

Thinking Out Loud



Let's Get "Strait" To The Point: Part 2

3/13/2026

What Is Going On?

On February 28, 2026, the United States and Israel initiated coordinated military operations against Iran, with the stated objective of dismantling the country's military capabilities and potentially facilitating regime change. We are now in day 13 of this conflict with tensions only escalating.

Markets are currently navigating a complex backdrop, with a hot military conflict unfolding alongside manic economic data. On one hand, the U.S. economy is showing signs of stabilization, with manufacturing firming, bank lending (standards) improving (easing). Credit markets remain orderly, as Investment Grade and High Yield spreads have widened modestly but remain stable. In equities, the long semiconductors/short software trade appears to be unwinding as large-cap technology may be once again viewed as a safe-haven sector. The key question mark, in our opinion, remains the labor market. February payrolls fell 92k and the unemployment rate edged up to 4.4%. December payrolls were also revised down by 65k, bringing the three-month average to just 6k jobs. Retail sales came in weaker than expected, while the Atlanta Fed's GDPNow estimate for 1Q26 has been revised down from above 3.0% to 2.7%. Meanwhile, the second estimate for 4Q25 GDP printed at 0.7% QoQ, well below the 1.8% consensus forecast. With inflation expectations rising, a rapid deterioration in labor markets and/or increased pressure on essential household spending — particularly food and energy — could quickly challenge the widely held soft-landing narrative.

What Does History Tell Us?

As is typical during major geopolitical conflicts, markets are experiencing a rapid, emotionally driven sell-off in the initial stages. As of 3/12/2026, the S&P 500 is down 3.0% from the start of the conflict, while global equities (MSCI ACWI ex USA Index) are off 7.6%. The 10 Yr TSY has backed up 30bps to 4.26%, while the 2 Yr TSY has backed up 34bps to 3.73%. Precious metals, particularly gold, have failed to attract safe haven flows, as the US dollar has appreciated.

Historically, military conflicts generate short-term volatility and initial market sell-offs, followed by stabilization as the scope of the conflict becomes clearer. Further, when hostilities are preceded by a buildup phase, equities often weaken during the anticipation period but recover once conflict begins as uncertainty resolves. A similar pattern emerged in late January and early February, when the S&P 500 traded near 7,000 as the U.S. assembled its largest military presence in the Middle East since the Iraq War. However, when conflict erupts as a surprise, equities often decline sharply in the initial reaction but then recover quickly. This dynamic is known as the "war puzzle," where markets sometimes rally on bad news once the event removes uncertainty.

History shows that U.S. equity markets tend to be resilient after geopolitical or military conflicts. While markets often sell off initially, volatility during wartime has frequently been lower than the long-term average, with the Gulf War being a notable exception. During these periods, investors often move into safe-haven assets such as Treasuries and gold before eventually viewing geopolitical shocks as buying opportunities for equities.

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Is It Different This Time Around?

Markets may be facing a somewhat different environment this time. More than \$6 trillion was initially wiped from global equity markets, while government bond yields moved higher, raising concerns that investors may be beginning to price in a stagflation backdrop. Oil has been central to this shift: at the start of the conflict, WTI briefly approached \$100 per barrel and Brent surged above \$119 before each falling roughly 11-12%, only to rebound back up near \$95 and \$100, respectively. **The key risk, in our view, is the continued flow of energy through the Strait of Hormuz and the potential for a sustained disruption to global supply.** The Strait carries roughly 20% of global crude oil and 25% of LNG shipments, including nearly 78% of exports to China, Japan, South Korea, and Taiwan¹. **Any prolonged closure would severely disrupt Asia's energy supply chain and pose a material risk to global economic activity.**

History may suggest this conflict will prove short-lived and that tensions will ease once the initial escalation subsides. However, we believe that assumption warrants greater scrutiny in this instance. Our research suggests Iran may be approaching a strategic crossroads with the West, where mounting external pressure – and the perceived threat to national sovereignty – could strengthen nationalist sentiment and rally domestic support around the regime, despite its repressive and authoritarian nature.

How Can Oil Spikes Translate Into Something Worse?

History suggests that oil price spikes associated with geopolitical conflicts are often temporary once supply conditions normalize. **The critical question, however, is whether today's economic backdrop makes this episode different—and whether a sharp rise in oil prices could transform a regional military conflict into a broader global economic shock, elevating recession risks and weighing on equity markets.** As we have previously noted, we believe this time may prove different, particularly as Iran's resolve appears to be hardening with each passing day, potentially limiting opportunities for de-escalation—even if an offramp were presented by the United States or brokered by neighboring Arab states.

Further, our research does suggest that oil price spikes have historically coincided with recessions and bear markets, often occurring around periods of economic contraction. However, the direction of causality is not always clear—sometimes the economy was already weakening, while in other cases the energy shock preceded the downturn.

One exception was the 2022 oil spike following Russia's invasion of Ukraine. Although the U.S. recorded two consecutive quarters of negative GDP growth—the technical definition of a recession—the broader economy remained resilient, with strong job growth and consumer spending, while GDP weakness was largely tied to trade and inventory swings. **Setting aside that episode, the current conflict and resulting oil spike remain a concern. At best, the military escalation coincides with and further complicates an already fragile soft-landing scenario. At worst, the economy may already be entering the late stages of the cycle and drifting toward recession. How rising oil prices interact with the global economy at this juncture remains the central question for investors.**

¹ www.atlanticcouncil

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Unlike prior geopolitical episodes, the current conflict represents a direct threat to both energy production and transportation capacity, with limited alternative supply routes available. It also carries the potential for an existential challenge to Iranian sovereignty.

