

6 March 2026

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GEOPOLITICAL ESCALATION AND THE BOND MARKET TRAP

Executive Summary

The sudden escalation of the U.S.–Iran conflict in early March 2026 has disrupted the conventional flight-to-quality dynamics typically observed during geopolitical crises. While investors initially sought safety in government bonds, this demand proved short-lived and quickly gave way to a sharp sell-off, pushing yields materially higher. The reversal in bond markets reflects a shift in investor focus toward the inflationary risks associated with rising oil prices, as well as a reassessment of expectations for monetary policy easing by the Federal Reserve (Fed). As markets priced in the possibility that energy-driven inflation could delay or limit interest rate cuts, U.S. Treasury (UST) yields moved higher across the curve. This report examines the drivers of higher UST yields, the evolving Fed outlook, and implications for the Malaysian bond market.

Initial Market Reaction: Flight to Safety

At the onset of geopolitical escalation, investors moved into safe-haven assets, particularly UST. This flight-to-quality demand lifted bond prices higher pushed yields lower, while global equity markets experienced heightened volatility. Such behaviour is typical during periods of geopolitical stress.

However, as the conflict persisted and oil prices surged, market dynamics began to shift. Investors increasingly priced in the risk of higher inflation and a delayed timeline for monetary easing, prompting a reassessment of interest rate expectations:

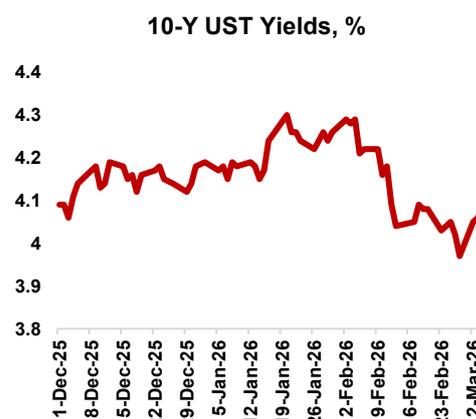
- The 10-year UST yield climbed back above 4%, reversing prior declines.
- Global bond markets such as Europe and UK also saw rising yields as inflation fears spread.

1. The Great Yield Reversal: Why UST Yields are on the Rise

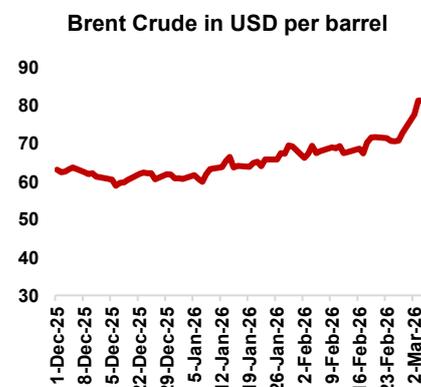
Typically, periods of war or heightened geopolitical tension trigger a rally in government bonds as investors seek safe-haven assets. However, the recent episode has diverged from this conventional pattern. Instead of declining, the 10-year UST yield surged to nearly 4.10%, its highest level in nine months, shortly after the conflict intensified. The safety bid failed due to three primary drivers:

The Inflation Resurgence (The "Energy Tax"): With Iran threatening to close the Strait of Hormuz, a chokepoint for 20% of global oil, Brent crude has spiked toward USD80-USD85. Markets are pricing in a supply-shock inflation scenario. Unlike a typical recession-led crisis, this conflict is viewed as a burning of money, which is fundamentally inflationary. Higher expected inflation weakens existing bond prices and pushes yields up.

Fiscal Deficit Fears and Term Premium Adjustment: The Trump administrations requested earlier this year for a USD1.5 trillion defense budget for 2027 —a 50% increase and significantly higher than the USD901 billion



Sources: Federal Reserve Board, Bank Islam



Sources: EIA, Bank Islam

approved by Congress for 2026, has raised alarms over the U.S. fiscal trajectory.

The nonpartisan Committee for a Responsible Federal Budget estimates that the proposal will carry a USD5 trillion price tag through 2035, ultimately increasing the national debt by USD5.8 trillion when accounting for interest. The organization points out that existing tariffs would likely cover only half of this expenditure, a funding strategy that remains precarious given the potential for the Supreme Court to invalidate a significant portion of those tariffs.

Investors are demanding a higher term premium to hold long-duration debt, fearing that increased wartime spending will worsen an already outsized deficit.

Conflict Duration Skepticism: While the administration initially framed the operation as a limited and targeted engagement lasting roughly four to five weeks to neutralise Iran’s naval and nuclear capabilities, the situation has since evolved more rapidly than anticipated. The intensification of Iran’s asymmetric responses has broadened the scope of the conflict, shifting it from a series of isolated military strikes into a more complex regional confrontation. In particular, the conflict has increasingly centred on critical energy chokepoints such as the Strait of Hormuz, raising concerns over potential disruptions to global oil flows and amplifying uncertainty in energy and financial markets.

