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ISRAEL'S IRAN STRIKE CHALLENGES MARKETS

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HIGHLIGHTS

- Israel's Iran airstrikes initially sent oil up 7% while bond yields rose, reflecting fears that energy shocks could reignite inflation and force the Fed to delay rate cuts.
- Each $10 oil increase adds roughly 0.5 percentage points to inflation, potentially pushing CPI from 2.4% toward 3-5% if crude sustains higher levels.
- Notwithstanding such risks, crude oil futures markets see the oil price returning to under the $70/barrel range this year and next, implying no lasting supply shortage.
- Historical precedent suggests measured portfolio adjustments rather than dramatic moves, as most Middle East conflicts since the 1970s have produced only short-lived market disruptions.

ANOTHER POTENTIAL STAGFLATION SHOCK?

When Israel launched surprise airstrikes on Iranian nuclear and military targets on June 13, global markets responded with a familiar playbook, but with a stagflationary twist that concerns investors. Oil surged, stocks tumbled, and safe-haven assets rallied in the immediate aftermath. Yet unlike typical geopolitical scares, bond yields rose rather than fell, a telling sign that investors fear this crisis could reignite the inflation dragon just as central banks thought they had it caged.

The market's initial reaction was swift. Crude oil futures jumped as much as 14% in overnight trading — one of the largest intraday moves in years — before settling with West Texas Intermediate up about 7% to the mid-$70s per barrel (**Figure 1**). That single-day surge matched the steepest oil spike since Russia's invasion of Ukraine in 2022, reflecting a hefty risk premium as markets priced in potential disruptions to global energy flows.

Equities initially sold off but seem to be taking some comfort in the possibility that this conflict will remain limited. The S&P 500 fell over 1% on Friday, erasing the week's prior gains, while the Dow plunged 1.8%. Airlines and cruise operators suffered particularly steep declines of 4% – 5% as investors anticipated higher fuel costs and reduced travel demand. Meanwhile, energy producers like ExxonMobil and ConocoPhillips gained over 2%, and defense contractors rallied more than 3% on expectations of increased geopolitical tensions.

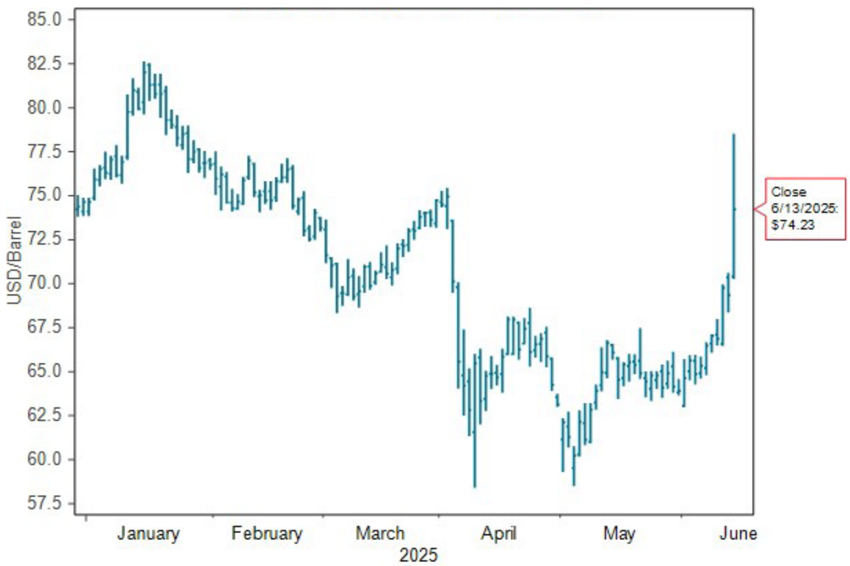
INFLATION WORRIES RETURN

What was notable in the early response of financial markets to this crisis was the bond market's behavior. Rather than the usual flight-to-quality rally, Treasury prices fell, and yields climbed. The 10-year yield jumped above 4.4%, while the 2-year yield rose about

7 basis points to nearly 4%. This unusual response reflects growing concern that an oil shock could derail recent progress on inflation, forcing the Federal Reserve to maintain its hawkish stance even as growth risks mount.

FIGURE 1

Brent Crude Oil Futures Price, 1st Contract (Open, High, Low, Close)



Sources: GW&K Investment Management, CME Group, and Macrobond

Brent crude oil futures jumped by as much as 14% on June 13th in response to Israel's attack on Iran, with the oil price benchmark closing the day with a 7% gain.

The arithmetic is sobering. Economists estimate that every $10 increase in oil prices adds roughly 0.5 percentage points to inflation.[1] If crude were to spike up to $120 per barrel, as JPMorgan warns could happen in a severe escalation, US consumer price inflation could approach 5% year-over-year, up from the current 2.4%.[2] This comes at a particularly awkward moment, as the economy was already grappling with tariff-induced price pressures on imported goods.

