



Iran faces down Trump

Peace deal may prove pyrrhic victory

Key points:

- **Iran conflict resolution:** the week saw signs of progress towards a peace deal, with Washington appearing to capitulate to some Iranian demands.
- **Inflation outlook persists:** inflation is still likely to hit 4% in the US and 3% in the Eurozone, prompting likely rate hikes from the ECB and BoE, despite weak growth trajectories.
- **Japan policy positioning:** the yen has strengthened following MoF interventions this week, potentially reducing pressure on the BoJ to hike rates at its June meeting.
- **UK political instability:** even if a leadership putsch does not take place over the coming days, then it seems unlikely that UK political risks will abate any time soon.
- **Market outlook cautious:** credit valuations look historically stretched, with stagflationary pressures and elevated recession risks supporting a cautious stance on European credit.

London, 8 May 2026: Nearly 70 days on from the US launch of Operation Epic Fury, it appears that some progress is starting to be made with respect to a peace deal between the US and Iran. With President Trump seeming increasingly desperate to draw an end to an unpopular conflict without appearing to lose face, it looks like the US administration is beginning to realise the limits of its military capabilities against a resolute and committed adversary.

Although Washington will want to spin things otherwise, this appears to be driving a degree of capitulation to Iranian demands. Ultimately, it may seem reasonable to conclude that we are heading back to a JCPOA type deal, which was on the table prior to the onset of war several months ago.

For all the physical damage and loss suffered by Iran in the intervening period, the fact that the IRGC has been able to control movement through the Strait of Hormuz can be seen as empowering Iran within the region, and potentially leaves the smaller GCC states hostage to Tehran's future demands.

This may be a bitter pill to swallow in Tel Aviv. However, it is an even more bitter pill in Dubai and Abu Dhabi, with the UAE seeming to have paid a high price for its loyalty to the US over the course of the past few months.

Meanwhile, one might imagine that an even more hardline and autocratic regime in Tehran may choose to be even more brutal and repressive in countering internal dissent within its own country. Although the Iranian economy is on its knees, as it recovers, so it may be reasonable to think that a paranoid theocracy may divert even more of its national wealth towards preserving its own future security and survival.

In time, this could set the stage for renewed regional conflict and may actually be one of the key narratives driving the pursuit of a nuclear deterrent, with the lesson from North Korea being that once one can be

attained, then others are much more likely to leave you alone in the future. Consequently, we are sceptical that Iran will give up its nuclear ambitions and there may be plenty of scope for a nascent peace deal to fall apart, if not in the short term, then at some point in the future.

Yet for now there will be relief, as and when shipping can resume and trade disruptions can start to unwind. However, we would caution against expectations that this will negate the economic shock which will continue to be to be felt for many months to come.

As previously shared, we expected oil prices to remain elevated and crude futures to remain around \$85 through the end of this year, even under the assumption that the Strait re-opens relatively soon. Inflation is still likely to hit 4% in the US and 3% in the Eurozone, in the wake of higher prices for food, energy, and a host of other goods which have witnessed increased shipping and input costs.

Against this backdrop, a rate hike from the ECB remains likely, and it is probable that the BoE will also need to follow suit, given entrenched inflationary passthrough effects, notwithstanding a weak economic trajectory.

Across the Atlantic, we continue to see no change in Fed policy in 2026, though we can start to become more confident that the next move in US interest rates will be lower, rather than higher, once inflation starts to fall into 2027. Consequently, we feel that US 5-year Treasury yields are unlikely to keep rising beyond 4%, and we have switched an inflation breakeven trade on medium-dated US TIPS, into an outright long in inflation-linked bonds, with yields at this level.

Elsewhere, our preference for inflation-linked bonds in Europe is also expressed on an outright basis in real yields in short to intermediate maturities. With some central banks likely more inclined to look through elevated CPI prints with economic growth slowing, we are happy to maintain this positioning.

Japan has been out for its annual Golden Week holidays, but as it returns, we look for evidence of increased share of asset allocation flows to be directed to domestic securities. This is a factor that may help to benefit JGB yields. Meanwhile, with the MoF intervening on a number of occasions over the past week, so a firmer yen may reduce pressure on the BoJ to hike rates at its June meeting.

We still think that Governor Ueda would be well advised to hike policy rates to 1.00% next month. If this is delivered, we look for an ongoing flattening of the long end of the yield curve with some life insurers already reporting increased intentions to purchase super long dated JGBs over the month ahead.

With respect to FX, we retain a modest long yen FX position. The determination to ensure the yen does not weaken would see us add to this holding on a return above ¥158 versus U.S.\$, though we are sceptical that the yen can rally below ¥150 in the absence of much more progress in narrowing interest rate differentials.

