RBC BlueBay Asset Management

Marketing communication

Bessent puts his reputation on the line

A bond buyback bonanza!

Key points:

- **U.S. Treasury intervention:** the U.S. Treasury has announced plans to increase purchases of long-dated bonds, signalling efforts to curb rising yields and ease mortgage costs.
- **Fed policy dilemma:** the Treasury's interventionist approach conflicts with the Fed's hawkish stance needed to control inflation, thus creating tension between monetary and fiscal policy objectives.
- **Middle East instability persists:** trade flows through the Strait of Hormuz have remained significantly reduced, with hopes for a peace deal continuing to diminish and conflict risks remaining elevated.
- **AI volatility dominates markets:** chip manufacturers have experienced extreme price swings this week, while AI-related issuance skewed towards longer-dated maturities is leaving the U.S. fixed income market suffering from a degree of supply indigestion.
- **Macro outlook remains uncertain:** a combination of policy uncertainty, supply-demand imbalances, geopolitical risks, and potential policy errors suggest markets may experience heightened turbulence as summer ends.

London, 21 August 2026: An announcement from the U.S. Treasury stating its intention to materially increase its purchases of long-dated government bonds saw the U.S. yield curve flatten over the past week. The unusual timing of this announcement appeared to be aimed at curbing the rise in long-dated Treasury yields, after these hit a new 20-year high earlier in the week.

In this respect, Scott Bessent has always argued that long-dated borrowing costs will fall materially on his watch, and that this will help the U.S. housing market by improving mortgage affordability. Yet with the trend over the past year running in the opposite direction, so it seems that the Treasury Secretary has been growing increasingly frustrated.

Indeed, it is not hard to imagine his boss screaming into his ear to ‘do something’ to fix the unwelcome move in borrowing costs, at a time when Trump’s approval rating sits at a record low.

In this context, the move to buy back longer-dated bonds, funded by shorter-dated liabilities, can be seen as having an analogous effect to what the central bank would seek to engineer under a quantitative easing policy initiative.

However, the size of these buyback operations is tiny compared to past Federal Reserve QE programs. In this respect, this initiative is more of a signaling effect on the part of the U.S. administration. At a time when the U.S. fiscal deficit remains extremely elevated, there remains zero appetite for fiscal consolidation.

Yet, it appears that the administration is inclined to do whatever it takes to ensure that borrowing costs don’t spiral higher. This objective was also a motivation behind recent intervention by the Treasury to support the yen in the FX market, yet Bessent should be aware that intervention can only buy time at best, if not supported by underlying market fundamentals.

Anyway, recent events do beg the question of what Bessent and Trump might be saying to Kevin Warsh at this point, given the Fed Chair's disdain for how the Treasury has sought to use its balance sheet in an interventionist manner such as this, under Janet Yellen, in the past.

Certainly, it strikes us that Bessent's actions put Warsh in something of a difficult position. This week's Fed minutes highlighted that a significant number of participants thought interest rates should rise over the months ahead.

Yet with some softening of economic data since the July meeting, unless August jobs and CPI reports surprise to the upside, it may seem difficult for the FOMC to deliver a September hike, as shown in interest rate futures markets pricing such a move with a probability of around 30% at the current point in time.

Nevertheless, it is still clear that the discussion will be with respect to delivering a more restrictive monetary stance, yet the buyback operations from the Treasury seem to be pointing very much in the opposite direction. Indeed, one may even begin to wonder whether a sustained further move up in yields would see the administration calling for a form of Yield Curve Control, as was seen as part of a very accommodative monetary policy stance adopted by the BoJ over many years.

Of course, the problem with seeking to cap yields in such a way is that it will give further upward impetus to inflation and in this respect, it is interesting to observe broad-based weakening in the U.S. dollar and a sharp move higher in gold prices in the wake of the Treasury's recent actions.

