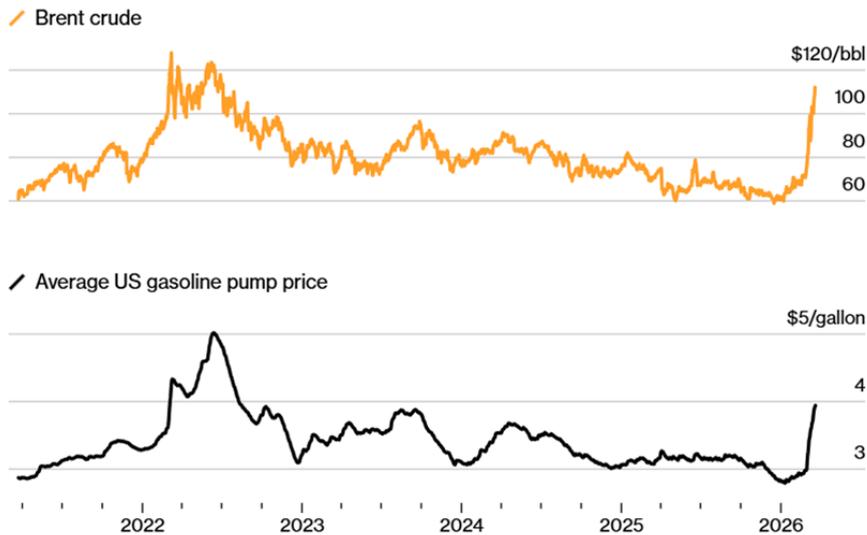


## Market Matters

### Investors awoken to idea of prolonged conflict

Global markets moved into a more unsettled phase last week as the Middle East conflict continued to intensify, with investors increasingly recognising that the disruption is likely to prove longer lasting and more economically significant than initially assumed. The effective closure of the Strait of Hormuz, through which a large share of global oil and liquefied natural gas normally flows, has shifted the narrative from a geopolitical shock to a sustained supply event. Oil prices have now remained elevated for several weeks, increasing the probability that the economic consequences extend beyond short-term volatility and begin to influence inflation expectations and monetary policy decisions more meaningfully.

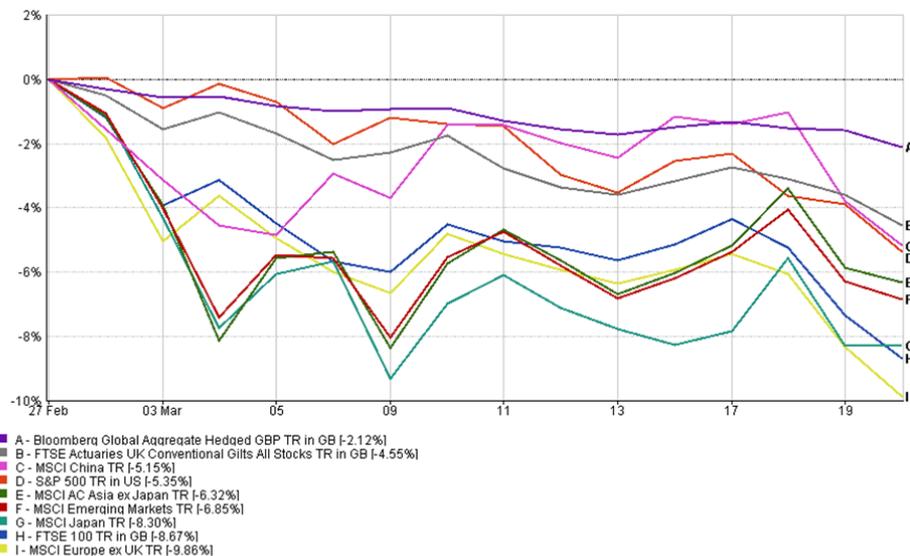
#### Oil and Gasoline Price Have Surged Due to Iran War



Political rhetoric has also hardened. Mixed signals from Trump, including suggestions that military objectives were close to being achieved, followed by renewed threats to target energy infrastructure, have added to uncertainty. From a market perspective, the absence of a clear diplomatic pathway is becoming as important as developments on the ground. Investors are increasingly focused on the duration of the disruption rather than simply its scale, recognising that prolonged energy shocks tend to have wider consequences for growth, corporate margins and financial conditions.

### Market performance reflects repricing rather than panic

This shift in perception has been reflected in asset market performance. Equity indices have weakened gradually over the past month, with declines broadening beyond the most energy-sensitive sectors. The US market, which initially showed resilience, has also begun to soften as higher bond yields and renewed inflation concerns have weighed on valuations. European and UK equities have experienced somewhat sharper moves lower, consistent with their greater exposure to imported energy costs and weaker underlying growth momentum.

