data are very likely and as central bank rhetoric turns more hawkish, it is very possible that this will be the catalyst which sees risk assets start to falter in the days to come. In this respect, we would observe equity markets always struggle to price geopolitical risk, and ultimately it will be rates and monetary policy which will have a more direct effect.

Elsewhere, it was interesting meeting with investors in Italy this week, getting a sense of the disgust and disbelief that the U.S. President should seek to attack the Pope, whilst posting religious self-images on X, which were viewed as grossly inappropriate in the Catholic country.

Politically speaking, it has been interesting to see political leaders of more far right populist parties in Europe seeking to distance their association with Trump, knowing this is also impacting their own standing with their electoral base. JD Vance's attempts to support the re-election of Viktor Orban in Hungary appear to have backfired, though it may seem quite likely that the Hungarian electorate were ready to replace Orban anyway. Yet it shows the extent of the international standing of the U.S. right now, that any association with this current Administration could have a detrimental impact. In this respect, one can only imagine further testing times in U.S./European relations ahead.

Indeed, heading to Washington next week, it is easy to wonder when Trump's attacks on NATO will see the U.S. withdrawing from the Alliance - or whether it will be time again to go after Greenland, as POTUS vents frustration at the relative failure of the U.S. policy in the Middle East.....

Contact:

Lydia Cambata
lcambata@bluebay.com

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