We continue to advocate for inflation-linked bonds and swaps to outperform against this backdrop, though the price action in this space has been very muted over the past several days. In this respect, it strikes us that the inflation-linked market feels confident in Warsh being sufficiently hawkish to drive down inflation and inflation expectations, yet the nominal interest rate market doesn't discount a full 25bps rate hike until January next year.

The takeaway here seems to be that the market is convinced that inflation data are set to remain relatively benign, yet we think this looks complacent in our eyes – especially with the conflict in the Middle East unresolved and the prices of refined products back close to their Q2 highs.

In the Middle East, hopes for a peace deal continue to diminish and it appears that we are set to remain in a grey zone for an extended period, with trade flows through the Strait of Hormuz staying at a fraction of the levels seen prior to the start of the war.

Although there is something of a stalemate for the time being, there seems a prevailing sense that renewed conflict remains inevitable at some point in the future, given how far apart the respective sides remain.

Meanwhile, with Trump half threatening to bomb U.S. ally Oman, an erratic White House continues to be a source of consternation around the globe. South Korea is also feeling the chilled winds from Washington in the wake of the U.S. announcing a reduction in its troop presence on the Korean peninsula.

Elsewhere, market attention continues to be dominated by sectoral swings and gyrations related to AI. In this context, chip manufacturers continue to be a driver of market volatility. By way of example, the share price of Korean company SK Hynix rose by 30% in the week up to 18th August, only then to reverse by 17% in the next two days before bouncing 10% in the 24 hours thereafter.

Such big swings in valuations, exacerbated by leveraged retail investors chasing price action in both directions, have rendered some markets nearly uninvestible. Nevertheless, what is in no doubt is that AI trends continue to build and show no sign of slowing. Hyperscalers continue to issue at a pace across global markets, and this week Australia was in the spotlight, with Alphabet announcing plans to come to market with a A$5 billion multi-tranche new issue.

One notable facet with respect to AI-related issuance over the past year has been how much of this has been skewed towards longer-dated maturities, with over 40% of 2026 issuance in DV01 terms coming in bonds greater than 20 years to maturity. This has represented a substantial amount of long-dated duration to absorb.

Even with the U.S. Treasury seeking to avoid issuing at the longer end of the curve, financing a growth in the outstanding volume of government debt in shorter-dated bills, it seems that the U.S. fixed income market has been left suffering from a degree of supply indigestion. Economic textbooks will record that a glut of debt will inevitably lead to a phenomenon of crowding out weaker borrowers, as issuance competes for a finite amount of demand.

Yet although current demand is not sated to this point, it has been interesting to reflect in 2026, that instead of this putting upward pressure on corporate bond spreads, in more recent times, it has been the whole of the yield curve which has been feeling the pinch.

Higher UK gilt yields have also been pushing up UK mortgage borrowing costs against the backdrop of a structurally weak UK housing market. Rightmove London prices recorded a 4% fall in the past month, and many surveys point to house prices now sitting 30% below their peak valuation in the capital, particularly with respect to higher value homes on sale.

Notwithstanding ongoing immigration bringing individuals to the UK and house building at a standstill, as bureaucracy and climbing building costs stymie development, the forward-looking outlook for housing is hardly more optimistic.

Worries with respect to 'mansion taxes' on more valuable homes have also overshadowed London house prices, whilst a degradation of landlord rights in favour of their tenants, has also witnessed many privately rented properties being offered up for sale.

Developments in the UK housing market are thus a factor which argue against a further tightening of financial conditions from the Bank of England and might suggest the bank should maintain policy rates unchanged, even if headline inflation is reaccelerating.

From this standpoint, there is little that the BoE can do to control energy price inflation coming from higher oil and gas prices, and this explains its focus much more on second round impacts, which could de-anchor price stability.

Consequently, although we project UK CPI exceeding 4% in Q4, we only expect the BoE to hike once over the next year, given a weaker underlying picture of inflation, as was shown in this month's consumer price and labour market reports.

