

Iran conflict scenarios: Strait of Hormuz and market implications

Early morning Saturday, February 28, the U.S. and Israel commenced military actions against Iran. Strikes targeted leadership, military sites, naval power and eventually oil infrastructure. The conflict is in its second week, with Iran using missiles and drones to strike against Israel and regional oil exporters. Equity markets are retrenching, with the S&P 500 retreating about 5% from January all-time highs before recovering recently, while the developed markets MSCI EAFE Index and the MSCI Emerging Markets Index declined 8%-10%.

Why the Strait of Hormuz matters

The key issue for markets is in virtual closure of the vital energy shipping lanes through the Strait of Hormuz and limited near-term alternatives at meaningful scale. The U.S. Energy Information Administration (EIA) estimates that roughly 20% of global oil supplies and 20% of global liquefied natural gas (LNG) transited the Strait of Hormuz in 2024.

The strait also influences food price risk through fertilizer trade and related agricultural inputs. The Fertilizer Institute (TFI) indicates that nearly 50% of global urea exports, used in fertilizer, originate from countries west of the Strait and typically transit this route. When shipping slows, tighter fertilizer availability can increase farming costs and contribute to food price inflation over time, particularly for import-dependent regions.

Market transmission and regional sensitivity

The selloff in equity markets reflects spikes in global oil and natural gas prices. Brent crude oil and wholesale gasoline prices are up approximately 50% from the start of the year. The rapid rise in oil prices catalyzed investor concerns centered on the potential for accelerating inflation and stalling growth.

International equity markets have tended to react more sharply than U.S. equities when energy supply risk rises, because many European and Asian economies import a significant share of the energy they consume. Higher oil and LNG prices can reduce household purchasing power, raise operating costs for businesses and weigh on near-term growth expectations for net importers. If fertilizer prices rise at the same time, food cost pressure can add a second inflation channel that reinforces the headwind for regions that import both energy and agricultural inputs.

Scenario framework: Outcomes driven by duration

In our view, the key for global economies and markets is the duration of shipping constraints through the Strait of Hormuz, which may differ from the duration of military operations in Iran. We outline three scenarios describing risks and impacts tied to how long global energy supplies are held up in transit:

Scenario 1 (best case): De-escalation and near-term normalization

This is a short-term resolution measured in days, where shipping restarts through the Strait of Hormuz over the course of the next week or so. While U.S. and Israeli strikes may continue, shippers receive insurance and U.S. naval vessels may offer security protection through their transit. We have modest expectations this is probable.

- This resolution would be welcomed by markets, with foreign equities the likeliest leaders. Recent foreign stock declines reflect their significant dependence on imported energy. With a near-term resolution, these regions would avoid the worst scenarios and strong fundamental trends in place prior to the conflict would remain intact.
- Until this scenario materializes, we would watch closely to validate equity price trends remain intact. This includes the S&P 500 remaining in an upward trend, above its 200-day moving average, currently around 6,585.

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- Also, we would confirm that inflation expectations remain contained with the 10-year Treasury yield holding in the recent range between 3.95%-4.35%, currently around 4.1%.
- We anticipate the market reaction to a short-term resumption of shipping traffic through the Strait of Hormuz would anchor on existing constructive trends in economic growth, corporate earnings and relatively stable-to-moderating inflation.

Scenario 2 (base case): Strait of Hormuz reopening within two to six weeks

In this scenario, insurance coverage for shipping resumes, the U.S. Navy provides protection for shipping as U.S. and Israeli military strikes virtually end Iran's capability to launch attacks, including drones and ship-to-ship missiles. The longer duration of closure keeps global energy prices elevated, lifting inflation in the short term around the globe. U.S. consumer spending slows somewhat as higher energy prices hurt their pocketbooks, though labor market stability and previous constructive momentum in consumer spending metrics provide some offset. Global equity prices could experience further volatility as the delay in reopening the Strait of Hormuz creates concern that oil supply constraints could dampen growth and stoke inflation, before ultimately resolving as oil transportation resumes. The S&P 500 likely breaches its 200-day moving average, with risk of a traditional correction (a 10% decline) to around 6,300.

- This resolution would offer opportunities for investors to rebuild U.S. equity positions amid constructive economic fundamentals.
- The rise in 10-year U.S. Treasury yields would afford investors an opportunity to add to bond portfolios at relatively attractive interest rates.
- Global equities would be more mixed; the longer duration could lead to somewhat more persistent inflation in coming months and some damage to economic growth.

Scenario 3 (tail risk): Disruption extends through the summer

Our downside tail risk case is the Strait of Hormuz stays closed to traffic through the summer, resulting in months of elevated energy prices, likely exceeding oil prices witnessed in recent days. Additionally, the recovery from this constrained supply availability would take longer to resolve, with Middle East infrastructure taking weeks for maintenance and a restart. While storage would be full, production facilities will soon need to shut down with nowhere to store the additional energy that is not leaving the region.

- Global equity markets may reach correction territory, potentially down as much as 20%, with foreign markets under greater pressure as they are dependent on imported energy.
- 10-year U.S. Treasury yields could rise above 4.5%, because investors must price for greater inflation pressure, but heightened growth risks could eventually push yield levels lower if investors anticipate the Federal Reserve (Fed) cuts interest rates to alleviate tight financial market conditions.
- With higher inflation, consumers will be under pressure, and the longer horizon for price pressure could start to hurt corporate profit margins. We would closely watch the labor market for dislocations, with companies resetting plans in the face of higher short-term costs.

Client guidance: Three recommended actions

Our base case is for some alleviation of oil transportation constraints in coming days or weeks, with a small but real risk the conflict lingers through the summer. As we weigh these risks, we emphasize economic fundamentals were strong as we entered this conflict. While we await resolution and evaluate emerging opportunities and risks, we encourage investors to take this opportunity to evaluate their long-term investment plan relative to risk tolerance. Through this evaluation we encourage the following three actions:

- 1) **Confirm target allocation and rebalance if needed.** If you and your wealth professional find you are in the wrong allocation, begin a plan to rebalance your portfolio into the correct allocation. Equity market volatility can often uncover a new understanding of personal risk tolerance. Additionally, bond yields remain high relative to the past 15 years, often allowing you to reduce their portfolio risk while remaining on track for your plan.
- 2) **If holding excess cash, consider a phased approach to investing.** If you are on the sidelines or find yourself with excess cash, current volatility presents an opportunity to start dollar-cost averaging into your portfolio. Use the opportunity of the decline in global equity markets to build toward your target position over the next few months.

- 3) **Address diversification gaps deliberately.** If you find you are missing asset classes, such as foreign stocks, smaller U.S. companies, global infrastructure or credit oriented fixed income, such as residential mortgage-backed securities or high yield municipal bonds, plan your transition now and begin a measured plan to rebalance now. We see significant forward opportunities across these asset classes and recent volatility offers an opportunity to add these diversified opportunities to your investment portfolio.

If you have questions about how current conditions relate to your plan, contact your wealth professional to review risk alignment, liquidity needs and any planned rebalancing decisions.

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