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What the Middle East conflict means for investors

CIO Essentials

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- Energy prices have risen sharply as a result of the conflict in the Middle East, triggering concerns about global growth and inflation in financial markets.
- US President Donald Trump has no interest in high oil prices ahead of the November elections, and history has shown that geopolitical events only have short-term effects on equity markets. We recommend that investors remain invested.
- Even though there are good reasons to believe the conflict may soon subside, the risk that a prolonged conflict could weigh on equities should not be underestimated. With a broadly diversified portfolio, investors can ensure that in such a negative scenario, the setback for the portfolio is cushioned.

Source: Gettyimages

Since March, the conflict in the Middle East has been shaping the economy and financial markets. Oil transport through the Strait of Hormuz—through which around 20% of the world's oil flows—has come to a halt. This has led to a significant increase in oil and gas prices.

If the conflict subsides in the coming weeks and oil transport through the Strait of Hormuz resumes, energy prices are likely to stabilize. The damage to the global and Swiss economies would be manageable. Supporting this scenario is the fact that persistently high oil prices would reduce US President Trump's chances in the US midterm elections this autumn. Rising gasoline prices would further increase the already high level of concern among US voters about affordability. Donald Trump therefore has a clear incentive for keeping the conflict short and stabilizing energy prices.

In this scenario, the Swiss National Bank (SNB) is likely to continue its zero interest rate policy, as it reaffirmed at its monetary policy assessment last Thursday. This means that long-term interest rates in Switzerland are also likely to remain at their current level.

History has shown that such geopolitical events only have short-term effects on equity markets, which is why we recommend that investors remain invested. A good example is "Liberation Day": About a year ago, markets slumped after Trump imposed high tariffs on many of the US's trading partners; however, equity markets quickly recovered and continued their upward trend.

History also shows that attempts to sell at the right time during geopolitical events and then re-enter the market later often fail. However, those who wish to gradually and systematically increase their equity market exposure should not be deterred by volatility. It is not crucial to time the perfect entry point, but rather to be invested in the equity market, which—over the long term—has offered significantly higher returns than a savings account.

Higher oil prices over a longer period cannot be ruled out

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Even though there are good reasons to believe that the conflict may soon subside, the risk that it could drag on for several months and keep energy prices elevated for an extended period should not be ignored.

Such a negative scenario could impact financial markets in two phases. In the first phase, the focus would be on rising inflation due to higher energy prices. If energy prices remain higher for a longer period, financial markets are likely to adjust in a second phase to significantly slower economic growth or even a recession.

In this second phase, concerns about a marked slowdown in growth could weigh on equity markets and lead to expectations that central banks will lower key interest rates to counteract the slowdown. This, in turn, would result in lower long-term interest rates, which means higher bond prices. Gold also typically benefits from falling interest rates. With a broadly diversified portfolio, in this negative scenario, investors can position so that any setbacks are cushioned by the positive performance of bonds and gold.

In the first phase, when the rise in inflation is in the spotlight, financial markets could also expect central banks to try to control inflation with higher policy interest rates. Such a development was observed in 2022. At that time, Russia's invasion of Ukraine led to a surge in energy prices. The equity market subsequently lost ground. However, since interest rates also rose, bond performance was also negative. A portfolio consisting only of equities and bonds lost significant value in 2022.

In such a situation, it helps to further diversify the portfolio with real assets or alternative investments such as hedge funds, which can provide additional protection during periods of inflation and rising interest rates.

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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
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Appendix

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