



Why not party when you are rolling in money?

The AI boom powers on

Key points:

- **U.S. economy:** despite somewhat softer than expected payroll growth, the U.S. labour market appears to be in relatively robust shape. Meanwhile, business investment spending continues to support GDP growth, driven by the AI boom.
- **Fed policy:** Warsh may keep his cards close to his chest, but it's clear that several FOMC voting members believe it is appropriate to be discussing higher rates.
- **European inflation:** Germany and France have posted more benign inflation data, but elevated gas prices could limit progress in returning inflation to target in the months ahead.
- **UK fiscal concerns:** gilt yields underperformed on projected spending plans associated with Andy Burnham taking over from Keir Starmer as the country's Prime Minister.
- **Japanese yen weakness:** Japanese yields underperformed, in part due to a move higher in the dollar/yen exchange rate, which has taken the Japanese currency's valuation to a 40-year low.

London, 3 July 2026: US yields were little changed over the past week. Although US payroll growth was somewhat softer than expectations, data with respect to job openings, jobless claims and unemployment all speak to a labour market in relatively robust shape. More broadly speaking, such is the strength of business investment spending, it appears that the AI boom is set to continue to drive an expansion in GDP, unless this suddenly starts to cool. But, for now, there may seem little sign of this occurring.

This said, it has been interesting to observe a growing equity price underperformance from the hyperscalers who are rushing to deploy cash, at the expense of the beneficiaries of this spending. Ultimately, this could suggest that we reach a point where one of the Mag-7 announces a cut in AI spend and this causes their stock price to rise, which could well see others follow in their wake.

However, we are not hearing anything from corporate executives, just yet, which might lead us to conclude that we have reached such a turning point. Consequently, it seems reasonable to extrapolate more of the same in the U.S. economy, for the time being.

In this light, we continue to reflect on the building price pressures stemming from the AI boom. In this respect, last week's 20% price rise from Apple and a similar move from Microsoft's Xbox, on higher chip costs, are instructive. Given how widely we rely on chips in so many products these days, this may speak to wider cost pressures across global supply chains.

In this respect, we continue to think that U.S. inflation will remain elevated, even as oil has returned to levels which prevailed ahead of the onset of the Middle East conflict.

With real interest rates in the U.S. economy currently negative and financial conditions indices supported by strength in equity and credit markets, there currently appears little policy restraint coming from monetary policy. In this respect, we think that the FOMC can be forgiven for concluding that policy is overly accommodative and this may warrant a reversal of the rate cuts which Chair Powell delivered in 2025.

Although Warsh will keep his cards close to his chest and does not want to deliver forward guidance, it is clear that several other voting FOMC members believe that it is now appropriate to be discussing higher U.S. rates.

In this context, it will be hard to rule out a hike at the July FOMC, even though we might think that the September meeting represents a more likely moment for the Fed to move. In the interim, even if the Fed defers raising rates for now, we think that there is every likelihood that they will want to sound hawkish and in that way bear down on longer-dated bond yields and inflation expectations.

This may make it difficult for Treasuries to rally and could further flatten the yield curve. However, for now, we continue to express no clear directional bias on Treasuries, noting that a degree of monetary tightening is already discounted in futures curves. This said, we continue to look for U.S. fixed income yields to underperform other markets in the wake of ongoing economic divergence between the U.S. and overseas markets.

More benign inflation prints in Germany and France helped support European yields over the past week, with Lagarde playing down the risk of back-to-back rate hikes at the July ECB meeting, in her speech at the Sintra conference. However, with natural gas prices remaining 40% above levels at the start of the Middle East conflict, due to ongoing supply disruption in Qatar, we would note that the need for countries across Europe to rebuild inventories ahead of the winter season could well limit the progress in inflation back to target over the months ahead.

Consequently, there remains an even chance that the ECB will deliver one more monetary tightening at its September meeting, and the ECB may retain a hawkish bias through the end of 2026.

Meanwhile, the past few weeks have seen sovereign spreads in the eurozone creeping wider, even as corporate credit spreads move in the opposite direction. There is no substantive fundamental driver for this price action, though we would observe reduced demand from overseas weighing somewhat on yields.

Historically, Japanese investors have been some of the biggest buyers of French OATs for example, but now that yields are more attractive with respect to JGBs, this is seen reducing the external appetite for French debt. At this time, we don't hold an active position in eurozone spreads, though around 85bps on 10-year bonds is a spread level which we think may represent interesting longer-term value in both Italy and France.

In the UK, increased focus on the country's fiscal stance has seen gilts underperform over the week, on projected spending plans associated with Andy Burnham taking over from Keir Starmer as the country's Prime Minister.

This week's release of the national Defence Investment Plan (DIP) has revealed a shortfall of GBP5 billion in the National Accounts, even before action is taken to raise the level of spending above the projected level of 2.7% of GDP. Advisors to Andy Burnham have been seeking to float the idea of issuing 'war bonds' in order to help finance the gap. However, UK fixed income investors will understand that these are just gilts by another name and in that respect, this is just adding to deficit related spending.

