

MARKET COMMENTARY

Rising stakes in the Middle East

GenAM Macro & Market Research

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- Israeli strikes on Iran, as well as the US bombing of nuclear sites, mark a significant escalation of the Middle East tensions. Israel is planning further attacks, “for as long as necessary”.
- While the initial focus seemed to be on removing the nuclear threat, both Israel and President Trump himself have floated the idea of regime change. We would argue that air strikes have never toppled a regime. Eradicating the Supreme Leader would create huge uncertainties, and more so as the US would not be in the position to physically occupy Iran through power transition, as they did in Iraq.
- Both Iran and the US have a lot to lose from a great sharp escalation – Israel maybe less so in the near term. The Iranian regime would be exposed to greater US involvement. Trump will want to avoid a long-lasting stagflationary shock that would be punished in the 2026 mid-term elections; already the US economy will be facing tariff-induced shock in the summer months.
- The market reaction suggests 1/ limited fears of escalation and 2/ a lower than usual appetite for the US currency and Treasuries in crisis time. The timid reaction of the US dollar is most striking, given the stretched sentiment and positioning (bearish USD) right as the crisis erupted.
- Key risks: a strike on Iran’s oil production would raise the oil price even further. The worst-case scenario for oil supply lies in Iran attempting to close the Strait of Hormuz. A surge of oil prices in the \$100-120/bl area would fan fears of a global economic slowdown.
- We discuss potential market implications, while reaffirming our bearish USD views and small duration long. Risk assets usually see a knee-jerk reaction, with the initial sell-off being quickly faded. Sector discrimination, both in Equities and Credit, matters (see below).

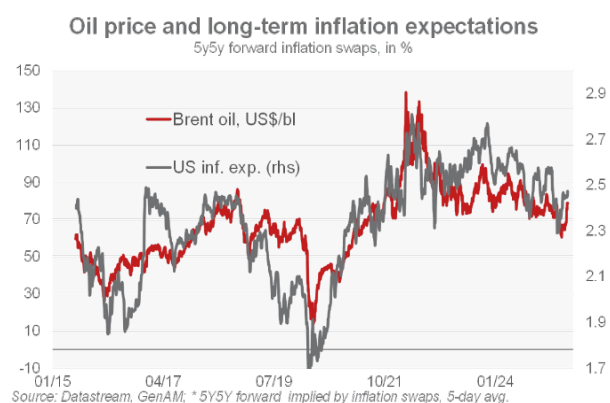
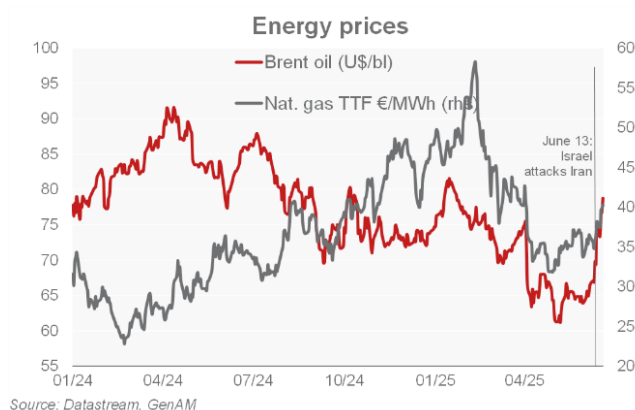
The crisis. Israel’s strikes on Iran, followed by surgical but powerful US strikes on buried nuclear facilities, are a significant escalation of the lingering conflict in the region. The attacks sanction concerns that Iran may be close to the critical point of uranium enrichment needed for nuclear weapon use. Israel has also felt emboldened by recent military successes against Iranian proxies (Hamas, Hezbollah) and the lack of any major US opposition to the strikes. Israel has targeted military commanders, leading scientists, Iran’s air defences and nuclear programme (such as the underground facilities in Natanz), as well as energy infrastructure (oil storage and gas fields) – falling short however of severely hitting oil production and shipping facilities. Israel is planning further attacks as officials warned the strikes would “last for as long as necessary to distance and remove the threat as much as we can” (Netanyahu). Iran has already pledged that Israel should “expect a severe punishment”. Leader Ayatollah Ali Khamenei also cited American bases in the region as a vulnerability for the US, without openly threatening

them. Since the beginning of the Israeli strikes, US president Trump has reaffirmed support to Israel. During last year's tit-for-tat strikes Iran appeared to avoid a sharp escalation. But with Iran's nuclear ambitions now under threat, stakes for Iran seem much higher this time and a much fiercer response may still be looming.

