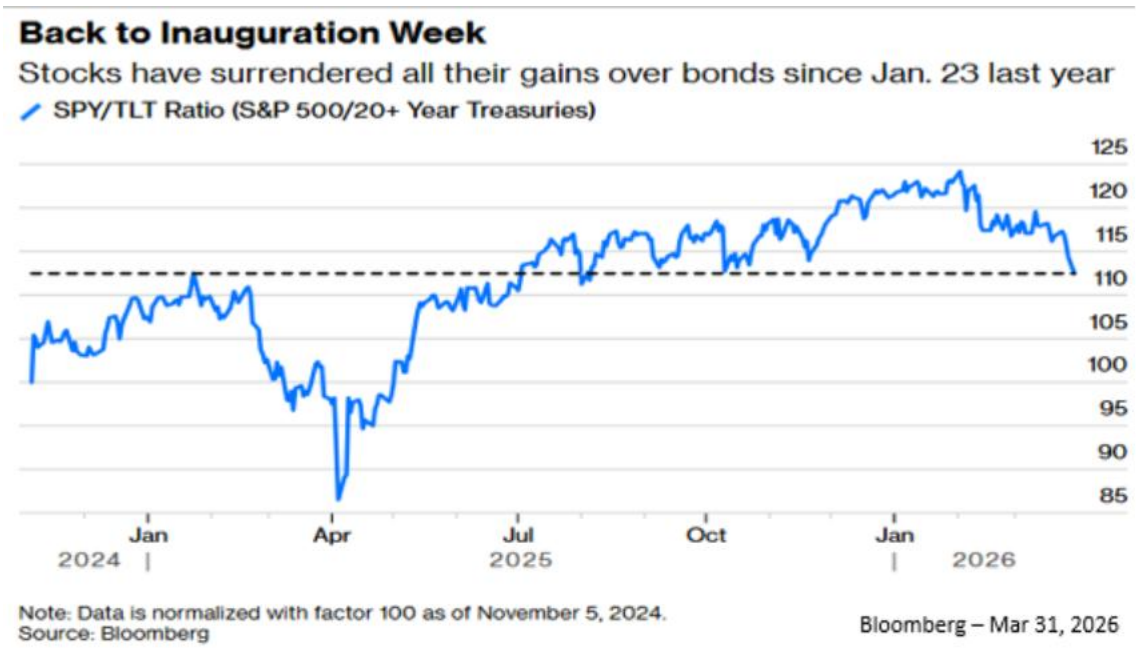
March Market Commentary | War, Oil, and What it Means for Markets

Markets Surrender Post-Inauguration Gains

Markets came under pressure in March, with both equities and bonds trading lower. According to Scotiabank, all global large cap equity indices posted negative returns for the month.

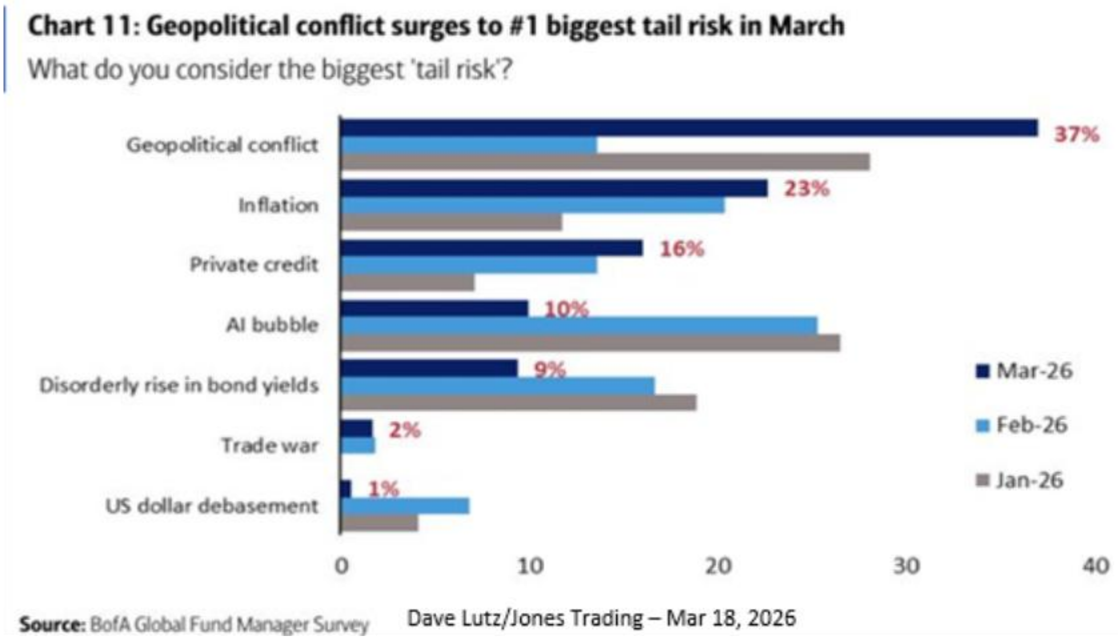
The S&P 500 fell 5.1% (price change, in U.S. dollars) and the S&P/TSX Composite declined 4.6% (price change, in Canadian dollars). Korean large cap stocks were particularly hard hit, losing 25.6%. Bond prices also fell, though by less than equities. The iShares 7-10 Year Treasury Bond ETF declined 0.8% in March, leaving it down 2.6% year to date. Bloomberg notes U.S. stocks have surrendered all their gains relative to bonds since Inauguration Day in January 2025.



