



Markets become disconnected from the reality on the ground

Markets Stable Despite Middle Eastern Stalemate

Key points:

- **Global supply chain tensions:** with the Strait of Hormuz remaining closed, the effects are now starting to be seen tangibly outside of the US.
- **Market disconnect:** meetings with DC policymakers revealed a seeming disconnect between what was being heard on the ground, and what may be embedded in market thinking.
- **Growth:** the prospects for a recession in Europe and in a number of countries in Asia continue to rise.
- **ECB rates:** even with an impending growth shock, we expect the ECB will hike rates in June and September, and the Bank of England may reluctantly be forced to follow suit.
- **UK political crisis and Gilts:** Starmer likely ousted after May and potential successor's agenda may clash with bond market constraints, creating potential for market accident.

London, 24 Apr 2026: Markets have continued to trade in a relatively stable fashion over the past week, with US stocks remaining at record highs, notwithstanding an ongoing stalemate in the Middle East.

With the Strait of Hormuz remaining closed, this continues to exacerbate tensions in global supply chains, with the effects of this now starting to be seen tangibly outside of the US, as airlines cut flight schedules and supply shortages lead to curtailed production in some countries.

In meetings with policymakers in Washington DC over the past week, what struck us was the seeming disconnect between what we were hearing, relative to what may be embedded in market thinking.

Although the U.S. economic outlook remains healthy, this is not mirrored overseas. Consequently, we observe that relative strength in the S&P in the U.S. should not be the basis for risk assets elsewhere. As a result, we would question the validity of the recent rally in European equities and credit, with the same applied in a number of markets in Asia, whose economies are similarly more exposed to downside risks as well.

Although the U.S. will experience an inflation shock on the back of higher commodity prices, it is much more immune to the physical shortages which loom elsewhere. Therefore, we think that the growth impact of the conflict on the U.S. economy is likely to be moderate, with aggregate demand continuing to be supported by tailwinds from tax cuts, deregulation and the investment boom in AI. However, the looming growth shock in Europe and much of Asia continues to build with every week that passes, with shipping in the Gulf largely at a standstill.

With respect to the conflict itself, several meetings with informed policy officials suggested that the current market assumption, that a renewed military escalation remains very unlikely, could yet prove to be inaccurate. Although a breakthrough in talks is a possibility, an extended stalemate has been our base case.

However, the more hawkish camp in DC voiced that, unless the U.S. can 'finish the job', it won't be long before Shahed drones are adapted to a jet powered engine and this will represent an even more serious threat to security. This grouping suggested that a key mistake at the inception of Operation Epic Fury (a bit like when Russia initially attacked Ukraine), is that the extent of the military strike was too limited.

In a rush to act, it appears that the U.S. deviated from previously prepared plans with respect to the optimal way to proceed. These plans noted that Kharg Island and the coast should have been simultaneously invaded at the onset of the initial strikes, in order to prevent Iran being able to exert strategic pressure through the disruption of an obvious choke point.

But hawks argue that this mistake can still be corrected, now that more U.S. military assets are being built up in the region. From this point of view, the U.S. is now in a much stronger position to mount a more widescale offensive than had been the case a few weeks ago. This grouping is also optimistic that with the UAE gaining more expertise in managing the current drone threat, with input from Ukraine, so the ability for Iran to land decisive blows across the region may be blunted.

There is a sense that Trump would like a swift end to the conflict, but it may be that a military escalation is the means to expedite this, given that hardline elements in Iran's IRGC seem very far from wanting to agree to the demands, which the U.S. Administration is committed to deliver before it is prepared to step away from the region.

Although the war itself is not popular in the U.S., it does seem that, for now, the main source of concern for voters is higher gas prices when they fill their cars at the pump. Indeed, even amongst a Democrat audience there is a sense that Iran has been a bad actor for many years and had this coming to them. Moreover, with midterms ahead, political analysts stressed that voters memories are short and in that context what really matters in the midterms, is what comes to pass in October, rather than where we are today.

On the midterms themselves, it may appear that the Democrats winning the House is a done deal. A victory in the Senate appears much less likely, but there is a growing view that the Dems could make a clean sweep at the national elections, which take place at the end of 2028.

Having noted this, there is also a sense that Trump will seek to rule via Executive Order in 2027, with frequent clashes with the courts as he seeks to test the Presidential privilege in a way not witnessed before. This makes Congress less relevant than may be expected over the next couple of years, and indeed the budgets of lobbying firms are being directed away from Capitol Hill and focus more squarely on the White House as a result.

Meanwhile, although the Dems may be inclined to launch impeachment proceedings against the U.S. President, these are seen as an irrelevance as there remains no viable path to such a motion gaining the required 60 votes.

Future Fed Chair Warsh's Senate confirmation hearings this week offered few new surprises. As previously stated, Warsh desires a smaller Fed balance sheet, though it is not completely clear he will be in a position to deliver one. This could argue for an offset via an easier interest rate policy. Broadly speaking, markets expect the incoming Fed Chair to be dovish on rates, but in all likelihood, monetary policy is set to remain on hold through 2026 with inflation much too high to merit a cut, but the barrier to monetary tightening as growth cools, also preventing the Fed from doing anything material.

No change in Fed rates is expected until the end of this year, and with little discounted in futures curves we think that Treasuries can range trade around current levels. As for the U.S. economy, if GDP expands by 2% when inflation rises to 4%, this implies 6% nominal growth and based on balance sheet leverage a healthy backdrop for nominal corporate earnings.

