RBC BlueBay
Asset Management

Market Commentary

Don't be fooled by the calm on the surface

Geopolitical concerns rose this week, and volatility is never far away

Key points:

- Israeli attacks on Iran overnight have seen a knee jerk flight to quality in financial markets this morning.
- This has the potential to be a fast-moving situation, but our initial assessment is that these attacks are to apply pressure on Iran towards a nuclear deal and an escalation to a wider Middle East war is unlikely.
- The main impact on the global economy and financial markets is via oil prices.
- Yet at a time of some market complacency, the Middle East and geopolitics more broadly is a source of risk, which we cannot ignore.
- Tariff revenues are flowing in, with the US Treasury recording USD23 billion of receipts in May.
- Bullish market sentiment persists in the US, but there is a risk of trade conflict escalation as the 9th July tariff deadline approaches.
- Sector-specific tariffs on the pharmaceuticals industry are expected soon, with Trump likely to crack down on Ireland’s tax haven status.

13 May 2025 (London) – Israeli attacks on Iran overnight have seen a knee-jerk flight to quality in financial markets this morning. This has the potential to be a fast-moving situation, but our initial assessment is that these attacks can be seen through the lens of the US using Israel to apply pressure on Iran towards a nuclear deal.

It appears that US tankers were utilised in refuelling and the US would have needed to give at least tacit support for Israel to move forward in this way. At present we think an escalation to a wider Middle East war is unlikely. After all, the Iranian regime, like all good dictatorships, values its own survival above anything else.

Military intelligence has suggested that the US and Israel lack the capabilities to eliminate Iran’s nuclear program using airstrikes alone and would need to have troops on the ground, which would be very problematic given the sheer size and scale of the Iranian Revolutionary Guard.

This is something we think that Trump will be very keen to avoid. Consequently, Israel and Iran may trade blows with drones/airstrikes for the time being, but we can hope this is contained.

The main impact on the global economy and financial markets is via oil prices. However, as long as Iran does not launch suicidal attacks on UAE facilities or attempt to blockade the Straits of Hormuz, then moves can be contained.

Yet at a time of some market complacency, which we have been highlighting, the Middle East and geopolitics more broadly is a source of risk which we cannot ignore.

As well as gaining on overnight news, Treasury yields were also supported by a relatively benign US CPI report during the past week. Core prices rose only 0.1% in May, leaving the annual rates unchanged at 2.8% year-on-year. However, we continue to expect inflation data to deteriorate over the coming months, as prices adjust in the wake of import tariffs.

In the immediate aftermath of Liberation Day, businesses have typically wanted to emphasise 'business as usual'. Against a backdrop of uncertainty, this has meant that firms have held off from making changes to prices and employment in the short term. Yet, it now seems understood that a minimum 10% rate of tariffs will remain in place, irrespective of ongoing trade discussions.

In that context, tariff revenues are rolling in, with the Treasury department recording USD23 billion of receipts in May. This additional cost has been borne by businesses to this point, but it is widely expected that much of this will be passed onto consumers in the course of time. A weak dollar and higher oil prices may also compound the need to adjust prices related to import costs. Consequently, we continue to see core CPI pushing towards 4% in the coming months, as this adjustment takes place.

In as much as a rise in inflation from tariffs represents a one-off adjustment, there is an argument that, as with a consumption tax hike, any rise in inflation will be transitory.

However, if the economy remains firm, there is a risk that higher prices in the short term will lead to higher wage demands and elevated inflation expectations.

From this standpoint, we think that the Federal Reserve will need to be careful not to stoke inflationary pressures by easing policy too much and look for the FOMC to retain policy on hold in the months ahead.

It is clear that the Trump administration would like to see lower interest rates. Indeed, this desire may also manifest in the suggestion that Treasury Secretary Bessent is being touted as a candidate for the Fed Chair, with support for Kevin Warch seemingly starting to wane. As an individual who has been eager to do Trump's bidding, the idea is that Bessent would be more likely to deliver low interest rates with less of a focus on inflation risks.

However, even if he is nominated and subsequently confirmed by Congress, Fed policy decisions are made by Committee, and any sense that a Chair is pandering to political influence is likely to be strongly resisted by other governors around the table. That said, were Bessent to get the nod, we would not be surprised that markets price a lower forward trajectory for Fed Funds and more likely a steeper yield curve, as a result.

In the next several days, global leaders will be spending time in Alberta for the 51st G7 summit. Expectations are relatively low with respect to a common agreement being found and any agreed communique is likely to be very light in terms of any details or specifics. As the clock ticks down towards the July 9th tariff deadline, it seems that progress on additional trade deals remains very limited.