Geopolitical Conflict: The Markets Number One Tail Risk

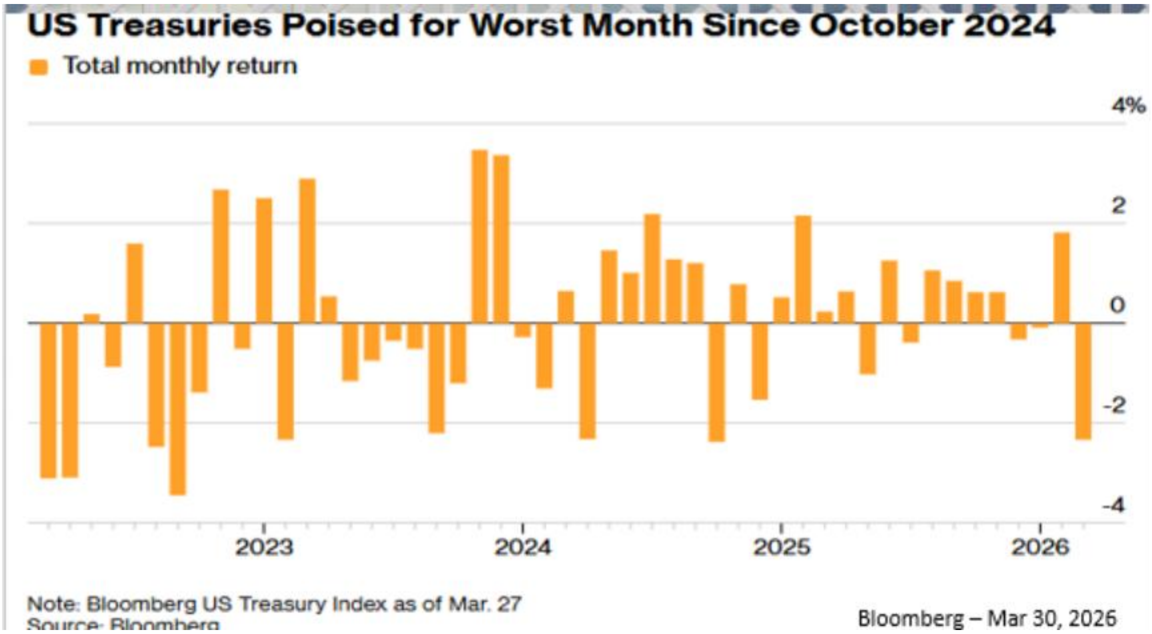
The dominant story last month was the war in Iran and the resulting spike in oil prices. Although markets trended lower last month, the range of possible economic outcomes from the war raises questions about whether traders have become too complacent.

According to a Bank of America (BofA) Fund Manager Survey for March, investors overwhelmingly identified geopolitical conflict as the market’s number one tail risks. Yet, according to Goldman Sachs, only a growth scare due to higher policy rates is currently being discounted. As Bernstein highlights, the current level of U.S. short rates are flagging the highest probability of a US recession in recent memory. At 22%, that probability remains relatively modest. High Yield spreads peg the chance of an economic contraction at zero. In our view, this may be somewhat optimistic. Not that we necessarily see a recession, but zero percent probability seems unlikely.



