

IRAN WAR: IS THIS TIME DIFFERENT?

Over the past year and more, investors have shrugged off an extraordinary series of geopolitical shocks. War in Europe. A shocking assault on Israel, followed by war in Gaza, spilling into Lebanon. Trade wars, triggered by suddenly high tariffs imposed by the US on allies and foes alike. Splits in the Trans Atlantic alliance as President Trump threatened to take over Greenland, part of the sovereign territory of NATO ally, Denmark. And the US military raid on Venezuela to seize Venezuelan President Nicolas Maduro, now imprisoned in New York.

Through all this, the US stock market has continued to rise, faltering only briefly after each shock. Investors learned that the US economy was resilient. Despite calls for recession, investment boomed with the promise of AI, and consumers remained steady.

Over the past week, the situation has changed. Suddenly, geopolitics are infecting the market mood. The Iran war, launched by the US and Israel with little warning on February 28, has sent tremors around the world. This time, investors are wary of buying the dip.

By Monday's close, stocks had fallen by almost 8% from the pre-war close on February 27. All three major US indices closed in correction territory. Markets in Asia, Europe and emerging markets deteriorated still more. The key 10-year US treasury yield closed on March 30 at 4.35%, a level last seen in late July of last year. Could the Iran war prove a breaking point?

GAME CHANGER?

There are growing fears that this time may indeed be different. Dangerous consequences for the US and global economy are now being signaled by financial markets. Policymakers around the globe are wondering how to manage what some, including the head of the International Energy Agency (IEA), are now calling the most significant energy security

challenge in history. Consumers in the US and Europe are paying almost a third more for gas at the pump than a month ago. Prices for other affected commodities – from fertilizer, needed for food production, to helium, an input for semi-conductors – will also likely rise.

Iran's ability to block the Strait of Hormuz, with oil tankers piling up in the Persian Gulf and oil and gas prices much higher, is what has changed the game. Just over four weeks into the war, it has become clear that President Trump overestimated the ease with which the US and Israel could overcome Iran and underestimated the potential damage that even a weakened Iran could inflict on the US and global economy through its stranglehold on oil and gas supplies from the Gulf.

Some observers including Ray Dalio see the miscalculation as one that is so enormous as to change the course of history – or at least hasten a trend of American decline that was already in train. According to this view, there is no way out of the conflict that will allow an American declaration of victory without a commitment of blood and treasure that US politics will not support. Iran would therefore remain in control of the Strait, humiliating America and making it clear that President Trump has suffered defeat. This in turn could weaken the US position in the world.

Others believe that the US dollar – a symbol of American economic strength and a tool of possible economic coercion through sanctions – will lose from the war. There could be a drift away from pricing oil in dollars, perhaps to yuan, and a broader shift away from oil and gas, where the US is a dominant producer, to renewables and nuclear energy.

In both cases, the message to investors would be to stay away from the US. But others see that as

shortsighted. President Trump may lose control of the narrative that until now has often allowed him to guide markets up and down merely by posting on Truth Social. Today's higher oil and gas prices will slow US growth and push up costs. The impact will be worse the longer the conflict goes on and the Strait is effectively closed, or under Iranian control. But the US is likely to remain the main market in which to invest – better than any alternative.

Market reaction suggests that this is a widespread view in the short-term, although the shifting sands of the war mean that sentiment can switch suddenly. For the medium and longer term, a glance at other options illustrates the pull of the US. Devastation to infrastructure and – importantly – the sense of safety in the Gulf makes investment there less attractive than it was a month ago. Europe is more vulnerable to higher energy costs than the US and was on a slower pre-war growth path. With Russia benefitting from the Iran war, the European defense sector is likely to remain strong. But that may come at the expense of consumer spending. China, the one true competitor to the US in terms of innovation and technology, including AI, is still overly dependent on exports for growth. Investors may also wonder about the business environment for foreigners in China given history.

For all of the fears of a repeat of the 1970s oil shock, there are important differences today. First, the increase in oil prices today – although large – is less than the quadrupling that took place during the Arab oil embargo in 1973/74. After briefly hitting \$120 a barrel in mid-March, oil prices have now settled uneasily at around \$100 to \$105, or some 50% above the pre-war level. Secondly, the world has become far more energy efficient in the past 50 years and thus better able to absorb energy price increases. The energy intensity of the US economy has fallen and that together with its becoming an energy exporter lessens the impact of recent energy price hikes.

Finally, expectations of inflation across the economy are much better anchored in today's world of independent central banks and flexible monetary

policies than in the 1970s. Although central banks allowed inflation to rise post-COVID, they eventually acted decisively to bring it down. In the US, inflation shot above 10% in the aftermath of the 1973 shock. But it rose even higher – to almost 15 % in 1980 – after policymakers eased prematurely in the mid-1970s. Sharply higher interest rates, ushered in by Federal Reserve Chair Paul Volcker in 1980-81 to bring down inflation, triggered a deep recession. Central bankers, as discussed below, are better equipped to manage shocks today.

