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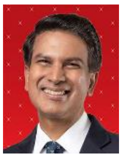
MACRO INSIGHTS

Inflation versus interest rates

20 July 2026



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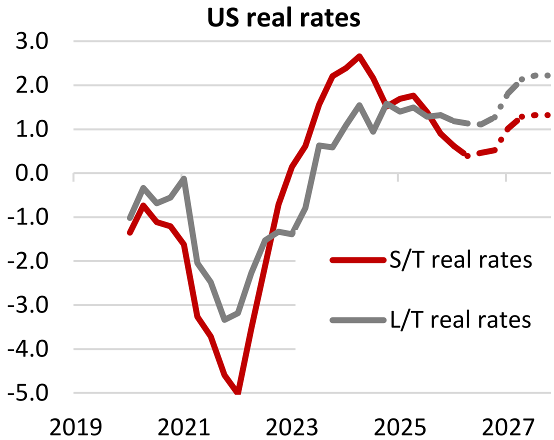
- *Middle East conflict and AI-driven demand have lifted inflation, but the shock looks manageable. Expect divergent policy response, with Korea/Taiwan tightening and India pausing.*
- *The IMF sees global inflation rising to 4.7% in 2026, up from 4.1%.*
- *War, tariffs, AI demand, and resilient consumption are key inflation drivers.*
- *The inflation shock appears milder than the 2022/23 surge.*
- *Korea and Taiwan risk overheating and may need tighter policy.*
- *India has room to pause, while Indonesia may need modest further tightening.*

CHART OF THE WEEK: US REAL RATES

Recent rise in inflation has pushed down US real interest rates, although they remain firmly in positive territory. Assuming energy inflation will not rise sharply going forward, we project further disinflation, and by extension, a rebound in real rates even without Fed policy tightening. Warsh-led FOMC would have to keep track of near-term inflation and economic growth dynamic to make policy calls; at this point, available data are not making an overwhelming case for a hike, in our view.



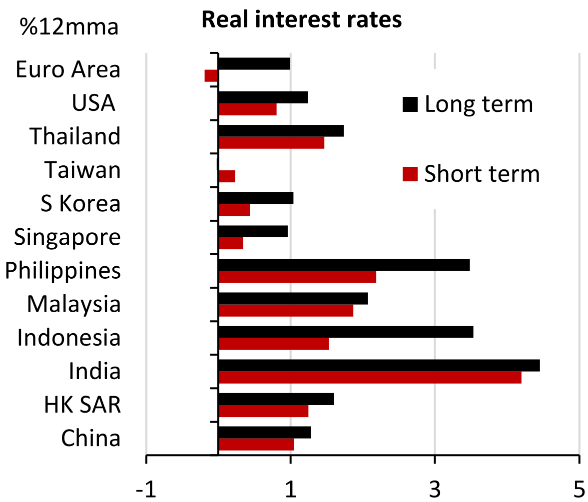
Source: CEIC, DBS. Short-term real rates calculated by taking the difference between end-quarter Fed funds rate and the average core PCE inflation for that quarter. L/T uses end-Q 10-yr bond yield.

COMMENTARY: INFLATION VERSUS INTEREST RATES

Taimur Baig

Conflict in the Middle East and the AI cycle have driven up prices this year. In its July update, the IMF projects that global inflation will rise from 4.1% to 4.7% in 2026.

These projections are less dire than initially feared when the Iran war broke out. This was going to be a year of higher inflation in any case; the IMF, back in October of last year had projected global inflation to rise by 30bps in 2026. Pass-through from tariffs, rising price of electronics on the back of the AI cycle, and resilient demand were expected to be key contributors to the modest increase in inflation around the world. Adding war-related considerations on top of those factors, a further 30bps increase in global inflation projection (to 4.7%) is not extreme by any means, in our view.



Source: DBS, CEIC. Calculations done with monthly data. S/T rates: 3-month bill; L/T rates: 10 yr bonds.

Granted, there will be consequences for those economies and individuals at the lower end of the income spectrum, monetary policy is already being recalibrated, exchange rates have been adjusting, but overall, compared to the inflation shock of 2022/23, this episode comes across to us as manageable.

The world is bifurcated between those with heavy energy dependence and those fortunate enough to have domestic endowments of energy; also, a line can be drawn between those benefitting from the AI cycle's demand surge for hardware and those not in that manufacturing ecosystem. As we consider market and policy outlook for the rest of the year, these issues come to the fore.

Take South Korea and Taiwan, both undergoing historic surges in export demand (rising presently at respective yoy rates of 70%+ and 40%+) and asset price boom. The fact that their inflation forecasts for 2026 are up only modestly should not hold back the monetary authorities from tightening policy. Indeed, time to get in the way of overheating is right now.

On the other end of the spectrum is India, with considerable exposure to the commodity price surge but still characterised by within-target inflation, firmly positive real interest rates, and measures being taken to mobilise capital flows. We think this gives the RBI plenty of space to maintain policy pause.

Indonesia has faced capital flow and exchange rate volatility this year, compelling Bank Indonesia to hike rates. Short term policy rates are heading in the right direction there, in our view; a little more work from BI should do it.

These cases point out the spectrum of monetary policy compulsions out there. Central banking is not one-size-fits all.

FX: TACO VS. NACHO

Philip Wee

Global investors entering the second half of the year find themselves caught between two competing geopolitical narratives: the **fading optimism of the "TACO"** (Trump Always Chickens Out) playbook, **and the stark, disruptive reality of "NACHO"** (Not A Chance Hormuz Opens).

As markets adjust to a more volatile reality, the illusion of predictable American economic coercion is giving way to a protracted conflict in the Middle East, just as a stark divergence opens between the world's major central banks.

