

Rates: Lessons from the Iraq war

We've not seen this exact movie before, but we've certainly seen a version of it. Magnitudes of some 40bp in the 10yr were obtained. Lower first, and then higher in yield. Sounds familiar. The big difference this time is the spike in short-tenor inflation break-evens. But real yields have held up. The market sees this as a pure short-term price shock, so far



US Treasury yields echo 2003-style swings, but markets are pricing a short-term inflation shock rather than lasting growth risk

Can we identify echos from the 2003 Iraq war for Treasuries and rates?

In 2003, in the weeks leading up to the war in Iraq, the US 10yr Treasury yield fell from 3.95% to 3.55%, a 40bp drop over a three-to-four-week period. Not all of this was reflective of the upcoming war, but a lot of it was. There was an overt build-up of military presence, as the coalition of the willing got ready. Hostilities finally kicked off on 20 March 2003, by which time the 10yr yield had popped back up to the 4.1% area. And in the first couple of weeks of the attack on Iran, the 10yr yield fell back down to the 3.8% area. The dominant impact impulse, over consecutive weeks, was in the direction of lower yields (a flight into Treasuries).

Just for context, the Fed funds rate was at 1.25% at the time (tail end of the dot.com bust). In fact, it got cut to a 1% low later in 2003. While the funds rate is at a different level today, it just so happens that the 10yr yield is in the same ballpark as it was back then. The events of the past few days are clearly not a perfect repeat of the Iraq War. But it is interesting to view the

magnitude of change. We're not suggesting this is determinative; just making the comparison to help set some expectations and identify some differences. One was a much lower effect on the oil price back then (Iraqi exports had already been slashed, so the oil price impact was minimal).

Fast forwarding to today, we identify some important nuances

Turning to now, the US 10yr yield shot to below 4% (to just above 3.9%) as the war with Iran broke out, but quickly reverted to above 4% (hitting 4.1% briefly). At the extreme, that's a 20bp swing. It's also a far swifter reversion higher in yield than would be expected based on the Iraq War experience. The 2/10yr curve has also flattened, as it did in the lead-up to the Iraq War. This flattening process is quite striking, and fits with the notion that a flight-to-safety trade continues to exist for Treasuries. This coincides with quite benign inflation expectations in the 10yr, with the implied break-even inflation rate there not deviating too far from 2.3% (absolutely fine).

But it's on the shorter tenors where we find spikes in inflation expectations. The 2yr break-even was in fact already elevated on the eve of last weekend's attacks, at around 2.8%. Now it's at 2.9%, reflective of the material rise in the price of oil. Beyond that, real yields have not done much, so the rise in break-evens is purely a function of higher regular yields. This tells us that markets are not, so far, discounting a material US economic activity risk from the current situation. Rather, the biggest risk is upward pressure on consumer prices. This, in turn, is anticipated to be temporary (long-term inflation break-evens remain tolerably benign).

Impact on European rates and projections for the second quarter

In terms of spreads to eurozone rates and yields, there is no big story to be told. The issue for Europe is its greater reliance on imported oil and acceptance of whatever the global price for energy is. Not to say that we do not see the same for the US. Rather, for Europe, it's more mechanical, albeit muted by a higher taxation element in the overall price set for energy. There has been quite a high correlation between eurozone and US rates since the conflict began, and we expect to see more of the same ahead.

We risk seeing increased bouts of flight to safety, pushing yields down. Don't rule out a break back below 4% on the US 10yr, even if brief, likely on a risk-off episode should things turn really sour. This could see the 10yr Bund yield falling back towards 2.5%. But as we look into the second quarter, we anticipate the US 10yr yield to get back up to the 4.3% area (a level that we observed for a period in January). That equates to the German 10yr yield rising to the 2.9% area. This reflects a resultant higher inflation narrative (higher energy prices). Beyond that, a subsequent calming in yields through

the second half of the year would reflect the payment for that in terms of a hit to real growth.

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