With retail investors still buying every dip and leveraging their own balance sheets as they seek to generate attractive investment returns, so this is continuing to help U.S. stocks for now. That said, policymakers in DC do appear concerned that the more prices may rise in the short term, the more they may end up reversing in due course.

However, away from the U.S., the picture looks a lot more challenging. We think that Eurozone inflation will rise above 3% and growth is set to slow below 0.5%, even if there is a swift re-opening to the Strait of Hormuz in the wake of a peace deal. But should transit of the Strait remain at a standstill, we would be inclined to subtract 0.1% from GDP and add a further 0.1% to inflation, for every additional week that we are stuck with this impasse.

Physical commodity traders are sounding a very clear alarm and as we reflect on the landscape, we are reminded of the steady march westwards of the Covid virus in January and February of 2020. In this respect, although we could see what was coming, it was only when it landed on our shores that we witnessed a much more material market event.

Similarly, we note that the very last tankers from the Gulf from before the war have been reaching their destinations in Asia in the past week. From this point forwards, supply shortages are only going to worsen, and it is inevitable that demand destruction will need to occur, in order to bring supply and demand back into balance.

This being the case, the prospects for a recession in Europe and in a number of countries in Asia continue to rise. Anecdotally, a 2.5% monthly increase in German producer prices and a 7.3% annual rise in UK food prices in March are harbingers of the inflation pain that may lay ahead.

Consequently, even with an impending growth shock, we expect the ECB to need to hike rates in June and September and the Bank of England may reluctantly also be forced to follow suit. In this context, we continue to add to positions in inflation linked bonds both on a breakeven and on an outright real yield basis. In Japan, we also see monetary tightening ahead, though we think the BOJ will defer hiking in April, with a 25bp increase likely to be signaled for June.

In the UK, on top of the economic problems which are building, political volatility is also on the rise and it now seems very likely that Prime Minister Starmer will be ousted after the UK local government elections in May. Angela Rayner is his most likely successor, and she will have a job allaying bond market concerns with respect to a more left-wing Labour Party agenda. In many respects, the Gilt market may give Rayner very little room for policy manoeuvre, much to the frustration of the Party base. This creates the pretext for a possible market accident, but with yields already elevated, we believe that the best way to position for this possibility is by maintaining a short FX stance with respect to the pound.

Elsewhere in FX we continue to favour EM oil-related longs versus energy importer shorts, though we have no strong view on the euro relative to the dollar. Structurally, we see value in the yen at 160 and retain a small long position, which we may be inclined to add to once the BOJ policy meeting is out of the way. The threat of intervention above 160 remains very credible.

Until the Strait of Hormuz reopens and the conflict between the U.S. and Iran is resolved, the news flow around this may continue to dominate markets for the time being. We have seen how U.S. stocks can be impervious to events many thousands of miles away. But shifting dynamics overseas will be more plain for those living in Europe and Asia to see as everyday lives are impacted. Indeed, at this rate, even our summer holiday plans are being placed at risk of being cancelled.

This speaks to a breakdown of risk asset correlations and portfolio repositioning, until investors can see beyond the inflection point when supply chains will be able to re-normalise. But with informed analysts citing the notion that it may be years until LNG prices decline in the wake of a building supply shortage that would have been present, even without the war in the Middle East and damage to Qatari infrastructure, this points to ongoing supply chain issues.

Another anecdote relates to the supply of car hub caps, which had been a market largely supplied by production from the UAE. But with the aluminium smelter in Abu Dhabi needing replacing, after molten metal solidified in the existing one in the wake of a power cut, so this may take 12-months to be brought back online. There are many micro examples of this where supply chains are global and vulnerable to disruption.

Looking ahead

In many respects an obvious corollary from the current conflict will be that going forward, countries need to re-establish greater self-sufficiency. Certainly in defence, in energy and in food production, it is important to have a degree of self-sufficiency rather than needing to rely on others. If this lesson was not learnt in Covid, and still not learnt after the onset of the Russia-Ukraine war, so it seems that after a third massive macro supply chain shock in just over 5 years, it will be unforgivable if this lesson is overlooked for a third time.

Politics and geopolitics are becoming more vulnerable, and in this respect a very obvious take away for policymakers is that in moments of crisis, you just cannot afford to be reliant on others.

For now, we retain a cautious posture in our strategies. We don't often see such a large disconnect between market thinking and what we are hearing in the policy community and experience has taught us to pay close attention when this is the case.

Of course, we hope that we can put this current crisis behind us. To this end, it is sad to note that, as a gloomy Chelsea fan, the team has failed to score a single goal in the Premier League since the Strait of Hormuz has been closed. That better get fixed soon, or next season could end up as bleak as Spurs at this rate!

Contact:

Lydia Cambata

lcambata@bluebay.com

About RBC BlueBay Asset Management

RBC BlueBay Asset Management ("RBC BlueBay") represents RBC Global Asset Management outside of North America and is an active asset manager with expertise across fixed income, equities and alternatives.

RBC BlueBay's solutions-driven approach means it endeavours to empower clients with the knowledge they need to help shape their investment decisions. It works and evolves with clients, creating and customising investment products that meet their needs.

Responsible investment is embedded across RBC BlueBay's business. This means it is not just an investment focus but is also ingrained in its client service experience and work to deliver solutions that support real-world impact.