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Peace Might Not Stop Rising Interest Rates

Market Commentary | June 4, 2026

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Key Observations

Optimism regarding an end to the Iran war has pushed stocks higher and oil prices lower. Stocks are up nearly 20% from their conflict lows, and oil prices have declined by about half from their peak at the height of the conflict.[1] Stocks have also been helped by renewed investor enthusiasm for AI stocks, and a stellar first quarter earnings season.

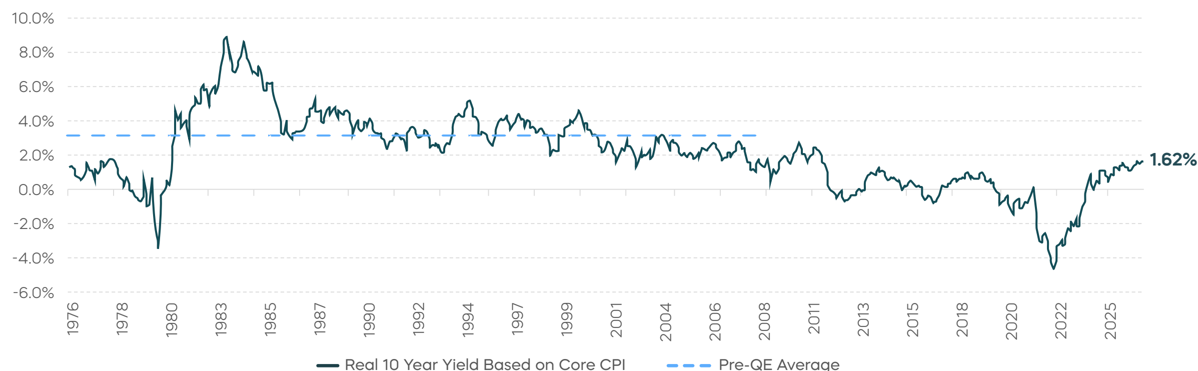
Will easing tensions soothe the bond market? A modest retreat in interest rates during the last couple weeks has helped. While the 10-Year Treasury yield is still substantially higher than it was at the end of 2025, a rally has shaved over 20 basis points from mid-May highs.[2]

The narrative seems straightforward: easing tensions could lower oil prices, lower oil prices could help cool inflation, and cooler inflation could help bring interest rates down. But what if it doesn't work out that way?

Even if a fragile peace holds, oil prices could remain elevated some time to come. As those costs bleed into broader inflation, it will keep upward pressure on interest rates. Such pressures could continue even if inflation recedes.

Chart of the Month

Interest Rate Normalization Might Not Be Over



Source: Bloomberg, data 4/30/1976–4/30/2026.

Typically, most market watchers expect the 10-year Treasury yield to be between 2% and 2.5% over inflation. Looking back nearly 50 years in the chart above, the average 10-year Treasury yield is indeed about 2.1% over the core Consumer Price Index. But that average includes long periods of Quantitative Easing (QE), including during the Great Financial Crisis and Covid pandemic, which artificially suppressed longer-term yields.

The average real yield prior to the inception of QE in 2008 was 3.2%. That adds up to a 10-year Treasury yield of over 5%, even if the Fed's 2% inflation target is achieved. Does this historical level mean that a 2% real yield on the 10-year Treasury could actually be a new normal? Possibly. But that would still leave the risk of inflation materially higher than 2%.

With inflation risk coming from both directions, it may be timely to consider stock and bond strategies that take this risk into account.