For them, as for investors, the key to the outlook is how long the Strait of Hormuz is closed. As the IEA has pointed out, the danger from this energy shock is its volume, with an estimated 11 million barrels a day being held off the world market for each day of the blockage, and damage to oil and gas facilities in the Gulf threatening their production. The longer the apparent stalemate persists, the worse the damage. A further risk was illustrated in recent days when Yemeni Houthis fired at Israel. The “backdoor” exit for Saudi oil goes through the Red Sea, which the Houthis may threaten to block.

PRE-WAR CONSENSUS ON ITS HEAD

From its outset, the Iran war turned previously consensus market positions upside down.

No longer are investors seeking to hedge against the US dollar. No longer are rate cuts definitely on the agenda. Indeed interest rate hikes are now seen as quite likely, certainly in Europe and perhaps in the US. The glitter has gone off gold and other precious metals as oil prices jumped and inflation fears resurfaced.

Financial markets have been extremely volatile since the war began. Fears of a lengthy conflict and prolonged increased energy costs weighed heavily some days. On other days, particularly when President Trump signaled a possible quick end to the war, markets rebounded, reflecting the underlying strength of the US economy. For more than three weeks, these opposing forces seemed in balance. Indeed, some market participants seemed

paralyzed in the face of uncertainty. Now that has changed, what next?

MARKET THEMES THROUGH THE FOG OF WAR

Much is uncertain, depending on developments in the Middle East. But a few market themes are clear. They are not what investors and traders were expecting a month ago.

First, and most notably, investors have turned back to the US as a safe haven. Secondly, markets priced for monetary policy to ease are now facing the possibility that central banks faced with potential stagflation will raise rates instead.

The return to dollar assets first. This has happened despite concerns that the US could become bogged down in another Middle East war. Unlike the move away from US assets that marked 2025, the dollar has climbed 3.0% in the four weeks since the war began. US equities are not immune to fears of a long and messy conflict, with persistently higher energy prices. Stocks have fallen as oil prices have climbed. But for much of the past month, US markets outperformed those elsewhere. Since February 27th Japan has fallen 13.2%, Europe 10.7%, and emerging markets 10.6%.

For some, this has smacked of complacency. BlackRock President Rob Kapito warned this week that markets were mispricing Iran risk. He argued that higher oil prices – perhaps reaching as high as \$150 a barrel – would hit US growth and push up inflation. Tighter monetary policy to combat inflation would add to the economic pain. Even if the war ended soon and the Hormuz Strait opened, oil and gas prices would remain higher than before the war as the damaged infrastructure is repaired.

There are nevertheless good reasons for the market reaction to be different from the post-tariff moves last year. The US is less dependent on energy imports, and on trade more generally, than many other countries. The oil price is set on global markets and gas prices have already followed this upwards, with a 34% rise to almost \$4 dollars a gallon

nationwide since February 27. But, as former Presidential advisor and Harvard professor Jason Furman noted in a recent [op-ed](#), Americans spent only 2% of their budget on gas last year – half as much as 50 years earlier when soaring oil prices triggered inflation and tipped the US economy into recession. For the economy as a whole, the US does not suffer from higher energy prices since it is now a net oil exporter. Energy producers benefit as consumers lose. More broadly, as Furman notes, the US economy has underlying strength that supported growth of more than 2% last year, as well as in 2024, even as inflation was mostly on a downward trend. Politically though, higher gas prices could impact the mid-term elections.

TESTING RESILIENCE – AND CENTRAL BANKING

Others are less sanguine about the global impact of the war. The respected Paris-based Organization for Economic Cooperation and Development (OECD) issued its latest economic forecast this week. Even assuming that the blockage of oil and gas exports is temporary, and that prices begin to come down mid-year, the OECD now projects US inflation will hit 4.2% in 2026, year on year. It foresees US growth slowing next year to 1.7%. The relative story remains the same: the US performs better than other advanced economies. But a longer stoppage would exert more damage. As the OECD notes, “the conflict in the Middle East is testing the resilience of the global economy.”

The conflict will also test central bankers, faced with the hardest economic situation: a danger of stagflation. This explains the second upset to pre-war market consensus: the possibility of interest rate hikes.

As Chicago Fed president Austan Goolsbee put it this week, the sudden rise in oil and gas prices threatens to produce the hardest choice for central banks: stagflation, when monetary policy goals conflict. Higher energy costs can worsen inflation both directly and indirectly if they feed through into more general price and wage increases. At the same time,

consumers lose spending power as they have to pay more for gas and other products with energy as a key input, eventually including food, thus risking economic growth. In Europe, ECB president Christine Lagarde has struck a hawkish note, warning this week “large, sustained deviations call for forceful monetary policy action, shifting to persistence as the tightening cycle matures, to prevent those deviations from becoming entrenched.” Markets now expect two to three hikes from the ECB in 2026.

