



Inflation pressures?

Battered Britain....keep calm and hold on!

Key points:

- **U.S. inflation persistence:** U.S. CPI has remained above the Fed's 2% target for over 60 months, with recent data showing broader price pressures than anticipated.
- **Middle East energy crisis:** we continue to see upside risks to energy prices, as reserves are depleted, and until we can see an end to the conflict, so it will be difficult to call the top in inflation with strong confidence.
- **Warsh Fed:** we expect the Fed to maintain a more optimistic view on prices and believe the bar for hiking rates remains very high.
- **Japan fixed income:** meetings with Japanese domestic investors this week suggested that many are increasing allocations to domestic fixed income securities.
- **UK political instability:** Prime Minister Starmer faced ministerial resignations, with gilt yields hitting 30-year highs amid leadership uncertainty and market fragility.

London, 15 May 2026: Global bond yields continued to track higher over the past week, as building inflation pressures weighed on sentiment. This move has seen the US Treasury issue 30-year debt this week, at a coupon of 5% for the first time since 2007, with US CPI having exceeded the Federal Reserve's 2% target for more than 60 months, on a consecutive basis.

In the short term, an acceleration in price pressures has resulted from the move in energy prices since the onset of the conflict in the Middle East. However, this does not fully explain last month's jump from 4.0% to 6.0% with respect to US PPI input prices.

In addition, this week's CPI report indicated that inflation in goods and services was more widespread than anticipated, and we can see the Fed's own benign assumptions with respect to the trajectory of prices being challenged at next month's FOMC meeting.

Many US economists have assumed for some time that trends in inflation will be mean-reverting, taking inflation back to target. Indeed, were we to see an end to Middle East supply chain disruptions, it is true that oil prices this time next year may be lower than they are today, and this could help create a much more benign backdrop.

However, we would also note that the longer inflation remains away from target, so the more that higher levels of inflation will become embedded in price expectations. This will see workers push for higher wages to ensure real incomes are not impaired. In some cases, employers may push back, though we doubt that workers' demands will be dulled, unless we witness a much more adverse growth backdrop in the labour market.

Moreover, US economic growth continues to be supported by rapid business investment related to tech for the time being. We would also highlight that a loss of migrant workers filling lower end jobs may see employers paying up to replace roles. Anecdotally, this certainly seems true for those looking for gardeners, childcare or domestic cleaning services.

Institutionally speaking, one narrative which has been advanced to counter inflation concerns relates to AI driving productivity gains in the quarters ahead, which it has been assumed will translate into lower prices. Yet, in the short term, the frenzy to build data centres and add capacity is actually creating shortages, which may appear to be having an upward impact on prices.

Additionally, it can be argued that interest rates need to be higher through periods of high productivity and investment, relative to periods where business investment is softer. Looked at another way, the theory of secular stagnation infers secularly lower levels of inflation and interest rates during periods where savings exceed investment, and this was a popular narrative in the last decade as boomers saved into retirement and business investment spending was more contained.

However, we are now entering an era where retirees are drawing down savings, at a time when investment spend is accelerating, and this may infer the opposite outcome. In this context, maybe it should not be unsurprising if inflation and interest rates remain higher over the next couple of years, in the middle of this intensive investment phase.

Ultimately, increased efficiency from AI may depress wage growth and this may become a more disinflationary force, but this is more of a long-term, rather than a short-term consideration. In this respect, the lesson to be drawn from the data is that this is not yet something which is at all apparent.

Notwithstanding elevated inflation, we expect the Warsh Fed to maintain a more optimistic forward-looking view on prices. From that perspective, we think that the bar for hiking rates remains very high, even though financial conditions indices are at levels which appear very accommodative.

We see US headline CPI hitting 4.5% in the next couple of months, but for the FOMC to adopt a more 'transitory' narrative for the time being, in the hope that a normalisation in energy prices and an end to supply chain pressures in the months ahead will alleviate the need to take any action. Of course, this assumption could be challenged if the crisis in the Middle East continues to drag on.

For now, it seems most commentators will assume that a peace deal is just around the corner, and with certain news sites seeming to plant stories with respect to an imminent deal every time that financial markets dare to dip, at this point this narrative hasn't really been called into question. Yet, as each week ticks by, so it seems that the leverage Iran is exerting continues to grow and the Trump administration seems ever more eager to find an exit.

