

WEEK ENDED MAY 29, 2026

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Great (Inflation) Expectations – Part II

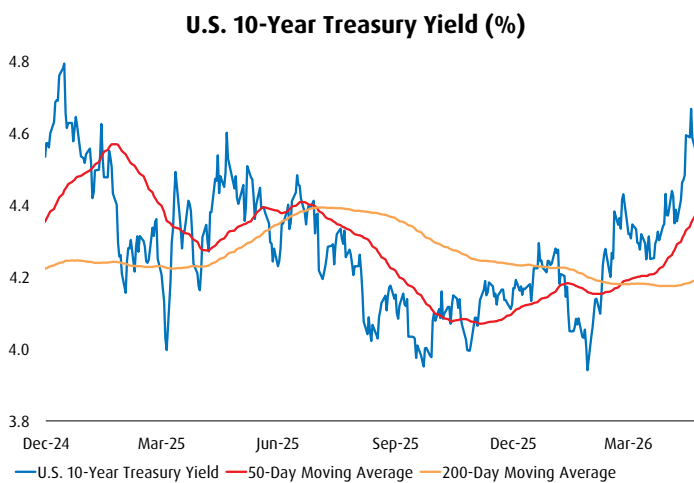
“Inflation is taxation without legislation.”

– Milton Friedman

The Through Line: Investors looking for resolution of the creative tension between cheerful equity markets and fretting fixed income markets were stymied yet again this week. Yields on 10-year U.S. Treasuries remained stubbornly above recent ranges while stocks hit new highs. The disconnect might be less puzzling than it seems at first blush. Investors may be more focused on strong growth pushing prices up (demand shock) versus an old-fashioned wage/price spiral (supply shock).

Why now?

For months, observers have marveled at the sturdiness of fixed income markets. Yields stayed in a relatively tight range despite sticky inflation readings, mounting fiscal deficits, and the systemic energy and supply-chain shocks resulting from the effective closure of the Strait of Hormuz. However, a smattering of recent inflation reports finally seemed to shake bond investors’ steady demeanor. These reports showed spreading cost pressures in the pipeline, in services, and in areas less overtly impacted by energy spikes. Yields at virtually all maturity levels have surged higher in recent weeks. Oddly enough, the upmove in rates has not disrupted the equity rally, leaving investors in both markets to muse “what gives?”



Inflation: a four-letter word (or not)

Equity and bond holders have different views on the helpfulness or harm caused by inflation and indebtedness. Stock investors are growth biased by nature, searching for attributes that will goose progress. Leverage – funding operations partly with bonds rather than all equity – works perfectly because it subsidizes increasing profits that can be spread across a fixed share base. A bit of inflation can add to pricing power, especially if it comes from increased demand (see memory chip prices for the most recent example). It’s even better when that demand-pull inflation is accompanied by a delicately balanced labor market where wage growth is contained. This means limited cost pressure but growing (inflating) selling prices to boost shareholder profits.

Bond investors, on the other hand, are anxiety prone by nature, always on high alert for things that will disrupt an entity’s ability to repay principal when a bond matures. More importantly, they are vigilant re systemic factors that may nudge inflation onto a higher trajectory, thereby degrading the purchasing power of their fixed payment (interest rate) stream. A bond that when purchased paid you 3% is clearly less attractive if you can purchase that same bond today and it pays (yields) 4%. Naturally, the first bond falls in price (in effect making the two now equal in yield).

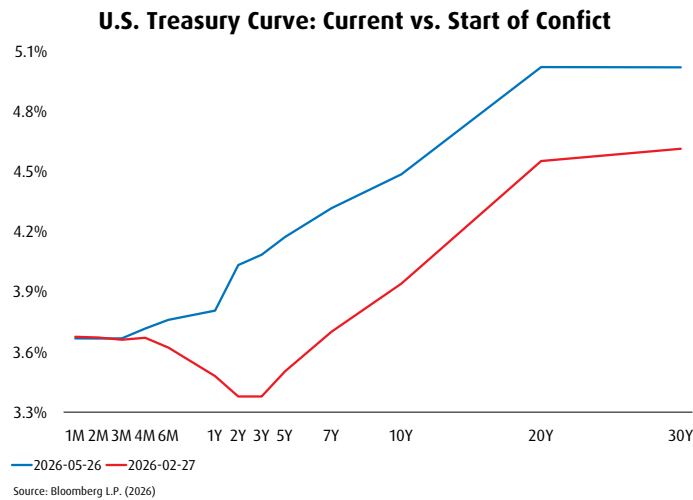
What’s in a yield?

