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CIO Alert: US-Iran escalation adds to geopolitical risks

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The simmering US-Iran conflict escalated this weekend with the start of joint US and Israeli airstrikes across Iran, which prompted Iranian retaliation. Our base case remains that there will be only a brief disruption to the global supply of energy. Markets may be volatile over the coming weeks but would likely thereafter start to refocus on positive global economic fundamentals.

What happened?

The US and Israel began joint airstrikes across Iran on Saturday, 28 February, with Iran's supreme leader Ayatollah Ali Khamenei among those confirmed killed. US President Donald Trump called for regime change, and on social media warned the strikes "will continue, uninterrupted through the week or, as long as necessary." However, on Sunday, a senior White House official said President Trump is "eventually" willing to talk to Iran's new potential leadership.

In addition to the death of Khamenei, numerous senior Iranian military officials have reportedly been killed, including the top commander of the Iranian Revolutionary Guard (IRGC). Iran's sitting President Masoud Pezeshkian described the operation as a "criminal attack," and the Islamic Revolutionary Guard Corps (IRGC) vowed the "most crushing" response.

With no successor to Khamenei announced, a temporary three-person constitutional council will nominally oversee Iran's leadership succession process.

Israel and Iran have continued to exchange fire, with missile strikes triggering sirens across Israel and explosions reported in Tehran, and both sides have reported casualties. Missile and drone barrages have been reported across the Middle East, and at US-linked military installations across the region, triggering air defenses.

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The strikes have also led to airspace disruptions across the Gulf. Major airports in Dubai and Doha suspended operations, with Emirates, Etihad, and Qatar Airways halting most flights. Reuters reports IRGC guards have radioed oil tankers to advise that no passage of the Straits of Hormuz will be allowed.

Energy markets were closed over the weekend. Regional equity markets, open on Sunday, fell between 2-5%.

What do we expect from here?

The escalation of the simmering US-Iran conflict to outright war was not unexpected. In our *Risk radar* published on 24 February, we stated that US strikes on Iran were within our base case expectations.

Ahead of the strikes, Brent Crude oil prices hit a seven-month high on Friday, and gold rose to USD 5,277/oz, just a few percentage points below its recent record closing highs.

Our base case remains that there will be only a brief disruption to the global supply of energy. We expect any initial rise in the price of oil to reverse, at least partially, once it becomes clear that supply disruptions are temporary, critical oil infrastructure is not destroyed, and the need for continued military action fades. In this scenario, markets may be volatile over the coming weeks but would likely thereafter start to refocus on positive global economic fundamentals. This would be in line with the impact of most geopolitical shocks in recent history.

Nevertheless, the commencement of strikes does increase the probability of our downside scenario in which a sustained disruption to energy supplies begins to have a bigger impact on the global economy and markets. We observed such negative outcomes following the Yom Kippur War in 1973, and following the start of the Russia-Ukraine War in 2022.

In weeks and months ahead, we will be closely monitoring several indicators.

1. *Will the flow of energy through the Straits of Hormuz continue?* This is the world's most important oil route, accounting for more than one-fifth of global oil demand and nearly one-third of seaborne shipments, moving about 21 million barrels per day to global markets from Iran, Iraq, Kuwait, Qatar, Saudi Arabia, and the United Arab Emirates. At present there are some signs that shipping companies have curbed transit through the route as a precaution. We will watch to see whether flows are disrupted more materially and how long such a disruption may last. In the 1980s Iran disrupted the shipping lane by placing mines in the waterway. Our base case is that Iran would not be able to disrupt the flow of energy for a sustained period, given the degradation of the country's military capacity, the heavy US military presence in the region and their own need to export.

2. *How will energy production be affected?* So far, aside from a disruption to supplies in northern Iraq, oil production continues across the region. There were also reports of three tankers suffering damage, although one was a shadow fleet tanker used by Iran. OPEC+, a group of oil exporting nations, also agreed on Sunday to increase their production quota by 206,000 barrels per day of production in April. Nonetheless, we will monitor whether Iranian retaliation damages the production and distribution capacity of other nations in the region. Additionally, any potential power vacuum within Iran could put Iranian energy production at risk over the medium and long term. Iran oil production (crude and natural gas liquids) was at nearly 4.8 million barrels per day in January—roughly 4.5% of global output—according to the International Energy Agency.