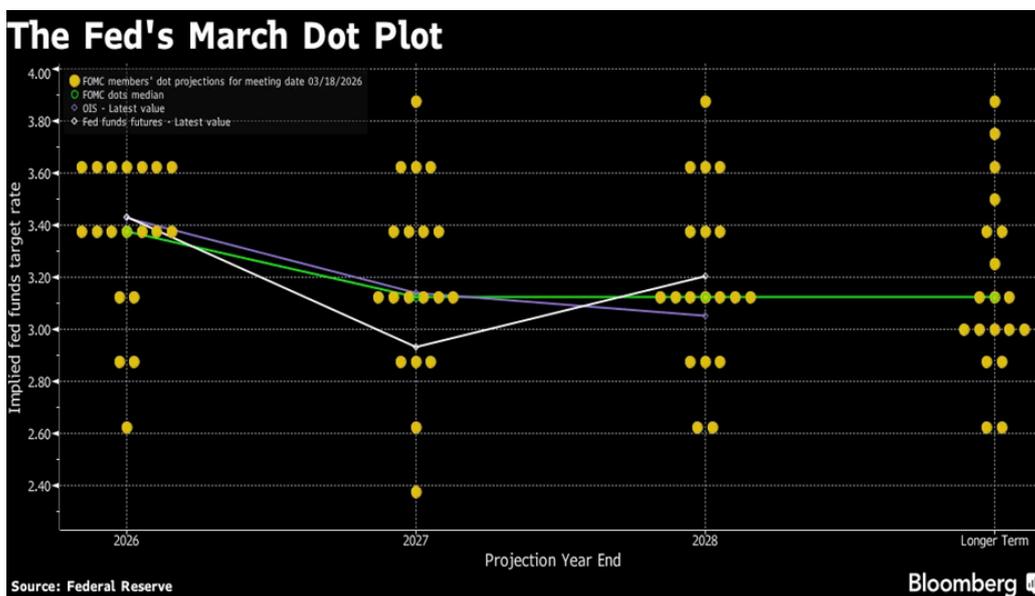


Importantly, the pattern of market moves has remained orderly so far! This suggests investors are adjusting expectations rather than panicking. There has been little evidence of systemic stress, credit spreads remain contained, and liquidity conditions are broadly stable, indicating that markets still anticipate a political resolution at some stage.

Government bond markets have been particularly sensitive to the evolving narrative. Yields have risen across most developed economies as investors reassess the likelihood and timing of interest rate cuts. The persistence of higher energy prices raises the risk that inflation will stabilise at levels above central bank targets, potentially requiring policy settings to remain restrictive for longer than previously assumed. The move has been more pronounced in markets where inflation expectations are perceived to be more vulnerable or where fiscal dynamics remain under scrutiny.

### Federal Reserve signals patience as war reshapes the inflation outlook

The Federal Reserve struck a notably cautious tone at last week's meeting, leaving interest rates unchanged while acknowledging that the inflation trajectory has become more uncertain amid the energy shock. Policymakers continue to expect only limited rate cuts over the coming year, but the bar to easing policy has clearly risen. Chair Jerome Powell emphasised that progress on underlying inflation will need to be sustained before any meaningful shift in policy stance can be justified.



Energy costs are feeding directly into goods prices and transport costs, while higher fuel prices are beginning to influence consumer inflation expectations. The Fed's updated projections, which show inflation settling modestly above previous assumptions, reinforce the sense that monetary policy may need to remain restrictive for longer than markets had anticipated earlier in the year.

From a market perspective, the implication is not that rate hikes are imminent, but that the easing cycle is likely to be pushed further into the future. In practical terms, tighter financial conditions raise the hurdle for equity valuations and increase the sensitivity of risk assets to geopolitical developments.

### United States economy remains resilient but political pressure is building

The US economy continues to display relative resilience compared with other developed markets. Corporate earnings momentum remains broadly intact, and domestic energy production provides a partial buffer against the external shock. However, the political economy of higher fuel prices is becoming increasingly relevant. Sustained gasoline prices at elevated levels have historically weighed heavily on consumer sentiment and can quickly become a focal point for domestic political pressure.

This dynamic is particularly important given the erratic signalling from policymakers over the past few weeks. Markets have reacted sharply to shifts in tone from Washington, with rallies on perceived de-escalation quickly reversing when more aggressive rhetoric re-emerges. As a result, volatility in US equities has increased even though underlying economic data has not deteriorated significantly. As we emphasised earlier, investors are beginning to treat the conflict as a macro risk rather than simply a geopolitical headline.

### United Kingdom faces stagflationary risks as energy shock hits a fragile economy

The UK enters this phase of the cycle with less economic momentum and greater exposure to imported energy costs. Recent data already suggested that growth was stalling before the conflict intensified, and the rise in oil and gas prices now raises the risk of a renewed squeeze on real incomes.

