Energy spikes and bond yields: Why the market has overshot

CIO Essentials

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- Geopolitical tensions are weighing on growth and inflation: The conflict in Iran and the closure of the Strait of Hormuz have weakened the global economic outlook, driving oil prices over 30% above pre-war levels. Inflation in the US is rising as a result, though the impact on economic growth has been limited. Europe, by contrast, has been affected more significantly, with emerging signs of economic strain, due to higher energy import costs.
- Central banks face a policy dilemma: Despite rising inflation (likely above 3%), central banks may show more patience than in past crises. We expect the ECB to keep rates unchanged, the Bank of England to cut rates next year, and the Fed to deliver two rate cuts by year-end. The bond market, however, is pricing in further hikes for all three banks, which we see as excessive.
- Investment implications: As energy prices normalize, bond yields could fall, benefiting high-quality short- and medium-duration bonds. Rising public debt—especially in the US—may weaken the dollar over the long run and support demand for gold as a defensive asset in the medium term.

Source: Getty_UBS

The outcome of the conflict in Iran and its economic repercussions remain difficult to assess, but one thing is clear: The global economic outlook has weakened since the start of the war. The closure of the Strait of Hormuz has quickly created a scarcity effect in oil markets. We now forecast Brent at USD 100 per barrel in June and USD 90 at year-end—over 30% higher than pre-war levels.

For the United States, the conflict in Iran is primarily being felt via higher inflation , potentially affecting the administration's approval ahead of the November midterm elections. However, the impact on economic growth appears contained, given the country's leading role as an oil and gas exporter and the boost from increased military spending.

In Europe, by contrast, the impact of the conflict extends beyond inflation, with a more pronounced effect on economic growth. Imports of oil and gas have become more expensive, and some sectors are beginning to show signs of strain. This has been partly mitigated by the high household savings rate, which acts as a buffer.

Central banks remain in the spotlight, facing a dilemma: raise rates to curb inflation, risking a recession, or let inflation run its course, with the risk of triggering wage-price spirals that are hard to contain.

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Compared to the inflation wave that followed the 2022 invasion of Ukraine, today's starting inflation is lower. And whereas the abandonment of Russian gas was a structural event, the closure of the Strait of Hormuz is expected to be temporary.

For this reason, even if inflation is likely to exceed 3% on both sides of the Atlantic, we expect central banks to prove more patient than in the past. We believe the ECB will keep rates unchanged despite hinting at possible hikes in its communications; the Bank of England to cut rates early next year, and the Federal Reserve to lower rates twice this year — in September and December—by 25 basis points each.

The bond market, however, has taken a different view, with yields now reflecting several rate hikes in the coming months for these banks. We believe this reaction is excessive, as the combination of higher energy prices and higher rates could lead to recession and, therefore, the need to cut rates again after just a few quarters.

As a result, yields could fall as energy prices normalize, benefiting bond prices. We see value in high-quality, short- and medium-duration bonds, complemented by selective exposure to emerging markets and high yield.

The war is also contributing to rising public debt through higher spending on armaments and subsidies to contain energy costs. This is a global issue but among the most evident in the United States, where the deficit has averaged above 6% since the 2008 global financial crisis.

The increase in US debt could make Treasuries—traditionally a market pillar—a more volatile asset, potentially undermining the dollar to some extent over the long run. For this reason, after the sharp correction following the start of the war in Iran, the search for assets with "safe haven" characteristics—especially in a context of monetary devaluation to facilitate debt management—could once again benefit gold in the medium term.

In such a scenario, some investors may be tempted to take profits in equities at record highs and increase their cash holdings. However, experience shows that being underinvested—that is, holding too much cash and too few equities compared to the ideal asset allocation—often exposes investors to greater risk, namely the loss of real value over time.

As a result, since the start of the year we have not changed our overall equity allocation, but have focused on sector composition—reducing exposure to technology, banks, Europe, and India, in favor of more defensive areas such as pharmaceuticals and Switzerland. We therefore continue to favor diversifying concentrated equity positions but retain a constructive stance to not miss the positive impact from good news.

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Note: For equities, we have a five-tier rating system with two additional preferences
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Appendix

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