



Hawks will begin to circle, as inflation heat rises over the summer

Bitcoin holders are bored, and the White House is getting into party spirit...

Key points:

- **Fed policy shift:** Fed officials have adopted a more hawkish stance, with September rate hike odds rising amid strong data.
- **AI and inflation:** economists have debunked the AI productivity deflation narrative, noting that historical tech booms coincided with higher neutral rates.
- **Middle East supply risks:** markets seem to have become desensitised to regional tensions, though ongoing disruptions may keep oil above USD90 through 2026.
- **Eurozone inflation surprise:** service price inflation reached 3.5% year-on-year in May, likely prompting the ECB to consider a September rate hike.
- **UK fiscal deterioration:** recent moves have created a GBP60 billion OBR shortfall, with Labour leadership hopeful Andy Burnham avoiding investor calls amidst rising fiscal concerns.

London, 5 June 2026: Global yields have risen somewhat over the past week, as we head towards central bank meetings later this month. Ahead of the June FOMC blackout period, Lorie Logan and Beth Hammack have both argued for a bias to hike rates in the coming months, in what appears to be a more hawkish shift across the Federal Reserve, in the wake of strong economic data and a booming equity market.

Earlier in 2026, anticipated softness in the labour market had been cited as a driver of lower interest rates, though recent releases have shown an acceleration in job openings, stable unemployment, and a recent uptick in the pace of hiring. Today's US labour market report will be closely watched, as always, though there seems little to suggest that the economy is losing much momentum.

By contrast, inflation risks continue to push higher, with the AI boom running hot. Moreover, it seems that an increasing number of economists are now starting to de-bunk the idea that AI will be a major force pushing inflation lower, as productivity accelerates. In this respect, all major historical technological advances that have raised growth rates and productivity have coincided with higher neutral interest rates (R^*).

Consequently, it would be unprecedented to think that AI will be very different, unless of course, it ends up causing much weaker economic growth, in a scenario where a collapse in employment leads to a collapse in consumption spending.

Although no change in monetary policy is anticipated at the June FOMC meeting, it is clear that Powell's easing bias is set to be scrapped, as Warsh's Fed draws back on its approach to forward guidance. We also think that Warsh will want to make his imprint, emphasising that he will seek to do as he sees fit and won't be subject to interference from the White House, as he seeks to cement his own legacy.

We think this could land somewhat hawkishly with some market participants who continue to hope for rate cuts ahead. However, it strikes us that there is very little evidence to suggest that monetary policy conditions with effective interest rates at 3.625% are remotely restrictive. If anything, financial conditions indices would suggest that US monetary policy remains accommodative and, in this respect, there is a building question in

markets as to whether the Fed should have announced rate cuts at the end of last year, which will have to be reversed in order to stop upside risks to inflation continuing to build.

In this case, we could see odds for a September rate hike start to grow, if inflation prints run hot over the summer and the equity market continues to push to new highs. Treasury yields may continue to struggle against this backdrop and although a more hawkish Fed can continue to flatten the US yield curve, we think that longer-dated yields may continue to struggle at a time of excessive supply and a backdrop of unchecked fiscal largesse.

Meanwhile, we continue to highlight intrinsic value in inflation-linked breakevens, with market participants remaining too sanguine in their assessment of upside risks with respect to prices, in our view.

Turning to events in the Middle East, it seems increasingly that markets have become de-sensitised to developments in the region. The overarching assessment remains that a peace compromise is likely to be established at some point in the weeks ahead, which will allow for a re-opening of the Strait.

However, in the event that a deal does get signed, then we think we will move into an uncertain period as questions persist with respect to what happens next. In this context, we think there could well be ongoing supply disruptions with periodic openings and closures, against a backdrop of ongoing regional volatility. From this perspective, although oil prices have failed to record new highs since the end of April, we doubt they will trade much lower than \$90 through the remainder of 2026.

Elevated energy prices and supply chain disruptions are set to keep inflation elevated on a global basis over the months ahead. Although gasoline prices have been stable since the end of March, there is a lagged impact on other goods prices as elevated inputs costs end up being passed on to consumers and in this context, PPI inflation continues to accelerate.

It has also been interesting to observe that a pick-up in inflation is not confined to goods prices. In this light, a 3.5% year-on-year rise in service price inflation in the Eurozone in the May data is likely to catch policymakers' attention. In this respect, a 25bps rate hike this month seems like a done deal, but we think that Lagarde will be wary of suggesting a series of further hikes, citing ongoing economic uncertainty.

In the Eurozone, the ECB will be wary of turning too hawkish against a depressed growth backdrop. Yet if events continue to follow its own adverse risk scenario, so a further hike in September may well also be on the cards. Given these views on inflation, we continue to highlight opportunities in inflation-linked trades in the Eurozone, as well as the US. With respect to nominal bonds, we see scope for Euro yields to outperform Treasuries on a relative basis, with the Eurozone economy looking much weaker than the US, comparatively speaking.