In the US, markets had expected rates to ease further this year. Although inflation was still above the 2% target – for the fifth year – the job market also had begun to show some weakness. Slower payroll growth could largely reflect a drop in supply, as immigration has been choked off. But unemployment has also risen gradually over recent months.

Beyond the economic reasons to expect monetary policy to ease, it was reasonable to expect that the handover of Fed chairmanship from Jerome Powell to Kevin Warsh will change Fed dynamics. Warsh was selected by President Trump, who has called loudly for rates to be cut, and appeared likely to be sympathetic to this. That call is now complicated by both higher energy prices and politics.

Although Powell’s term as Chair officially ends in May, he made clear in the press conference following the March Fed meeting that he would stay as interim chair until his successor is confirmed. That is being held up by Senator Thom Tillis, until the Justice department drops its threat to subpoena Powell over the costs of a new Fed building. Powell also said that he would stay on as a Governor – as he can even after stepping down as Chair – until that is resolved.

With Asia, including Korea and Taiwan, now viewed as especially vulnerable to the cut off in energy supplies with the closure of the Strait of Hormuz, markets have sold off AI beneficiaries including SK Hynix, Samsung, and TSMC.

THE WAR ITSELF: CAN ANYONE “WIN?”

Investors wondering what comes next have first to decide on how the Iran war will proceed. Escalation or de-escalation? Opinion is divided. With more American troops being deployed to the region and due to arrive in coming days, many fear a lengthy and messy fight, perhaps involving troops on the ground.

President Trump is a master at getting out of trouble. Many have criticized the lack of a clear, or clearly articulated, political goal for the war. Paradoxically, this may give the President room to maneuver, with the possibility of defining as victory whatever the situation is when he decides the costs of war outweigh its potential benefits. It seems clear that an attempt at real regime change – that would dismantle the theocracy and shift power away from Iran’s revolutionary guard – would be seen as too risky by the White House.

The initial Saturday surprise attacks against Iran killed many of its leadership, including Supreme Leader Ali Khamenei, and destroyed much of its weaponry. For a few days it looked as if President Trump might be able to walk away with another quick victory, following the removal of President Maduro of Venezuela just weeks earlier. This is no longer the case.

Iran’s strength and persistence in opposing US and Israel, despite the overwhelming military and intelligence force of the latter, has taken many by surprise. We are seeing once again the limits of what even the most powerful military in the world can achieve if opposing an enemy that is fighting for survival, and from home ground. Four weeks in, Iran’s willingness to hit at Gulf states, blow up energy facilities, and close the Strait of Hormuz may appear close to suicidal. But it has given the regime leverage against the US. At this point, it is not clear whether that will force a stand-down or not. The likelihood that the US and Israel have different goals, and that US allies in the Gulf are also divided, makes the future of the conflict even harder to predict.

For all the drama and chaos in the headlines, and on the ground in the Middle East, opposing forces have been in a strange and uncertain equilibrium. President Trump continues to talk about negotiating an end to the war. But he is also sending thousands more troops to the region. Those troops could be used to land on the islands in the Gulf, notably Kharg island where Iran's oil facilities are. Iran continues to hold hostage the passage of oil and gas through the Strait of Hormuz, while much of its leadership has been assassinated by Israel and its military assets destroyed by US and Israeli bombs.

Perhaps the most important indicator will be American sentiment. The war has so far proved unpopular among the public, as well as among many analysts. At some point, President Trump may decide that the pain is too great. The big question is whether the Strait of Hormuz gets opened through negotiation or through a dangerous escalation of military conflict.

EQUITIES

As noted above, as the fear of prolonged higher energy costs took hold this week, all the major indices have dropped. On previous dips, many have rushed to buy. A case could be made that with the current selloff, into correction territory, valuations are more reasonable. The S&P index's 12-month forward P/E has come down from around 21.1x to 19.9x. However, that is still above the long-term average of 17.7x. Moreover, the risk of earnings revisions to the downside are growing the longer the crisis plays out.

What has been especially striking beneath the headline numbers of the major indices is how little has been driven by company-specific fundamentals. The market has traded as a macro instrument first and a collection of businesses second, with positioning, factor exposure, and top-down risk management dominating bottom-up differentiation. Hedge funds have leaned heavily on index futures, ETFs, and other macro hedges to protect legacy long books rather than aggressively reshaping portfolios one name at a time.