Investors can no longer look through this volatility because the risk has transitioned from a transitory geopolitical blip into a structural supply-side shock; sustained energy price spikes are effectively resetting the inflation floor, forcing the Fed to pivot away from its cut-first bias toward a hawkish, higher-for-longer defensive posture.

The uncertainty surrounding the war’s end-date, coupled with mounting fiscal deficits from wartime spending, has forced a permanent repricing of the term premium, ensuring that government bonds no longer serve as a reflexive safe haven but rather as a liability sensitive to the compounding costs of a protracted war of attrition.

Key takeaway: Bond yields are now being shaped more by inflation expectations and policy repricing than by pure risk aversion.

2. Fed Expectations: An Extended Rate Pause

The conflict has effectively boxed in the Fed. The optimism that fueled the market in late 2025 has evaporated as the probability of a June rate cut plummeted from 41% to 31% in just one week.

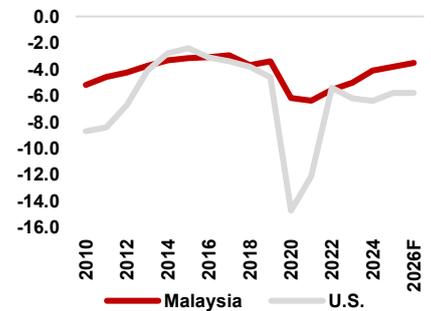
While June rate cut expectations have weakened, the latest data from CME FedWatch remains for two 25bp rate cuts later in the year. However, the timing may shift toward the second half depending on inflation and labor market data.

If inflation moderates sustainably, yields could stabilize or retrace lower. Conversely, persistent energy-driven inflation may delay easing and keep yields elevated.

September is the New June: Markets have now pushed back the first anticipated 2026 rate cut to September with a probability of 44%. Two cuts in 2026 remains a possibility but it is now heavily contingent on the conflict remaining contained. If oil stays elevated, the Fed may be forced into a hawkish pause to prevent second-round inflationary effects, even if economic growth begins to soften.

The UST Yield Curve: We are seeing a bear-flattener where short-term rates remain high due to the higher-for-longer interest rates, while long-term yields rise on inflation and fiscal concerns.

Fiscal Balance: U.S. vs Malaysia, % of GDP



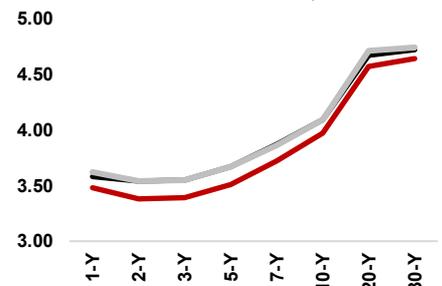
Sources: Office of Management and Budget, Ministry of Finance, Bank Islam

Target Rate Probabilities for Fed Meetings

Meeting Month	Probability (1 Week Ago)	Probability (Current)	Change
Jun-26	41%	31%	-10%
Sep-26	39%	44%	5%
Total 2026 Cuts	2 Cuts	2 Cuts	

Source: CME FedWatch

UST Yield Curves, %



Source: Federal Reserve Board

3. Impact on the Malaysian Bond Market

Malaysia finds itself in a unique position due to its status as a net energy exporter, but it is not immune to the global yield surge. Sustained elevation in UST yields may exert upward pressure on local bond yields, particularly through foreign fund flows.

However, domestic fundamentals—including inflation trends and Bank Negara Malaysia’s (BNM’s) policy stance—will play a critical role. If domestic inflation remains contained, local bonds may demonstrate relative resilience despite global volatility.

Summary of Bank Islam’s 2026 Macroeconomic Forecasts

Indicator	2026 Forecast	Key Drivers
GDP Growth	4.7%	Domestic consumption & tourism (Visit Malaysia 2026).
CPI Inflation	2.0%	Expected to remain benign despite subsidy rationalization.
OPR	2.75%	The central bank will likely focus on balancing growth support with a vigilant eye on inflationary risks.

Sources: Ministry of Finance (MoF), Bank Islam

Fiscal Path: Malaysia’s fiscal trajectory for 2026, characterized by a targeted deficit reduction to 3.5% of GDP, serves as a critical stabilizing anchor for the domestic bond market. The government is committed to improving its fiscal position and continues its consolidation efforts. The fiscal deficit is projected to narrow to 3.5% of GDP in 2026, an improvement from the estimated 3.8% in 2025.

