

Dropping in to See What Condition Financial Conditions Are In

Report for the Week ending 04 April, 2026

Dylan Smith

Key Takeaways

- **MONOLOGUE:** The Iran war remains an unstable equilibrium with binary outcomes. Markets are captive to every hint of progress on the Strait of Hormuz, and this week's news flow was taken as a green light for a rebound.
- **MACRO:** The US labor market entered the war in decent shape. Payrolls rebounded by 178k, unemployment ticked down to 4.3%, and claims are at three-year lows. Globally, inflation is following expected patterns: European headlines jumping while core holds, Japan insulated by subsidies, and US expectations climbing.
- **MARKETS:** Stocks posted their first weekly gain since the war began, led by tech. WTI crude inverted its traditional discount to Brent on a "security premium" for deliverable US barrels. Gold rallied alongside risk assets.
- **MEMO:** Financial conditions are tightening from highly accommodative to neutral — not enough to cause a recession, but sufficient to freeze the nascent M&A recovery. Value exists in underpriced assets for those with patience and risk tolerance.

Monologue

This week we've reserved our best work for the Macro Monitor and Memo sections, so I'll keep the editorializing short and sweet.

There isn't terribly much to say, sadly. Global markets are captive to any hints as to the progress or lack thereof toward a re-opening of the Strait of Hormuz. For all the *Sturm und Drang* driving intraday volatility – hot-and-cold statements from President Trump, threats on economic and civilian infrastructure from both sides, and now the downing of two US aircraft and yet another 48-hour "or else" deadline from the President – the situation has changed little over the past few weeks. Iran controls the Strait, and the US is being drawn into a gradual escalation as it fails to find the leverage needed to secure a ceasefire on terms that it can accept.

This situation may persist for some time, but it is a fundamentally unstable equilibrium with binary outcomes. Either a ceasefire will be found and market conditions will begin to normalize, or it will escalate out of control, in which case we must adjust to a long war and a new economic reality. That the tipping point between these two outcomes depends on the unpredictable caprice of one man is the defining challenge of our times.

Speaking of economic reality, our Memo this week takes a deep dive into the tightening of financial conditions that has resulted from the war. We look at the extent, shape, and impact of the tightening, concluding that (so far) it's not recessionary, but will put the brakes decisively on the still-young M&A and private equity recovery. We may have to delay that narrative for another year and muddle through once again.

As our analysis of the state of the labor market on the eve of the Iran war in the Macro Monitor section shows, we're in some ways very lucky that the US economy was in relatively good health when this shock arrived. The outlook from here depends on how long the war lasts (as I'm sure everyone is tired of hearing by now).

Markets seem to have picked up a similar message this week, with something of a mini-recovery taking hold as investors moved into market segments that have looked oversold, notably US technology stocks. I would caution against complacent dip-buying unless you have a very strong view on President Trump's ability to pull a

ceasefire out of the hat — those will be the assets that will fall first if the negative binary discussed above is that one we end up in.

With that, enjoy this week's note.

Dylan Smith

Founder and Chief Economist

Marginal Movers

Rising 📈

- **Prices:** [The Effects of Tariffs on the Components of Inflation](#) — A sector-level explanation for delayed tariff pass-through based on data from multiple advanced economies.
- **Good old-fashioned industrials:** [European PE refocuses on tangible assets amid AI uncertainty](#) — "PE investors in Europe are turning to the old economy, as AI disruption and heightened geopolitical uncertainty underscore the importance of tangible assets."

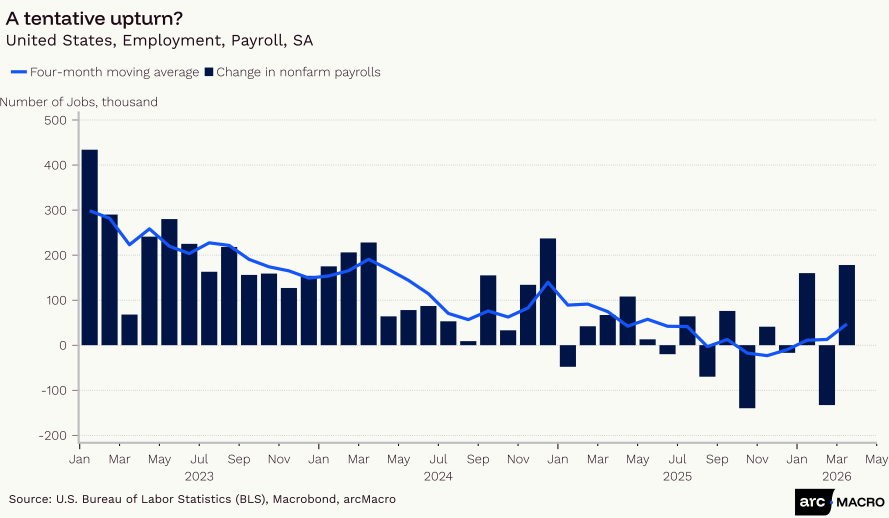
Falling 📉

- **Financial advisors:** [Wave of private debt cash-outs lays bare role of wealth advisers handling alt investments](#) — Don't blame the business model, blame the salesman.
 - **Treasuries:** [Decoupling Dollar and Treasury Privilege](#) — Forget "dollar debasement;" the problem is an oversupply of US Treasuries: "while the U.S. dollar exhibits strong convenience post-Global Financial Crisis, the U.S. Treasury convenience has not only declined substantially but has turned negative, most strongly so at medium- to long-term maturities." Bonus: [deep historical perspective](#) from The Economist.
-

