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## RATES RISE AS SAFE-HAVEN DEMAND SPUTTERS

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**Despite the traditional status of US Treasuries as a global safe haven in times of crisis, yields have jumped in response to the Iran war.** Ten-year yields were up 38 basis points in the month of March, while two-year yields climbed 42 bp on diminished expectations of a Fed rate cut. Average mortgage rates also jumped to 6.52%, the highest since September. Concerns over the inflationary impact of higher oil prices, along with uncertainty over trade flows and disruptions in the petrodollar cycle have tamped down haven demand from overseas investors.

**Futures markets no longer expect the Fed to cut rates this year.** In February, futures traders had fully priced in two quarter-point cuts in the Fed funds rate by year-end. Today, there's a 78% chance the US central bank will remain on hold through December, with a 10% chance that the Fed will actually hike rates a quarter-point by then. Fed officials have signaled a wait-and-see stance, acknowledging both potential inflation and a weakening labor market. Two-year inflation expectations currently stand at 3.35%, well above the Fed's 2.0% target.

This stagflation risk comes at a sensitive time for monetary policy. The confirmation of Kevin Warsh, Trump's nominee to replace Jay Powell as head of the Fed, remains in limbo due to pending litigation against the current Fed Chair. Senator Thom Tillis has vowed to block the nominee until the litigation is resolved. And the market's reaction to the Iran war is also at odds with Warsh's pre-war call to cut rates more aggressively. For now, Fed officials and the market are signaling a smooth transition, but much will depend on how long hostilities in the Middle East continue.

**The disruption of the petrodollar cycle is contributing to higher rates.** Under an agreement negotiated more than 50 years ago, Middle East oil producers price their product in US dollars and reinvest their profits in Treasuries and other dollar-denominated assets. Normally, a spike in oil prices will have a favorable impact on demand for US debt, as higher prices mean higher profits for oil producers, which are then recycled into the US economy and government bonds. However, Iran's shutdown of the Strait of Hormuz as well as its attacks on its neighbors' oil infrastructure mean that major producers cannot get their oil to market. With their economies at risk, Middle Eastern allies are likely to scale back their promised US investments.

Alongside the impact on crude oil, the Iran war is prompting a surge in the prices of other key commodities, including LNG and aluminum, hurting the economies of our key trading partners in Japan and Europe. And with the new tariff regime now well underway, the war may accelerate the disengagement we've started to see in the past year. In the past five weeks, foreign central banks have reduced their holdings at the Federal Reserve Bank of New York by \$82 billion to \$3.7 trillion, the lowest level since 2012. This disengagement will not be swift or dramatic, but it's likely to create steady upward pressure in the long run.

**In the meantime, rates continue to be buffeted by the ebb and flow of hostilities** and mixed messages coming from the White House. Volatility has reached levels last seen during the "Liberation Day" tariffs a year ago. However, absolute rate levels remain in line with where they were last summer. A threatened breakout to the upside of the recent range has reversed quickly but suggests that the risk of higher rates remains elevated while the war lasts.

