Cross-Asset Outlook

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بنك أبوظبي التجاري
ADCB

Hawkishness peaks, opportunity speaks

Kishore Muktinutalapati
Head - Investment Strategy
+971 (0)2 812 6457
kishore.muktinutalapati@adcb.com

Mohammed Al Hemeiri
Senior Specialist
+971 (0)2 812 6450
mohammed.alhemeiri@adcb.com

www.adcb.com/marketinsights

- **Markets have reached peak hawkishness, with front-end pricing of two Fed hikes inconsistent with the underlying macro data; softening inflation, stabilizing growth, and a more balanced Fed tone point to an extended hold rather than renewed tightening.**
- **Disinflation is broadening across the economy, reflected in falling breakevens, and driven by lower energy prices, easing travel-related components, and a reversal of anomalous rent prints, while trimmed-mean measures confirm benign underlying inflation – undermining the case for further Fed action.**
- **Cross-asset implications: 2-year Treasuries offer compelling carry and total-return potential, US growth exceptionalism offsets rate expectations providing stability to the USD, and gold continues to draw structural diversification demand despite near-term volatility.**

Hawkishness is peaking

The global macro landscape is undergoing a subtle but important transition. After several months in which markets have steadily repriced the Federal Reserve toward a more hawkish stance, we believe the current moment represents the apex of that hawkish narrative. The combination of softening inflation dynamics, a stabilizing growth backdrop, and a shift in the composition of price pressures suggests that the market has moved too far in anticipating additional tightening. In our view, the Fed is unlikely to deliver rate hikes this year, and the current pricing of two hikes in the front end of the US curve is inconsistent with the underlying macro data. As this disconnect becomes clearer over the coming months, we expect a gradual easing of rate hike expectations, with meaningful implications across rates, FX, and commodities.

We see no Fed hikes this year, and the market's pricing of two is simply out of line with the macro reality.

The June FOMC meeting crystallized the tension between the Fed's communication and market interpretation. While the dot plot indicated a median expectation of one hike, markets moved swiftly to price in two, reflecting a belief that the Fed may need to reassert its inflation-fighting credibility. Yet this interpretation overlooks the evolving inflation dynamics beneath the surface. The Fed's communication has indeed shifted to a more balanced tone, but the underlying data do not support a renewed tightening cycle. Instead, they point toward a central bank that is approaching the limits of its hawkish stance, with the next phase likely characterized by a willingness to remain on hold at least till the five workgroups constituted by new Chair Warsh publish the results of their review.

This is why we describe the current environment as peak hawkishness: a moment when the market narrative is more hawkish than the Fed's own baseline, and more hawkish than what the inflation and growth data justify. Historically, such moments have tended to mark turning points in the rates cycle, with front-end yields stabilizing or drifting lower as the market gradually realigns with the central bank's true reaction function. We believe a similar dynamic will likely unfold over the coming months.

Exhibit 01: Markets see US policy rates going up before coming down

Meeting Date	29-Jul-26	16-Sep-26	28-Oct-26	9-Dec-26	27-Jan-27	17-Mar-27	28-Apr-27	9-Jun-27	28-Jul-27	15-Sep-27	27-Oct-27	8-Dec-27
475-500	0%	0%	0%	0%	0%	1%	1%	1%	1%	0%	0%	0%
450-475	0%	0%	0%	1%	3%	4%	4%	4%	4%	3%	3%	2%
425-450	0%	0%	4%	11%	14%	16%	17%	15%	14%	12%	11%	10%
400-425	0%	17%	25%	32%	33%	**33%**	**33%**	32%	30%	27%	25%	23%
375-400	34%	**50%**	**46%**	**39%**	**36%**	33%	33%	**33%**	**33%**	**32%**	**31%**	**30%**
350-375	**66%**	33%	25%	16%	15%	13%	12%	15%	17%	20%	21%	23%
325-350	0%	0%	0%	0%	0%	0%	0%	1%	3%	6%	7%	9%
300-325	0%	0%	0%	0%	0%	0%	0%	0%	0%	1%	1%	2%
275-300	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%	0%