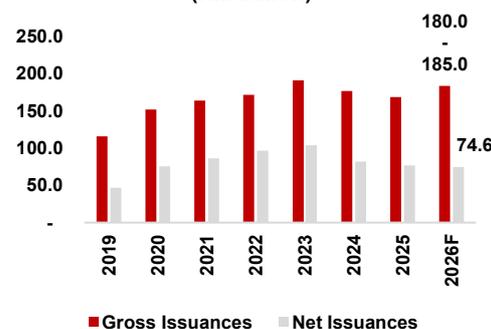
Based on the anticipated maturity schedule and the government’s commitment to fiscal consolidation, we posit that gross MGS/GII issuance will be between RM180.0 billion and RM185.0 billion in 2026. This issuance will be necessary to roll over the RM108.7 billion in maturing debt (MGS: RM46.5 billion, GII: RM59.2 billion) and to fund the projected fiscal deficit of RM74.6 billion, which reflects an improvement over the 2025 deficit of RM76.7 billion.

This disciplined fiscal consolidation contrasts sharply with the expanding U.S. deficit, effectively shielding MGS yields from the aggressive volatility seen in USTs and allowing the market to remain resilient even as global higher-for-longer pressures mount.

Local Bonds Buoyed by Domestic Institutional Support: By the end of 2025, pension funds solidified their lead as the primary investors in the local government bond market, increasing their ownership to 32.0% of total outstanding issues from 30.7% a year prior. Banking institutions maintained a close second position with a 29.3% share (4Q2024: 29.1%). This robust domestic appetite was further reinforced by a broad base of institutional support, including insurance companies, Development Financial Institutions (DFIs), and BNM, which collectively anchored market demand.

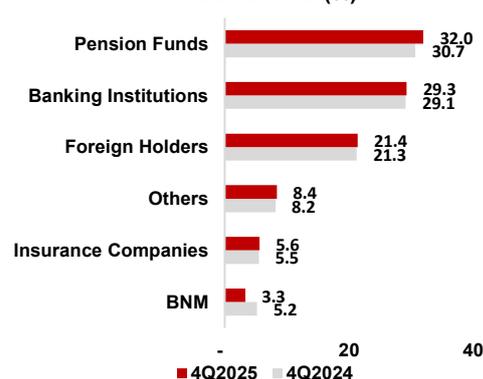
Monetary Policy: BNM is expected to keep the OPR steady at 2.75%. This stability helps anchor the MGS market, preventing the wild swings seen in the U.S.

Gross and net MGS/GII issuances (RM billion)



Sources: BNM, Bank Islam

Ownership Distribution of MGS, GII, MTB and MITB (%)



Sources: BNM, Bank Islam

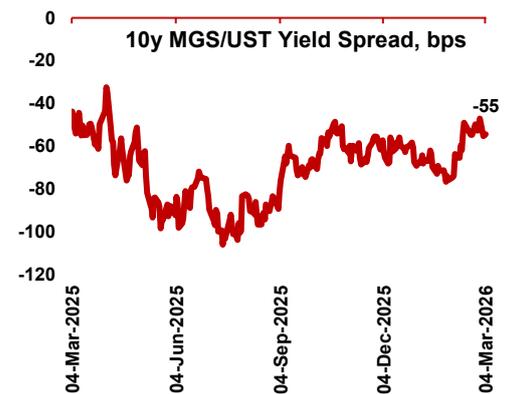
Outlook for Malaysia: The MGS market is expected to remain constructive, albeit with a cautious undertone. Despite elevated global volatility, Malaysia’s ongoing fiscal consolidation, targeting a deficit of around 3.5% of GDP in 2026, alongside a relatively stable inflation environment continues to support the attractiveness of MGS as a relative “safe harbour” within the emerging market universe. However, the sustainability of this supportive outlook will depend partly on movements in global benchmark yields, particularly UST securities. Should the yield differential between UST and MGS widen excessively, it could dampen foreign investor appetite and introduce some upward pressure on domestic yields. As such, while underlying fundamentals remain supportive, market conditions are likely to stay sensitive to shifts in global interest rate expectations and risk sentiment.

Emerging market spread dynamics will also be influenced by global risk sentiment. Any prolonged geopolitical instability could widen spreads temporarily.

Conclusion

The bond market’s initial rally following the U.S.–Iran conflict reflected classic risk-off dynamics as investors sought safety in government bonds. However, this safe-haven demand proved short-lived. As the conflict persisted and oil prices rose, market focus quickly shifted toward the inflationary implications of higher energy costs and the potential delay in monetary policy easing by the Fed. Consequently, yields on UST reversed higher as investors repriced inflation risks and scaled back expectations for near-term rate cuts. The shift toward reduced near-term easing expectations supports a higher-for-longer rate environment in the near term.

Our base case remains for two Fed rate cuts later in the year, contingent upon clearer disinflation trends. For Malaysia, external yield movements will remain influential, but domestic macroeconomic conditions will ultimately determine local bond market direction.



Source: Federal Reserve Board, BNM, Bank Islam