1 Source: Bloomberg, data 3/30/26–5/31/26.
2 Source: Bloomberg, data as of 5/31/26.

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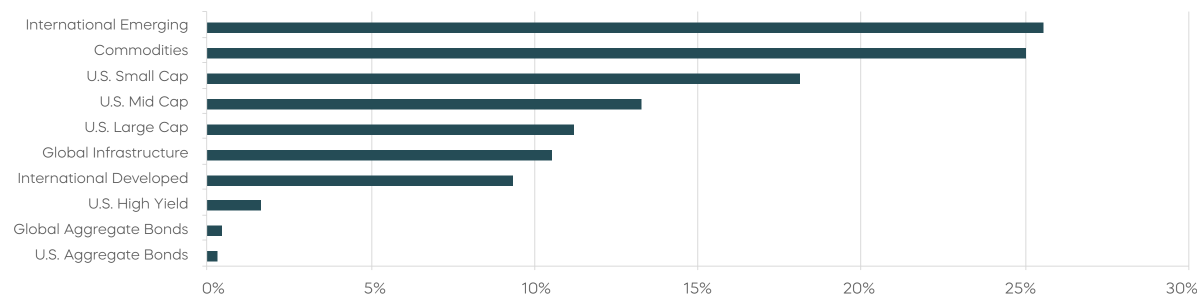
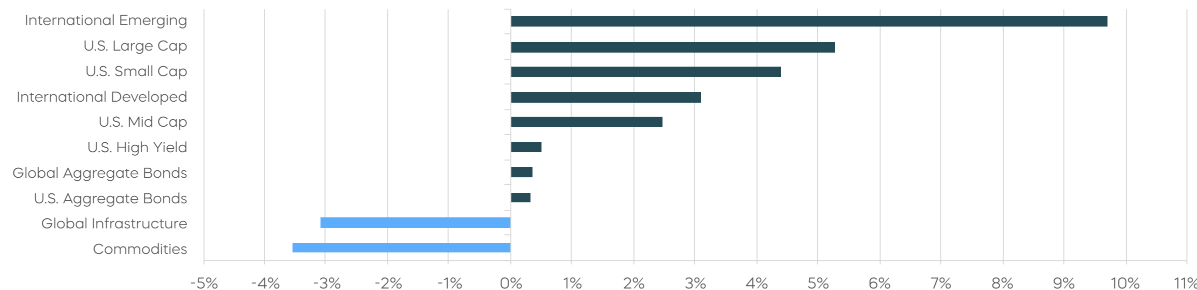
Asset Class Perspectives

Asset Class Returns – May 2026



Asset Class Returns – Year-to-Date 2026



Source: Bloomberg. May returns 5/1/26–5/31/26; year-to-date returns 1/1/26–5/31/26. Index returns are for illustrative purposes only and do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged, and one cannot invest directly in an index. Past performance does not guarantee future results.

The following are observations on a range of asset classes. For each, green indicates a constructive backdrop, yellow indicates a neutral environment, and red would indicate a challenging backdrop.

Asset Class		Key Observations
Equity		
U.S. Large Cap	Green	IPO enthusiasm and a potential Iran deal seem to have picked up the baton from the strong earnings season.
U.S. Mid Cap	Green	A midcap allocation may be one of the most straightforward offsets to historically high large-cap concentration risk.
U.S. Small Cap	Yellow	Higher commodity prices may hinder Fed cuts that can benefit small caps.
International Developed	Yellow	Structural challenges in Europe could be a headwind.
International Emerging	Green	Persistently elevated commodity prices may provide a boost.
Fixed Income		
U.S. Aggregate Bonds	Yellow	Demand-driven inflation could complicate the policy outlook for the Fed.
U.S. High Yield	Yellow	Spread tightening alongside of the stock market rally may present a valuation challenge, as default rates are expected to rise.
Global Aggregate Bonds	Green	Opportunities may emerge in countries where markets have aggressively priced in rate hikes tied to energy shocks.
Alternatives/Real Assets		
Commodities	Green	A modest overweight may be timely during periods of heightened geopolitical risk and conflict.
Global Infrastructure	Green	Consider a focus on the owners of infrastructure assets, whose business models are generally inflation and recession resistant.