Bond yields comprise several different parts:

- **Risk free rate** – the base return (real yield) expected and reflected by the prevailing rate on short-term U.S. T-bills.

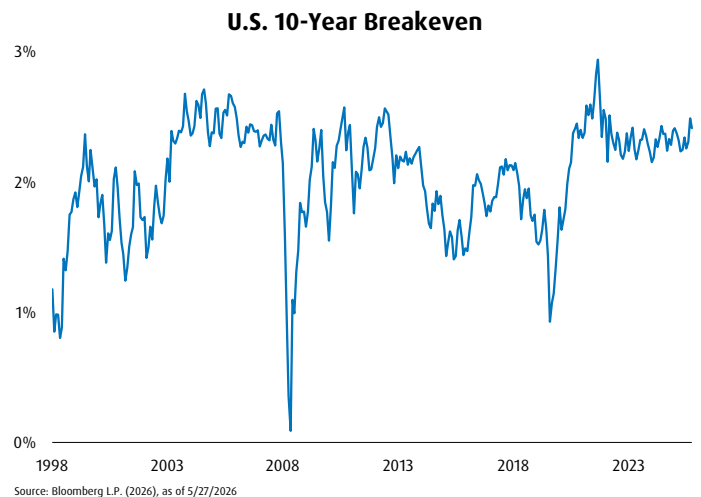
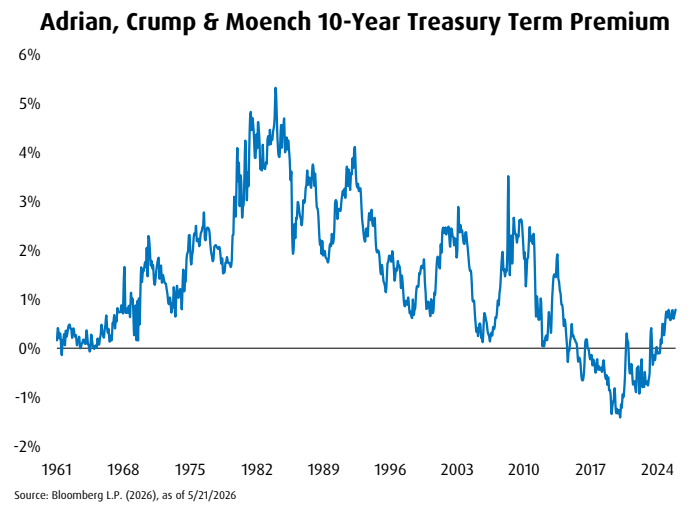
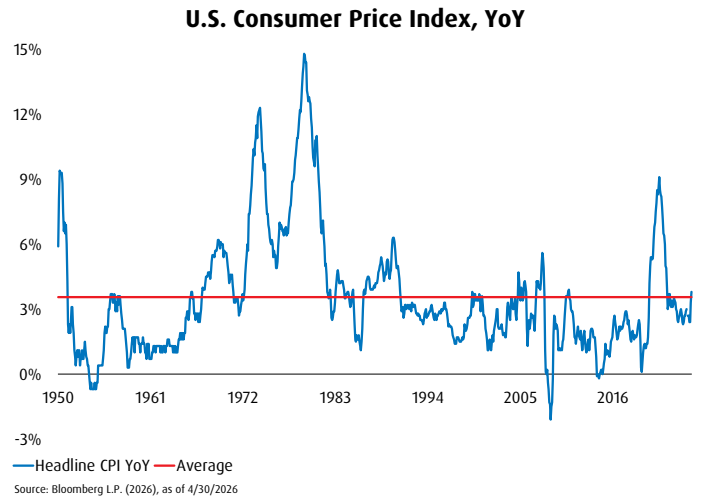
- **Inflation component** – the additional yield investors demand to compensate for potential inflation during the bond’s holding period.
- **Term premium** – an incremental amount investors demand for holding assets that have longer-dated maturities.

