Weekly round up (Week 20)

As markets grapple with rising geopolitical tensions, persistent inflation, and renewed uncertainty regarding the path of U.S. interest rates, Jerome Powell is stepping down from the Federal Reserve after steering the global economy through one of the most volatile periods in modern history. This week's market movements suggest that his successor, Kevin Warsh, is inheriting a far more complex inflationary environment than many investors had anticipated.

Investors adopted a more defensive stance this week as sentiment deteriorated across most markets. The VIX—our preferred gauge of uncertainty—trended steadily higher, posting its first weekly gain since late March. Political uncertainty has intensified on several fronts, while economic data suggested that the conflict with Iran was beginning to have a measurable impact on inflation.

Government bonds were not spared, with yields rising across the yield curve. U.S. Treasury bills underperformed at short maturities as investors reassessed the direction of the Federal Reserve's (Fed) next monetary policy decision. The debate has shifted: the question is no longer when the Fed will cut rates, but whether it will raise them. Overnight interest rate swaps reflect the extent of this reassessment, now pricing in a 65% probability of a tightening before the end of the year and fully anticipating an additional 25 basis points (bp) of hikes by the first quarter of 2027.

The Senate confirmed Kevin Warsh as the 17th Chair of the Federal Reserve by a vote of 54 to 45, bringing Jerome Powell's eight-year term to an end. With an iron fist in a time of instability, Powell navigated an unprecedented pandemic and the worst inflation in forty years while preserving the central bank's independence, raising rates 15 times and lowering them 11 times during his tenure. Few Fed chairmen have been tested so severely; yet he leaves the institution as strong as he found it.

Warsh takes office amid a highly complex landscape, and the latest price data from China were likely among the first items on his desk Monday morning. Although the two-day summit between Donald Trump and Xi Jinping in Beijing was described as "historic" by the Chinese leader, it ended with warm statements and a promise to meet again in the fall, without any concrete agreements or tangible progress.

Beyond this diplomatic show, however, it was the economic data that sent the most striking signal to the new Fed chair. Chinese producer prices surged 2.8% year-over-year (y-o-y) in April, the fastest pace since the start of the pandemic and a sharp acceleration from the previous month's 0.5%, as the conflict with Iran drove up energy and input costs across Chinese industry. For the Fed chair, this means that China, which for several years has acted as a powerful disinflationary force on the global economy, may well be reversing that trend. The world's factory is no longer exporting deflation. The U.S. import price report for April confirms this, with a 1.9% month-over-month increase, driven by oil but also by broad strength in non-energy goods. Strong demand for AI-related equipment continues to push up prices for capital goods, while year-over-year prices for Chinese imports have turned positive for the first time since late 2022.

The inflationary impact of the conflict in the Middle East has also been reflected in domestic data, which exceeded expectations across all indicators. The consumer price index rose 3.8% year-over-year, with gasoline prices surging nearly 28% in the last two months alone. The pressure was not limited to energy; food prices, rents, and airfares also rose sharply, illustrating the broader pass-through of energy costs to the rest of the economy. Producer prices reinforced this trend, with raw material costs rising 1.4% in April, above a previous reading that had already been revised upward by 0.7%, a sign that industrial inflationary pressures remain firmly entrenched.

In Europe, concerns over rising energy costs have pushed bond yields higher, with UK gilts underperforming their European counterparts. Yields on 30-year gilts have reached levels not seen in a quarter-century (see Chart of the Week). However, the energy shock does not explain everything for the UK. Gilts are now facing political headwinds following the Labour Party's heavy defeat by Reform UK in the local elections, which has heightened doubts about Keir Starmer's popularity and triggered an open battle for his succession. Prediction markets currently assign a 66% probability that Starmer will be replaced as Labour leader before the end of September , with Andy Burnham the favorite to succeed him.

But Burnham's rise is not without complications: remarks he made last year, suggesting the country was “at the mercy” of bond markets—which he has since claimed were taken out of context—nevertheless worried investors and added an extra layer of uncertainty to an already neglected bond market.

However, the unenviable distinction of the week's worst-performing government bond market goes to Japan, where the yield on 30-year Japanese government bonds (JGBs) broke the 4% mark for the first time since their introduction in 1999. As elsewhere, yields were pushed higher by growing fears that rising energy prices might not be merely temporary. In Japan, however, reports that the government is considering a supplementary budget have reignited long-standing concerns about fiscal discipline, exacerbating pressure on an already strained market. For a country with one of the highest levels of gross debt in the developed world, rising yields are not merely a market nuisance: they pose a direct threat to the sustainability of public finances.