Central scenario. Predicting the future of such conflict is obviously hard, yet **we still see a fierce and long-lasting escalation as a risk scenario, rather than the central one.** Iran's retaliation will presumably be limited by the eradication of its air defence and the **strong US military capacity in the region.** The US Navy has positioned very significant forces within striking range of Iran. Though it is not yet clear how successful the US bombing was over the weekend, the US appears to have the bomb technology and capacity to potentially hit key nuclear facilities that are buried deep under mountains. **Gulf states** such as Saudi Arabia, Oman or even Turkey have been quick in condemning Israel's attack, and the US will want to prevent a broad regional conflict that may threaten key milestones achieved during Trump's recent visit to the region. Trump will also want to **limit the stagflationary shock** that the crisis will inflict to the economy. Tariffs already will push US inflation higher through summer, and a surge in oil prices is most unwelcome ahead of the peak driving season. US officials, including VP Vance, have made clear that US strikes had solely been directed to nuclear sites, and not to civilians – hence urging for great restraint in the Iranian response. President Trump himself, calling US strikes a “spectacular success”, warned that “there will be **either peace** or there will be **tragedy** for Iran, far greater than we have witnessed over the last eight days.”

Key risks. The range of possible outcomes is greater than such binary representation, and we must recognise large uncertainty. The risk of escalation comes from the **extremely high stakes** that both parties face. Iran will remember the fate of Iraq and Libya, after being cut off from presumed weapons of mass-destruction programs. On the Israeli side, concerns about diplomatic talk being too slow in stopping Iran's progress towards becoming a nuclear power imply vital security risks. The Israeli government has even hinted at **seeking regime change in Iran.** Although the US Administration seems very focused on ending the Iranian nuclear programme, not the authorities, Trump **blurred the message** on Sunday (22 June 2025) when he floated the idea of regime change. We would argue that air strikes have never toppled a regime. If anything, attacks from outside tend to rally populations around the flag. Importantly, the United States would not be able to physically occupy Iran through power transition, as they did in Iraq. Still, eradicating Supreme Leader Ayatollah Ali Khamenei would create huge uncertainties.

The oil price. The key area of contagion for global markets is the oil price. On Monday morning oil prices briefly spiked above U\$ 80/bl before easing to around 78 currently, still 12% higher than before Israel attacks on June 13. Israel's attacks thus far have mostly spared Iran's production facilities (roughly 3.3m bl/day, about 3% of global supply, thereof 1.5-.6m of exports, largely towards China). So, the market reaction thus far is mostly a jump in the risk premium on potential disruptions short term. While the front Brent contract rose 8.5\$ last week, to c. 75\$/bbl, the Dec. 2025 contract gained just over 2\$, to ~73\$. A **strike on Iran's oil production** may raise the price even further, even if the impact may be cushioned if Saudi Arabia and other oil producers compensate activating spare capacity (currently estimated at more than 4m bl/day for OPEC). The **worst-case scenario for oil supply** lies in Iran attempting to close the Strait of Hormuz, which is passed by around 25% of seaborne global oil supply. This could take the oil price well above \$100/bl. However, we see this as a last resort, largely self-harming option, as by doing so Iran would alienate the Gulf countries, unwinding two years of rapprochement and above all China, a main loser of such closure. Nearly half of China's oil supply flows through the Straits.