Treasuries Deliver Their Worst Month Since October 2024

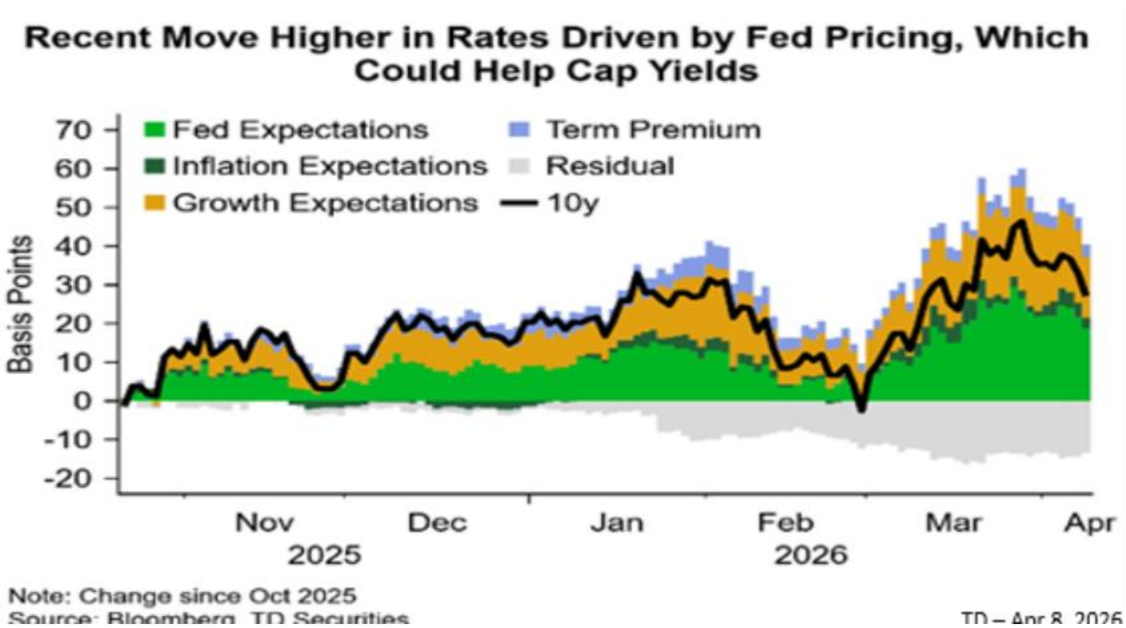
Perhaps the most perplexing development last month was the increase in bond yields (and the accompanying decline in bond prices). As highlighted by Bloomberg, US Treasuries delivered their worst monthly return since October 2024, with longer term yields rising most sharply. A recent Apollo chart shows long-term rates started to diverge from short-term rates since early 2025, producing a steeper yield curve. Bloomberg believes that since the start of 2026, higher 10-year yields have been driven in part by rising oil prices, a correlation Strategas observes is consistent with past energy shocks.



Higher Yields Driven by Real Rates, Not Inflation

This is understandable, given higher oil prices typically translate into higher inflation. However, this is fully what markets are pricing on. Short- term inflation break even rates and inflation swaps have moved higher, but longer-term inflation expectations remain well anchored. As Bloomberg highlights, the combination of higher nominal 10-year yields and stable forward breakeven rates (specifically, the 5-year breakeven rates five years forward) suggests that most of the increase in yields reflect a rise in real rates rather than inflation expectations.

A chart prepared by TD Securities breaks this down further, attributing the bulk of the increase in 10-year yields to Higher Federal Reserve (Fed) rate expectations and stronger growth expectations, with minimal contribution from inflation expectations or term premium (the additional compensation investors demand for holding longer-duration bonds). We also suspect that rising conflict costs and their impact on the growing U.S. deficit may be weighing on bond investors, a concern Bloomberg has also flagged. The Markets' complacent view on inflation likely reflects the belief that the war will be short-lived and its inflationary impact transitory. It is worth noting that this consensus began to shift late in the month, as a resolution to the war looked increasingly unlikely, and the prospect of slower economic growth raised the likelihood of the Fed cutting rates.



Volatility in Fed Funds Rate Expectations

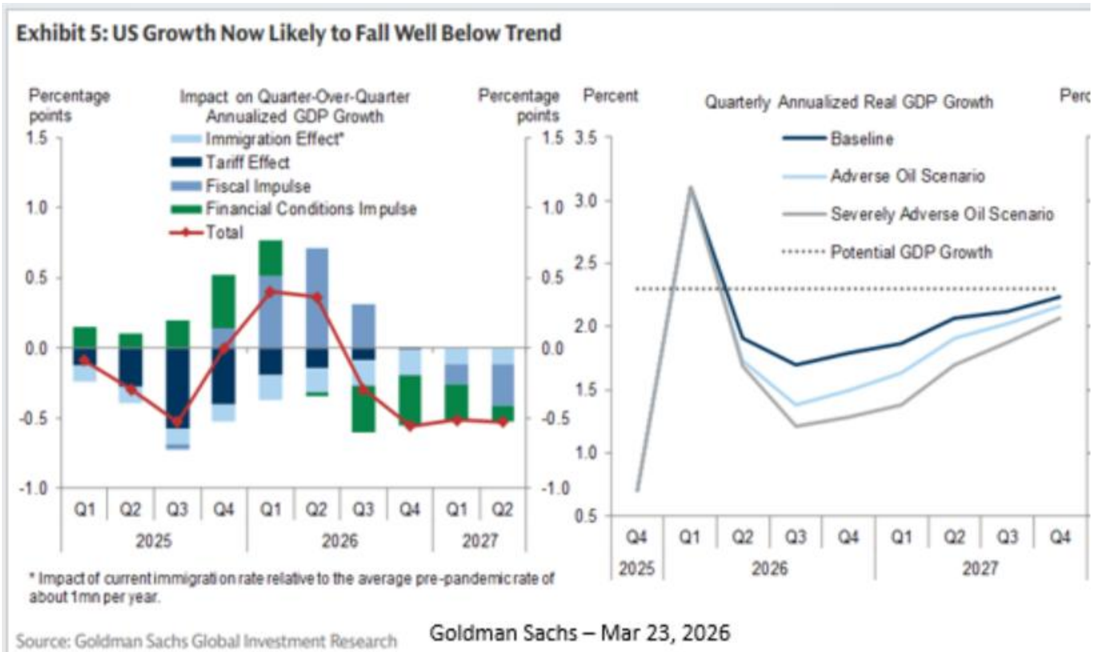
After oil prices, nothing proved more volatile last month than expectations for where the federal funds rate would end the year. At the start of 2026, markets were pricing in two rate cuts, a view broadly endorsed by the Federal Reserve itself. By mid-March, however, Federal funds futures had shifted to pricing in a rate hike by year end. Two-year bond yields, commonly used as an indicator of where the fed funds rate should move in the short term, also traded well above the current effective federal funds rate. By month-end, the prospect of a rate hike had largely faded, but two-year yields remained elevated.