In this regard, we had initially been hopeful that Japan would be one of the first countries to reach an agreement, yet Tokyo has been frustrated in its attempts to take steps to remove auto tariffs. From this perspective, it seems that the UK deal probably represents the best template, which Japan and other trading partners may be able to hope for.

Based on 2024 volumes, this could permit up to 1.5 million Japanese car exports at a reduced tariff rate of 10% going forward, but it seems unrealistic to think that trade will be tariff-free in this space.

This being the case, it may appear that Ishiba decides that it is not in his interest to make concessions, ahead of Japan's own Upper House elections due on 20th July. Meanwhile, progress on EU trade talks seems even more distant.

Indeed, even the UK deal, which was reached last month, is something that continues to be debated, as policy officials seek to thrash out the details. In this regard, the US is trying to push the UK to agree to impose restrictions on Chinese investment, but the UK is wary of taking action, which could make it subject to retaliatory action from Beijing.

Elsewhere, representatives from the Chinese and US governments met in London this week, in order to shore up progress with respect to the 'Geneva consensus', which was thrashed out last month. It appears that the US has been pushing for progress, given its need to access rare earths and other critical minerals and this has put Beijing in a relatively strong negotiating position.

Ultimately, it may seem that 30% tariffs will stay in place and this will limit US-China trade in the quarters to come. At this point, the battle ground seems to relate more to trans-shipments through third countries and US pressure on other nations to adopt a more restrictive stance towards China on trade.

The upcoming NATO summit on 24th June is also an event we are keeping our eyes on. Suggestions coming from Italy this week, that they may only look to implement NATO spending goals on a 10-year view, appear to contradict messaging coming from Germany and Brussels, suggesting a much more rapid ramp-up in spending.

In part, this may reflect a desire from Italy and some others to push increased spending onto the EU, rather than the national budget. Nevertheless, the amounts being discussed are material and could have a major inference for forward-looking government bond supply. We are inclined to think that markets are currently understating this and also the growth uplift, which may occur from this additional spending in the years ahead. This leaves us inclined to fade rallies in yields.

That said, risk assets continue to climb the wall of worry. Earnings were OK, the US economy is continuing to grow, and inflation has been contained for now, even as tariff revenue comes rolling in. We continue to see complacency in this bullish price action ahead of the July 9th deadline and would not be surprised to see a trade conflict escalation around the corner.

In this respect, we think that action on the pharma industry could be imminent with respect to sector-based tariffs. It strikes us that the Trump administration is eager to end companies using Ireland for the sake of a tax arbitrage by big pharma and tech, and is also in a position to threaten parallel imports which would undercut inflated US drug prices.

Arguably, this could be a win for voters within the Trump base. Meanwhile, we think that reciprocal EU action could seek to target big US tech firms. However, on this point we think that Trump is unlikely to be too troubled by EU action against woke Silicon Valley firms in the same way that we think that the EU is unlikely to lay everything on the line to protect Irish interests, noting that it took this position already when it came to Brexit.

Although an escalation of trade tensions could trigger renewed dollar weakness, we would note that unlike the start of April when the market was positioned long of the dollar, this is now very much the other way round. Elsewhere, yield curve and credit positions were broadly rangebound during the past week.

In Japan we look forward to MoF plans on June 20th with respect to reductions in long-dated bond supply. It seems that the market consensus already expects a yen 300 billion reduction in longs, though we would hope that policymakers will go further than this in order to bring more stability back to the long end of the market.

Looking ahead

We don’t expect to see much clarity with respect to policy at next week’s FOMC. Given the uncertain macro backdrop, it seems wise that the Fed will keep its options open. Powell is likely to face questions as to why he is not easing policy more rapidly, and Trump is also likely to be wading in on this debate from the sidelines.

However, with the economy doing fine for the time being, it is not clear that the delivery of the Fed mandate on growth or inflation is being challenged at this time. This can serve as justification for the FOMC to take a firm line in its wait-and-see approach.

With yields rallying in the past week, we might look towards adopting a short duration stance if this move extends further. However, for now, 2 and 10-year bond yields are not far from where we see fair value.

We are also wary of potential for a flight to quality, if trade tensions flare up, creating renewed downside risks to growth. Instead, we continue to see more asymmetry in terms of yield curve positions and so sit with a long-dated steepener in the US Treasury market and an opposite stance in Japan.

We see plenty of scope for volatility to increase in the coming weeks and it seems that Scott Bessent could be at the centre of it. Having emerged victorious in the power struggle for influence in the White House, it has also been circulated how the Treasury Secretary threw a punch at Elon Musk, in the wake of being rugby tackled by his erratic counterpart from the DOGE.

Honestly speaking, who knew that Scott had it in him! Perhaps it is best to reflect that, as with markets at the moment, the perception of calm may mask the turbulence that sits below the surface.

Notes to Editors

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