Macro Monitor

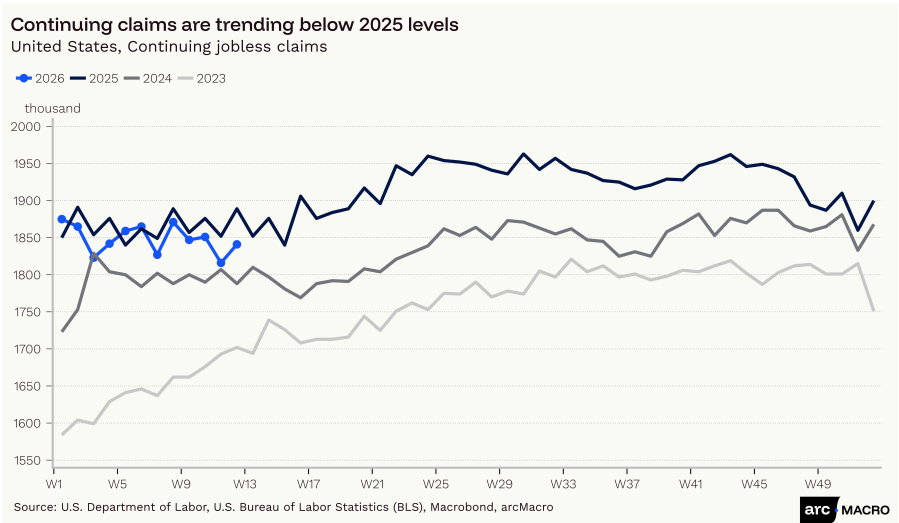
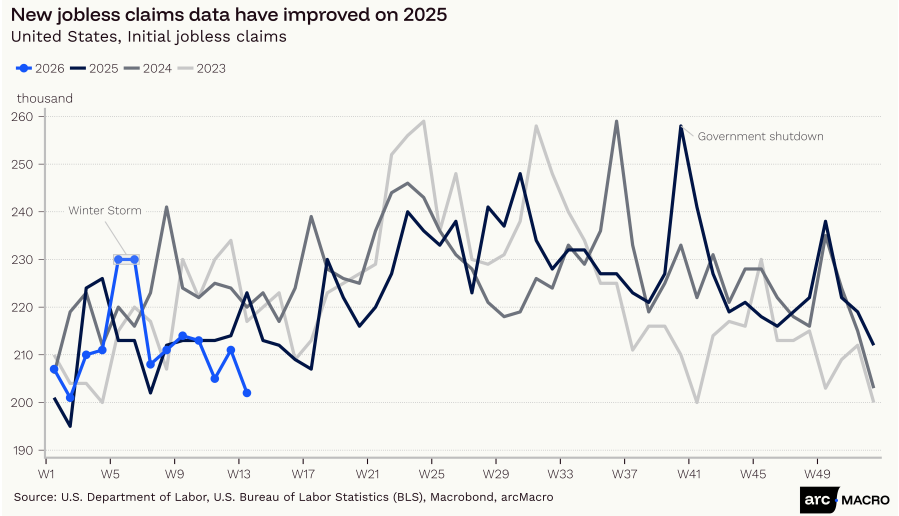
Marginal labor market improvements

As expected after February's surprise decline, US job growth rebounded in March. The monthly change in nonfarm payrolls went from a decline of 133k in February to a gain of 178k in March. Smoothing through the wild swings this year, net job growth is averaging a healthy 73k, and has picked up from what looks like a low point in the second half of 2025.