Sources: CME Fed Watch tool, and ADCB Asset Management

Disinflation is broadening beneath the surface

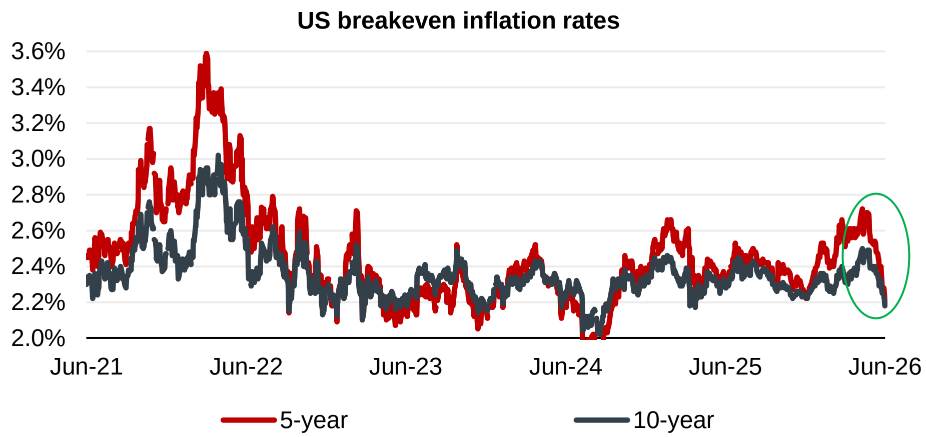
The most compelling argument against further Fed tightening comes from the inflation data. While headline inflation has been volatile, the underlying trend is one of broadening disinflation, driven by both cyclical and structural forces. One of the clearest signals comes from inflation breakevens, which have fallen sharply in recent weeks. This decline has been closely correlated with the drop in oil prices, itself influenced by the increasing likelihood of a US-Iran agreement that could restore supply to the market. Although geopolitical risks remain and could re-ignite volatility, the baseline scenario is one in which energy prices exert a disinflationary impulse over the coming months.

Inflation breakevens have tumbled, tracking the slide in oil prices driven by growing odds of a US-Iran agreement.

The decline in gasoline prices so far in June is particularly noteworthy. The magnitude of the drop is sufficient to generate an outright decline in seasonally adjusted headline CPI, a rare occurrence outside recessionary periods. This alone should temper the market's hawkish expectations. But the disinflation story extends well beyond energy. According to Goldman Sachs Global Investment Research, core CPI inflation is expected to average just 0.17% over the next three months, reflecting a combination of factors that are likely to persist through the summer.

Airfares are set to decline as jet fuel prices fall, reversing some of the earlier strength driven by supply constraints and elevated travel demand. US hotel rates, which surged during the World Cup period and other seasonal events, are now normalizing as booking-time prices adjust downward. Perhaps most importantly, the unusually strong rent inflation print in the Northeast in May appears to have been a statistical outlier rather than a structural shift. As this reverses, shelter inflation – the largest component of core CPI – should continue its gradual deceleration.

Exhibit 02: Breakeven inflation rates have fallen below the pre-conflict levels indicating that disinflation could take hold again



Sources: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, and ADCB Asset Management

Core PCE inflation, the Fed's preferred measure, is likely to remain somewhat firmer in the near term. This is partly due to the mechanics of imputed financial services prices, which tend to rise when equity markets rally, and partly due to price increases in software and accessories, categories that carry a much larger weight in PCE than in CPI. However, more statistically filtered measures such as trimmed-mean PCE continue to show benign underlying inflation, reinforcing the view that the disinflation process remains intact.