Gilt markets have reacted accordingly, with yields moving higher as investors price out expectations of near-term policy easing and begin to factor in the possibility of more persistent inflation. Unlike in previous cycles, the rise in yields has not been driven by strong growth expectations but rather by concerns about inflation resilience and fiscal vulnerability. This combination can create a more challenging backdrop for domestic equities, particularly in sectors exposed to consumer spending.

The Bank of England is therefore likely to remain cautious. While weaker growth would normally justify policy loosening, the risk that higher energy prices feed into broader inflation expectations makes an early rate cut increasingly unlikely. In effect, the UK faces a more classic stagflationary mix of subdued growth and rising price pressures.

### **Europe caught between inflation risk and weaker demand**

The euro area sits somewhere between the US and the UK in terms of exposure. Growth conditions remain relatively subdued, yet the region is highly sensitive to disruptions in energy supply. Policymakers at the European Central Bank have adopted a wait-and-see approach. Still, there is a growing recognition that sustained high energy prices could eventually require a firmer policy response to prevent second-round inflation effects.

European equity markets have been particularly sensitive to this uncertainty. Export-oriented sectors face the dual challenge of softer global demand and higher input costs, while financial conditions are tightening as bond yields edge higher. The result has been a gradual repricing rather than a sharp selloff, reflecting the market's attempt to balance cyclical headwinds with the possibility of eventual policy support.

### **Back to the Conflict and what markets are really saying now**

The focus has shifted to how long energy disruption persists and how much economic damage accumulates before political pressure forces a resolution. Mixed signals from Washington, including threats to energy infrastructure alongside suggestions that military objectives are largely achieved, have reinforced the sense of tactical volatility rather than strategic clarity. Oil prices above \$110 and the continued fragility of shipping routes have therefore transformed what began as a geopolitical shock into a clear macroeconomic concern.

Importantly, market behaviour still reflects a view that the situation, while serious, remains ultimately solvable. Equities have weakened, bond yields have adjusted higher, and expectations for near-term rate cuts have been pushed back. However, the stability in credit markets suggests investors believe a negotiated stabilisation is likely, even if the path towards it is uncertain. The longer oil prices remain elevated, the stronger the domestic and global incentives become for policymakers to find a workable solution.

### **Why pressure to stabilise is intensifying**

Economic realities are now driving the political timetable. For the United States, rising gasoline prices risk undermining consumer confidence and indirectly tightening financial conditions. Across energy-importing regions, the implications are similarly uncomfortable. Gulf economies can tolerate heightened tension, but sustained disruption to critical infrastructure or trade flows would carry significant financial risks. Europe and Japan are exposed primarily through imported inflation rather than direct military threats, yet the economic impact could still be meaningful. The limited appetite among allies for deeper military involvement also increases the likelihood that diplomatic channels and technical arrangements around shipping security will play a larger role in shaping outcomes.

Iran's approach so far appears calibrated rather than maximal. Selective disruption provides leverage without fully collapsing its own economic lifelines. This leaves, however narrow, room for a face-saving de-escalation in which transit conditions gradually improve while political rhetoric remains confrontational.

### **What does a realistic off-ramp look like?**

A comprehensive political settlement remains unlikely in the near term. A more plausible scenario is a narrower stabilisation that allows each side to claim progress while reducing pressure on global energy markets. The United States could argue that key military objectives have been achieved, while Iran could emphasise regime resilience and strategic deterrence. Such positioning would make it easier to step back without formal concessions.

In practical terms, markets are less concerned with political symbolism than with restoring predictable energy flows. Even partial improvements in shipping security, informal transit guarantees, or a pause in strikes on critical infrastructure could help anchor inflation expectations and support risk sentiment. The outcome may look untidy and temporary, but financial markets would likely respond positively to any credible signs that supply chains are normalising.

### **What are the risks that could still unsettle markets?**

The main danger remains the risk of escalation before an off-ramp emerges. Significant damage to production capacity or major attacks on regional energy assets would risk shifting the current orderly repricing into something more destabilising. In that environment, concerns would extend beyond delayed rate cuts towards broader financial tightening and sharper growth downgrades. For now, the relative calm in credit markets indicates investors still see this as a downside scenario rather than the central case.

### What are the implications for investors?

An appropriate stance is neither complacency nor panic. The situation has clearly become more serious, and markets are now adjusting to the possibility of sustained energy-driven inflation and tighter policy constraints. At the same time, a considerable amount of capital remains cautious and under-invested. Political incentives to prevent further economic damage are strengthening, which means that genuine progress on energy stability could trigger a meaningful relief rally.

In short, the conflict has evolved into a more complex macro risk, and volatility is likely to remain elevated in the near term. Yet the very severity of the oil shock increases the probability that a pragmatic compromise will eventually emerge. The path may remain unpredictable and sentiment fragile, but if even a partial stabilisation materialises, market recoveries could be sharp as investors reposition for a less constrained global outlook.



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