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The US-Israel-Iran Conflict seven weeks later—Economic, market, and investment portfolio implications

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Key takeaways

- Our baseline scenario (approximately three-quarters probability) is for contained escalation and eventual de-escalation, but there is a significant (one-quarter probability) risk of further escalation with a potentially severe negative outcome including increasing oil prices. Ultimately, because both Iran and the US would lose under a prolonged military conflict that would result in a destruction of energy supply capacity, our baseline is a de-escalation.

- If the baseline scenario does come to fruition, oil prices are expected to decline moderately (projected at around US$90/barrel for Brent crude on average in the next 12 months, from ~US$102/barrel today) but not return to pre-conflict levels due to supply disruptions, lingering geopolitical uncertainty, and the need to replenish inventories. If the situation escalates, oil could spike to US$140–175/barrel—with key risks being Iran either attacking additional energy infrastructure in the region, mining the Strait of Hormuz and/or using their proxies to attack or disrupt shipping in the region, while the US (and potentially NATO) would clear the Strait of Hormuz using naval assets, impose a naval blockade on Iranian linked commercial vessels, and/or potentially send boots on the ground to seize Kharg Island (which provides a seaport for exports for about 90% of Iran's crude oil exports).

- Under our baseline scenario, the macroeconomic impact is higher inflation and weaker growth globally, including for Canada and the US. For example, we expect higher oil prices to reduce both Canadian and US growth by around 0.2% in the next 12 months and to increase headline (core) inflation by 0.6-1.0% (0.2-0.3%). In both economies, we foresee limited marginal upside of energy production in volume due to supply constraints. In other words, this channel is not expected to provide a sizeable growth relief. While higher oil prices should be positive for the Canadian terms of trade, this is a (large) cash flow tailwind for energy producers only—not for the consumers. We expect the Bank of Canada and the US Federal Reserve (Fed) to not react to the one-off energy shock. Unlike 2022, the economy is not being boosted by massive demand shocks related to large-scale stimulus and a post-pandemic reopening. Additionally, trend inflation is decelerating, in contrast to the period before Russia's invasion of Ukraine in 2022, when inflation was already elevated and accelerating. We acknowledge that the primary risk is that both the Fed and the Bank of Canada could implement a hawkish insurance rate hike, but this would likely occur only if core inflation starts to accelerate again in the coming months.

Scenario analysis: Baseline and escalation

The central framework for understanding the conflict are scenario analysis and game theory, which acknowledges the unique nature of this event-driven risk but also accounts for each side's material constraints. We believe there are two core scenarios:

1. **Baseline (De-escalation/Containment)**: Assigned a three-quarters probability, this scenario assumes both sides move toward negotiation and/or a resolution on the transit through the Strait of Hormuz. Meanwhile, any escalations would be contained between US/Israel and Iran. Oil prices would decline but not return to pre-conflict levels due to supply disruptions, lingering geopolitical uncertainty and a need to replenish strategic reserves.
2. **Escalation**: With a one-quarter probability, this scenario envisions further military escalation by either both sides if negotiations fail to reach a sustainable working agreement around: (i) the passage of the Strait of Hormuz, and (ii) Iran's nuclear and ballistic missile programs. Such negative a scenario would lead to more severe economic and market consequences, including damage to energy infrastructure in the region and passage in the Strait of Hormuz being disrupted for a longer period of time.

Since last week, and despite the US military blockade in the Strait of Hormuz, we consider that the likelihood of an escalation has diminished but remains elevated enough to reduce the attractiveness of risk assets in the near future.

Drivers, constraints, and negotiations

Ultimately, both Iran and the US are constrained from engaging in a prolonged military conflict. Iran's imperative is regime survival, while for the US it is the rising cost of living and energy prices ahead of the November midterm election.

For Iran, a prolonged war threatens the survival of the regime with the degradation of both domestic energy and civilian infrastructure. To reiterate, Iran's imperative is regime survival. Prior to the war, civilian unrest threatened the stability of the regime. Regime mismanagement of the economy coupled with further sanctions caused hyperinflation and a currency crisis. For the regime to survive post-war, Iranian negotiators are looking for an end of hostilities and sanction relief.

Furthermore, China's interests represent an external constraint on Iran. First, an energy shock would severely hurt global growth and trade, a key contributor to current growth in China given its balance sheet recession. Second, Iran runs a trade deficit with China, despite Iran being a net exporter of oil to China. In fact, Iran imports many goods from China used for its military. Lastly, Iran is not China's strongest energy partner. Saudi Arabia and the rest of the Gulf Cooperation Council (GCC) are larger exporters of energy to China than Iran. As a result, China holds leverage on Iran, which will push Iran to negotiate rather than escalate.

For the US, a prolonged energy shock stemming from a prolonged conflict would erode President Trump's popularity domestically and within his own party ahead of midterm elections. It would also put under question its naval strength that has underpinned global trade.

