



## Will Warsh end up more hawkish than Powell?

### A Middle East impasse fuels inflation fears

#### Key points:

- **Middle East tensions persist:** the U.S-Iran impasse continued unresolved this week, with Trump's threatened military escalation being walked back as talks remain distant.
- **Fed policy:** we continue to look for higher inflation going forwards. Although not our base case, should CPI print with a 5% handle and remain there for a few months, we would expect the Fed to hike in September.
- **Europe divergence:** with the ECB more likely to be ahead of the curve in seeking to dampen inflation, in an already sluggish economy, so this might lead to a widening of the yield differential between US treasuries and bunds in the coming months.
- **AI:** during the current investment buildout phase, AI represents more of an inflationary driver, than a disinflationary driver in the US economy.
- **Emerging markets:** political uncertainty weighed on Brazilian and Colombian assets this week. On a more constructive geopolitical note, we are becoming somewhat hopeful of a peace deal in the coming months in Ukraine.

**London, 22 May 2026:** Recent moves higher in yields appeared to start weighing on sentiment in risk assets at the start of the week, with investors beginning to notice that the next move in US interest rates is now priced as a hike, in early 2027.

However, with strong Nvidia earnings continuing to sustain the constructive backdrop surrounding AI, we doubt that the equity market's bullish mindset is likely to shift much, for the time being. Indeed, with the rush to deploy capital showing little sign of price sensitivity, it is questionable how far cash rates would actually need to rise, in order to temper tech demand.

In this context, we have noted that during the current investment buildout phase, so AI represents more of an inflationary driver, than a disinflationary driver in the US economy. Over time, AI may act to suppress wages, though for the time being, the US labour market appears in a healthy balance, with lower income roles posting earnings growth, explained by the loss of migrant workers, who had previously depressed wages.

With the Middle East remaining at an impasse, we continue to look for higher inflation going forwards and currently see US CPI peaking at around 4.5% over the summer. However, the lack of an early resolution represents a further upside risk to inflation.

From this perspective, although we can be confident that the FOMC won't be hiking rates in June, should CPI print with a 5% handle and remain there for a few months, then we would expect the Fed to hike in September. Although this is not our base case, and it is our belief that Warsh will want to look through the elevated price data in the short term, the risk of a hike will only continue to build, for as long as we remain on this current trajectory.

In this respect, market participants may come to appreciate that Jay Powell was a relatively dovish Fed Chair, and that Kevin Warsh may yet end up being somewhat more hawkish by comparison.

We continue to favour a position in US inflation break-evens, via inflation swaps, on the thinking that the market remains too complacent on inflation. Given the Fed targets PCE inflation at 2%, this is consistent with CPI inflation at 2.5%.

With US CPI presently at 3.8% and set to move higher, we think that 5-year inflation swaps below 2.75% appear to build in very little inflation overshoot in the upcoming period. This may seem particularly surprising on consideration that US inflation has sat above the Fed's target for the past 60 months, and this is surely now a factor bleeding back into price expectations. Consequently, we think that the risk on inflation swap rates appears asymmetrically skewed to the upside.

We also like to own inflation-linked bonds and swaps in the Eurozone, based on the same logic. However, here we see more opportunity in an outright long position in real yields, rather than holding these positions on an inflation breakeven basis.

As real yields trade with a lower market beta than nominal yields, so this portfolio construction means that we trade slightly long of euro duration and slightly short of US duration, which appears to be correct on a relative basis. With the ECB more likely to be ahead of the curve in seeking to dampen inflation, in what is already a sluggish economy, compared to the US at risk of being more behind the curve, so we might project that this can lead to a widening of the yield differential between US Treasuries and Bunds over the coming months. This should be underpinned by relative trends in economic growth on a relative basis between the respective economies.

Returning to the Middle East conflict, there was some volatility earlier in the week when Trump announced that he had been planning a military escalation this Tuesday, before being dissuaded by the Gulf states. This said, it seems like White House tweets are now increasingly taken with a pinch of salt and the reality for the time being seems to be that little is changing on the ground.

Talks about talks are ongoing, but the US and Iranian positions remain a good distance apart and as time goes by, the more the IRGC is likely to determine that its own leverage is increasing. The mostly likely path forwards thus seem to infer the US deciding to fold on its demands and walking away at some point.

