

# Iran shock is driving central banks apart

## Flash Fixed Income | March 2026

- The energy shock from the Middle East conflict has reset the outlook for central banks globally, with UK rate expectations taking the hardest hit.
- The conflict has amplified the UK's vulnerability to inflation relative to the US, potentially stripping the Bank of England of the near-term easing the UK economy badly needs while leaving the Federal Reserve's room for manoeuvre comparatively intact.
- The pattern of US Treasuries failing to hedge risk market downturns is becoming more frequent. We think it is harder to assume government bonds will effectively dampen portfolio volatility during periods of acute stress, and this should be considered in portfolio construction.

The US-Israeli military operation against Iran that began on February 28, and Tehran's retaliation across the Gulf region, has dominated market price action for the past two weeks. At time of writing, disruption to shipping through the Strait of Hormuz has pushed Brent crude oil up to around \$100 a barrel and caused sharp moves across global equity and bond markets.

We will not attempt to predict the duration or outcome of the conflict. As fixed income investors, our focus is on how the shock ripples through the variables that we believe matter most for bond markets: inflation, growth, and the reaction functions of the central banks that set rates against that backdrop.

What we find interesting is that a divergence in outlook between the Bank of England (BoE) and the Federal Reserve (Fed), which was visible well before the conflict began, has been widened considerably by the energy shock.

### The safe haven that wasn't

Before examining central bank paths, it is worth noting the failure of US Treasuries (USTs) to perform their traditional safe haven role during a risk-off event. The 10-year UST yield rose above 4.1% in

the days following the outbreak of hostilities, selling off alongside equities rather than providing the offset investors typically expect.

We observed a similar breakdown during the tariff-driven sell-off of April 2025, though for different reasons; on that occasion we attributed it to investors reappraising the sustainability of the US fiscal position, whereas the current episode is driven by energy-led inflation fears.

The causes differ, but the pattern of USTs failing to hedge risk asset drawdowns is becoming more frequent. It is becoming harder to assume that government bond allocations will effectively dampen portfolio volatility during periods of acute stress, and this probability should be factored into portfolio construction.

### Divergent paths were already priced in

To understand what the energy shock has done to rate expectations, it helps to recall where they stood before it. On February 25, three days before the first strikes, markets were pricing both the BoE and Fed to cut rates over the next year with the European Central Bank (ECB) on hold: UK rates were expected to fall from 3.75% to 3.27% at the one-year horizon, while US rates were expected to decline from 3.63% to 3.07%.

## Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	-0.08	-1.08	3.4	4.4
GBP IG	-0.85	-1.30	5.4	5.8
US IG	0.00	-0.76	5.0	6.4
EUR HY	-0.22	-1.09	5.5	3.0
GBP HY	0.94	-0.63	8.4	3.0
US HY	0.26	-0.53	7.0	3.0
EM HY	1.45	-0.19	7.3	4.0
Euro Senior Banks	0.01	-0.89	3.3	3.7
COCO	0.51	-0.87	5.8	3.6



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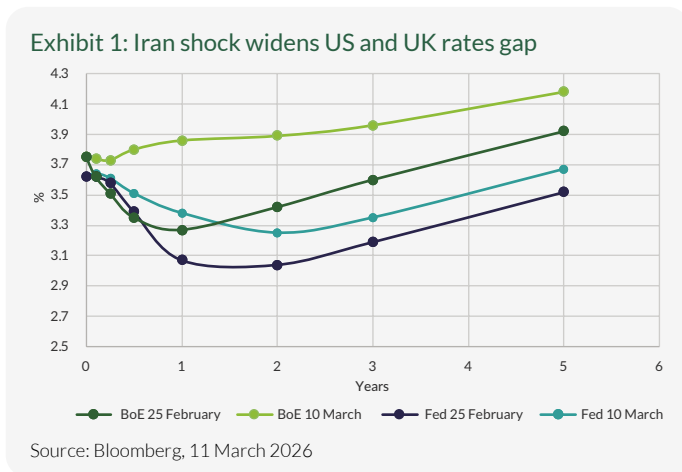
But beyond that one-year point, the two curves told different stories. US rate expectations were essentially the same at two years out (3.04%) before rising modestly to 3.52% at the five-year point – a profile consistent with a central bank easing gradually toward neutral with minimal inflationary resistance. The UK curve, by contrast, turned upward quickly. At two years, the market was pricing the BoE at 3.42%, 15 basis points (bp) higher than the one-year expectation, and by the five-year point, often taken as a proxy for the market's view of the neutral rate, the expectation rose to 3.92%.

