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Markets caught between military and central banks

Investment strategy insights

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- **Hormuz and central banks, the game changers:** As geopolitical tensions and energy price spikes dominate headlines, energy supplies and central banks steer market direction. Bond yields are surging and stocks are wobbling, yet volatility remains surprisingly contained. Investors are closely watching every move from the ECB and BoE. With policymakers signaling a hawkish stance but keeping rates steady for now, the next chapter for markets will depend on their response to inflation and growth risks.
- **Staying Invested Typically Pays Off:** In times of uncertainty, exiting the market can mean missing out on rebounds. Our strategy is to stay invested, while pivoting toward defensive sectors and high-quality bonds to weather volatility and seize opportunities. We focus on resilient areas—Switzerland, European health care, and companies benefiting from structural trends such as AI, longevity, and the energy transition.

Financial markets often observe wars with a degree of detachment, "looking through" the headlines and limiting portfolio damage. So far, equity markets have declined —mirroring the increases in energy prices—but, overall, volatility has remained in check.

In contrast, the bond market has felt the strain, with yields moving sharply higher. The German two-year Bund has risen from 2.0% to nearly 2.7%, the 10-year from 2.1% to over 3.0%, and spreads on Italian and other bonds have widened. Gold has also experienced a significant double-digit correction.

These moves reflect concerns about a potential shift in monetary policy, with falling rates having been a key market support in recent years. Any central bank pivot now hinges on a difficult-to-forecast variable: the duration of the Iran conflict, structural damage to critical infrastructure, and the reopening of the Strait of Hormuz.

Sharp spikes in oil and gas prices, if short-lived, tend to have manageable economic effects, especially as reserves help cushion the impact in the near term. But if supply disruptions and elevated energy costs persist, the effects on the economy and inflation become more pronounced, raising the specter of stagflation—stagnant growth coupled with high inflation.

To gauge the impact on inflation and growth, the duration of the conflict and the persistence of high energy prices are key. Our base case assumes energy flows will be restored without meaningful or lasting economic damage, and oil and gas prices will settle at lower levels than today (we forecast Brent crude at USD 90/bbl at the end of June, falling to USD 85/bbl in 12 months). Although gas prices have also risen since the outbreak of the conflict, they remain far

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below their 2022 peaks.

Higher prices are already feeding into the economy. Inflation in the coming months is likely to rise, with headline rates exceeding 3% year on year, possibly reaching 4% if supply disruptions persist, in both the Eurozone and the UK. Higher inflation and rising bond yields—which make borrowing more expensive across the economy—are likely to reduce growth by 20-30 basis points this year.

Before the conflict, we expected GDP to grow a little above 1% in the Eurozone and the UK this year; we still expect positive growth, but weaker than before the conflict.

The Eurozone is particularly vulnerable: It uses less energy per unit of output than other regions, thanks to greater efficiency, but remains a net importer (about 70% of energy is imported) and relies on Middle Eastern supply routes. The energy mix is dominated by oil and gas (about 58% of final consumption), while France is in a better position owing to its reliance on nuclear power.

As in 2022, after the gas spike following Russia's invasion of Ukraine, support packages for households and businesses are expected. These measures can soften the economic blow but come at a cost—higher deficits and debt, leading to rising financing costs. It's likely that any support will be measured and temporary.

Stagflation is the toughest scenario for central banks, presenting a real dilemma: Raise rates to curb inflation and risk triggering a recession, or let inflation run and risk entering a self-reinforcing inflationary spiral that is hard to break. Before the war, markets expected two rate cuts in the US and relative stability in Europe. Now, expectations have shifted to more than two hikes in the Eurozone and steady rates across the Atlantic.

Following the round of central bank meetings at the end of March, the message is clear: Inflation is heading up and policymakers are sending hawkish messages, with their focus on the second-round effects of inflation (inflation expectations) rather than the initial shock. Therefore, we expect the European Central Bank (ECB) and Bank of England (BoE) to keep rates on hold with hawkish guidance until the energy shock has passed.

What does all this mean for portfolios? The Middle East conflict highlights the Achilles' heel of a balanced portfolio: In a stagflation scenario, where inflation is high but growth is weak, both stocks and bonds lose value. Stocks drop as higher rates weigh on valuations and growth, while bonds fall as yields rise. The inflation crisis of the 1970s and the global shock of 2022 are clear examples.

Based on current information, if the conflict doesn't drag on, central banks may wait a few more months before hiking rates. If that's the case, the bond market may have overreacted, and high-quality government bonds and short-term investment-grade corporate bonds (around two years) could now offer attractive entry points, with yields likely to decline in the coming months.

On the equity side, our approach is to stay invested to avoid missing potential rebounds. We continue to hold an Attractive view on equities overall; however, to better manage risk, sector rotation makes sense: Since the start of the year, we've moved to a Neutral stance on US tech, Europe (especially banks), and India owing to their sensitivity to high energy prices and geopolitical uncertainty, favoring defensive areas like Switzerland and European health care.

We also continue to see compelling investment opportunities in European companies positioned to benefit from global trends—such as *Artificial intelligence*, *Power and resources*, and *Longevity*—as well as the region's ambitious structural reforms.

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Attractive: We consider this asset class to be attractive. Consider opportunities in this asset class.
Neutral: We do not expect outsized returns or losses. Hold longer-term exposure.
Unattractive: We consider this asset class to be unattractive. Consider alternative opportunities
Note: For equities, we have a five-tier rating system with two additional preferences
Most Attractive: We consider this asset class to be among the most attractive. Investors should seek opportunities to add exposure.
Least Attractive: We consider this asset class to be among the least attractive. Seek more favorable alternatives opportunities.
When equities are included with the other asset classes in the three-tier rating system, we collapse "Most Attractive" with "Attractive" and "Least Attractive" with "Unattractive."

Appendix

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