The closure of the Strait of Hormuz would amount to a form of mutual assured economic destruction, disrupting roughly 20% of global crude oil supply and about 25% of LNG shipments—more than twice the scale of the Suez Crisis and nearly three times that of the OPEC oil embargo. Southeast Asia and India appear particularly exposed, consuming nearly 80%² of the oil exports that transit the Strait. While France, Germany, and the U.K. are less dependent on oil flows through the region, they remain meaningfully reliant on LNG shipments that pass through this route.

To calm markets, 32 countries have announced the release of a record 400 million barrels³ from strategic reserves. While initially welcomed, the release may ultimately fall short, serving more as a political bridge—buying time for a potential ceasefire while easing domestic pressure as fuel prices rise ahead of U.S. midterm elections. With global oil demand near 100 million barrels per day⁴, the reserves represent only about four days of demand and will be released gradually. Meanwhile, the conflict has removed roughly 20 million barrels per day from global supply, while reserves may add only about 2 million barrels per day, leaving a potential shortfall of roughly 18 million barrels.

While the U.S. has become a net exporter of oil, surging energy prices—and the risk of renewed inflation—could still impact the domestic economy and capital markets. If the Strait of Hormuz remains shut, it may place the FOMC in an increasingly difficult position and create a challenging backdrop for incoming Fed Chair nominee Kevin Warsh. Prior to the conflict, markets expected further progress on inflation and at least two rate cuts in 2026. The Fed Funds target range remains at 3.50%–3.75%, unchanged since year-end 2025. However, at the time of drafting this note, the CME Fed Watch Tool now shows markets pricing only one additional 25-basis-point cut in 2026, down from two before the conflict, reflecting concerns that higher energy prices could slow disinflation.

What Do We Think Is In Store Next?

In short, we feel there are three potential outcomes.

1. Short Duration (1–3 Weeks) – Low Probability (10%)

Iran capitulates, a less conservative regime emerges, and the Strait of Hormuz reopens within weeks. This is the most favorable outcome for risk assets, in our view, but seems less likely by the day. Oil could retrace quickly, with Brent falling back toward the low-\$70s and potentially the \$60s by late 2026.

2. Persistent Disruption (4–8 Weeks) – Highest Probability (50%)

Iran sustains resistance with support from allies such as Russia and China, allowing the regime to remain intact and potentially become more emboldened. The Strait of Hormuz remains closed while drone strikes continue across the region. Under this scenario, Brent crude trades in the \$90–\$100 range, markets move sideways, and

² www.atlanticcouncil.org

^{3,4} www.discoveryalert.com

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central banks remain cautious. In our view, recession risks rise until a ceasefire is brokered—potentially by a neighboring Arab state—or Iran agrees to tighter nuclear restrictions and enhanced international oversight.

3. Prolonged Conflict (>2 Months) – High Probability (40%)

A drawn-out conflict involving U.S. ground forces could keep Brent crude well above \$100 and risk systemic damage to energy infrastructure and supply across the region. As in 1973, it is the duration—not the initial price spike—that ultimately transforms a geopolitical shock into a global economic shock. In our view, this scenario would first raise concerns about stagflation and could quickly evolve into a recessionary environment, as the Fed moves to stabilize markets by aggressively cutting the short end of the curve while long-term yields remain elevated.

What Should Investors Consider Doing (Or Not Doing?)

Avoid panic selling unless liquidity is needed. Historically, geopolitical-driven sell-offs in U.S. equities have tended to reverse over time. Investors who sell into the initial drawdown often miss the subsequent recovery. In our view, portfolios should be aligned with long-term objectives rather than short-term emotion or fear, unless near-term liquidity needs or capital preservation considerations require a more defensive allocation.

Differentiate between anticipated and surprise escalation. The U.S.–Iran conflict followed a visible buildup phase, which historically has been more favorable for equities once hostilities begin. Much of the selling often occurs before conflict starts—unless severe disruption persists and the probability of a prolonged conflict rises meaningfully.

Monitor oil as the key indicator. Brent's move toward and above the \$100–\$120 range is the critical variable to watch.

Tilt rather than de-risk broadly. Instead of moving aggressively to cash, consider rotating toward sectors and assets that historically benefit from geopolitical stress.

Use hedges strategically. Gold and short-duration Treasuries have historically provided portfolio ballast during geopolitical crises—Treasuries for safe-haven flows and gold for uncertainty-driven demand.

Which Sectors Could Benefit?

Aerospace & Defense: Likely beneficiaries as military spending rises in the U.S. and Europe in response to heightened geopolitical tensions.

Energy: Oil and gas producers benefit from supply disruption premiums, while increased military activity and industrial production support additional energy demand.

Commodities & Gold: Gold serves as a traditional safe haven, while commodity producers—particularly industrial metals—benefit from increased demand tied to defense production and advanced weapons systems.

Cybersecurity, AI & Robotics: Modern warfare is increasingly technology-driven, directing government and defense spending toward cybersecurity, artificial intelligence, and autonomous systems.

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Post-Conflict Infrastructure: Once hostilities end, companies tied to reconstruction—roads, bridges, utilities, buildings, and heavy equipment—typically benefit as rebuilding efforts accelerate.

Which Sectors Could Face Headwinds?

Airlines & Tourism: Highly sensitive to rising fuel costs and weaker travel demand, creating pressure on both margins and revenue.

Consumer Discretionary: Rising energy prices act as a tax on consumers, compressing margins and reducing discretionary spending.

Insurers: Elevated claims risk and uncertainty around geopolitical and energy-related liabilities may weigh on the sector.

We'd love to hear your thoughts.

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