



It's hot, but markets feel pretty chilled

Inflation expectations heat up....

Key points:

- **Middle East peace:** oil prices have returned to pre-conflict levels, with Brent crude at USD 70 per barrel and inflation fears receding.
- **Fed hawkish posturing:** Warsh has talked tough on inflation, but subdued forward expectations give him room to defer action whilst taking credit later.
- **UK political uncertainty:** markets are taking Burnham's prospective premiership on trust, yet his actual policy plans remain unclear.
- **Japanese yen:** Governor Ueda faces ongoing pressure to accelerate the pace of monetary policy tightening as yen weakness risks further inflation.
- **LatAm shift:** victory for right-wing candidate de la Espriella in the Colombian elections has helped boost sentiment across LatAm assets.

London, 26 June 2026: A declining oil price helped yields to rally over the past week, as inflation concerns continue to mitigate in the wake of the Middle East peace deal which has led to the reopening of the Strait of Hormuz. At USD70 per barrel, Brent Crude is now back at levels seen prior to the inception of the Iran conflict. It appears that earlier projections with respect to physical shortages have failed to manifest in a tangible way.

Consequently, inflation-linked bond breakeven rates and inflation swaps have declined to levels in line with central banks' price targets. However, we would note that for the time being, current inflation will remain at elevated levels and a decline in CPI measures is only likely to occur gradually over the months ahead.

That said, this changing inflation picture can be seen reducing the necessity for central banks to deliver interest rate hikes. From this perspective, government bond curves may cease flattening, with shorter-dated maturities likely to be better supported going forwards.

In the U.S., a robust economy driven by gains in investment related to the AI boom will likely see inflation remaining elevated through the course of 2026. From this perspective, the Fed can be expected to retain a hawkish bias, but it may yet refrain from delivering a rate hike.

As a new Fed Chair, it is understandable that Kevin Warsh will want to talk up his inflation-fighting credentials. However, a peaking in CPI data and subdued market projections with respect to forward inflation gives Warsh plenty of reason to defer any policy action at the next couple of meetings.

In this context, Warsh may be able to talk tough without actually needing to deliver anything and then take the credit as price pressures start to mitigate. Markets continue to discount a Fed hike by October, with some additional tightening discounted in the New Year. This pricing may now start to look too aggressive,

though the fact that inflation does remain well above target for the time being is likely to ensure that some premium for policy tightening continues to be discounted in the weeks and months ahead.

From this standpoint, the outlook for duration is looking more favourable than it has done for some time. However, we would continue to highlight more value in overseas markets, where the outlook for growth is materially weaker than has been the case in the U.S.

In the Eurozone, the bond market was supported this week by comments from ECB's Lagarde, noting that she sees "no need for a more forceful response to the Iran War". This can be interpreted as making a rate hike in July very unlikely.

However, with ECB member Philip Lane citing the risk of a more persistent inflation overshoot and the ever-hawkish Isabel Schnabel also talking up the case for further policy tightening, markets continue to discount a high probability of a move in September to 2.5% cash rates.

But with PMI data highlighting a soft backdrop for economic activity, we are more inclined to think that the ECB may now be done hiking. From this point of view, we continue to view 2-year swaps at 2.75% as attractively priced.

The outlook for longer-dated bonds may not be as clear if we see ongoing expansionary fiscal policy. With 30-year bund yields at levels matching where they were trading at the start of 2026, we think that gains are more likely to be earned in shorter and intermediate maturities.

The outlook for policy rates in the UK is also being helped by a moderation of inflation fears. Ostensibly speaking, markets now price one hike from the Bank of England over the months ahead, with cash rates then subsequently staying around 4% for the balance of 2027.

Historically speaking, price stability tends to be more weakly anchored in the UK than other economies. There has been a risk of a larger inflation overshoot in the UK than we have seen elsewhere based on past comparisons, such as the energy price shock from the Ukraine war in 2022. However, if the inflation picture is not as negative as had been feared, then as a high beta market, so the gains to be made in the UK could potentially be larger than elsewhere.