### Key Statistics: Interest Rates, Unemployment and Inflation

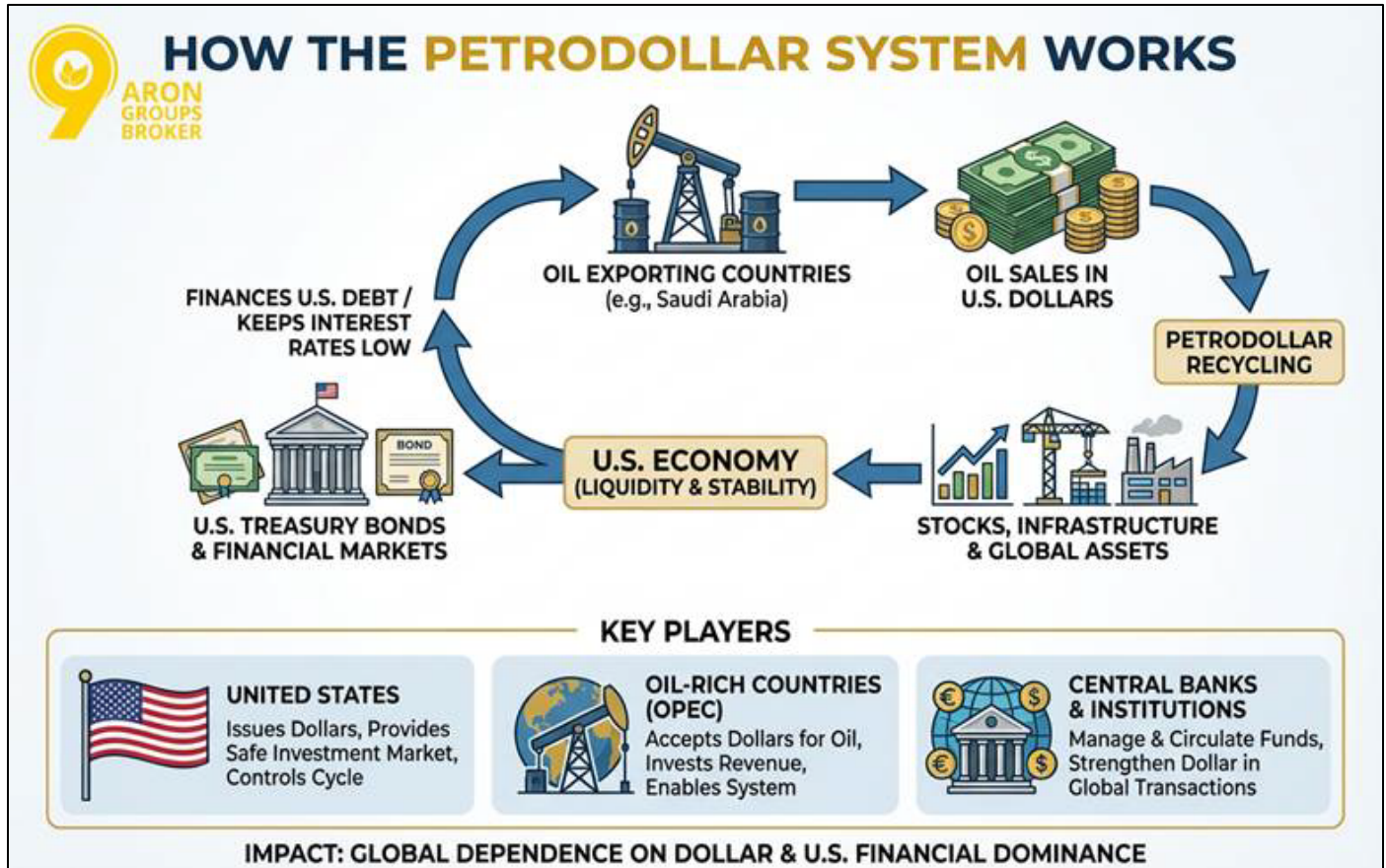
	Year-end <u>2022</u>	Year-end <u>2023</u>	Year-end <u>2024</u>	Year-end <u>2025</u>	March 31, <u>2026</u>
10-yr Treasury yield	3.87%	3.88%	4.57%	4.17%	4.32%
2-yr Treasury yield	<u>4.43%</u>	<u>4.25%</u>	<u>4.24%</u>	<u>3.47%</u>	<u>3.79%</u>
Spread	-0.56%	-0.37%	0.33%	0.70%	0.53%
Fed Funds Target (mid)	4.375%	5.375%	4.375%	3.625%	3.625%
CME Term SOFR 1-month	4.36%	5.35%	4.33%	3.69%	3.66%
CPI (y/y change)	6.5%	3.1%	2.7%	2.7%	2.4%
Core PCE (monthly)	4.7%	3.16%	2.81%	2.83%	3.06%
5-yr TIPS (market breakeven)	2.38%	2.15%	2.39%	2.27%	2.66%
U-3 Unemployment	3.5%	3.7%	4.1%	4.4%	4.3%
Real avg weekly earnings	-3.1%	0.5%	1.0%	1.1%	1.6%
Annual change in NFP jobs	+4,503,000	+2,560,000	+1,450,000	+371,000	+152,000

### 2-YEAR vs. 10-YEAR US TREASURY YIELD



Source: Bloomberg Finance LP

- The 2-year Treasury yield jumped to its highest level of the year, with a trough to peak rise of 62 bp.
- 10-year yields topped out at 4.40%, 50 bp above their 2026 lows.



Source: Aron Groups

- Middle East oil exporting countries are constrained in getting their product to market, forcing them to scale back the recycling of petrodollars. This puts upward pressure on yields.
- If the conflict is resolved quickly, this will be a short-term phenomenon, but the longer the war lasts and the more damage to life and property ensues, the more embedded the problem becomes.

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