

EMD FLASH COMMENT

IRAN: FATTER TAILS

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GlobalEvolution

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Tactically, the Middle East escalation calls for a cautious stance on EMD risk exposure and core duration, in line with our recent top-down stance. Judged by the objectives and the amount of military resources deployed by the US as well as Iran regime’s willingness to retaliate amid its fight for survival, the conflict could be more long-lasting than the initial market reaction indicates. That said, the Washington’s aversion to higher oil prices and Iran’s limited military capabilities should prevent the conflict extending into the *strategic* investment horizon. In the same vein, sustained spikes in oil prices seems unlikely. While the range of outcomes has widened, this should not be a game-changer, neither for markets nor the business cycle.

By Witold Bahrke, Senior Macro and Allocation Strategist

“Epic Fury”: Worst escalation in decades

US and Israel have launched the most severe attack against Iran in decades. In the grand scheme of things, operation “epic fury” hardly came as a surprise (see chart 1) and showcases one of the most prominent top-down regime shifts we have highlighted for some time, namely the transitions from low towards higher geopolitical uncertainty.

However, it seems the consensus expected a more limited military operation, at least initially. The US’ apparent objective of achieving a regime change in Iran has not been aired beforehand. Teheran’s response has been more wide-ranging than anticipated. While many observers saw a military intervention coming, few analysts did expect Iranian attacks on civil targets in other gulf states and a de-facto closure of the Hormuz Strait, through which 20% of the world’s oil shipments are flowing.

Chart 1: Probability of US striking Iran has been elevated for some time, pulling oil prices higher.



Already at the current juncture it is therefore fair to

say that the Middle East conflict has entered a new dimension. In order to assess the wider impact on the global economy as well as markets, the key question is how long the conflict will last.

Timeline: Not days, not months but probably weeks

There’s a lot to win but also a lot to lose for the involved parties, both economically and from a security perspective. Taking into account what appears to be the main parties core objectives, the military action is unlikely to last months. A resolution within days appears equally unlikely.

The US military build-up in the region is testament to the US wide-reaching ambitions, or as Trump put it, the US will do “whatever it takes” to achieve its objectives. Based on recent military actions and statements from the White House and Israel’s government, US and Israel prime objectives are to prevent Iran from becoming a nuclear power, destroy vast parts of its military resources and toppling the current regime.

For Washington, the oil price is also part of the equation. Here, the silver lining is that the US president wants to avoid higher oil prices into the mid-term elections. While this implicit objective should prevent the conflict from stretching over months, it also increases the incentive not to end the military campaign too soon as quick wins are a distant prospect in the region. Iran could ramp up it’s production much faster than e.g. Venezuela. To that end, the White House administration might see the current conflict as a once in a generation opportunity to achieve these goals. Based on our best judgement,

it takes a serious reshuffling of the Iranian regime to pave the ground for a sustained increase in oil supplies and minimizing the risk of renewed disruptions in the future.

In other words, some kind of regime change or at a minimum a leadership reshuffling in Teheran is a necessary condition for achieving both security and economic objectives. The country's leadership structure is very complex and the term "regime shift" can take many forms. While it takes the finishing line less clear than in previous military operations, it seems quite clear this objective will not be achieved within days, pointing towards an extended military campaign.

What about Iran? Given US and Israel's goals described above, the Iranian regime - or at least the remaining parts of it - is fighting for its survival. As things stand, it has no obvious off-ramps. This makes Iran a less rational player. Consequently, it stated having "no red lines" when it comes to retaliatory responses. Granted, its military capabilities are severely hampered. Still, Iran should be able to e.g. impair oil flows from the region significantly for an extended time period. At the time of writing, Iran has claimed to close the Strait of Hormuz according to state media. Even before this headline broke, insurance companies withdrew their war-risk coverage which effectively causes oil flows through the strait to dry up.

Altogether, the conflict looks to span over several weeks. However, uncertainty has jumped higher, as well. The combination of a very ambitious plan on the US/Israeli side and a desperate Iranian regime that feels it has its back to the wall implies a wide range of outcomes and fatter tail risks around the main scenario.

Although Teheran has refused to negotiate since the US and Israel started their attacks, one cannot rule out that the Iranian regime changes its mind in the eleventh hour and seeks to negotiate, causing the conflict to be halted within days. On the other hand, Iran remains something of a black box and we might underestimate the regime's ability to cling to power and keep the conflict going. In that case, the conflict could take months and recession risks would re-emerge as oil prices take quantum leap higher, leading to a sharp sell-off in risk assets (see table 1).

Table 1: Expected short-term impact of Middle East conflict on key market prices¹.

Length of military conflict	Oil	Core Rates	Dollar	Risk Appetite
Days	↓	↑	→	↑
Weeks (base case)	→	↑	↑	↓
Months	↑↑	↑↓	↑↑	↓↓

Source: Global Evolution

Fundamentals: No game changer

It goes without saying that the key transmission mechanism between geopolitical risks in the Middle East and the economy at large is the oil price. On a positive note, the oil market finds itself in an ample supply regime and OPEC has already pledged to increase its daily oil supply by more than 200,000 barrels/day in response to the escalation. However, our suspicion is that markets are pricing a quick resolution, underestimating the risks of a prolonged conflict and Iran's willingness to hit the wider oil infrastructure and trade channels. Therefore, we think current oil prices will prevail around current levels and could briefly spike significantly higher, although such moves should prove to be short-lived.