In the wake of Operation Epic Fury, Wall Street is experiencing a sharp awakening. For months, the prevailing market assumption was that President Donald Trump's bellicose tariff threats were merely high-stakes leverage tools, an "escalate to de-escalate" strategy designed to wring concessions from trading partners before ultimately backing down.

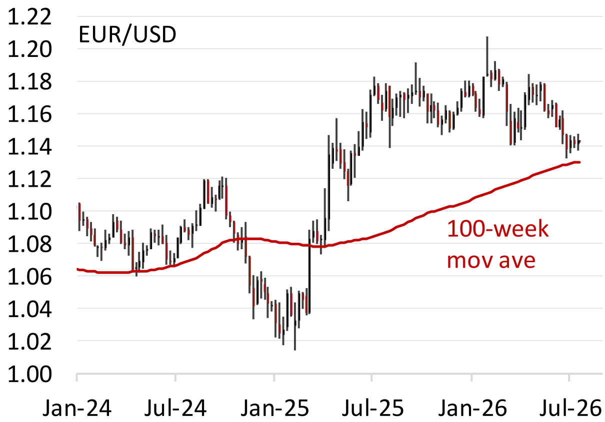
However, **a kinetic military conflict operates on a fundamentally different axis of power than a trade war**. While Washington can choke off international market access to enforce its will commercially, it has met its match in Tehran. Iran has demonstrated both the political will and the structural capacity to endure extreme economic pain to maintain its strategic stranglehold on the Strait of Hormuz.

The June Memorandum of Understanding was supposed to offer a diplomatic off-ramp. Formulated behind closed doors via third-party channels, the MOU attempted a transactional "assets-for-access" swap. Washington would temporarily unfreeze specific Iranian assets in exchange for both navies standing down their vessels in the Strait. Deep-seated mutual distrust has exposed the fragility of this diplomatic truce.

As the threat of collapsing talks looms, **market sentiment has shifted from cautious optimism to open anxiety**. While this has triggered a resurgence in global oil prices, **a wholesale rerun of the acute panic that caught markets flat-footed in March-April is also unlikely** after months of adjustments to continuous maritime friction.

Against this volatile geopolitical backdrop, the coming fortnight may **underpin the EUR, driven by a market preference for the European Central Bank's new and transparent Framework Guidance over Fed Chairman Kevin Warsh's campaign to end forward guidance**.

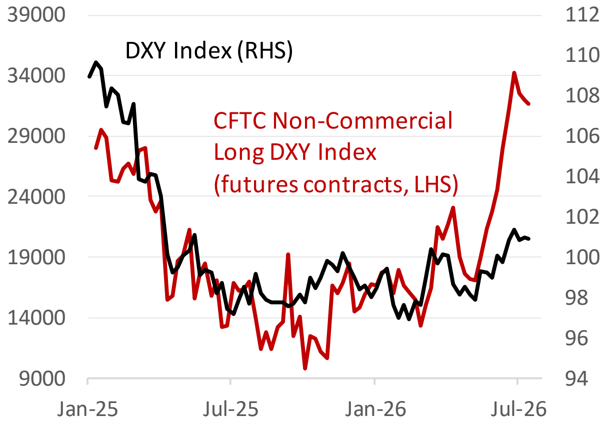
EUR has a support around 1.1310



Sources: Bloomberg, DBS

The ECB has flagged a tactical pause at its governing council meeting on July 23. However, the market is currently pricing in an 87.8% chance of a 25-bps hike to 2.50% at the subsequent September 10 meeting. If the ECB affirms this trajectory, the EUR/USD pair could break above this month's tight range of 1.1360 to 1.1480.

The USD's disconnect with speculators



Sources: Bloomberg, DBS

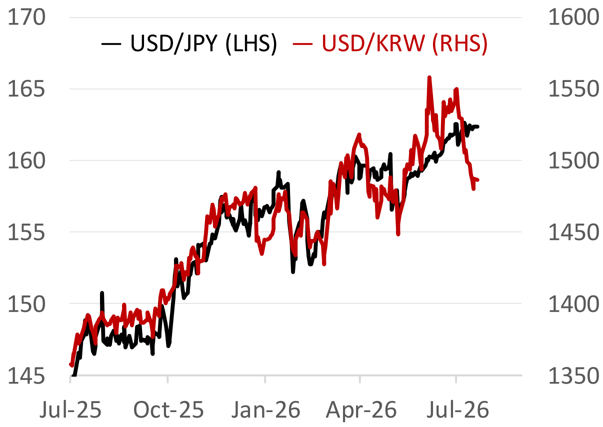
Conversely, Warsh's testimony to US lawmakers last week confirmed his intention to restore an "uncertainty premium" to the market's pricing for a September hike. Warsh plans to use the July 28-29 FOMC meeting to foster an "honest internal discussion" with his colleagues at the Fed. Markets will become anxious that slashing the FOMC statement and Warsh's refusal to provide his own forecasts at his first FOMC meeting in June could be a prelude to stripping the dots and the Summary of Economic Projections of their market-moving authority at the September meeting.

We have lowered our end-2026 forecasts for USD/KRW to 1450 from 1485 previously for the following three reasons:

First, we now see the Bank of Korea delivering two instead of one rate hike for the rest of 2026, following last week's hawkish 25-bps increase in the base rate to 2.75%.

Second, the USD/KRW has fallen from 1560 to 1490 so far this month, decoupling significantly from USD/JPY, which has held firm around 162.

USD/KRW lower despite sticky USD/JPY



Sources: Bloomberg, DBS

Third, the Ministry of Finance and Economy and the Bank of Korea have executed major regulatory rollbacks in the capital market and foreign exchange reforms to improve market accessibility after MSCI denied South Korea an upgrade to its Developed Market watchlist in June.

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