RBC BlueBay
Asset Management

Marketing communication

Trump hubris meets reality

It's not going swimmingly for the President!

Key points:

- **Fed rates outlook:** the Fed has pivoted to data-dependent policy, with markets now pricing a September hike following Kevin Warsh's hawkish tone at the inaugural FOMC meeting.
- **European inflation divergence:** the Eurozone economy continues to show weakness, with lower oil prices potentially allowing the ECB to maintain rates unchanged over coming meetings.
- **UK political transition:** with potential Labour leader Andy Burnham winning a seismic by-election, we remain cautious with respect to UK assets and feel that markets have discounted relatively little, by way of a UK political risk premium.
- **Japan policy normalisation:** the BoJ delivered another rate hike this week, though persistent dovish bias from the government continues to weigh on the yen's valuation near intervention levels.
- **Macro summary:** the new approach taken Warsh may increase market volatility, with data-dependent policy dominating decisions. Dollar strength is putting pressure on emerging markets, though tech bullishness is supporting risk appetite, despite credit spread pressure.

London, 19 June 2026: A relatively hawkish tone coming from Kevin Warsh's inaugural FOMC meeting saw a flattening of the Treasury curve during the past week.

With a number of Fed participants projecting a need for monetary tightening in the months ahead, interest rate futures now discount a 25bps hike at the September meeting, with a further move embedded into expectations early next year.

This pricing has come a long way over the past several months and Fed expectations now appear fairly valued, in our perspective.

With the Fed deliberately paring its approach to forward policy guidance, what we do know is that data will end up determining the path and timing of future monetary policy actions. In this context, inflation risks are now very much the dominant focus for the FOMC, with next week's core PCE data expected to show price gains running at an elevated 3.4% year-on-year.

A further print in this data series will be released prior to the Fed's July meeting and another move upwards could be a pretext for a July hike. However, this seems unlikely, given the retracement lower in oil prices this month, on the back of the tentative Iran peace deal.

Similarly, evidence of further softening in inflation could also enable Warsh to defer a hike beyond September. Yet, if financial conditions remain accommodative and the stock market buoyant, strong economic momentum may well limit the speed at which inflation is reversed. From this perspective, a September hike seems like a reasonable base line, in our view.

Notwithstanding this, a clear message, is that every meeting can now potentially be a live policy meeting. This being the case, financial markets probably need to be much more focussed on economic data and much less distracted by tweets coming from the White House going forward.

It is also apparent that Warsh's decision to establish a number of taskforces to review elements of the Fed's mandate delivery, means that he is well placed to keep his options open. For example, if Warsh wants to defer action, then he can argue that he first wants to await taskforce findings.

Similarly, if he wants to take unpopular action, then again, he can blame this on one of these bodies. It is also noteworthy that these initiatives will be taking place at a time when the administration is working to reduce the number of roles at regional Federal Reserves. This puts Warsh in a strong position to exert some leverage internally within the Fed system, in order to be able to steer outcomes to his favour.

Regarding inflation, break-even rates have moved lower over the past week, with inflation swaps giving back some of their past performance. Obviously, with current spot inflation well above current rates priced in inflation-linked bonds, positive carry of close to 200bps at a time when headline inflation is at 4.2% is offsetting moves lower in break-evens themselves.

We would also question how successful the Fed will be in lowering inflation back to target on a timely basis, having missed this target to the upside, for more than five years in a row. In this respect, for all of Warsh's tough talk cementing his commitment to delivering price stability, it is noteworthy that as Warsh sees things, he prefers only to care about the big figure to the left of the decimal place, when it comes to inflation prints.

As a result, one might surmise that an outcome in the 'high 2s' may well be deemed acceptable to the new Fed Chair. On this point, we may yet see inflation remaining well above 2.0% for an extended period.

Moreover, if inflation is really too high today in the opinion of the Fed Chair and policy is overly accommodative, then this begs the question why there was not more of a robust discussion with respect to a rate hike at this particular FOMC meeting. It can be argued that if rates are too low today, then upside prices risks may continue to grow, in the period prior to the next Fed meeting.

In this respect, perhaps Warsh will find that it is easier to talk tough than to deliver a policy change, which will be far from popular in a number of quarters. On this point, ultimately it will be Warsh's action, not his words (or lack of them) which will determine how he comes to be viewed.

Turning to Europe, we would continue to highlight that against the backdrop of weaker economic growth, it should be possible for inflation to moderate more quickly than across the Atlantic. In this context, we are more inclined to believe that lower oil prices may enable the ECB to maintain rates unchanged at the next several policy meetings.