Short-term yields are heavily influenced by central bank policy (current and expected). Intermediate and longer bond yields, on the other hand, incorporate additional factors such as growth and *expected* inflation that impact term premiums and inflation break-even rates (another name for the inflation premium). These influences can be seen in the chart below that shows the yield curve on the day before the Middle East conflict started and the current curve. The rise in the blue line reflects expectations for central bank cuts being priced out, while the steeper trajectory at the long end reflects investors’ expectations of resilient and improving economic growth – with a side helping of some inflation.



Through much of this century’s first two decades, inflation – and inflation expectations – were very low. In fact, central banks struggled to get inflation *up* to a target level of 2%. This extended period of low (and in some cases negative) rates lulled investors, companies and consumers into a distorted sense of “normal.” Zero percent auto loans and 2.75% home loans are *not* the long-term norm. **Even the Fed’s 2% inflation target could be considered wishful thinking against a backdrop of longer-term inflation averaging over 3%.**

However, a string of shocks during the current decade on top of the fevered buildout to underpin the next industrial and productivity revolution has pushed a more normalized level of inflation and activity back into the system.



The dawn of a new (old) era

Last week ([WSP - Great \(Inflation\) Expectations - Part I](#)), we shared our suspicion that the push higher in rates at least partly reflects strong economic growth brought about by critical bottlenecks (e.g., access to the electric grid, sufficient semiconductor memory chips) in the AI infrastructure buildout process. *In the long run, AI could well prove deflationary as significant step-ups in productivity are realized (which happened for many technological innovations that preceded it, including the internet). Before we get to that point, however, hyperscalers consider the race to build competitive models and sufficient infrastructure to support them a matter of life or death. This creates a demand pull of price increases (a.k.a. inflation) as they secure the necessary inputs to rapidly scale development.*

A substantial uptick in debt issuance may also be exerting upward pressure on rates. Data center, grid, infrastructure and reshoring activities are all demanding debt capital. So, too, are mega-sized M&A (merger and acquisition) deals. Continued sovereign issuance is required to fund rapidly expanding defense budgets in the U.S. and EU, plus increased fiscal spending to support aging populations, tax cuts and other political priorities. **Bond vigilantes continue to play a vital feedback role by reacting to each new offering.** In some cases, they sent politicians a forceful message in their demands for higher-than-expected yields as a condition for purchasing new-issue sovereign debt.

Kevin Warsh and the Fed's balance sheet

Incoming Federal Reserve Chair Kevin Warsh has his work cut out for him thanks to the recent upmove in rates that is pressuring the government's funding options. Given the spike, the interest-paid line item is the single largest discretionary item in the U.S. budget – larger even than (last year's) defense outlays. This will reinforce the intense pressure from 1600 Pennsylvania Avenue to find ways to reduce rates.

The Fed's balance sheet remains substantially larger than it was pre-GFC, despite several attempts to wrestle it down to earlier levels. Chair Warsh has repeatedly expressed a desire to shrink the balance sheet's size. This may be difficult because past attempts have ended up pressuring short-term rates since maturing notes were not replaced, thus reducing the amount of reserves in the system. In addition, the U.S. Treasury continues to finance the bulk of the deficit at the shorter end of the yield curve, also lending pressure. Thus, the yield curve may be flatter than it would usually be under a normalized financing structure. During market swings from easing to tightening, the short end of the market may exhibit relatively high volatility. Case in point: the U.S. Treasury 2-year range since the early days of the conflict has been 75 basis points compared to 45 basis points for the 10-year yield. **As Mr. Warsh finds his sea legs, we would not be surprised (history offers multiple examples) to see fixed income markets layer a policy premium (a.k.a. higher yields) into their yield expectations until his views, leadership and communication style become clearer.**

Implications for Investors

A number of factors could limit a yield-curve shift lower in the near term: resilient growth; added issuance; increased government spending on fiscal and defense projects; still sticky inflation; and accommodative monetary policy already in the system (during a Fed leadership change no less). Reduced expectations for rate cuts and increased short-term risk of a rate hike will tend to pressure real yields higher. Right now, 30-year U.S. Treasury *real* (inflation adjusted) yields are flirting with 3%, the highest in almost 30 years. AI productivity gains are expected to be deflationary over time, but in the near term the pressures on resources and prices will continue to feed into inflation.