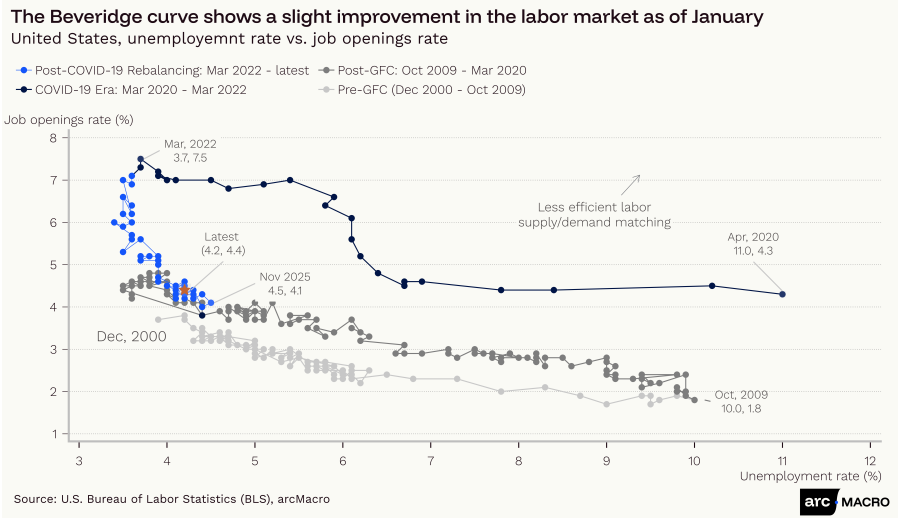


With so much volatility creeping into the payrolls survey that collects the NFP data, it's worth looking elsewhere to assess the health of the labor market, with the serious caveat that none of these data capture the initial impact of the Iran war. That said, labor markets move slowly, so it will be the last place we see the impact of the war on economic activity.

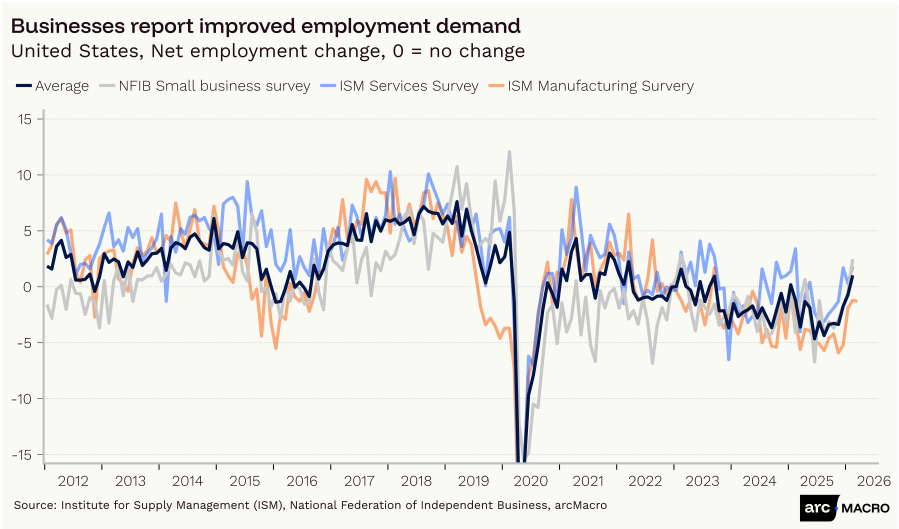
The unemployment rate declined in March, dropping by 0.1 percentage points to 4.3%. Furthermore, real-time tracking of job losses from unemployment claims has been lower in the first quarter of 2026 than they were at any point in the last three years. So much better, in fact, that continuing claims (which measures ongoing unemployment after initial claims are filed) have fallen appreciably below 2025 levels.



Looking at hiring and firing trends shows we're still in a "frozen" market, with hiring below recent trend and drifting down, but economy-wide layoffs very low, even by pre-COVID-19 standards. The best summary of where the labor market currently stands is provided by the Beveridge curve, which plots the unemployment rate (labor supply) against the job openings rate (labor demand — the percentage of vacant positions as a share of total filled and unfilled positions). We've seen an improvement since November, with the labor market looking very much how it did just before COVID-19. Not the overheated market of 2021-2024, but also nothing to panic about.



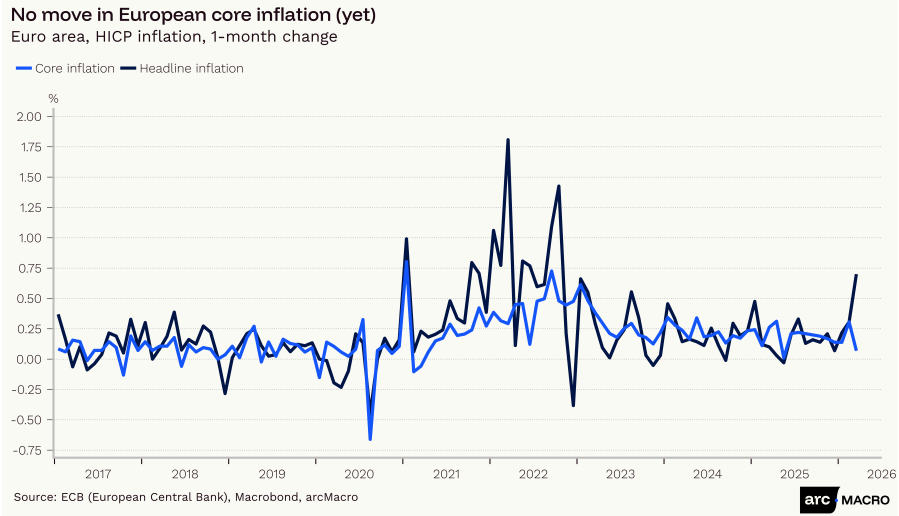
And a final, positive data point from before the Iran war started: surveys report that Main Street has been hiring rather than retrenching staff for the first time since 2023.



Inflation patterns begin to emerge

Over the past week, we’ve received official data that gives us some insight into the size of the inflation shock from the Iran war, how quickly it’s spreading, and how it might affect economic activity.