Taken together, these dynamics argue strongly against the need for further tightening. The Fed's mandate is to balance inflation control with economic stability, and the current data suggest that inflation is moving in the right direction without requiring additional policy intervention. This is the essence of our peak-hawkishness thesis: the market is pricing a tightening cycle that the data do not justify, and that the Fed is unlikely to deliver.

The Fed's reaction function is shifting toward patience

Markets may swing between hawkish and dovish takes, but the direction is unmistakable: peak hawkishness is behind us.

The Fed's communication has evolved in subtle but important ways. While policymakers have maintained a hawkish tone to avoid further easing financial conditions, the underlying message has shifted toward a more balanced assessment of risks. More importantly, Warsh's Fed is keen on not losing its narrative by giving away too much in the form of forward guidance. The even split among FOMC participants on the possibility of further hikes reflects this uncertainty. But it also highlights a key point: the Fed is no longer in a mode of active tightening. Instead, it is in a phase of strategic patience, waiting to see how the combined effect of war-distortions and US resilience pass through the economy.

This shift is consistent with historical patterns. When inflation is decelerating, growth is stabilizing, and financial conditions are not excessively loose, the Fed tends to pause rather than push ahead with additional hikes. The market's pricing of two further hikes therefore appears inconsistent with the Fed's own reaction function. As the disinflation data accumulate, we expect the market to gradually unwind this hawkish pricing, leading to a softening of front-end yields.

This process is unlikely to be linear. Markets may oscillate between hawkish and dovish interpretations of incoming data. But the direction of travel is clear: the peak in hawkish expectations is behind us, and the next phase will be characterized by a gradual easing of rate-hike pricing.

Cross-Asset implications of peak hawkishness

The transition from peak hawkishness to a more balanced policy outlook has important implications across asset classes. In rates, the front end of the US curve stands out as the most mispriced segment. In FX, the USD is likely to remain supported by US growth exceptionalism even as rate expectations soften. In commodities, gold is poised to benefit from a normalization in real rates and a stabilization in the USD, despite near-term volatility.

Rates: A constructive view on the front end

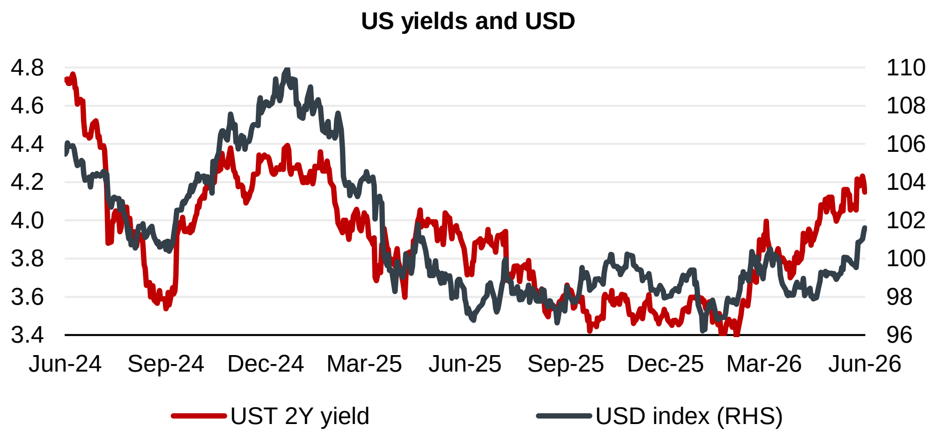
Short-dated US Treasuries are the clearest beneficiary of the peak hawkishness dynamic. Carry remains elevated, and the potential for modest yield declines creates an attractive total-return profile. On our trade ideas list, we therefore initiate a long position in the 2-year Treasury index, with a total return target of 5%. The risk reward profile is therefore compelling, and we see the long 2-year position as a core expression of our peak hawkishness thesis. These developments may also provide some near-term relief to the duration trades which have come under pressure. However, beyond the near-term we stay cautious on duration as term premia tend to cast larger negative influence.

