

Macroeconomics

Market Brief: Investment Perspectives on the Middle East Conflict

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Our Public Investing leadership team outlines key investment observations and potential implications for equity and fixed income markets in light of geopolitical developments in the Middle East.

Key Takeaways

1 Market Reaction Has Been Flipping Back and Forth

As the situation evolves on an hour-by-hour basis, equity, fixed income, currency, and commodities markets have seen notable increases in volatility.

2 Key will be Duration of the Conflict

A longer, drawn-out campaign may have a greater chance of contributing to sustained market weakness.

3 Our Base Case Remains Robust Global Growth

We believe any impact will be short-lived, but we acknowledge that tail risks are growing.

What's Happened: What We Know So Far

Escalation in the Middle East: Following a US/Israeli military operation that resulted in the death of Iran's Supreme Leader Ayatollah Ali Khamenei and other senior officials, the situation in the Middle East has escalated significantly. US messaging has emphasized a strategy of regime change alongside specific military objectives designed to degrade Iran's conventional capabilities (including its ballistic missile stockpiles and naval capabilities) while preventing the reconstitution of its nuclear program and ensuring the regime can no longer arm, fund, or direct terrorist organizations globally. In response, Iran's Islamic Revolutionary Guard Corps (IRGC) launched missile attacks on targets across the wider region.

Strait of Hormuz Disruption: The Strait of Hormuz—a critical chokepoint for global energy flows—has reportedly seen a sharp decline in commercial traffic in the immediate aftermath of the strikes. Public commentary and shipping updates have been mixed and fast-moving, ranging from partial reductions in transits to language implying a “shadow closure.” Several major carriers have reportedly paused or curtailed transits as conditions evolve. For context, the Strait of Hormuz is widely cited as the world's most important oil transit chokepoint, carrying roughly one-fifth of global petroleum liquids consumption in recent years.

Macro and Market Implications

Increase in Uncertainty Contributes to Volatility: Equity markets have flipped back and forth as market participants debate the potential duration and economic impact of the conflict. US rates sold off as higher oil and energy prices stoked inflation concerns.

Broader Market Impacted Only by Further Escalation: In our view, broader markets are likely to be significantly impacted only if there is damage to critical oil infrastructure in the region (with a multi-year recovery timeline) or the Strait of Hormuz is closed for an extended period. We believe such an escalation is likely to push oil prices above \$100/bbl. This is a key tail risk we are monitoring closely, and one that we may choose to hedge more actively if the probability continues to rise. This is not our base case today, but the probability is increasing as the conflict continues.

Structural Elements to Cushion Impact Absent Further Escalation: In the absence of such an extreme escalation, several structural elements may buffer the impact of a short-term conflict. These include a larger-than-expected OPEC+ supply increase of 206,000 b/d, the alliance's approximately 4 million b/d in spare capacity, an estimated 2.6 million b/d of available pipeline capacity that can bypass the Strait of Hormuz, and finally the potential release from strategic reserves both in the US and China. It is worth noting that China, the biggest importer of Iranian oil, has built strategic oil reserves of around 200 days.

Views from our Investing Teams

Multi-Asset Solutions

While our base case of above-trend global growth and synchronized cyclical reacceleration remains intact, we recognize that the distribution of risks around that base case has widened materially. Tail

risks have grown fatter across multiple dimensions, including but not exclusively geopolitical escalation in the Middle East and its potential to disrupt energy supply chains. Due to this view, we recently took proactive steps to bolster portfolio resilience without abandoning our constructive positioning. We slightly reduced net equity beta through a combination of non-linear equity downside protection, credit hedges, and deployment of dry powder in our tail risk hedging strategies. These actions are designed with the aim to add downside convexity and asymmetric protection in a stress scenario while preserving upside participation should the base case continue to play out, essentially creating a smile-shaped payout structure.

Europe vulnerable to escalation: In the event of a severe escalation, Europe is particularly vulnerable to an outsized impact, given its high dependence on energy imports and its equity markets' exposure to global cyclical. While Asian countries are the primary buyers of Middle Eastern Liquefied Natural Gas (LNG), any disruption would force global competition for alternative supplies, pushing prices higher worldwide. Europe's vulnerability is amplified by its unusually low gas inventories, which are below 30% capacity. In response to Qatari LNG production halts, the European benchmark TTF natural gas price has surged by as much as 50%, and a prolonged shipping disruption in the Strait of Hormuz may drive prices significantly higher. As such, we preferred to source our non-linear downside protection via European equities, though we do not hold an outright underweight.