Economic Calendar

Date Time	Event	Prior
6/09/2026 6:00	NFIB Small Business Optimism	95.9
6/09/2026 8:30	Trade Balance	-$60.3b
6/09/2026 10:00	Wholesale Inventories MoM	0.50%
6/10/2026 8:30	CPI YoY	3.80%
6/10/2026 8:30	Core CPI YoY	2.80%
6/11/2026 8:30	PPI Final Demand YoY	6.00%
6/11/2026 8:30	PPI Ex Food and Energy YoY	5.20%
6/12/2026 10:00	U. of Mich. Sentiment	44.8
6/15/2026 8:30	Empire Manufacturing	19.6
6/15/2026 9:15	Industrial Production MoM	0.70%
6/15/2026 9:15	Capacity Utilization	76.10%
6/16/2026 8:30	Import Price Index MoM	1.90%
6/16/2026 8:30	Housing Starts	1465k
6/17/2026 8:30	Retail Sales Advance MoM	0.50%
6/17/2026 10:00	Pending Home Sales MoM	1.40%
6/17/2026 14:00	FOMC Rate Decision (Upper Bound)	3.75%
6/18/2026 8:30	Philadelphia Fed Business Outlook	-0.4
6/24/2026 10:00	New Home Sales	622k
6/25/2026 8:30	Personal Income	0.00%
6/25/2026 8:30	Personal Spending	0.50%
6/25/2026 8:30	PCE Price Index YoY	3.80%
6/25/2026 8:30	Core PCE Price Index YoY	3.30%
6/25/2026 8:30	Durable Goods Orders	–
6/26/2026 8:30	Wholesale Inventories MoM	–
6/30/2026 10:00	Conf. Board Consumer Confidence	93.1
6/30/2026 10:00	JOLTS Job Openings	–
7/01/2026 5:30	Challenger Job Cuts YoY	–
7/01/2026 10:00	ISM Manufacturing	54
7/01/2026 10:00	Construction Spending MoM	0.40%
7/02/2026 8:30	Change in Nonfarm Payrolls	–
7/02/2026 8:30	Average Hourly Earnings YoY	–
7/02/2026 8:30	Unemployment Rate	–
7/02/2026 10:00	Factory Orders	–
7/02/2026 10:00	Factory Orders Ex Trans	–
7/06/2026 10:00	ISM Services Index	–

Source: Bloomberg, data as of 6/1/26.

Kieran Kirwan, CAIA
Director, Senior Investment Strategist

Equity Perspectives

Rising Rates Not Enough to Stop Equities

U.S. equities delivered strong headline returns in May and extended the market's powerful recovery from the lows in late March. According to Standard & Poor's, the S&P 500 delivered eleven all-time closing highs during the month.

While such a strong performance from a broad index could suggest a constructive risk environment, the dynamics are considerably more nuanced. Stock-level and factor-level dispersion (the gap between winners and losers) has been elevated for some time, extending a period favorable to rules-based strategies and reinforcing the importance of stock selection.

Despite a late-month pullback, Treasury yields increased in May as economic data continued to point to resilient growth and inflation readings remained above the Federal Reserve's long-term target. Growth, momentum, and high-beta factors outperformed in May, as AI-driven optimism disproportionately boosted technology shares, including a sudden reversal for software stocks. Technology stocks accounted for a substantial share of May's S&P 500 returns. Value-based and low-volatility strategies generally underperformed. Utilities and real estate stocks were amongst the worst of them, as higher discount rates weighed on relative performance.

Overall, equity markets seem to have absorbed higher yields, which could be a sign of broader investor confidence in corporate fundamentals after the blowout first-quarter earnings season. Overall, May seemed to reflect an environment in which conditions remained supportive for equities, but with elevated dispersion and heightened interest rate sensitivity leading to different results across stocks, sectors, and investment factors.

Positioning Equities for Rising Rates

With interest rates on the rise from late-February lows, investors are again forced to contemplate the impact on their portfolios. Generally speaking, when rates rise, bond prices fall. And most fixed income categories have indeed faced headwinds. But equity investors also have to contend with the impact of rising interest rates.

Looking back, equity performance has been mixed during periods of rising rates. It can be affected by factors such as the starting yield level and the pace of increases. But the reason rates are rising may be one of the most influential factors.

Equities typically struggle during periods of high inflation when the Fed is in a rate-tightening mode. Conversely, they typically do well when rates rise during periods of strong economic growth and expanding corporate profits.