Longer term, the sovereign debt overhang will remain throughout the developed markets. There is little prospect of governments reining it in while they borrow to fund domestic spending and ramp up military expenditure. Reflecting these trends, 62% of respondents to the Bank of America's most recent Global Fund Manager Survey indicated they expect the 30-year Treasury yield to top 6% in the next 12 months. A surge of that degree would almost certainly pressure stocks. It could make for a simultaneous rally in bonds – though we suspect it would be short lived since growth would suffer against a backdrop of more rapidly escalating inflation and higher financing costs.

Volatility will likely remain elevated while markets try to find acceptable real interest rates that will gradually clear the expected increase in sovereign and corporate bond supply. In this environment, a more defensive duration is recommended. This stance should protect against upside inflation and policy surprises – and sustained geopolitical risk. At the same time, the combination of attractive real yield and inflation compensation in the U.S. (and even in the Canadian bond markets) should help mitigate the short-term impact of higher volatility.

In focus in North America

Jon Borchardt, Sr. Analyst

George Trapkov, CFA, VP and Portfolio Manager

This week

New U.S. Federal Reserve Chair – Kevin Warsh is now the Federal Reserve Chair. During the May 22 swearing-in ceremony, President Donald Trump said he wants Mr. Warsh to be “totally independent” but also reiterated his view that “the Fed has lost its way in recent years.” In the past, Mr. Warsh has labeled persistent inflation a choice driven by policy decisions of the central bank and government. He also argued that Fed officials were too slow to raise rates coming out of the COVID-19 pandemic. Mr. Warsh takes the helm at a time when inflation appears to be reaccelerating, and an increasing number of Fed officials prefer to remove the easing bias from official policy while foreseeing scenarios where rate policy could move higher. A speech last week by former Fed Chair candidate and current Federal Reserve Governor Christopher Waller emphasized his shifting narrative. Mr. Waller, who had argued for additional rate cuts earlier this year, has become increasingly concerned that higher energy and commodity prices caused by an extended Strait of Hormuz blockade are beginning to permeate core inflation. The Fed’s preferred inflation metric, personal consumption expenditures (PCE) inflation, has trended well above target for more than five years. Mr. Waller believes that can be attributed in large part to consecutive price shocks. Higher prices are weighing on consumer confidence; Mr. Waller now sees growing risk of longer-term inflation expectations becoming unanchored. Thus, Governor Waller says he can “no longer rule out rate hikes further down the road.” Chair Warsh will have to balance his long-held inflation views and renewed price pressures against President Trump’s repeated calls for lower interest rates to support economic growth.

Tariffs STILL a thing – On February 20, the Supreme Court ruled that the International Emergency Economic Powers Act (IEEPA) did not give President Trump the legal authority to implement wide-ranging tariff policy. The court did not offer guidance on what should happen to the more than \$160 billion in IEEPA tariffs collected to date. Absent this, the Court of International Trade ruled on March 4 that U.S. Customs and Border Protection (CBP) must provide tariff refunds to more than 330,000 importers of record (IOR). The refund system was established at the end of April; applications have been flowing in since. CBP has said once an application has been submitted, the approval process should take 60 to 90 days. From an investor perspective, tariff refunds should be a positive story, providing a cash injection that could support growth initiatives, lower consumer prices or increased shareholder returns. Despite this, Bloomberg reported only 5% of Russell 5000 companies mentioned refunds on calendar Q1 earnings calls. Companies face both political and legal jeopardy from pending refunds. Companies (e.g., Costco, FedEx, Amazon

and Lululemon) face lawsuits from consumers who feel they overpaid for goods because of tariffs and are now entitled to a portion of the rebate. Meanwhile, General Motors, Ford and Eastman are treating refunds like a one-time accounting benefit that will help offset cost headwinds rather than an influx of cash. For now, the timing of IEEPA refunds remains in question and a lack of clarity lingers around how companies, investors and consumers will benefit in the end.

Canadian retail sales – In March, retail sales in Canada increased 0.9% entirely due to higher gas prices. Other sectors were notably softer; five of the remaining eight posted declines. The biggest weak spots were in building materials and garden supplies (-2.9%, possibly hampered by colder-than-normal temperatures), general merchandise (-0.5%) and autos (-0.5%). Sales ex-autos and gas slipped 0.1%. The advance reading for April calls for a 0.6% increase, but that was likely also driven by gasoline prices, which rose another 8.9% in the month. The details of the March figures suggest consumer spending (ex-gas) will remain under pressure until energy prices normalize.

