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As this is being written, the Mideast war is still raging, oil prices are skyrocketing, and heightened uncertainty is battering the financial markets. As Federal Reserve chair Powell noted, no one knows how the Mideast war will end or how it will impact the economy. That uncertainty, unsurprisingly, has put policy on hold until a clearer vision of how things will work out comes into focus, something that probably will not happen until the conflict ends and the oil spigot reopens.

The disruption in the oil markets since the war's outbreak has been historically swift and deep, comparable to previous oil shocks in the 1970s and following Russia's invasion of Ukraine in February 2022. Its impact on broader inflation and economic activity, however, has been milder, primarily because the economy has become less energy intensive than it was fifty years ago and is in better shape to absorb the shock than in 2022, when it was still licking its wounds from the pandemic. If the war winds down within the next month or so and the Strait of Hormuz reopens, the lingering damage should be contained, setting the stage for a rebound in the second half of the year even as inflation eases amid falling oil prices.

However, if the war and the squeeze on oil supplies last longer, the pain will be deeper – both on the inflation and growth sides of the ledger. Over time higher oil prices bleeds into broader inflation, boosting inflation expectations even as it saps household purchasing power. Importantly, higher energy prices, particularly at the pump, will force households to make difficult trade-offs. Consumers are likely to cut back on other purchases and draw down savings to sustain spending. But with personal savings rates already at historically low levels, those buffers are already thin so overall spending will suffer, dragging down the economy's growth rate. What's more, the pain from higher gas prices affects lower- and middle-income consumers the most. The knock-on impacts on both energy and food prices would disproportionately burden lower-income households, deepening the bifurcation of the consumer seen over the past several years.

The Fed on Hold – For Now

The Federal Reserve decision to leave interest rates unchanged at its mid-March meeting was never in doubt, so the interest was all in the updated policy statement, accompanying economic and interest rate projections and post-meeting press conference. But the uncertain scale and duration of the energy price shock facing the economy means the updated economic projections could change significantly depending on the course of the war. Indeed, at the post-meeting press conference, Fed chair Powell wryly noted that if there was one time that the Fed could have skipped making projections, this was probably it.

Still, the economic projections do provide useful guidance into the Fed's thinking, which can either confirm or refute prevailing expectations. Despite the obvious inflationary impact from the oil shock, the Fed's projection still calls for a rate cut later this year and another in 2027. Underpinning that forecast is the belief that the oil shock is causing a one-time boost in prices, not a sustained pickup in inflation that would involve recurring sizeable price increases. The Fed hopes that once the conflict ends, oil prices will recede and bring down overall inflation. It can then turn its attention to the growth side of the ledger, which has been weakening amid stagnant job growth and the hit to incomes from tariffs and five years of elevated prices.

At first, the financial markets aligned with the Fed's forecast and even priced in more than one rate cut, believing the downside risk to growth was greater than the upside risk to inflation. More recently, however, that sentiment has pivoted to the other direction, with the markets even pricing in a small – but growing – probability of a rate hike this year. That pivot may or may not come to pass, but it has real time consequences for investors, as market yields have increased since the Fed meeting and stock prices have floundered, with the Dow and Nasdaq entering correction territory in late March.

Bond Pessimism May Be Overdone

Historically in times of amplified uncertainty, risk averse investors flock to the safety of Treasuries. But the world has turned unanimously bearish on bonds, with the 10-year Treasury yield briefly hitting 4.50 percent in March from under 4 percent before the war. We caution, however, that this upsurge in pessimism, which is driven primarily by heightened oil-induced inflation expectations, is not likely to last. For one, surging oil prices is a price shock stemming from a supply shortfall, rather than from excess demand, which is the usual catalyst stoking a sustained increase in inflation. The impact of a relative price shock is usually transitory.

For another, a sell-off in bonds, when combined with a strengthening dollar, is often self-limiting because both tend to constrain demand and ease inflationary pressures, creating the preconditions for a bond rally. What's more, AI-driven productivity growth remains intact and is also inherently disinflationary as well as potential source of job destruction. Indeed, we note a recent comment from Anthropic CEO, Dario Amodei: "50% of all entry-level lawyers, consultants, and finance professionals will be completely wiped out within the next 1–5 years." From our perspective, this implies that graduate students and early-career hires may face a meaningfully more competitive and uncertain entry-level job market.

Finally, while long bond yields tend to be pulled higher by rising oil prices, the end of an oil shock has historically always led to much lower bond yields. This is mainly because an energy crunch is ultimately contractionary for output growth, with only the duration and severity of the crunch determining how much damage it will impart to the economy. Not coincidentally, bond yields have come off their peak as the calendar turned to April, amid growing market concerns over the growth-dampening impact of surging gas prices and chatter that President Trump is willing to end the war even without the reopening of the Strait of Hormuz

Avoiding Past Mistakes

For its part, the Fed is keenly aware of the mistake it made in 2022, when it waited too long to raise rates amid the worst inflation flareup since the 1970s, believing that it would be transitory. Chair Powell acknowledged that there was some discussion of a rate increase at the mid-March meeting should certain conditions evolve. But those conditions are far from being in place, and the prevailing view among policymakers was that they are not likely to evolve.

We agree with that sentiment for several reasons. Most important, the inflationary backdrop is less troubling than in 2022. For one, labor market conditions are far weaker and less likely to stoke a spike in wages than in 2022 when there were severe labor shortages. For another, supply chains are less stressed as the product shortages caused by pandemic related factory shutdowns no longer exists. Finally, housing inflation is retreating, unlike the spiral following the pandemic when remote work drove households to seek larger spaces further away from offices, creating a demand for homes that greatly exceeded the available supply.

