UBS

15 April 2026, 07:30 UTC
Chief Investment Office GWM
Investment Research

Higher energy prices don't necessarily mean tighter monetary policy

Investment strategy insights

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- Rising energy prices are likely to drive headline inflation higher in the short term, and markets have already shifted their expectations toward a more restrictive monetary policy stance.
- Policymakers are well positioned and are typically expected to look through oil-driven supply shocks, waiting for clear signs of persistent inflation before acting. While this may delay Fed rate cuts, we do not expect them to be cancelled: our base case is for Fed easing to begin slightly later in 2026. We expect the ECB to keep rates unchanged for now, maintaining a hawkish tone in its forward guidance.
- Higher bond yields have increased the appeal of short-duration, high-quality bonds, while diversified sources of income and gold continue to offer effective hedges against macroeconomic risks.

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The Iran conflict represents a classic energy supply shock to the global economy. A shock of this nature means that supply constraints, not higher demand, place upward pressure on energy prices. All central banks understand that monetary policy is not well-equipped to address inflation caused by reduced supply rather than higher demand, as higher interest rates will only suppress spending and not boost supply. However, many will argue that monetary policy can be effective in helping contain inflation expectations, especially over the medium term.

Fed Chair Powell has recently emphasized that monetary tightening is typically not the right response to supply shocks, preferring to "look through" such events unless inflation expectations become unanchored. Analysis by the Dallas Fed shows that the incremental price pressure due to rises in energy prices tends to fade quickly after a few months, with core inflation little changed. With inflation still above target and uncertainty elevated—especially due to higher energy costs from Middle East tensions—the Fed remains cautious and in wait-and-see mode, seeking clear evidence of sustained core inflation declines before easing policy. As a result, we now expect the first rate cut to be delayed until September rather than June but still anticipate a total of 50 basis points in reductions for 2026.

Current market pricing is for the ECB to deliver two rate hikes by year-end. To be sure, the chances of the ECB hiking interest rates this year have increased substantially. In its own scenario analysis published at the March policy meeting, the ECB showed the impact of the Iran conflict as having a larger effect on inflation than on growth. For a central bank with a sole inflation mandate, the desire to hike rates to ward off the threat of second-round effects from the energy shock—such as rising wage demands—is clear. Arguably, the precedent of the 2022 inflationary episode—when the ECB aggressively hiked interest rates—is shaping how investors expect the ECB to react to an energy supply shock today. However, we believe the economic backdrop is notably different and should prompt the ECB to respond differently as well. Back then, the rebound in demand following the COVID-19 lockdowns was

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already driving inflation well above target, running close to 6% when the Russian invasion of Ukraine and subsequent disruptions to energy supplies put further upward pressure on prices. Additionally, interest rates were then at historic lows. Today, the economic background is arguably less favorable. Although inflation has been moving back towards the ECB's 2% target, the labor market has been softening. Moreover, monetary policy has only just recently returned to a neutral setting. Given the risks the conflict poses to the growth outlook, and the tightening of financing conditions that has already occurred in the bond markets, we believe the ECB is unlikely to rush into hiking and will likely wait to assess the consequences for the broader economic outlook over the next few months. Thus, for now, we expect the ECB to look through the current inflation shock and keep rates on hold when it next meets in April.

We think markets have priced in too much tightening from top central banks in recent weeks. The rise in benchmark government bond yields in USD, EUR, and GBP has further improved their appeal, while current market pricing still looks too hawkish relative to our view that the Fed remains on a medium-term easing path and the ECB on hold. Against this backdrop, we see an attractive risk-reward profile for short-duration high-quality bonds. In a risk scenario where growth concerns intensify and financial conditions tighten further, higher-quality and longer-duration bonds should be better placed to perform.

For investors, we firmly believe that they should not try to "trade" geopolitical events but instead stay invested while taking steps to progressively de-risk portfolios the longer the current energy price shock persists. We recommend diversifying excess exposure to at-risk equity markets in favor of structural growth and defensive markets.

The prospect of a longer-lasting conflict is heightening the vulnerability of traditional equity and bond portfolios as correlations are starting to converge, eroding diversification benefits. In our view, investors should use periods of market volatility to diversify beyond traditional asset classes. With this in mind, we believe that upside exposure to the US dollar, oil, and broad commodities can help hedge portfolios in the short term, while we also see medium-term value in gold.

The respective negotiating positions of the US and Iran remain far apart, with disagreement over Iran's nuclear program, the issue of war reparations, and control of the Strait. But our base case remains that both sides have an incentive to find a diplomatic solution, which should allow investors to gradually focus again on resilient economic and earnings fundamentals.

We believe it remains crucial for investors to make incremental changes and not large, abrupt shifts to their strategic portfolio allocation. With US domestic support for the war low and falling, and gasoline prices and bond yields rising, it also remains possible that the Iran conflict ends soon, which we believe markets would likely take as a short-term bullish signal, even if this leaves longer-term issues like the security of the Strait of Hormuz and Iran's nuclear stockpiles unresolved.

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Appendix

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