This has contributed to one of the sharpest alpha drawdowns in almost three years, as gross exposure has been cut from a high starting point and net exposure brought down quickly. By contrast, much of the long-only community appears to have been caught flat-footed, reluctant either to chase the rotation or to add risk into a market where macro developments have repeatedly overwhelmed micro conviction. This helps explain why price action has often felt air-pocketed and indiscriminate even on the days when the index level itself remained relatively stable.

At the sector level, the move has been narrow but meaningful. Energy has stood apart as the clear winner, while even traditionally defensive groups such as consumer staples and healthcare have sold off, underscoring that this has not been a standard flight to safety but a repricing around energy security, inflation risk, and global growth sensitivity.

Conversations with energy specialists have been notably more pessimistic than the broader market, with many arguing that recent events have amplified an already-tight medium-term supply picture rather than created a temporary shock. Their view is that years of underinvestment had already left the system short of cushion; refinery disruptions, the eventual need to rebuild the US Strategic Petroleum Reserve, and the likelihood that other large importers may reconsider holding minimal strategic reserves could all reinforce a more structural deficit from 2027 onward. That possibility matters not only for inflation and policy expectations, but also for relative equity performance, as international markets have become more vulnerable to swings in oil given their greater external energy dependence.

FIXED INCOME, CURRENCIES, AND COMMODITIES

As highlighted above, macro assets are the most affected by the geopolitical turmoil, wrong-footing market participants in a myriad of ways. Two of the biggest shocks are the rally in energy prices and rebound in the dollar. These two moves have had

major knock-on effects, including in precious metals, interest rates, and high beta currencies.

A surge in energy prices is unsurprising in the context of a major war in the Middle East and, in particular, the closure of the Strait of Hormuz. Before the war, consensus positioning was for energy prices to trade sideways or even lower in 2026. Instead, Brent Crude is 86% higher year-to-date and 53% higher year-on-year while European natural gas is nearly 90% higher year-to-date and approximately 40% higher than its year ago price.

Energy commodities are not the only commodities impacted by the disruption in the Strait. Fuel alternatives including ethanol have seen their prices rise substantially, as have other directly impacted materials such as petrochemicals, aluminum, helium, and fertilizers. In contrast, precious metals prices have dropped sharply. Gold and silver are down 14.6% and 25.2%, respectively, so far in March – erasing essentially all their year-to-date gains.

The moves in precious metals are in part a reaction to the resilience during the war of the dollar, even as equities and fixed income have suffered. High beta, mostly emerging market, currencies have been the hardest hit with South African rand, Egyptian pounds, Hungarian forint, Thai bhat, and Mexican peso performing particularly poorly. Developed market currencies have fared better, but majors such as the yen, Swiss franc, euro, and Norwegian krone are all 2-4% weaker against the dollar since the conflict began.

Interest rate expectations have also shifted. As of market close on February 27th, short term interest rate markets were pricing two full interest rate cuts from the Fed by the end of 2026, with a near 50% probability of a third. Inflationary concerns stemming from the conflict have caused a significant repricing in those expectations, with markets now pricing as much as an 80% chance of a hike by the end of this year in recent days, before receding some. An even more dramatic repricing has occurred on the other side of the pond with markets now expecting more than two hikes from both the European Central Bank (ECB) and Bank of England (BOE). Markets had been

pricing a 50% chance of a cut from the ECB and two cuts for the BOE. These front-end re-pricings have been accompanied by back-ups in rates across the curve, inflicting losses on fixed income portfolios.

PRIVATE CREDIT

Private credit has faced an intensifying wave of negative headlines in recent months, with the largest retail funds the epicenter of investor and media concern. Federal Reserve Chair also has recently talked about the risks in this market. Gross redemption requests for the largest leveraged vehicles reached 8-9% in 1Q26, with Blackstone's BCRED reporting a 7.9% un-annualized gross redemption rate and BlackRock's HLEND reporting 9% before capping at its 5% contractual obligation.

Beyond the liquidity headlines, more durable structural pressures are accumulating within private credit portfolios. A looming maturity wall presents a near-term challenge: Lincoln International's Q4 2025 data shows that debt maturing in 2026 and 2027 carries the highest proportion of stressed senior debt (fair value below 90% of par) of any maturity cohort, with approximately 30-35% of those maturities having already been amended and extended once. Simultaneously, private credit's concentrated exposure to software and other asset-light businesses (estimated at approximately 60% of the market) creates a structurally distinct vulnerability to AI-driven disintermediation of the recurring-revenue models that underpinned the original lending thesis, with recovery rates on asset-light borrowers likely to prove materially worse than historical averages in a default scenario.

The risk of contagion extends well beyond the semi-liquid vehicle universe. Insurance companies, having grown their private credit allocations materially in recent years, represent a further channel of transmission. In credit markets, stress has a way of spreading to places it was not expected to reach, and the opacity that once attracted investors to private credit now makes it harder to distinguish isolated problems from systemic ones.