Risks unbalanced as "war premium" fades

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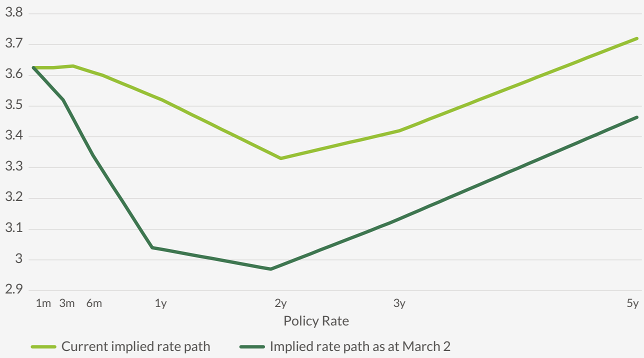
- Interest rate projections have swung violently in response to the energy shock of the Middle East conflict, with US markets understandably showing greater resilience than their European counterparts.
- In our view, risk assets currently appear to reflect an optimistic baseline scenario of an end to the conflict in relatively short order, but risks are unbalanced given the downside from further escalation is greater than the potential upside from resolution.
- Government bonds may have failed to hedge against an inflation-driven downturn in risk assets, but we expect them to do so if markets begin to price a growth shock and we also value their liquidity through volatile periods.

We believe that the war in the Middle East put central banks in a difficult position, particularly after the inflation scars of 2022. While current inflation pressures are not as severe – in 2022 an energy supply shock from the Russia-Ukraine war was combined with a Covid-driven demand shock – inflation in many economies has been "sticky" and remains above target, despite the steady progress of the last few years.

The main mechanism through which markets are expressing progress on the geopolitical front, especially in the Middle East, is the oil price. A closure of the Iran-bordering Strait of Hormuz was essentially a worst-case from a commodity perspective, shutting down a supply route for 20% of the market while also forcing production downtime in the region, and this was before attacks that are said to have damaged production capacity in certain countries for several years.

With oil (going by Brent crude) around 58% higher year-to-date as of April 15, inflation expectations have moved too, and as a result one of the most notable developments in fixed income over the past six weeks has been an aggressive bear flattening of the curve as the market has priced out rate cuts and priced in the prospect of rate hikes (see Exhibit 1).

Exhibit 1: US rate cuts priced out by curve flattening



Source: Bloomberg, 15 April 2026

This poses some interesting questions for diversified fixed income investors. First, with correlations between risk-on and risk-off assets once again positive in a period of inflation-driven volatility, how can we manage government bond exposures? Second, with government bond markets so far pricing in more of an inflation shock than a growth shock from the war, is this consistent with our views on the direction of interest rates?

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	0.52	0.67	3.4	4.4
GBP IG	-0.18	0.77	5.4	5.8
US IG	0.93	0.98	5.0	6.5
EUR HY	0.34	1.02	5.6	3.0
GBP HY	1.33	0.72	8.7	3.0
US HY	1.45	1.54	6.8	3.0
EM HY	2.77	1.35	7.2	3.9
Euro Senior Banks	0.55	0.59	3.3	3.7
COCO	1.37	0.86	5.8	3.6

Gordon Shannon
Partner, Co- Head of Investment Grade, industry experience since 2007.

George Curtis
Partner, Portfolio Management, industry experience since 2012.

Third, with equity markets having largely regained their pre-war levels and credit spreads and having reversed much of their March widening, are risk markets pricing in potential macro risks correctly?

Rates projections have swung violently

Before answering these questions, it is worth looking at what have been some interesting cross-asset moves in more detail.

On the rates side, before the start of hostilities markets were pricing 60bp of rate cuts for the US this year. This had swung to 14bp of rate hikes by late March, and has now reversed again to 8bp of cuts for 2026. The moves in Europe and the UK have been even more extreme, given the vulnerability of energy-importing European economies to an oil shock, particularly given their lower GDP growth than the US. From pricing in 13bp of cuts from the European Central Bank (ECB) before the war, the market now implies 56bp of hikes, having peaked at 80bp of hikes in late March. For the UK, the view has shifted even more violently from 50bp of cuts from the Bank of England (BoE) to 35bp of hikes now, though again this is down from a peak of 85bp of hikes.

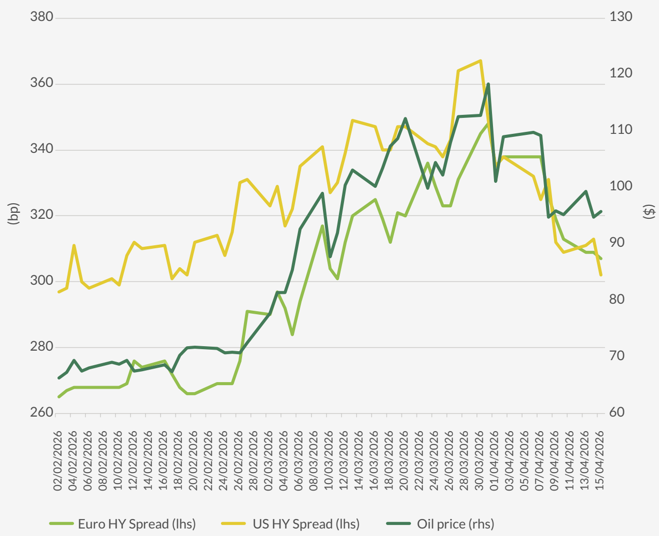
To be clear, some of the pricing dynamics in shorter maturity government bonds have been driven by technical factors. Yield curve “steepeners” – positions that benefit from long end yields rising relative to short end yields – were a crowded trade in early 2026 so the aggressive curve flattening we saw in early March led to a technical unwind of many leveraged holders (such as hedge funds), in addition to the unwind of certain trades in options and volatility markets. But the repricing has also been driven by hawkish central bank talk (particularly from the ECB and the BoE) as inflation expectations spiked.