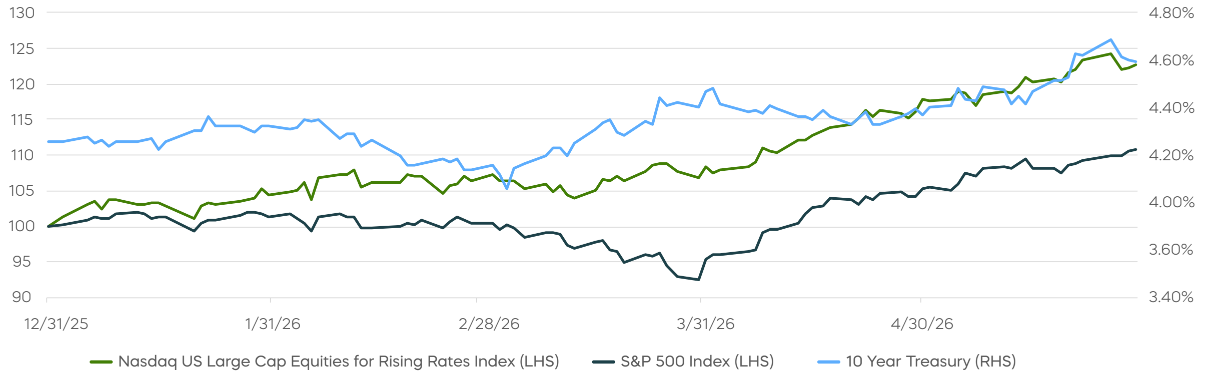
While inflation currently remains above the Fed's 2% target, today's economic backdrop and rate environment seems consistent with periods of historically positive equity performance. That said, investors should be aware of an equity index strategy designed to outperform when interest rates rise: the Nasdaq U.S. Large Cap Equities for Rising Rates Index.

Equities are not monolithic, and sectors can behave very differently during periods of rising rates. The financials and energy sectors have historically performed well, for example, while rate-sensitive sectors like utilities and REITs have not.

That's where the strategy behind the Nasdaq U.S. Large Cap Equities for Rising Rates Index comes in. It targets the five sectors with the highest recent correlations to changes in 10-year U.S. Treasury yields, and within those sectors, the stocks that have tended to outperform as rates have risen. This produces a dynamic portfolio of 50 stocks from five sectors. Sectors with the highest correlation to rates have the highest weighting, while stocks within each of the five sectors are equally weighted.

The index's recent performance illustrates how a rising-rates equity strategy may help investors build a more offense-oriented equity portfolio during periods of rising rates.

The Nasdaq U.S. Large Cap Equities for Rising Rates Index Has Outperformed this Year



Source: Bloomberg, data 12/31/25-5/31/26. Index returns are for illustrative purposes only and do not reflect any management fees, transaction costs or expenses. Indexes are unmanaged, and one cannot invest directly in an index. Past performance does not guarantee future results.

Bryan Gao, CFA
Investment Strategist

Fixed Income Perspectives

Demand-Driven Inflation Risk Keeps the Fed Cautious

With inflation reaccelerating since the end of last year, the new Federal Reserve Chair Kevin Warsh faces the difficult task of building consensus among a divided Fed board. Both core CPI and core PCE inflation rose in March and April, complicating the policy outlook.

