

Rate dynamics under different Iran scenarios

Bloomberg: DS ABN <GO>

- The Iran conflict has pushed up government bond yields, with more hawkish central bank policy expectations flattening yield curves in Europe and the US
- Using three scenarios for the conflict, we describe the impact on the EGB and UST markets
- In the middle scenario, where the conflict will end in the next two months, we expect the Bund curve to bear flatten initially, and to bear steepen thereafter...
- ... while in the negative scenario the expect a continuation of the bear flattening and country spreads to widen further
- We expect OATs to outperform BTPs, as Italy relies more on LNG imports from Qatar and France is this time better positioned for an energy shock
- In the positive scenario, we expect the Bund curve to bull steepen



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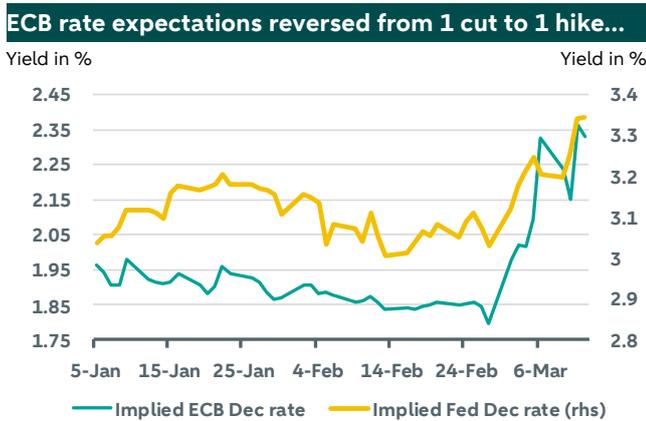
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Inflation fears resulted in a significant bear flattening

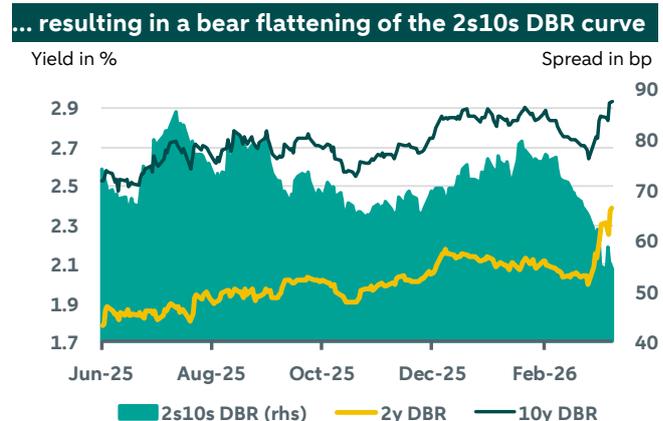
Over the past two weeks, financial markets have responded sharply to the onset of the Middle East conflict. Beyond the profound human tragedies, the geopolitical tensions have triggered significant repricing of central bank expectations, primarily driven by surging oil and gas prices. That, in turn, markedly shifted government bond markets.

On 27 February, the market was pricing a 50% probability of a 25bp cut by the ECB by year-end. However, by the start of this week, sentiment had swung towards almost two 25 basis point hikes being priced for this year. This adjustment was only partially reversed following comments from US President Trump on Monday evening, hinting that the conflict could be resolved 'very soon', which led the market to price in just one hike. However, market sentiment has been extremely volatile over the past two weeks and, at the time of writing, sentiment turned somewhat more negative again, with a second rate hike by the end of this year now being priced in at more than 50%.

In the US, the outlook for the Fed funds rate also changed, with expectations moving from at least two cuts on 27 February to just over one rate cut, as inflation concerns intensified due to higher energy costs (see left graph below).



