

When Oil Shocks Last, Long Bonds Feel It

The Case for Staying Shorter, Higher Quality, and Income-Focused

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A lot changed in one quarter.

At the beginning of the year, the market was increasingly convinced that the Fed's next move would be to cut rates. Inflation numbers had been coming down, energy prices had eased, and that showed up in the bond market. Longer-term yields were falling, and the yield curve continued to steepen as investors looked ahead to lower fed funds rates.

That changed quickly.

As the Iranian conflict developed and energy prices moved higher, expectations for Fed cuts faded. Yields rose across the curve, with the short end moving up more sharply during March. The curve is still in a broader steepening pattern, but the quarter was a reminder that inflation risk has not gone away.

Over the trailing year, the short end of the curve still held up better than the long end. The 30-year Treasury yield moved from roughly 4.63% to 4.91%, while shorter rates were modestly lower. That is one reason we continue to believe duration risk remains one-sided. If inflation stays sticky, or if oil prices remain elevated, longer-dated bonds carry more downside risk.

Our fixed income strategy remains consistent. We continue to focus on short-duration, high-quality corporate bonds. Corporate earnings have remained strong, balance sheets are generally healthy, and short corporate spreads have widened enough to create attractive opportunities as bonds mature and we reinvest.

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The main point is that income continues to drive returns. We are not depending on a major decline in rates to produce performance. In a market where inflation remains stubborn and long-term rates remain vulnerable, we believe getting paid to stay shorter and more flexible is the right approach.

The Economic Backdrop

The economy remains more resilient than many expected. Services activity is still expanding, consumer spending has held up, and the labor market remains healthy. Hiring has slowed, but there is no evidence of broad-based layoffs or recessionary pressure.

Manufacturing is also showing signs of improvement after several years of working through the COVID-era backlog and supply-chain distortions. Backlogs have normalized, delivery times have improved, and capital spending appears to be broadening beyond data centers. Reshoring, tax incentives, accelerated depreciation, and R&D-related benefits are all helping support investment.

At the same time, inflation remains the central issue. It has come down from the 2022 peak, but it is still not back to the Fed's 2% target. Sticky inflation measures remain elevated, and core services inflation is still too high for the Fed to ignore.

Federal Debt and Interest Cost Remain a Long-Term Pressure Point

The other issue that continues to matter for interest rates is the federal debt burden.

The U.S. government is carrying a much larger debt load, and a meaningful amount of that debt continues to refinance at higher rates. That matters because interest expense is becoming a larger share of federal tax receipts. We have talked about this before, but it remains one of the more important structural issues in the bond market.

When interest costs consume a larger share of government revenue, it limits policy flexibility. More money goes toward servicing past borrowing, and less is available for defense, infrastructure, entitlement reform, tax policy, or other priorities. It also means the Treasury has to be much more careful about how it manages the maturity schedule of the debt.

There are only a few ways out of the problem. One is to inflate the debt away, which simply shifts the cost to savers and consumers. Another is austerity, which can weaken the economy, reduce tax receipts, and lead to job losses. The better path, though not easy, is to restrain spending where possible while growing the nominal economy faster than the debt burden. That requires real economic growth, productivity gains, and a broader tax base.

This is why we continue to watch both the Treasury's refinancing strategy and the Fed's policy approach closely. If the government can grow the economy while managing the debt maturity schedule, the problem will become more manageable. But if inflation stays elevated and rates remain high, interest expense will continue to pressure the federal budget.

For the bond market, this reinforces our concern about the long end of the curve. Large deficits, rising interest expense, and heavy refinancing needs all argue for a higher term premium. That does not mean long rates move higher every quarter, but it does mean the risk is not symmetrical. In our view, long-duration bonds still require a lot of confidence that inflation will fall, deficits will narrow, and the market will remain comfortable funding the government at today's rates.

That is not a bet we are eager to make.

Oil Adds Another Layer of Risk

The Iranian conflict adds another layer of inflation and rate uncertainty.

The first-order impact is straightforward: higher crude oil, gasoline, diesel, jet fuel, and freight costs. If the conflict is short-lived, the Fed can likely look through it.

The larger risk is duration. The longer the shock persists, the more likely it is to spread into freight, food, chemicals, utilities, wages, and inflation expectations. That is when a temporary oil shock becomes a broader inflation problem.

The U.S. is in a much better position than it was in the 1970s. Back then, the U.S. was heavily dependent on imported oil. Today, the U.S. is a net energy exporter, and our direct dependence on Middle Eastern oil is limited. That is a major difference.

But oil is still a global market. Europe and Asia are much more dependent on Middle Eastern supply, and if those regions face shortages, global crude and refined product prices will rise. U.S. refiners will sell into the highest-margin markets, which means U.S. consumers and businesses still feel the impact even if our domestic supply position is stronger.

So the question is not whether the U.S. is as vulnerable as it was in the 1970s. It is not. The question is whether the disruption lasts long enough to drain inventories, force production shut-ins, and keep prices elevated. That is what would make the inflation problem more serious.

AI and Productivity

One possible offset to these inflation pressures is productivity. AI adoption has moved quickly across technology, finance, manufacturing and even government. If AI allows companies to produce more with the same resources, it could help offset some of the inflation pressures coming from reshoring, higher energy costs, tighter labor markets and fiscal deficits.

But we are still early. There is a lot of discussion about AI replacing jobs, especially in technology, but some of that may simply be companies normalizing headcount after over-hiring during the COVID period. For now, AI is more of a medium-term productivity story than an immediate solution to sticky inflation.

Bottom Line

Our view has not changed.

Inflation is likely to remain stickier for longer. The Fed may not have as much room to cut rates as the market expected earlier in the year. The Iranian conflict adds another source of energy-price and inflation uncertainty. And the federal debt burden adds a structural reason to be cautious about longer-term rates.

In that environment, we continue to favor short- and intermediate-duration bonds, higher coupons, and high-quality corporate credits. We want to be paid through income rather than rely on falling rates to generate returns.

Position accordingly: short duration, liquid, high quality, and focused on capturing yield while limiting unnecessary exposure to long-end interest rate risk.

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