More generally, most of the spikes in geopolitical tension seen over the last 35 years have not impacted oil prices in a sustained manner, as the initial rise in prices was offset by expectations of slower growth. The only big exceptions are the 1990-91 first gulf war and the 2022 Russian invasion of Ukraine. We then think a sustained and persistent rise in price could materialise only in case of a large disruption in oil flows, which at the moment looks not very likely.

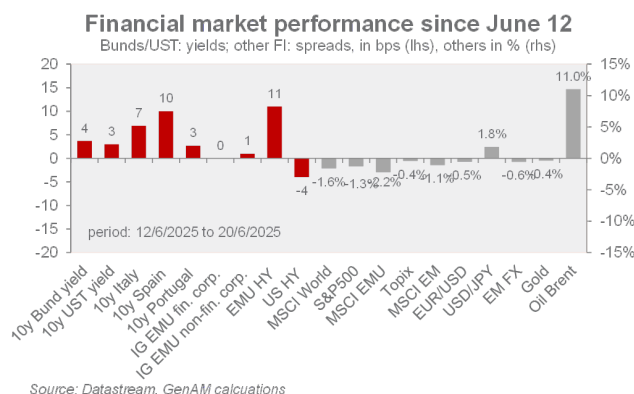
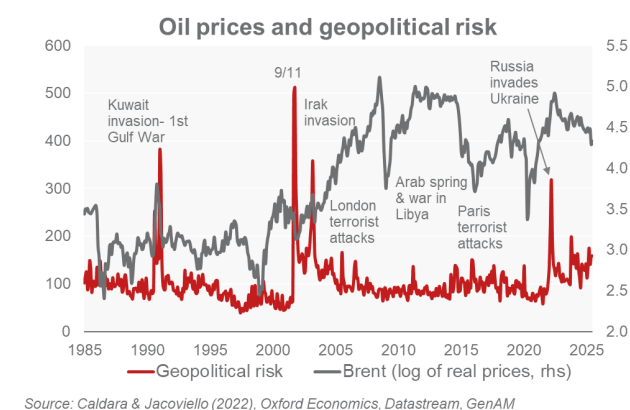
Inflation. Oil prices have jumped, but so far, the **resulting inflation shock to advanced economies is still likely to be relatively muted**. At current levels around U\$ 78/bl, the oil price (Brent) is still somewhat lower than the US\$80+ levels seen a year ago (left chart above) even if somewhat higher than the levels prevailing over autumn 2024 (U\$ 70-75/bl). Furthermore, even though US tariffs may push US inflation higher over the coming months, inflation expectations seem much better anchored following a prolonged consistent disinflation period over the past couple of years. Admittedly, long-term market-based inflation expectations remain sensitive to swings in the oil price, but this link seems to have weakened over recent years (right chart). A jump in the oil price would temporarily raise inflation in the advanced economies. But if not sustained for months, in this setting of more stable expectations and acknowledging headwinds to growth, central banks would likely be more willing to look through this supply shock. As a result, the Fed (already exposed to an inflation bump this summer) and to a lesser extent the ECB may decide to delay their next rate cuts further (ECB into the autumn, Fed possibly to next year) but are unlikely to react by outright rate hikes. This may help to keep the overall market impact muted.

Economic growth. Obviously rising geopolitical risk and a surge in oil prices act as a stagflationary shock. The Fed estimates that a 10\$ increase in oil prices pushes inflation up by 0.4pp, and growth down by 0.4pp. After a relatively strong first quarter in the euro area, we see signs already of some slowing into summer. Indeed, the front-running of production and exports, ahead of tariffs, has started to reverse. The US consumer is exposed to the tariff-relation inflation bump, which will eat into purchasing power at a time of slowing labour trends. Slower profit growth is also likely to cap capex in the next few quarters.

