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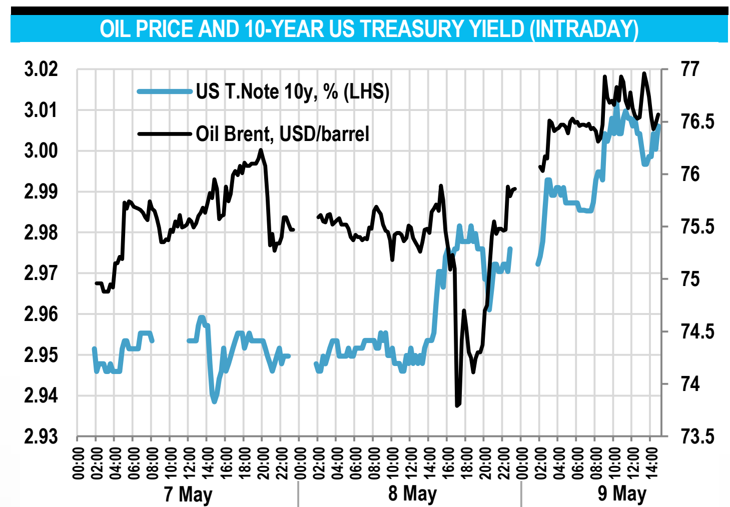
Uncertainty and bad inflation risk on the rise

■ Markets have reacted in a calm way to the US decision to withdraw from the Iran nuclear deal ■ Despite the increase in geopolitical uncertainty, there has been no flight to safety and US treasury yields have followed oil higher ■ Should oil prices continue to increase, this would end up acting as a headwind to growth

On 12 January, President Trump announced that he would extend sanctions relief to Iran for one more 120-day period, adding that in the absence of a renegotiated deal, it would be the last extension. Since the month of February, markets have increasingly anticipated that such a withdrawal might very well happen, pushing up the price of oil. In recent weeks, the correlation between oil and the 10-year US treasury yield has been high. Both have been rising in tandem, although oil was not the only factor causing the 10-year yield to cross the 3.00% barrier at some point. The announcement on 8 May that the United States will withdraw from the Iran nuclear deal and will re-impose sanctions has caused, as expected, an additional increase in the price of oil, reflecting the concern that US sanctions will reduce Iranian supply to the global market.

The withdrawal announcement causes an increase in geopolitical and economic uncertainty but this hasn't impressed equity markets yet, possibly because part of this increase had already been priced in: US equity indices closed unchanged and the following morning, Asian markets were slightly down and some were even up. Europe was higher as well. As a consequence, the flight to safety that might have been expected on the back of the increase in uncertainty did not materialise, which meant that bond markets were driven by the inflation outlook, so on balance, yields moved up a bit.

OIL PRICE AND 10-YEAR US TREASURY YIELD (INTRADAY)



Source: Bloomberg, BNP Paribas

Short term relief that the market reaction was so limited does not change the key conclusion that the world has become a more complex place. If the price of oil were to rise further, at some point concern will mount about the possible detrimental consequences for growth: higher oil triggers 'bad inflation' (originating in the supply side) which may end up causing a stagflationary shock via reduced real spending power of households and a drag on earnings of oil-intensive companies. All the more so in the eurozone where the oil price increase expressed in euro in recent months partly reflects the weakening of the euro against the dollar of about 5% since the end of January. On the other hand, eurozone resilience should be high given the levels of growth, confidence, job creation, income growth and the increase in the participation rate. Finally, central banks would be put to test in deciding whether to react to higher headline numbers or to focus on core.

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