According to BMO, the neutral rate (also referred to as R* or R-Star, the overnight rate that is neither stimulative nor restrictive to the economy) is roughly in line with where the federal funds rate stands today. That may leave room for one cut. Based on Goldman Sachs' assessment of financial conditions, markets may already be doing the Fed's work for it: weaker equity markets, wider credit spreads, higher rates, and a stronger U.S. dollar are all contributing to a recent tightening in financial conditions.

Growth Forecasts Move Below Trend

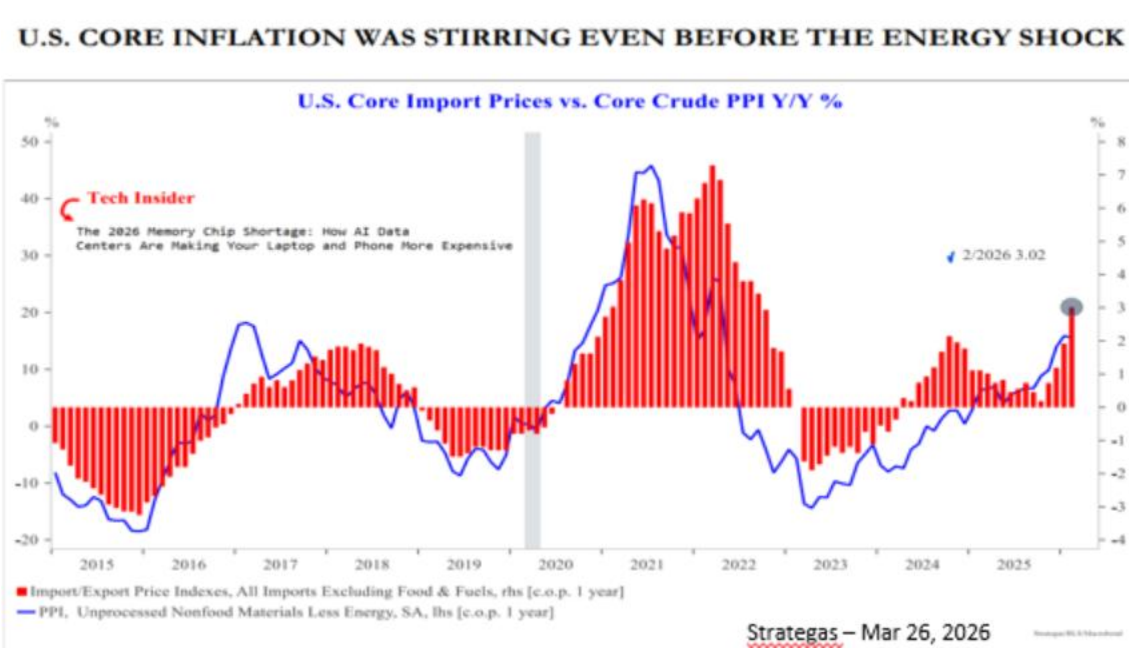
We agree that the Fed is unlikely to raise rates when higher inflation stems from a supply shock rather than excess demand. Demand destruction should eventually bring the oil market back into supply/demand equilibrium, which is why markets began shifting their focus toward growth risks at the end of the month. According to Goldman Sachs, U.S. growth is now forecast to fall well below trend, with tighter financial conditions expected to weigh on the U.S. economy beginning in the third quarter.