U.S. consumer remains “choiceful” – On a recent earnings call, the CEO of BJ’s Wholesale told investors that consumers have been resilient overall, but the K-shaped economy is a real thing. The only substantive growth is coming from affluent customers while lower-income households are experiencing considerable pressure. This dynamic likely helps explain the differing degrees of negativity reported among May consumer confidence reports. Last week, the University of Michigan’s Consumer Sentiment Index dropped 10% month over month to a new record low reading of 44.8, while long-run inflation expectations rose to 3.9%. By demographic group, lower-income consumers and those without a college degree saw the largest sentiment declines, while the survey points to growing discontent among Independent and Republican voters. The Conference Board’s May Consumer Confidence survey revealed a slight month-over-month dip in confidence; respondents said inflationary pressures related to the Middle East conflict are a near-term headwind, but optimism on the outlook ticked higher. A more positive outlook was centered on the rebound in equity markets and optimism that the conflict would soon end. Two-thirds of respondents noted cutting back on spending due to rising prices, while spending plans on big-ticket items and services moderated further in May. The Michigan survey tends to focus more on pocketbook issues, while the Conference Board survey appears to capture higher-income and labor-market-sensitive sentiment and also incorporates a wider range of factors. This likely helps explain some of the divergence between the two surveys, though the broader message remained the same: consumer sentiment worsened in May.

Next week

A data-heavy week ahead will bring key reads in both countries on manufacturing and services activity plus employment. The Fed's Beige Book, typically chock full of keen front-line regional insights, drops on Wednesday.

Monday 6/1 – U.S. S&P Global Manufacturing PMI, ISM indexes, Construction spending | Canada S&P Global Manufacturing PMI

Tuesday 6/2 – U.S. JOLTS surveys | Canada none scheduled

Wednesday 6/3 – U.S. ADP employment, S&P Global services and composite PMIs, durable goods orders, Fed's Beige Book | Canada S&P Global Services and Composite PMIs

Thursday 6/4 – U.S. Initial jobless claims, Challenger data | Canada none scheduled

Friday 6/5 – U.S. Non-farm payrolls, Consumer credit | Canada Employment statistics

Data scorecard as of May 27, 2026

Equity Market Total Returns						
	5/27/2026 Level	WTD	YTD	2025	2024	5-Year*
S&P 500	7,520	0.6%	10.4%	17.9%	25.0%	14.4%
NASDAQ	26,675	1.3%	15.0%	21.2%	29.6%	13.4%
DOW	50,644	0.1%	6.0%	14.9%	15.0%	11.6%
Russell 2500	5,083	1.6%	18.2%	11.9%	12.0%	7.3%
S&P/TSX	34,412	-0.2%	9.5%	31.7%	21.7%	16.1%
MSCI EAFE	11,549	0.6%	8.9%	31.2%	3.8%	8.9%
MSCI EM	956	3.2%	24.7%	33.6%	7.5%	4.2%
Bond Market Total Returns						
		WTD	YTD	2025	2024	5-Year*
Bloomberg U.S. Aggregate		0.5%	0.1%	7.3%	1.3%	-0.4%
Bloomberg U.S. Treasury		0.5%	-0.3%	6.3%	0.6%	-1.0%
Bloomberg U.S. Corporate		0.6%	0.3%	7.8%	2.1%	-0.1%
Bloomberg U.S. High Yield		0.3%	1.5%	8.6%	8.2%	4.5%
Bloomberg 1-10 Year Munis		0.4%	0.4%	5.1%	0.9%	1.2%
Bloomberg Canada Aggregate		0.6%	1.2%	2.4%	4.0%	-0.4%
Bloomberg Canada Treasury		0.5%	0.9%	1.4%	2.9%	-0.8%
Bloomberg Canada Corporate		0.5%	1.3%	4.4%	6.9%	1.5%
Government Bond Yields						
	5/27/2026	Last Month End	Last Quarter End	2025	2024	5-Year Average
U.S. 10-Year Treasury	4.48%	4.37%	4.32%	4.17%	4.57%	3.37%
Canada 10-Year Government	3.46%	3.54%	3.47%	3.43%	3.23%	2.81%
U.K. 10-Year Gilt	4.86%	5.01%	4.91%	4.48%	4.56%	3.16%
German 10-Year Bund	2.99%	3.04%	3.00%	2.85%	2.36%	1.66%
Japan 10-Year Government	2.69%	2.52%	2.35%	2.06%	1.09%	0.65%
Currencies & Real Assets						
	5/27/2026 Level	WTD	YTD	2025	2024	5-Year*
USD Index	99.21	0.0%	0.9%	-9.4%	7.1%	1.8%
CAD:USD	\$0.72	-0.2%	-0.8%	4.8%	-7.9%	-1.5%
Bitcoin	\$75,145.71	-1.0%	-14.3%	-6.5%	120.5%	24.8%
Gold	\$4,453.98	-1.2%	3.1%	64.6%	27.2%	17.9%
Oil (WTI)	\$88.68	-8.2%	54.4%	-19.9%	0.1%	3.4%