Implementation at attractive pricing: We implemented these protective options when their premiums were still relatively low, presenting a potentially attractive risk/reward opportunity. So far, the relative price action in European equities is validating that view.

Fixed Income

Our base case assumes the conflict does not significantly escalate further. However, we recognize that a prolonged situation is a tail risk particularly if the Strait of Hormuz is closed, putting upward pressure on inflation and potentially triggering a global growth shock. It may also have a deeper impact on markets for both winners and losers, including oil suppliers as well as defense industries.

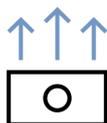
We share below commentaries from a few of our Fixed Income investors. Many of our sub-sector teams, including leveraged credit as well as securitized credit, are potentially more insulated from direct impact of events in the Middle East. On positioning, we stand ready to adjust our exposure across curves and countries should the balance of risks change in this fluid situation. We remain agile in our positioning and will look to manage dynamically as events progress.

Select sub-sector team views and positioning



Currencies

- The primary transmission channel from the Middle East conflict to markets is oil. Therefore, a sustained price increase would potentially heighten volatility and pressure crowded consensus trades, particularly if deleveraging accelerates. Sustained FX volatility poses a direct risk to carry trades.
- Current positioning reflects elevated themes, including flatter yield curves, a stronger US dollar, and vulnerable FX carry trades. We remain overweight to the US dollar, which should be supported in an uncertain environment.



Developed Market (DM) Rates

- Core government bond yields rose on March 2 as concerns over rising inflation outweighed the general risk-off tone among investors.
- Rising yields in isolation suits our overall underweight stance to duration.



Emerging Market (EM) Debt

- High-grade oil exporters typically benefit from large buffers and elevated energy prices. However, a sustained disruption in the Strait of Hormuz remains a significant tail risk that could flatten DM curves and pressure oil-importing economies through inflationary and terms-of-trade shocks.
- We maintain an underweight in the Middle East. Importantly, the larger Middle East Investment Grade names matter most from an index weight perspective, and valuations in the stronger IG credits in the region are not attractive versus the broader EM universe. As a result, even these higher-quality credits could trade wider during periods of conflict-driven risk aversion, particularly if market technicals deteriorate.
- We also note that the weaker Middle East credits are susceptible to sharper spread widening and technical selling, though these issuers are few and generally small weights in the main benchmarks.



Investment Grade (IG) Credit

Initial spread widening on March 2 could provide opportunities to tactically add risk. We have slightly added risk at the index level in both Europe and global IG.

Fundamental Equity

- **Energy & Oil Dynamics:** The conflict is not viewed as a definitive "win / loss" for energy companies or oil-deficit nations yet. We maintain an **underweight** position in the impacted region and are managing energy beta actively. The impact of oil supply shocks is partially mitigated by the structural growth of Electric Vehicles (~20% of global auto supply), which has decoupled global growth from oil demand compared to historical comparable events.
- **Shipping & Logistics:** A significant "squeeze" in shipping rates is observed. Rising transportation and insurance costs may prevent oil exporters from fully capturing the benefits of higher crude prices.
- **Regional Stability:** Despite the strikes, Middle Eastern markets have remained relatively orderly. Notably, the Gulf Cooperation Council (GCC) countries have shown signs of diplomatic unity in keeping trading channels open, and no systemic "breakage" in financial infrastructure has occurred so far. Markets in the region stayed open on Sunday and Monday, March 1-2, and observed moderate movements across the board.
- **EM Earnings Growth:** We maintain a constructive view on EM earnings, with 25% growth expectations underpinned by AI development and infrastructure. India may be somewhat negatively impacted but overall, the structural tailwinds should sustain growth despite the geopolitical overhang.
- **Market Sentiment:** While a drawdown is possible if the conflict drags out, the market currently holds a "benign" view, pricing in a relatively short-lived event.

Quantitative Investment Strategies

- **Quality, Trend & Momentum:** We are seeing bids for higher quality names, and the low volatility trade is doing well. Investors have not been caught off-guard, and the market reaction is playing into the **pro-trend and pro-momentum positioning**.
- **Regional Performance:** Europe is bearing the brunt of geopolitical shock, leading to underperformance in EU equities. We remain constructive on ex-US markets in the long term but have adopted a "wait-and-see" approach in the short term.
- **Risk Profile:** Recent trading days have been relatively muted from a macro risk perspective, showing only marginal underperformance despite the headlines. The VIX curve and the pricing for May volatility contracts show that the market believes the conflict is short-lived.

Where Do We Go from Here?

We expect the volatility in energy prices, safe-haven currencies and credit spreads to create significant opportunities to re-deploy risk once markets stabilize and our views are further refined.

