

Major financial fallout from US war on Iran

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25 March 2026

One of the main financial effects of the continuing US war against Iran is the fall in government bond prices and the consequent rise in their interest rate or yield, as investors consider that stagflation—a combination of sharply rising prices coupled with a slowdown or even recession—is becoming increasingly likely.

Bloomberg reported earlier this week that “the spectre of stagflation caused by the Iran war has wiped out more than \$2.5 trillion from the value of global bonds in March,” putting it on course for the biggest monthly loss in three years.

It noted that while the loss in market value in bonds was considerably less than the estimates of the \$11.5 trillion wiped off global stock markets, it was “more unexpected as debt typically gains in times of geopolitical turmoil.”

This is because under so-called “normal” conditions government debt is considered a “safe haven” amid financial turmoil. But with government debt reaching record highs in many advanced economies—led by the US, where the national debt has now topped \$39 trillion—that is no longer the case and old norms are being overturned.

There is a significant move out of US government debt as a new burst of inflation, reflected most sharply in the escalation of petrol and diesel prices, begins to take hold, wiping out the prospect of an interest rate cut by the US Federal Reserve any time this year.

The yield on the two-year Treasury bond, which tends to move in line with expectations of what the Fed will do on rates, has risen by 0.5 percentage points so far this month—a significant hike where movements up or down are usually only a tiny fraction of that amount.

At the same time, the yield on the 10-year US Treasury bond, regarded as a benchmark for markets around the world, has risen by 0.44 percentage points so far this month.

The marked rise at the shorter end of the market has significant implications for the funding of US debt, because the Treasury has been increasingly seeking to obtain funds via two-year bonds to lessen the higher interest rate costs at the longer end. But this strategy is being thrown awry by the rise in rates on two-year debt.

A \$60 billion auction of two-year Treasury debt on Tuesday drew what the *Financial Times* called “tepid investor demand” with the primary dealers—the banks which take up the debt not purchased by other financial institutions and investors—having to absorb the biggest portion of the offering.

The global bond selloff has been most sharply expressed in the UK market.

Gilts, as government bonds are known, have been taking a hammering, even recalling the events of September-October 2022, when the Bank of England (BoE) had to intervene to prevent a market meltdown in the wake of the Liz Truss budget, which attempted major tax cuts for the wealthy and corporations financed by increased debt.

The decision by the BoE last week to keep interest rates on hold, dashing market hopes of rate cuts this year, and its warnings that the war will drive up inflation possibly leading to rate increases, deepened a “brutal sell-off in the gilt market,” according to the FT.

The yield on two-year bonds rose by 0.4 percentage points to 4.4 percent, “making it one of the worst days for short-dated UK government bonds in recent years.”

The yield on the 10-year bond rose 0.11 percentage points to 4.85 percent, its highest level since the global financial crisis of 2008.

Before the war was started on February 28, the market expectation was that the BoE would signal rate cuts at its March meeting, and even after it began there was a hope that it would “look through” the energy price hikes in determining its policy.

Instead, there was a very different message from the

central bank's Monetary Policy Committee, which said that should the surge in energy prices prove "larger or more protracted" and started to feed into wages, it would have to tighten monetary policy.

This was an expression of what is the guiding thread of all central banks in the so-called "fight against inflation," which is concerned, above all else, not with bringing down prices but with suppressing the wage struggles of the working class in response to the hit on living standards.

Yesterday, the president of the European Central Bank, Christine Lagarde, delivered a similar message to that of the BoE. She said it was "too early" to act on interest rates, but the central bank would not hesitate if there were "second-round effects via wages and inflation expectations."

Besides its effect on the supply and price of oil and a whole range of products—such as urea, used for fertilisers, helium, jet fuel and diesel, and a range of other industrial commodities—the war threatens to disrupt the flow of money from the Gulf countries into major financial markets.

In an article in the FT, economic and financial analyst Mohammed El-Erian noted that the members of the Gulf Cooperation Council (GCC)—Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the UAE—"have collectively grown over the decades into one of the most consequential forces in global finance, investing across the world."

The scale of their influence can be gauged from the size of investment commitments into the US from their sovereign wealth funds last year. They amounted to a total of \$3 trillion in a series of multi-year projects, including semi-conductor infrastructure, energy and the military. But now there are reports that some of the GCC members may be reconsidering because of the financial pressures on them created by the war.

The GCC countries are already heavily invested in the US, pumping money into stocks, bonds, hedge funds, real estate and infrastructure to the tune of \$2 trillion.

The anger of some of the GCC business elites was given vent in an X post by the Dubai-based billionaire Khalaf Al-Habtoor earlier this month, in which he asked Trump "a direct question."

"Who gave you the authority to drag our region into a war with Iran?" he asked. "And on what basis did you

make this dangerous decision? Did you calculate the collateral damage before pulling the trigger? And did you consider that the first to suffer from this escalation will be the countries of the region itself!"

In his comment piece, El-Erian noted that "with the energy sector experiencing a 'sudden stop,'" the region faces "unanticipated near-term revenue pressures."

What impact this will have on the US and global financial markets remains to be seen, but any change in global capital flows and a rise in interest rates hits financial markets already experiencing a degree of fragility, due to the surge in government debt and the financing demands of the AI industry.

The net result of "higher for longer" borrowing costs, El Erian concluded, will have a "disruptive impact on virtually every country, corporation and household, which compounds the longer the war lasts. It's an environment that also risks aggravating existing financial frailties—such as those associated with the AI bubble, certain segments of private credit and some sovereign debt concerns—while potentially exposing new ones."



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