Relative to 2022, the move up in inflation in Europe has been much more modest and this means that a cycle of rate hikes appears unlikely to be warranted. In this context, we continue to see more value in shorter-dated yields in the Eurozone than in US Treasuries, and ongoing economic divergence may continue to underpin this differential for months to come.

In the UK, victory for Andy Burnham at the Makerfield bi-election sets the scene for a leadership contest over the next several days, with the former mayor of Manchester set to take over from Keir Starmer as UK Prime Minister.

In this context, we see the Labour Party making a more decisive shift to the left, embracing policies of increased spending and inflation in the months to come as Burnham seeks to implement his vision for the country.

Although he has avowed to stay within fiscal rules, it appears that he may try to tweak these by extending the period over which analysis is performed, in order to backload fiscal tightening and therefore spend more money up front in the next couple of years.

We also suspect there will be a push to move some spending (such as infrastructure projects and incremental defence spending) off balance sheet and thus mobilise additional capital. However, we are wary that sceptical markets will look through such moves as delivering additional fiscal easing via the back door.

In this case, there is a risk that his credibility could be tested by the market. On this basis, we remain cautious with respect to UK assets for the time being and feel that markets have discounted relatively little, by way of a UK political risk premium.

Meanwhile, in Japan, a rate hike from the BoJ this week was welcomed by financial markets, with Ueda seemingly set to continue to normalise monetary policy on a gradual basis. Japanese data remains relatively upbeat and economic fundamentals may be consistent with a more rapid trajectory of rate hikes. However, with Prime Minister Takaichi remaining committed to maximising nominal GDP growth, this continues to suggest a more dovish bias.

This being the case, it seems that Japanese interest rate differentials relative to the US are unlikely to close any time soon, and consequently the BoJ policy stance seems set to continue to weigh on the valuation of the yen.

Although the Japanese currency remains extremely undervalued on a valuation basis, we have decided to close a long FX position just above Y160, on the view that only intervention (and the threat of intervention) are able to prevent the yen from weakening further in the short term.

However, there is now a growing risk that the range could break higher in the coming weeks and from this perspective, the risk/reward in running a long yen position no longer seems to be particularly appealing.

The implementation of a Middle East deal helped to support sentiment in risk assets over the week, as oil prices moved lower. Although we would continue to highlight ongoing risks to supply chains and the scope for renewed hostilities in the region, there appears a desire to look through the noise.

In this context, risk appetite continues to be buoyed by ongoing bullishness in the tech sector, as typified by a 50% rally in the value of Space X shares, in the immediate aftermath of the recent IPO. In credit, spreads reversed intra-week gains, against the backdrop of heavy supply and a more hawkish interest rate outlook. That said, spread volatility remained very much contained in a narrow trading range.

In FX, the dollar continued to rally in the wake of the FOMC meeting, with a relative widening of forward-looking interest rate differentials between the US and other major economies. The value of the euro has pushed toward the year's lows close to USD1.14.

Meanwhile the yen has reached levels, where intervention may be expected, though for now, the Ministry of Finance has been relatively silent. A firmer dollar can also weigh on sentiment in emerging markets, and there was some softness in both local market rates and FX, as the dollar appreciated.

Looking ahead

We feel that the new approach taken by Warsh at the Fed may highlight scope for increased uncertainty and market volatility. As noted earlier, every policy meeting is now a live event. By paring communication, so Warsh can keep his options open by keeping the market guessing.

In addition, noting how Warsh is inclined to view the level of interest rates, as well as the size of the balance sheet, as tools at the Fed's disposal, it is also possible to consider that he may seek to advance the notion that active balance sheet management may be a more effective tool than interest rates to achieve a more restrictive stance.

In particular, if excessively loose financial conditions are encouraging speculative behaviours, which add to inflationary pressure, then curbing this through a more restrictive liquidity regime could be a more advantageous way to address this than hiking the Funds rate per se.

Further conclusions can probably wait, but elsewhere in Washington DC it seems like life is growing ever more challenged for an embattled US President. Domestic commentators and many within his own party have given a very critical assessment of Trump's MOU with Iran, noting how the whole folly of the 'Epic Fury' campaign has only managed to empower the position of the Iranian regime, within the Middle East region, and make the world a more dangerous place. It has also exposed the limits of US military power and may well serve to limit international adventures in the quarters and years to come.

Meanwhile, close to home, Trump's pet project to clean up the Reflecting Pool at the Lincoln Memorial has also gone far from swimmingly. Far from the heralded pristine 'American flag blue', everything has turned a rather lurid shade of green over the past week. First, it was the Iranians, now it seems to be a bloom of algae that is getting the better of Donald Trump. Then again, green policy was never really meant to be one of his strengths….

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