



Who's right on oil, commodity or bond markets?

The overarching question now facing financial markets is whether traffic through the Strait of Hormuz, representing 20% of global oil supply, can resume in the near future. Commodity markets have taken a relatively benign view, futures curves indicating Brent oil prices will fall from \$100pb this morning, to \$75pb by early next year. Bond markets have been more cautious, building in expectations of an ECB rate hike by July and persistently higher inflation over the medium-term. Next week's central bank policy meetings will likely deliver a hawkish message, attempting to rein-in inflation expectations, signaling possible rate hikes and mindful of the experience following Russia's invasion of Ukraine when persistent inflation lingered longer than anticipated. However, the key issue remains - when and if, the disruption to oil supply will end?

Commodity markets still point to temporary disruption to Middle East oil supply: The stark reality is that 20% of global oil supply is currently cut-off in the Gulf, with little sign traffic through the Strait of Hormuz will resume in the near future. Yesterday, Brent crude oil prices rose back above \$100 per barrel (pb) with natural gas prices at €51.5 per megawatt hour (mg/hr). Nonetheless, commodity markets still seem to be making the assumption the disruption to energy supply will be short-lived. The futures contract for delivery in March 2027 falls back to \$76.60, and for natural gas to €44.28 (see chart below). However, there is surely a risk oil production is shut down for an extended period. Notably, US Treasury secretary Scott Bessent has now called for an international coalition to escort tankers through the Strait of Hormuz "as soon as it is militarily possible".

Bond markets take a less sanguine view of persistent inflation: Thus far, the equity market reaction has been relatively sedate; the S&P500 (-2.5%), Nasdaq (-4%), Euro Stoxx 50 (-1.3%) seeing moderate falls year-to-date. The dollar has clearly benefitted from safe-haven flows, trading at \$1.145 against the euro this morning. As the prospect of Bank of England rate cuts has receded, a cut on March 19th no longer seen as likely, sterling has also rallied, now at 86.3p against the euro.

The bond market reaction has been more striking. German 10-year bund yields are now 2.95%, close to breaching 3% for the first time since 2011. In contrast to commodity markets, bond investors are now pricing in persistently higher inflation. Not surprisingly, the 1-year euro inflation swap is now at 3%, building-in the first round impact of higher oil and natural gas prices. However, 5-year and 10-year inflation swaps have also risen sharply, to 2.33% and 2.26% (up from 1.83% and 1.96% respectively at end-February).

European Central Bank now seen as raising rates twice to 2.5% in 2026: Options are now fully pricing-in a rate hike from the ECB by July, to 2.25%, with a 75% probability of a second 25bp hike to 2.5% by end-2026. Similarly, for the Bank of England, a 75% probability of one 25bp hike to 4% is implied. The Fed is still, on balance, expected to cut, but now just once with an 80% probability by December. However, market pricing of central bank policy rates has been exceptionally volatile over the past week, in tandem with commodity prices - and will evolve as events unfold.

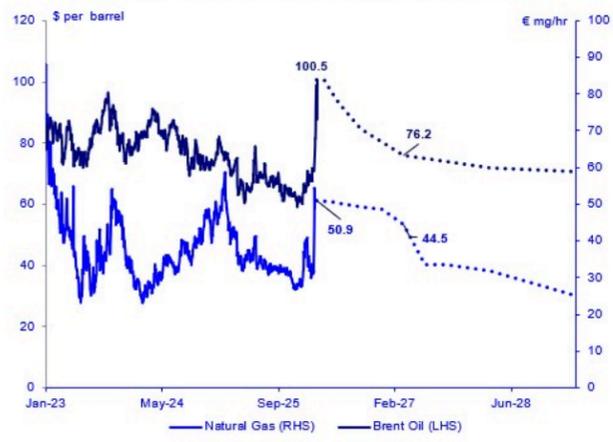
Central Bank policy meetings to deliver hawkish message on rates: No change in rates is expected from the Bank of England, European Central Bank or Federal Reserve next week. Policymakers will no doubt stress the highly uncertain environment. However, the textbook response to an energy price shock is to rein-in inflation expectations - by reiterating commitments to the 2% inflation target and signaling interest rate hikes may be required. Also, the period following Russia's invasion of Ukraine will be fresh in the mind - when central banks were judged to have underestimated lingering persistent inflation - adding to the impetus for a hawkish message or even pre-emptive action on rates.

This isn't 2022/2023: Central Bank's will no doubt be mindful of the experience of 2022/23. However, it is worth remembering Russia's invasion of Ukraine was preceded by the Covid19 pandemic. This was associated with enormous fiscal deficits (exceeding 10% of GDP) and monetary (the ECB's deposit rate at -0.5% and a fresh round of quantitative easing) stimulus. Pent-up demand built-up during the Covid19 pandemic, and supply-chain disruption, were also far more acute. In the near-term central banks are likely to act more aggressively this time around. However, if Brent crude prices fall back sharply, in line with futures curves - the positive impact on CPI inflation could prove short-lived. The key risk however, is that with 20% of global oil production unable to make it's way through the Strait of Hormuz, Brent oil prices could still move, to coin a phrase, 'higher for longer'.

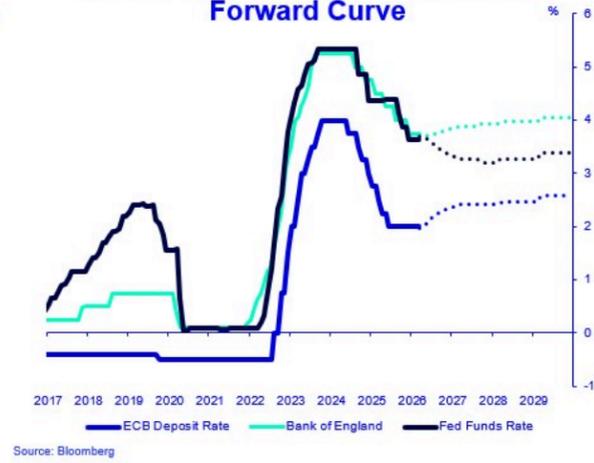
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Energy Prices and Futures Curves



Central Bank Policy Rates and OIS Forward Curve



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