Goldman still sees some support from fiscal policy and President Trump's "One Big Beautiful Bill" but expects financial conditions to move from being stimulative to restrictive as the year progresses. The labour market will be a key variable in shaping the Fed's response. U.S. payrolls rebounded in March, but underlying hiring activity remains weak. Fortunately, layoffs, however, have remained low, keeping the job market and the unemployment rate relatively stable, at least for now.



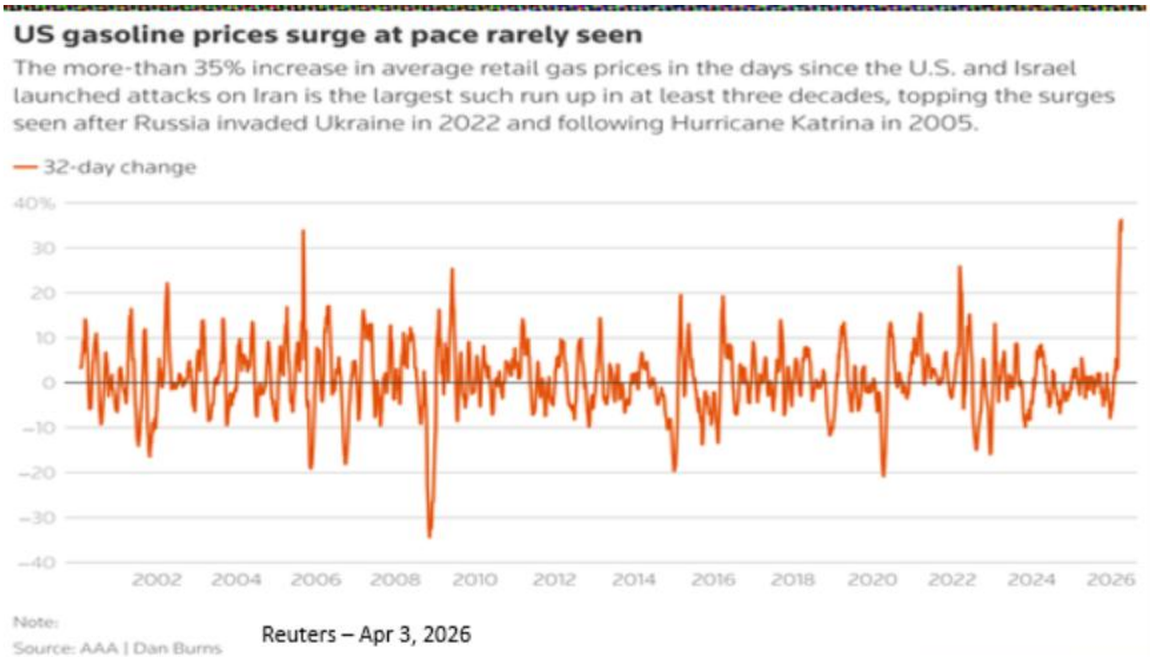
The Other Half of the Fed's Mandate

On the other half of the Fed's dual mandate, inflation outlook also remains uncertain. While the Consumer Price Index (CPI) continues to trend lower, the Wall Street Journal (WSJ) highlights the opposite trend for Core Services Personal Consumption Expenditures (PCE) excluding housing. Strategas recently noted that core CPI was showing signs of breaking higher even before the recent energy shock, with U.S. core import prices, commodities, and (Producer Price Index (PPI) core crude all trending higher. According to Bloomberg, services and core goods are pressuring input costs for businesses.



Gas Prices: The Most Visible Inflation Pressure

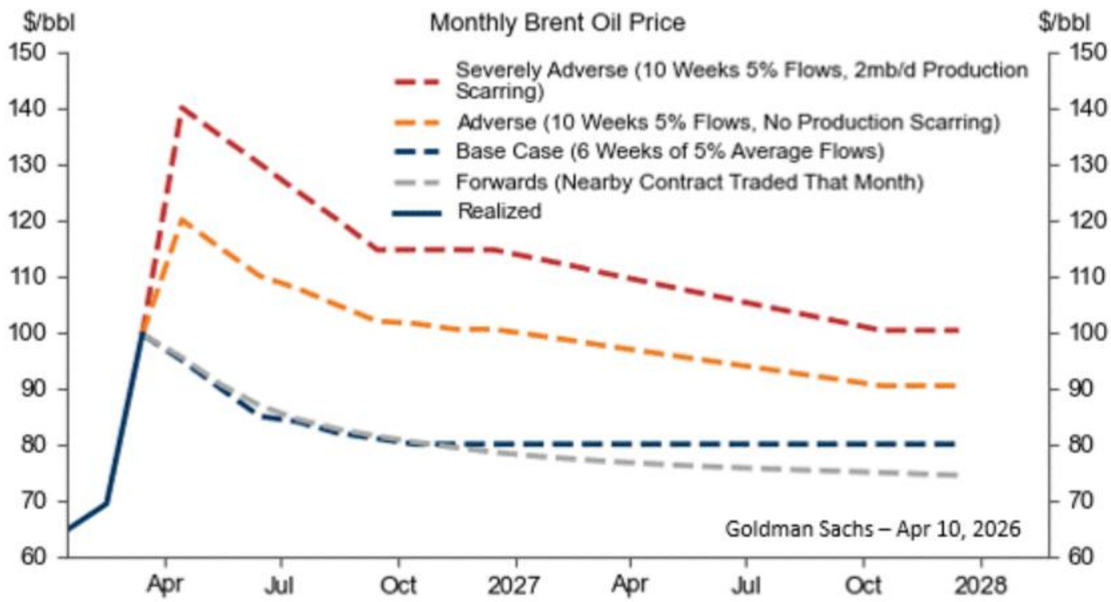
The most visible evidence of inflation for consumers in the short-term is gas prices. According to Reuters, U.S. gasoline prices have surged more than 35%, eclipsing previous pricing spikes such as those seen during the Russian invasion of Ukraine in 2022 and Hurricane Katrina in 2005. Bloomberg estimates higher gas prices could boost headline inflation back over 3% in March, a figure that proved accurate (March CPI came in at 3.3%). While this will come straight out of consumer's pockets, Apollo notes that income tax refunds are currently running approximately 14% higher than last year, which should provide some offset.