The primary risk is the duration of the conflict rather than the immediate price levels. A short-lived event allows for a market retrace, while a prolonged closure of the Strait of Hormuz remains the critical tail risk.

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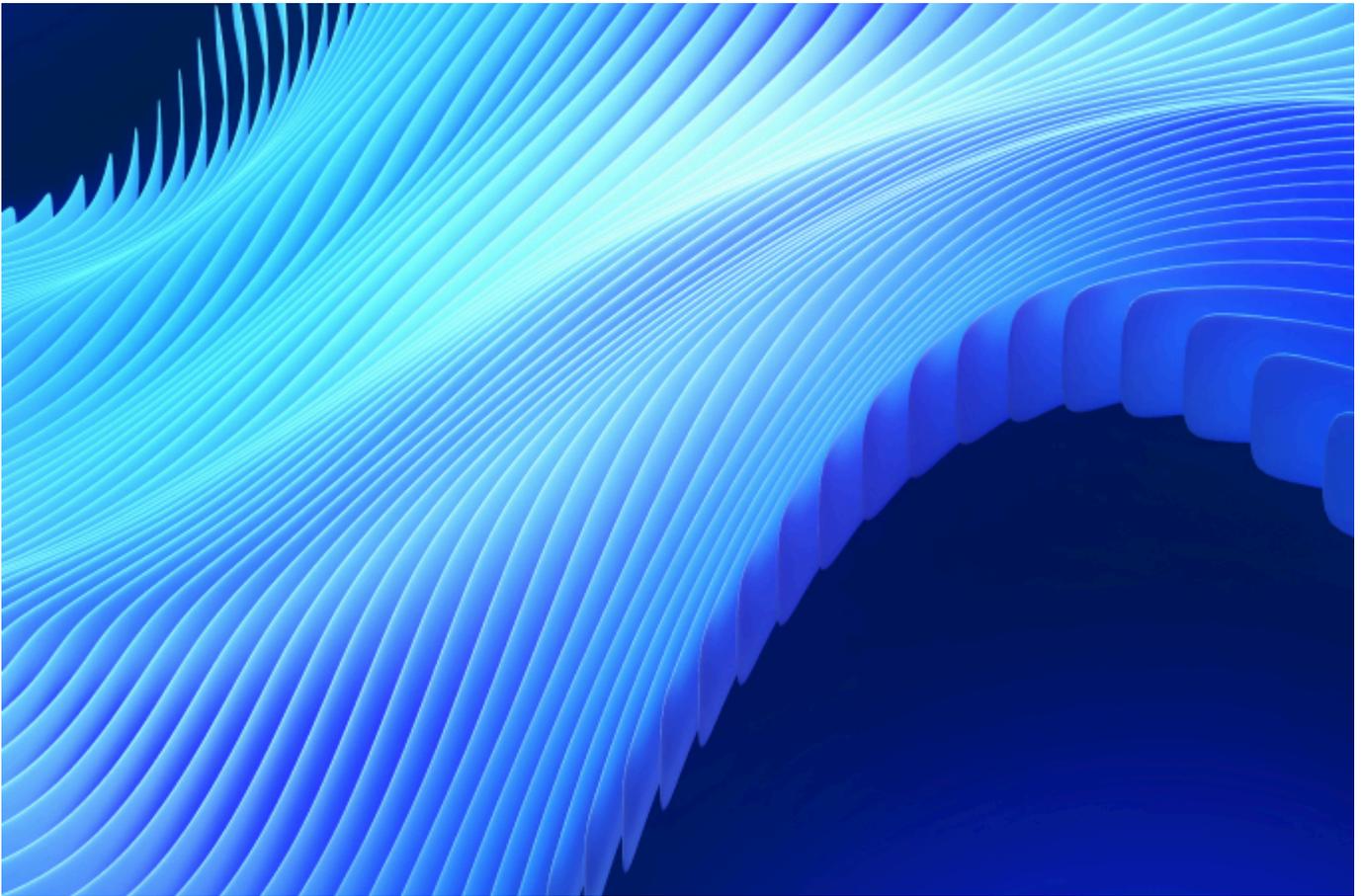
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Bbl: Barrel of crude oil

B/d: Barrels per Day

FX Volatility: Measures the frequency and magnitude of exchange rate changes for currency pairs, driven by economic data, geopolitical events, and market sentiment.

VIX Curve: VIX curve shows where VIX futures are priced across different maturities, giving a snapshot of how markets expect stock market volatility to evolve over the coming months

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