This might appear to point towards an eventual capitulation on the part of the U.S., but with the two sides remaining far apart, it might be overly hopeful to expect a rapid conclusion to the current impasse. Consequently, we continue to see upside risks to energy prices, as reserves are depleted. Until we can see an end to the conflict, so it will be difficult to call the top in inflation with very much confidence.

From this perspective, we continue to favour inflation linked bonds. At the same time, we have no really strong views on market direction and curve shape with respect to bunds and treasuries. By contrast, in Japan, we believe that an overshoot in inflation is more likely to be contained and with a yield curve which is very steep, so we are more inclined to be constructive on JGB yields.

Meetings with Japanese domestic investors suggest to us that many are increasing allocations towards domestic fixed income securities, with a number highlighting value in long-dated JGBs, whose running yield is now not far from 7%, on a U.S. dollar currency hedged basis. These investors have suggested a steadier approach to deploying capital spread over a few months, and there is a risk that higher global yields limit the enthusiasm to add duration in the near term.

However, with Japanese pension funds being able to satisfy return requirements in domestic fixed income, we think that an investor base, which has been structurally underweight, will come to the support of the market over the months ahead.

Meanwhile, in the UK, we have witnessed another week overshadowed by political developments, with Prime Minister Starmer very much on the brink. A slew of ministerial resignations citing a loss of confidence in the PM suggest that an announcement with respect to a timetable for his departure could be imminent.

Yet with Andy Burnham emerging as the principal successor favoured within the Labour Party, this may preclude a quick transition, with the Mayor of Manchester still to secure a seat in the House of Commons.

Indeed, given recent electoral results, it cannot be taken completely for granted that Burnham would emerge victorious as a Labour candidate in a by-election, and his resignation could also hand the mayoralty of Manchester across to the Reform Party (albeit were footballer Gary Neville to run for Labour as some suggest, this might mitigate that risk).

This said, it would still look inevitable that Starmer's days are numbered regardless, and against this backdrop UK financial assets and sterling seem likely to be subjected to an elevated political risk premium for an extended period.

As a result, we have added to short positions in the pound and see the outlook for sterling as very asymmetric, given that we struggle to see the currency rallying against a weak economic environment.

Looking ahead

Now that the Trump-Xi China summit is complete, we sense that the U.S. President's next big date in the diary is the 4 July celebrations, marking 250 years since the U.S. Declaration of Independence. Commentators have reflected that Trump will want to ensure that the conflict in the Middle East is over in time for these Semiquincentennial celebrations.

Some DC contacts have suggested that this could open a window for a last military escalation in the next week or two, noting that Trump's approval rating is now so low at -21, he has little to lose. Indeed, prospects for the midterms continue to turn against the Republican Party, with the race for the Senate now very much in play.

Indeed, if things go from bad to worse for Trump over the summer, this could even lead to discussion of a seemingly far-fetched scenario in which the Democrats win 60 seats and are in a position to impeach Trump in 2027.

Yet, regardless of the challenges in the macro and political backdrop, U.S. stocks have continued to rally unperturbed, as consumers and businesses leverage balance sheets with momentum in the S&P supporting further gains. With the Warsh Fed seeming unlikely to push back on this price action, so this move may continue to run for the time being, even if valuations look very stretched.

In many respects, it is tempting to think only a proper U.S. recession would act as a sufficient force to restrain the ingrained 'buy the dip' mindset. Yet, as reflected last week, we question the ability for assets away from the U.S. and the boom in tech to sustain such price action. Particularly in credit, we are cautious that spreads will not be able to rally further and over the coming weeks and months ahead, the backdrop in the economic news flow is set to be challenging.

As for politics, the environment in the U.S. seems increasingly chaotic, based on what we are hearing from those inside the administration. But if it is chaos in the White House then it is a proper shambles in Westminster. A Labour leadership election which sees the country pivot further to the left couldn't be happening at a worse time, given fragile gilt market sentiment sending yields to a 30-year high.

It is questionable whether investors would be prepared to give a candidate such as Burnham the benefit of the doubt, happy to sell first and ask questions later. Consequently, there is a risk of a return to market crisis

in the UK and another Prime Minister with a shorter tenure than a lettuce (or for that matter a manager of Chelsea football club these days!)

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