Fiscal Tailwind Meets Oil Headwind

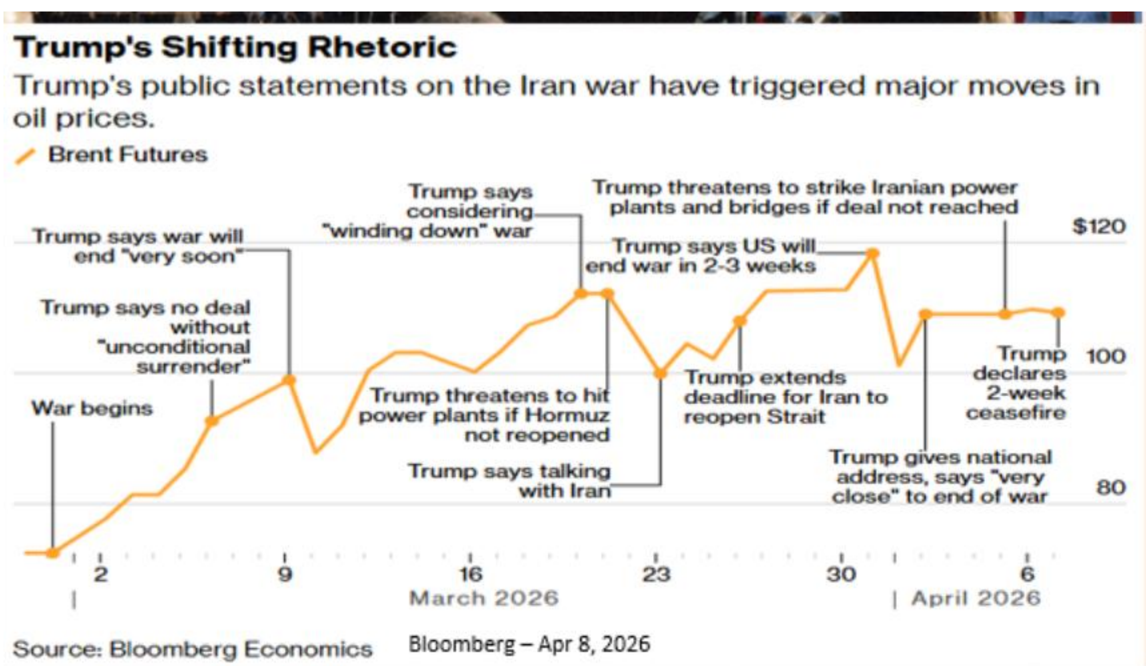
In the short term, the anticipated fiscal policy tailwind is likely to be at least partially offset by inflation and higher gas prices. The longer the war continues, the greater the threat to economic growth. Bloomberg's Macro Man, Cameron Crise, recently highlighted the growing sensitivity of equity markets to oil price volatility. We remain concerned that markets may be underestimating how long the conflict in Iran could persist. Bloomberg has noted that stocks were slow to fully grasp the implications of the 1973 oil embargo, a dynamic that may be repeating itself today.

According to BofA, 36% of Fund Managers expect Brent crude to fall back to a $70-$80 per barrel range by year end. While only 15% see it remaining above $90 per barrel. Goldman Sachs, however, outlines a severely adverse scenario in which disruptions affecting 5% of global oil flows lasting 10 weeks, combined with 2 million barrels per day of impaired production, could push crude above $140 per barrel and keep it above $100 per barrel through next year.