That said, it would be a mistake to view the current oil spike as a short-term price shock that will completely unwind when the conflict ends. There is an adage that states oil prices go up like a rocket but come down like a feather. With their knock-on effects yet to fully play out, inflation will be higher this year than expected before the Mideast war. As long as the economy holds up that should keep the Fed on the sidelines, if only to keep inflationary expectations in check.

Possible Scenarios

In times of war, nothing is cast in stone. The prospect of a quick ending looked less likely in late March. Trump's 15-point peace plan was publicly rejected on March 25. Iran, in turn, issued a five-point counteroffer essentially demanding sovereignty over the Strait of Hormuz, war reparations, and binding guarantees against future attacks. These are non-starters. From our lens, the diplomacy is largely performative thus far. Trump has been using the expectation of diplomacy to jawbone markets into calm. Iran is using rejection to signal resolve. The gap between the two sides remains significant, and the U.S. is now sending more troops into the region.

Hence, it might be time to consider the worst-case scenario facing the Fed, in which hostilities reaccelerate, global oil prices average around \$140/barrel for two months, financial market conditions continue tightening, and supply-chain disruptions amplify. Ignoring oil shocks is no longer viable for the Federal Reserve; inflation expectations would rise as second-round inflation effects on food and other goods take hold. Under these conditions, the central bank is likely to raise rates despite slower growth and a weaker labor market, pushing the US into a mild recession in the first half of the year.

Under the most benign scenario, oil prices have peaked but remain elevated through March and April as tensions ease. Should hostilities continue to unwind, oil prices will drift back below \$80/barrel over the coming month, while equity markets reverse their declines and bond yields embark on their time-honored downward path following an oil shock. Under such a scenario, it would make sense for the Federal Reserve to look through the temporary rise in energy prices as inflation expectations would likely remain well anchored. With the economy weaker than before the war, the stage would be set for a resumption of rate cuts.

There is a nontrivial chance of either scenario evolving, but our sense is that the probable outcome will thread the needle. The war will eventually end, hopefully within the next month, leaving oil prices – and inflation – higher for longer and the economy weaker than before the war. However, longer term market-priced inflation expectations have remained anchored until now and should remain so if a near-term resolution of the conflict is struck. While inflation will end the year further away from the 2 percent target than expected, the Fed should view that as a negative supply-side shock and shift its focus towards the growth side of its dual mandate. It is important to remember that the Fed's tools have little impact on supply and are designed to influence the demand side of the economy. With demand destruction from surging energy costs becoming ever more apparent amid a fragile job market, any indication that a ceasefire is imminent increases the odds of a rate cut sooner than later. As the calendar turned to April, positive signs were flashing, stoking optimistic vibes through the financial markets. But unpredictability has been the trademark of the conflict, and investors would do well to stay flexible.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISON

U.S. Treasury Market	Yield %			Total Return (%)	
	12/31/2024	12/31/2025	3/31/2026	1st Qtr.	12 M 2026
3 Mo Bill	4.32	3.63	3.68	0.87	4.05
2 Year Note	4.24	3.48	3.80	0.23	3.55
5 Year Note	4.38	3.73	3.94	-0.14	3.89
10 Year Note	4.57	4.17	4.32	-0.31	3.72
30 Year Note	4.78	4.85	4.91	-0.14	-0.66

Municipal Bonds	Yield (%)			Total Return (%)	
	12/31/2024	12/31/2025	3/31/2026	1st Qtr.	12 M 2026
BB General Obligation Index	3.53	3.42	3.55	-0.32	4.27
BB New York Bond Index	3.74	3.73	3.84	-0.11	4.21
BB California Bond Index	3.50	3.44	3.57	-0.32	4.28
BB Revenue Index	3.84	3.77	3.87	-0.13	4.31

Equities	Levels			Total Return (%)	
	12/31/2024	12/31/2025	3/31/2026	1st Qtr.	12 M 2026
S&P 500	5,882	6,846	6,529	-4.35	17.77
Dow Jones	42,544	48,063	46,342	-3.19	12.23
Nasdaq	21,012	25,250	23,740	-5.82	23.99

Commodities	US \$			Total Return (%)	
	12/31/2024	12/31/2025	3/31/2026	1st Qtr.	12 M 2026
Comex Gold Future (\$ per oz)	2,641	4,341	4,648	6.15	42.38
Commodity Futures (CRB) Index	297	299	372	24.65	20.41
W. Tx Int. Crude Future (\$ per bbl.)	72	57	101	76.49	55.43

Currencies	Levels			Percent Change (%)	
	12/31/2024	12/31/2025	3/31/2026	1st Qtr.	12 M 2026
DXY	108.49	98.32	99.96	1.67	-4.08
Yen	157.20	156.71	158.72	1.28	5.84
Sterling	1.25	1.35	1.32	-1.84	2.39
Euro	1.04	1.17	1.16	-1.64	6.81

Global Bond Markets	Levels			Total Returns USD (%)	
	12/31/2024	12/31/2025	3/31/2026	1st Qtr.	12 M 2026
German 10 year	2.36	2.85	3.00	-2.19	7.57
Japanese 10 Year	1.09	2.06	2.35	-2.77	-9.75
UK 10 Year	4.56	4.48	4.91	-3.44	5.83

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