These numbers tell us the market believed the BoE would cut in the short-term because the economy needed it, but then risked being unable to sustain lower rates with inflation reasserting itself within two years. The gap at the five-year point between the UK and US of 40bp implied a structurally higher inflation rate for the UK, a notable judgement for an economy growing considerably more slowly than the US.

The curve of ECB rate expectations also sloped upwards after 12 months, but from a starting point of more benign inflation. The ECB's expected rate sat at 1.93% at one year, 2.08% at two years and 2.59% at five years. The market was comfortable that euro area inflation was under control.

### Iran shock has amplified the gap

The numbers as of March 10 tell the next chapter of the story. UK rate expectations have jumped to 3.86% in one year, 3.89% in two years and 4.18% in five years. The BoE's cutting cycle has effectively been cancelled. The inflation problem previously expected to materialise within two years has been pulled into the present with no subsequent let up.



The US curve has shifted upward too, but here the market believes inflation will moderate sooner and that the Fed still has some room to ease. One-year expectations sit at 3.38%, two-year expectations lower at 3.25% and five-year expectations at 3.67%. The US monetary policy narrative has been moderated, not rewritten.

The ECB, previously viewed as comfortably on hold, has not been immune from this shift, with expectations having risen to 2.34% at one year, 2.44% at two years and 2.82% at five years. Europe is more exposed to energy disruption than the US, and the market is adjusting accordingly. However, the absolute level of ECB expected rates remains far below those of either the Fed or the BoE, reflecting a Eurozone economy where underlying inflation pressures are less entrenched.

Looking at the magnitude of the shift, the UK has been hit hardest. Rate expectations have risen by 59bp at the one-year point, compared with 41bp for the ECB and 31bp for the Fed. At the five-year point the gap between the UK and the US has widened from 40bp before the conflict to 51bp. The long-run structural difference in inflation expectations has grown.

One caveat is warranted here on central bank base rate expectations as implied by market pricing. The Gilt market is currently experiencing significant technical stress. The energy shock has forced the unwinding of crowded macro positions, with hedge funds exiting leveraged Gilt trades that had been predicated on UK yields converging toward those of other major economies. The implied rate paths derived from Gilt pricing should therefore be read with some caution; they are capturing position liquidation as well as genuine shifts in expectations.

In particular, we disagree with the market's assertion that rate hikes are possible from the BoE this year. In our view, the rate-setting Monetary Policy Committee (MPC) would argue energy price impacts to headline inflation are non-core and lean on the negative growth impact of the shock. However, we believe the direction of travel is robust even if the precise magnitude of the moves is being exaggerated by technicals. The UK was already priced as more inflation-vulnerable than the US across the entire curve. The energy shock has hit the more vulnerable patient harder. That conclusion does not rely on pinpoint accuracy in Gilt-implied rate expectations.

### Why the UK is more exposed

The asymmetry in how the energy shock is hitting rate expectations reflects genuine structural differences. The UK is a net energy importer, meaning higher oil prices feed more directly and quickly into its inflation basket than they do in the US, which as a net energy producer has a natural hedge against price spikes.

## Rates dashboard

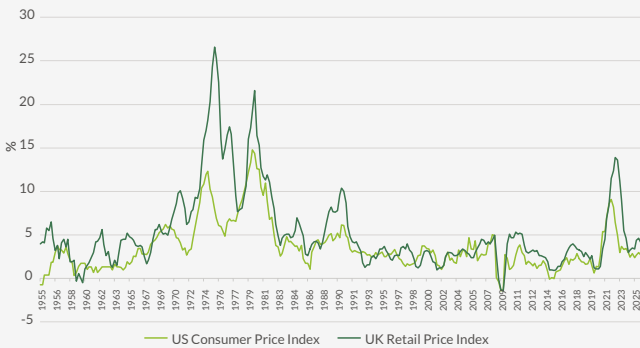
		Change (bp)			
		Current %	1w	1m	YTD
US Treasury	2yr	3.65	11	20	20
	10yr	4.23	13	9	11
	30yr	4.88	14	9	7
UK Gilt	2yr	4.01	30	36	28
	10yr	4.69	25	18	19
	30yr	5.35	20	3	13
German Bund	2yr	2.38	25	31	26
	10yr	2.93	18	12	8
	30yr	3.49	9	0	2