Source: Bloomberg, ABN AMRO Group Economics

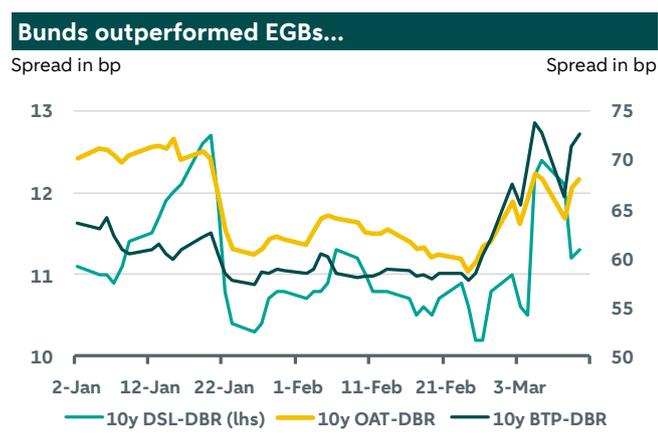


Source: Bloomberg, ABN AMRO Group Economics

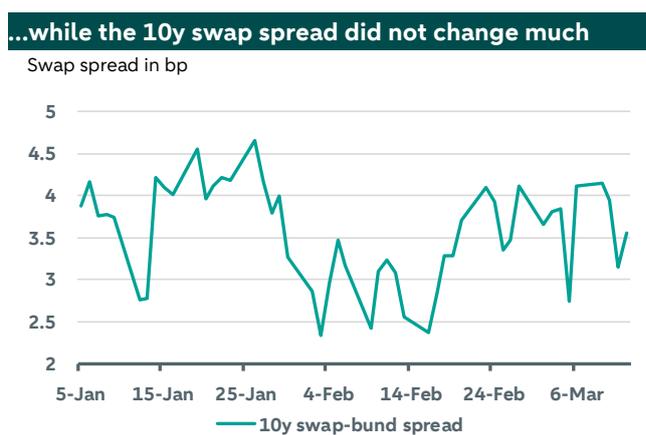
As a result, European government bonds (EGBs) saw their yield curves bear flatten, while in the US Treasury market (UST), the 2s10s UST curve experienced a parallel shift upwards. Given the heightened inflation expectations, yields in the front-end of the EGB curves were more affected, given the higher sensibility of this part of the curve to potential rate hikes by the central banks. However, also longer-dated yields increased notably amid the Middle East conflict. The 10-year Bund yield retraced to the levels seen at the beginning of February (see right chart above). Because the yields along the Bund

curve increased and also the 10y swap-bund spread has not widened, these recent market developments suggest that the shift in inflation and central bank expectations dominate flight to quality impact. This is as expected, given the nature of the oil shock.

However, in recent weeks, the spreads between Bunds and other European government bonds (EGBs) have widened considerably, partially reversing the tightening of spreads that had been underway for some time. In these turbulent times, investors are evidently seeking a safe haven within the EGB spectrum, which makes them favour Bunds over other EGBs. The Dutch State Loans (DSLs), despite being the only other AAA-rated country in the EGB market (besides the Bund), also saw spreads widening by a few basis points. However, this could be explained by the superior liquidity of Bunds, which makes investors also favour Bunds over DSLs. The most significant spread widening occurred between Bunds and French OATs or Italian BTPs, which typically indicates that investors prefer to be invested in higher-rated EGBs (see left chart below).



Source: Bloomberg, ABN AMRO Group Economics



Source: Bloomberg, ABN AMRO Group Economics

Rates expectations under three scenarios for the Middle East conflict

In our recent Top of Mind note (see [here](#)), three potential scenarios were set out for how the conflict in the Middle East could turn out. Given the still high degrees of uncertainty, in the scenarios below we refrain from giving probabilities, as these are a constantly moving target. Instead, we focus our analysis on describing the various effects the conflict could have, which depend largely on how long the conflict and the corresponding disruptions to energy supplies lasts. Each scenario is briefly described below.

Middle: The conflict will end in the next two months. Under this scenario, our macro team sees elevated oil and gas prices in the near term, resulting in eurozone inflation hovering around 1.2pp higher and growth around 0.2pp lower in 2026. This would result in one ECB hike of 25bps as soon as the April meeting. In the US, we expect the Fed to delay easing until Q2 2027, keeping rates on hold at 3.75% (upper) until then.

Negative: The conflict lasts up to a year. In this scenario, oil and gas prices jump to an average of around \$130 per barrel and €120 per megawatt hour, respectively, by year-end. Second round effects for eurozone inflation are more pronounced, resulting in inflation around 2.3pp higher (peak >5%), and growth is 0.4pp lower in 2026. The ECB would react by delivering three 25bp rate hikes in 2026 (one in Q2 and two in Q3), resulting in a policy rate of 2.75% by year-end. In the US, we expect a single 25bps hike in Q2, with potential easing postponed until the second half of next year.

Positive: The conflict ends within weeks. In this case, energy supply would normalize quickly with falling oil and gas prices. Eurozone inflation would still somewhat remain higher than our previous base case, but moves rapidly lower. Growth effects are close to negligible. Consequently, there would be no need for ECB hikes in this scenario. Regarding the US, we continue to expect three rate cuts in June, September and December, bringing the Federal funds upper rate to 3% at year-end.

Based on these three scenarios, we describe below how we expect the Bund and UST curve to develop:

Middle: As the ECB hikes once in Q2, short-term rates would remain elevated around 2.25% in 2026 as this part of the curve is mostly driven by ECB expectations potentially slightly higher in Q2 as risks of additional hikes put pressure on rates until the conflict is resolved. The resolution of the conflict would temporarily bring down the 10y Bund to 2.8%, after which it resumes its rising trajectory on the back of higher ECB rates and further increase in the term premium due to the fiscal easing in Germany. As a result, we expect some additional bear flattening until the conflict is resolved and a bear steepening thereafter.

Regarding country spreads, we expect these spreads to slightly widen until Q2 on the back of a still cautious sentiment, and to tighten thereafter. For France, we expect country spreads to increase further from Q4 on the back of heightened volatility due to the upcoming Presidential elections in 2027. This will also likely have some spillovers, especially for Belgium.

Looking at the US Treasury curve, we expect higher 2y UST yields due to higher Federal fund rates compared to market pricing, with some slight bear steepening by-year end given the higher term premium on the back of concerns around a rising US deficit.