With the UK now set to permit new domestic oil and gas projects to proceed after a sensible government U-turn under Burnham, this may help reduce the UK's energy dependency on the Middle East over the medium term, even if this offers little comfort for now. What could be a positive near-term impact would be if the government were to address the power generation pricing formula, which has effectively meant that the UK pays a price at a ceiling determined by the highest cost marginal supply.

Addressing this would bring power bills down, help tackle the cost-of-living crisis and would also lower inflation, offering the BoE some relief. It may be hoped that the government identifies this glaring anomaly and makes a change that can make a real difference. Were policy to move in this direction, we see value at the front end of the yield curve, though we continue to be much more wary of longer-dated gilts on broader fiscal-related concerns.

Markets elsewhere in Europe remain quiet for the summer. In Japan, long-dated yields rallied in sympathy with long-dated Treasuries, and we increasingly infer that the Japanese government is similarly working on plans to help prevent long-dated borrowing costs from spiralling higher.

This is reflected in reduced longer-dated JGB issuance and more recently by discussions aimed at giving retail Japanese investors increased tax breaks when investing in Japanese government bonds. We continue to see value in 30-year JGBs at 4% yields and expect the market to stabilise at this level.

Although this week's Japan CPI reports registered a rise compared to June, price gains remain below 2% on an annual basis and although some further upward trend should be seen in the next several months, it is clear that price expectations are much more anchored in Japan than is the case elsewhere.

In FX, the dollar was softer in the wake of the Treasury buyback plan. It is also tempting to think that ongoing erratic comments from Trump may prompt Reserve managers in countries like Korea and Oman to look to diversify reserves away from the US$.

Gold has been boosted by central bank buying over the past several weeks and the ongoing weaponisation of the dollar continues to undermine its appeal, notwithstanding ongoing growth exceptionalism and leadership in AI. Elsewhere, the Canadian dollar has been helped by progress on a U.S. trade deal, though broadly speaking, FX volatility has remained relatively muted for now.

With respect to activity, we have added exposure to the Hungarian forint over the past few days, following some weakness in the past month. We continue to see Hungary as an attractive longer-term EU convergence play.

Looking ahead

In this context we will also be watching Iceland's upcoming EU vote on 29th August with interest. With the 'yes' camp polling with a small majority, an outcome which restarts EU membership talks could trigger interest into Icelandic bonds and FX, especially with Icelandic cash rates at 8% and the country in a strong net reserve position.

A further referendum would be required to ultimately join the EU, but it seems clear that if Icelandic citizens can be persuaded, then the rest of the EU would accept them with open arms.

With respect to Iceland, it is also interesting to reflect how Trump's interventions in Greenland have helped to shape opinions and drive a more pro-European identity. Around the world it is notable to reflect on how many individuals feel fearful of their futures against the backdrop of very uncertain and unstable times.

With fears of a dystopian AI future adding to the sense of unease, it has been interesting to witness the behaviours this is manifesting. In this respect, the trend among the super-rich to buy private islands and to build huge underground bunkers is far from reassuring. It is also interesting to contrast this risk-averse sentiment to valuations in financial markets, which seem much more wedded to the utopian ideal, which a number of tech CEOs have publicly wanted to embrace.

It is understandable that visionaries will want to sell dreams of a future full of limitless possibilities, in an age of abundance where we live, free from disease. Yet, we should all know that it is wise to take this sales pitch with a suitably large pinch of salt.

Similarly, it is understandable that Bessent and Trump will want to sell an outlook of strong U.S. economic growth, low inflation, low yields and low deficits in the years ahead, in the same way they want to sell the notion of total victory over Iran and a bright new future in the Middle East.

However, such claims can also be understood as a sales pitch, and at a time when voters seem to be growing increasingly tired and cynical of these grandiose claims, it will be interesting to see what comes next if markets don't play ball with what the administration wants to see.

The risk of a policy error may increase materially in such an outcome and, as we have come to experience in the Middle East, poorly executed plans may run the risk of making a bad situation much worse, if you aren't very careful. As the summer comes to an end, so this may suggest that volatility could be about to increase….

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.