The specter of 1970s-style stagflation suddenly doesn't seem so far-fetched. Back then, oil embargos and supply shocks created a toxic mix of high inflation and sluggish growth that confounded policymakers for nearly a decade. Today's dual headwinds of tariffs and energy costs could create similar policy dilemmas, forcing the Fed to choose between supporting growth and fighting inflation.

FED IN A POLICY BIND

The Israel-Iran conflict has so far modestly reshaped monetary policy expectations. Interest-rate futures markets quickly pushed out bets on Fed easing, with traders now expecting the central bank to remain on hold longer than previously anticipated. The rise in the 2-year Treasury yield, which closely tracks Fed policy expectations, signals that markets believe officials will be reluctant to pivot to rate cuts anytime soon while oil-driven inflation looms.

[1] Ryan Sweet, "US: Some disinflationary forces are fading faster than others," Oxford Economics (Weekly Briefings), June 13, 2025.
[2] Natasha Kaneva, "Oil Markets Weekly: 7% Probability of Something That Has Never Happened," *J.P. Morgan Global Commodities Research*, June 13, 2025.

This puts Fed Chair Jerome Powell in an uncomfortable position. The central bank had been seeing encouraging signs that inflation was cooling toward its 2% target. Now officials must weigh a new upside risk to prices against the potential for an oil shock to eventually slow economic growth and become disinflationary through demand destruction.

The textbook approach suggests central banks should "look through" temporary energy price spikes, focusing instead on underlying core inflation trends. But with inflation expectations still somewhat elevated and the Fed's credibility on the line, officials may have less room to be patient this time around.

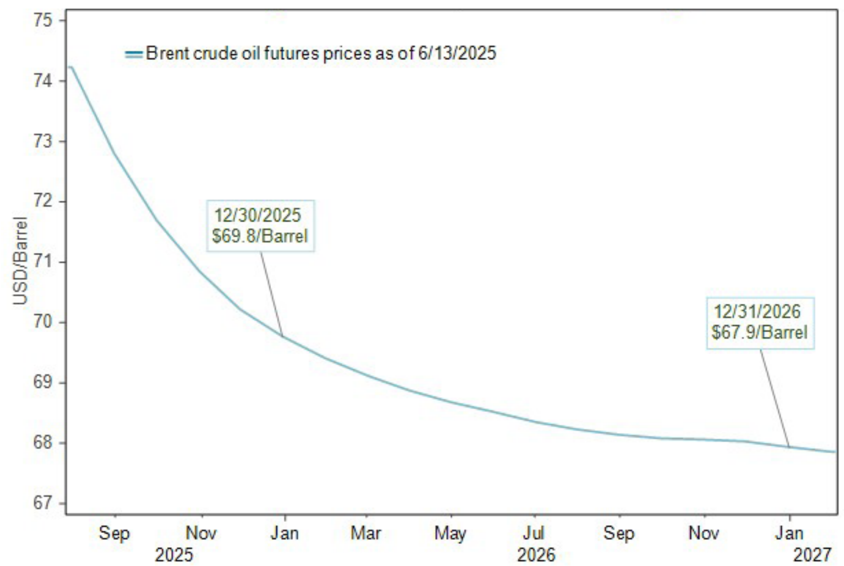
HEDGING THE RISKS

Options markets reveal that traders are taking the threat seriously. There's been a surge in bullish call options betting on oil reaching $90 or $100 per barrel in coming months. Based on recent price action, dealers' quotes imply roughly a 1-in-8 chance that WTI tops $90 before year-end and a 1-in-20 shot of triple-digit oil. Those probabilities were negligible a week ago, underlining how much geopolitical tail risk is now embedded.

Yet many experts maintain that absent direct attacks on oil facilities or critical shipping chokepoints like the Strait of Hormuz, through which 20% of global oil passes, the price surge will likely prove temporary. J.P. Morgan's commodities team, while acknowledging near-term risk premiums, still forecasts oil prices returning to the low to mid-$60 per barrel range over the course of the year. That is not too far from what is projected by oil futures prices (**Figure 2**), suggesting the market's base case remains that this shock won't evolve into a lasting supply shortage.

FIGURE 2

Crude Oil Futures Curve Projects Brent Crude Oil Prices Returning Below the $70/Barrel Range



Sources: GW&K Investment Management and Macrobond

Futures prices for Brent crude oil project that prices will return to below $70/barrel over the course of 2025 and 2026, reflecting market expectations of no lasting supply shortage.

