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Strategic Portfolio Advice Team – June 19 2025

Interpreting signals
from the global economy
and financial markets

Decoder

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In Focus

- **Iran and Israel are trading missiles and bombs again. When they first did so one year ago, markets shrugged the whole thing off.**
- **This time around, at least the oil market is taking notice. The oil price is up some 11% since just before the attack.**
- **What happens next largely depends on the US. Though Trump has isolationist tendencies, there is a chance America will join the conflict.**
- **In that case, a stagflationary shock would come for Europe, and international relations would suffer further.**

The Middle East

Well, here we are again. A little over a year ago, we published a Decoder on the implications of the exchange of missiles between Iran and Israel. As it turned out, that skirmish did not evolve into a wider war, even though relations between the two countries never did improve.

For the past week, bombardments have commenced again, this time with Israel seemingly gaining the upper hand. In this Decoder we quickly revisit our conclusions from last year and discuss whether they still hold; we ponder the different circumstances on both sides of the conflict, and in the wider world; and we discuss the different ways that this war can end.

Previously on the Geopolitics show

A direct exchange of bombs between Israel and Iran was a rare occurrence until last year. Iran preferred to target Israel through proxies, including Hezbollah, Hamas and allies in the Syrian government. Israel, for its part, had been proactive about preventing its enemies from gaining access to nuclear weapons, even bombing a reactor in Saddam's Iraq back in 1981. But operations against Iran were always done covertly, for example through the assassination of nuclear scientists or with the introduction of malware at nuclear research facilities.

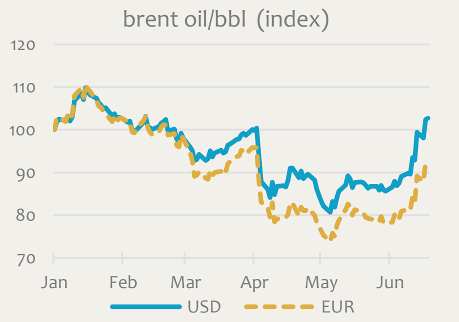
So the volleys of missiles and drones that we saw in April last year crossed a line; financial markets, however, did not see the escalation as significant. The oil price briefly went up before falling back; equity and rates markets showed no particular pattern. Even the Tel Aviv stock exchange was unperturbed in the aftermath.

A possible explanation for all this investor stoicism was that the exchange had been expected, and was known to be limited. Iranian proxies had all been weakened in the months previously, leaving Iran with no other option than direct bombardment to retaliate for an earlier slight. But it clearly was not an all-out attack, and both parties could climb down easily.

At the time we warned about the normalization of military actions, which hurt international trade and carry the risk of supply shocks. Routine strikes are bad news (even before contemplating their human cost) as they erode the trust that underpins the global economic and financial system. And supply shocks are

In Figures

Oil: up since the attack, unchanged YTD

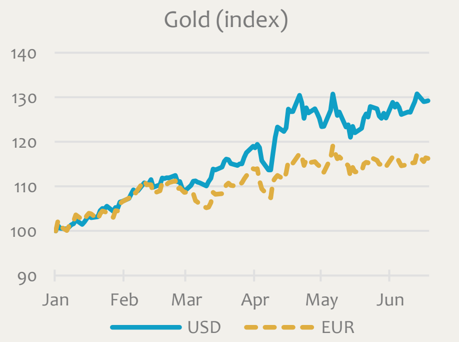


Up until the Israeli attack, the oil market had been dominated by concerns about the business cycle and expanded OPEC+ supply. Contrary to last year, the oil price did respond to the war: it is up 11% since June 11.

USD: a not-so-safe haven

The dollar is down against the euro for the year and flat since June 11 (−10% and +0.2%, respectively). From April 9 to 16 of last year, the week of the previous round of attacks, USDEUR appreciated 2.2%.

Gold keeps ascending, not accelerating



There was no notable increase in the rate at which the price of gold keeps going up after the attacks; in euros, gold has been stable since mid-April.

Data: Bloomberg, APG AM.

much harder to accommodate than the demand shocks we have gotten used to since the 1980s, which makes for a tougher climate for investors. Finally, the binary nature of geopolitical risks leads to a much less attractive trade-off between risk and return.

What changed?

The most significant change since last year is the team in charge on the American side. The Trump government had been negotiating for months with Iran about its nuclear program and the sanctions imposed, when Israel decided to intervene. Where the Biden administration could be counted on to de-escalate in such a situation, Trump is wavering on whether to join the attack; the US has already deployed an aircraft carrier and tanker airplanes to the region.