Yet this may be a bitter pill to swallow and, for sure, Trump will want to be able to sell the campaign as the great success. From this standpoint, we wonder whether the US will decide to let the bombs fly once again in one last defiant act, notwithstanding the possible lack of a coherent plan or strategy, were this to occur.

On a more constructive geopolitical note, we are becoming somewhat hopeful of a peace deal in the coming months in Ukraine. Increasingly, it appears that Putin is looking for an exit and it is notable how prior Russian battlefield advances have stalled and are starting to reverse.

It appears that the EU is set to play a much bigger role in negotiations with Moscow, with Angela Merkel, or possibly even Mario Draghi, playing a role with respect to the intermediation. An end to conflict would be a welcome outcome, though given the state of Russia's energy structure, which has seen it produce well below its OPEC quotas in past months, we think it would be incorrect to assume that peace with Russia would mean that the problems in the Middle East no longer require worrying about.

Elsewhere in emerging markets, the coming week sees the first round of Presidential elections in Colombia. Local assets have been under pressure in the run-up to this vote, but we see scope for a sharp rally, were we to witness the market favourable outcome which we have been looking for.

Meanwhile, political risks in Brazil have also been building, contributing to risks on local currency bonds. We see substantial value in Brazilian rates at 14%, against inflation expectations around 4% and we have also favoured the Brazilian real, which has been trading well, helped by its attractive interest rate carry. Yet with the Brazil real over-owned by international investors, we have decided to close risk in FX, in case political volatility prompts a sudden rush to the exit.

In the UK, gilts and the pound have recovered last week's losses, with some investors reassured that Andy Burnham pledged not to change the fiscal rules were he to become the next UK Prime Minister. The current Mayor of Manchester still needs to win a by-election in Makerfield first, and this cannot be taken for granted.

Moreover, he remains committed to raising taxes and spending in a material way and we are very sceptical that this will go smoothly, if he does end up in 10 Downing Street later this summer. Meanwhile, better data on UK growth and inflation in the past week has helped sentiment in UK financial assets.

Yet with the utility price cap set to rise +13% in July, so the good news risks being short lived. We are happy to remain on the sidelines on the UK, with the thought that this could leave us free to add, were there to be a much larger market dislocation on the back of position capitulation.

In FX, we continue to favour a short stance in the pound. We have also added to a long position in yen over the past week as the Japanese currency approaches Y160 versus U.S.\$.

We are confident that the BOJ will now hike in June, and this should help underpin the yen going forwards. The Ministry of Finance is also committed to intervening in the FX market and has set Y160 as something of a line in the sand that it is not prepared to cross.

We retain a more cautious stance in credit spreads, notably so in Europe where we see the economy more exposed to the threat of recession risks. As previously argued, we see an asymmetric return profile in spreads.

Further tightening seems unlikely from already narrow spread levels. Moreover, an abundance of supply remains a strong headwind blowing against the market. Meanwhile, a larger move wider in spreads appears much more plausible, if oil prices head towards \$150, triggering much more focussed fears of recession.

## **Looking ahead**

Reflecting on the road ahead, this weekend sees the end of the UK Premier League football season, with West Ham United (and sadly not Spurs) looking destined to be relegated from the league. In a torrid season, the team's bubble making machine, which is used to celebrate each goal with the club anthem, 'I'm forever blowing bubbles', hasn't been getting that much use over the past year.

Maybe Jensen Huang may be able to find a better use for it instead! Certainly, it has been striking in Nvidia's recent results to witness an acceleration of AI deal making and partnerships, through which billions of dollars are recycled through firms back into orders for Nvidia's own chips, driving revenues and earnings ever higher.

Although there is nothing at all incorrect in such vendor financing arrangements, the circular nature of these cash flows could be a factor helping to inflate bubbles that the AI machine is itself creating. As the song goes....pretty little bubbles in the air! But as West Ham fans know too well, those bubbles don't have a habit of lasting ever so long before they disappear without a trace.

## **Contact:**

Lydia Cambata

[lcambata@bluebay.com](mailto:lcambata@bluebay.com)

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