

Financial market jitters had been expected starting last week as U.S.-Israeli forces launched a military campaign on several locations in Iran, which included the death of the Iranian leader. The U.S. market's somewhat muted reaction early, showing just a minor decline, appeared to be in keeping with a relatively limited magnitude of military action and expectations of a limited time span of action. Further weakening in sentiment was related to an intensification of the conflict into Lebanon, which raised market concerns of a wider regional conflict. Foreign stocks in Europe, Japan, and emerging markets, have suffered a bit worse, due to their higher degree of energy import dependence compared to the U.S.

Of course, the kinetic situation remains quite fluid, and hopes are that the human cost will remain low. Iran has responded militarily, attacking the oil infrastructure of its neighbors, before apologizing at one point, with financial market reactions continuing to hinge day to day on the most recent actions, regions targeted, and political responses. Earlier this week, hints from the U.S. administration implied the war would be over "soon," which led to some optimism. A key fear has always been the potential closure of the Strait of Hormuz—a narrow passage between Iran and Oman that represents one of the most strategic waterways in the world—through which one-fifth to one-fourth of the world's crude oil shipments pass. Hampering ships navigating through the strait is perhaps Iran's most effective geopolitical weapon. Although U.S. forces have decimated the Iranian navy, more subtle targeting of vessels has continued, with the mere threat of attacks and the more extreme action of laying mines being enough to significantly reduce commercial shipping traffic. Indirectly, the sharp rise in shipping insurance costs has been an effective weapon in its own right, as have higher oil prices. How long the physical conflict lasts is a primary concern for the world economy.

Most directly, as has been the case with Middle East conflicts for decades, the price of crude oil is the first point of market focus. Prices have moved 5-10% per day several times already, as the worst was feared, about not only shipments out of the Persian Gulf but also a stoppage in Iranian production (5% of world output), creating a negative supply shock. On the other hand, the world had been otherwise well-supplied with crude oil as of late, potentially muting some of that impact, and keeping world prices lower than they would have been otherwise. There is also the complexity of phantom oil tankers floating around the world's oceans that contain Russian sanctioned oil in legal limbo. This becomes even more complicated for Iran, in that it needs to keep producing and selling domestic oil to fund its budget and military actions. (The Iranian economy broadly has been otherwise crippled with sanctions, which have kept economic growth low and inflation high for years, fueling internal societal discontent.)

Second order effects include weakness in U.S. and international stock and bond markets. The U.S. has become somewhat more buffered from Middle East oil concerns due to strong North American petroleum production with contributions from shale, while European and Asian markets remain much more sensitive. While economies are less reliant on the price of crude oil than they used to be (the base case being the price shocks and resulting inflation during the 1970s), it's still a substantial economic input, especially as higher prices translate into higher costs for transportation and manufacturing, and related products are affected, such as gasoline, jet fuel, and petroleum-based chemicals and fertilizers. With strong recent stock market performance and elevated valuations in some areas, the margin for error has tightened, which raised sensitivity to exogenous factors like geopolitical trouble. As these types of

fears can come in bunches, the Iran conflict and potential for AI disruption in software have acted somewhat back-to-back.

While bonds have often acted as a safe haven during stormy times for stocks, concerns over rising oil prices pushing headline inflation higher, have kept the Fed and other central banks on hold, and kept yields from falling. However, should economic conditions worsen as a byproduct of the conflict, it's possible central bank easing talk might begin again, although above-target inflation could complicate the message. From an asset class standpoint, commodities have again proven productive as an insurance policy from geopolitical strife, due to crude oil obviously, but also precious metals continuing their strong momentum from the past year. While times like these are unsettling, they serve as good reminders for owning a diversified portfolio, which includes a variety of non-correlated financial assets (and commodities specifically in this case).

As we tend to regularly see, markets seem to prefer a known outcome (even if bad) rather than living with long periods of uncertainty. While military actions thus far have been limited and targeted to certain military installations and political leadership, worries are focused on the regional and global implications of a war being sustained with an unclear timeline for resolution. Iran appears to have been on the brink of collapse for a while, with few friends in the region, widely assumed to be a state sponsor of various terrorist groups, internal public discontent and demonstrations, a forceful government response unpopular globally, and now the death of the public leader with an unpopular succession plan (the former leader's son). That 'wildcard' nature has raised the stakes more than last year's targeted nuclear strikes, with regimes on the brink being far less predictable. At the same time, the region has changed over recent years, with the regime in Syria having turned over as one example, and greater cooperation seen among several other Gulf states.

More positive news is that such periods of financial market concern, even during intense geopolitical conflicts, have tended to be short-lived historically. Markets have a limited attention span, moving from one worry to the next, but ultimately fall back to an anchor of corporate fundamentals and trend growth. In the U.S. specifically, earnings growth has been running at over two times its multi-decade long term average, helped by robust profit margins and the tailwinds of last year's tax extensions. However, risks remain in that sustained higher oil prices and supply shocks elsewhere raise the probabilities of the global economy tipping into recession. But, such prices would need to be sustained and overwhelm any offsetting supply solutions, as well as offset the positives of generally decent growth in other sectors. As it's often put in commodity markets, "The cure for high prices is high prices." Although military conflict is unsettling to markets and watchers, other components of the economy appear to be in decent shape, which adds an element of resilience.

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