FX: USD stability amid shifting rate expectations

The USD has strengthened following the June FOMC meeting, reflecting the market's interpretation of the Fed's message as more hawkish than expected. The rise in front-end yields reinforced this reaction, and the shift in tone relative to previous meetings – clearly less dovish – provided additional support. However, as rate hike expectations soften, the USD's upside is likely to be capped.

At the same time, US growth exceptionalism provides a durable floor for the currency. The US economy continues to outperform its developed market peers, and this growth differential is likely to persist even as monetary policy stabilizes. As a result, we maintain a neutral stance on the USD. We do not expect further rally in the greenback, but neither do we anticipate a significant decline. Instead, the USD is likely to trade in a broad range, supported by growth fundamentals even as rate expectations ease.

Exhibit 03: The USD has been closely tracking the path of 2Y yield



Sources: LSEG Workspace, and ADCB Asset Management

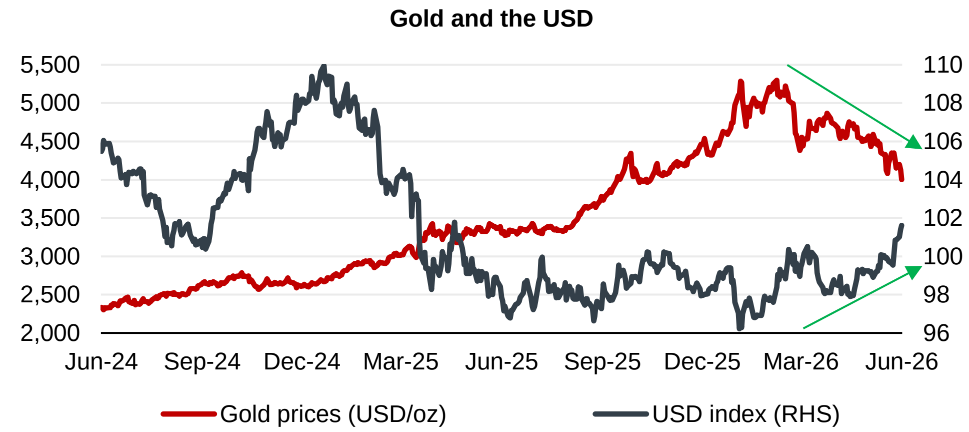
Gold: Medium-term constructive despite near-term volatility

Gold's near-term outlook is complicated by the post-FOMC rise in real yields and the potential unwinding of macro hedge positioning. These factors could exert downward pressure in the short run. However, the medium-term outlook remains constructive, supported by a range of structural and cyclical drivers. Gold allocations in private portfolios remain low by historical standards, and geopolitical developments and broader concerns about Western fiscal sustainability may encourage diversification into gold. Central banks continue to accumulate gold as part of their reserve diversification strategies, providing a steady source of demand. As real rates normalize and the USD stabilizes, gold's medium-term risk-reward profile becomes increasingly attractive.

Central banks keep buying gold, turning reserve diversification into a steady demand engine.

We therefore reiterate our constructive medium-term view on gold, while acknowledging that near-term volatility may persist as markets navigate peak hawkishness.

Exhibit 04: Negative correlation between gold prices and the USD appears to be increasing again



Sources: LSEG Workspace, and ADCB Asset Management

Conclusion: A turning point in the macro narrative

The current moment represents a turning point in the macro narrative. Markets have priced in a degree of hawkishness that is inconsistent with the underlying inflation dynamics and with the Fed's evolving reaction function. As disinflation broadens and growth stabilizes, the case for further tightening weakens, and the market is likely to unwind its excessive hawkish pricing. In our view, the peak in hawkish expectations is behind us, and the next phase will be characterized by a more balanced policy outlook and a gradual easing of rate-hike pricing. This transition has clear cross-asset implications. The front end of the US rates curve offers attractive risk-adjusted returns, the USD is likely to remain range-bound rather than directional, and gold retains a constructive medium-term outlook despite near-term volatility.

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