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SARIF Commentary: July

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The re-escalation in the Gulf has pushed inflation and growth in opposite directions, leaving central banks with a difficult trade-off. Front-end bond valuations look appealing, but higher energy prices remain the key risk.

Market Review

The Strait of Hormuz: Re-Closed and Oil Rebounds

July's dominant theme was renewed geopolitical risk in energy markets. The US–Iran memorandum of understanding signed on 18 June proved short-lived, with the ceasefire breaking down on 13 July and Iran reimposing restrictions on commercial shipping. By late July, the Strait of Hormuz remained effectively closed and Brent crude had rebounded to $100 per barrel. A prolonged stalemate now looks more likely than a quick resolution, keeping oil prices elevated and maintaining pressure on front-end yields.

Higher oil and gas prices are pulling inflation and growth in opposite directions. They lift headline inflation through energy, petrol and transport costs, but also act as a tax on households and businesses, weakening real incomes, margins and demand. This leaves central banks with a difficult choice: tighten and risk amplifying the growth shock, or pause and risk headline inflation feeding into wages and services prices. In Australia, the UK and Europe, where growth was already softening, markets may have priced too much tightening. The US is more resilient, supported by household spending and AI-related capex, but it is not immune to a further oil shock.

The key risk is that the buffers that contained energy prices during the first Hormuz closure are now largely spent. OECD commercial inventories have fallen sharply, the US Strategic Petroleum Reserve is near multi-decade lows, and earlier IEA-coordinated releases leave limited scope for a repeat. Product markets are also tight, with US middle-distillate stocks below seasonal averages and refining margins at record highs. China's inventory buffer has also been drawn down after imports fell sharply during the closure. If the Strait remains closed, depleted OECD stocks, a constrained SPR and a reduced Chinese buffer create meaningful upside risk to oil prices.

Australia: Softening Underneath the Surface

The Reserve Bank of Australia (RBA) held the cash rate at 4.35% in June, noting that earlier tightening has yet to fully flow through the economy. Before the June quarter CPI, markets priced the cash rate near 4.60% by year-end, implying one further hike. However, trimmed mean inflation came in below expectations at 0.8%, giving the RBA room to wait at its August meeting. Further tightening is now priced at less than a 50% probability. Our view is that the RBA is done for 2026, unless the Gulf conflict escalates further.

Growth is deteriorating beneath the headline numbers. Q1 GDP rose just 0.3% quarter-on-quarter and was flattered by data centre and AI infrastructure investment. Excluding this narrow, import-intensive capex category, momentum looks weaker against falling residential construction and soft consumer sentiment. Labour data also point to spare capacity: unemployment is above the RBA's forecast, while underemployment and underutilisation have risen. This reduces the risk of renewed wage acceleration and weakens the case for additional RBA tightening.

Europe: Tightening Into a Slowing Economy

The European Central Bank (ECB) raised rates by 25 basis points to 2.25% in June and held in July, with attention now on September. Markets are pricing a further 50 basis points of tightening before year-end, but we view this as too aggressive given weaker growth and limited evidence of second-round inflation effects.

Growth is clearly slowing. The Euro area composite PMI fell to 48.5 in May, a 30-month low, while services dropped to 47.7. This matters because any second-round inflation effects would likely appear first in services pricing and wage settlements. Instead, services activity, new orders and expectations are all weakening.

Wages also continue to cool. Labour-cost indicators point to easing pressure rather than a repeat of the 2022–2023 wage-price spiral, while core inflation remains close to 2.3%. The ECB's inflation-focused mandate means officials will remain vigilant, and a September hike remains possible, but there is little evidence so far that the energy shock has spread into broader price-setting behaviour.

In the UK, markets price at least two Bank of England hikes by year-end. Recent inflation has been below BOE forecasts, core inflation is 2.6% year-on-year, and wage growth and vacancies are easing. With policy already restrictive, growth weak and price pressures contained, the BOE may be able to keep rates on hold for 2026, absent further Gulf escalation. UK front-end valuations therefore look relatively attractive.