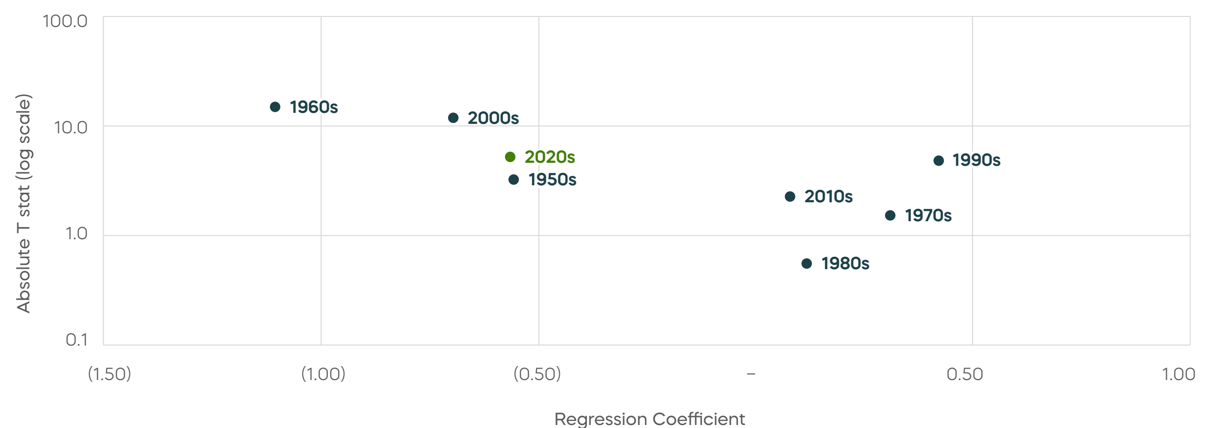
The Fed can generally look through supply shocks as one-time impacts on inflation, whether from tariffs or oil prices. Demand-driven inflation, however, is often stickier. It can reflect an overheating economy and, if sustained, become more difficult to reverse.

With continued large-scale AI investment and resilient U.S. consumption, the Fed may be concerned that demand-side forces are contributing to renewed inflation pressure. Fed research has attempted to divide recent inflation into supply and demand components. But separating those forces has always been difficult, especially in real time. Supply and demand shocks are often interrelated and shifts in inflation expectations can further obscure things.

One way we assess the balance between supply and demand forces is through the Phillips Curve, which captures the typically inverse relationship between unemployment and inflation. Although the Phillips Curve has been one of the core relationships in macroeconomics since its introduction in the 1950s, it has failed to hold over a number of extended periods. In a narrower setting, however, its mechanics are more reliable: a positive demand shock should raise inflation and reduce unemployment in the short run.

Looking at the Phillips Curve by decade, the periods where the relationship broke down (with a positive regression coefficient and low statistical significance) include the 1970s and 1980s, when the U.S. experienced high inflation driven largely by supply shocks. By contrast, the current post-Covid decade shows a renewed inverse relationship with strong statistical significance. This could suggest that demand-side forces have played an important role in inflation during this cycle. And that evidence may keep the Fed cautious about assuming that current inflation will prove transitory.

Phillips Curve Points to Demand Forces Driving Inflation this Decade



Source: FRED, unemployment rate vs consumer price index for all urban consumers. Data January 1950 through April 2026. Regression coefficients indicate the direction of the relationship, and the t-statistics indicate the statistical strength of the relationship.

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At the same time, the labor market appears to be in a delicate balance, so the Fed may not rush to hike rates. In our view, the Fed's near-term stance seems to be a wait-and-see approach similar to the one it adopted following last year's tariff shock. Discussions around alternative inflation measures, such as trimmed mean inflation, may change the framing, but they do not change the basic policy problem: the Fed needs more data before it can confidently distinguish supply-driven from demand-driven inflation.

We therefore maintain a cautious view on duration and the long end of the yield curve. Looking ahead, we are focused on three potential signals that could lead us to reassess that position.

First, interest rate volatility has historically been strongly correlated with term premium, a key component of long-term interest rates. Over the past year, rate volatility has fallen sharply toward pre-Covid levels while term premium has remained elevated, with long-term Treasury yields remaining near post-Covid highs. This could suggest the market is pricing in a structurally higher term premium, while expressing confidence that long-term rates may remain capped. If inflation pressure builds alongside positive aggregate demand shocks, however, the market may begin to price in a less dovish Fed reaction function, particularly if any rate sell-off appears inflation-driven. In that scenario, higher rate volatility could be an early sign that markets are assigning greater weight to demand-side inflation risk.

Second, the current administration has made housing affordability a key policy priority. The recent advancement of the 21st Century ROAD to Housing Act points to continued efforts to reduce regulation and increase housing supply. Still, the main obstacle to affordability remains financing cost. The President has repeatedly emphasized that housing is "all about interest rates." Setting aside compensation for borrower prepayment optionality, the spread of current-coupon MBS over the 10-year Treasury is nearly 100 basis points (Bloomberg, as of 5/31/2026). Any policy action aimed specifically at reducing mortgage rates could increase the market's perception that fiscal initiatives are being used to drive down interest rates.

