

Summary

- The conflict in Iran has caused severe oil supply shortages, causing prices to spike and leading to wider inflationary concerns.
- Upward pressure on inflation and interest rates is a particular worry for countries that rely on imported energy – countries like the UK.
- Bonds, traditionally a safe haven in times of market volatility, are particularly vulnerable to inflation.
- Historical examples of oil crunches, from the 1970s to the more recent Covid and Ukraine crises, may offer some guidance as to what to expect next, but are ultimately unreliable as lessons for today's unprecedented context.
- Pensions are generally on solid ground with investments matched well to liabilities – but as the traditional safe haven looks a little stormy, it makes sense to reassess and seek out effective diversification elsewhere.

Iran war and the impact on bond markets

Sandra Haurant analyses how the US-Israel war with Iran is driving volatility in bond markets, and what the turbulence means for pension funds

why has this sector been impacted, and what does it mean for pensions?

Of the many repercussions caused by the US-Israeli war with Iran, the one that has grabbed perhaps the most headlines is Iran's near closure of the Strait of Hormuz. The narrow corridor of water connecting the Gulf with the Arabian Sea is, in normal times, one of the busiest oil shipping routes in the world, with around a fifth of the world's oil and liquefied natural gas passing through. At the time of writing, though, the strait is an effective impasse, bringing to a halt a huge proportion of the world's supply of oil and gas, pushing up commodity

prices, and leading to broader inflation. But why do these facts hit bonds so hard?

begin to worry about is when the energy increases feed through into other parts of the economy through second round effects of higher electricity, fertiliser costs and other energy-related components." Payden & Rygel director, global fixed income portfolio manager, Paul Saint-Pasteur, explains: "Bonds have traditionally earned their safe haven status from their tendency to perform well during periods of economic weakness. In a typical downturn, falling growth expectations and subdued inflation lead central banks to ease policy, driving bond yields lower/prices higher. In these periods, bonds can also provide diversification as riskier assets come under pressure."

However, Saint-Pasteur says, retaining that safe haven status depends on the type of challenges. "If bonds tend to respond favourably to growth shocks, they are far more vulnerable to inflation shocks. In such environments, bonds can lose both their defensive qualities and their diversification benefits."

Ultimately, in this case, says Saint-Pasteur: "This shift in expectations has driven bond yields higher, undermining their traditional role as a safe haven."

Which bonds are most affected, and why?

Not all countries will be affected in the same way – and some will be hit harder than others. "Anywhere that has a significant need to import energy is particularly exposed. The UK, along with the rest of Europe, will potentially face the largest costs from the oil price spike," says Thornton.



Bonds have traditionally formed the bedrock of pension funds, bringing to portfolios healthy diversification and balancing out typically more volatile equities. But in the context of conflict, things can take a surprising turn. And since the US-Israeli war on Iran began on 28 February, bond markets have been severely shaken. So

prices, and leading to broader inflation. But why do these facts hit bonds so hard? "It all comes back to inflation," says Keyridge Asset Management head of fixed income, John Thornton. "The sharp increase in oil prices means inflation will be higher, which could result in central banks raising interest rates as they did in 2022. What the policymakers really

And looking at the wider picture, Global Evolution senior macro and allocation strategist, Witold Bahrke, says that different geographical areas will have different levels of exposure to the current turmoil. “Developed markets are moving away from the low-inflation era. Persistent geopolitical tensions, fiscal expansion, and changing global dynamics mean higher inflation uncertainty is likely to stick,” says Bahrke, who highlights the more structural issues at play here. “This undermines bonds’ traditional role as portfolio insurance, as both bond and equity prices are now moving in tandem more often.” On the other hand, the story is different for emerging markets, he argues, where: “disciplined fiscal and monetary policy, helped by low Chinese inflation, has kept inflation risks more contained”.

Could UK gilts bear the brunt?

The chancellor, Rachel Reeves, warned at the start of the conflict that the UK faces likely increases in inflation, and, according to Thornton: “This is one potential scenario that markets are taking seriously. The extent and persistence of the increase in inflation is unclear at the moment, but the direction of travel is apparent. Higher rates of inflation would suggest higher interest rates are needed, which would hurt longer-dated bonds more.

Saint-Pasteur adds: “Inflation expectations and the path of future monetary policy rates are key drivers of bond returns. When inflation is expected to rise, investors demand higher yields to compensate for the erosion of real returns. If central banks are expected to abandon rate cuts or raise rates, this reinforces upward pressure on yields.”

And, he says: “The UK economy is particularly sensitive to higher energy prices. As a net importer of energy, increases in global energy prices can feed rapidly into domestic energy costs, with potential second-round effects across the broader economy. Against the backdrop

of higher energy prices, financial markets have shifted from expecting almost two interest rate cuts from the Bank of England in 2026 before the conflict erupted to pricing in more than three rate hikes as of 20 March, a turnaround that has been negative for gilt returns.”

“The scale of the moves so far suggests most schemes would be well positioned to ride out the volatility”

How will this turn out?

Making forecasts amid an unpredictable and unstable conflict situation is impossible, which leaves us with a tendency to look to the past to see how ostensibly similar situations have played out. Saint-Pasteur says: “The closest precedent is the 2022 energy shock, when a surge in oil prices fed into already elevated inflation and forced central banks to tighten policy more aggressively than expected. That episode has probably meaningfully shaped today’s market reaction.”

Nonetheless, he says, there are crucial differences. “Unlike 2022, today’s shock is more clearly a supply-driven energy shock, which central banks would typically ‘look through’ rather than respond to with tighter policy. In addition, global economies are on weaker footing. Labour markets, especially in the US, are softening, government support is more limited, and core inflation has already moderated in many regions.” As a result, he argues: “While markets have rapidly repriced toward higher rates, the precedent may be imperfect. If higher energy prices prove temporary or begin to weigh on growth, the outcome could diverge from 2022, with central banks ultimately leaning towards rate cuts rather than hikes, despite the initial inflation impulse.”

The Covid pandemic, brought its own energy challenges, too, although,

as RBC BlueBay Asset Management senior portfolio manager, investment grade, Kasper Hense, points out, this period brought about a “demand shock”, while today’s challenges, again, are very definitely about a “supply shock”. And the examples of the 1973 and 1979 oil crises are frequently raised. It is true that supply was the issue here, but Bahrke says drawing direct lessons from that period’s history is unreliable because: “The current situation is, in many respects, unprecedented. That period [*the 1970s*] saw far more persistent inflation and stronger wage bargaining, fuelling lasting price rises and more aggressive central bank action,” he says. “Today, wage dynamics are less inflationary, and oil price spikes are expected to be more short-lived.”

Nonetheless, Thornton says: “There aren’t any perfect reference points here, but the broad trend of a supply side shock is relatively well understood. The key question is how long the oil supply is constrained and to what degree.”

What should pensions do?

There is a lot to be said for keeping calm and carrying on, says Thornton. “All schemes should have developed risk management plans as part of their investment strategies. There is likely a period of increased volatility ahead across bond, currency and equity markets, as well as clearly the oil market.” He adds: “The scale of the moves so far suggests most schemes would be well positioned to ride out the volatility. You may see that plans for any pension risk transfer transactions could be temporarily postponed unless tracking portfolios have been implemented.”

Against an unstable background, then, says Bahrke: “As safe-haven status falters and correlations shift, investors need to look beyond traditional government bonds to achieve effective diversification.”

 Written by Sandra Haurant, a freelance journalist