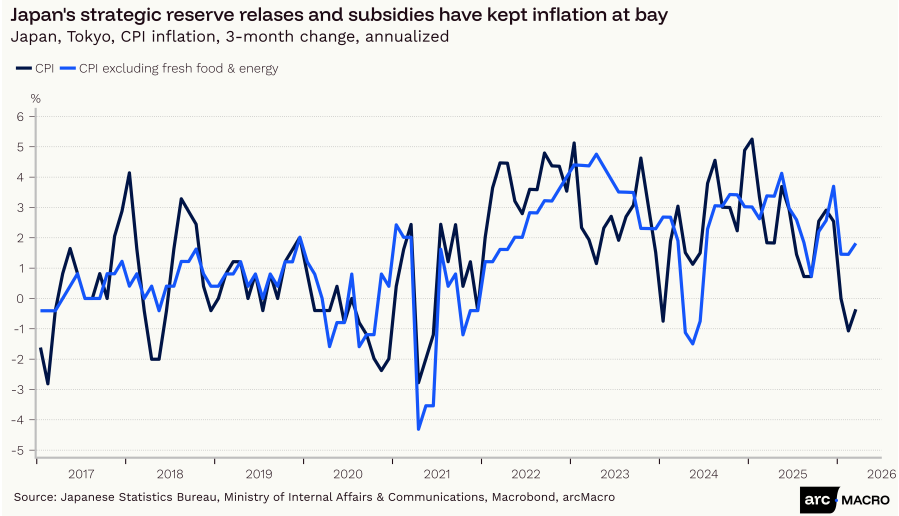
European consumer price data for March showed a sharp jump in headline prices (+0.7%, the largest monthly rise since October 2022). But core inflation actually fell. However fast this shock moves through the economy, it’s still following the expected transition patterns.



That said, sentiment is holding up well in Europe, with survey respondents appearing less concerned about Iran than they were about Russia in 2022.



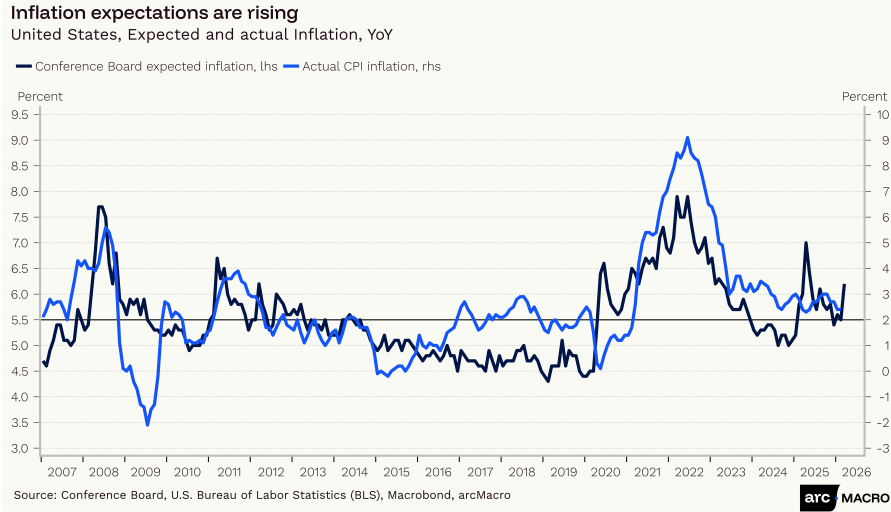
Japan's inflation data shows no impact at all — testament to the effectiveness of oil reserve releases and subsidies aimed at cushioning consumers from the effects of the war.



Not so in China, where the PMI survey covering March is showing firms facing a significant increase in input prices, with selling prices drifting up too.



We don't have March inflation data for the US just yet, but the most important metric for those watching interest rates is inflation expectations. The Conference Board's latest report on expectations does indeed show an increase in 12-month expected inflation from 5.5% to 6.2%. That's still far smaller than the 7% expected after the "Liberation Day" tariff announcements, but we know that actual inflation increases expectations, so this number is likely to rise.



See the appendix for arcMacro proprietary Factors and the Key Macroeconomic Indicators tracking chart.

Market Monitor

The most striking market move this week was the inversion of the typical discount that WTI crude oil trades at relative to Brent crude. WTI is now at a premium. Partly this is a technical phenomenon – the first Brent contract has rolled to June, while WTI is still for delivery in May. This usually doesn't matter, but there are a deeper force at play. US-produced WTI crude oil has gained a "security premium" on demand for immediately deliverable physical barrels, as questions over the deliverability of Brent intensify with the Strait of Hormuz closed to tanker traffic. The demand shift from Brent to WTI has been large enough to invert the traditional discount.



Benign week-on-week moves have once again masked a high degree of underlying volatility in global markets. After initially selling off, equity markets closed the week higher as a combination of soothing words from President Trump (equity markets are still highly sensitive to his pronouncements of progress in the Iran War) and increasing conviction that some industries now look oversold, supported risk appetites.