This adds to the near-term upside risk to inflation we highlighted in our recent [outlook](#). The military conflict shouldn't alter the trajectory of the overall business cycle, though, provided the conflict does not last several months and medium-term oil prices do mean-revert back to current levels. Military escalations of limited time spans tend not to have significant and long-lasting effects on overall growth. Even with oil prices remaining relatively high in the short-term, levels are far from extreme in a historic context, limiting the potential fallout from weaker household demand.

That said, differentiation is key. Oil importers will be hurt, while oil exporters could benefit from current developments. China, in particular, could be negatively impacted by higher oil prices over the coming months and a potential regime shift in Iran. It is an oil importer and has bought the bulk of Iranian oil. On the other hand, oil exporters outside the Middle East are among the winners relatively speaking, as they stand to benefit from higher oil prices while at the same time

¹ Relative to current levels (as of March 2 2026)

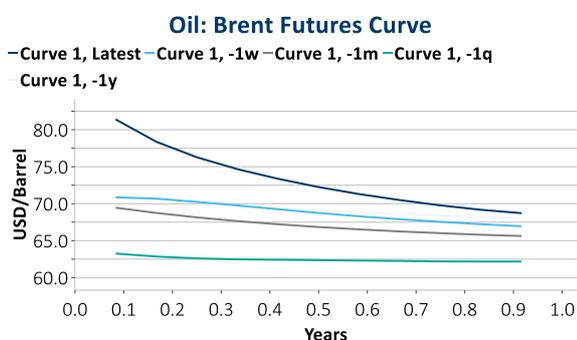
being shielded somewhat against a regional geopolitically-driven risk premium.

Markets: We're not there, yet

Historically, such geopolitical events had “buy-the-dip” written all over them, presenting buying opportunities across a broad spectrum of risk assets. Ultimately, this time might not be all that different, offering attractive entry points further down the road. It is still early days but investors are seemingly taking comfort from historic precedence.

On the flipside, operation “epic fury” triggered fatter tail risks. Markets might underestimate the stamina of the major conflict parties US, Israel and Iran. The risk of a more prolonged period of geopolitical tensions, risk aversion and higher for longer oil prices (see chart 2) seems underpriced as oil futures downward trajectory has remained largely unchanged over the past months. Core rates and Fed’s expected rate path has moved higher in the first trading session after the attacks on Iran were launched, albeit moderately so. EM sovereign spreads barely reacted.

Chart 2: Oil price futures



Source: Global Evolution, Macrobond and Bloomberg

We are constructive when it comes to full year EM debt returns as the global economy remains resilient and fundamental datapoints (inflation, growth) support the case for EM debt (see the latest Global Evolution outlook [here](#)). We therefore believe tactical set-backs presents attractive entry points in e.g. lower-rated EM credit segments.

All being said, we’re not there yet as neither the US, Israel nor Iran has clear incentive to de-escalate within days. The trifecta of investors underpricing the risk of an extended conflict, stretched tactical indicators (sentiment, positioning and valuation) and additional inflation risks reinforces our tactically cautious stance on overall EMD risk exposure as well as core duration.

Near-term, our base case therefore suggests higher oil prices, upside risks to core rates as inflation risks linger, downside risks to EM currencies and a bias towards further EM credit spread widening.

Positioning: Keeping some powder dry

Overall, our core strategies are well positioned for a period of higher oil prices, elevated market volatility, spread widening and EM FX depreciation risks. From a top-down perspective, we entered the year with a cautious tactical stance on overall EMD risk and duration. In an asset allocation context, our tactical preference for hard currency EM debt and USD strengthening should pay off. We have reduced the riskiest credit segments in the hard currency universe, bringing down overall portfolio betas. Although a resilient global economy should create attractive entry points in the longer-term, we are opting to keep some powder dry amid near-term spread-widening risk.

From a regional perspective, we have reduced the exposure to the Middel East and are now underweight the region in our hard currency sovereign strategy. On the local currency side, we have reduced positions in Romania and Hungary as Eastern Europe is the most vulnerable region when it comes to higher energy prices and Dollar strength. Additionally, we have trimmed exposure to South Africa, reflecting its high-beta characteristics and sensitivity to a risk-off USD environment. China, which is most exposed to higher oil prices in the near-term and disruption in Iranian oil supply, has been a significant underweight for some time. Meanwhile, our preference for Latin America should benefit from the Middle East conflict and higher oil prices as the region has many oil exporters, while at the same time being somewhat distanced from rising geopolitical risks in the Middle East region.

Turning to Frontier Markets, history has shown that this segment has weathered major EM and global drawdown periods relatively well. Furthermore, Frontier Markets debt has typically rebounded quickly from drawdowns, largely due to strong local investor participation, which reduces forced selling during global risk-off episodes. At the same time, the high carry component has supported overall returns.

As the Frontier strategy maintains a relatively low duration, it is less sensitive to global rate movements compared to comparable fixed income strategies. Currently, the Frontier blended strategy holds positions in 37 countries, of which only a handful are directly impacted by the escalation of the conflict.

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