Moving forward, both sides may use escalation threats as a bargaining tool in early negotiations, making it difficult to distinguish genuine intent from negotiation tactics. In addition, ceasefires are generally fragile as both sides establish conditions for negotiation. However, we believe that ultimately both sides will come to some arrangement that sees the resumption of higher transit through the Strait of Hormuz, in line with our baseline scenario.

Given that control of the Strait of Hormuz is de-facto under the Islamic Revolutionary Guard Corps (IRGC) at the moment, the ability of Iran to charge a toll for the safe passage of ships through could become a backbone of a new equilibrium within the Middle East to assure the consistent undisrupted passages of energy through the Strait of Hormuz.

Market and economic implications

Oil and commodities: The conflict has driven up commodity prices, including oil. In our baseline de-escalation scenario, Brent crude is projected to settle around US$90/barrel, with a possible range of US$75–95/barrel. This is lower than current elevated prices but above pre-conflict levels, reflecting persistent supply disruptions, lingering geopolitical uncertainty, Iran's expected continued influence over the Strait of Hormuz, and inelastic global demand to replenish inventories. Any further escalation could push oil to US$140–175/barrel.

Indicators and signposts: Three main indicators are being monitored to verify our scenario analysis:

- Number of vessels passing through the Strait of Hormuz: Increased numbers are positive; restrictions or attacks are negative.
- Frequency and nature of attacks by Iran on neighbouring countries and use of regional proxies like the Houthis: Fewer and more targeted attacks suggest de-escalation; broader attacks indicate escalation.
- Evidence of negotiations: Dialogue between parties is a positive sign, as it reduces downside risks.

Policy responses: The initial policy response in Asia and parts of Europe (in more than 30 countries) has been fiscal, including subsidies and price controls to cushion the energy shock. Central banks, especially in developed markets, are largely adopting a "wait and see" approach for now. We expect the Bank of Canada and the Fed to not react to the one-off energy shock. Unlike 2022, the economy is not being boosted by massive demand shocks related to large-scale stimulus and a post-pandemic reopening. Additionally, trend inflation is decelerating, in contrast to the period before Russia's invasion of Ukraine in 2022, when inflation was already elevated and accelerating. We acknowledge that the primary risk is that both the Fed and the Bank of Canada could implement a hawkish insurance rate hike, but this would likely occur only if core inflation starts to accelerate again in the coming months. In contrast, the European Central Bank (ECB) could be a more hawkish and preemptive central bank given the larger inflation shock it faces and potentially more persistent nature of these pressures. Europe relies heavily on Liquefied Natural Gas (LNG) imports to meet its energy needs and LNG prices have risen more due to damage made to energy infrastructure.

We anticipate that the Bank of Canada will raise its policy rate by 25 basis points in late 2026 or early 2027. This expectation is based on our outlook for persistent wage growth and continued accommodative monetary policy. In contrast, we expect the Fed to lower its policy rate by 25 basis points during the same period, reflecting slower economic growth and ongoing disinflation amid a tight monetary policy environment.

Macroeconomic outlook: The near-term impact of the conflict is weaker growth and higher inflation—particularly for net energy importers such as Europe and Asia. Equity markets in energy-producing countries, such as Canada and the US, should remain more resilient and attractive. The outlook for risk assets beyond the near-term remains constructive. Pre-existing tailwinds—global fiscal stimulus, strong demand for military investment, investment for supply chain resiliency, and technological innovation (notably AI)—continue to support growth. While the conflict dampens the outlook, it does not materially alter the medium-term growth trajectory or our constructive long-term trajectory for asset returns.

Portfolio and asset allocation strategies

In response to heightened risk and uncertainty, portfolio managers are emphasizing quality and, in equities, low-volatility and high-dividend positioning. Tactical adjustments have included reducing exposure to riskier assets and increasing the use of portfolio hedges. Strategic asset allocation remains the primary driver of returns, and the advice is to maintain discipline and avoid attempts at market timing during volatile periods.

Currency markets and gold

US dollar: While the currency has performed strongly in response to the conflict, it is expected to weaken over the medium term. Factors include cyclical overvaluation, anticipated US growth slowdown relative to other economies beyond the near-term, a resilient medium-term global growth backdrop, and global reserve diversification. Portfolio strategies are managing currency risk both actively (favoring quality energy exporters) and strategically (increasing hedges in US equity exposure).

Gold: Despite its reputation as a safe-haven asset, gold has underperformed recently, affected by increased retail demand (making gold more cyclical), Russian selling to cover fiscal deficits, and rising opportunity costs from higher yields. Additionally, following the very strong return performance of this asset, profitable gold positions may also have been liquidated to fund margin calls elsewhere in portfolios. All that said, the long-term outlook for gold remains positive, underpinned by strong central bank demand.

Long-term outlook and enduring investment themes

The ongoing events in the Middle East call for prudence in the near term, emphasizing quality and diversification, and maintaining a focus on long-term strategic asset allocation. While the balance of risk is to further escalation in the short term, the underlying macro environment remains broadly supportive for risk assets over the medium term. Staying disciplined and invested is recommended as the appropriate approach in navigating ongoing geopolitical and policy uncertainty.

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