This said, the outlook for the UK gilt market continues to be overshadowed by political uncertainty, with markets awaiting the effective coronation of Andy Burnham, as the 7th UK Prime Minister in the past 10 years.

Over the past week, suggestions that Burnham would eschew the left wing of the Labour Party and look to select Wes Streeting as his Chancellor of the Exchequer have led to hopes that, once in office, Burnham will follow an economic agenda not greatly dissimilar to that seen under Starmer and Reeves.

Arguments have been made that he has become aware of the limited scope to deliver fiscal easing and that he will want to ensure that he does not end up in confrontation with financial markets, as this could cost him the very job he has coveted for so long. This may prove to be true. Yet it strikes us that markets are currently taking a lot on trust and we are yet to hear very much from Burnham with respect to his intended policy plans.

After all, if Burnham is just another Starmer, albeit with a more vibrant personality and a Manchester accent, one wonders why the Labour Party have been as enthusiastic to dispose of their current leader, who led them to a record victory at the UK polls just a couple of years ago.

In contrast to other central banks and economies, in Japan there remains ongoing pressure on Governor Ueda to accelerate the pace of monetary policy tightening and return monetary policy to more of a neutral stance, after years of ultra-low interest rates.

In this respect, a strong dollar continues to pressure the valuation of the yen. It may seem that without taking more action to bring forward a next rate hike from the end of 2026 to the fall, there is a growing risk that the yen could drop further in the coming weeks.

We would highlight that should this occur, the blame for this move will be very much at the feet of Prime Minister Takaichi. A weak yen is very unpopular in Japanese society and further weakness in the currency risks adding to inflation and further impacting affordability.

Consequently, a move towards ¥170 could be very costly for the Prime Minister's approval rating. With kingmakers such as Aso manoeuvring in the background, hopefully Takaichi realises that this is something she cannot afford to allow to occur.

With respect to JGBs, we continue to hold a constructive view on long-dated bonds. Unlike other global curves, which are very flat, the curve in Japan is exceptionally steep. In this way, there is plenty of protection in longer-dated bond yields with 30-year securities above 3.75%.

In FX more broadly, a strong dollar has been supported by strong economic data and perceptions of a more hawkish pivot from the FOMC. However, with the pricing for Fed hikes likely to top out, we think that the greenback will likely lose some momentum in the coming weeks. Although we were always sceptical around the narrative of dollar debasement, we doubt that the U.S. administration seeks a much stronger trajectory for the dollar.

Medium-term shifts in asset allocation may lead to a resumption of a weaker dollar trend, with many large investors citing that they feel over-invested in U.S. assets from a strategic standpoint, against the backdrop of increased U.S. policy uncertainty and elevated valuations in U.S. stocks.

Meanwhile in EM, a victory for right-wing candidate de la Espriella in the Colombian elections has helped boost sentiment across LatAm assets, with a renewed focus on the Monroe doctrine and an increased U.S. role to play in a regional context in the western hemisphere.

If the move upwards in U.S. rates and the dollar flattens out over the next few weeks, then this may create a more favourable market backdrop for fixed income markets such as Brazil, and others where yields have recently been under upward pressure.

In credit, firm stocks and a lower oil price have helped maintain the bid for spread products. However, with issuance continuing to be abundant, there is no real catalyst at this point to drive spreads tighter.

On the back of its recent IPO, SpaceX tapped the corporate bond market, with Fitch assigning a BBB+ rating, despite being unable to offer many supporting financial metrics. Despite some initial excitement and demand, long-dated bonds traded around 15bps wider, with investors seemingly concluding that there may be plenty more debt issuance to come, as the loss-making company finances its future path to profitability.

More generally speaking, we would acknowledge that the Middle East peace deal and lower oil prices mean that the adverse scenario, which could push Europe into a widespread economic contraction, and which would have put significant upward pressure on credit spreads, appears to have materially receded over the past couple of weeks.

