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Strikes on Iran – assessing the market impact



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Markets face a significant – but not yet destabilising – shock after the US and Israel launched strikes against Iranian military targets. The immediate implication is a repricing of tail risks with oil prices potentially rising, risk assets falling and safe haven assets benefitting, but much depends on whether the conflict spills into broader regional or domestic instability.

Key takeaways

- US and Israeli airstrikes and Iranian attacks in retaliation have raised the risk of a full-scale Middle East war.
- The death of Iran’s supreme leader raises the chances of regime change along with protracted instability in Iran and may reduce the risk of a sustained regional conflict.
- Markets will likely demand a higher premium, at least temporarily, until clarity emerges on Iran’s internal stability and the intentions of its geopolitical partners.
- We think oil prices will likely rise even if a sustained closure of the Strait of Hormuz remains unlikely for now; in broader financial markets, US Treasuries, the US dollar and gold may gain, while equities may see a sharp but potentially short-lived sell-off.

STRIKES ON IRAN – ASSESSING THE MARKET IMPACT

The geopolitical landscape has shifted dramatically after the US and Israel began extensive aerial operations against Iranian military targets on Saturday, 28 February, aiming to degrade Iran’s ballistic missile capabilities and large parts of its naval infrastructure. By Sunday morning, it was confirmed that Iran’s supreme leader Ayatollah Ali Khamenei had been killed. The Iranian Red Crescent said more than 200 people had been killed across the country.

Iran responded to the strikes with rocket and drone attacks on Israel. Bahrain, Qatar and the United Arab Emirates, which host US military bases, thwarted Iranian retaliatory attacks. Kuwait, Jordan and Saudi Arabia also said they had intercepted Iranian attacks.

US President Donald Trump publicly urged Iranian troops to lay down arms and has encouraged the Iranian population to challenge the regime once US and Israeli operations conclude. In our view, these statements underscore that political objectives may extend beyond a narrow military strike, even if a full-scale regime-change strategy remains uncertain.

In recent weeks, we assessed four possible scenarios about how escalating tensions between the US and Iran over the latter’s nuclear plans may play out:

1. Non-military measures to advance negotiations.
2. Military intervention without regime change.
3. Regime change.
4. Escalating regional war.

Financial markets will reopen following the attacks facing a situation somewhere between scenarios 2 and 3, but with real risks of spillover into a broader regional war (scenario 4).

Mr Khamenei’s death raises the likelihood of regime change and protracted instability in Iran. But that situation may be viewed more positively by markets as it potentially reduces the risk of regional conflict and makes more positive long-term outcomes plausible (eg, a more moderate and accommodating Iran). Still, big risks linger as any transition is fraught with potential pitfalls (worst-case outcomes could be civil war and/or economic collapse).

Our expectation in recent weeks had been that scenarios 2 or 3 were most likely. Market pricing prior to the attacks appears to have shared this view.



Oil: pricing out benign outcomes

Even after last week’s adjustment in risk premium, we expect oil prices to climb. With scenario 3 looking increasingly likely, we see scope for Brent crude to rise early in the week as markets price out the more benign scenarios. Importantly:

- A direct disruption of Iranian exports would have limited effects, given they are already sanctioned. But shipments to China might be affected – the Asian giant receives the vast majority of Iranian oil exports.
- Markets could be forced to consider higher-probability paths to meaningful supply disruption: domestic instability, sabotage, or regional tensions.
- A sustained closure of the Strait of Hormuz remains unlikely for now, but is a non-negligible tail risk, given the strategic value of this chokepoint for global oil and LNG flows.

For now, the most plausible short-term trajectory is higher volatility, but not a sustained move toward price levels associated with scenario 4.



Gas markets: limited immediate spillover, but tail risks may widen

Unlike oil, global gas prices may see only a modest early-week reaction, as liquefied natural gas (LNG) supply is not directly affected. But with Iran’s rhetoric linking the crisis to “regional resistance” and with potential alignment from Russia or China still unclear, markets may begin to price greater uncertainty around regional supply routes. Tail risks around LNG price spikes therefore widen, even if the modal expectation remains muted.



Financial markets: possible flight to quality

Beyond energy markets, risk sentiment will weaken, especially if:

- Iranian counterattacks intensify.
- Anti-regime protests emerge inside Iran.
- Or Tehran signals willingness to extend the conflict beyond its borders.

Some flight to quality is possible, with the Swiss franc and gold gaining. Normally, US Treasuries and the US dollar should rise, but their path is less clear compared to past episodes of geopolitical strife, given the changing role of the dollar. Equities may see a sharp but potentially short-lived sell-off, consistent with historical experience from targeted US military strikes.

Tightening financial conditions would disproportionately affect economies most reliant on capital markets, such as the US.



Central bank implications: complicating interest rate decisions

Energy-driven inflation impulses will complicate the monetary policy outlook:

- A 5%–10% rise in oil prices typically adds 0.1–0.3 percentage points to headline inflation in the US and Europe almost immediately.
- Central banks may “look through” temporary price spikes, but if the conflict becomes prolonged and energy price hikes are sustained, there is a risk of a further drift in inflation expectations. That could be critical, especially where headline inflation has exceeded targets for several years already (eg, US and UK).

As a result:

- The US Federal Reserve could lean dovishly if financial conditions tighten sharply, although with core inflation still running at around 3% and many on the Federal Open Market Committee appearing less confident about the disinflationary trajectory, divisions are possible. More clearly visible downside risks to growth and the labour market may be required before policy is adjusted.
- The European Central Bank and Bank of England may be more cautious, especially if gas prices follow oil higher. The Swiss National Bank may be forced to intervene if the franc appreciates beyond 0.90 to the euro.
- Asian central banks will face increased FX volatility but likely stay on hold.



Implications for Emerging Markets Debt (EMD)

- Previous bouts of conflict in the region in recent years (e.g. last year’s 12-day war) have resulted in short-lived and limited sell-offs in markets in the region, given that such episodes remained relatively contained to few countries or periods of time.
- Should oil prices remain elevated for a sustained period of time, some investment rotation into oil exporters would be likely. Yet, with the EMD asset class being split virtually equally between oil importers and exporters, and recent valuations already leading most investors to look at relative value opportunities, the asset class would still likely see relative winners and losers from this potential new oil prices and geopolitical backdrop.
- EMD assets could be more significantly impacted in the event of a meaningful and sustained turn in global risk sentiment, which would be more likely in the event of scenario 4, with regional conflict/instability. Countries in the broader Middle Eastern region, including the Gulf countries, Turkey and Egypt, could then be impacted by lower investors’ appetite in the context of meaningful positioning, especially in local-currency-denominated assets in some of these markets.



Three variables to watch this week

The next days will determine whether markets price a stabilisation or escalate toward higher-risk regimes:

- Domestic dynamics inside Iran – Evidence of protests or unrest would increase uncertainty and prolong elevated energy prices.
- Iran’s response beyond Israel – Signs of continued disruption in the Gulf – directly or via proxies – would immediately lift oil and LNG risk premium.
- Signals from global actors – Any political or logistical support, tacit or explicit, from Russia or China would shift the probabilities toward a broader geopolitical confrontation.

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