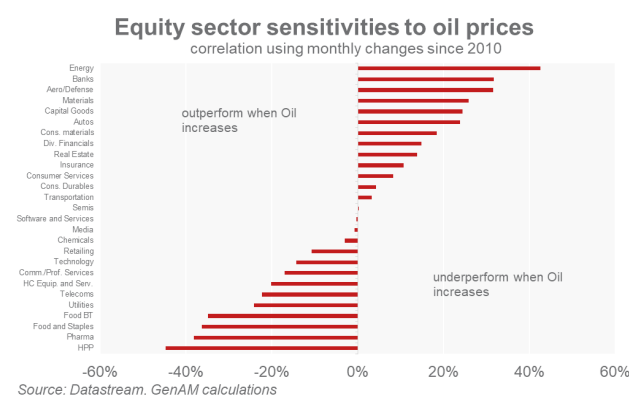
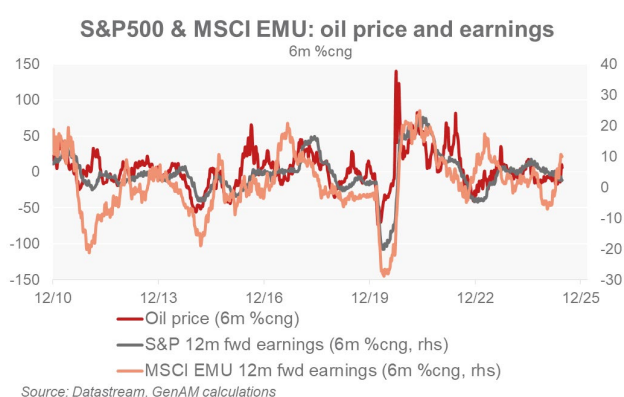
The markets. Overall markets reacted in a risk-off mode to the attacks, with oil prices surging and equity markets falling. Strikingly, the US dollar initially gained, but this seems to have faded quickly, reinforcing concerns about its diminished safe-haven status. Still, this is an improvement from the US dollar's negative response to rising trade tensions over the past weeks: indeed, a sharper rise in energy costs would particularly harm energy importers (including euro area and Japan) whereas the US has turned into a net exporter of oil. Treasuries (and Bunds) also failed to act as a safe-haven, as 10-yr US yields are trading around 4.40%, close to 12/6 closing. The US attacks of June 22 neither triggered lasting flows into Bunds and US Treasuries. In fact, yields even rose slightly. Of course, surging oil prices tend to have mixed effect on bonds, given the downward impact on growth but the upward one on inflation.

Our bias remains towards a small pullback in bond yields, and a marginal duration long, a trade that has more juice but also more risk in the US than in EUR. That said, given the fiscal risks in the US and the still comparatively low term premium despite the continuing rise in the US government debt ratio our bias is towards bull steepening, hence we stay cautious towards the very long end of the curves and prefer to invest the belly.

We stay structurally bearish the US dollar which has barely benefited from the geopolitical tensions **as another sign of its eroded safe-haven appeal**. But in the near-term we warn about volatile conditions. Indeed, both positioning and sentiment, reflected in option skew (risk reversals), appears very negative, exposing investors to sudden corrections.



For **risk assets**, the typical pattern is for the S&P to lose 5-6% in the first couple of weeks following a geopolitical shock, then to reverse the move in a V-shape recovery – as we recently saw with the Russian invasion of Ukraine in February 2022 and the terrorist attack on Israel in October 2023. Usually, correlation between oil price and EPS is positive, partly because an increase in oil price often signals a better economic momentum ahead. That said, a 10\$ spike in oil prices due to geopolitical tensions could decrease earnings growth by around 1.5%, if sustained, through lower GDP growth and an additional negative effect due to increased uncertainty. Energy sectors (near 4% weight for the EMU weight) will partially compensate for the decline in index earnings, as the former would see positive revisions. **All in all, prudence may be warranted in the very near term, but we would look to buy the dips in risk assets, and more so as investor positioning currently looks below neutral levels.** For what it is worth, mind that **seasonal forces are very positive for July**. Of course, the very large uncertainty requires a flexible approach, and any escalation involving a collapse of the Iranian regime or the closure of the Straits would likely cause deeper losses (risk scenario). We are now tactically neutral on EMU vs US (vs. OW EMU in recent months); the more defensive nature of US could play well as air strikes continue. **UK equities** should benefit from their defensive nature and exposure to the energy sector. Also, **overweight MDAX & EU small**, two domestic baskets, together with **financials, food retail plus structural themes linked to Defence, construction, RE**.