The S&P 500 rose by 3.4%, with Information Technology (+4.6%) and Communication Services (+6.4%) the strongest performers. In a reversal of recent trends, the Energy sector sold off. The Nasdaq rose by 4.4%, beating both the more cyclical Dow Jones Industrial Average (+3.0%) and small-cap Russell 2000 (+3.3%).

As we noted last week, the precious metals markets looked set up for positive correlations between risk appetite and prices to persist for a while. Consequently, the price of Gold was up by \$135 per ounce, or 3.0% this week.

Sovereign fixed income moves were small and mixed, with changes in major global 10-year benchmark rates ranging from -10 to +2 basis points. In the US, investment grade corporate spreads narrowed, diverging from the higher-risk leveraged market, where B-rated spreads were essentially flat. The DXY US dollar index closed the week 0.5% weaker.

See the appendix for the market monitor table

Memo

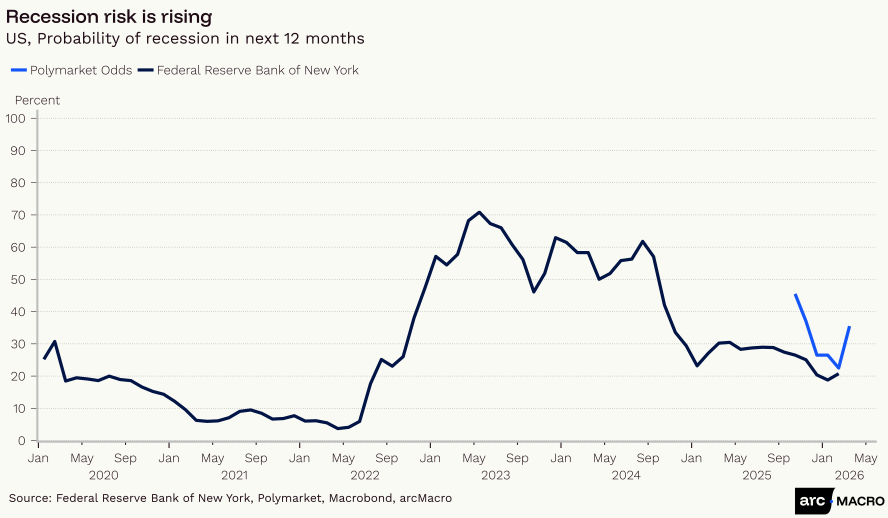
How Much Have Financial Conditions Tightened?

Bottom line: The effects of the Iran War on the US economy will be felt through the financial conditions channel before consumers and businesses retrench spending due to higher inflation. At present, financial conditions are moving from highly accommodative to neutral.

What it means for investors: The tightening in financial conditions that we've witnessed so far is not enough to cause a recession, but it will be sufficient to dampen enthusiasm for M&A activity and scupper marginal investment spending, just as that area of the economy was heating up. There is value to be found in underpriced assets for those with a higher-than-average risk tolerance, but some patience will be required to realize those returns.

Since the Iran war started on February 28th, US recession odds have risen steadily. According to Polymarket, the probability of the US entering a recession this year is up from 22.5% on the eve of the war to a one-in-three chance now. Slower-moving market-based measures, such as the New York Fed's estimate, are still around 20%.

It's notable that all measures are still lower than they were in October 2025, and very far below the 60%+ levels we saw in 2023-24 when interest rates peaked. That recession did not happen.



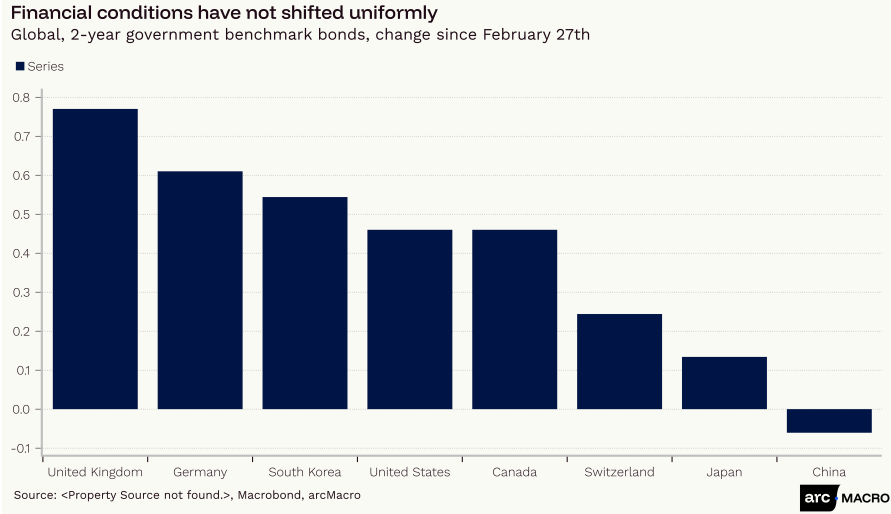
One reason the odds of a recession are still assessed as being below 50% is that the US economy went into the war looking fairly healthy. What's more, the path to a recession scenario requires several sequential assessments that lower the overall odds. The debates currently swirling in the public square center on how long the Strait of Hormuz will be closed, how high inflation will rise conditional on this, and (a second conditional), how much spending will be re-directed or delayed as a result of these inflationary pressures.