*Annualized 5-Year data as of December 31, 2025. Benchmark data does not reflect actual investment performance but reflects benchmark results of the underlying indices referenced. You cannot invest directly in an index. Index definitions can be found at the end of this publication.

Index Definitions

Equity indices

S&P 500® Index is an index of large-cap U.S. equities. The index includes 500 leading companies and covers approximately 80% of available market capitalization.

NASDAQ Composite Index is a market-cap weighted index of the more than 3,000 common equities listed on the Nasdaq stock exchange.

Dow Jones Industrial Average (“DOW”) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange and the Nasdaq.

Russell 2000® Index (Russell 2000®) is an unmanaged index that measures the performance of the smallest 2000 U.S. companies in the Russell 3000® Index.

S&P/TSX Index is a capitalization-weighted equity index that tracks the performance of the largest companies listed on Canada’s primary stock exchange, the Toronto Stock Exchange (TSX).

MSCI EAFE Index (Developed Markets —Europe, Australasia, and Far East Index) is a standard unmanaged foreign securities index representing major non-U.S. stock markets, as monitored by Morgan Stanley Capital International. The index captures large and mid-cap representation across 21 developed markets countries around the world, excluding the U.S. and Canada.

MSCI Emerging Markets Index is a market capitalization weighted index representative of the market structure of the emerging markets countries in Europe, Latin America, Africa, Middle East and Asia. Prior to January 1, 2002, the returns of the MSCI Emerging Markets Index were presented before application of withholding taxes.

Fixed income indices

Bloomberg U.S. Aggregate Bond Index is an unmanaged index that covers the U.S. investment-grade fixed-rate bond market, including government and credit securities, agency mortgage pass-through securities, asset-backed securities and commercial mortgage-based securities.

Bloomberg U.S. Treasury Index is an unmanaged index that includes a broad range of U.S. Treasury obligations and is considered representative of U.S. Treasury bond performance overall.

Bloomberg U.S. Corporate Bond Index measures the investment grade, fixed-rate, taxable corporate bond market. It includes USD denominated securities publicly issued by U.S. and non-U.S. industrial, utility and financial issuers.

Bloomberg U.S. Corporate High Yield Index is an unmanaged index that covers the USD-denominated, non-investment-grade, fixed-rate, taxable corporate bond market. Securities are classified as high yield if the middle rating of Moody’s, Fitch and S&P is Ba1/BB+ or below.

Bloomberg 1-10 Year Blend Municipal Bond Index is a market value-weighted index which covers the short and intermediate components of the Bloomberg Capital Municipal Bond Index — an unmanaged, market value-weighted index which covers the U.S. investment-grade tax-exempt bond market.

Bloomberg Canada Aggregate Bond Index measures the investment grade, Canadian dollar-denominated, fixed-rate, taxable bond market. It includes treasuries, government-related, and corporate issuers.

Bloomberg Canada Aggregate Bond Index - Treasury is the treasury sub-component of the Bloomberg Canada Aggregate Bond Index, which measures the investment grade, Canadian dollar-denominated, fixed-rate, taxable bond market.

Bloomberg Canada Aggregate Bond Index - Corporate is the Corporate sub-component of the Bloomberg Canada Aggregate Bond Index, which measures the investment grade, Canadian dollar-denominated, fixed-rate, taxable bond market.



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