Credit’s “war premium” has faded

Credit spreads, in a similar vein to rates, have been correlated with the price of Brent crude oil but in many places have reversed all or more of their move wider (see Exhibit 2).

US markets have bounced strongly, with US high yield (HY) spreads at 302bp now 21bp inside their pre-war level, while US investment grade (IG) spreads at 81bp are 4bp tighter. The two indices peaked at 367bp and 94bp respectively, so the reversal has been sharp. European HY spreads on the other hand sit roughly 20bp wide of their pre-war level, while European IG spreads sit a touch inside (the indices peaked at 348bp and 96bp respectively).

Exhibit 2: Credit spreads have followed oil price lower



Source: Bloomberg, ICE BofA Indices, 15 April 2026

Spreads therefore have been reasonably well supported, particularly in IG, and the bounce back has been strongest in the US. Both these things make sense to us under the baseline scenario of a resolution to the conflict in relatively short order, with a more limited economic impact in the US versus Europe and generally resilient corporate balance sheets across the IG universe.

Returning to the three questions we posed earlier, and how we construct portfolios in this environment, the dynamic between rates and spreads has been consistent with a mild stagflationary shock. While we are not geopolitical analysts, we believe the path for a deal is there and both sides are incentivised to find a solution. However, with risk assets essentially pricing in this optimistic baseline scenario, there is an asymmetric risk for investors given the potential spread tightening on a resolution is far smaller than the potential widening if talks were to break down and deepen the oil supply shock.

For this reason, we still favour a cautious approach to credit selection with a bias towards higher quality, with the potential selective layering of hedges (if appropriate for the mandate) to help mitigate spread widening in the downside scenario.

Rates dashboard

			Change (bp)		
		Current %	1w	1m	YTD
US Treasury	2yr	3.71	-9	-8	26
	10yr	4.25	-7	0	13
	30yr	4.88	-3	5	8
UK Gilt	2yr	4.12	-14	-28	39
	10yr	4.76	-7	-8	26
	30yr	5.49	-1	6	27
German Bund	2yr	2.41	-19	-18	29
	10yr	2.96	-10	0	11
	30yr	3.54	-4	9	6

			Change (bp)		
	Market projection	Current %	1w	1m	YTD
Base rate 3.75%	end-2026	3.52	-11	-17	44
	end-2027	3.32	-10	-9	9
Base rate 3.75%	end-2026	3.99	-18	-44	64
	end-2027	2.51	-16	-16	13
Base rate 2.00%	end-2026	2.50	-20	-25	39
	end-2027	2.51	-16	-16	13

Indicative market indices, data as at 15 April 2026. Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour, 15 April 2026.

The tension in government bonds

On the rates side, while government bonds have not been an effective hedge against the downturn in risk assets, government bond curves have tended to hold on to their "war premium" more than other markets. In our view, outright government bond yields can potentially offer attractive carry and upside if markets further price out hikes. We also believe a worsening of the conflict in the Middle East could benefit government bonds, as markets would likely start to price in more of a growth shock and a rising risk of recession than they have so far. Countering this, however, is the negative fiscal dynamic and renewed concerns about government debt levels in many developed economies (which could potentially get worse in a recession), so we expect supply to continue to influence issuance patterns and pressure longer dated government bond yields.

We believe this tension is consistent with the macro regime we have been trading in for the past four years. Rates volatility may remain elevated in an environment of higher inflation and large fiscal deficits. While historically government bonds have different performance characteristics than risk assets during periods of acute growth slowdown or recession, markets haven't really had to test this theory in recent years given generally very robust growth (a corollary of deficit spending).

Government bonds have liquidity value

From a portfolio perspective, government bonds can, at times, be a source of risk within fixed income portfolios. Thus, our aim is to carefully manage duration exposure while diversifying across currencies.

But it is worth remembering the value of government bonds is not just in their ability to hedge a real recessionary slowdown (where inflation can quickly move lower), but also in their liquidity. Our core exposure tends to be credit, so having liquidity in volatile periods when markets are most illiquid is intended to provide valuable flexibility to take advantage of dislocations.

Ultimately at present we think higher quality credit offers attractive yields without taking much duration risk, and our focus continues to be on corporates and financials with highly defensible balance sheets.

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Further Information and Literature: TwentyFour Asset Management LLP
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