

Unconstrained fixed income views: March 2026: Oil shock raises tail risks as markets brace for volatility



Events in the Middle East mean inflationary pressures are rising and central banks are on alert.

March 2026

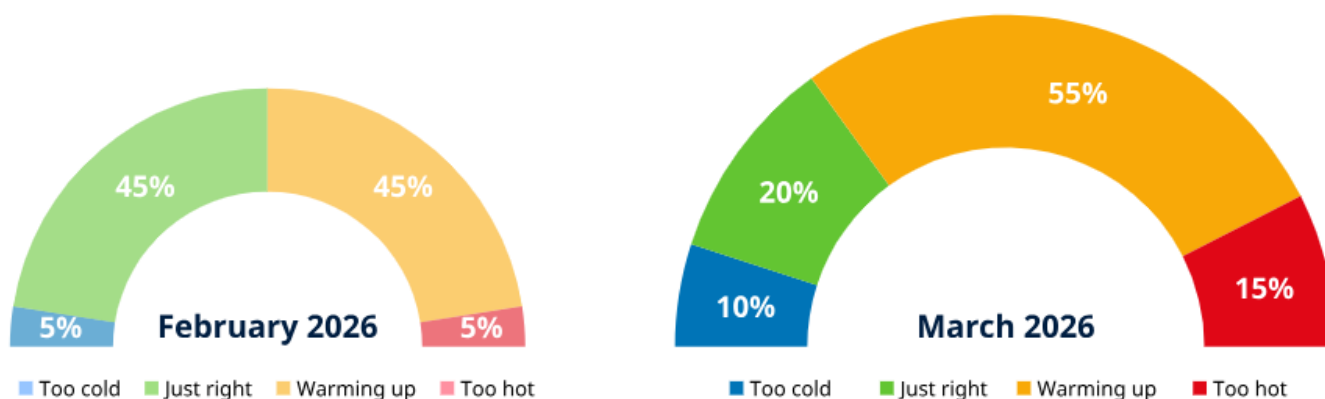
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The Iran conflict has entered its third week and various outcomes remain possible. This makes it difficult to have clarity around the economic and financial market outlook: the world economy will simply look very different if oil is above US\$120 per barrel versus if it is below US\$90.

In this environment the best course of action is to humbly acknowledge what we don't (and can't) know and focus on those geographies and asset classes where we have conviction.

The oil supply shock has seen us widen the tail risks in our probabilities, with both "wings" rising versus February at the expense of the mildly dovish "just right" scenario. Predictably, given the inflationary impact of the oil shock, our "too hot" scenario rose, but we remain lower than the market-implied probability here.

Scenario probabilities: tail risks rising



Source: Schroders, March 2026. 617130

The "too cold" scenario would see the Federal Reserve (Fed) cutting 4+ times in 2026, 2-3 cuts for "just right", while in "warming up" the Fed is only cutting once or is on hold. Finally, in a "too hot" scenario the Fed is moving back towards hikes in 2026, because inflation is becoming problematic again.

Duration matters

That duration (a bond's sensitivity to interest rates) is crucial is a cliché for fixed income investors.

But in this instance, we don't (just) mean bond duration, but the persistence of the current conflict. As above, there are lots of things we don't know about how this will resolve, but we observe markets are currently pricing this as a sharp but ultimately short shock before normalisation. We would simply caution that anything that challenges this thesis will cause further market volatility ahead.

How big a shock might this be?

Given the huge volatility and uncertainty, it is impossible to say how big an impact on growth or inflation this crisis may have. It will vary significantly depending on whether oil settles at US\$80, US\$100, US\$120 per barrel, or even higher.

But we can estimate ranges for how severe the growth and inflation shock will be given different scenarios for oil. Oil stabilising around US\$80 would add around half a percentage point to headline inflation (as measured by the consumer price index), all else being equal. This would imply a headwind to growth, no doubt, but would be unlikely to cause serious alarm.

If we settle around US\$100 per barrel, the situation becomes more difficult. The impact on inflation (and consumers' real incomes) could be closer to 1%, leading to a bigger slowdown in growth. Above US\$120, the risk of recession would be meaningfully higher because that would likely be enough to erode consumers' real income growth.

At least the starting point is better....

Central banks will be closely watching the likelihood of second-round impacts, such as rising medium-term inflation expectations, wages and supply chain disruption. The good news is that the starting point is better than in the 2022 energy price shock after the start of the Russia-Ukraine conflict, when supply chains were already highly disrupted, inflation expectations dis-anchored and wage growth far above target-consistent levels. The war was simply the straw that broke the camel's back.

Across all these domains things are now much closer to equilibrium. That is not to be complacent – this is a major shock and could easily spiral out of control - but we'd rather go into this situation from a good starting point than a bad one. We remain vigilant for signs of second-round inflation effects, but our base case would be these would be much more moderate than last time round.

From cuts to hikes - market pricing has gone pillar to post

Bond markets have repriced significantly since the onset of the Iranian conflict. This is especially the case outside of the US and at shorter-dated tenors, with most central banks now having some degree of hiking priced over the next twelve months having previously priced either cuts or being on hold.

What does this mean for bond portfolio strategy?

Given the volatility and the continued sensitivity to global energy prices, we maintain a largely neutral stance on overall duration, preferring to focus on cross-market opportunities.

Canada is currently our top pick in global duration (interest rate exposure). The economic backdrop – including a weakening labour market and slowing core inflation – appears inconsistent with the two rate hikes being priced by the Canadian bond market for 2026.

We also see opportunities in Australian duration. Here the situation is somewhat different. The economy is strong, but the market is now pricing the Reserve Bank of Australia's policy rate to go higher in 2026 than in the post-Covid peak, despite a materially better inflation outlook now compared to then.

We like to pair both markets against US Treasuries, where rate cuts are still priced in.

We're more neutral on the UK, where the risk/reward is not as asymmetric as in other jurisdictions, such as Australia and Canada, and so we remain neutral for now.

Sitting, waiting, wishing...

We remain patient in asset allocation. Valuations have improved in corporate credit, but remain unattractive overall. We move both investment grade (IG) and high yield globally to neutral from a negative score previously. Given the recent cheapening (both outright and versus US IG), however, we do upgrade US agency mortgage-backed securities back to positive and it is our top pick in asset allocation alongside emerging market local rates.

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