In Credit, the price move in **IG has been very muted, supporting our view that the asset class is increasingly treated as a haven**. Summer technicals also look strong, with limited new issuance and still robust demand (inflows). EUR High Yield spreads widened some 15bp from the tights two weeks ago; in the central scenario – free of recession – we would expect the drawdown to be limited. That said, both for IG and HY sector differentiation is important.

Corporate sectors. The chart below shows **equity sector sensitivity to oil prices, with clear winners and losers**. For both equities and Credit, the negative shock on sentiment tends to **initially weigh on cyclicals** (except for oil-related names), **often creating a buying opportunity**.

In Credit, corporate hybrids should show resilience, due to their high concentration in energy and utility sectors. **Banks, on the other hand, appear more vulnerable**—both because they tend to underperform when spreads widen and because they currently look expensive relative to their cyclical exposure. **Utilities**, in this environment, work better as a defensive asset in Credit than in Equities. **Airlines** may also come under pressure due to their sensitivity to rising oil prices. The two tables below highlight potential impact and sector preferences in an escalation scenario.

Positive	Neutral	Slightly Negative	Negative
Metals & Mining	Telecoms	Food Retail	Non-Food Retail
EU International Oil	Food, Beverage, HPC	Consumer Durables & Apparel	Building Materials
Oil Servicing Companies	Tobacco	Low quality National Oil	Mass-market OEMs
	Airports/Toll Roads	Chemicals	OE Suppliers
	Healthcare	Mass Transit/Rail	Transport/Freight
	Utilities	Postal Operators	
	Oil Companies	Capital Goods	
		Premium OEMs, tire manufac.	
		Property developers	
		Retail RE companies	
		Financials	

Sectors	Credit-Relevant Comments on selected sectors
Autos	<ul style="list-style-type: none"> OEMs remain exposed to rising steel and aluminium prices (39% and 11% of vehicle mass respectively) Suppliers are most vulnerable due to limited pricing power and margin compression EV transition adds complexity: platinum and palladium price divergence may affect catalytic converter demand
Consumers Discretionary	<ul style="list-style-type: none"> Higher steel /resins prices will impact white good producers Apparel companies will be affected by the increasing freight and shipping costs due to airspace closures and rerouting Demand elasticity may amplify credit spread widening in lower-rated names
Energy	<ul style="list-style-type: none"> Higher oil prices benefit upstream energy credits, especially outside the GCC Refiners and downstream players may face margin compression if crude spikes persist
Industrials - Capital Goods	<ul style="list-style-type: none"> Rising input costs (metals, energy) and supply chain disruptions weigh on margins Demand-side risk from delayed infrastructure and capex cycles
Materials	<ul style="list-style-type: none"> Chemicals, building materials, and packaging most exposed to raw material inflation (e.g., aluminium, copper, nickel) Upstream/base chemical producers more vulnerable than specialty names Credit impact depends on hedging, contract structure, and ability to pass through costs
Real Estate	<ul style="list-style-type: none"> Higher inflation and rates increase refinancing risk, especially for developers Letting businesses with indexed leases are more insulated Credit spreads likely to widen for high-yield issuers with short debt maturities

Transport / Postal operators	<ul style="list-style-type: none"> • Airlines and logistics firms face fuel cost pressure; airspace closures add to operational risk • Postal operators less exposed (fuel ~3% of revenue), but yield management becomes critical • Airport and toll road concessions more resilient due to inflation-linked revenues
Financials	<ul style="list-style-type: none"> • Banks may underperform as spreads widen, and risk aversion rises. • Credit quality could deteriorate if geopolitical stress triggers a macro slowdown. • Exposure to EM sovereigns and commodity-linked corporates adds to systemic risk.

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