A Credibility Gap in the News Flow

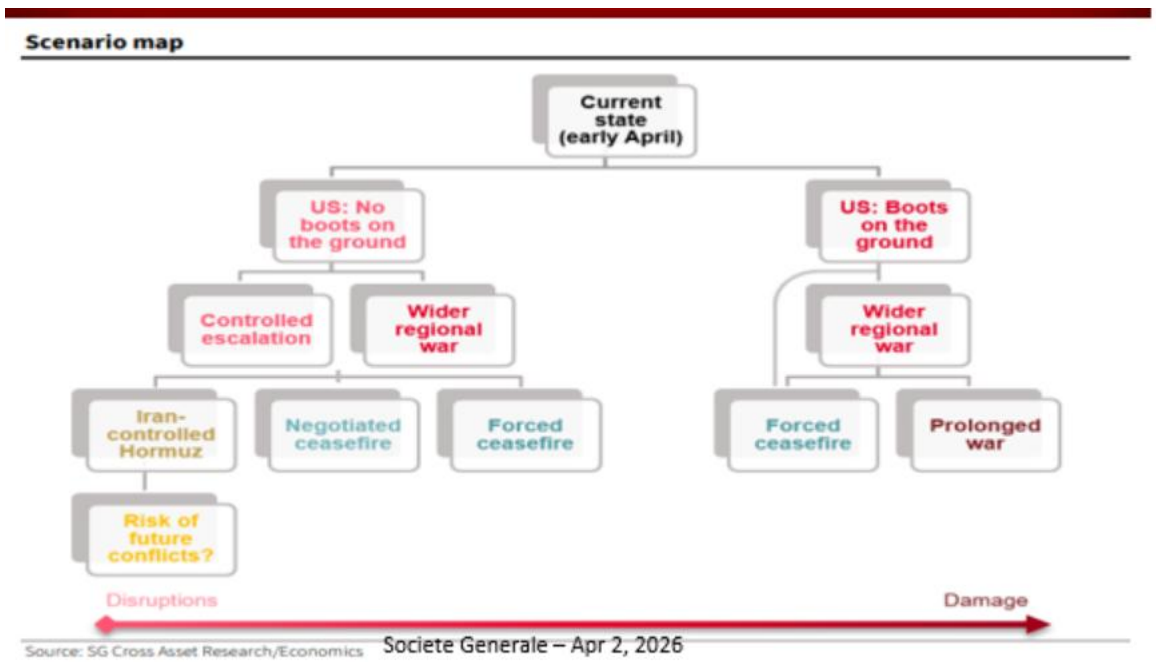
While that scenario represents a severe outcome, it deserves serious consideration given the limited credible information flowing from either side in the conflict. Rhetoric from Iranian leadership is to be expected. More concerning, however, is the inconsistent and unpredictable nature of the public statements from U.S. leadership, including President Trump. This makes any longer-term assessment of the conflict's duration extremely difficult. Stocks have rallied and oil prices have fallen on any hint from President Trump that the conflict may be winding down, only for the President to subsequently threaten to bomb Iran back to the "stone ages" often within the same news cycle.



A Narrow Path to Resolution

Increasingly, it appears President Trump has fallen into a difficult position. To claim victory, the U.S. needs the Strait of Hormuz opened. Iran is aware of this and views control over the Strait as leverage, it is reluctant to surrender without costly concessions. Short of deploying ground troops to secure the Strait (a move that would carry serious political costs to Republicans ahead of the upcoming midterm elections), the two sides appear are too far apart on the terms of any settlement.

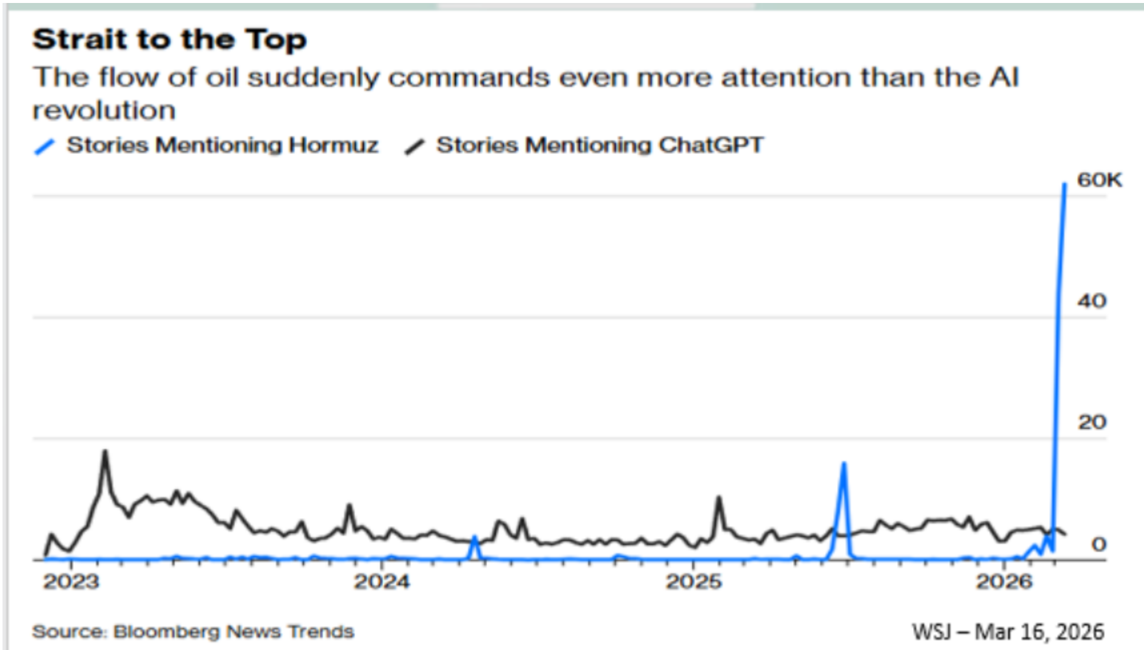
The situation remains highly fluid and could change at any moment. That said, both sides have a strong incentive to end the fighting and reopen the Strait. According to Strategas, Polymarket assigns a 60% probability that the war will end by June 30th, while Bernstein points out conflicts involving major powers tend to be either fleeting or protracted. If it doesn't end soon, it could drag on for an extended period.