United States: Talk Is Cheap - and the Bond Market Knows It

The July Federal Open Market Committee (FOMC) meeting provided an early test of the view we set out last month. In June, we argued that Warsh's hawkish debut looked more like credibility-building than a firm guide to the US Federal Reserve's (Fed) reaction function: "talk is cheap, and it remains to be seen whether the Fed actually delivers on the hawkish messaging." July did little to disprove that. The Fed held rates at 3.50%–3.75%, while three members dissented in favour of an immediate 25bp hike. Warsh again offered no forward guidance and said he "welcomes" higher long-term Treasury yields, reinforcing uncertainty over how much of the rhetoric will translate into action.

Markets were unimpressed. Equities initially rallied, then reversed, while the curve steepened sharply. The 30-year Treasury yield rose 12 basis points to 5.21%, its highest level since 2007, while the 2-year yield fell 4 basis points to 4.24%. This bear steepener suggests investors are less worried about near-term hikes and more concerned that the Fed may be too slow to contain inflation.

The inflation data were more encouraging. June core PCE, released the day after the FOMC meeting, rose just 0.1% month-on-month and eased to 3.3% year-on-year, while headline PCE fell as the brief June Hormuz ceasefire reduced energy prices, confirming earlier June CPI and PPI releases. Did the Fed see the inflation data early? In addition, the Dallas Fed Trimmed Mean PCE was 2.2% on a 12-month basis and services inflation was 2.3% year-on-year. This is an alternative inflation measure that Warsh has referenced previously. Excluding the energy shock, US inflation is moving closer to the Fed's target, but core PCE remains well above at 3.3%, maintaining pressure on the Fed to act.

By month-end, US front-end rates priced one September hike and a 50% chance of another in December. That remains consistent with last month's observation that "markets have taken his comments at face value and repriced sharply", but we continue to think actual Fed delivery is less certain than the rhetoric implies. The Fed has more flexibility than Europe to look through energy-driven headline inflation, and if the July and August inflation readings confirm recent progress, it may avoid tightening in 2026 while waiting for Warsh's taskforces to report back. However, critically this depends on oil remaining below $100 a barrel.

Portfolio Changes

Several crosscurrents are making outright long-duration calls difficult, despite appealing valuations in Europe and the UK, in particular. The main risk is a materially higher oil price if the Strait of Hormuz remains largely closed. Front-end yields have been closely tied to oil, particularly in Europe given gas-price sensitivity and the ECB's inflation-focused mandate. In the US, the Fed's reaction function is uncertain, but inflation excluding energy is improving. In Australia, growth is weak and recent CPI data suggest the RBA can wait, although the risk premium now available is limited.

We are maintaining modest duration of 1 to 2 years, focused on front-end markets where valuations are most compelling. Around half of the exposure is in Australia, where we have greater confidence in the weakening growth outlook and an RBA on hold. We also hold smaller short-end positions in Europe and the UK which have the most attractive valuations, and in the US we hold a yield curve steepening position and three-year TIPS (real rate exposure) as a hedge against a much higher oil price. Given higher volatility, we are adjusting exposures more actively as valuations change.

Credit: Reducing exposure to reduce correlated risks

In credit, we reduced exposure where spread risk looks asymmetric. We cut emerging market debt exposure from 6% to 2.5% to reduce exposure to oil-sensitive correlated risks, closed the 5% AUD CDX sold protection position near this year's tightest levels and cut the small position in US hybrids. We also increased the AUD subordinated bank exposure from 10% to 15% (replacing the sold AUD credit protection). With call dates under three years and spreads above 125bps over the RBA cash rate, these Australian bank securities offer very attractive compensation for low spread-duration risk, provided they are called within three years as expected.

Foreign Currency: Maintaining higher levels of FX risk

We maintained a 7% short AUD position, mainly against the US dollar, as a hedge against further escalation in the Strait of Hormuz. The USD should benefit from safe-haven demand in a geopolitical shock, while the AUD is vulnerable as a high-beta, China-sensitive currency. The position also helps offset potential losses in credit and front-end duration if oil rises, inflation expectations reprice and spreads widen. We view it as an asymmetric macro hedge rather than a directional currency position.

In summary, July's changes reflect a more selective expression of our view that markets have priced too much tightening relative to underlying growth and inflation trends, particularly outside the US. We are maintaining modest front-end duration, trimming credit where risk-reward has deteriorated, and retaining hedges against a renewed oil shock.

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