

FIXED INCOME ISSUE REPORT

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Global Fixed Income

Bond yields to partially retrace rise

- The US-Iran memorandum of understanding has been finalized (its official signing is set for Jun 19), signaling a clear path towards ending the war.
- Since the outbreak of the conflict, KTB yields have risen more than 60bps.
- Approximately 20bps of this increase stems from war-driven inflation expectations, which expectations should gradually recede.

President Trump has just declared that the deal with Iran is now complete, and Iran's deputy foreign minister has said that an MOU between Iran and the US has been finalized. Although the official signing of the agreement is set for Jun 19, the alignment of statements from both the US and Iran suggests that the war is on the verge of ending.

Bond yield increases to reverse course

As of the morning of Jun 15, 3-year and 10-year KTBs are trading at 3.72% and 4.13%, respectively—both more than 60bps above levels seen in late February, just before the outbreak of the war (3.04% and 3.45%, respectively). Yet, a full reversal of these spikes is unlikely, as: 1) while global oil prices are falling and are likely to stabilize further, the pace of decline is likely to slow; and 2) domestic retail fuel prices take time to drop—gas stations still have older, more expensive fuel in their inventories, and they tend to pass on cost increases faster than cost falls.

The rise in yields cannot be attributed solely to higher oil prices or elevated inflation expectations—stronger GDP growth forecasts have played a major role. Before Korea's 1Q GDP was released, yields on 3-year KTBs stood at 3.36% and yields on 10-year KTBs at 3.70%. Following the positive GDP surprise, the 10-year yield rose 40bps. Based on the robust GDP data and strong export data, Bloomberg consensus now has Korea's 2026 GDP growth at 2.6% (vs 2% previously). Consistent upwards pressure on yields is usually seen when economic growth forecasts are upwardly revised—such pressure should persist, irrespective of whether the Iran war ends.

Given that inflation expectations rose 20bps when the war in the Middle East began, we estimate that roughly 20bps of the total yield increase (since late February) is reversible. Yet, any fall (and stabilization) in yields is likely to be gradual, given that: 1) the GDP growth-driven component remains intact; and 2) with a rate hike still ahead, the markets are still working out a consensus for the terminal rate.

Our baseline forecast for the policy rate remains unchanged: Rate hikes in Jul 2026, Oct 2026, and Feb 2027, for a terminal rate of 3.25%. While market expectations for a terminal rate have drifted above 3.5%, we anticipate that the US-Iran peace deal will serve as a catalyst to draw consensus closer towards our forecast.

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