Market Moving Against the Bessent Playbook

Economically, this is not the environment that Trump and the Republicans envisioned when they presented their case to voters in November 2024. Treasury Secretary Bessent predicted that the U.S. dollar would weaken, oil would decline, bond yields would fall, and stocks could move higher. Markets appear to be moving against him on all four counts.

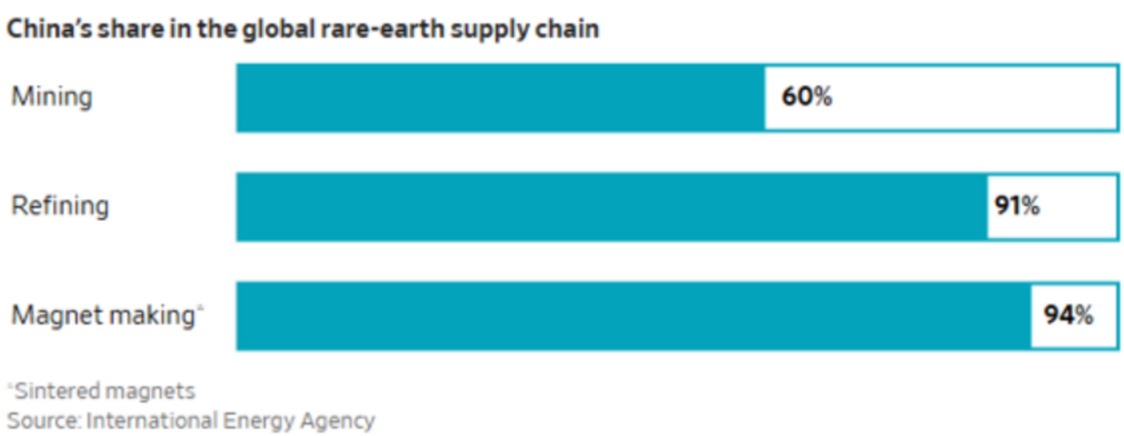
War now dominates the headlines. According to Bloomberg News Trends, global oil flows have commanded more public attention than even Artificial Intelligence (AI) revolution. Tariffs and other political controversies appear to have faded into the background.



Beyond Iran: A More Complicated World

Even if a peace deal were reached, it could take months for markets to normalize, if they ever fully do. The geopolitical repercussions of recent events are likely to be felt well beyond the current administration. As the WSJ highlights, the Strait of Hormuz isn't the only key maritime chokepoint for oil and global trade. Iran has demonstrated the outsized impact that a militarily weaker force can have when it targets a strategically vulnerable pressure point.

China, which cannot be characterized as militarily inferior, has its own sources of leverage, most notably it's near-monopoly in rare earth minerals. The world has become considerably more complex, and that complexity is something many investors find deeply uncomfortable.



Earning Do the Heavy Lifting

What investor do respond to, however, is earnings, and the U.S. market is still forecast to deliver on this front. As highlighted by Sherwood News, last month saw a historic divergence between U.S. stock prices and earnings expectations. According to Bloomberg, rising earnings forecasts alongside falling prices are driving valuations lower. While the S&P 500 may be down nearly 6% from its January 27th high by the end of March, the S&P 500 forward price-to-earnings (P/E) multiple had declined more than 15%.

According to Morgan Stanley, a decline of this magnitude is already in line with prior growth scares. In our view, there's still much to like about this market, just somewhat less than before the war in Iran and its inflationary repercussions began to take hold.