HISTORICAL PERSPECTIVE OFFERS COMFORT

A look at past Middle East conflicts provides some reassurance. Outside of the truly seismic oil embargo era of the 1970s, regional conflicts have rarely derailed global markets for extended periods. The 1990 – 1991 Gulf War saw oil prices double and stocks fall 20%, but once the conflict was resolved quickly, markets rebounded strongly. Similarly, the 2003 Iraq War initially spooked investors but ultimately proved short-lived as a market factor.

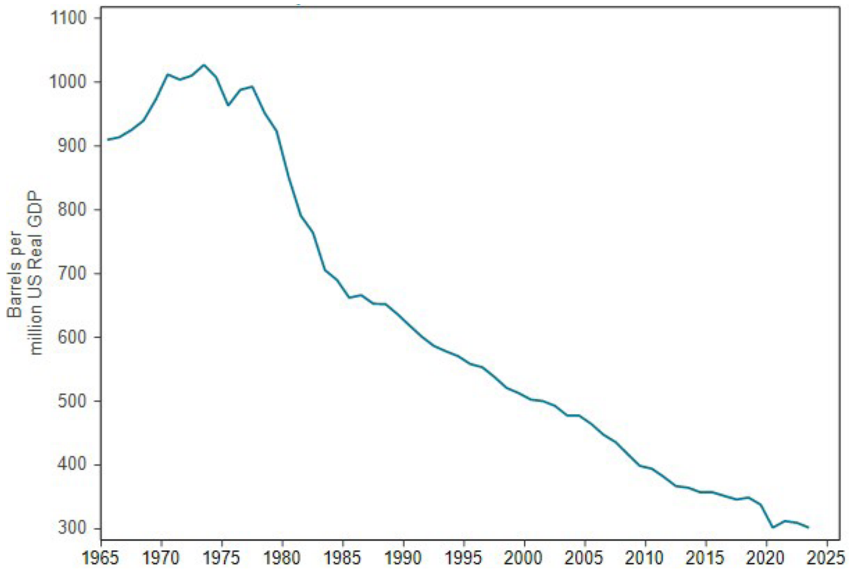
More recent regional flare-ups — including multiple Israel-Gaza conflicts and the 2006 Lebanon war — have produced brief safe-haven flows into gold and Treasuries that typically faded within weeks. In short, for the past two decades, conflagrations and war in the Middle East have rarely caused global investors to de-risk or rethink their investment strategies as long as they remained regional affairs.

ECONOMIC RESILIENCE HAS IMPROVED

Crucially, today's economy is far better equipped to absorb oil shocks than during the crisis-prone 1970s. The US now uses roughly 300 barrels of oil per million dollars of GDP, down by nearly 70% from the late-1970s (**Figure 3**). This dramatic improvement reflects gains in energy efficiency, the shift toward a services-oriented economy, and technological advances, including far more fuel-efficient vehicles.

FIGURE 3

America Has Become Less Dependent on Oil: Barrels Used per Million Dollars of Real GDP



Sources: GW&K Investment Management, BP, and Macrobond

Today's economy is far better equipped to handle oil shocks than in the 1970s, with oil used per unit of real GDP down by nearly 70% since then.

Moreover, America has transformed from oil supplicant to significant producer thanks to the shale boom. Higher oil prices now generate offsetting benefits through increased domestic energy sector revenue and investment, cushioning some of the economic blow. The Strategic Petroleum Reserve, while smaller than in the past, provides policymakers with tools to help stabilize prices during supply disruptions.

THE CASE FOR STAYING CALM

While some tactical portfolio adjustments make sense — perhaps favoring energy and defense stocks while reducing exposure to airlines and other oil-sensitive sectors — history counsels against dramatic moves based on geopolitical headlines alone. A small allocation to gold or commodities can provide useful tail-risk hedging, but wholesale retreat from risk assets has rarely proven wise during Middle East crises.

The market's relatively measured response so far (the S&P 500's decline last Friday essentially just erased the prior week's gains) suggests investors are hedging their bets rather than positioning for economic catastrophe. It is worth noting that oil prices were higher as recently as January without causing market upheaval, putting the current mid-$70s level in perspective.

Much will depend on developments in coming days. If Iran chooses limited retaliation, allowing tensions to cool, oil prices could retrace their spike and inflation fears could subside. But if the conflict escalates dramatically — potentially targeting oil infrastructure or shipping lanes — all bets would be off. Signals from Iran that it is willing to restart nuclear talks with the US is an encouraging sign that a path toward de-escalation still exists.

For now, the balance of probabilities suggests this will prove another in a long line of Middle East scares that ultimately fade from market consciousness. The key is ensuring portfolios are positioned to weather short-term volatility while not losing sight of longer-term investment objectives should this storm pass. In a world where geopolitical risks seem ever-present, maintaining perspective and avoiding panic remain investors' best tools.

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