It appears there are a number of areas where the incoming Prime Minister is also committed to boosting investment, but the political reality is that he will face some difficult choices in the weeks ahead. Taxes may rise, but this will only weigh on economic sentiment and growth, and ultimately it won't be a surprise to us if markets test his resolve and commitment to fiscal sustainability at a relatively early point after he takes office.

Over the past few weeks, it seems that many investors have wanted to take Burnham at his word, believing the fiscal framework will be respected. This has also been exemplified in market hopes that Burnham would pick Wes Streeting as his Chancellor of the Exchequer.

However, based on our analysis, we think that Streeting represents an unlikely choice for this post. In that context, we would note that the 'soft left' holds the balance of power in Westminster's Parliamentary Labour Party. On this basis, Ed Miliband remains a favoured candidate within these ranks, notwithstanding his negative perception on the part of UK financial market participants.

Consequently, we would not be surprised to see scope for underperformance in the gilt market in the weeks ahead and although we see little appeal taking a short position in a market whose valuation looks more attractive than many others, we would rather wait for a moment of elevated stress in UK politics as a more attractive time to look to buy.

Japanese yields underperformed over the past week, in part due to a move higher in the dollar/yen exchange rate, which has taken the Japanese currency's valuation to a 40-year low. The failure of intervention thus far to stabilise the value of the yen runs the risk of another leg to currency weakness, which feeds back into domestic inflation. We note that this will be very unpopular with Japanese voters and may end up harming Takaichi's position as Prime Minister, noting that she has been responsible for co-opting the BoJ to maintain accommodative monetary policy, which leaves it looking like it is now well behind the curve.

A strong acceleration in this quarter's Tankan survey on business sentiment highlights the underlying strength in the Japanese economy and looking within the details, it appears that price risks on the upside are starting to build.

The announcement of a ¥370 billion (USD2.1 trillion) investment plan over the next 14 years further cements the determination to boost GDP. Although this may be seen as more of an aspirational target and we doubt this will add to JGB issuance in 2026 or 2027, a higher potential growth rate could suggest higher neutral levels of interest rates and this could be a factor sustaining elevated yields. However, with long-dated JGBs at 4%, we continue to believe that the yield curve is so steep that higher short rates can easily be accommodated without the need for higher long-dated yields.

We are not particularly concerned about the Japanese fiscal trajectory and would express more concern as fixed income investors if inflation were to suddenly move sharply higher. For now, Japanese CPI pressure is contained, but the valuation of the currency could lead to a deterioration in the outlook.

With respect to the yen, we have no active position at this time. In the short term, we hope that intervention will contain further weakness over the next few weeks, but unless policy makers in Tokyo shift their thinking, the risks to a renewed leg of yen weakness appear to be growing.

Elsewhere, a U.S. holiday-shortened week made for a quieter week in credit markets and also in emerging markets.

Looking ahead to the second half of the year

Correctly determining the future path of the U.S. economy and Fed policy will be important to successful portfolio positioning over the coming weeks. In this context, we would recall that the FOMC acts as a committee with a chair and in this respect, decisions with respect to monetary policy won't be fully dictated or controlled by Kevin Warsh. Consequently, Fed rates won't be dictated by Kevin Warsh (or Donald Trump for that matter).

It also occurs to us that many money managers seem to want to believe that the Fed won't hike and this mindset is most prevalent in credit, equity and private markets. This could highlight potential vulnerability, noting that if the Fed does hike, then a hawkish statement justifying such a move will trigger expectations for a further move to follow thereafter.

Meanwhile, on the weekend when the U.S. will be celebrating its 250th anniversary of its Independence, it is an interesting time to take stock of the nation, which has ascended to the position of the dominant global superpower over the past century. Looking ahead, there is much that looks bright and hopeful into the future, but there are also important fault lines and emerging challenges which the country will need to overcome, if it is to continue to thrive for the next 50 years, let alone for another 250.

Importantly, the rise of AI risks accelerating wealth concentration in a country which has long been resistant to more redistributive tax policies. Stagnating real incomes for many ordinary Americans risks more politically extreme outcomes, in an age where bias is confirmed through social media and values such as respect and tolerance appear to be on the decline. Climate change may not seem an immediate concern to those currently in power, but will be a topic which will inevitably resurface, increasing competition for resources.

Many of the challenges faced by the U.S. (and by many countries around the world) require sound policy making with a sufficiently long-term perspective. Yet we seem to inhabit a world increasingly focussed upon shorter-term payoffs and this is only too true in financial markets.

In this respect, it is hard not to look at what is happening to chip stocks in recent weeks as a form of casino-type speculative investing. In societies addicted to smartphones it seems that we have all become addicted to short-term dopamine hits and in the U.S., it seems that this is something which Trump has been able to understand and use to his advantage.

In this context, notwithstanding a growing list of losses and policy failures over the past year, the U.S. President is certainly blessed in posting USD1 billion crypto profits in what was a declining market. No wonder he is in the mood to party. However, it is doubtful whether many of his MAGA followers will have been nearly so fortunate....

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