Finally, sell-offs tied to concerns about the long-term sustainability of U.S. debt may create tactical opportunities. The fiscal trajectory appears concerning and has likely contributed to a higher term premium. However, we think there is potentially a sustainable path forward if growth remains strong and the primary deficit stays contained. While many market participants focus on rising interest expense, the sustainable level of debt-to-GDP ratio ultimately depends on the primary deficit, assuming nominal growth can outpace the cost of debt over the long run. According to the Congressional Budget Office, excluding interest payments would reduce the projected 2026 deficit from 5.8% of GDP to a primary deficit of 2.6% (The Budget and Economic Outlook: 2026 to 2036, CBO, February 2026). If Secured Overnight Financing Rate (SOFR) swap spreads were to widen meaningfully during a rates sell-off, for instance, that could indicate that market concern over debt sustainability has become overextended.

Sources for data and statistics: Bloomberg, FactSet, Morningstar, and ProShares.

The different market segments represented in the performance recap charts use the following indexes: U.S. Large Cap: S&P 500 TR; U.S. Large Cap Growth: S&P 500 Growth TR; U.S. Large Cap Value: S&P 500 Value TR; U.S. Mid Cap: S&P MidCap TR; U.S. Small Cap: Russell 2000 TR; International Developed Stocks: MSCI Daily TR NET EAFE; Emerging Markets Stocks: MSCI Daily TR Net Emerging Markets; Global Infrastructure: Dow Jones Brookfield Global Infrastructure Composite; Commodities: Bloomberg Commodity TR; U.S. Bonds: Bloomberg U.S. Aggregate; U.S. High Yield: Bloomberg Corporate High Yield; International Developed Bonds: Bloomberg Global Agg ex-USD; Emerging Market Bonds: DBIQ Emerging Markets USD Liquid Balanced.

The different market segments represented in the fixed income returns charts use the following indexes: Global Agg Bond Market: Bloomberg Global-Aggregate Total Return Index Value Unhedged USD; Mortgage Backed Securities: Bloomberg U.S. MBS Index Total Return Value Unhedged USD; Treasury Bonds: Bloomberg U.S. Treasury Total Return Unhedged USD; U.S. Agg Bond Market: Bloomberg U.S. Agg Total Return Value Unhedged USD; Corporate Bonds: Bloomberg US Corporate Total Return Value Unhedged USD; High Yield Bonds: Bloomberg U.S. Corporate High Yield Total Return Index Value Unhedged USD; Interest Rate-Hedged High Yield Bonds: FTSE High Yield (Treasury Rate-Hedged) Index; Treasury Inflation Protected (TIPS): Bloomberg U.S. Treasury Inflation Notes TR Index Value Unhedged USD; Short term (1-3 Yr) High Yield: Bloomberg U.S. Corporate 0-3 Year Total Return Index Value Unhedged USD; Senior Loans: Morningstar LSTA U.S. Leveraged Loan 100 Index; Short term (1-3 Yr) Corp Bonds: Bloomberg U.S. Corporate 1-3 Yr Total Return Index Value Unhedged USD; Floating Rate: Bloomberg U.S. FRN < 5 yrs Total Return Index Value Unhedged USD; Interest Rate-Hedged Corporate Bonds: FTSE Corporate Investment Grade (Treasury Rate-Hedged) Index.

The S&P 500 is a benchmark index published by Standard & Poor's (S&P) representing 500 companies with large-cap market capitalizations. The Nasdaq U.S. Large Cap Equities for Rising Rates Index is designed to measure the performance of companies in the Nasdaq U.S. Large Cap Index whose stock prices have historically exhibited relatively high correlation to movements in interest rates. **THESE ENTITIES AND THEIR AFFILIATES MAKE NO WARRANTIES AND BEAR NO LIABILITY WITH RESPECT TO PROSHARES.**

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