Additionally, we have been struck by yet more managers rushing to launch CLO platforms. This issuance is keeping a very strong technical demand on 'BB' and 'B' rated bank loans, which is helping to support the European credit market more broadly.

Consequently, although we see limited scope for spreads to rally at this juncture, there is not a strong obvious catalyst driving spreads materially wider, and in that context, we have decided that it is appropriate to reduce the magnitude of credit hedges within our strategies.

A sharp decline in forward inflation expectations caused an underperformance in U.S. and European inflation-linked bonds and swaps over the past week. We have reduced positioning in the context of euro inflation, noting that a weaker economic backdrop and a more assertive ECB is likely to ensure a quicker return in inflation to target than what we expect across the Atlantic.

Our own sense is that with Warsh caring about the 'big figure on the left of the decimal place' when it comes to inflation, then this is consistent with the FOMC wanting to get the core PCE down from 3.4% today to a level closer to 2.5%. However, even at this level, this would be consistent with CPI inflation close to 3%.

With the U.S. economy strong and AI driving price pressures higher in the race to build infrastructure, we see U.S. inflation only coming down slowly. In this respect inflation swaps continue to offer very attractive carry, with spot inflation almost 200bps above forward levels at 2.3%.

Over the past several days, we have closed a U.S. duration short position and have also been reducing credit hedges. We have also closed a successful trade in short-dated Hungarian rates in the wake of a strong rally. We now see more value in longer-dated Hungarian bonds and would reflect that with the EU eager to try to draw Hungary closer to the rest of Europe, there can be scope for additional convergence relative to bunds over time.

We also look for a prospective EU convergence dynamic in Iceland if voters in the country agree to resume stalled EU accession talks in their referendum at the end of August. Polls on this vote are quite evenly split, but a positive vote could provide a significant impetus for longer-dated yields, were Iceland to agree to eventually join the euro.

Looking ahead

As we look ahead into the second half of the year, we would acknowledge that the past few months have been a challenging period from a macro investment perspective. During Q2, we had looked for the macro backdrop to be shaped by evidence of a building and persistent inflation shock (hence positioning in inflation-linked bonds and swaps) and also the thought that Europe was exposed to elevated recession risks in the wake of high inflation, tighter monetary policy and supply chain disruptions. These trends have not really played out in the way we had envisaged and so it has been necessary to reposition and reassess.

This noted, we continue to have high conviction on U.S. inflation persistence, relative outperformance of European bonds versus Treasuries and a flattening of the long end of the yield curve in Japan. We see opportunities in a number of EM local markets and feel that EM can perform better if trends towards a stronger dollar and higher U.S. yields start to abate.

In credit markets, we run a relative value approach and although we take modest levels of FX risk at present, we think that ongoing global and geopolitical upheaval and volatility will certainly offer opportunities for active positioning in the weeks and months ahead.

Meanwhile, with Europe experiencing a heatwave and record-breaking temperatures, it has been striking to notice the number of red-faced Brits at home, as well as abroad, over the past week. Hindsight can be a wonderful thing, and it can be easy to look back with some sense of regret. But there will always be plenty of learning experiences in life.

What matters most is that we learn from them and don't put ourselves in a painful position again, looking forwards. The first half of 2026 has not been easy, but as any football supporter will tell you, games are rarely ever decided in the first 45 minutes. Here's to a strong second half....

Contact:

Lydia Cambata

lcambata@bluebay.com

About RBC BlueBay Asset Management

RBC BlueBay Asset Management ("RBC BlueBay") represents RBC Global Asset Management outside of North America and is an active asset manager with expertise across fixed income, equities and alternatives.

RBC BlueBay's solutions-driven approach means it endeavours to empower clients with the knowledge they need to help shape their investment decisions. It works and evolves with clients, creating and customising investment products that meet their needs.

Responsible investment is embedded across RBC BlueBay's business. This means it is not just an investment focus but is also ingrained in its client service experience and work to deliver solutions that support real-world impact.