

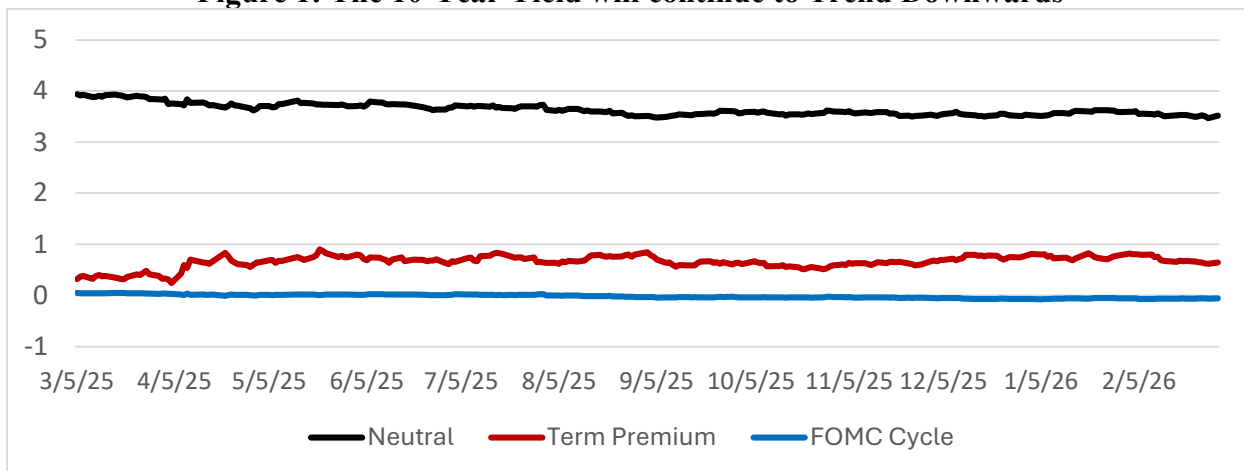
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### The Risk of Higher Oil Prices is Overrated

The war with Iran will have economic effects far greater and persistent than any other geopolitical event since President Trump returned to office. Most of these will be unintended and, for now, the direction of these effects on inflation, growth, etc. is impossible to forecast. We are not surprised that yields have again spiked since the conflict began. Surprisingly, however, this appears to be a response to the risk of higher oil prices, which we believe is misguided.

Markets are repeating an old pattern of responding to Middle Eastern tensions by worrying about higher oil prices slowing growth and bringing back inflation. Once, this was valid; the 1979 Iranian revolution did contribute to stagflation. That is, however, ancient history. **Even \$100 per barrel crude oil would have only a minimal impact on the real U.S. economy, slowing GDP growth by no more than 0.2% and raising unemployment by no more than 0.1%.** And while higher crude prices will mechanically boost headline inflation, we expect no effect on core-inflation. We agree with former Chicago Fed President Charles Evans who wrote “since the mid-1980s, however, sharp increases and decreases in commodity prices have had little, if any, impact on core inflation.” Still, given that the FOMC includes members who remain too concerned with inflation, **we think the next rate cut will have to wait until June.**

**Figure 1: The 10-Year Yield will continue to Trend Downwards**



The risk from the war is instead from the important, but currently unforecastable economic fallout that will emerge. We expected this to show up in higher term premiums (red in Figure 1, estimated by the New York Fed), but these have remained steady. Higher yields instead reflect fears of much tighter monetary policy. Given our views on oil prices, this will not last.

The most important driver of yields remains bond markets' expectations of neutral (black in Figure 1), which have steadily fallen from around 400 bps to about 350 bps. This has grounded our longstanding view that yields will fall. We still believe neutral is just below 300 bps, **underpinning our view that the 10-year Treasury yield will end this year at 375 bps and will hit 340 bps sometime in 2027.** At the same time, the ten-year term premium has oscillated between 50 and 90 bps, predictably rising during periods of heightened economic or political uncertainty before again falling back towards fundamentals. We have largely ignored these fluctuations and expect the term premium to eventually settle around 60 bps, especially now that the Fed's asset sales are over. We also note that the impact of short-term changes in FOMC policy (blue) has remained only a minor factor. This pattern of yields drifting downwards, along with periodic spikes in term premiums, will continue for the rest of the year.

#### **Other Developments in Macroeconomics:**

1. We remain worried that more than 100% of U.S. employment growth over the past year has come from private education and healthcare, with the rest of the labor market having contracted. ADP's February report was better in this regard, but still not good, showing private employment growth of 63,000 with 58,000 in education and healthcare. **Any growth in the rest of the economy has been rare, so the 5,000 increase might be a very early and fragile sign of resumed hiring in the labor market.** If confirmed by Friday's BLS February employment report, we are likely to modestly upgrade our macroeconomic outlook, currently standing at a 55% chance of a U.S. recession within the next year. We are also encouraged by this week's excellent ISM services reading at 56.1% (versus 53.1% expected).
2. Tempering our excitement over this week's good data is the dreary February Fed Beige Book. **The combination of seven districts showing "slight to moderate growth" and five exhibiting "flat or declining" activity suggests that overall GDP growth is slowing.** San Francisco, New York, and Minneapolis reported declines, significant given that San Francisco is, by far, the most populous district at over seventy million people. The Beige Book also notes that "employment levels were generally stable," suggesting a continuation of the low-fire, low-fire labor market. The New February Challenger survey echoes this, finding that while announced layoffs dropped from 108,000 to 48,000, firms also plan to hire few workers this year. Finally, the Beige Book suggested that AI remains

only a secondary driver of weak hiring. We continue to attribute it instead to firms streamlining their payrolls now that the very tight labor market of 2022-23 has passed.

3. U.S. labor productivity grew at 2.8% in 4Q2025 (and 2.2% for all of 2025). Although solid, this is not very informative because it simply is the gap between output and hours. The most interesting aspect of the release is the hours worked measure because it captures an aspect of the labor market not reflected in headcounts. Hours worked have now been stagnant since late 2023, a full year longer than headcount measures. **This hints that firms may have room to stretch their current labor forces before adding new workers.** If so, a recovery in the labor market may not initially fully show up in the more popular BLS and ADP measures, which show headcounts, but rather in hours. As of 4Q2025, however, there is yet no evidence of this.

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