Negative: Under the more negative scenario, we would see pressure particularly on the short-end part of the curve, with both the Fed and ECB hiking rates. Hence, we expect a continuation of the bear flattening given the higher central bank rates and lower growth in both the US and the eurozone, which will have a downward pressure on the 10-year part of the curve. We do not foresee any curve inversions in EGB markets as we do not expect a recession, although growth will be lower. In the US, curves should begin to steepen again in Q4 on the back of a higher term premium due to concerns around a rising US deficit.

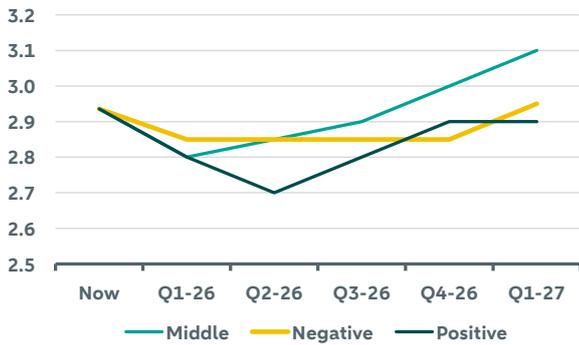
We expect all EGB country spreads to widen. The risk-off sentiment should provide support to Spain vis-à-vis riskier countries such as France and Italy. Despite the fiscal situation in France, Italy is expected to underperform France in moments of rate hikes and heightened volatility. Further supportive to this is the fact that France has a strategic advantage in meeting energy demand in comparison to Italy. France last year exported 90 TWh of electricity as nuclear capacity ramps up following several outages in 2021-2022. During the previous energy crisis (when Russia invaded Ukraine), France was in an unusual situation where many nuclear reactors were shut down simultaneously for maintenance. Hence, the country would be better positioned this time were a second energy crisis to unfold. On the other hand, Italy is the most exposed EU nation to the disruptions around LNG imports coming from Qatar, according to data from BNEF. The country relied on Qatar for 11% of its gas demand in 2025, significantly higher compared to other eurozone countries, and there are challenges around filling up this demand from somewhere else. Nevertheless, as we approach the French presidential elections (to be held in April 2027), we expect French country spreads to widen again.

Positive: Would the conflict resolve quickly, we expect to see falling rates across the entire Bund curve, with a more pronounced fall in the 2y than in the 10y, resulting in a bull steepening by the end of Q2. After that, we foresee higher 10y yields on the back of the German fiscal stimulus, driving a steepening of the Bund curve.

Similarly, in the US, the quick resolution of the conflict, together with the Fed easing monetary policy, should also push yields lower across the entire curve. However, we foresee limited room for additional falling 10y yields thereafter due concerns around the high US deficit. As a result, we expect a curve bull steepening only up until end of Q3.

10y Bund estimates under different scenarios

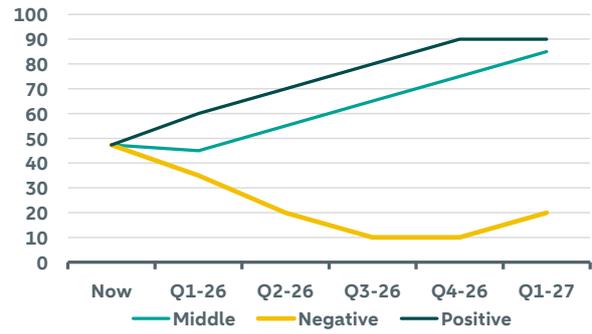
Yield in %



Source: Bloomberg, ABN AMRO Group Economics

2s10s Bund curve estimates under different scenarios

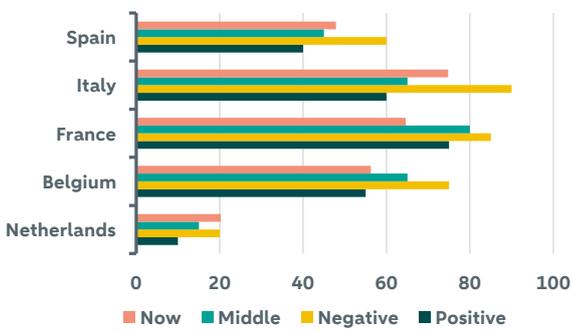
Curve spread in bps



Source: Bloomberg, ABN AMRO Group Economics

EGB spread estimates under different scenarios

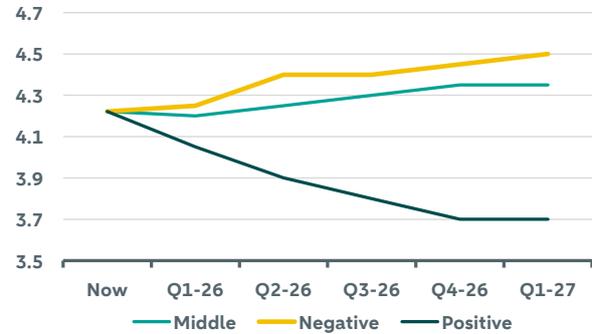
Spread over 10y Bund at year-end (bps)



Source: Bloomberg, ABN AMRO Group Economics

10y UST estimates under different scenarios

Yield in %



Source: Bloomberg, ABN AMRO Group Economics

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