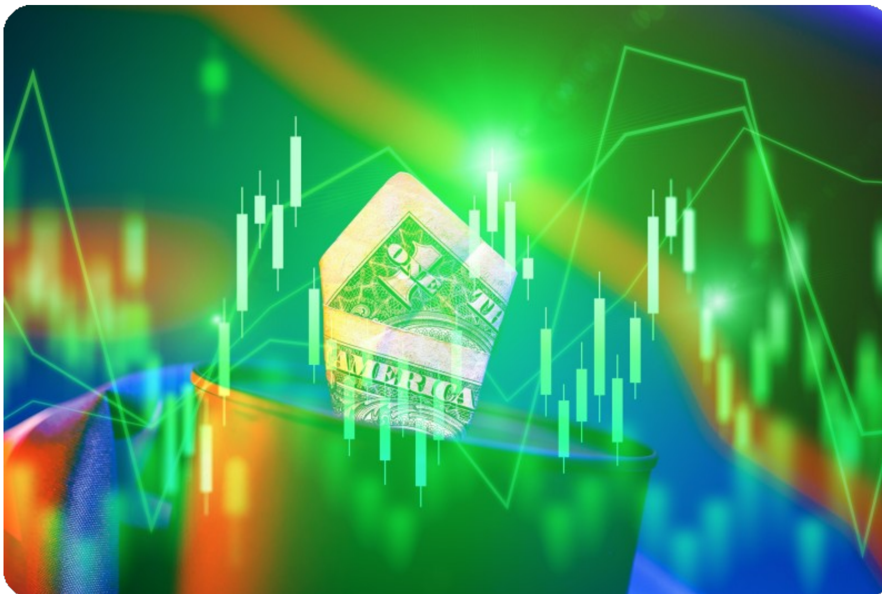
Article | 15 May 2026 RATES

Rates face risk of instability

Market rates have risen because of the Iran war, but have been controlled (apart from UK gilts). An extrapolation of the shutdown of the Strait points to higher market rates still. We expect the US 10yr yield to land at around 4.5% by mid-year, but it risks overshooting in the next few weeks



Bond yields have risen but remain orderly. We don't expect it, but conditions could deteriorate quickly

US Treasuries showing measured reaction to grind higher in the price of oil. That can change

Where to start. The stand-off between the US and Iran is as good a place as any. The basic market assumption is that the Strait of Hormuz will remain stuck until we know more. And while it's stuck, inflation expectations continue to ratchet higher. If that's true, it's tough to imagine any other route for Treasury yields apart from up, at least in the coming few weeks. US headline inflation has already hit 3.8% (we've just had the April reading). It was 2.4% before the war. We'll very likely hit 4% for May. A continuation of the war, and we risk adding to that.

We have 4.5% as a target for the 10yr Treasury yield for mid-year, but between now and then it risks trading up to the 4.5% to 4.75% area. It's exposed to a snap higher in yield at any point, should Treasury bond investors decide to *really* sell. The flow data since the war began shows some selling, but also buying, and in fact, in net terms, no *marked* selling. Instead, there

has been a re-marking higher in yields in tandem with the slow elevation in inflation expectations. These, in fact, remain relatively tame; the 10yr break-even inflation rate is 2.5%. Good, as it's not particularly high. Bad, as it has plenty of room to move higher.

The eurozone, UK and Japan are trucking along with varying impulses

Eurozone yields are feeling the same pressures, albeit more focused on shorter maturities, as a series of European Central Bank hikes are now discounted (at least 75bp). Upward pressure on market rates is set to be sustained in the weeks ahead, and for at least as long as the stalemate in the Strait persists. The 10yr rate is liable to remain comfortably above 3%. After all, eurozone inflation is now running at 3% and is also on the rise. The 1yr European inflation breakeven is just short of 4%, highlighting the inflation concern the ECB risks reacting to with rate hikes. This protects longer tenors, but does not shield them.

There are also idiosyncratic pressures elsewhere. Both the UK and Japan have had their issues in the past few quarters. Of late, the UK, in particular, has been hit. In fact, since the Iran war began, the UK 10yr gilt yield is up some 90bp. A large chunk of that has nothing to do with the war. Political wobbles and underlying fiscal deficit concerns have been drivers. In Japan, rates have been too low for too long, and this has manifested in material depreciation pressure on the yen. Japanese rates are up in tandem with US rates since the war broke out, but can keep on rising in relative terms when the war ends, as rates adjust higher into the medium term.

The war remains the driving force for direction. We look up for yields ahead first

In the end, direction continues to come from the path of the war. If the past couple of weeks are anything to go by, then the path ahead is clear and yields continue to test higher. It gets more complex beyond that. Whatever happens, we are being left with an echo of higher inflation. So, even if we were to see an earlier-than-expected end to this conflict, yields won't lurch lower dramatically.

If they do, they'll find fairer value at higher-than-normal levels. For the US, that means the 4.25% area as a downside level. And for the eurozone, the 3% area is set to prove a sticky floor. For now, though, we're looking up for yields, not down.

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