	Market projection	Change (bp)			
		Current %	1w	1m	YTD
Base rate 3.75%	end-2026	3.39	6	30	31
	end-2027	3.26	3	6	3
Base rate 3.75%	end-2026	3.83	33	52	48
	end-2027	2.55	16	33	17
Base rate 2.00%	end-2026	2.50	25	50	39
	end-2027	2.55	16	33	17

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It is worth noting that historically the UK has always been the more susceptible to bouts of inflation (see Exhibit 2). If we look at the UK Retail Price Index (which gives a longer history than CPI) versus the US Consumer Price Index – we see that they generally sit at a similar level and both have scope to be higher. However, drawing attention to periods of high inflation specifically, it is almost always the UK rate which reaches the highest level.

**Exhibit 2: The UK is more vulnerable to bouts of inflation**



Source: Bloomberg, 11 March 2026

At the same time, with fewer captive domestic buyers for Gilts following the buyout of many defined-benefit pension schemes, the UK government must compete globally for capital by offering higher yields, a dynamic that was already pushing up borrowing costs before the conflict.

We believe the US has more capacity to absorb the shock. A stronger economy, a more flexible labour market, the dollar's reserve currency advantage, and with the complications we explored in January ([Flash Fixed Income: The Fed independence premium](#)) notwithstanding, the Fed enters this episode with considerably more room than the BoE.

### The BoE's dilemma

The BoE now faces a genuinely difficult position. Before the conflict, the February MPC meeting had already revealed a divided committee; the vote to hold rates was 5-4 with a near-majority favouring a cut. The case for easing was strong on domestic grounds: weak demand, a softening labour market and a disinflationary trend that was expected to bring Consumer Price Index (CPI) inflation back to the 2% target by spring.

That path has now been disrupted. What was being priced as an 80-90% probability of a March rate cut just weeks ago has apparently collapsed to near zero. The MPC is left confronting a supply-side inflation shock in an economy too weak to absorb tighter policy. Doing nothing may be the least bad option, but "least bad" makes for an uncomfortable policy stance when the economy is crying out for support.

Additionally, in a world less constrained by international law, and marked by more frequent conflicts, increased defence spending will be needed. Funding military catch-up would magnify the UK's existing fiscal strain.

### The Fed has room to wait

The Fed is in a comparatively more comfortable position, though "comfortable" is a relative term. Markets have scaled back expected easing from around 60bp to 35-40bp for 2026, and the market now sees the first cut being pushed toward mid-year at the earliest.

But the Fed still has the luxury of patience in a way the BoE does not. US core inflation looked to be on a clearer downward trajectory before the shock, the labour market has not deteriorated to the point where inaction carries an immediate cost, and importantly, the shape of the US curve still continues to suggest that rate cuts are still anticipated, even if they arrive later and in smaller increments.

### What this means for fixed income investors

The divergence in central bank outlooks has direct implications for portfolio positioning.

First, the case for caution and diversification across government bond curves has strengthened in our view. Safe haven status cannot be assumed; geopolitical shock impacts vary across regions and hedge fund activity in government bonds may generate an illusion of enhanced liquidity that evaporates under stress.

More broadly, the conflict has widened the range of plausible outcomes for both central banks. We believe this is not the moment for large directional bets on either curve when so much depends on the evolution of a conflict no one can confidently forecast. What matters instead is keeping portfolios flexible enough to adapt as the picture clarifies.

We don't think government bonds can be a portfolio's only expression of caution in this environment. The underlying credit risks taken need to be selective. Companies with strong balance sheets, global revenue diversification and pricing power are better positioned to navigate an environment of elevated energy costs and uncertain policy.

In our view, portfolio robustness from here will come from deep fundamental research rather than an increasingly unreliable negative correlation to risk assets from government bonds.

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