Hot winds fan the flames

Warsh words…but cool action ahead!

Key points:

- **Middle East geopolitics:** the conflict continued to disrupt Strait of Hormuz trade flows this week, maintaining upward pressure on global energy prices and bond yields.
- **U.S. monetary policy:** the Fed has likely deferred a rate hike until September, though Chair Warsh is expected to adopt hawkish rhetoric at next week's meeting.
- **European inflation resurgence:** natural gas prices have returned to March highs, creating material upward pressure on Eurozone utility bills in the second half of this year.
- **UK fiscal fragility:** Prime Minister Burnham's government has announced new spending commitments without offsetting measures, thus risking policy missteps.
- **A cautious outlook:** the summer holiday season brings reduced liquidity and elevated risks, suggesting investors should wait for attractive entry points with asymmetric return potential.

London, 24 July 2026: Ongoing tension in the Middle East continued to put upward pressure on global bond yields over the past week, with higher energy prices renewing concerns with respect to inflationary pressures and need for tighter monetary policy over the months ahead.

Yet, although tit-for-tat exchanges of fire across the Persian Gulf suggest little scope for the normalisation of trade flows through the Strait of Hormuz any time soon, there remains an abiding sense that the US administration has very limited appetite for a prolonged conflict, leading to a commitment of putting boots on the ground on Iranian soil.

In this context, there remains an embedded expectation in markets that a return to talks will resume at some point in the coming weeks, and thus the recent spillover into risk assets has been relatively muted.

With the US mid-term elections drawing closer and domestic hostility to the costs of the war in Iran continuing to mount in the US, it occurs to us that Trump will probably look to pivot sometime soon. Meanwhile, the Iranian regime appears as intransigent in its demands as ever and will probably bet that it is in a position to call the US administration’s bluff.

However, this does set up a dangerous game of ‘chicken’, with Trump fiercely opposed to being seen capitulating in the face of Iranian resistance. This could make for unpredictable outcomes with messy tails, and it seems that investors are barely rewarded in trying to look through the noise and adopt a material view, against a backdrop of such potential volatility.

In this case, waiting for entry points to trades that seem more favourably asymmetric in their prospective return potential seems to make most sense to us. Meanwhile, were we to witness a larger market dislocation, then this could create much more attractive entry points with respect to long risk positions.

In the US, next week's FOMC meeting will be live, and it seems clear that there will be some discussion with respect to policy tightening. However, in the wake of last month's lower inflation print, Warsh may feel under no immediate pressure to act and so it still seems likely that a decision may be deferred until the next meeting in September.

That said, if the US economy remains robust at that time and oil prices continue to trade close to current levels, a 25bps hike should be expected in the Fall. Although crude oil itself remains below $100, the reality is that there is much more pain in refined products, with crack spreads at historically wide levels, which might seem more consistent with WTI prices around $130 per barrel.

With higher gasoline and diesel prices feeding more broadly into prices of consumer goods so we think that US inflation is likely to remain more elevated than is being discounted by markets, and consequently we see US inflation swaps as underpriced in our view.

Otherwise, we can be very confident that Chair Warsh will want to sound hawkish and do everything he can to bolster his inflation-fighting credentials, without actually doing anything just yet. This could prompt some further flattening of the US yield curve for the time being. However, with the US fiscal position continuing to deteriorate and the bill for Trump's Middle East war continuing to rise, so we think that ultimately this can be a factor which may see the curve re-steepen at a later point in time.

In Europe, natural gas prices are a much more important inflation component. European energy suppliers appear to have held off from rebuilding stocks ahead of winter, in the hope that prices may trend lower over the summer.

However, TTF futures have now returned to their highs in March, and this means that utility bills face material upward pressure in the second half of 2026. With this lifting Eurozone inflation, it is not surprising to have heard a relatively hawkish message from Lagarde at this week's ECB policy meeting, and a second 25bps hike in the cycle is now widely expected at the September meeting.

Meanwhile, multi-year highs in government bond yields are creating more fiscal pressure on those sovereigns with elevated debt burdens and this has been a factor pushing spreads wider. As a result of this, we have moved to an underweight stance in Italian BTPs.