On the Israeli side, US support is a crucial factor for how far it could take the current attack. Its armed forces have already been stretched by operations in Gaza and its stock of air defense missiles is rapidly depleting. Aside from the US, there will be relatively little international support forthcoming, after widespread condemnation of the treatment by Israel of civilians in Gaza.

At this point, Iran seems decidedly weaker than last year. Virtually all its proxies close to Israel have been decimated. With its air defenses in tatters, it is reduced to responding where it can and hoping that Israeli appetite for a protracted war is low. It can apply pressure by continuing to target Israel with what missiles are left, and possibly by instructing its proxies in Yemen to target international ships or energy infrastructure in Gulf states. While Israel may be hoping to cause a regime change in Tehran, the likelihood of achieving one through aerial bombardment must be low.

Market response

Prices in financial markets are all about expectations for the future. The most straightforward change in these expectations concerns the oil market. While the West no longer consumes Iranian oil, other parts of the world do, and a reduction in supply would (indirectly) affect all oil consumers. So far, most of Iran's export facilities have not been targeted. But the possibility of reduced supply did cause the oil price to increase by some 10% since just before the attacks. This has driven the curve into steep backwardation.

The price increase certainly also includes a risk premium for the possibility of a wider supply disruption. Iran has the means to close off the strait of Hormuz, a choke point that 20% of the global oil and LNG trade passes through. Such a blockade would send prices much higher, but it is unattractive to the Iranian government: besides cutting of Iranian exports as well, it would also be certain to invite a response from the US. However, if at some point the Iranian oil export industry is destroyed anyway and the US looks set to enter the fray, the relative costs would decline and this option may be on the table. One sign that oil importers and shipping companies worry about this scenario, is that the price of chartering a very large crude tanker from the Gulf to China has more than doubled in the last week.

Uncharacteristically, the outbreak of another war did not stop the US dollar from declining against other major currencies. The dollar is down versus the euro since the air campaign started (graph). The 10-year Treasury bond staged a small rally, with the rate falling some 12 bps, and equity markets declined marginally. The VIX increased from 18 to 21. Gold continued to appreciate in price, but not noticeably faster after the outbreak of hostilities (graph). Apart from the oil price, these are not large moves, indicating that investors see de-escalation as the most likely outcome. Trump's bellicose comments (on Tuesday the President demanded "total surrender" from the Iranians) may be overruled by his longstanding desire to extract the US from foreign wars.

Possible repercussions

With Iran happy to end this war as soon as possible, and Israel dependent on US support, we are once again at a point where it all depends on what Trump wants to do next. It is hard to predict through all the prenegotiating bluff. While markets seem to be discounting a back-to-normal scenario, it worth exploring the repercussions of escalation and US involvement.

Despite the sputtering performance so far, we would likely see the dollar strengthen and safe rates decline in the immediate aftermath; energy would rally and risky assets decline. Depending on the intensity, in the longer run, protracted conflict could turn into a stagflationary shock for Europe.

A full-on war with Iran would draw American weapons and attention to the Middle East, likely leaving Europe by itself to support Ukraine. This would worsen the tensions in NATO, and heighten the security crisis on Europe's eastern border. An increase in defense spending, already on the table at next week's NATO summit, would be expedited. The ensuing growth impulse would help with the stag-, but not the -flation part. Higher inflation would put upward pressure on interest rates in the medium run.

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Higher rates would likely cushion the blow

The combination of an inflationary shock combined with increased uncertainty is not a great environment for pension investors, even though higher rates would likely cushion the blow. In the longer run, escalation sets up a test for European unity that could help the EU move forward; financing with common bonds would probably avert another debt crisis, but the costs of rearmament and ageing cannot be borne without painful measures in Europe's welfare state.

Investing through it

At the risk of sounding out of touch with the grim realities of warfare, we end with viewing the situation as an asset-allocation exercise. For immediate risk-mitigation, oil and gold can serve as hedges, as can inflation linkers. In the longer run, incomplete interest rate hedging and real assets help navigate the runup in inflation. As such, most pension funds already have a balance sheet that can deal with the possible outcomes of the conflict.

There remains some downside risk in equities and alternative risk assets. In the longer run, these should be compensated by the geopolitical risk premium that tends to materialize when the conflict is over.

Viewed from a distance, a higher propensity to settle international conflict by military means does not bode well for the return of globalization and gains from trade. If it continues, it suggests that the costs of global business are going up, and both firms and investors will need to reconsider the risks of venturing outside the home market.