

Don't rule out a yield curve inversion if Middle East tensions return

Middle East tensions appear to be subsiding for now. But risks abound, muddying one of investors' favourite indicators: the yield curve. In our base case, the curve flattening will extend as long as tensions remain high. In a more adverse scenario, the yield curve could invert



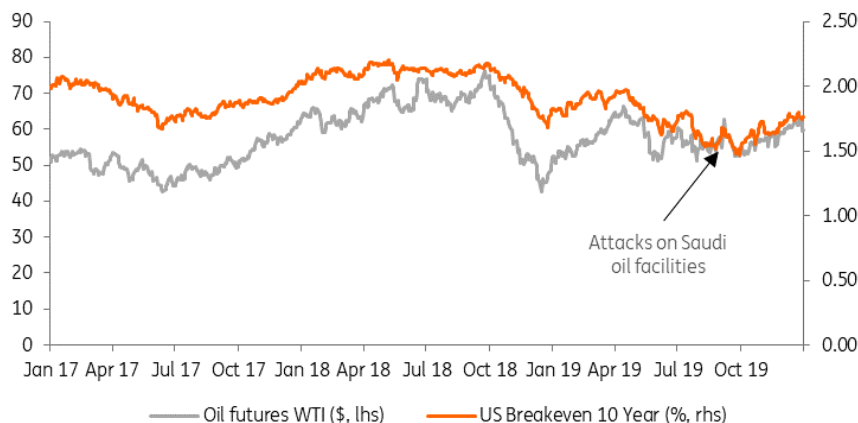
Base case: long bonds to benefit from safe-haven demand

As we wrote [at the onset of this phase of the US-Iran tensions](#), the bar for a sustained rise in oil prices is high. For a number of reasons pertaining to the structure of oil production and the state of reserves, it would take a fairly significant disruption to tighten supply. Additionally, our US economist expects the Federal Reserve to be able to 'look through' a temporary rise in inflation due to energy prices, if only due to the hit to disposable income. Well-anchored inflation expectations in consumer surveys, such as the University of Michigan's, are another factor that would allow the Fed to be patient in reacting to the higher oil price.

In our base case, we are thus inclined to think that the crisis in the Middle East has little relevance for the inflation compensation offered by dollar rates products, in particular at the long-end. A more direct impact has been felt on the risk premia component of interest rates, on account of the flight-to-quality flows. Due to the negative carry of front-end Treasuries, we think this is more likely to benefit longer tenors. The same goes for foreign flows into dollar fixed income: FX hedging costs

are in many cases making all but the longer bonds prohibitively expensive to hold.

In short, we see little need for long-dated interest rates to rise to compensate for inflation risk. We actually see a case for them to continue moving lower as risk-averse investors seek the safety of US Treasuries.



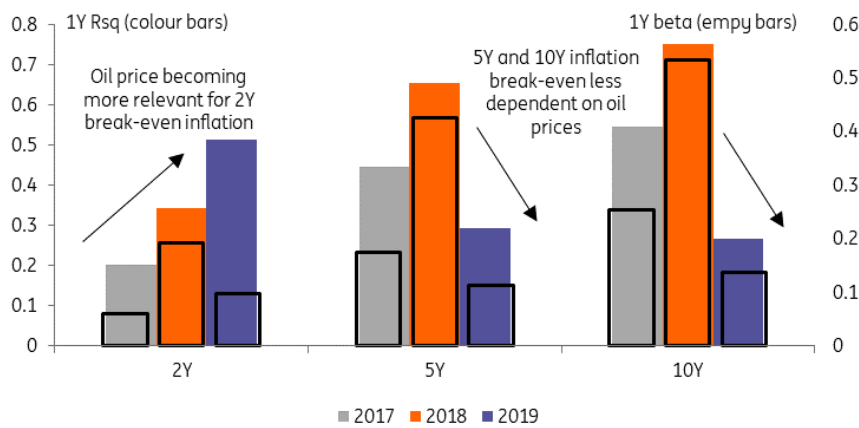
Source: Bloomberg, ING

Oil shock scenario: more detrimental to the front-end

It is nevertheless interesting to consider rates' reaction to a 'tail risk' scenario where the rise in oil is sustained long enough to have a material impact on inflation. The dollar inflation market has seen an interesting development in the past year. Historically, oil prices have had a greater correlation with long-term inflation expectations, say over the next 10 years. Since 2019, oil has played a greater role in shaping short-term inflation expectations, for instance over the next two years. Some may blame the adjustment lower in growth expectations, some the growing appetite for duration globally. To us, they are two faces of the same coin: investors are increasingly expecting sluggish long-term inflation and growth.

For this reason, our view that a short-term increase in oil prices would translate into lower long-dated interest rates also applies to a more extreme scenario where higher oil prices are sustained for a longer period of time. But it gets more interesting.

We have said above that it is a stretch for the market to shift its Fed expectations based on higher oil prices, as the pass through to inflation at this stage is at best uncertain. If inflation expectations for the coming few years were to rise materially, however, we think this would prevent short-dated rates from following their long-dated counterparts lower. We touched upon the less attractive carry of short-dated interest rates above. Expectations for higher inflation in the short term would worsen the attractiveness of short Treasuries. In addition, any fear of Fed tightening, even misplaced, would be detrimental to this sector of the curve. This could very well bring another yield curve inversion.



Source: Bloomberg, ING

Flattening all around and tail risks

In summary, we see plenty of risks of curve flattening, for a number of reasons, in the event that tensions are protracted. The risk of a rise in inflation break-even is limited to the very front-end and to the most adverse scenario, in our view, but cannot be dismissed out of hand. Only if the current crisis blows over do we envision a return to the re-steepening trend that prevailed at the end of last year. Here too, we would warn that a lot of the factors that drove the curve steeper: better growth expectations and the phase one trade agreement, are unlikely to be repeated in the short term.