In Japan, we expect the BoJ will raise cash rates to 1% at its policy meeting this month, with a move up to 1.25% expected towards the end of the year. Recent comments from Governor Ueda appeared to suggest that the BoJ may determine that it is appropriate to increase the pace of monetary policy normalisation if upside risks to inflation start to build.

A clear path to policy normalisation in Japan may help support long-dated government bonds and the yen, though markets have been concerned about political interference from Takaichi seeking to drive a more dovish policy stance. However, recent comments from the Japanese Prime Minister appear to suggest that she is understanding that such an approach may be counter-productive and may also hurt her popularity rating if this were to cause renewed weakness in the valuation of the Japanese yen.

UK growth and inflation look more exposed to economic shocks than we see elsewhere. In this context, price expectations appear less well anchored than we see in other economies, with UK consumers less resistant to swallowing higher prices (as long as they can negotiate higher wages – and benefit payments).

An example of this is shown in ongoing prevalence of higher mobile phone charges in the UK going back over the past 10 years, at a time when comparable costs in the Eurozone have remained on a declining trajectory. With the BoE appearing to suggest some tolerance for overshooting prices, so it is understandable that UK CPI may continue to exceed Eurozone data by at least 100bps on an ongoing basis.

Yet, a sanguine attitude toward inflation in the UK remains problematic, with a high proportion of national debt issues on an inflation-linked basis. As a result of this, overshooting inflation has a direct linkage back into the country's fiscal debt dynamics. Noting this, it has also been concerning to read that recent moves in inflation and yields, plus weaker growth, suggest an OBR fiscal shortfall of as much as £60 billion in the national accounts.

This is hardly the sort of backdrop that a new Prime Minister with extensive spending plans will want to reflect on. Perhaps it is therefore unsurprising to note Andy Burnham skipping a planned call with sceptical gilt investors, which had recently been lined up. Although Burnham has sought to quell concerns by professing adherence to the current fiscal framework, it strikes us that a move to the left will deliver certain increases in spending, which will be funded by uncertain increases in taxation revenue. In this context, with tax burdens already higher, so raising tax rates won't raise more revenue if this harms growth.

In emerging markets, a victory in Colombia for the right-wing candidate de la Espriella came as a positive surprise to markets, with local asset prices rallying strongly. It seems very likely that the candidate who has been endorsed by President Trump will prevail in the second-round run-off and seek to usher in greater fiscal consolidation and more market friendly policies.

We have seen a number of countries in LatAm leaning more towards right-wing candidates more broadly over the past year, though would note that this probably has more to do with a desire to ditch unpopular incumbents, rather than an ideological desire to fall in-line with a US-oriented agenda. That said, we think that assets in a number of LatAm countries are attractively priced and that away from the political noise, enjoy some favourable trends with respect to their underlying economic fundamentals.

Notwithstanding some sense of ongoing volatility and upheaval on a macro basis, credit market conditions have remained benign for the time being. Corporates continue to issue debt, with projected volumes from the large US hyperscalers continuing to be revised ever higher on the back of surging investment spending. Accommodative financial conditions and growth in the net money supply has helped ensure that there is cash available in order to sustain credit demand from investors happy to target attractive absolute yields levels.

However, we wonder whether this may change should central banks turn more hawkish and reign-in growth in credit aggregates with a view to restraining emergent inflation pressure. Yet with credit spreads closely following equity market moves, so there is also a sense that a bigger shock may be needed in order to force a re-focus on what have been deteriorating underlying credit fundamentals in a region such as the Eurozone.

Looking ahead

Much of the market focus will be on upcoming jumbo equity raises from SpaceX, Anthropic and Google, which cumulatively will be absorbing close to USD250 billion of new capital. With much of this coming from retail investors speculating on short-term gains and momentum, so it has been interesting to observe a sharp correction in the price of Bitcoin and other digital assets as holders get bored by lacklustre returns in crypto and seek to jump on momentum.

From this perspective, it is instructive to see how assets can struggle as they move from being the flavour of the month to being suddenly out of fashion. At least it can be said for Bitcoin, that Iranian toll collectors in the IGRC have found an actual use for this particular asset.

On another note, it seems oddly fitting to think that the US 250 Independence celebrations will showcase a fight taking place at the White House. With the UFC octagon and arena under construction on the South Lawn, you half wonder whether Cabinet members will be practising their moves inside the West Wing, and it will be interesting to see if Trump sits watching his gladiators beast each other from a Presidential golden throne. You certainly wonder what George Washington, or Abraham Lincoln would have made of this all....

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