But recession odds as they stand may be too low. Commentators are largely missing a more immediate, and possibly more important, channel: tightening financial conditions are imparting a broad and blunt shock on the US economy that will manifest long before consumers and businesses adjust spending plans in response to higher prices.

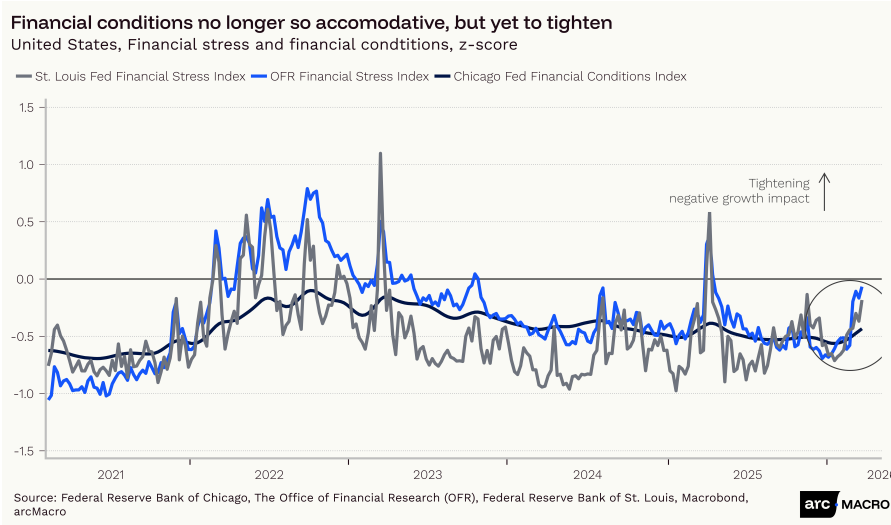
In this Memo, we quantify the tightening in financial conditions as a result of the war. We find that they're on the verge of switching from highly growth-supportive to a mild drag on activity. That's not enough to trigger a recession — and we're still positioned for a snap-back to supportive conditions if the Strait of Hormuz opens up within the 2-3 month timeline many geopolitical analysts predict.

Mapping the tightening in Financial Conditions

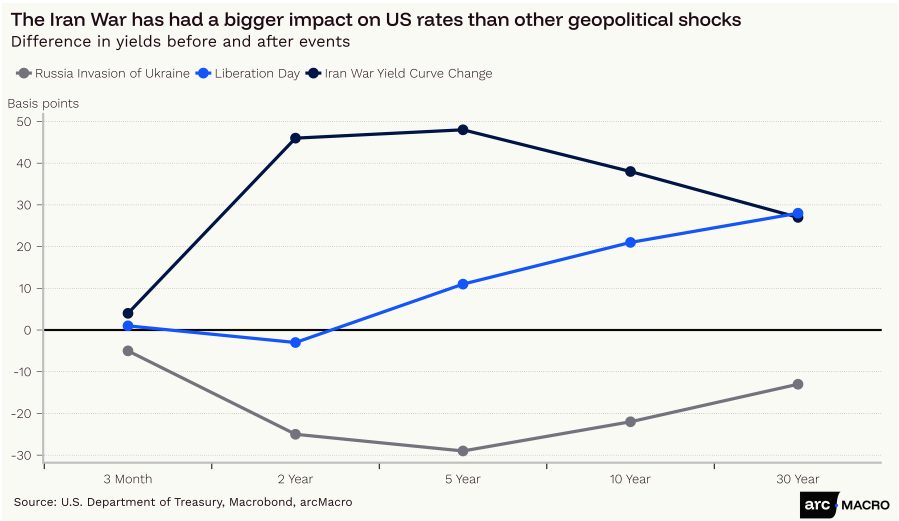
1. The main impulse of the tightening in financial conditions comes from higher expected future policy rates (or at least a removal of the expectation of significantly lower rates). The size of this re-rating, best captured in 2-year sovereign bond yields, suggests that economies with less subsidized energy markets and higher reliance on the Gulf are seeing the strongest rise in interest rates.



