



A Messi world

A cautious stance

Key points:

- **Middle East conflict:** ongoing conflict has continued to drive oil prices higher, with no clear resolution or off-ramp currently in sight.
- **U.S. inflation downside surprise:** we think that it would be wrong to conclude that this removes any pressure on the Fed to tighten monetary policy, albeit it offering the FOMC the opportunity to defer a policy change later this month.
- **Eurozone:** a weaker underlying economy suggests that inflation risks should be more muted than in the U.S. but gas prices bear monitoring.
- **UK leadership transition:** Shabana Mahmood appears likely to become the next chancellor. Seen as more fiscally responsible, this makes her a more market-friendly candidate than some of the alternatives.
- **Japanese yields decline:** Japanese yields moved lower in response to comments from Finance Minister Katayama, urging domestic pension investors to invest more in domestic securities.

London, 17 Juli 2026: Ongoing conflict in the Middle East continued to overshadow global markets over the past week, with short-dated yields rising in response to higher oil prices. Although there remains considerable resistance within the U.S. with respect to committing boots on the ground, it seems that the Trump Administration is reluctant to walk away and permit the Iranian regime a free hand to shape and dictate the narrative in the region going forwards.

The concern is that this risks a war without an obvious ending and off-ramp in the absence of compromise, and at this point there appears no pressing imperative which will drive both sides to the negotiating table.

In this context, events in the Middle East and transit through the Strait of Hormuz appear stuck in a 'messy middle', in which conflict may flare up and then quieten on an ongoing basis. This could suggest that oil prices remain around prevailing levels and this continues to infer that inflation remains elevated on a more protracted basis.

That said, this week's monthly U.S. CPI data release recorded a downside surprise, as the prior month's decline in energy prices offered some relief to policy makers. Yet, rather than reading too much into this figure, we think this serves as more of a reminder that individual monthly prints are likely to continue to have an elevated level of volatility.

Consequently, we think that it would be wrong to conclude that this removes any pressure on the Fed to tighten monetary policy, albeit it offering the FOMC the opportunity to defer a policy change later this month.

In the Eurozone, a weaker underlying economy suggests that inflation risks should be more muted than in the U.S. However, elevated gas prices are a source of concern with a growing need to build reserves in the coming months, ahead of the coming winter season.

Disruption to Qatari production and exports of LNG has seen gas prices climb and this will be something which the ECB and other regional central banks will be paying close attention to over the next several months. Noting this, we feel that the ECB has done a better job than others of hiking early and helping to prevent any rise in medium-term inflation expectations, which could subsequently necessitate more assertive policy action.

In this light, we continue to favour European yields, relative to those in the U.S. Over the past week we have tactically added exposure to 10-year bunds at around 3.12%, whilst adding exposure to U.S. inflation swaps at attractive levels in the wake of the U.S. CPI report.

Meanwhile, in the UK it is increasingly likely that Shabana Mahmood will be the chancellor of the exchequer. She is seen as fiscally responsible and has a stated desire to trim the welfare state, all of which makes her a more market-friendly candidate than some of the alternatives (especially Ed Miliband).

Earlier in the week, we added exposure in short-dated UK interest rate contracts given that there are nearly three Bank of England (BoE) rate hikes being discounted in the coming 12-month period. Although a deteriorating UK inflation outlook will likely force the BoE to tighten policy in the months ahead, a weak underlying growth backdrop suggests to us that risks are tilted more to no hikes at all, or at most one or two hikes.

In contrast to dynamics in other global markets, Japanese yields moved lower over the past week in response to comments from Finance Minister Katayama, urging domestic pension investors to invest more in domestic securities.

Prior discussions we have had with Japanese domestic investors have suggested that there is widespread support for increasing allocations towards Japanese government bonds in the current fiscal year, though there has been hesitation in pulling the trigger on these moves against a backdrop where yields had been continuing to trend higher. However, if we have now reached a point where this trend starts to turn, then there could be material funds on the sidelines which are waiting to deploy.

With the Japanese yield curve very steep relative to overseas markets, this means that there is plenty of room to absorb higher Japanese cash rates in coming quarters without putting pressure on longer-dated yields. This should speak to a flattening of the yield curve and in this context, 30-year bonds have outperformed over the past week, as JGBs have rallied.

Elsewhere, events in the Middle East created something of a risk-off tone across global markets over the past week. That said, movements in equities and credit have remained very muted compared to prior historical context.

In equities, ongoing volatility in semiconductors and AI continues to be a focus for attention, and in credit markets it has also been notable how debt from hyperscalers has continued to underperform against the backdrop of elevated supply. Yet elsewhere, demand remains robust and ongoing interest to buy any dip also continues to suppress volatility.

Nevertheless, we continued to voice that the current market context is not one where it is a compelling argument to run an outright long position in credit spreads, and we think that it remains appropriate to hedge long exposure with short positions in CDS.

We have continued to look for opportunities to add exposure selectively where market dislocations and compelling entry opportunities present themselves. In this light, we have added exposure in short-dated UK interest rate futures, which comes on the back of a capitulation in short-dated yields, where other investors had previously been adding exposure to the UK at levels which are now offside. We continue to believe that in the current market, if we can be patient and wait for opportunities to present themselves, then these will present themselves over the weeks and months to come.

Looking ahead

Seasonally low liquidity raises the prospect of elevated market volatility should geopolitical and economic shocks reshape the broader macro backdrop in the weeks ahead.

Over the past couple of months, greed has been dominating fear in global markets and so consensus positioning has accumulated on the long side. Recession risk remains low at the current time and unless something changes, then this may help contain any weakness.

However, we feel that the trade-off between risk and reward favours a cautious stance for the time being; a bit like the stance England took after going one up in the World Cup semi-final this week. It's clearly still very much a Messi world!

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