In the UK, yesterday's local elections may prove a pivotal moment with respect to UK politics. In the wake of a dismal showing for Labour, analysts are now left asking the question of when, rather than if, Starmer will be replaced as Labour Party leader and British Prime Minister.

Betting sites now have Andy Burnham neck and neck with Angela Rayner, with the mayor of Manchester seeming to enjoy all the current momentum at a time when Rayner's popularity ratings represent a challenge to her candidacy.

However, as Burnham cannot run, unless and until he secures a Westminster seat in a by-election, this means that if contenders want to cut off his chances, then the window to move against Starmer is in the here and now.

Burnham's prospects appear to be helped by a material disaffected Labour vote defecting to the Green Party, as the de facto protest party of the left. In this context, supporters will argue that the way for Labour to win and stop the rise of Reform and the populist right is to head in a more left leaning direction.

Yet were Burnham to emerge victorious, then this could set the stage for further UK financial market volatility, with gilt investors fearful of plans to boost spending at a time when tax rates are already at

historical highs. In this context, even if a leadership putsch does not take place over the coming days, then it seems unlikely that UK political risks abate any time soon.

From this perspective, we continue to think maintaining a short position on the pound has merit, with the UK economy also set to underperform its global peers.

Aside from some of the macro and political drivers, risk assets have continued to power ahead over the past week, with equity indices in the US and Asia posting new record highs. Strong earnings momentum and a seemingly insatiable appetite in AI has seen retail investors eager to jump onto the rally, leaving those who have been fretting around valuations and elevated P/E ratios feeling a sense of regret.

FOMO sentiment is undoubtedly sucking many in to jump on board at this point and a more decisive bullish swing in sentiment could yet see an acceleration in price action in the near term, as positioning and leverage is dialled up another few notches.

However, in credit it is hard to mirror such positive sentiment. Similar to equities, credit valuations look historically stretched, though unlike equities there is no lure of a right tail in the return distribution, which could herald the sort of potential outsized rewards by picking the winning stocks.

Moreover, at a time when we see a global economic shock and supply chain disruption acting as a stagflationary impulse for months to come, there is a risk of adverse credit migration and rising default risks, with recession risks more elevated in regions such as Europe and parts of Asia.

Consequently, we think that retaining a cautious stance on credit in Europe remains the correct view, even though spreads have continued to push tighter in recent days, in sympathy with other markets, on hopes for a Middle East deal.

Looking ahead

We express concern that pretty much all the good news has been priced at this moment, and this leaves us feeling relatively cautious. This said, we also know that what drives prices in all markets will be the intersection between buyers and sellers and from this perspective, if the pendulum which swings between fear and greed continues to shift in a more constructive direction, we know that prices can continue to rally.

From this perspective, it is also important in reflecting a cautious view, not to be overtaken by a more bearish mindset, which falls subject to confirmation bias. This noted, underlying yields and spreads in government and corporate bonds will continue to be driven by economic data, policy action, credit migration and changes in the level of defaults. This being the case, once the noise from the geopolitical headlines starts to abate, then data will provide much more of an investor focus.

With respect to the Middle East, we are struck that although the Iranian economy is in dire shape, the demonstration of resilience by the country is increasingly viewed as a strategic asset, in and of itself. Despite the US and Israel throwing everything at Tehran, the regime remains intact and possibly more resolute than ever.

Moreover, Tehran has managed to demonstrate that it is the big power in the Middle East, with an ability to wreak havoc on the global and regional economy. Noting this, it is very possible that finalising an interim agreement to re-open the Strait of Hormuz could still take time, with Iranians sensing US capitulation and wanting to maximise their own moment of leverage, for as long as they have it.

In this respect, it may be tempting to think that the problems in the region seem to have now gone away, but there is a difference between the speed at which Trump can tweet and the actual reality which will drive events on the ground. As a result, we won't be surprised if the Iranian side pushes for reparation payments, an end to sanctions, ongoing control over transit in the Strait of Hormuz and some of the other items on their wish list, even before we move to talks with respect to the future of the Iranian nuclear programme.

Although the US administration will want to literally 'trump' their wins, the dawning reality is that this has been a costly conflict which has cost the USA friends around the world, and which has achieved painfully

little. In this respect, the ultimate deal is unlikely to be better than the one that had already been on the table before any attacks were launched. Meanwhile, the world would appear to be in a more volatile and unsafe place than it was before.

Contact:

Lydia Cambata

lcambata@bluebay.com

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