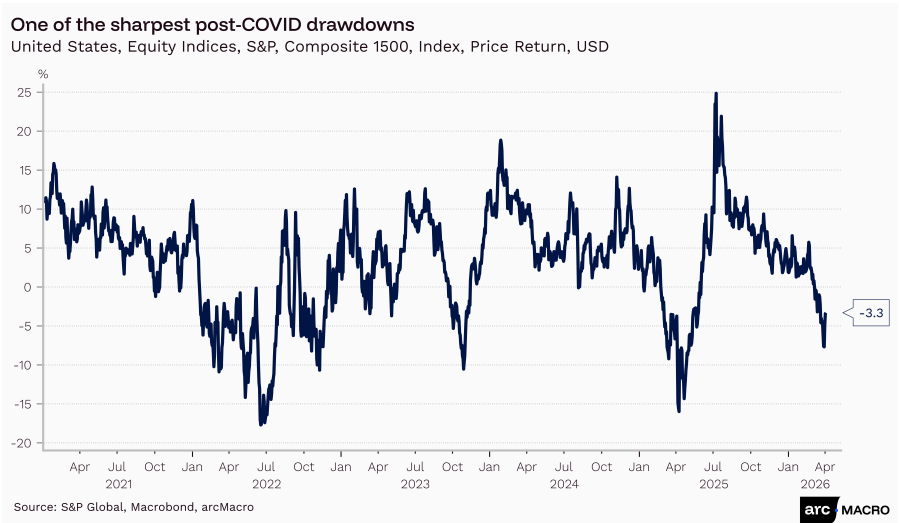
2. In the US, this has caused broad indexes of financial conditions (which include rates, spreads, dollar strength, and equity markets) to tighten from "very accommodative" to "neutral" in short order.



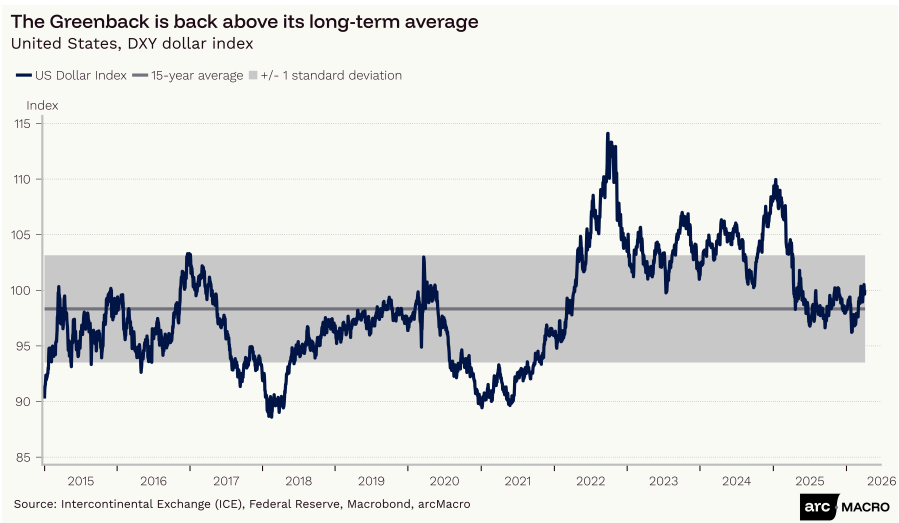
3. The impact of the Iran War on interest rates has been historically significant. Two recent benchmark geopolitical events – Russia's invasion of Ukraine, and the Liberation Day tariffs – led to a smaller shift in the yield curve or actively lowered the front end.



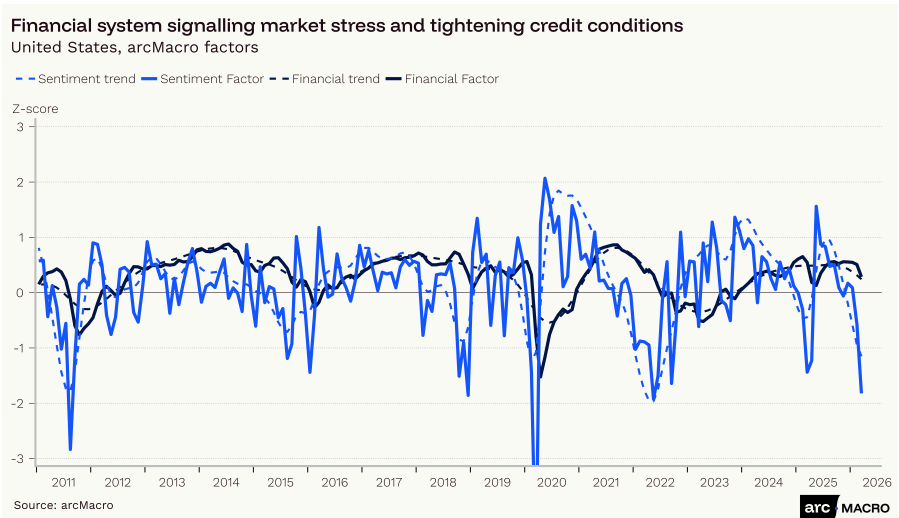
4. Aside from rates, equities have been a major contributor to tighter financial conditions. The transmission mechanism from financial prices to economic activity from both is rapid; higher rates increase the cost of leverage and scupper investments, and lower valuations reduce the value of collateral used to finance spending.



5. The dollar's rise since the start of the war (up 2.3%) has not helped matters either, though the impact here will be relatively minor.



6. Our own tracking paints a more nuanced picture. Our Financial Factor, which measures the long-term, slower-moving credit cycle, has moved from accommodative (half a standard deviation easier than average) in February to mildly accommodative (0.25 standard deviations) in March. That's significant, but far more striking in the collapse in the Sentiment Factor, which measures fast-moving risk-on/risk-off dynamics captured in asset prices. This has a more fleeting direct effect on growth, but we've found that very large sentiment moves can predict future tightening in the credit cycle, which is why we believe our Financial Factor will soon turn to an active drag on growth as the War grinds on.