3. *How quickly will US and Israel "declare victory" and how quickly will Iran's capacity to retaliate be degraded?* Our base case view that there will not be a sustained disruption to oil supplies is predicated in part on the relative military success of the US-Israeli operation so far and the likely rapid degradation of Iranian military capacity. We also believe the Trump administration will be mindful of the domestic political risk of a sustained increase in oil prices heading into the US midterm elections in November. At the same time, the Iranian regime remains in place, and it is in its interests to prolong the conflict and disrupt energy flows to attain leverage. While this remains the case, the risk of a more sustained and disruptive conflict remains a possibility.

4. *What would be the impact of a higher oil price on inflation and growth?* The sensitivity of the global economy to moves in oil prices has been on a long-term downward trend for decades, as the energy intensity of growth has reduced. But a sustained rise in energy prices would nonetheless be an economic drag. Analysis by the Dallas Fed shows that a 10% rise in gasoline prices increases headline PCE inflation by 0.2ppt in the first month (with a cumulative impact of 0.3-0.4%), but the incremental effect quickly fades after a few months and, similar to other studies, US core inflation is little changed. Even a temporary closure of the Strait of Hormuz (which could drive oil prices even higher) would have a

“comparatively modest” impact on US inflation. Nonetheless, the US, as a major producer, would be less affected than Europe and Asia, which are more exposed to imports.

On GDP growth, higher oil prices would affect consumers and firms through higher costs, similar to an increase in taxes. Oil markets tend to be self-correcting with supply increasing as prices rise, so we would not expect any price spike to have a lasting impact on growth. However, if higher prices were sustained, we estimate that the negative impact on oil importing economies would be measured in basis points and would likely fade after a few years.

We also note that much of Iran’s oil production goes to China, accounting for about 13% of water-bound oil imports for China. So any significant disruption could be a potential headwind. However, there is evidence that China has been preparing for disruptions. Other nations, notably the US, could also choose to release strategic reserves to mitigate short-term supply shocks.

5. *How would central banks react to higher energy prices?* A potential worry for investors would be that an oil price-driven increase in inflation could cause top central banks to move toward rate hikes. However, comments by top central banks over recent years have suggested an eagerness not to overreact to one off increases in price levels, including most recently from higher US tariffs. Nevertheless, central banks will also be mindful of the risk that inflation expectations increase, particularly given the experience of 2022-23.

How to invest?

Historically, the impact of geopolitical shocks on markets has tended to be short-lived, unless they morph into economic shocks. Making snap decisions to de-risk portfolios amid geopolitical conflict has historically not been a profitable strategy. In line with our base case view that this conflict will not lead to sustained global economic disruption, we believe that investors should maintain a long-term focus, stay invested in broad equity indices, and use periods of volatility to build more diversified portfolios.

Position for a broadening rally. While equities may take a risk-off tone in the initial reaction to the military escalation, we believe the overall backdrop for equities remains positive, with robust US economic growth, strong corporate earnings growth, and high levels of fiscal spending around the world supporting a further 10% rise from current levels by end 2026.

Alongside more gains for US indices, we see further upside for Europe, Japan, China, and emerging markets in 2026, making a global equity allocation attractive, in our view. We believe investors with concentrated positions in individual tech stocks or US tech as a whole, or with biases toward one region should take the opportunity to diversify, to capture returns and manage risks. In Europe, we favor “leaders” across sectors, including stocks from the defense sector, which offer structural growth, and have also proven to be good portfolio protection in an uncertain geopolitical environment. In APAC, we believe China (including China tech), India, Australia, and Japan will be among the areas driving the next leg higher.

Favor commodities. Prior to the US-Israel attack on Iran, Brent Crude oil prices already increased by the most at the start of a year since 2022. We see further upside for broad commodities in 2026, driven by primarily by our positive outlook for metals. The fast-moving nature of events in the Middle East increases the appeal of actively managed commodity strategies in our view, given increased intra-commodity market volatility.

We also believe a modest allocation to gold, of up to a mid-single-digit percentage of total assets, can enhance diversification and buffer against geopolitical risks.

Hedge market risks. The US-Israel strikes on Iran serve as another reminder of the importance of diversified strategic asset allocation to help defuse market risk. Adequate exposure to quality fixed income and alternatives such as hedge funds can help reduce portfolio volatility and limit the impact of shocks. Investors should of course assess their ability and willingness to manage risks related to alternative investments.

In FX, short term strength for perceived “safe haven” currencies such as the Swiss franc and potential weakness for more cyclical currencies is probable following the weekend’s event, though in our base case we think these moves are likely to prove short-lived. Investors can consider using currency dislocations to rebalance currency allocations as appropriate.

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