As well as having high debt levels, Italy is exposed to the Middle East shock with a large share of its electricity production coming from gas. In addition, elections in 2027 could also be a source of renewed political volatility against an anemic growth backdrop.

On a relative basis, we see more value in Euro spreads from sovereigns such as Bulgaria and Hungary. In addition, issuance from high quality LatAm names, such as Chile, also offers an attractive spread pick-up in a stronger underlying credit story.

In the UK, new Prime Minister Burnham surprised many in naming John Healey as Chancellor. Yet, for all his comments relating to his desire to respect the fiscal framework, thus far all we have heard from Burnham is a continual drip-feed of new planned spending commitments, without anything tangible being done as an offsetting measure.

A clearer position with respect to the Budget and the UK fiscal position will come into view in October, but we would note that higher funding costs have already eroded any fiscal headroom under the OBR measures that Chancellor Reeves thought she had created. Consequently, the UK is in a delicate fiscal position and policy missteps by the new team could well prove very costly to their medium-term aspirations.

UK inflation is also subject to a sharp rise higher in the coming months, given the country's misguided policy of pricing all supply in line with the higher marginal cost of energy production. If Burnham wanted to make a beneficial change, then altering this framework asap would be strongly advisable, otherwise Q4 inflation in the UK could peak at 5%. This would be an outcome that we would see necessitating two rate hikes from the Bank of England in the second half of the year.

The UK could badly use some good news on inflation. In light of this, it is an economy far more exposed than others to the types of macroeconomic pricing shocks we are currently witnessing. That said, should conditions change and this delivers a more benign inflation path, then we can't see the BoE delivering any more than 50bps of hikes in the coming year, and it could well deliver less than this given half a chance. On this basis, we see value in June 2027 UK interest rate futures, with three such hikes already fully discounted in prices.

The evolving global macro backdrop also has the BoJ rethinking its policy stance. With ongoing pressure on the yen, notwithstanding attempts by Finance Minister Katayama to stabilise it, so there seems a growing realisation from the Takaichi camp that Governor Ueda and colleagues must be allowed to normalise interest rate policy quicker than the very gradual path of rate hikes of 50bps per year, which has characterised the landscape for the past 24 months.

Policy tightening will help ease fears that the BoJ is behind the curve, and we may well see longer-dated yields rally, as the curve flattens. Consequently, we continue to see attractive relative valuations at the 30-year point on the Japanese yield curve.

In equity markets, there has been further elevated volatility in the valuations of semiconductors and hyperscalers. Concerns with respect to ever-growing investment plans have been weighing on IG credits in this space, with Google under pressure over the past week.

With so much debt coming to market, new issues are having to offer some concessions to help build their book, though subsequent tightening of price guidance often means that optically oversubscribed new issues are struggling to rally at all from their new issue spreads.

Elsewhere in credit, market moves have been much more muted. Nevertheless, the past week has seen spreads in aggregate move to their widest levels for more than a month.

Looking ahead

As we move into August, summer holiday season is a time when market liquidity is reduced and the risk to larger market moves coming from macro shocks can be elevated.

It strikes us that many investors have maintained a stance which has tended to be long in duration and long in risk assets since the start of the second quarter, on the assumption that the Middle East conflict would pass and that prior trends towards lower inflation and lower interest rates may return, against a relatively benign growth backdrop.

However, events over the past couple of weeks call these assumptions back into question. Consequently, should there be a more material escalation of hostilities, then this could see a more outsized move in markets than we have witnessed to date.

Although this outcome is not necessarily our baseline view, we think this serves as a reminder to proceed with caution, and to be disciplined with respect to adding exposure only at attractive levels that offer robust medium-term value. In this respect, we think that as the summer continues to grow hotter, so it makes sense to take cover in the shade.

With the war in the Middle East spreading to the Red Sea, it is not yet clear that either side in the conflict has reached a pain threshold, which will drive them to the negotiating table, and so newsflow in the week ahead could well continue to deteriorate for the time being.

Across much of the Northern hemisphere, a hot, dry summer is leading to widespread wildfires breaking out, wreaking destruction and posing a threat to life. It is also a reminder of how a serene and peaceful landscape can change very suddenly, and you don’t want to set up camp in the wrong position.

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