Conclusion

Financial conditions have tightened enough to move from supportive of economic growth to neutral. The overall scale of the tightening is far smaller than recent episodes, notably the Fed's 2022-24 hiking cycle. However, its shape matters, transmitting primarily through higher rates in the belly of the yield curve and lower equity valuations.

This will remove one source of growth from the economy, but is not yet enough to trigger an immediate recession.

The biggest victim will be the M&A industry, where a cyclical upswing supported by easier financial conditions is in its early phases. Higher interest rates and spreads, and lower valuations, reduce leverage and kill marginal deals. Alongside the freezing impact that the looming SpaceX listing is having on the IPO market, it looks like we'll have to push pause on the PE/M&A recovery and muddle through for yet another year if a ceasefire is not reached soon.

Appendix

Proprietary Factor and Regime Model and Key Indicators

The Week in Markets

	Latest*	Change since last week (units)	Change since last week (%)	3-month change (units)	3-month change (%)	Year-to-date change (units)	Year-to-date change (%)
Equity							
S&P 500	6583	106	1.6	-263	-3.8	-263	-3.8
Information Technology			2.5		-7.6		-7.6
Financials			1.0		-9.5		-9.5
Consumer Discretionary			-0.4		-9.9		-9.9
Communication Services			4.0		-5.7		-5.7
Health Care			0.7		-5.2		-5.2
Industrials			1.6		5.6		5.6
Consumer Staples			1.5		7.1		7.1
Energy			-3.6		32.5		32.5
Utilities			2.2		8.6		8.6
Real Estate			3.2		3.8		3.8
Materials			3.1		10.6		10.6
Nasdaq Composite	21879	471	2.2	-1363	-5.9	-1363	-5.9
Dow Jones Industrial Average	46505	545	1.2	-1559	-3.2	-1559	-3.2
Russell 2000	6288	91.3	1.5	120	1.9	120	1.9
Sovereign Fixed Income							
US: 2-year Treasury Note	3.84	-0.04		0.37		0.37	
US: 5-year Treasury Note	3.99	-0.07		0.26		0.26	
US: 10-year Treasury Note	4.35	-0.09		0.17		0.17	
FRA: 10-year OAT benchmark	3.75	-0.10		0.19		0.19	
GER: 10-year Bund benchmark	3.03	0.01		0.18		0.18	
CHN: 10-year CGB benchmark	1.82	0.00		-0.00250		-0.0274	
CAN: 10-year GoC benchmark	3.5	-0.07		0.080		0.080	
Corporate Bond Spreads							
US: A-rated	75.8	-3.4		6.0		6.0	
US: BBB-rated	115	-3.6		10.7		10.7	
Leveraged Loan Spreads							
US: BB-rated	262	0.868		6.1		6.09	
US: B-rated	459	2.59		67		66.9	
US: CCC-rated	1925	10.9		361		361	
Foreign Exchange Rates							
DXY US Dollar Index	100		-0.1		1.7		1.7
EUR/USD	1.15		0.1		-1.9		-1.9
USD/CAD	1.39		0.3		1.5		1.5
USD/CNY	6.89		-0.3		-1.5		-1.5
USD/JPY	159		-0.5		1.5		1.5
GBP/USD	1.32		-0.7		-2.0		-2.0
USD/CHF	0.801		0.4		1.0		1.0
Commodities							
WTI Crude	112	11.9	11.9	54	94.3	54.1	94.3
Gold	4639	183	4.1	272	6.2	272	6.2
S&P GSCI Commodities			7.2		40.7		40.7
S&P GSCI Industrial Metals			3.5		5.4		5.4
S&P GSCI Agriculture			-2.1		2.0		2.0

* Weekly closing value. Color indicates positive (green) or negative (red) change since prior week.

Source: S&P Global, Russell Investment Group, Nasdaq, U.S. Department of Treasury, Macrobond Financial AB, Central Bank of Germany (Deutsche Bundesbank), Bank of Canada, Intercontinental Exchange (ICE), International Monetary Fund (IMF), CME Group, LBMA (London Bullion Market Association), Robert Shiller, Chicago Board Options Exchange (CBOE), U.S. Department of Labor, U.S. Bureau of Labor Statistics (BLS), Federal Reserve Bank of Atlanta, Citi, Federal Reserve Bank of St. Louis, Energy Information Administration (EIA), Pitchbook | LCD, arcMacro



arcMacro Real Time Factors

United States, z-score



Source: arcMacro

Disclosures

AI Declaration

All written content, analysis, and opinions are original and ascribed to the author. AI tools were used for proofreading and summarization purposes only. AI tools may also have been used in the development (codebase) of the analytical models reported in this document.

Disclaimer

This publication is for informational and educational purposes only and does not constitute financial or investment advice. Nothing in this report should be construed as a recommendation to buy, sell, or hold any security or financial instrument. Always consult a qualified financial advisor before making investment decisions.
